Daiwa Capital Markets

Russia Economic Review

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Highlights

- Russia's Central Bank (CBR) announced that it has begun regular market purchases to rebuild its forex reserves, which were eroded by its unsuccessful defence of the rouble in 2014. The move was widely considered to be an "intervention" in the FX market, signalling that the authorities are content for the exchange rate to remain relatively stable near RUB50/USD for as long as the oil price remains close to $65/bbl.
- The steady easing of monetary policy underway since January's rate cut has brought some relief, with lower interbank interest rates passed on to borrowers and savers by commercial banks. And with a further rate cut expected in June, we think that ongoing "normalisation" of domestic financial market conditions will help to promote a more positive trend in the real economy supported by a revival in consumption.
- The first estimate of GDP in Q115 provided an upside surprise, with a smaller-than-expected contraction of 1.9%Y/Y. But car sales and industrial production figures for April were very disappointing while the budget deficit has widened significantly. The firm trade surplus, however, is supporting the stability of the rouble.

Russia's Central Bank announces market interventions… this time buying dollars

The Central Bank of Russia (CBR) announced on 14 May its plan to start replenishing its foreign exchange reserves. That follows a decline of almost one quarter in its forex reserves in 2014 amid its aggressive but ultimately unsuccessful interventions aimed at supporting the then-plunging rouble, and a further fall of 7.6% during the first three months of 2015 mostly due to its FX repo transactions conducted with Russian banks. The steady trend appreciation of the rouble since February has enabled the CBR to undertake this step. Indeed, the announcement was widely considered an attempt to prevent significant further rouble appreciation – an impression reinforced by subsequent comments from the Finance Ministry that it too had made foreign currency purchases – thus running counter to the CBR's previous assertion that it favoured a freely floating exchange rate.

We are not alarmed. After all, it is appropriate for the CBR to look to replenish its reserves, and it is not unusual for central banks to act to smooth currency fluctuations on volatile markets. The CBR also signalled that its daily interventions would be limited to $100-200mn per day, only a fraction of daily trading volumes on the domestic FX market ($22bn on the MICEX FX market in April, implying that the CBR's interventions would amount to less than 1% of the market). So, given the relatively limited firepower, at least to date, the CBR's market operations might be considered to be barely more substantive than "verbal interventions" aiming to smooth market volatility and signalling to market participants that the authorities are content for the exchange rate to remain relatively stable near RUB50/USD for as long as the oil price remains close to $65/bbl. So, in the short term, we think that rouble exchange rate will continue to fluctuate around the current level. Over the medium term, however, movements in the rouble will continue to be determined by oil prices and the geopolitical situation.

Sailing in calmer waters: interbank rates are decreasing

The series of moves to ease monetary policy this year, the most recent of which was the 150bps cut in the one-week repo rate to 12.5% on 30 April, has helped to ease volatility on the Russian interbank market. And interbank rates have also fallen in line with the policy interest rate.

After the CBR hiked its key interest rate by 650bps, from 10.5% to 17%, in its unsuccessful attempt to halt the near free-fall in the currency, domestic interbank rates inevitably soared amid shrinking liquidity. At their peak, the 1-day and 3-month interbank rates reached almost 30%, implying effective paralysis of domestic money markets. However, in January 2015, the CBR noted that its medium-term inflation forecast had improved and, aware of the failure of the extreme tightening in late 2014, started to ease monetary policy enabling interbank rates to decline. At the end of January, after the key interest rate was cut to 15%, the 3-month interbank rate slightly moderated to 27.5% and the 1-day rate to 16.5%. Of course, at those levels, both were still too high to revive domestic borrowing. But the trend of "normalisation" of domestic markets has continued against the backdrop of the stable rouble and improving inflation forecast. Indeed, after markets re-opened following the long May holidays, the 3-month interbank rate fell further. By 20 May, it stood at 10.4%, below the key interest rate, indicating far more favourable liquidity conditions and expectations of further monetary easing.

Following the trend in the interbank market, commercial banks have started to cut their deposit rates. While over the course of 2014 average deposit interest rates for the ten largest banks increased by 7.3ppts to 15.6%, they have decreased from the beginning of this year to 12.4% in May. And some banks, notably Russia's largest retail bank Sberbank, have started to decrease their lending interest rates (e.g. on loans to the agricultural sector and consumers, etc.). And while rates are still high, continuing monetary easing along with improving market sentiment should help to revive consumption, which is still in the doldrums as illustrated by plummeting car sales.

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Plunging car sales highlight weak consumption

The inflation outlook continues to improve. We agree with recent comments by Minister of Economic Development Ulyukaev that CPI might undershoot the government's forecast of 11.9%Y/Y at year-end. While prices rose 8.2% in the year to 18 May, weekly inflation of 0.1%W/W in each of the past four weeks is consistent with that more optimistic scenario. The gradual easing of inflation – which has sharply hit real wages (down more than 9%Y/Y in March) – will be crucial for reviving struggling domestic demand. However, for the time being, pessimism continues to reign over the consumption outlook.

The weakness of consumer spending was highlighted by the latest data for car sales, which plunged by 41.5%Y/Y in April, the second sharpest drop (after the 42.5%Y/Y decline the previous month) since November 2009 when demand was hit by the global financial crisis. Moving in tandem with falling car sales, car imports fell by 52.4%Y/Y in March having fallen almost 60%Y/Y in January and February in the aftermath of the rouble's depreciation. The current decline in car imports is marked, but is similarly still not quite as deep as those of more than 70%Y/Y every month between March and December 2009. On that occasion, a gradual recovery trend re-emerged in early 2010, although the subsequent peak in sales – achieved in mid-2012 – still fell short of the pre-crisis peak in the first half of 2008. Likewise, this time around, we expect a gradual recovery in car sales to take hold in due course, although again it will take several quarters to return back to the 2012 peak.

GDP in Q115 was an upside surprise, IP in April was the opposite

Given the currency crisis, GDP growth of 0.4%Y/Y was firmer than might have been expected, as consumers brought forward spending ahead of fears of future sharp price hikes. By the same token, the preliminary official estimate by the Russian Federal State Statistics Service of GDP in Q115 offered an upside surprise, with a contraction of 1.9%Y/Y beating the previous estimate of a drop of 2.2%Y/Y made by the Ministry of Economic Development. Likewise, it beat the Bloomberg consensus forecast by 0.7ppt.

While the full report due in mid-June will reveal the details, the headline GDP figure raised hopes that the economic crisis passed its nadir in February and March, with the economy subsequently starting to stabilise amid more favourable oil prices and the less volatile rouble exchange rate. With the unemployment rate remaining relatively low – a touch less than 6% in March – and recent survey reports of a slight tightening in the labour market, certainly there are hopes that the drop in consumer spending might ease in coming months. However, data showing a much steeper-than-expected drop in industrial production in April of 4.5%Y/Y (seasonally adjusted industrial production fell 1.6%M/M<), more than 3ppts worse than the consensus expectation and the weakest since 2009, provided a reminder that, at a minimum, the path to economic recovery is likely to be a bumpy one. Indeed, the detail was even more shocking than the headline figure, with manufacturing output down a whopping 7.2%Y/Y, more than 5ppts weaker than the previous month. Mining output, meanwhile, fell 0.8%Y/Y having posted positive growth in March. One factor to blame for the unexpected scale of the drop in industrial production in April is, indeed, high borrowing costs in the domestic market which make companies unable not only to invest, but, also, in some cases maintain their current levels of operations. But we expect these restrictions to be gradually mitigated as progress is made in monetary easing.

Firmer trade balance as exports and imports both shrink

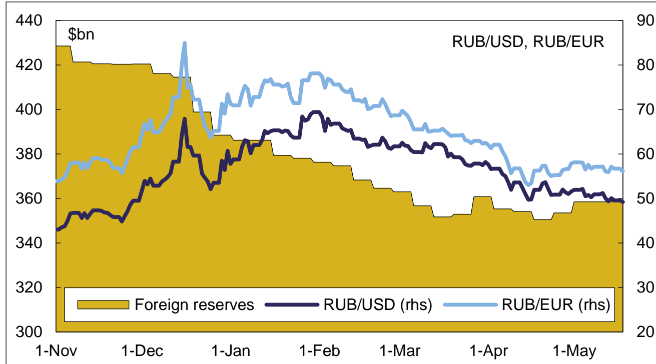
Not least due to the weakness of domestic demand, the trade balance remains relatively firm with a surplus in March of $15bn, almost one quarter lower than a year earlier but still $2.7bn above the Bloomberg consensus and $1.4bn higher than the previous month. Exports decreased by 31.1%Y/Y and imports by 36.4%Y/Y.

According to the data published by Russian Federal Customs Service, in the first quarter of the year fuel and energy products accounted for about two thirds of exports down from more than three quarters a year earlier. Among other items, the shares taken by chemicals increased to 6.7% (up from 5.0% one year earlier), and machinery and equipment to 4.8% (up 2.2ppt compared to a year earlier). Meanwhile, despite the imposition of sanctions, the European Union remained Russia's most important trading partner by some distance with a share of 45.4% (albeit down from 49.7% in Q114). From a country perspective, at face value, China was largest trading partner, with total trade of $15.3bn, followed by the Netherlands ($11.3bn) and Germany ($11.2bn). But given the role of Netherlands as an entrepôt, the importance of that country for Russian trade is almost certainly exaggerated by these figures, while Germany's importance is commensurately under-represented. Total trade decreased with almost all countries, with the drop in trade with Japan (down almost 9%Y/Y to $6.1bn in the first three months of 2015) far more modest than the halving in trade with the UK and neighbouring Poland.

Fiscal deficit reached 4.4% of GDP in year to April

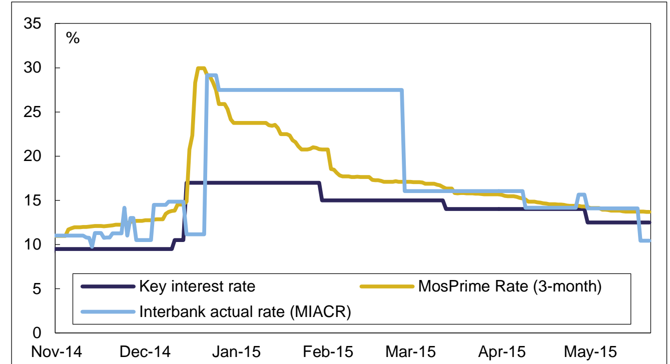
Unsurprisingly, the government's anti-crisis spending measures, as well as the decline in tax revenues related to the contracting economy, saw the fiscal deficit amount to 4.4% of GDP in the year to April according to the Russian Ministry of Finance. That compares with a full-year figure of 0.5% of GDP in 2014. Revenues reached 36.3% of this year's budget plan with government expenditure similarly amounting to 36.4% of the budgeted amount. Finance Minister Siluanov subsequently stated that the deficit would reach about 3.4% of GDP this year with the government planning to reduce it by approximately 1ppt of GDP each year thereafter. His prognosis for this year is a slight improvement on the most recent Russian Ministry of Economic Development forecast (issued in February 2015), which had envisaged the federal budget deficit at 3.8% of GDP in 2015 and the non-oil deficit widening to 11.5% of GDP.

Foreign reserves and exchange rate



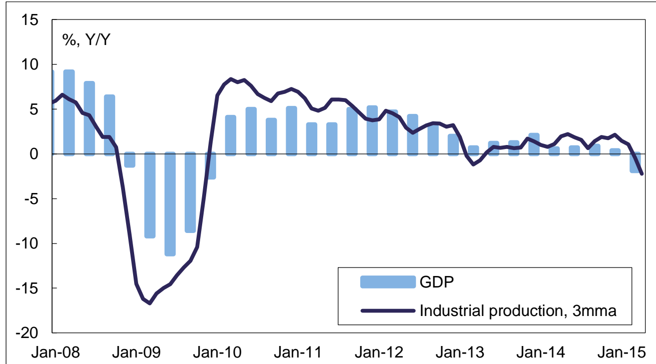
Source: CBR, Bloomberg and Daiwa Capital Markets Europe Ltd.

Key policy and interbank interest rates*



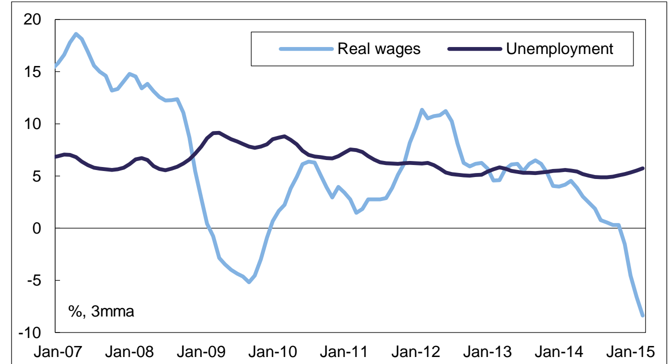
**MosPrime Rate (Moscow Prime Offered Rate) is a reference rate fixed by the National Foreign Exchange Association (NFEA), based on the offer rates on Russian Rouble deposits as quoted by Contributor Banks.*
Source: CBR, Bloomberg and Daiwa Capital Markets Europe Ltd.

GDP and industrial production



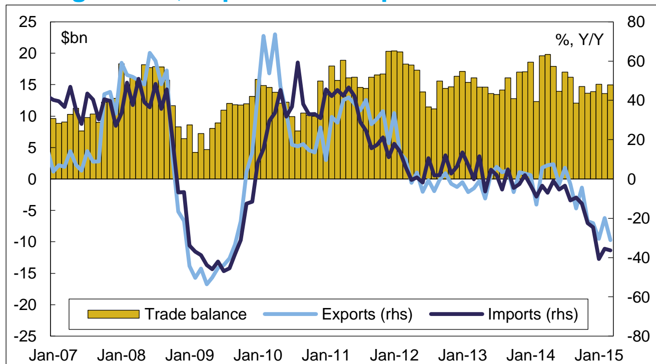
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Real wage growth and unemployment rate



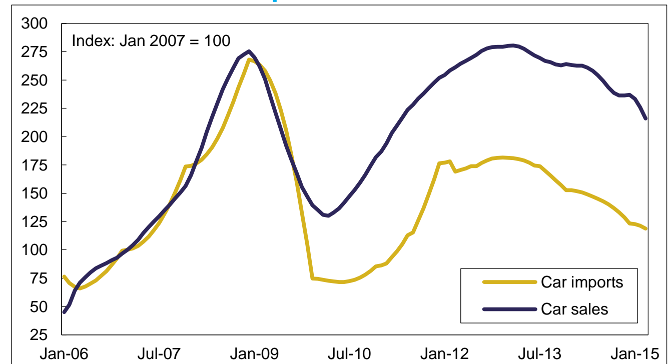
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Foreign trade, imports and exports



Source: Datastream and Daiwa Capital Markets Europe Ltd.

Car sales and car imports*



**Data are 12-month moving averages. Source: Datastream and Daiwa Capital Markets Europe Ltd.*

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