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Russia Macro View

Trip notes: Economy flirting with recession, but in no crisis

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- **This note is based on our recent meetings in Moscow during Sep 29/30th.** We met with senior officials from the Central Bank, Ministry of Economy, Ministry of Finance, international financial institutions and independent analysts.

- **The Russian economy may be near recession with little prospect for a substantial near-term improvement.** The impact of sanctions on the Russian economy will become clearer over time, but it will probably be quite difficult to unpack the effect of sanctions from the many other factors that help to explain Russia's slowdown, a slowdown which was quite evident even before the Ukraine crisis intensified in early 2014. Some of these factors include a deteriorating terms of trade, weak investment climate, challenging demographics, currency which may not particularly cheap, and the fact that both fiscal and monetary policy have been tightening in recent years. Despite the broader deceleration of the economy, it has so far avoided technical recession, but the sanction-based backdrop may increase the chances of this happening.

- **There is no 'crisis' in the economy, but the effect of sanctions will be to dampen growth prospects in a variety of ways.** The IMF, for one, isn't ready to call a recession as it expects GDP growth of 0.2% this year and 0.5% in 2015. But an intensification of the sanctions tit-for-tat between Russia and the West is likely to worsen these numbers. Sanctions will affect the Russian economy in both direct and indirect ways. The direct impact comes mostly from the loss of access to international capital markets for significant Russian borrowers, and the rising cost of capital that results from this. But the indirect impact is also likely to be significant, and this has two elements. The first is the likelihood that a sanctions environment will deaden Russia's commitment to structural reforms, rendering the investment climate weaker. The second is the effect that a sanctions environment will have on macro-economic policy, both monetary and fiscal. The bottom line is that Russia's response to sanctions will end up in a tightening of policy, amplifying the consequences of Russian economic isolation.

- **Fiscal policy is being kept deliberately tight, and the Finance Ministry emphasizes the need to 'absorb the shock' of sanctions**. The MinFin argued that a loosening of fiscal policy at this stage could have a number of unwelcome effects. It would produce inflation (since Russia barely has an output gap) or it would erode financial stability by eating into the current account surplus, resulting in a need to further tighten monetary policy. In order for looser fiscal policy even to be considered, the MinFin believes that the current account surplus would need to increase first, since this would at least provide a stronger starting point before deterioration sets in, and help build a cushion for Russian borrowers that may have limited access to international capital markets due to sanctions.

The Finance Ministry seems to be currently winning the argument about fiscal policy, but there are challenges. MinFin holds out Brazil as a cautionary tale. Looser fiscal policy there in the past couple of years has led to sovereign rating downgrades, very tight monetary policy, and a recession. However, opposition is strong and the most obvious one comes from the Economy Ministry, which is vociferous in its call for looser fiscal policy. Their view is that next year's budget deficit should be 1.5% GDP, rather than MinFin's 0.6%, and they believe that a third of this bigger deficit should be financed by the Central Bank. In the Economy Ministry's view, additional public spending should focus on addressing Russia's infrastructure shortages – although their priorities here were not precisely spelled out – and this would help boost public sector investment spending towards 7%, helping to generate GDP growth of 3% next year, rather than the 1.2% that is assumed in the budget. In addition to the Economy Ministry, there seems to be broader opposition to some of the MinFin's measures. For example, the MinFin has had to backtrack on a measure which would have ended pension payments to retirement-age Russians still in work.

Tighter monetary policy seems the necessary consequence of a weaker rouble. The Central Bank seems to think its relatively dovish stance in the September meeting may have been somewhat inappropriate. We indeed sensed some hardening of the Central Bank 's position since the September meeting, which may have been at least partly driven by the larger-than-anticipated RUB weakening over the last couple of weeks. The Central Bank believed that Russian market participants had interpreted the Bank's July statement as more hawkish than the Bank intended, and a less aggressive September statement was intended to counter that. Since the Bank emphasized its 'credibility problem', monetary policy seems likely to tighten further from here. Although the Central Bank believes that the exchange rate pass-through to CPI is lower than it used to be, the scale of the rouble's recent fall may require further monetary policy diligence. More broadly we are of the view that while the CBR has been doing a very good job in the last five years, the recent geopolitical backdrop has complicated the Central Bank's task, sometimes leading to larger volatility and reduced consistency in communication to market participants.

Just as the Economy Ministry criticizes the fiscal stance, it is also criticizes the Central Bank. The Economy Ministry believes that inflation targeting is being imposed on Russia too soon. (There's some irony here as the current Economy Minister was involved in devising Russia's inflation-targeting framework in his capacity as former Deputy Governor of the Central Bank). In the Economy Ministry's view, the exchange rate should be as much an object of policy as the inflation rate, and the Minister has successfully pressed for regular 'coordination dialogue' between the Central Bank, the Finance Ministry and the Economy Ministry.

Those arguing for looser macro policy are likely to keep pressing their case. Technically the only available means of generating additional public sector financing for the economy now is through the National Welfare Fund, RUB 3.15 trillion in total, of which 60% has been made available for financing (40% for infrastructure, 10% for Rosatom, and 10% for the Russian Direct Investment Fund). Of this RUB 1.9 trillion that is available, RUB 1 trillion has already been provided to VEB and others, leaving RUB 900 billion for further investment. Rosneft, Novatek, Lukoil, and Domededovo airport are all apparently seeking funding. Although there might be strong macro arguments to keep fiscal policy tight and to make particular effort to maintain the current account surplus, the political arguments may pull Russian policymakers in the opposite direction.

We sensed a lack of intention to introduce capital controls. Despite speculation that Russia may resort to some form of capital controls to address the more challenging external backdrop, we did not get the feeling that this is being seriously considered. While this is a policy tool that every policy-maker has at its disposal, we are of the view that we are now far away from Russia imposing capital flows restrictions, not only because of the copious FX reserve cushion, but also because this would represent a drastic shift in the monetary policy paradigm that the CBR has been consistently (and so far successfully) followed.

'Joined up' policymaking seems little in evidence right now. The Central Bank, Finance Ministry and Economy Ministry have somewhat opposing views of the world. The Economy Ministry wants looser fiscal policy and a modification of Russia's inflation-targeting framework. The Finance Ministry wants tighter fiscal policy and looser monetary policy. And the Central Bank seems headed for tighter monetary policy. This absence of coordination by itself could create some kind of additional tax on animal spirits in Russia, since it enhances uncertainty for the economy as a whole.

Appendix A-1

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