Russia: Fiscal stimulus may increase further

Russian budget spending accelerated to 39% YoY in April on higher transfers to pension fund and regional budgets. This is likely to lead to a widening of the budget deficit to 4-5% of GDP in 2020. A suspension of the fiscal rule, currently under discussion, may support RUB and OFZ in the short term, but may challenge Russia's macro strengths

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Budget deficit widened to 3% of GDP in April, net of one-off proceeds from the central bank

In 4M20, the Russian budget had a small surplus of 0.4% of GDP (RUB0.1 tr). The nominal fulfillment was heavilly affected by massive one-off revenues in the amount of 3.4% of GDP (RUB1.1 tr) proceeds coming from the Bank of Russia (CBR) in favour of the Finance Ministry, attributable to the handover of the 50% equity stake in Sberbank, Russia's biggest lender. Adjusting the numbers for that deal, Russia's federal budget deficit was 3.0% of GDP (RUB1.0 tr), which is larger than the 2.0% of GDP (RUB0.6 tr) deficit we expected.

The higher-than-expected deficit (adjusted for the one-off proceeds) was driven purely by the expenditure side, as overall federal spending accelerated from 18% year on year in 1Q20 to 24%

YoY in 4M20 (+40% YoY in April alone). The primary drivers of the acceleration were pension spending (federal transfers to the state pension fund), other social security spending (transfers to social security funds responsible for medical insurance and other benefits), as well as transfers to regions.

The revenue side was in line with our expectations, with non-oil revenues (excluding one-off items) growth slowing from 13% YoY in 1Q20 to 2% YoY in 4M20 (-26% YoY in April) on deterioration of profit tax, VAT and other revenue items. Oil revenues, normally accounting for around 40% of the budget revenues, also expectedly deteriorated, however, the collection per US$1/bbl of oil price has actually improved (with April oil revenues down only 25% month-on-month in USD terms despite a 47% MoM drop in spot Urals in March) possibly attributable to inertia created by long-term supply contracts amid likely flat oil&gas output.

2020 deficit likely to widen to 4-5% GDP

The budget fulfillment for 4M20 has prompted us to widen our 2020 deficit expectations from an inital 3-4% of GDP to the 4-5% of GDP range despite the unchanged average Urals assumption of US$36/bbl. The key reason is that in addition to the 3.5% of GDP fiscal stimulus, which was already announced, we now assume an extra 1% of GDP spending to be announced later and which will represent a catch-up on the spending backlog of RUB1.1 tr accumulated over the previous years. This additional spending is likely to be needed in order to support household income ahead of the national voting on constitutional amendments to take place sometime this year and Parliamentary elections in 2021. To remind, the currently announced 3.5% of GDP stimulus includes only 2% of GDP worth of spending (the rest is tax breaks and guarantees), out of which we see only 1% of GDP representing new spending, financed with proceeds from the Sberbank handover.

In order to finance the new potential 1% of GDP worth of spending and to account for a potential reduction in the regular non-oil revenues, the government may have to increase the net borrowing plan from the current 1.5% of GDP (RUB1.7 tr) to up to 3.2% of GDP (RUB3.5 tr), which appears ambitious but potentially doable, given the CBR support in the form of long-term refinancing facilities, dovish key rate guidance, low 4% share of OFZ holdings in the local banks' assets, as well as low competition for credit from banks' corporate and retail clients. The remaining RUB1.5 tr out of the total RUB5.0 tr deficit may be financed from the drawdown of fiscal savings, replacing the undercollection of oil revenues amid the new oil price environment.

Fiscal rule suspension (under discussion) - ST positive for RUB and OFZ, LT negative for the budget framework

The above-mentioned framework should be more or less within the general framework of the fiscal rule, which is in place in Russia since 2017. Meanwhile, recently there have been some media reports indicating that the government is consdering to suspend the fiscal rule in 2020-21, supposedly to allow for higher spending at any given oil price. Without going into the probabilities of this decision being actually taken, we have the following considerations:

- The most important practical area of the budget policy that is regulated by the fiscal rule is not budget spending per se, but rather accumulation and usage of the fiscal savings. Under the current rule, any extra fuel revenues received under Urals above US$42.4/bbl should be saved in the National Wealth Fund while at Urals below this threshold level the NWF should finance budget spending in the amount of fuel revenue undercollection. Strictly speaking, the fiscal rule does not prohibit extra spending - its main goal is to require that extra spending is financed with non-oil revenues and/or market borrowing. As a result, if the government actually decides to suspend the rule, it would not only allow higher fiscal spending (i.e. to potentially add the 1% GDP spending we are already expecting), but also to shift the financing mix from borrowing to spending the fiscal savings in case of adverse debt market conditions. This could lower the concerns regarding potential oversupply on the local currency state bond (OFZ) market.

- Another important practical area of the fiscal rule is the FX market, as the CBR, while obviously having room for manoeuvre in the near term, in the longer run has been aligning its FX operations with the accumulation and spending of the NWF. Suspension of the rule would require additional comments from the CBR in terms of volumes and framework of its FX operations, however it would be reasonable to expect that in case of higher usage of FX savings by the government, the CBR may boost FX sales on the market, being potentially positive for the RUB exchange rate in the near term. In case of higher FX sales even our recently upgraded USDRUB expectations will have room for further improvement.
- The suspension of the fiscal rule could be motivated by the desire to increase the short-term flexibility of the budget policy in the face of deteriorating activity outlook and high volatility on the financial markets. While such an approach has obvious short-term benefits, it may also put the sustainability of the Russian economic policy framework in focus. Russia's fiscal savings, currently at 11% of GDP, have been considered one of the pillars of the macro stability, however following the purchase of the 50% equity stake in Sberbank, the liquid FX portion of the NWF has already dropped to 8% of GDP, according to our estimates, and another 1.5%of GDP or more could be spent this year to finance the budget deficit. That still leaves an ample safety net, but with the deterioration of the non-oil revenue trend and increase in spending, the breakeven Urals for the budget can jump from US$48/bbl in 2019 to c.US$75/bbl this year. In this context, without a transparent and sustainable framework limiting the budget vulnerabiltity to the external environment, the market perception of Russia as a macro stability play may face some erosion.

Assuming another potential round of fiscal stimulus in the amount of 1% of GDP, we expect the fiscal deficit to reach 4-5% of GDP this year, out of which up to 1.5% of GDP could be financed from the sovereign wealth fund and up to 3.5% of GDP with local borrowing. A potential suspension of the fiscal rule for 2020-21, which is apparently under discussion, would mean a shift in the financing mix from borrowing to a drawdown from the wealth fund. In the short term this can support the FX and debt markets through higher CBR FX sales and lower concerns regarding OFZ oversupply, but in the longer run (if the suspension proves more permanent than expected) it may challenge the macro stability portion of Russia's investment case.

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