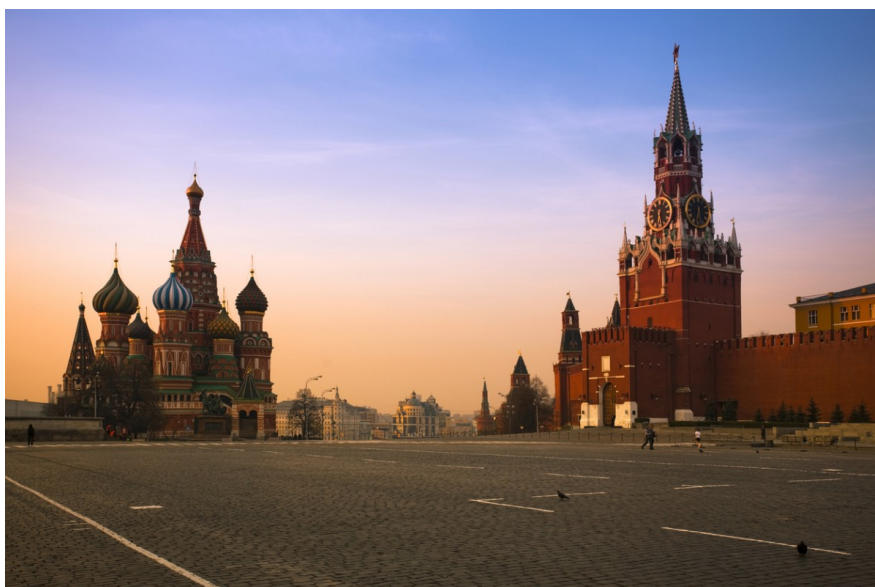


A potential ratings upgrade for Russia won't impact sentiment

Moody's indicates there's a high likelihood that Russia will be brought back to investment grade next year, but don't expect a sudden improvement in Russian capital flows



Source: istock

Ba1

Russia's rating from Moody's

Positive outlook

A strong signal from Moody's

Moody's indicated today, Thursday, there's a high likelihood that Russia will be brought back to investment grade next year, from the current Ba1 (with a positive outlook) so long as there's no sharp tightening of sanctions. This clearly recognises Russia's prudent budget policy thus far. But it will do little to improve Russian capital flows due to uncertainties related to emerging market flows, sanctions and local budget policy.

Moody's comments justified by Russian budget policy...

We believe Moody's comments are reflective of Russia's consistently conservative budget policy. Tighter non-oil revenue collection and control of expenditure have allowed the government to reduce the price of Urals crude oil needed to balance the Russian budget (breakeven oil price) from \$60-70/bbl in 2015-17 to \$50-55/bbl in 2018. The official budget plan for 2018-21 implies breakeven of \$50/bbl amid the increase in the VAT rate, the completion of tax changes in the oil and gas industry, and the increase in the retirement age. We believe that with this lower breakeven level, along with state debt of less than 15% of GDP and state savings of 5-8% of GDP, the risk of Russia defaulting on its obligations should not be higher than that of its investment grade peers - even if sanctions are imposed on Russian sovereign debt.

...but no guarantees of higher capital inflows to Russia

So, will this statement translate into higher capital inflows into Russia? We see two sets of challenges:

The first is that Russian capital flows are not currently driven by rating considerations:

- Russia already has investment grade ratings from S&P and Fitch (BBB- in FX). The positive action from S&P in February this year upgraded Russia's composite rating to investment grade but did not offset deterioration in the market sentiment
- Since April, non-residents reduced their position in OFZ, the local state bonds by 25%, or around RUB550 bln, following the global trend in EM outflows and reflecting the risk of sanctions against the new state debt
- Given the external policy uncertainties and limited local activity, Russian corporates show little interest in external financing; in 3Q18 they reduced their foreign debt by \$15 bln, bringing the total net redemption since mid-2014 to nearly \$170 bln (adjusted for FX revaluation effect)

The second set relates to the growing risks of easing in budget policy, which could prevent Moody's from implementing the upgrade:

- The federal budget expenditures of 17% of GDP drafted into the 2018-2021 budget represent a 12-year low for Russia, and the sustainability of this target might be challenged by the slowing economic activity and weakening popular support
- The growing upward pressure on local gasoline prices amid weak margins in the oil downstream sector may force the government to make a tough choice between allowing higher-than-expected CPI growth (further disappointing consumer sentiment and potentially triggering further Bank of Russia rate hikes) and using the budget means to support the oil and gas sector
- The budget rule - which is favoured by the rating agencies because it prevents the spending of any fuel revenues received should Urals exceed \$40-43/bbl in 2017-21 - may have to be eased in order to accommodate the two above mentioned measures. Easing might also take place if adverse market conditions prevent the Finance Ministry from fulfilling the massive net OFZ placement program of RUB1.6-1.8 trillion p.a. in 2019-21F.

Russia intensifies net foreign debt redemption in 3Q

<https://think.ing.com/snaps/russia-intensifies-foreign-debt-redemption-in-3q/>

Prospects for rouble assets

In the short-term we expect RUB to continue benefitting from the strong current account surplus of \$30-35 bln in 4Q1F, which will not be sterilised by FX purchases and which have been on hold since mid-September until the end of 2018. However, the prospect of portfolio flows into RUB assets are still subject to uncertainties related to EM FX and Russia-specific foreign policy issues.

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