

Russia reshuffle: mind the budget policy

The resignation of the Russian cabinet and proposals of constitutional reform are aimed at boosting local confidence through promises of a better income trend and smooth political transition in 2021-24. The prospects for financial assets, especially bonds, will largely depend on the scale of the budget easing, which now seems increasingly likely



Source: Shutterstock

Reshuffle - the long awaited surprise

Several important events took place on 15 January in Russia (in order of appearance):

- During his annual state-of-the-nation address, President Vladimir Putin announced measures aimed at supporting lower income families with children, worth 0.3-0.5% of GDP in extra spending
- He also proposed amendments to the constitution that would boost parliamentary control over the Cabinet, codify the powers of the State Council and cap the maximum amount of presidential terms at two, regardless of whether those terms are consecutive or not
- Dmitry Medvedev, who has been Prime Minister since 2012, resigned, while Mikhail Mishustin, head of tax service, has been nominated as new PM

Taken together they send long-awaited political signals relevant to the economic trends in the

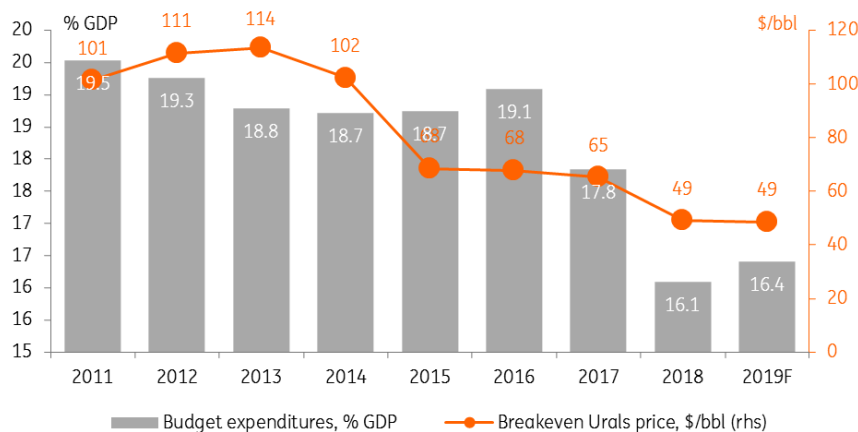
current electoral cycle, which includes the 2021 parliamentary and 2024 presidential elections.

First, there seems to be a roadmap for political transition. One of the key questions following Vladimir Putin’s re-election for the second consecutive presidential term (fourth in total) in 2018 was the upcoming transition in 2024. The proposed constitutional reform (speculation of which has been circulating for two-three years) therefore is not a shock, but rather a long-awaited answer: it appears that Vladimir Putin is planning to vacate the presidential post, while retaining control over the executive branch either through the State Council or through an empowered parliament. In a way, this should lower some political uncertainties, which might have been a concern for the local corporate sector.

Second, economic policy may shift from macro stability towards more fiscal stimulus. The outgoing Cabinet’s key achievement was the dramatic improvement in Russia’s fiscal position, with the budget breakeven oil price dropping from US\$110-115/bbl in 2012-13 to below US\$50/bbl in 2019, partially due to a reduction in state expenditures by around 3-4% GDP, more robust tax collection, increase in VAT rate and retirement age in 2018. While these measures were necessary to rebuild fiscal reserves, which now exceed 7% of GDP, and keep state debt low, they also contributed to stagnation of household income and consumption, leading to disappointing approval ratings. As a result, it is no coincidence that the resignation (speculation of which has also been circulating for two-three years) of the current Cabinet comes hand in hand with the call for a stronger parliament and announcement of additional social policy initiatives on top of the already announced plans of investing a portion of fiscal savings into local projects.

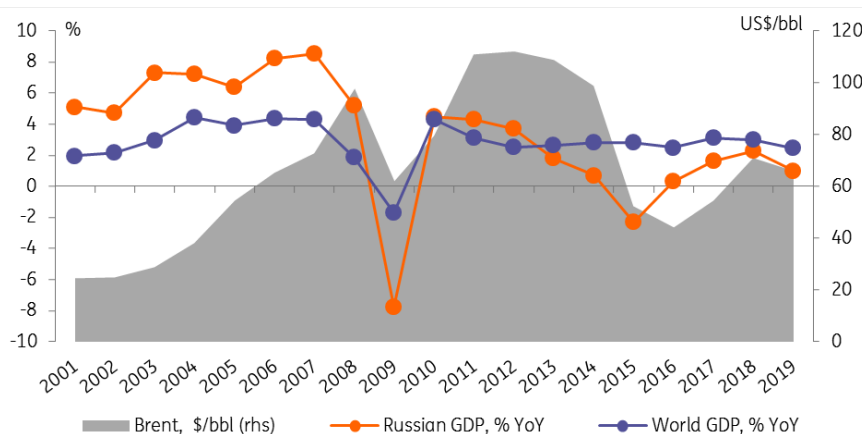
Third, Cabinet will focus on boosting efficiency of state administration. The new PM nominee has been credited with massive upgrade in the tax administration system, allowing to increase its transparency for the business and to boost collection for the budget. This suggests that overall increase in efficiency and quality of state services may be on the agenda, which is a positive sign. The new PM’s brief experience in financial markets in 2008-10 is also a positive sign. Meanwhile the technocratic nature of the new appointment, as opposed to previously rumoured Alexei Kudrin, the head of Audit Chamber, or German Gref, Sberbank’s CEO, suggests that the Cabinet is unlikely to take more active role on the broader policy agenda, keeping the question of structural reforms open for now.

Figure 1 Outgoing Cabinet's economic policy has been focused on macro stability



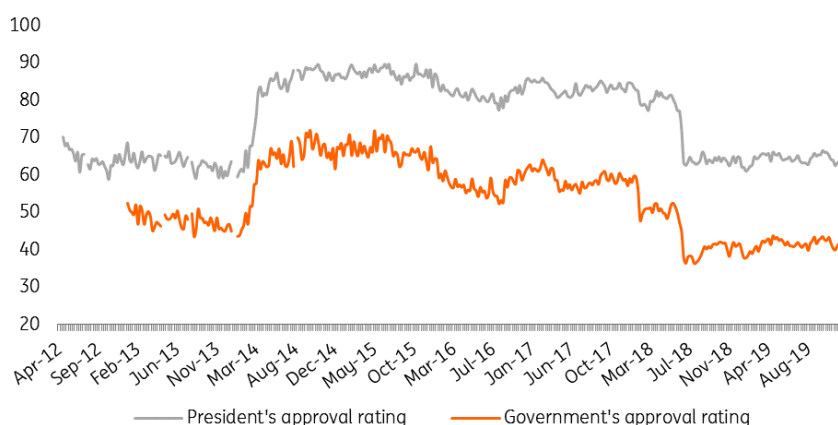
Source: Finance Ministry, ING

Figure 2 Russian GDP growth has been disappointing



Source: State Statistics Service, IMF, ING

Figure 3 Approval ratings have been under pressure over the last couple of years



Source: WCIOM, ING

Economic implications – looser budget policy, stronger growth, more cautious Central Bank

The recent events confirm our long-standing take that the budget policy is set to ease. In practical terms, it means that this year's expenditure plan will likely increase by at least 0.6-0.7% of GDP, accounting for the social policy measures announced by the president, and the spending backlog from 2019, representing allocations for the National Projects (state infrastructure spending). In addition, some 0.3% of GDP could be invested locally from the National Wealth Fund, as guided earlier. This should positively affect both consumption and investment growth, and even with some potential offsetting factors from growing imports this creates a 0.5 percentage point upside potential to our conservative 1.5% GDP growth expectations for 2020. Additional stimulus of 0.3-0.5% of GDP p.a. on social policy will raise the question of financing - it could be done through additional borrowing or thorough relaxation of the budget rule.

In the meantime, fulfilling the president's goal to exceed global GDP growth in 2021 (IMF expects

3.6%) will still be a challenge, especially given that the estimates for Russia's potential growth rates are between 1-2% per annum. In fact, the key concern is that the recent reshuffling so far provides little clarity on the prospects of the structural reforms. While the composition of the Cabinet has yet to be announced, the nomination of the head of tax service as PM may indicate that the economic policy agenda will be dominated by the fiscal tools, while the prospects of private sector participation remains open.

Given the likely fiscal easing and no clarity on the structural transformation, the Central Bank may now have additional cause for a cautious approach. Even though the current social policy proposals are not nearly as massive and inflationary as the previous suggestion to provide tax breaks on the personal income tax worth up to 1% of GDP, they do not exclude further easing in 2021-24 and would require at least some time to re-assess inflationary risks. For now, our slightly more conservative than consensus expectation of CPI growth accelerating from 3.0% in 2019 to 3.7% in 2020 is gaining ground. This speaks more in favour of our cautious view on the key rate floor at 6.0% and no cut at the upcoming 7 February meeting. The Central Bank communication in the coming weeks will be the key watch factor.

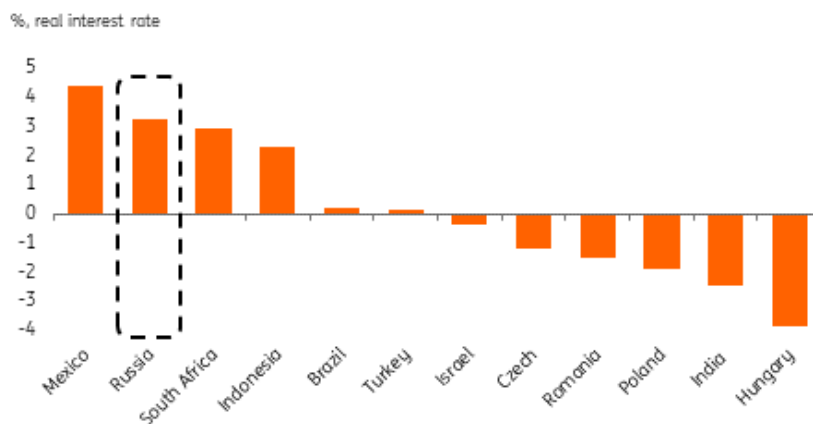
Market implications - neutral for RUB, less optimism on rates

FX – neutral: We don't think the government reshuffle should be an overt negative for the currency at this point. Unless we have more clarity and details, concerns about possible irresponsible fiscal easing (one which would reintroduce a credit risk premium into the ruble) are not justified, in our view, while RUB still benefits from one of the highest real rates in the liquid EM FX world (Figure 4). As per below, and the possibility of a looser fiscal policy stance should make the Central Bank of Russia more cautious (ie, no rate cut in February), meaning that both nominal and real rates should be supportive of the currency. The very orderly nature of the government reshuffle also suggests limited scope for political risk premium being priced into the ruble (in contrast to such a political risk premium warranted for some of its CEEMEA FX peers). With global risk sentiment remaining benign following the US-China Phase One deal agreement and ruble still being modestly undervalued within our Behavioural Equilibrium Exchange Rate valuation framework (Figure 5), this also suggests limited scope for a meaningful RUB depreciation. At this point, we see the biggest risk to RUB being a reversal in the foreign holding of OFZ (which increased meaningfully over the course of the last year). However, for this to happen the market needs to first see the evidence that the possible fiscal stimulus would be of a magnitude to meaningfully change the growth and inflation dynamics. Currently, this is not the case in our view. The near-term RUB price action should therefore remain well behaved, with the bias remaining for a higher USD/RUB in coming months (back into the 62-64 range) due to a combination of a shrinking current account surplus and stable or growing FX interventions.

Sovereign debt & rates – no panic, but less optimism: The government reshuffle should have more implications for the rates market, rather than FX. First, the possibility of fiscal easing should make the CBR more cautious, with the central bank likely staying on hold in the February meeting (it will give the Central Bank some time to study the reasons beyond the low CPI level which don't appear to be demand driven). We continue to see the current market pricing of close to three rate cuts this year as aggressive, with only one rate cut (delayed beyond the February meeting) as more likely. Secondly, the increased spending could possibly lead to an increase in OFZ supply, which is already high. The cautious CBR

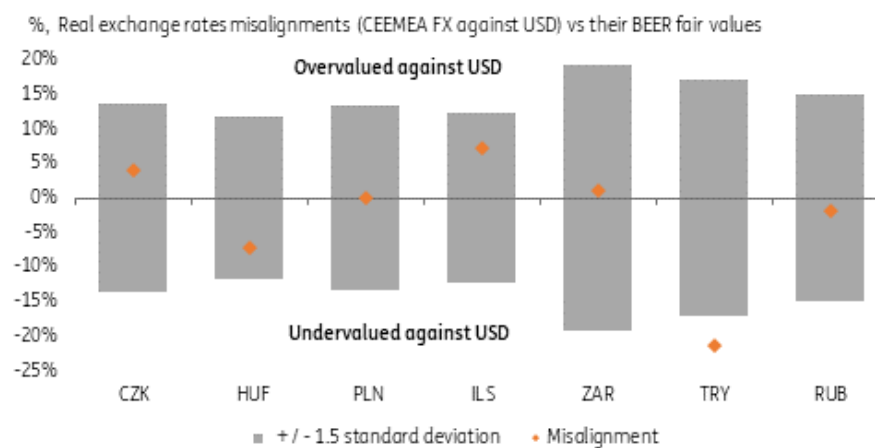
and the uncertainty about the size of the fiscal easing package also suggest a pause in the OFZ gains, with one-way position also acting as a limiting factor for further gains (foreign holdings of OFZ increased to 32% last year). Still, unless a meaningful pro-inflationary, pro-growth fiscal package is announced (not our base case) the scope for a meaningful OFZ sell-off is limited.

Figure 4 RUB benefits from relatively high real rate



Source: Bloomberg, ING

Figure 5 RUB still remain modestly undervalued vs USD



Source: Bloomberg, ING

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