23 September 2019

Russian de-dollarization

Banks on board, others need convincing

Over the last 5-6 years, Russia has made some progress in diversifying its trade flows and international liabilities away from the US dollar. We note, however, that USD is still quite popular as an asset for the private sector despite the persisting risks of US sanctions. This and other trends covered in this report are relevant for companies and banks focused on doing multi-FX business in Russia.

Given the persistent newsflow on Russia's de-dollarization efforts, we have decided to make a broad overview of the progress in this area since the end of 2013, when Russia entered a new geopolitical reality. We have the following observations:

- The de-dollarization, a drop in the role of USD, is seen in most areas, including trade flows, foreign debt, international assets held by banks and the Central Bank of Russia (CBR), local loans, and local FX market turnover. The only exception is international assets held by companies and households, where the role of USD increased.
- De-dollarization progress is optically suppressed by the effects of depreciation of EUR and RUB to USD by c.20% and 50% respectively since 2013. If the USDRUB and EURUSD had remained unchanged over the last 5 years, the drop in the share of USD would have been more pronounced.
- Even with de-dollarization, Russia still sees a huge (estimated US$190 billion in 2019) annual net inflow of USD via the trade channel, which even after being extracted through the budget rule and foreign debt redemption is still enough to be accumulated as international and local assets by the private sector.
- De-dollarization is favoured by the banks, while the rest, including companies, households and even the government, are holding on to their US dollars which are more attractive relative to euro thanks to higher interest rates.
- As a result, the local FX market is still dominated by the USDRUB pair, and the progress of EUR is very slow, so far.

Having looked at the de-dollarization progress so far, we have the following conclusions:

- Further de-dollarization of trade is possible along with a switch of the oil export contracts to EUR, as the key Russia counterparties, including the EU and China, are looking for ways to bypass the USD area.
- Foreign liabilities in USD will remain the first in line to be redeemed due to sanction risks and high interest expense relative to EUR. Foreign borrowing in EUR, RUB, and other FX appears more stable even if it is used only to refinance the existing debt.
- De-dollarization of Minfin's assets is possible after 2020, when the liquid portion of the National Wealth Fund (NWF) reaches 7% of GDP, allowing bigger diversification of instruments.
- De-dollarization of the real sector FX assets is the biggest challenge, as the overall preference to FX savings need to be addressed through higher local investment opportunities.
- Otherwise Russian financial stability will remain exposed to the risks related to sanctions (USD) and the euro area banking sector stability (EUR).

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De-dollarization on the agenda

De-dollarization in Russia has been in the focus of the business community over the last 5-6 years. The process, which started with political declarations and now seems to have gained real traction, has implications for the corporate and financial sector.

We have gathered information on the evolution of the role of USD in the Russian economy since the end of 2013 until the latest available reporting dates of 2019. Most of the data is official statistics coming from the Central Bank of Russia (CBR). The two exceptions are: (1) FX structure of local bank loans and deposits (we extrapolated the data from IFRS reports of banks accounting for 50-70% of FX deposits and 80-90% of FX loans) and (2) the FX structure of non-equity international assets by non-financial corporates and households' for 2013-14 (the FX structure is inferred from the available data on the overall volume and the contribution of FX revaluation effect in the growth).

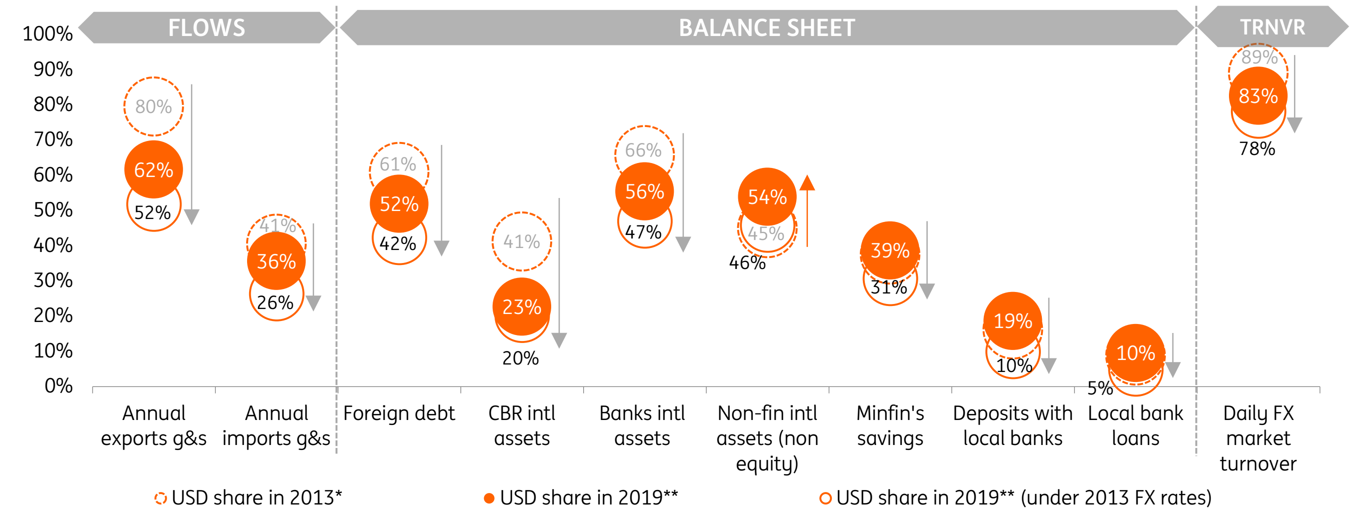
There was no available data on the FX structure of the non-financial sector's international equity (direct and portfolio) assets (equivalent to US$300-400 billion) and liabilities (equivalent to around US$500 billion). As a result, our analysis covers around 80% of Russia's US$1.3 trillion international assets and 50% of its US$1.0 trillion international liabilities as of year-end 2018.

De-dollarization of transactions and liabilities, not assets

Based on the data gathered, we have the following observations:

- The de-dollarization, a drop in the role of USD, is seen in most areas, including trade flows, foreign debt, international assets held by banks and the CBR, local loans, and local FX market turnover. The only exception is international assets held by companies and households, where role of USD increased.
- De-dollarization progress is optically suppressed by the effects of depreciation of EUR and RUB to USD by c.20% and 50% respectively since 2013. If the USDRUB and EURUSD had remained unchanged over the last 5 years, the drop in the share of USD would have been more pronounced.

Fig 1 Role of USD in Russia: evolution as a share, 2013 and 2019

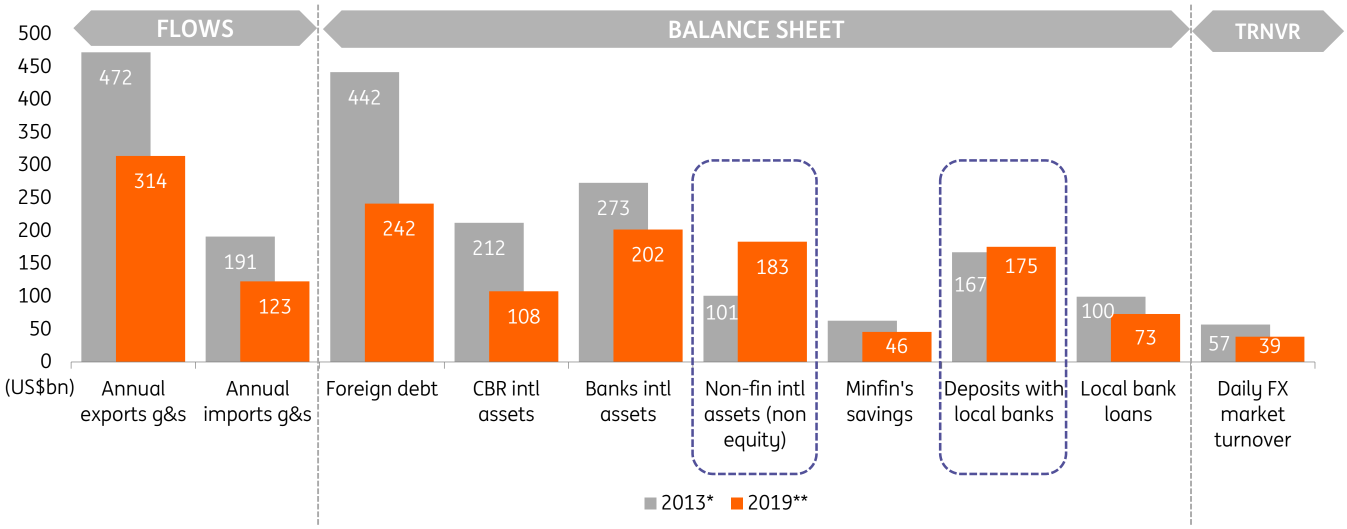


*ING estimates for 2013 intl. assets and 2013-19 local banks' balance sheets. **Latest available data for 2019 vary from YE2018 to mid-2019.
Source: Bank of Russia, Russian Customs, Finance Ministry, KUAP.RU, ING;

- Even with de-dollarization, Russia still sees a huge (estimated US$190 billion in 2019) annual net inflow of USD via the trade channel, which even after being extracted through the budget rule and foreign debt redemption is still enough to be accumulated as international and local assets by the private sector.

- De-dollarization is favoured by the banks, while the rest, including companies, households and even the government, are holding on to their US dollars which are more attractive relative to euro thanks to higher interest rates.
- As a result, the local FX market is still dominated by the USDRUB pair, and the progress of EUR is very slow, so far.

Fig 2 Role of USD in Russia: evolution in US$bn, 2013 and 2019



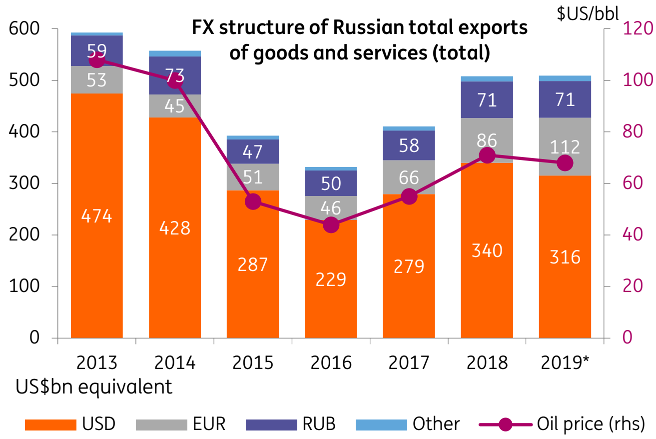
*ING estimates for 2013 intl. assets and 2013-19 local banks' balance sheets. **Latest available data for 2019 vary from YE2018 to mid-2019.
Source: Bank of Russia, Russian Customs, Finance Ministry, KUAP.RU, ING;

In order to make conclusions on the further prospects of de-dollarization, we take a closer look at each of the abovementioned areas, covering Russia's international trade flows, financial balance sheet, and the turnover of its FX market.

Exports: from petro-dollars to petro-euros?

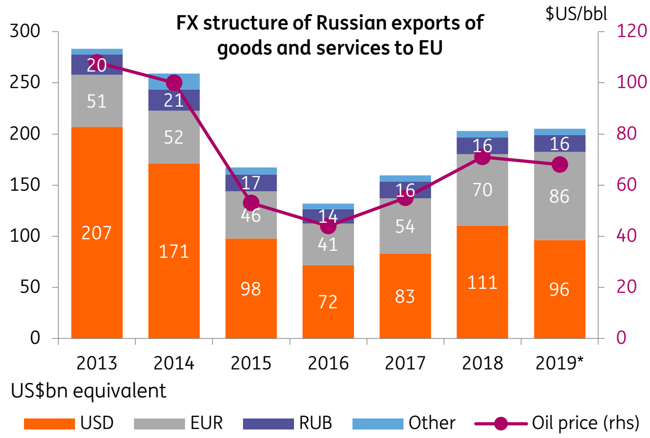
- Russia's exports of goods and services remain the key driver of USD inflows into Russia. Based on 1Q19 data, this year, a little over US$300 billion worth of goods and services exports will be settled in USD, 62% of the total.
- As 60-70% of Russia's merchandise exports are hydrocarbons which are predominantly settled in USD, the US dollar export proceeds are still heavily correlated with the oil price. So, around 80% of the US$150 billion decline in the annual inflow of USD via exports in 2019 vs. 2013 can be explained by the US$40/bbl drop in the oil price.
- Still, the remaining 20% (US$30 billion) decline represents an actual de-dollarization. The risk of US sanctions and global trade tensions are creating bilateral incentives to switch from USD to EUR, even in oil&gas trade. For example, EU has been considering invoicing Iranian oil in EUR since 2018 due to the latter's lack of access to the SWIFT payment system because of US sanctions. Also, by mid-2019, France, Germany, and the UK have activated INSTEX system to enable de-dollarized EU-Iran merchandise exchange. Meanwhile, the recent media reports suggest that Russian oil majors, including Rosneft, are planning to start invoicing oil contracts in EUR.
- It is not clear so far, how long it will take to fully de-dollarize Russian exports, and whether it is at all possible, however based on the 1Q19 trade data there are clear signs of higher EUR-denominated exports to EU and China and RUB-denominated exports to India.

Fig 3 USD proceeds remain heavily correlated with oil export volumes...



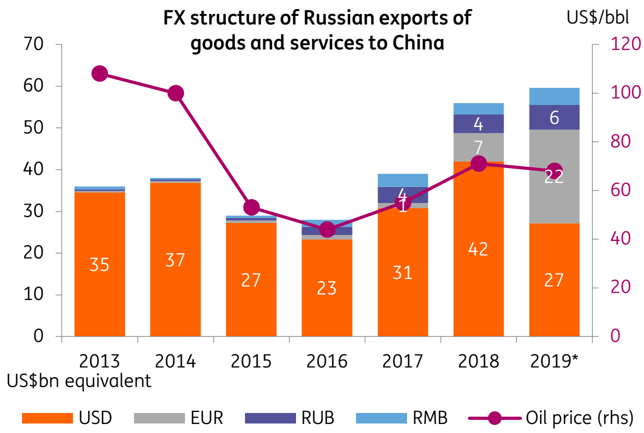
*ING estimates based on 1Q19 data
Source: Bank of Russia, Federal Customs, CEIC, ING

Fig 4 ...but EUR is gaining importance for Russia-EU trade...



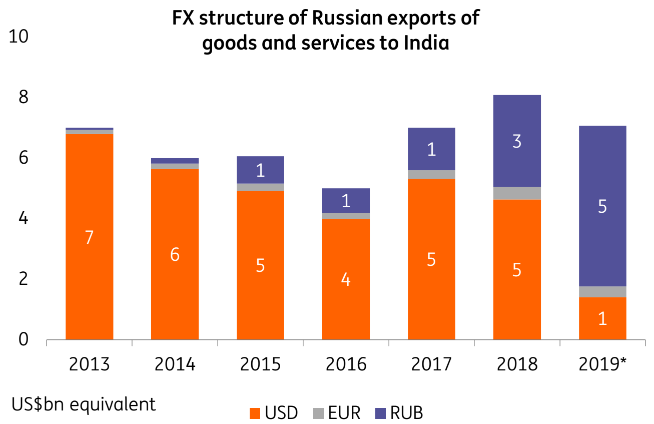
*ING estimates based on 1Q19 data
Source: Bank of Russia, Federal Customs, CEIC, ING

Fig 5 ...and for Russia-China trade too



*ING estimates based on 1Q19 data
Source: Bank of Russia, Federal Customs, CEIC, ING

Fig 6 RUB is also gaining importance - in non-oil trade

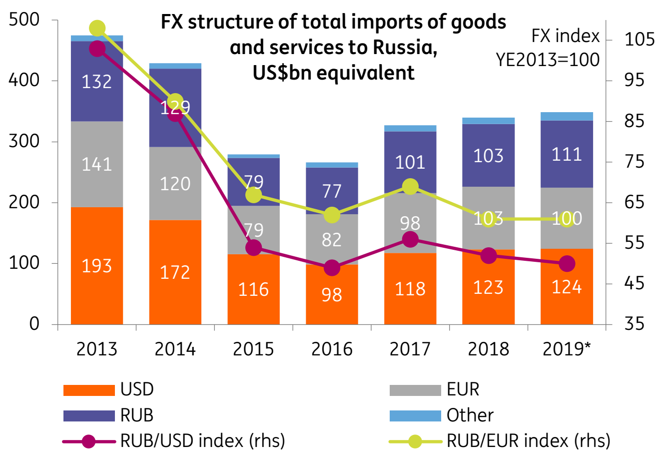


*ING estimates based on 1Q19 data
Source: Bank of Russia, Federal Customs, CEIC, ING

De-dollarization of imports: following the exchange rates

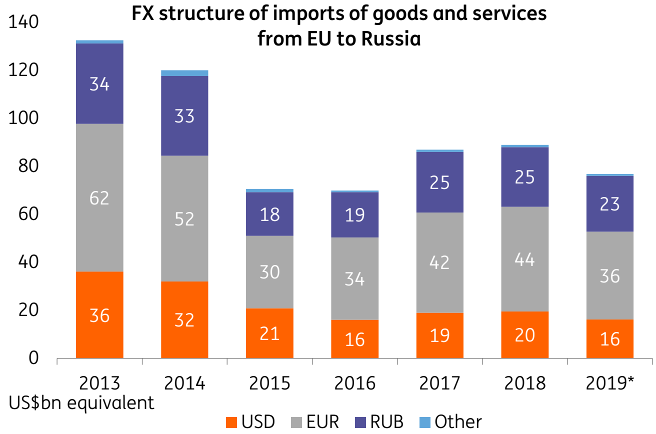
- The drop in annual USD import volumes over the last 5 years reflects the decline in total imports in response to the material RUB depreciation to the key currencies. The overall volume of imports to Russia dropped by US$125 billion in 2019F vs. 2013, out of which USD accounts for 55%, meaning that imports in other FX also declined.
- Still, some de-dollarization of import flows (in terms of USD share) is also ongoing, reflecting the weakness of EUR vs. USD since 2013. Since 2013, RUB depreciated by c.50% to USD and by c. 45% to EUR. The dominance of EU as Russia's trade partner persists despite the ban of food imports from the EU in place since 2014.
- Ruble keeps dominating the imports from the former USSR, while with China-Russia trade, RMB is gaining importance.

Fig 7 USD imports subtly squeezed out by EUR and RUB



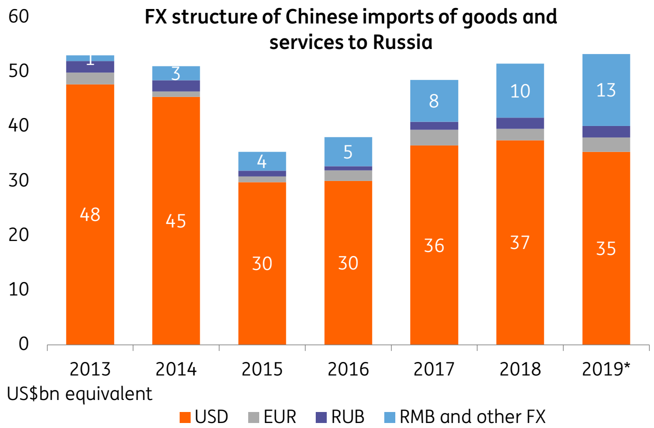
*ING estimates based on 1Q19 data
Source: Bank of Russia, Federal Customs, CEIC, ING

Fig 8 EU remains Russia's key imports originator, with EUR as key currency



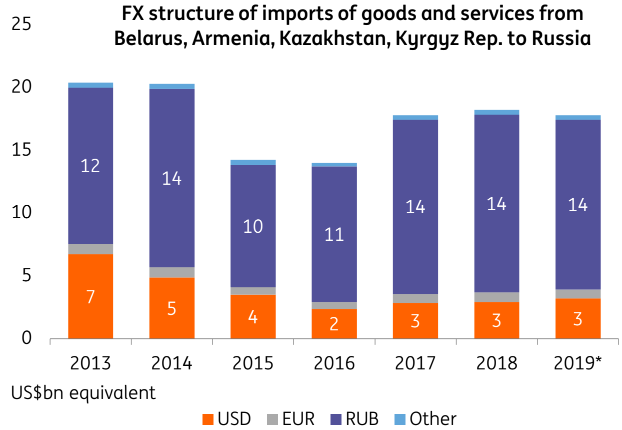
*ING estimates based on 1Q19 data
Source: Bank of Russia, Federal Customs, CEIC, ING

Fig 9 Growing ties with China explain increasing importance of RMB



*ING estimates based on 1Q19 data
Source: Bank of Russia, Federal Customs, CEIC, ING

Fig 10 EU remains Russia's key imports originator, with EUR as key currency



*ING estimates based on 1Q19 data
Source: Bank of Russia, Federal Customs, CEIC, ING

Net USD trade inflows still significant – c.US$190 billion in 2019

Despite the reduction in the USD exports and imports, the net USD inflows into Russia via the trade channel are still significant. According to our estimates this year it will total around c.US$190 billion vs. c.US$280 billion in 2013. The following portion of the article discusses how those inflows affect Russia's international balance sheet.

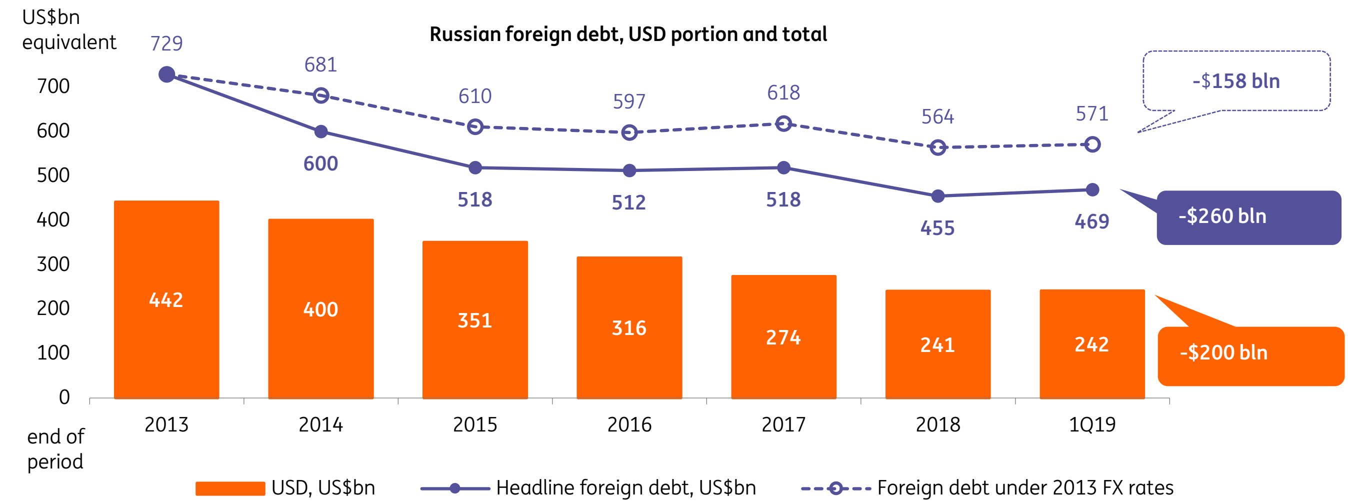
Foreign debt - active de-dollarization

- A reduction of USD liabilities is the most obvious channel of using the surplus USD. Starting in 2014, Russia, mainly corporates, has been actively redeeming foreign debt, reflecting sanction-driven closure of access for major Russian corporates to new international financing.

- Since the beginning of 2014 and by the end of 1Q19, the USD-denominated portion declined by US$200 billion, while the overall foreign debt dropped by US$260 billion, though around US$100 billion out of that sum reflected FX revaluation effect (weaker RUB and EUR vs. USD). In other words, the entire drop in the Russian foreign debt reflected reduction in the USD-denominated liabilities. Under unchanged FX rates, the share of USD would have dropped from 61% to 42% (not 52%).

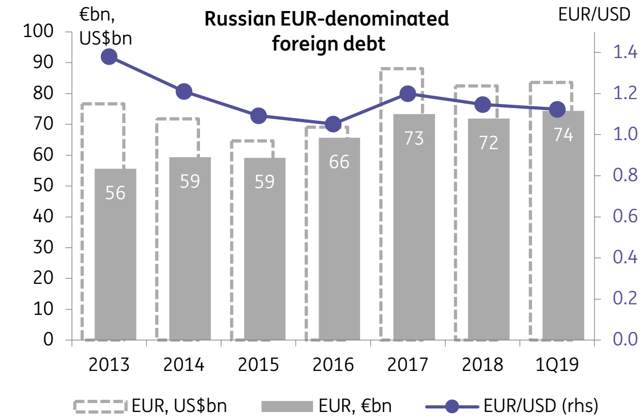
- In 2014-17, Russia was partially replacing the USD debt with EUR and RUB, but since 2018 accumulation of non-USD debt stopped as well, reflecting a lack of local investment demand. Still, the stable foreign debt in EUR, RUB, and other FX suggest continuous refinancing of non-USD debt.

Fig 11 The entire drop in the Russian foreign debt reflected reduction in the USD-denominated liabilities



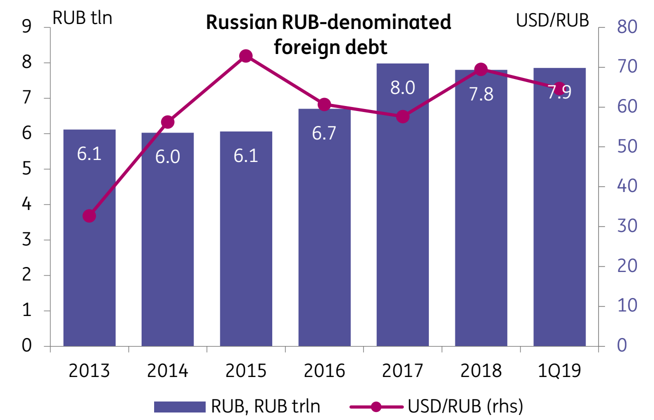
Source: Bank of Russia, Bloomberg, ING

Fig 12 Accumulation of foreign debt stopped in EUR…



Source: Bank of Russia, Bloomberg, ING

Fig 13 …and in RUB, reflecting lack of investment demand



*ING estimates based on 1Q19 data
Source: Bank of Russia, Federal Customs, CEIC, ING

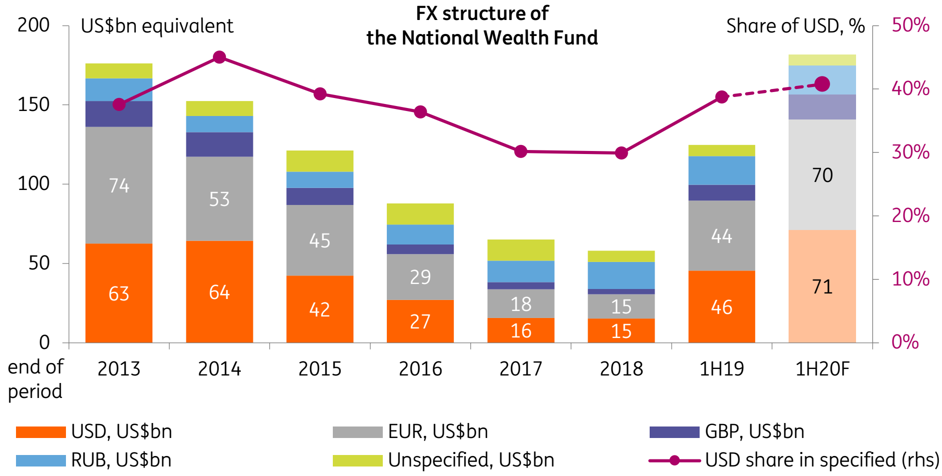
Foreign assets - Finance Ministry accumulates USD as per budget rule, but will stop soon

The still substantial net USD trade inflows (even after foreign debt redemption) keep accumulating as assets of the non-financial sector, including the government, companies, and households.

- Since 2017, Russia is implementing the fiscal rule dictating accumulation of windfall oil revenues within the National Wealth Fund (a sovereign wealth fund), which is kept mostly in FX and deposited with the Central Bank. The amount of FX purchased on the open market was US$14 billion in 2017, US$36 billion in 2018, and is likely to total around US$60 billion in 2019F. Those amounts are purchased mostly in USD and then partially converted into EUR and GBP in order to comply with the requirement to keep the liquid portion of the NWF distributed between USD/EUR/GBP in a 45/45/10 proportion. The FX accumulated in a given year, is officially incorporated into NWF in the middle of the following year. This means that the current official size of NWF, which is around US$125 billion in FX, including US$46 billion in USD, underestimates the actual volume by US$40-60 billion in FX, including US$18-27 billion in USD. In other words, thanks to the budget rule, the amount of USD held by the Russian government is now higher than in 2013, while the share of USD in Minfin's savings remains roughly unchanged at around 40%.

- The share of USD in state savings may start to drop after next year, as after the liquid portion of NWF hits 7% of GDP (currently it is US$98 billion, or 6% of GDP), the list of instruments available for investment will be widened to include riskier assets. This means that the USD purchased on the market starting in 2020 may then be converted into other FX, and the accumulation of USD in state savings may stop.

Fig 14 State savings see no de-dollarization due to fiscal rule and NWF investment memorandum, but it may change soon



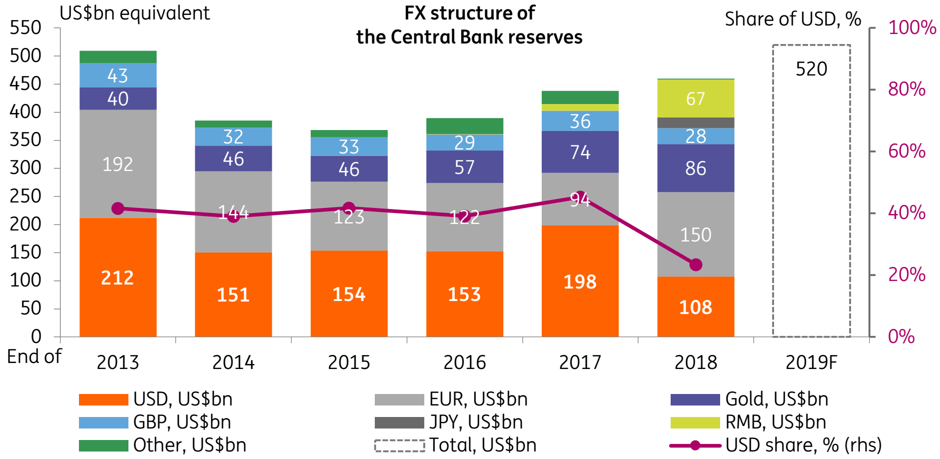
Source: Finance Ministry, ING

CBR assets actively de-dollarized in 2018, further sale of USD limited due to Minfin's deposit with CBR

- The presence of USD in the state savings deposited with the CBR limits the latter's ability to fully de- dollarize its assets. To remind, it has already actively diversified away from USD starting in 2018, following SDN sanctions on Rusal and Renova. USD is being replaced with EUR, gold, JPY, and RMB – to reflect developments in global trade and geopolitics. CBR is the headliner of global trend, as the share of USD in global FX reserves dropped from 66% in 2014 to 62% in 2019.

- That said, the presence of around US$70 billion of USD in the NWF deposited with the CBR, suggests that the scope for further sale of USD from the CBR reserves is limited to around US$30 billion in absolute terms. A further drop of USD share in reserves will likely take place organically amid the overall growth in the non-USD reserves.

Fig 15 CBR actively de-dollarized in 2018, further room limited due to NWF



Source: Bank of Russia, ING

Private companies and households are accumulating USD assets abroad…

Still, even after redemption of foreign debt and extraction via the budget rule, the private sector is still facing significant inflows of USD. For example, according to our projections, this year, out of an expected US$190 billion net USD trade inflows only around US$10-15 billion will be used to redeem corporate foreign debt and around US$60 billion will be sterilized via the budget rule. The remainder is at the disposal of the private sector, which does not seem to be in a rush to de-dollarize.

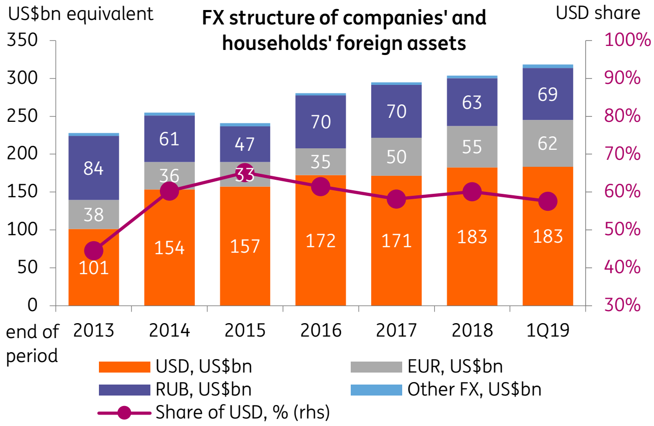
- Given the subdued investment demand in Russia the current account surplus is not 'digested' locally and is rather turned into international assets by the non-financial sector, including outward FDI by companies and accumulation of FX accounts abroad by wealthy individuals, being an important driver of capital outflow. This process itself is a subject for a separate analysis. Here we focus only on the role of USD in this process.

- While we are not surprised at the accumulation of international assets by the Russian private sector, it is puzzling that the preference for USD remained high over the last 5 years despite the increased risk of US sanctions. Our estimates based on official statistics by the Bank of Russia suggest that the USD portion of the international assets held by non-financial companies and households have increased by around US$80 billion since the beginning of 2014, and the share of USD stays around 60% of total. We believe the high preference for USD is explained by the relatively higher interest return on the USD assets than the ones in EUR, which so far outweigh the risks related to US sanctions.

- We note, however, that the inclusion of several large Russian companies into the US Treasury's SDN list (which may lead to a freeze of the USD-denominated holdings) in 2018 may potentially limit the preference for USD in the longer term perspective.

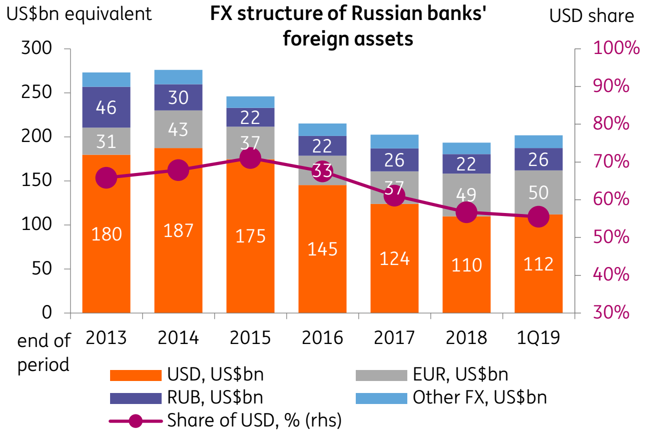
- The Russian banks, on the other hand, are generally in line with the de-dollarization trend, reducing their FX and USD assets in line with the gradual redemption of the foreign debt.

Fig 16 Non-financials accumulate FX assets, show high preference for USD



Note: FX structure for 2013-14 is not available publically for non-financial sector, and was inferred from the published CBR data on the overall volume and the contribution of FX revaluation effect in the annual growth
Source: Bank of Russia, ING

Fig 17 ... Banks reduce FX assets and diversify away from USD



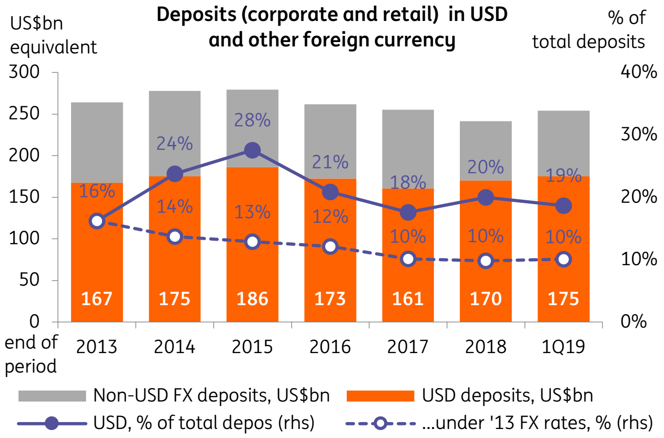
Source: Bank of Russia, ING

... and locally, though to a lesser extent

Persistent preference for USD assets by companies and households is also seen when looking at the FX structure of the local banks' balance sheet, though to a lesser extent. Given the lack of sector-wide data on FX composition, we looked at the publicly available financial reports of the major players, accounting for c.60% of the sector's FX deposits and c.90% of the FX loans. Extrapolating the individual data on the sector, we have the following estimates and observations.

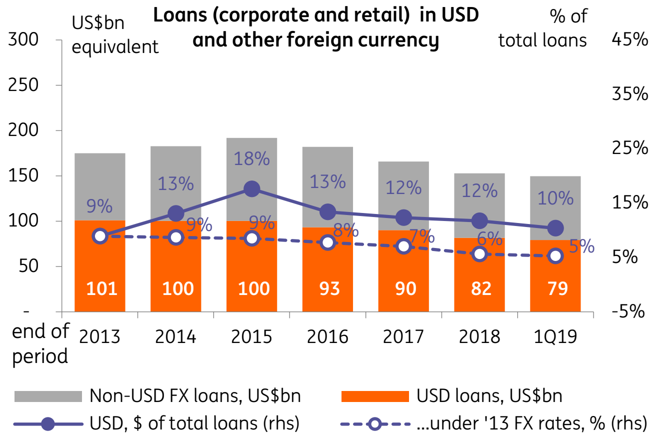
- The USD accounts held by corporates and households in the Russian banking system is currently estimated at around US$175 billion, which is slightly higher than the US$167 billion at the end of 2013.
- The dollarization of the total deposits appears to have increased at first glance (from 16% in 2013 to 19% now), however, adjusting for the massive USD appreciation vs. RUB over the period is necessary in this case. Under unchanged 2013 FX rates, the current amount of USD corresponds to 10% of the total corporate and retail deposits, which suggests some progress in de-dollarization in this area, but the stabilization of the share since 2017 suggest that the process might have reached its limit. In order to proceed, some general increase of trust to RUB is required.
- USD is consistently the most popular foreign currency among the depositors, accounting for 63-70% of the FX deposits (60-65% after adjusting for the EURUSD revaluation effect). It appears that the key reason for this is the relatively higher return on the USD deposits vs. EUR, as is the case of international assets. The current push to allow local banks to have negative rates on EUR (currently it is legally prohibited in Russia) suggests that USD is to maintain its popularity even despite the US sanction risks.
- Unsurprisingly, the companies' and households' preference for USD liabilities is declining along with the overall shift away from FX risk, with local USD loans dropping both in absolute terms and as a share of total loans.

Fig 18 Households and companies have stable preference for FX savings since 2017, USD remains the most popular FX deposit



Note: USD volumes estimated by ING based on the IFRS reports of banks accounting for c.60% of the FX deposits and c.90% of the FX loans of the Russian banks.
Source: Bank of Russia, IFRS reports by major banks, ING

Fig 19 ... Banks reduce FX assets and diversify away from USD



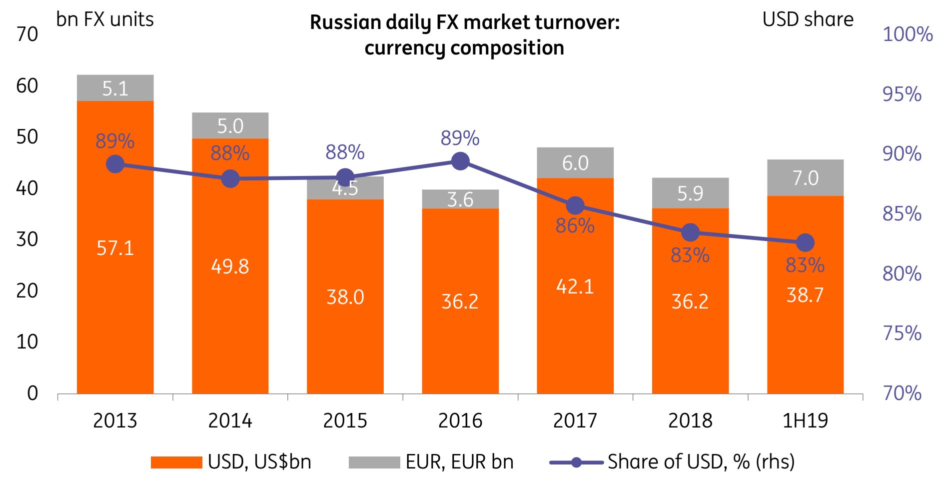
Source: Bank of Russia, IFRS reports by major banks, ING

FX market turnover still USD-heavy, but EUR is gaining importance

The above-mentioned trends help to explain the conditions of the local FX market.

- According to the CBR data, the average daily USD trading volumes of the Russian FX market (spot and derivatives, trading through centralized exchange platforms and over-the-counter) declined from US$57 billion per day in 2013 to US$39 billion per day in 2019, or by US$18 billion. The drop in absolute terms to a large extent reflects lower USD inflows via the trade channel on lower oil prices.
- The share of USD on the local FX market, after staying stable and very high at around 90% in 2013- 2016, started to decline in 2017 and currently has reached 83% (would have been 78% under unchanged 2013 FX rates). We attribute this to a higher share of EUR in the Russian external trade, which led to an increase in EUR trading volumes from EUR5 billion in 2013 to EUR7 billion in 2019. Still, the high preference for FX on the asset side still secures USD's dominance on the local FX market for the time being.

Fig 20 USDRUB pair still dominates the FX market, but EURRUB is gaining ground



Source: Bank of Russia, ING

Key takeaways

Having looked at the de-dollarization progress so far, we have the following conclusions:

- Further de-dollarization of trade is possible along with a switch of the oil export contracts to EUR, as the key Russia counterparties, including the EU and China, are looking for ways to bypass the USD area.
- Foreign liabilities in USD will remain the first in line to be redeemed due to sanction risks and high interest expense relative to EUR. Foreign borrowing in EUR, RUB, and other FX appears more stable even if it is used only to refinance the existing debt.
- De-dollarization of Minfin's assets is possible after 2020, when the liquid portion of the National Wealth Fund reaches 7% of GDP, allowing bigger diversification of instruments.
- De-dollarization of the real sector FX assets is the biggest challenge, as the overall preference to FX savings need to be addressed through higher local investment opportunities.
- Otherwise Russian financial stability will remain exposed to the risks related to sanctions (USD) and the euro area banking sector stability (EUR).

Disclaimer