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Russia: Best. Policy. Ever.

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Our recent trip to Russia reinforced our view that Russian ruble debt is very attractive, supported by excellent economic policy. In particular, high real interest rates set by an orthodox central bank, strong and improving fiscal policy, and resultant stabilizing growth and improving external accounts are conspiring to create a self-reinforcing cycle for ruble bonds. In particular, they mean the carry is high and they create the risk of duration rallies both if the central bank maintains tightness (due to ongoing inflation collapse) or if they loosen policy (due to the interest rate curve simply shifting downward). External accounts and growth stabilization support the ruble. In fact, if this continues, a strengthening ruble might reinforce the disinflation trend and create a virtuous cycle for the local currency market, of stable-to-stronger ruble, declining inflation expectations, declining interest rates, inflows and growth supporting a stronger ruble. Fiscal policy anchors the whole thing.

Central bank policy tight and likely to stay that way.

The CBR believes that it has a historic chance to get rid of inflation once and for all and this explains why its real policy rate is among the highest in EM. Even though the CBR resumed rate cuts in the middle of last year bringing the nominal policy rate from 11% to 9.75% in the past nine months, the real policy rate rose from 3.5% to 5.2% during the same period.

There are strong arguments why the CBR is likely to ease more in the coming months. First, businesses routinely use 4% inflation expectations as an input in their internal forecasts - which is a good sign as regards the CBR's credibility and anchoring inflation expectations. Second, high real rates restrain borrowing – especially in the corporate sector – stifling nascent recovery. It is true that many companies in Russia are cash-rich but others need to borrow – especially in sectors that benefit from import-substitution and contribute to growth rebalancing and diversification (agriculture, food production, fertilizers, and chemicals). However, the CBR's singular focus on sustainable disinflation is unlikely to change any time soon which means that policy adjustment will be very gradual and real interest rates will remain attractive going forward.

Fiscal policy strong and improving.

Russia's fiscal performance deteriorated in the past few years with the fiscal gap reaching 3.9% of GDP in 2016 as the country had to deal with the consequences of lower oil prices and sanctions. However, the fiscal framework appears to be on a firmer footing now. The fiscal rule is in place – so the windfall gains from higher oil prices will once again will be saved and used to rebuild the reserve fund. The 3-year fiscal plan looks pretty tight: it is based on fairly conservative assumptions for growth, inflation and the price of oil and envisages reducing fiscal deficit from 3% of GDP in 2017 to 1% in 2019. President Putin and the government understand the value of having fiscal buffers (this includes a proposal to have a build-in rule to spend only a portion of the reserve fund to finance fiscal deficit). There is general understanding that some taxes might need to be higher (the personal income tax rate in Russia is only 13%), and that the current concept of privatization is pretty much exhausted (there are discussions about reducing the government stakes in natural monopolies and companies like the national carrier Aeroflot).

External accounts strong, growth stabilizing, providing support for ruble.

Russia's external balances remain strong. The current account is in surplus (around 2% of GDP last year). The total external debt was virtually unchanged in 2016 at USD518.7bn – way below its peak of USD732bn in Q2-2014. The central bank started to rebuild its international reserves which are now close to USD400bn (30% of GDP) and this strengthens Russia's position as a net sovereign creditor.

Russia's cyclical indicators are turning the corner and this should provide general support for RUB in 2017. The real output growth returned to the positive territory in Q4-2016, the composite PMI is well above 50.0, electricity consumption so far this year is the highest since 2012, and real retail sales and disposable income are gradually rebounding. We also think that lower policy rates and the pent-up demand for maintenance investment should boost

the overall investment growth in 2017/18. Consensus now expects the economy to expand by 1.2% in real terms in 2017 and risks are most likely to the upside.

There are several risks to this view, including structural limits to longer-term growth and the CBR taking its time to cut rates.

There are structural limits to growth longer-term

Russia's potential growth is very low – various estimates point to 1-2% (way below the pre-crisis estimate of 4%). There are multiple reasons why this is the case: (a) oil prices are structurally low and this affects investor confidence, investments and capital inflows; (b) demographic problems are severe (some estimates suggest that the number of youngsters coming to the market in the next 10 years is twice as low as in the past 10 years); (c) other sources of potential growth (catching-up effect and technology transfers after the beginning of the economic transformation in the 1990s) are now depleted. While the current orthodox policy framework was perfect for getting the house in order, it can do little to push Russia's potential growth much higher. The country needs to make some hard decisions to boost potential output including such areas as judicial and governance reform, economic diversification and support for non-oil sectors, and pension reform (people finally started to live longer) - but this is unlikely to happen before the 2019 presidential elections. A good thing is that there seems to be understanding at the top that the change is needed and the general policy agenda seems to be there.

Central bank may take its time in cutting rates

First, inflation expectations remain elevated (especially among the poorer groups of the population) while the labor market remains tight (the rate of unemployment is 5.6%). Second, the government's fiscal policy should still be tested and there is a non-trivial probability that there will be further increase in social payments in the run up to the presidential election which might boost consumption-related inflation pressures. Third, the government's plan to resume FX purchases for the reserve fund is likely to cap RUB appreciation pressures. Even though the FX-CPI pass-through is now lower, it remains asymmetric (stronger on the depreciation side). There is also a residual impact of 2015 depreciation in some commodity groups. The CBR believes it can be relatively more hawkish under these circumstances Finally, the CBR is looking at the experience of countries that successfully introduced inflation targeting in the past and it seems that many of them run very high real interest rates (often north of 4%) for an extended period of time to establish credibility.

Nonetheless, high carry, particularly if it is high in real terms, plus a strong external position, and the hope of ongoing fiscal consolidation mean, in our opinion, that one gets paid a lot of premium while these risks to our view become clearer.

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