Russia

FISCAL DRIVER FOR RATES

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Launching the new monetary easing cycle in Russia last June, the CBR sounded the alarm about backsliding on fiscal policy. It is concerned that the government may start spending the overflow balances of the National Welfare Fund, into which $65 billion has been injected this week. The rates outlook now depends heavily on what the government decides to do about this NWF question and some related matters.

- CBR governor Nabiullina has Putin's trust and is not bluffing: if the CBR's NWF-related concerns are ignored, not only will rate cuts go no further than the 25-50bps implied by guidance for the period until H1/20, but rates might go up again.
- There is much more to this policy debate than a marginal inflation-growth trade-off: at stake is the integrity of the fiscal rule – affecting not only credit fundamentals but also, via the rule's effect of stabilizing the ruble REER, the prospect of sustainably higher potential growth.
- Spending NWF resources would be stagflationary, pointing to aggregate dissaving and higher long-term interest rates – when what is needed, on the contrary, is the launch of the proposed new private pensions investment scheme known as IPC.
- We predict that the government's economic team led by Finance Minister Siluanov will end up heeding the CBR by limiting any NWF spending to overseas projects that support Russian companies' export businesses while having no real BoP impact.
- Pending verification of government 'compliance' going into 2021, the CBR will remain cautious – keeping its policy rate at least 250bps above core inflation; but on this 18-month horizon, more material easing is possible, especially if IPC is in place.

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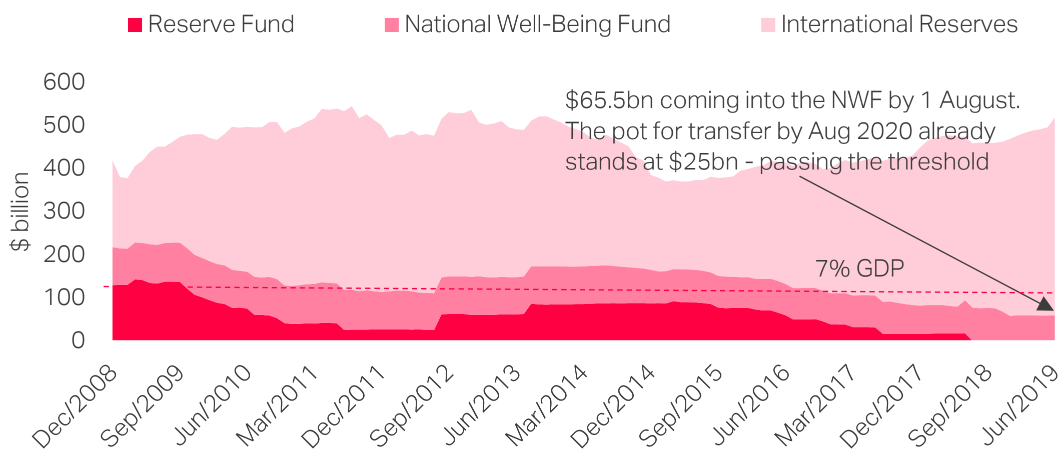
The CBR sounds the alarm

Even as it launched into an easing cycle in June, the CBR raised a red flag on fiscal policy. This warning was repeated in the press release accompanying the second 25bps cut in its policy rate last Friday. The CBR's concerns have to do with a possible decision by the government to spend all or part of the overflow balances of the National Welfare Fund (NWF). This overflow was defined in 2017 as the liquid resources of the fund exceeding 7% of current GDP; and while reaffirming the status of that 7%-of-GDP base as a 'rainy day' fiscal buffer, that 2017 rule permits the government to spend any excess balances above that threshold.

As of yesterday (this timing determined by accounting procedures under the Budget Code), liquid NWF resources will have risen close to the threshold (see chart below). By this time next year, the NWF will have overflow funds which the Finance Ministry forecasts will amount to 1.7% of GDP and indicates will start to be spent from 2021 onwards. The CBR is signalling that monetary policy will have to anticipate any firm prospect of such NWF 'leakage'.

Reserves position



Source: CBR

This fiscal policy question matters for the local rates outlook. Assuming as we do that the CBR will maintain its present independence (this judgment resting on President Putin's repeated demonstrations of confidence in the CBR governor, Elvira Nabiullina), the potential for rate cuts beyond the initial phase of the new easing cycle will depend heavily on government policy decisions. In addition to what the government decides to do with the NWF overflow, other relevant decisions here have to do with the supply side and savings – especially the planned new pension investments scheme.

The CBR will push back against "fiscal dominance". Were the CBR to take a negative view of the government's future decisions on these questions, this would reduce or eliminate the scope for reducing the policy rate by more than the 25-50bps from the present 7.25% level by the first half of next year, as implied by the CBR's latest communication. In the worst case, adverse fiscal policy decisions could result in the CBR hiking rates again.

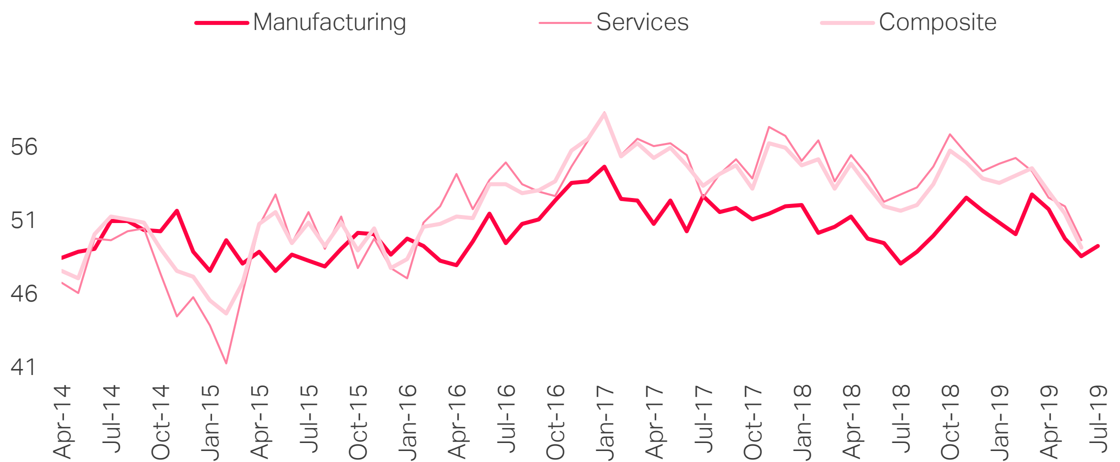
A good perspective on this outlook comes from the CBR's own guidance on the neutral real interest rate as being in the range of 2-3%. The CBR is now saying that it expects inflation to have returned to its 4% target during H1/20 and that the further fall(s) in the policy rate that it expects by then will signify an easing of its monetary policy stance from "moderately tight" to "neutral". This implies that, pending more clarity from the government on fiscal policy,

the CBR will remain cautious – probably keeping real rates towards the upper end of its neutral range. As and when the government does reveal its hand, the CBR could respond by shifting monetary policy in either direction – i.e. including rate hikes in a positive output gap scenario stemming from fiscal loosening.

Why the NWF fuss?

To gauge this prospect properly, we must step back and examine the fundamental reasons for the CBR's concerns. At first sight, this policy tension looks simple enough. GDP growth is running this year well below the Russian economy's in any case modest potential rate of 1.5-2%. When the first official estimate for H1 GDP appears in the middle of this month, it is likely to show real annualized growth of less than 1%. The latest PMI survey data show all indices falling into 'negative' territory (below the 50 mark) for the first time since the depth of the recession that followed the 2014 oil price and geopolitical shocks (see chart below).

PMIs: Worst since the post-2014 recession

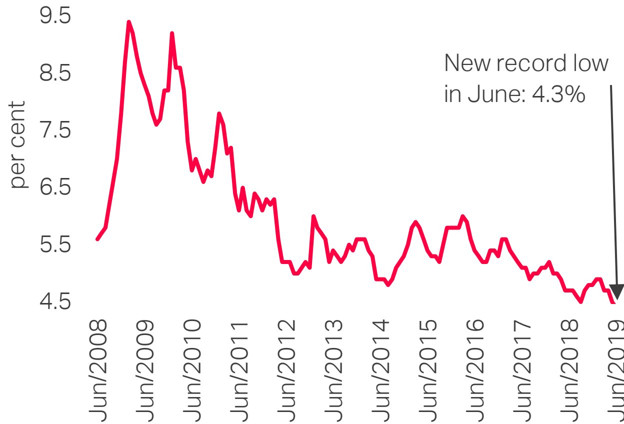


Source: IHS Markit

Some stimulus is expected from budgeted infrastructure spending linked to the new 'national projects' and due to start in earnest during H2. But this stimulus could take longer than that to get going properly, let alone make itself felt in the economy. Against this background, there will be increasing political pressure to put excess fiscal savings to work, rather than leave them invested abroad (the liquid resources of the NWF are held in top-rated OECD government bonds).

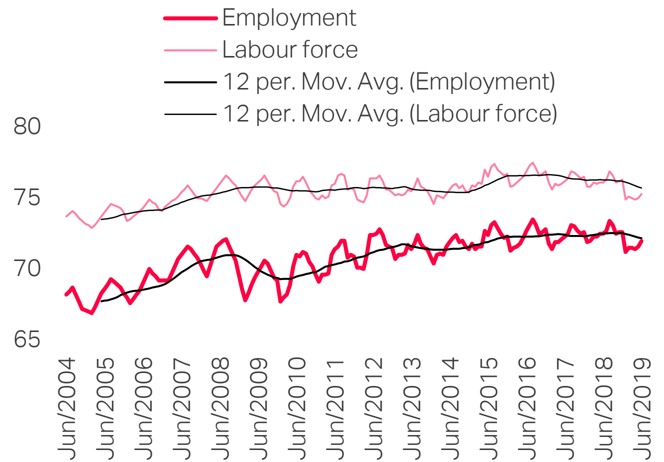
The CBR's objection that any additional budget spending would be inflationary might be justified simply with reference to the labour market. Even though growth is running below potential, the structural demographic pressure on the working age population is now reflected in a labour market that has never been tighter. This year, the unemployment reading has posted record lows with each passing month, while total employment continues to fall (see charts below).

Unemployment rate (ILO definition)



Source: Rosstat

Labour market: demographic pressure



Source: Rosstat

In reality, however, the CBR's concerns run much deeper than the present labour market conditions and the immediate risk of wage inflation pressures. At stake in the government's pending fiscal and related policy choices is the stability and integrity of the entire macroeconomic policy construction. The effects of spending NWF resources would not be limited to creating some additional inflation pressure. Any such move would also impair structural stability and credit fundamentals. Above all, there would be no trade-off with growth – barely even in the short run and certainly not in longer run, since the whole strategy of achieving a sustainably higher potential growth rate would be jeopardized. The roots of these nefarious effects lie in the way that a decision to dip into the NWF to increase federal budget spending would amount to a relaxation of the fiscal rule in only the second year of its full operation.

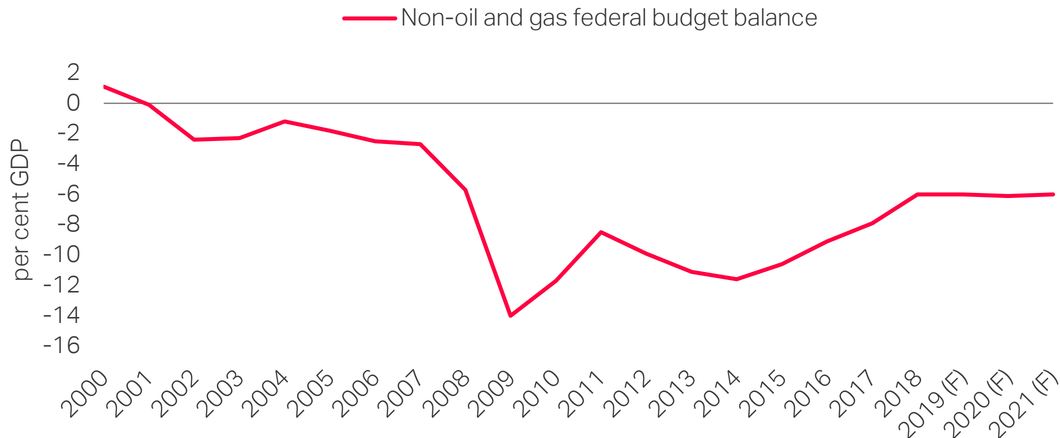
Fiscal rule recalled

The next step in this analysis must therefore be to recall the two key parts of the fiscal rule adopted in 2016. The first places a limit on federal budget spending linked to a reference oil price of $40/bbl (adjusted for US inflation, so that means $41.8/bbl for the present year's budget). In this framework, the funds available to be spent are a combination of all non-oil & gas revenues plus only that portion of oil tax revenues attributable to an oil price up to that reference level. This first part of the rule caps the non-oil & gas deficit at 6.5% of GDP (see chart below).

The second main feature of the rule provides that all 'excess' proceeds of oil & gas taxation must be saved. The route from taxpaying oil & gas companies to the NWF passes through the domestic FX market. The (excess) oil tax proceeds are ruble balances (since all taxes must be paid in rubles) which the Finance Ministry uses to fund foreign currency purchases in the open market. The foreign currency acquired in these FX market interventions under the fiscal rule ('FXFR') is then squirrelled away in the NWF. The liquid core of the NWF – defined, as noted, as 7% of GDP – may be drawn down only to finance programmed spending in the event of the oil price falling below the $40/bbl reference level (such drawdowns are subject to an annual limit of 1% of GDP).

The main benefits of FXFR are to stabilize domestic liquidity and the ruble's REER. On the first – liquidity-related – point, the FXFR mechanism works by returning rubles absorbed through taxes to the banking system.

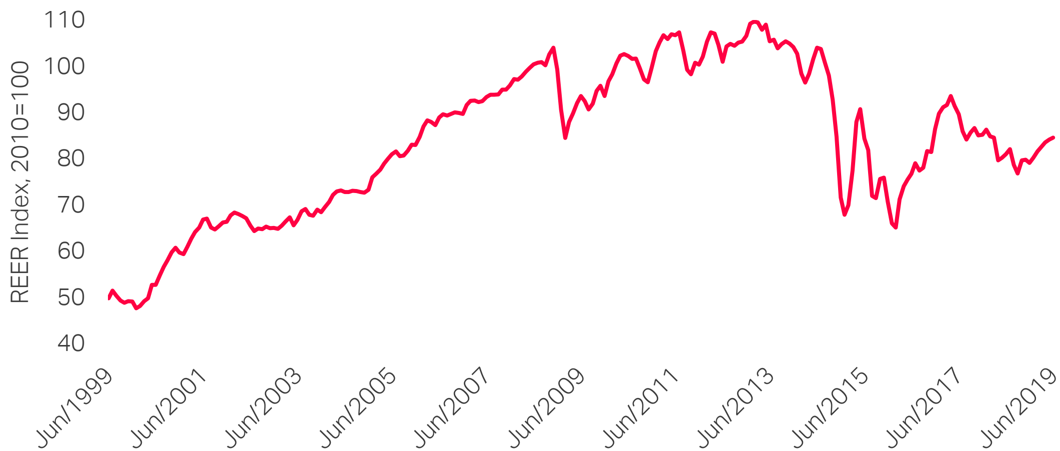
Oil revenue spending capped by the fiscal rule



Source: Ministry of Finance

As for the very important REER point, FXFR stabilizes the nominal exchange rate despite oil price strength. This effect of reducing the correlation between the ruble exchange rate and the oil price was enhanced by a change introduced early last year in the method for fixing the scale of monthly FXFR interventions such that the mechanism has since then been stripping out around two-thirds of the impact of the oil price on the exchange rate. With the nominal exchange rate thus held relatively steady by FXFR, and the CBR's inflation targeting regime meanwhile driving down the CPI, the desired effect of a stable REER is obtained. While the history of the REER shown in the chart below reflects a combination of drivers, the fiscal rule contributes to the trend seen here of REER stabilization.

Ruble REER: held down



Source: BIS

Maintaining by this means a competitive real exchange rate is crucial for the overall strategy of raising potential growth in an investment-led model. This competitiveness creates profitable opportunities in many sectors where Russia has some comparative advantage apart from oil & gas. Put another way, it treats the so-called 'Dutch disease' which severely afflicted the Russian economy during previous episodes of high oil prices since the early 2000s. Other things being equal, the competitive exchange rate should stimulate productivity-enhancing investment, in turn boosting potential growth.

Effects of weakening the fiscal rule

This recap on the features and operation of the fiscal rule makes it easier to see the costs and risks of any backsliding. The drawbacks would play out on a broad front.

- As we have seen, one of the rule's important benefits is to **reduce the vulnerability of the public finances and the wider economy to oil price swings**. Spending a portion of the NWF – that is, excess oil tax revenues – would, in effect, raise the fiscal framework's reference oil price above $40/bbl. So the defences against an oil price collapse would have been weakened. Compromising the fiscal rule is a sure route to deteriorating credit fundamentals and possible rating downgrades.
- If the oil price remains broadly unchanged, an immediate and certain **negative effect would be REER appreciation**. This effect would, in turn, weaken growth prospects.

The extent of the inflationary effect of spending more oil tax revenues would vary according to whether that spending financed efficient government investment (the supply-side expansion balancing some of the demand pressure) or pure consumption (the most inflationary variant). Either way, any desired positive flipside in the form of some incremental demand-led growth would be rapidly countered by the effects of real-terms ruble appreciation. The higher REER would shift the balance of aggregate demand and supply in the sense that much of the increased domestic demand would be met by external supply – in other words, leak out into higher imports, running counter to the strategic policy goal of tapping external demand to boost sustainable growth.

Returning to the other set of drawbacks linked to increased oil price vulnerability, the hazards are greater than may appear from our review of the headline fiscal rules. In reality, Russia's fiscal framework is now based on an oil price not of $40/bbl, but above $50/bbl. The reason for this is that the fiscal rule allows for debt financed spending of 1.5% of GDP – of which 0.5% is new net borrowing designed to fund ambitious infrastructure plans. Another relaxation of the rule introduced last year – and also amounting to nearly 0.5% of GDP – in effect diverts funds that would otherwise have gone to the NWF into domestic gasoline subsidies. The CBR has been relaxed about those relaxations because they are consistent with its inflation goals (infrastructure being financed by borrowing rather than monetizing the fiscal buffers, and the gasoline subsidy stabilizing one of the most sensitive components of the CPI basket). However, pushing the real-life reference oil price up higher than the present level of over $50/bbl would be destabilizing – if only by weakening defences against future shocks.

As far as the REER is concerned, a silver lining of last year's sanctions blows to the ruble is that the present REER is now at a level which, in a balance of payments perspective, would be consistent with a $35/bbl oil price. That amounts to a useful cushion that should not be lightly thrown away – especially given the expected downward direction of the oil price in the medium to long term. Another lost benefit concerns the effect of the fiscal rule in reducing exchange rate volatility – and the spread of that volatility to inflation expectations, asset markets and real output. Since the government's inclination to spend excess NWF resources might be expected to rise in line with the oil price (since it might then seem safer to take some liberties with the fiscal rule), that would make policy more pro-cyclical – in turn aggravating volatility.

The savings urge

The macroeconomic policy framework supports the strategic goal of sustainably higher investment-led growth through various channels. We have already noted several of these channels: low and stable inflation and lower volatility (especially through the exchange rate) facilitate longer-term business planning and investment commitments, while a stable REER increases the range and extent of profitable opportunities. Another benefit of the framework – specifically the inflation targeting regime involving positive real interest rates – is its support for increased long-term domestic savings to finance investment.

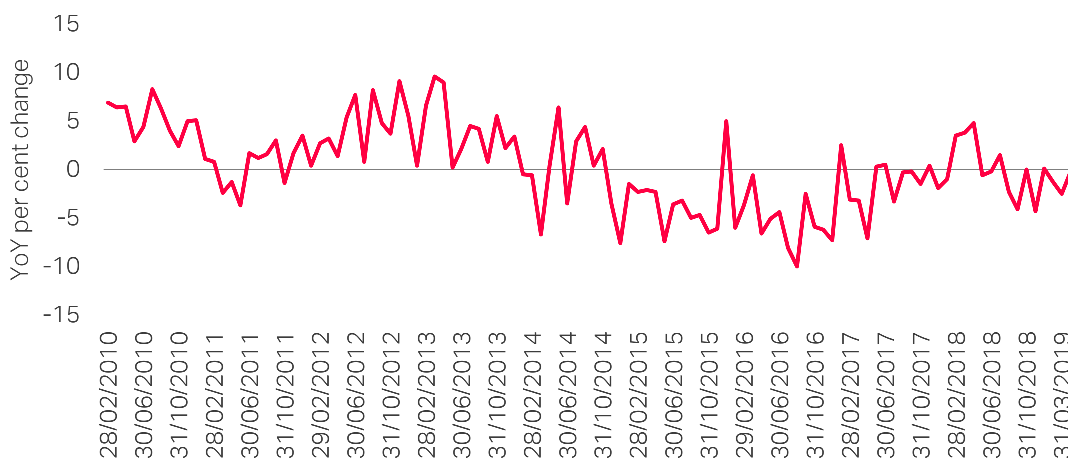
From one angle, the NWF is an example of that increase in long-term money. As we have seen, however, the drawbacks of spending that particular form of savings – i.e. NWF money – outweigh any benefits. Moreover, there is a further flaw in the case for NWF spending that gets to the heart of Russia's growth problem. Finance Minister Siluanov advocates public investment (including, potentially, NWF-funded) as catalysing much more private investment. This looks like a category error. That supposed multiplier effect would only materialize if other pre-conditions for private investment obtained – above all, an improvement in vital aspects of the investment climate like the defence of private property, and the protection of business owners and managers from predatory law enforcement and rubber-stamp law courts.

These 'basics' have been highlighted yet again this year by the shocking Calvey affair. They were re-stated by Nabiullina in a landmark speech on 4 July. Her summing-up deserves quoting in full:

We have all been saying and repeating these things for many years. At first, such statements seemed spot on. Then they began to feel commonplace. Later still, official declarations about improving the investment climate started to seem like empty talk – but now, at times, come across as a cry of despair.

The best available source of increased long-term savings to fund higher private investments comes from households in the form of investible pension pots. "Best" because tapping private savings contains aggregate demand, and "available" in the sense that the government (and CBR) have a readymade plan that goes by the name of "Individual Pension Capital" (IPC) However, the political decision to go ahead with this plan remains in the balance.

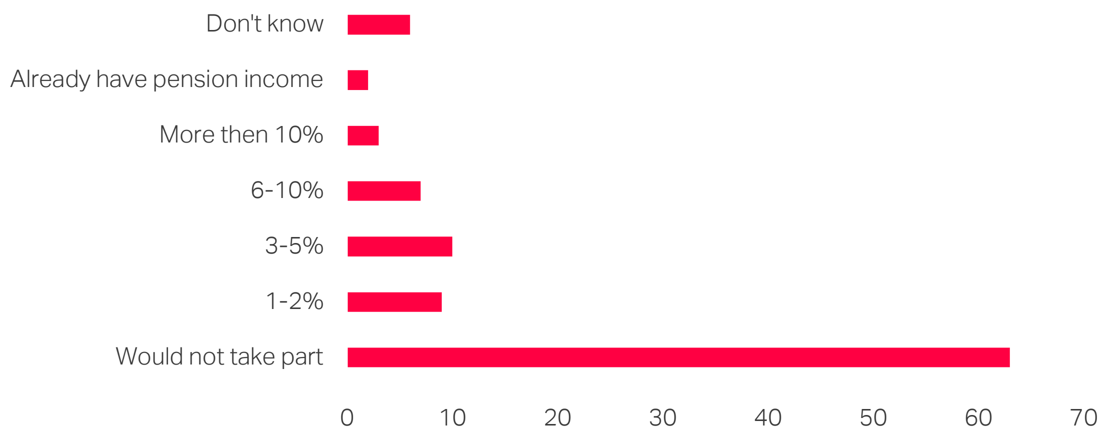
Household incomes



Source: Rosstat (quarterly data)

This pension savings question is linked to our main theme of risks to the fiscal rule in a couple of ways. First, the same lacklustre growth and stagnating living standards (see chart above) that boost the temptation to spend the NWF also make the authorities reluctant to dock people's take-home pay in order to save for their retirement. At the time of writing, Putin's reported position is that IPC may go ahead next year, but only on a purely voluntary basis. There are unlikely to be many volunteers. A survey carried out last May by the Levada Center polling agency revealed that no more than a third of employees would be prepared to enrol in such a scheme. On this evidence (see chart below), the CBR is now proposing to wait another year on the grounds that by then living standards should have recovered somewhat, making it politically easier to launch IPC on what it considers to be the only effective basis of automatic enrolment (with an opt-out provision).

Willing to forego income for pension investment? If so, how much income?



Source: Levada Center

The second read-across from NWF spending to the IPC question is more psychological but still, in our view, real. Softening the budget rule by dipping into the NWF would be negative not only for monetary policy and rates markets but also from the more strategic perspective of mobilizing savings for investment-led growth. If the government thinks it has money to spend, there will be less stimulus to create other forms of saving such as IPC. The end result is aggregate dissaving (and, in particular, by the mid-2020s, net funds outflows from the domestic capital market as previously invested pensions pots are paid out to new retirees), pushing up long-term rates.

Any urgency?

So far, we have considered the reasons why the CBR is exercised by the possibility of the government deciding to spend overflow NWF balances. A final question is "why now" – both in the sense of why the CBR has started sounding the alarm about this, and also from the point of view of the timescale in which this policy driver might move markets.

From a glance at some of the recent newsflow, the matter might not seem too urgent. Siluanov has gone out of his way to say that the government will not take any definitive decisions on future management of the NWF without careful consultation with the CBR and taking into account the wider implications of possible decisions – especially for monetary policy.

For all this caution, the government's direction of travel on this policy front is heading towards at least some spending from the NWF. The plan that has now emerged is to allocate NWF resources to fund lines of export credit. Fiscal policymakers are focused mainly on the creditworthiness of external borrowers, while aiming to support the expansion of non-resource exports is a central plank of the new growth model. The government's budgetary commission meeting on 17 July approved draft amendments to the Budget Code to this effect and earmarked a hefty Rb4.2 trillion for this purpose in 2020-21.

Even more recent events, however, once again appear to downplay the urgency. The Duma Budget Committee held a revealing hearing on 23 July that saw the policymakers rehearse their arguments in public. In the Finance Ministry corner was Siluanov's deputy, Sergey Storchak, while the CBR was represented by Nabiullina's deputy, Ksenia Yudaeva.

- Storchak played everything down: he said that the proposed NWF-funded export credits would not start until 2021; they would be submitted for case-by-case approval to the parliament; and, in any case, not all of the overflow funds in the NWF would be spent.
- Yudaeva replied that none of that dealt with two fundamental objections. Investing NWF resources in illiquid loans to foreign governments was sub-optimal from a reserves management point of view. The second – and main – problem was that even this export credit plan would still mean using oil tax revenues to boost aggregate demand in the Russian economy, and this would increase the ruble REER.

Yudaeva won that round: the Duma Budget Committee recommended against passing those proposed Budget Code amendments.

Investment conclusion

That Budget Committee recommendation will not end the story. The debate will resume after the summer break. Until such time as the government gives up the idea of using the NWF to boost aggregate demand, the CBR will maintain its highly cautious bias in monetary easing. That CBR response would flow in particular from its estimate of the monetary policy lag being 9-18 months. In other words, possible government action in 2021 would need to be 'priced' into monetary policy without delay.

We expect this policy uncertainty – and the related uncertainty surrounding the IPC project – to drag on. Pending more visibility on these fiscal and structural policy decisions, the upside potential for investors exposed to Russian rates looks like being limited to a further 50bps reduction in the policy rate by Q1/20.

As for the outcome on these policy drivers, we predict that the Finance Ministry will end up respecting the CBR's position. This would involve spending a (modest) part of the NWF overflow in a way that did not affect the ruble. For example, vendor finance to South Africa to buy Russian nuclear power stations would mainly fund costs outside Russia with no consequent effect on Russia's BoP. But some risk of leakage into the domestic economy would remain.

If we are right about this being the government's line, the CBR would likely maintain, on a 12-month view, a cautiously neutral monetary stance while verifying the government's 'compliance'. That could mean keeping its policy rate at least 250bps above core inflation. The prospects of easier policy might improve by 2021. By then, any NWF spending will be clearly seen to be innocuous, the pension age increase will have loosened the labour market and, in addition, a satisfactory version of the IPC reform might have been implemented.

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