Alfa-Bank

Macro Insights

AB-ICI: Focus on exchange rate volatility undermines economic confidence

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January 11, 2019 www.alfa-bank.com Moscow

Investment Summary

- AB-ICI remained under pressure, declining by 0.1% m/m in November
- External factors were rather favorable in November, while the market focus turned to the local agenda
- CBR plans to return to forex purchases will force the market to continue monitoring the exchange rate and is negative for confidence

AB-ICI down 0.1% m/m in November

AB-ICI continued to deteriorate, dropping 0.1% m/m in November

The AB-ICI remained subdued in November, declining 0.1% m/m. The underperformance was due to the fragility of the deposit base and market nervousness over sanctions.

Economic confidence under pressure due to ruble deposit outflows

- **Economic confidence** continued to deteriorate in November, amplified by a decline in ruble-denominated retail deposits, which dropped in November by 0.2% m/m and reached only 8% growth in annual terms. Ruble deposit nervousness is assumed to be a reflection of inflationary fears, which forced the population to reduce exposure to ruble-denominated assets. By Contrast, the reliance on foreign currency increased in November, as retail forex-denominated deposits increased by $1 bn, almost reaching their August level of $88 bn, and accounted for 21.3% of total deposits.

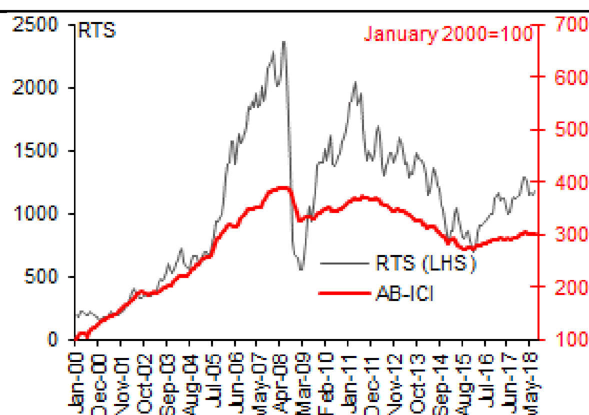
Market confidence remained unchanged but sentiment appears weak due to the lower duration

- **Market confidence** remained unchanged in November. Although the RTS index remained flat vs. October and the CDS returned to October's level, there were no new Russian bonds issued in November and the slight decline in the duration of corporate bonds implies weakness in market sentiment.

Share of foreign banks increased slightly to 7.0% of assets vs. 6.8% at the end of 2017

- **Foreign confidence** demonstrated some improvement in November; however, this seems to be a temporal trend resulting from short-term corporate account inflows. As of November 2018, foreign banks accounted for 7.0% of total Russian banking assets vs. 6.8% at end-2017.

Fig. 1: AB-ICI and RTS Index: AB-ICI down 0.1% m/m in November



Source: RTS, Alfa Bank

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In a relatively favorable external environment, the Russian market was concerned about local issues

Entering November, the Russian market was concerned about the outcome of the US mid-term election, which turned out to be neutral from a Russia perspective. However, the de-escalation in US sanctions rhetoric and speculation the US Treasury Department would remove sanctions from three companies related to Oleg Deripaska were offset by tensions between Ukraine and Russia (an incident in the Kerch Strait) – a situation, which prevented a strong recovery in economic sentiment.

The pause in the budget rule mechanism in September points uncertainty regarding the local policy mix

The main issue regarding local economic policy in November was the introduction of changes to the Russian budget rule, which in its current form compels the cabinet to save oil revenues in excess of $40 per barrel and to convert those funds from rubles into foreign currency on the open market. These transactions were executed by the CBR. In August, the budget rule was amended due to high volatility on the FX market, prompting the CBR to halt forex purchases on behalf of the Finance Ministry. However, the issue with the budget rule implementation seems to be more than just a question of financial stability risk that demanded action from the CBR in September.

Russian budget rule was drafted for the environment of the capital inflows, which is not the case…

The first issue is related to the budget rule in relation to the balance of payment dynamics. The current budget rule looks effective in an environment of moderately high oil prices and moderate net capital inflows, which were the case when the budget rule was implemented in 2017. However, the combination of rising oil prices and increasing net capital outflows, experienced by the Russian economy in 2018, rendered this rule unsustainable from an exchange rate perspective. The persisting fear of sanctions may cause weakness in the capital account and undermine the base of the budget rule.

…and for the period of low interest rates which are now raising

Secondly, the current budget rule was ideally drafted for the period of low global interest rates which incentivized the government to follow a borrowing strategy. This strategy emerges from the relationship between the budget breakeven oil price and the budget rule oil price. While the breakeven oil price is estimated to be above $50 per barrel, the budget rule sets the benchmark oil price at $40. The gap between these two prices suggests that the government is forced to rely on borrowing to cover the deficit. However, in an environment of increasing global interest rates, the strategy of replacing oil revenues by debt borrowing may become too expensive.

Uncertainty around the budget rule will keep market focused on the exchange rate and exert a pressure on the AB-ICI index

Despite the challenges the budget rule faces from the current economic environment, it does not look like the CBR plans to implement any amendments. The regulator has recently confirmed its decision to return to the market with forex purchases on behalf of the Finance Ministry from 15 January. In a way, the decline in oil prices, to around $60 per barrel (Urals), provides the CBR with a means to return to the market without substantially damaging the ruble exchange rate – current oil prices imply monthly purchases of around $3-4 bn, which is half the amount of June-August 2018. At the same time, the framework of the purchases will remain unchanged – i.e. the CBR will commit to fixed amounts of daily purchases – which is a negative development. This method of budget rule execution deprives the CBR of flexibility - in case of unexpected negative changes to the external environment, it may again have to resort to a new round of manual adjustments. This implies that the market will remain focused on exchange rate volatility, an environment which will keep economic confidence under pressure.

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This document is published on a monthly basis.

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