Country monitoring: Russia

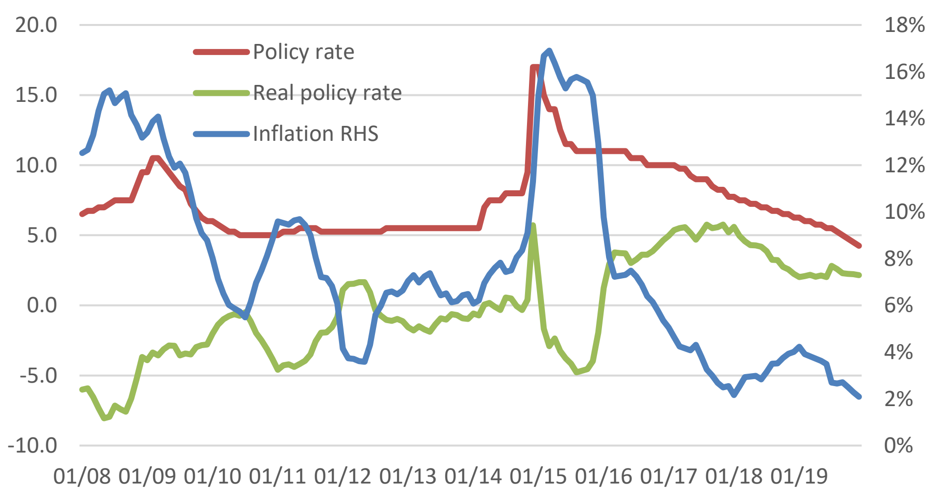
Inflation has bottomed, but rates have not

January inflation posted a new low of 2.2% yoy, down from 2.5%, continuing to surprise both the consensus and the CBR's forecasts to the downside. Our models suggest that we are close to the bottom of inflation but, fundamentally, price pressure will remain weak in 2018-19E, leaving ample space for easing ahead (200bp this year and 150bp in 2019, much more than consensus expectations). The ongoing restructuring of corporate balance sheets, the sanctions and the lower crude price than before are contributing to the disinflation phase.

Our estimates for debt servicing costs for a standard mortgage suggest that affordability should improve greatly as a result of the easing cycle, which should prove to be an important stabilising mechanism for the country. We note that, although we see scope for rate cuts (200bps this year and a further 150bps in 2019), we may also see increased macroprudential measures and selective increases in capital requirements for some financial institutions as the central bank aims to limit excessively aggressive lending practices.

Headline inflation has continued to drop rapidly in Russia, thanks partly to a favourable harvest, but also because the traditional demand-led price pressures are muted, by historical standards. Here, we present some important indicators describing this. Surveys on households' inflation expectations show increasing anchoring around the 4% target for the CBR. Although the unemployment rate is low, job creation is modest and this is very visible in the very low wage growth (for Russian standards). It is true that real wage growth has recovered thanks to falling inflation, but the nominal growth pace has been stuck at low single digits, and was even negative in December. Services inflation is the lowest since 2012, while goods inflation is the lowest since at least 2002.

Inflation and rates outlook

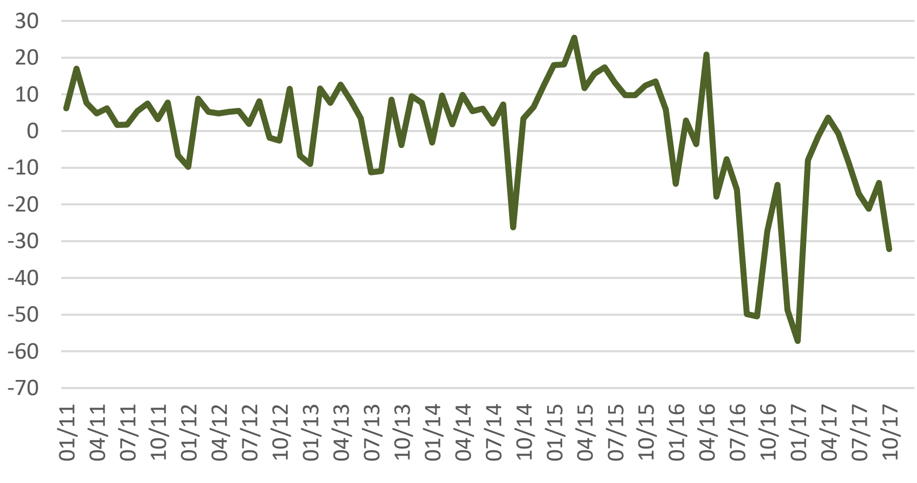


Source: Macrobond, ADA Economics Ltd, %

Russia is halfway through a corporate sector restructuring, in our view, which is a powerful driver of the disinflation phase that has been visible for the past year and a half. Of course, lower oil prices than previous business cycles and the sanctions are contributing to this adjustment. To appreciate the magnitude of the balance sheet strain, the two charts below say it all, in our view: the total debt of non-financial corporations relative to GDP according to the financial accounts data set – which is the most comprehensive way of measuring total financial assets and liabilities in a country. Deleveraging is taking place, and the latest CBR data only refers to 1Q17, so there is likely more than what the chart shows, but the legacy stock is significant. The second chart shows the difference in the number of new companies created and the number of companies shut down. Since 2015, the difference has often been heavily negative – a testimony to the consolidation that is taking place.

Our models suggest that January may prove to be the low point for inflation: the effects of the favourable harvest and past RUB appreciation are almost over, while wages should rebound modestly from the low 4Q average reading. That said, we believe it will be difficult to bring inflation, on a sustainable basis, to or above the 4% target amid the current conditions in 2018E and 2019E. First, although there maybe pressure for the RUB to recover from the current levels, the authorities do not have an incentive to allow much appreciation, part of the oil impact on the currency is offset by the MOF intervention and foreigners are already fairly heavily positioned in the local bond market. Secondly, in our experience, corporate sector balance sheet restructuring phases can last five years, easily, and the debt load in Russia would strongly indicate that this is likely to be the case. As a result, pressure on wages should stay low, which eliminates a key influence on inflation in the medium term.

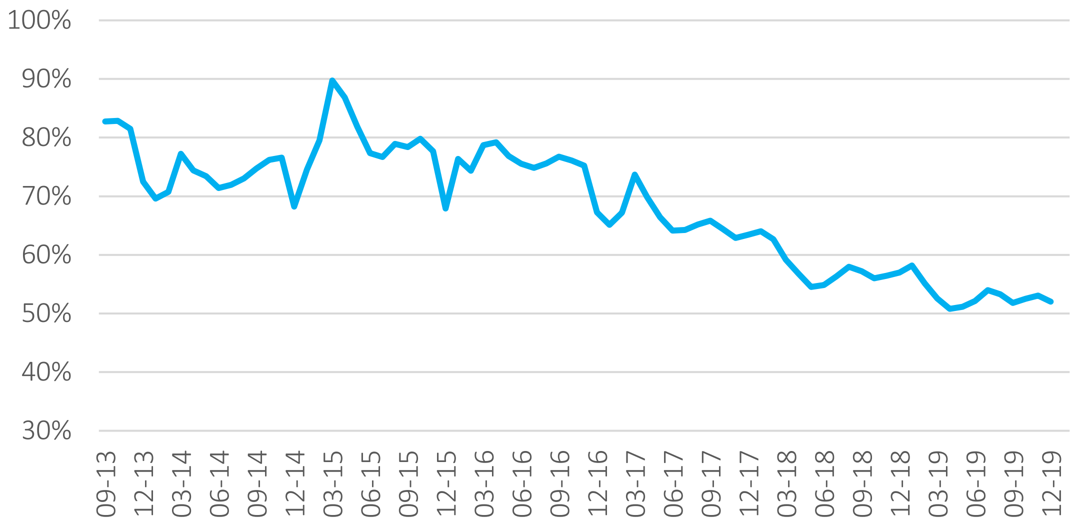
Difference between the newly established and the closed companies



Source: Macrobond, ADA Economics Ltd, %

We note that we have not changed our real GDP growth estimate for this year or the next – stuck at a conservative 1.5% – notwithstanding that oil prices, on average, may prove higher than what we assumed in our year-ahead report (USD 65/bbl potentially, going forward, rather than the USD 55/bbl we had assumed). The reason for our stubborn position is that, when we look at the key drivers of GDP growth on a sustainable basis, broad money growth (M2) proves to be a very good leading indicator. However, so far, broad money growth is stable at around 10-12% yoy, which is too low to push growth to 2% or higher on a sustained basis. That said, we note that some changes are taking place in the credit survey data, which may change our forecasts in the future. Lending activity has picked up – this is due partly to the RUB weakness, but also partly reflects the improved affordability of loans. Also, deposits and debt securities that do not classify in M2 are rising much faster than the deposits included in M2. This, in time, may lead to a pick-up in M2, if some of that liquidity is moved into products with shorter maturities.

Debt servicing costs in % of avg wage for a standard 15-yr loan in RUB



Source: Macrobond, ADA Economics Ltd, %

To illustrate the impact of the easing cycle, so far and going forward, we have made back-of-the-envelope calculations for debt-servicing costs for an individual with average monthly income taking out a 15-year mortgage, with a 20% downpayment on a RUB mortgage. We have taken the price quotes for an average price of a small (50sqm) apartment outside the city centre. We compute these calculations for all the countries in our space: it is not a perfect measure as it cannot capture the dispersion in prices and incomes, but it is a solid benchmark to measure if mortgages are affordable and how the trend is unfolding, given the rise in house prices and wages. We have assumed that average wages rise by 5% this year and 6% next year, house prices up by 3% per year in 2018 and 2019, on average, and interest rates falling eventually to 4.25% by the end of 2019, from 7.75% currently. We have also assumed that the current average 200bps spread between the policy rate and retail lending rates will be kept this year, but that it will widen to 250bps next year. This is an adjustment that sounds plausible, given the fast easing and the international experience of countries in similar situations. The results are shown below. Although Russia would not become equivalent to CEE in terms of affordability (debt servicing costs are at around 35-40% maximum), the improvement is noticeable.

Our reading of the central bank's communication is that the bank will not signal aggressive easing ahead, but will continue to guide the market in a gradual fashion and will be happy to reduce the policy rate, as long as the implied current real interest is not lower than 1.5-2%. The CBR, in our view, has also signalled clearly that it will actively use macroprundential measures to make sure that the reduction in the policy rate does not fuel excessive leverage and lending practices. As a result, we would not be surprised if some financial institutions see their capital requirements increased in the coming year and, with time, lending practices may also be tightened.

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