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Russia's Path to Credit Strength Amid Biting Sanctions

Almost five years ago, the United States and the European Union imposed biting sanctions on Russia following its annexation of Crimea, and more sanctions have been added in the subsequent years. However, in the face of the sanctions, the Russian economy appears relatively resilient, and the government has yet to experience an obvious popular backlash. While Russia's economic growth will likely remain subdued amid its worrying demographics, lacking structural reforms, and reliance on commodities (primarily oil) in the real economy, we think the authorities will stay on the prudent path that they have forged in recent years. This situation is not expected to change unless additionally severe sanctions (such as the ban on purchasing new Eurobonds or a complete ban on trade) are imposed.

Those prospects remain uncertain as the U.S. Congress has introduced important legislation, but it is unclear whether it will be approved. Meanwhile, the newly formed European parliament may be less inclined to escalate sanctions against Russia. If additional sanctions eventually emerge, Russia's potential response would only add to the uncertainty.

Given the state of the Russian economy and the uncertainties that lie ahead, this paper analyzes how Russia has coped with the sanctions thus far, what might lie ahead in the coming months and years, and how this might affect its strong credit profile going forward.

Of Election Interference and Other "Malign" Activities

Since its annexation of Crimea in March 2014, the sanctions on Russia have broadened in response to its interference in the 2016 U.S. presidential elections, its role in the Syrian civil war, the alleged use of chemical weapons in the UK, and its hostile activities against the U.S. more generally.

The initial sanctions targeted individuals and entities that either had ties to, or were supportive of, the Russian war effort in Ukraine. Over time, the sanctions expanded to include key sectors of the Russian economy (defense, energy, and finance) including, but not limited to, systemically important banks, such as VTB and Sberbank, and energy giants, such as Rosneft and Gazprom.

In August 2017, the Countering America's Adversaries Through Sanctions Act (CAATSA) added more teeth to the sanctions by mandating that secondary sanctions be applied to countries, firms, and/or individuals that engaged in "significant transactions" with Russia's defense or intelligence sectors, while also targeting foreign investments in Russia's energy sector. The CAATSA law was first used in March 2018 when the U.S. administration sanctioned Russian individuals and entities indicted in Special Prosecutor Robert Mueller's investigation into Moscow's meddling in the 2016 elections. Importantly, the CAATSA gave the U.S. Congress substantial powers to impose or lift sanctions, effectively requiring broad Congressional support to remove the sanctions.

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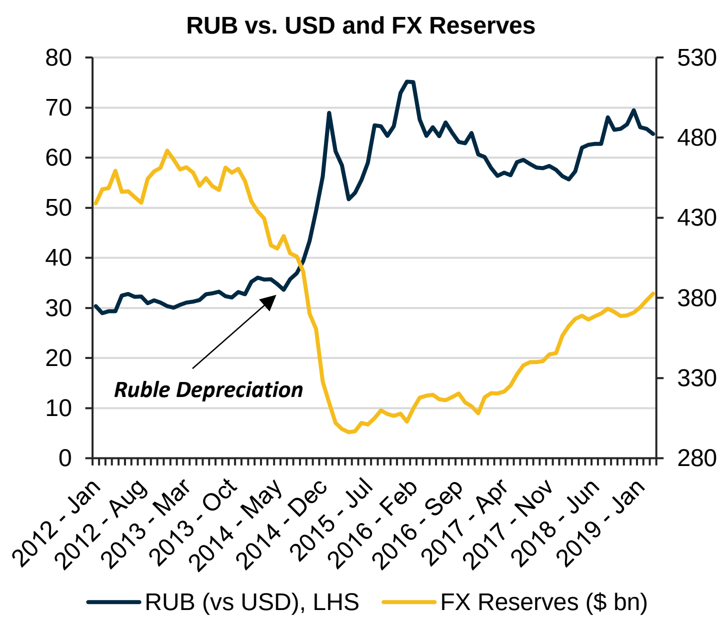
In addition, Russia's alleged interference in the 2018 U.S. mid-term elections and its general efforts to challenge traditional spheres of U.S. influence create an impression that the sanctions regime placed on Russia is permanent. This impression has been reinforced by the forthcoming sanctions under the Chemical and Biological Weapons and Warfare Elimination Act—the proposed bi-partisan legislation under the Defending American Security from the Kremlin Aggression Act (DASKAA) of 2019—as well as Russia's measures to reduce its vulnerability to future U.S. sanctions (e.g. by reducing the Central Bank's dollar holdings, etc.). If approved in its currently proposed form, DASKA would be particularly painful for Russia as it would block investment into the country's new sovereign debt offerings and introduce new measures targeting the banking and energy sectors.

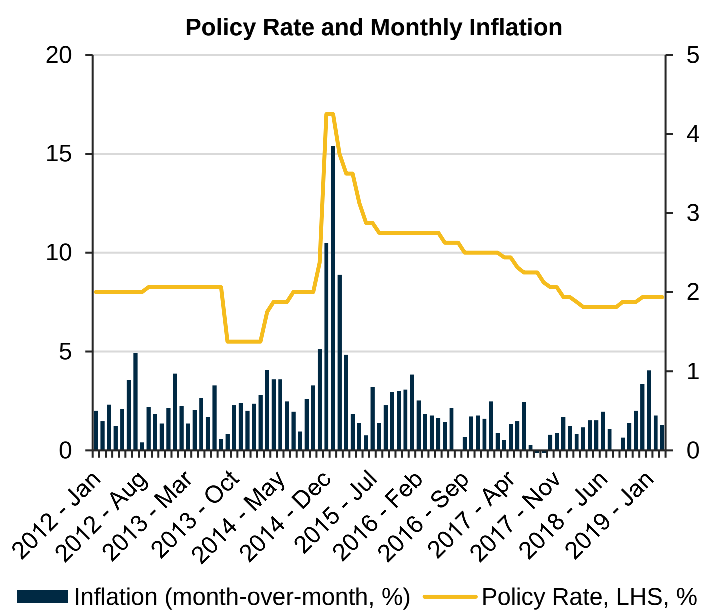
If the sanctions against Russia were designed to inflict economic pain, deter further aggressive military action in Ukraine or elsewhere, prevent interference in democratic elections, reduce intelligence gathering capabilities in the West, and punish it for using banned chemical weapons in a foreign country, the results have been mixed at best. For example, on the economic front, while the population's living standards and the foreign investment environment have deteriorated, the broader effect of the sanctions may have been stymied to this point as Russia has simultaneously achieved macroeconomic stability and a stronger external financial position.

The Path to Macroeconomic Stability Amid Disappointing Growth

The invasion of Crimea and the secession in the Eastern Ukrainian Donbass region took place shortly before oil prices tumbled from $120 per barrel to about $50 per barrel. The Russian economy, therefore, was hit by the double shock of sanctions and sharply declining oil prices. The authorities' first reaction was predictable and one previously seen in other emerging markets: they tried to control the currency depreciation by hiking interest rates and by using FX reserves, which were about $450 billion at the end of 2013, i.e. before the oil shock and the invasion of Crimea. Figure 1 shows the decline of the ruble vs. the U.S. dollar and the decline in FX reserves in late 2014. Ultimately, in December 2014, the Central Bank of Russia switched to a regime of pure inflation targeting and a free-floating exchange rate. It started cutting the policy rate once monthly inflation started to decline (see Figure 2), and meanwhile, the Ministry of Finance was starting to adopt a very prudent stance.

Figures 1 and 2: Ruble vs. USD and FX Reserves; Policy Rate and Monthly Inflation



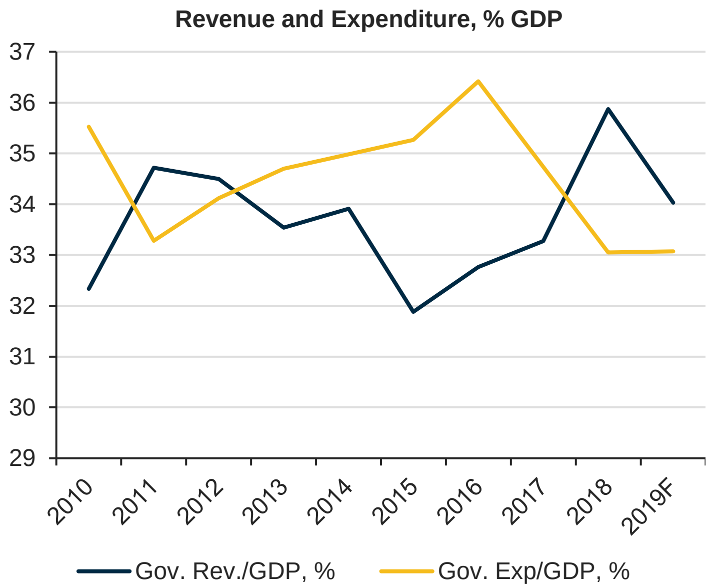


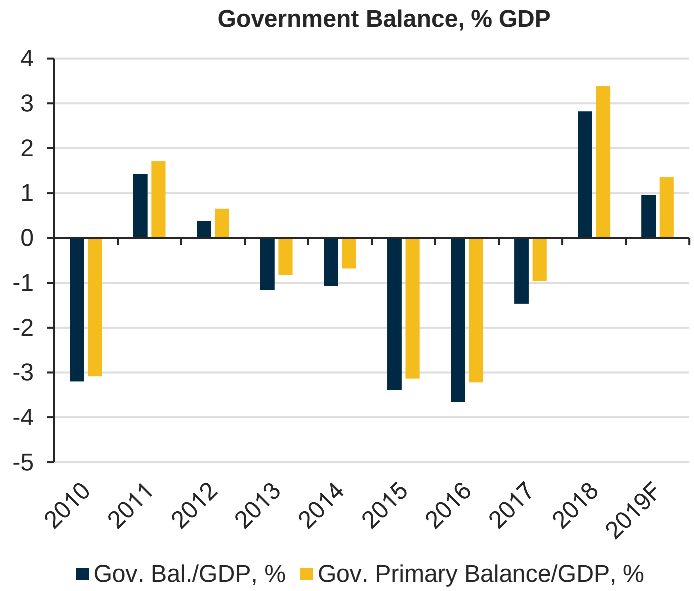
Source: Haver Analytics as of May 2019

The objective of the very orthodox policy adopted at the end of 2014 was to quickly rein in inflation, thus limiting an already sizeable decline in households' purchasing power and consumption that, in turn, prevented any major form of widespread economic dissatisfaction.

The other crucial element of the macroeconomic adjustment process was the adoption of a prudent fiscal policy. This took some time as the economy was in recession and the authorities had to face the negative impact of sanctions and the Crimea annexation. Figures 3 and 4 show how the authorities entered a more prudent fiscal phase in 2017 that culminated in recording a sizeable surplus in 2018, thanks to higher oil prices. Recent budgets assume an oil price of around $40 per barrel, and the increased revenues due to higher oil prices have gone to the country's sovereign wealth fund rather than increased expenditures.[1]

Figures 3 and 4: Revenue and Expenditure; Government Balance

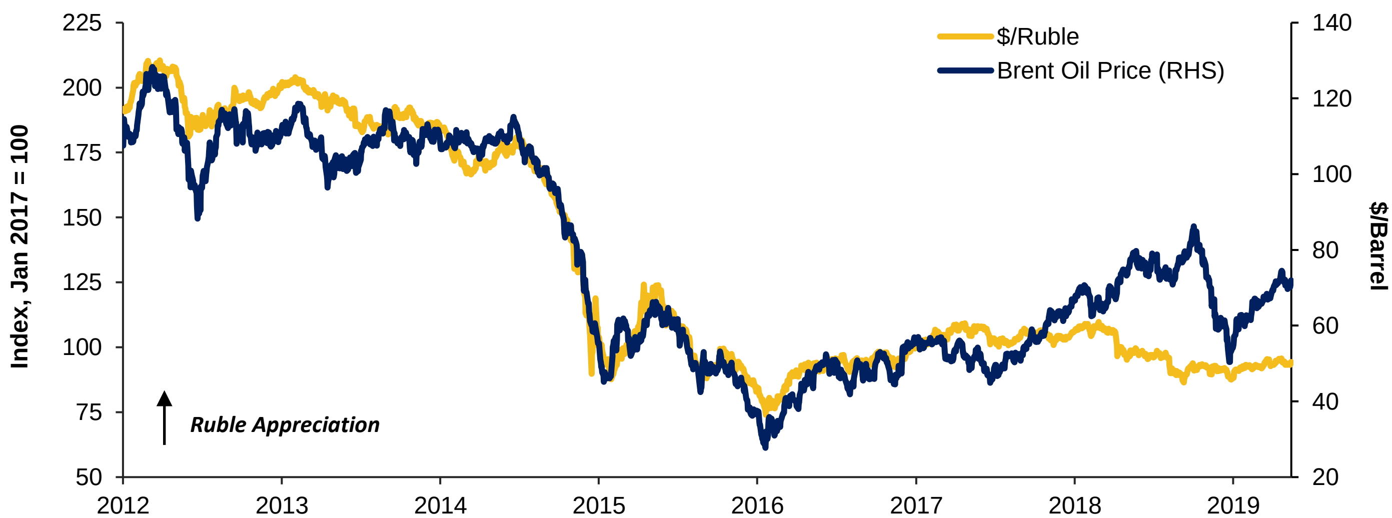




Source: International Monetary Fund as of May 2019

The combination of orthodox monetary policy, prudent fiscal policy, and a bit of luck (high oil prices) has thus allowed Russia to record a strong current account surplus (2018's level was due to stagnant imports and an increase in oil exports; see Figure 6). From a macroeconomic point of view, Russian authorities succeeded in stabilizing the economy, rebuilding its foreign exchange reserves, lowering its debt-to-GDP ratio, and putting the country in a much safer financial situation. In fact, existing sanctions, the threat of additional sanctions, and the newly-adopted fiscal stance facilitated a more independent monetary policy given that the ruble exchange rate has become less correlated with oil prices (see Figure 5).

Figure 5: While Closely Correlated Historically, the Ruble Exchange Rate and Brent Crude Prices Have Recently Diverged



Source: Haver Analytics as of May 2019

[1] *See: Apurva Sanghi and Naoko Kojo, Will Russia's new fiscal rule end its oil and gas dependence?, December 6 2017, Brookings* *https://www.brookings.edu/blog/future-development/2017/12/06/will-russias-new-fiscal-rule-end-its-oil-and-gas-dependence/*

Figure 6: Russia's Current Account (Q4 Avg.)

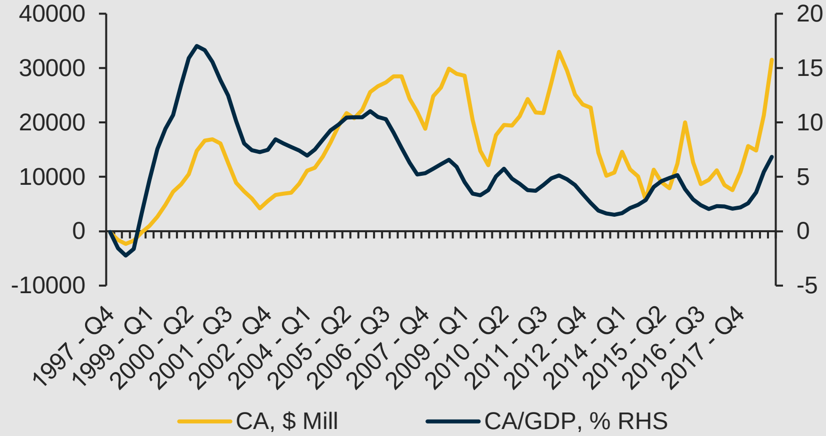


Figure 7: GDP Growth, Export Prices (% YoY)

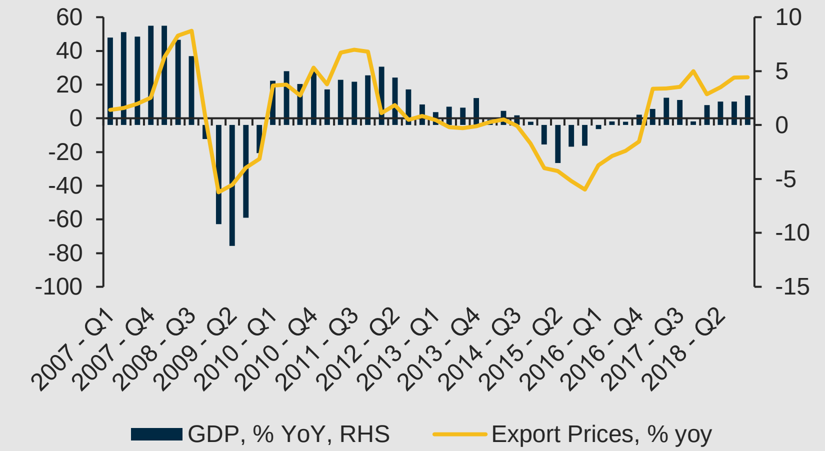
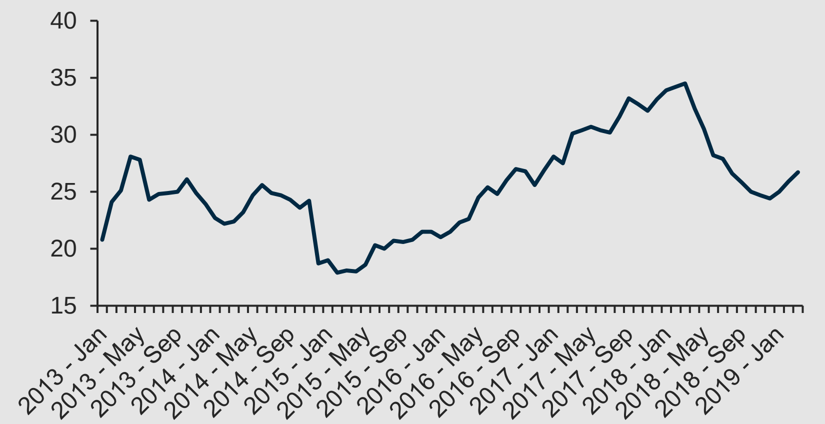


Figure 8: Non-Resident Holdings of OFZ, %



Source for Figures 5, 6, and 7: Haver Analytics as of May 2019

But growth is picking up only marginally, and unemployment remains under control mostly thanks to an aging population and the expanding service sector.

It is not clear what impact sanctions have had on the real economy. On the one hand productivity is growing at 2.5% and accelerating. On the other hand, the rate of GDP growth is similar to that in the period before 2014—a disappointing outcome given the recession in 2015—and remains highly dependent on oil and oil prices (see Figure 7). Furthermore, aside from the pension reform, structural reform remains absent—yet that is part of the macroeconomic adjustment.

As a matter of fact, the only truly structural reform has been the imposition of Russian sanctions on EU agricultural goods, which contributed to an improvement in the Russian agricultural sector to the point that the country is now a leading exporter of many agricultural commodities (the weaker ruble has helped as well).[2] The investment climate and property rights remain weak, as the recent incarceration of a prominent foreign investor indicates, and the government keeps a strong control on the economy.[3] Therefore, it is difficult to say that sanctions have broadly contributed to Russia's slow growth trend. They have affected some sectors more than others but, overall, the growth trend has not changed significantly between the 2011-13 and the 2016-18 periods.

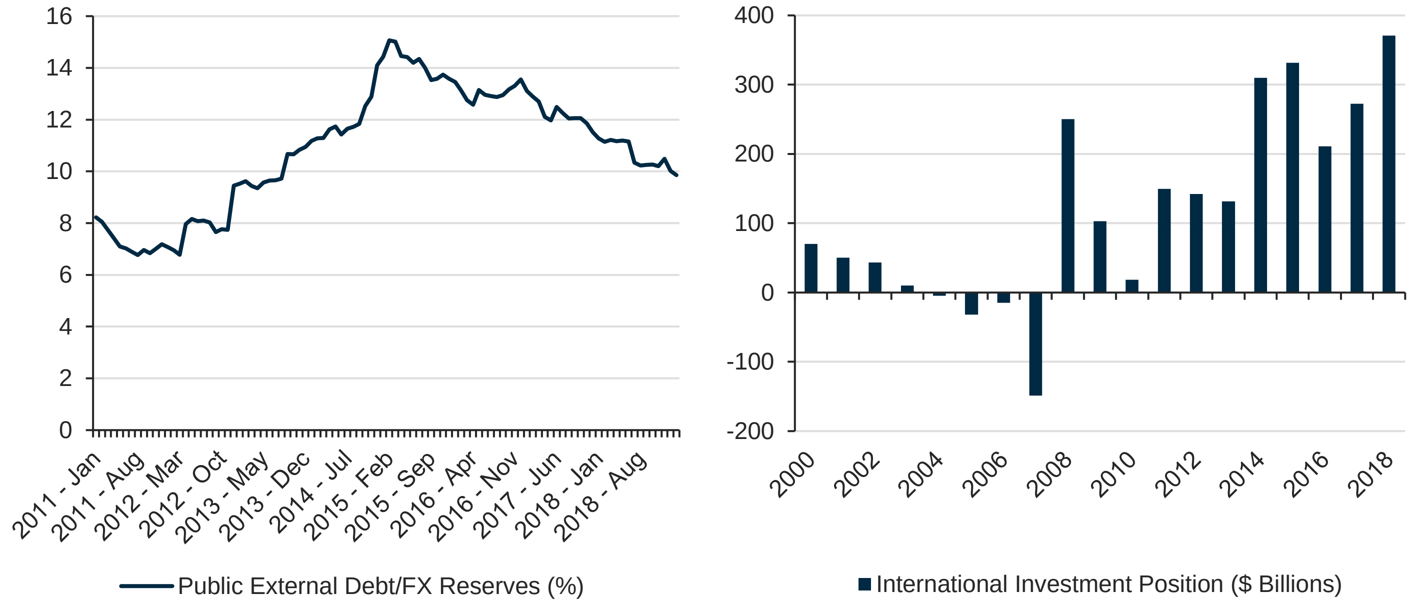
From a financial point of view, the clearest indication of the impact of sanctions is the share of OFZ—the federal RUB-denominated bonds—held by foreigners. Figure 8 clearly shows the impact from the biting sanctions imposed in the Spring of 2018. More recently, foreign investors have returned to the local market, perhaps due to perceptions of reduced risk of additional sanctions and/or the authorities' continued appropriate macroeconomic stance.

However, from the perspective of a holder of dollar-denominated Russian bonds, the country appears to be a remarkably safe credit. Public external debt is about 10% of the current FX reserves (Figure 9) and the net International Investment Position is at a record level (Figure 10). In addition, amongst EM credits, Russia and Botswana have the lowest debt-to-GDP ratios at 14%.

[2] *Russian agriculture sector flourishes amid sanctions, Financial Times, April 19, 2017, https://www.ft.com/content/422a8252-2443-11e7-8691-d5f7e0cd0a16*

[3] *Calvey's arrest sends chill through Russia's foreign investors, Financial Times, February 18, 2019, https://www.ft.com/content/fc2f021a-32ae-11e9-bd3a-8b2a211d90d5*

Figures 9 and 10: Public External Debt/FX Reserves (%); Net International Investment Position



Source: Haver Analytics as of May 2019

Combined with Russia's strong ability to pay, it is perceived to have a strong willingness to pay as well. Russians—from the president to the common citizen—remember the humiliation of its 1998 debt default, which they appear committed not to repeat in the future.

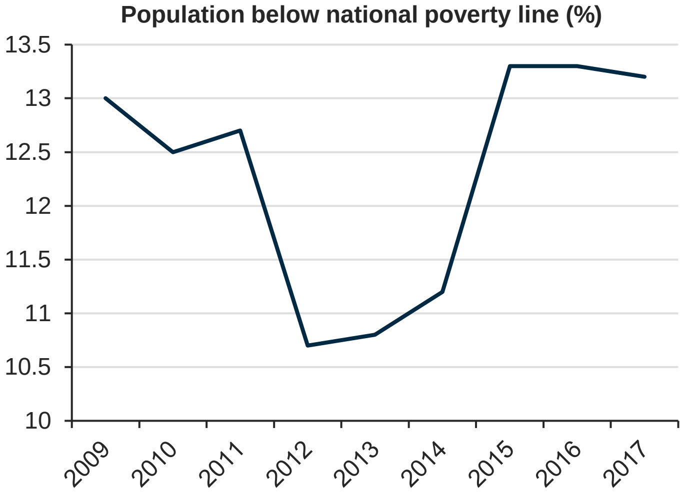
So far, Western sanctions have affected the Russian economy up to a point, and the country is financially stronger than in 2014, although many structural challenges have yet to be addressed. Going forward, the crucial questions for investors are whether this situation is going to continue, whether one should expect more biting sanctions in the future, how Russia might consequently respond, and how its credit profile may change.

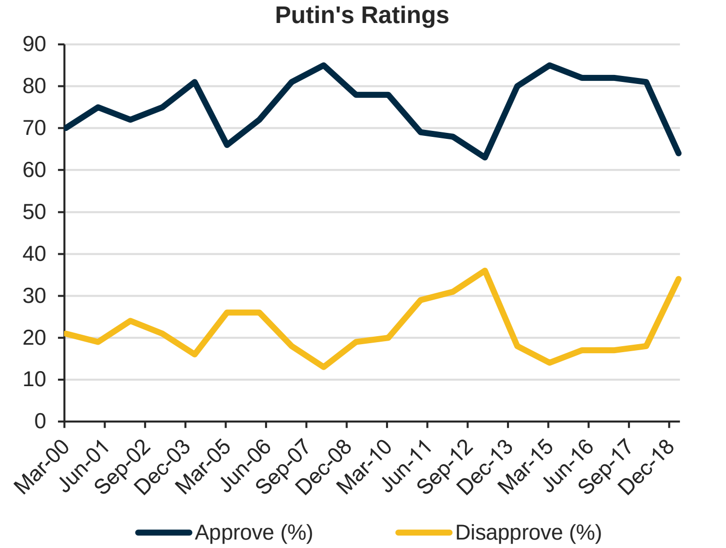
The Outlook

While Russia's financial position has improved, this contrasts Russians' living standards as the percentage of the population living below the poverty line has increased and is above levels from a decade earlier (see Figure 11). Although President Putin generally remains popular, his approval rating has declined to the lows from just before the annexation of Crimea amid the deterioration in living standards and the introduction of unpopular pension reform, which entails a higher retirement age. The rise in Putin's approval rating from early 2014 came amid the annexation of Crimea—not as a reaction to the sanctions imposed by the U.S. and the EU—suggesting that sanctions have not boosted Putin's standing among Russians (see Figure 12).[4]

[4] *Back in 2011-2013, the decline in the President's approval rating was due to poor delivery of social services that had fueled popular dissatisfaction especially outside Moscow.*

Figures 11 and 12: As the Percent of Russians Living Below the Poverty Line has Increased, Putin's Generally-Favourable Ratings Have Declined.





Sources: Figure 11, the World Bank; Figure 12, Levada Centre as of April 2019

Another way to gauge Russians' disenchantment with Putin and their concerns about living standards is to look at what they think about their country's past when the state was seen ensuring social justice. For example, an April 16, 2019 poll by the Moscow-based Levada Center showed 70% of Russians thought Joseph Stalin's rule was good for the country, with another 51% viewing Stalin himself positively.

Popular dissatisfaction has not yet found a political outlet as opposition parties remain marginal and opposition leaders are often subject to police action. In addition, the recent sovereign internet law may further enhance the government's control over the opposition. As a result, President Putin does not face any real political threat at present: his grip on power remains firm, and he will likely continue with his policies, both domestically and internationally, at least until his term expires in 2024.

As 2024 approaches, the issue of Putin's succession will increase in importance. Investors are likely to focus on whether Putin leaves office, as mandated by the constitution, or whether he chooses to follow the example of other strong leaders (in China, Egypt, and Turkey, for example) who recently changed their countries' constitutions to secure longer terms in office. It is very difficult to assess the potential market reaction if Putin follows the path taken by Turkey's Erdogan or Egypt's Sisi. In recent episodes, markets reacted positively when sound macroeconomic policies were pursued (as in the case of Egypt); or negatively when macroeconomic policies were unsound (as in the case of Turkey).

Potential Scenarios and Bondholder Implications

Looking ahead, then, we evaluate four possible scenarios and the potential implications for bondholders.

Scenario A (60% probability): No changes in Western policy, i.e., piecemeal sanctions affecting people without significantly affecting the Russian economy.

In this scenario, the Russian economy will keep moving along recent trends: the state would play an even more significant role, diversification from oil would continue very slowly, and macroeconomic policy would remain prudent. It would remain a favorable environment for bondholders.

Scenario B (20% probability): Escalation of sanctions—such as a ban on buying sovereign Eurobonds—that significantly affects the Russian economy.

In this scenario, Russian companies and the sovereign would be unable to access capital markets. The economy would probably become more and more dependent on the state, and capital flight would likely resume. In terms of existing holders of dollar-denominated debt, the outstanding Eurobonds would probably be honored for reputational reasons, which could be beneficial to the sovereign bondholders, who may also benefit from some scarcity value. It would be more complicated for companies to keep doing business with limited access to credit, and corporate bondholders would need to assess each company individually (although the state would likely rescue "strategic" companies). GDP growth would be much more subdued, and the economy would be even more exposed to oil price volatility. Russia would continue to deepen the strategic relationship with China, further diversify its FX reserves away from the U.S. dollar, and challenge the U.S. global position more aggressively, which, in turn, may incrementally increase the risk of more sanctions. Popular discontent could not be ruled out.

Scenario C (10% probability): Break-up of the Western front, with the EU stance becoming softer than that of the U.S.

In this scenario, Russia's economic outlook is likely to improve, and investors' focus would likely shift to the possible confrontation between the EU and the U.S. The outlook for the Russian sectors more tied to the EU could improve, but it is uncertain whether the revived Russian agriculture sector could withstand competition from EU products (we assume that Russia would drop the import restrictions as the EU softens its stance). Overall, though, macroeconomic stability in Russia would be strengthened, resulting in another bondholder-friendly scenario.

Scenario D (10% probability): An agreement is reached between all the participants. The EU and the U.S. change course, concluding most of the sanctions in place since 2014 upon Russia's strong and credible commitment to implement the Minsk agreement (designed to end the conflict in Eastern Ukraine) and not to interfere in upcoming Western elections. This scenario would be the "dream scenario" since everybody, most notably bondholders, in Russia and in the West could gain, but we are afraid it will remain a dream for the time being.

CONCLUSION

Since 2014, the United States and the European Union have been imposing sanctions on Russia, but the Russian economy does not appear, at prima facie, to have suffered significantly, and there has been no popular backlash against the government. While we think that the authorities will not deviate from the prudent path followed in recent years, the economy will keep experiencing subdued growth since structural reform is still lacking, and oil and commodities still play a predominant role in the economy. Therefore, our conclusion is that Russia can cope with current sanctions fairly easily, mostly thanks to the adoption of very prudent macroeconomic policies and, as in the past, to some luck, i.e., the increase in oil prices.

This situation is not expected to change unless severe sanctions (such as a ban on purchasing new Eurobonds or a complete ban on trade) are imposed. The signals in this respect are mixed: important legislative bills have been introduced in the U.S., but it is unclear whether additional sanctions will be forthcoming and whether the EU and other countries would follow the lead of the U.S. Meanwhile, the newly formed European Parliament may be less inclined to escalate further sanctions against Russia. It remains a fluid situation for a country that continues to largely shrug off the effects of the sanctions and maintain a highly attractive credit profile.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income as of May 2019.

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