

Hooked On Oil: Is Russia Breaking Free?

March 14, 2019

Key Takeaways

- Since 2016, the correlation between oil prices and the ruble exchange rate, Russia's fiscal spending and GDP growth has weakened, mainly because of government policies and international sanctions.
- The new fiscal framework benchmarks fiscal expenditures to a conservative oil price of \$40 a barrel (in 2017 prices, adjusted 2% annually), requiring the government to save windfall oil revenues and invest them in foreign assets.
- International sanctions have altered the pattern of capital flows, making them less procyclical.
- Nevertheless, the Russian economy remains structurally dependent on revenues from oil and gas exports. The sector still accounts for almost 60% of total goods exports and 45% of federal budget revenues.
- Non-energy exports have picked up recently, supported by the improved price competitiveness of domestically produced goods. Still, it will take time and effort for non-energy exports to drive Russia's export performance.
- If accompanied by structural reform, the weaker transmission of oil price volatility to Russia's economy could gradually facilitate economic diversification and sustainably boost economic growth.

PRIMARY CREDIT ANALYST

Karen Vartapetov, PhD
Frankfurt
(49) 69-33-999-225
karen.vartapetov
@spglobal.com

SENIOR ECONOMIST

Tatiana Lysenko
Paris
(33) 1-4420-6748
tatiana.lysenko
@spglobal.com

ADDITIONAL CONTACT

EMEA Sovereign and IPF
SovereignIPF
@spglobal.com

Is Russia no longer hooked on oil? The price of oil has historically shaped the country's balance of payments, the Russian ruble exchange rate, public finances and, ultimately, economic growth. Yet, over the past couple of years, the sensitivity of domestic economic and financial conditions to oil price movements has diminished. More recently, the exchange rate seemed to completely "decouple" itself from international oil prices.

While the benchmark Urals oil price increased 20% from April to September 2018, the ruble exchange rate depreciated 13%. At the same time, the rising Urals oil price, which was on average 30% higher in 2018 than in 2017, did little to significantly boost economic growth. In fact, domestic demand growth slowed down last year, while a boost to growth (which averaged 2.3% in 2018, up from 1.6% in 2017, according to a recent Rosstat estimates) came from foreign trade, with exports rising by more than 6% and imports growing only modestly, by less than 4%.

This is a striking change from the past, when a 30% rise in the oil price was typically associated

Hooked On Oil: Is Russia Breaking Free?

with 8%-9% growth in domestic demand and a double-digit rate of growth in imports. Here, S&P Global Ratings analyzes whether Russia has indeed freed itself from oil dependency, a situation we described five years ago in the article, "Hooked On Oil: Russia's Vulnerability To Oil Prices," published on March 26, 2012.

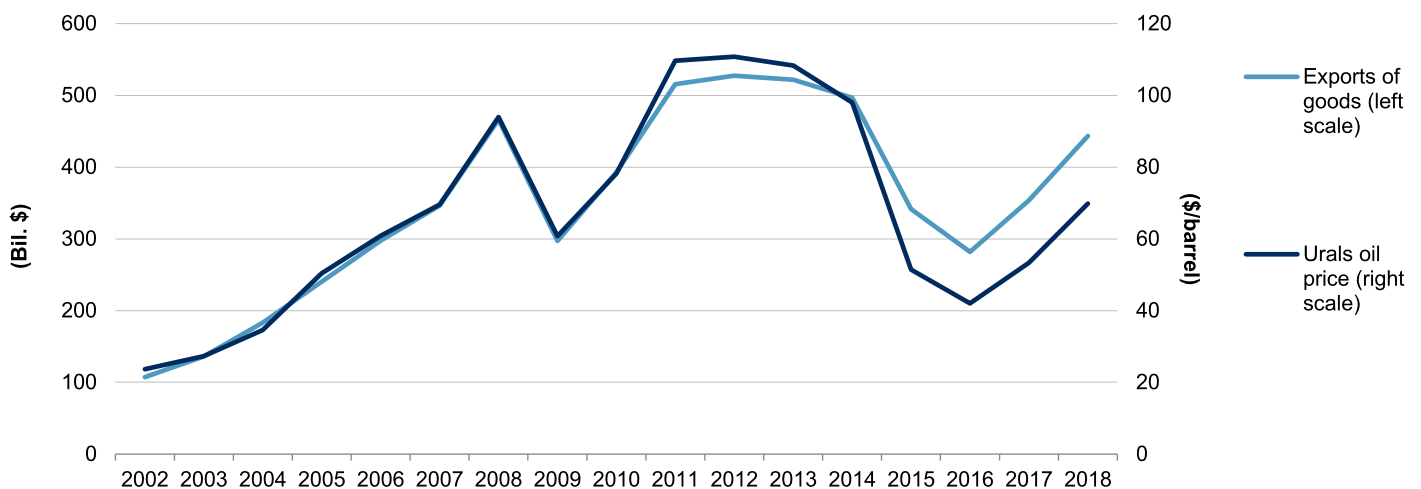
The price of oil has long been the major driver of Russia's business cycle, proving a boon in some years and a burden in others. Soaring oil prices fueled income growth and domestic demand in the decade preceding the global economic and financial crisis of 2008-2009, and supported the post-crisis recovery in 2010-2011. The terms-of-trade shock at the end of 2014 demonstrated the downside of this tight relationship. The collapse of oil prices, coupled with international sanctions, resulted in deep currency depreciation, a surge in inflation, a tightening of credit conditions, and a prolonged recession.

The impact of oil and gas price fluctuations on the Russian economy reflects the importance of the hydrocarbon sector in generating the country's exports and budget revenues. Exports of crude oil and oil products accounted for 46% of all the country's goods exports in 2018 (down from 54% in 2014), while gas exports accounted for another 12%. The share of oil and gas exports in GDP was about 16%.

Russia's export revenues and the ruble exchange rate had therefore moved in tandem with oil prices (see charts 1 and 2). The ruble tended to appreciate as oil prices increase, and to depreciate as oil prices fell. This is particularly visible in the ruble's real effective exchange rate (REER; the trade-weighted nominal exchange rate, adjusted to inflation differentials between Russia and its trading partners; see chart 2). That's because in the past, the Central Bank of Russia (CBR) intervened in foreign exchange markets to restrict nominal appreciation of the ruble. This kept the nominal exchange rate relatively stable, but led to a rapid expansion in the money supply and fueled inflation, pushing up the REER.

Chart 1

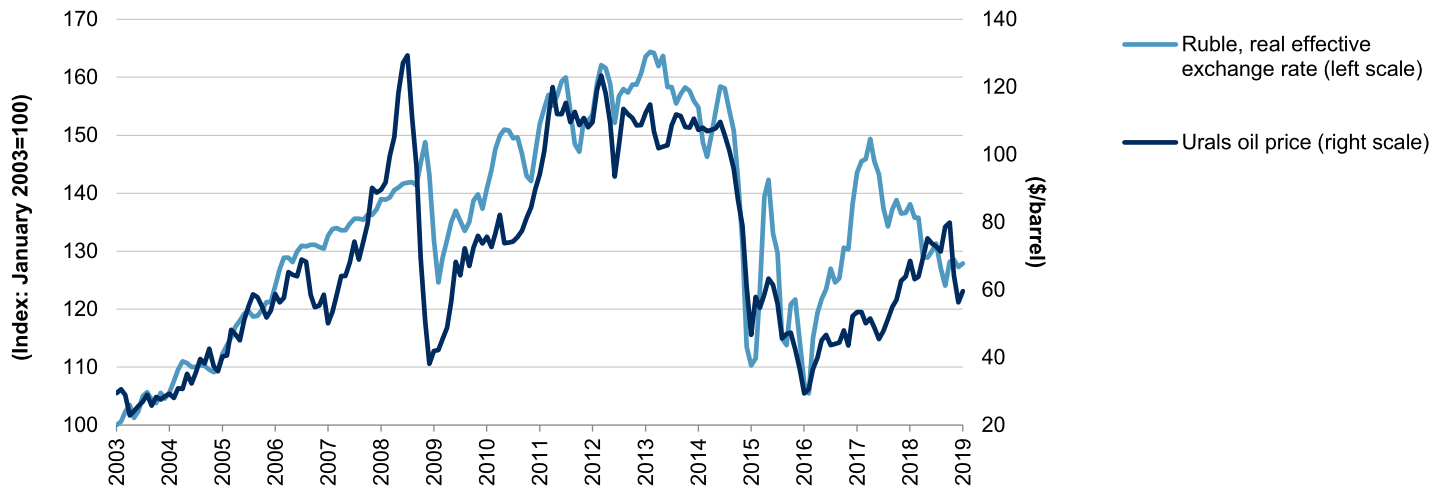
Russia's Goods Exports And The Price Of Oil



Sources: Central Bank of Russia, Datastream, S&P Global Ratings calculations.
Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Chart 2

The Price Of Oil And The Ruble's Real Effective Exchange Rate



Sources: Central Bank of Russia, Datastream, S&P Global Ratings calculations.
Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

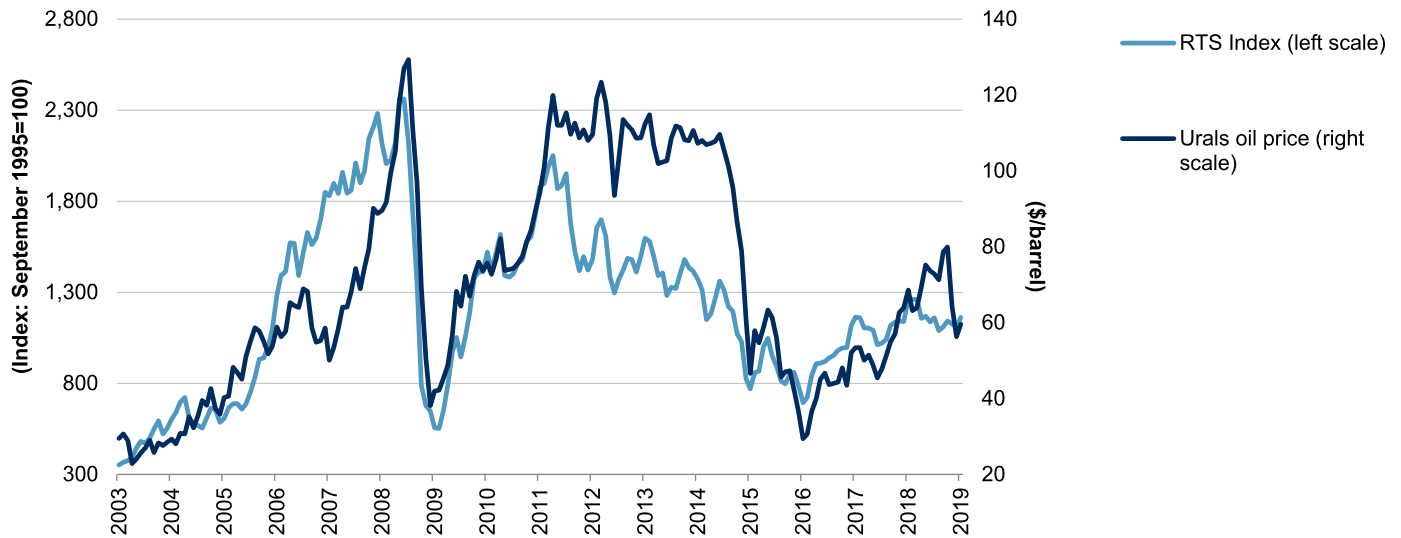
The fiscal channel has been another important driver of the transmission of oil price fluctuations to the Russian economy. Oil-and-gas-related revenues account for 45% of federal budget revenues and about one-third of general government revenues (here and below we use the government's definition of oil-and-gas fiscal revenues as the sum of receipts from energy export duties and the mineral extraction tax). Past efforts to use windfall oil revenues to repay external debt and build up assets in oil funds were an important factor behind our upgrade of the Russian sovereign to investment grade in early 2005--only four years after country had emerged from a sovereign default. However, previous fiscal frameworks did not succeed in avoiding procyclical fiscal policies and insulating the economy from oil price swings. During the periods of commodity booms, government spending rose in tandem with soaring oil revenues, resulting in a fiscal stimulus to the overheating economy.

Fiscal policy also amplified the impact of rising oil prices on the REER. The Russian economy exhibited signs of the "Dutch disease," that is, currency appreciation during the periods of rising commodity prices. Over 2003-2012, the ruble's REER appreciated more than 60%. This undermined the competitiveness of non-energy sectors, fueling imports and hindering the diversification of exports. The collapse of oil prices at the end of 2014 and the beginning 2015 led to a sharp exchange rate adjustment, with the REER depreciating by 30%. Currently, REER is some 20% weaker than in 2013. This has helped improve the price competitiveness of locally produced goods.

Other economic and financial indicators, including asset prices (see chart 3), and, ultimately, GDP growth (see chart 4) have also correlated with oil prices.

Chart 3

Russian Share Prices And The Price Of Oil

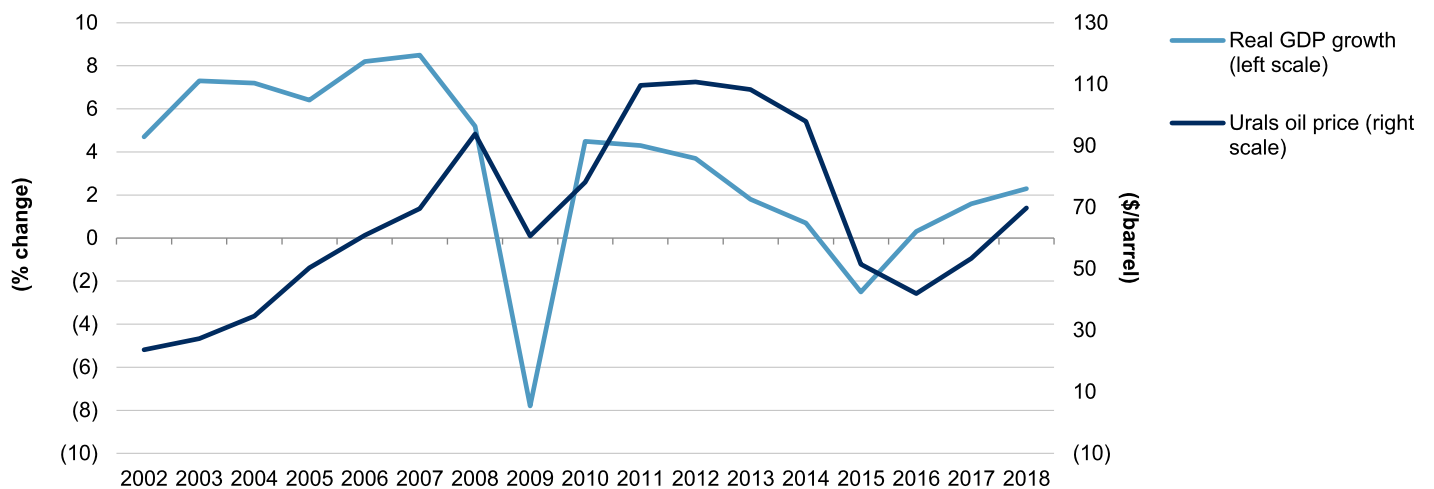


The RTS Index is capitalization-weighted composite index calculated based on prices of the 50 most liquid Russian stocks of the largest and dynamically developing Russian issuers presented on the Moscow Exchange. The index is denominated in U.S. dollars.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Chart 4

Russia's Real GDP Growth And The Price Of Oil



Sources: Rosstat, Datastream.

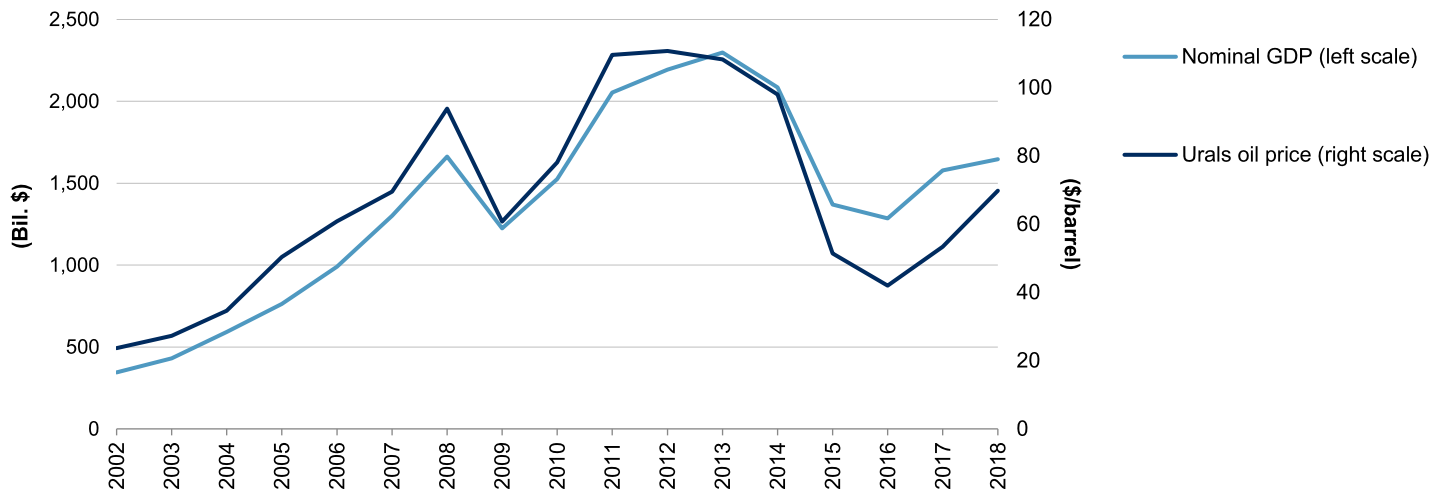
Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Hooked On Oil: Is Russia Breaking Free?

In particular, the rise and fall in Russia's nominal GDP measured in U.S. dollars have closely followed oil price fluctuations (see chart 5). This reflects the impact of oil prices on real GDP growth, but even more so on the REER.

Chart 5

Russia's Nominal GDP In U.S. Dollars And The Price Of Oil



Sources: Rosstat, Datastream.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

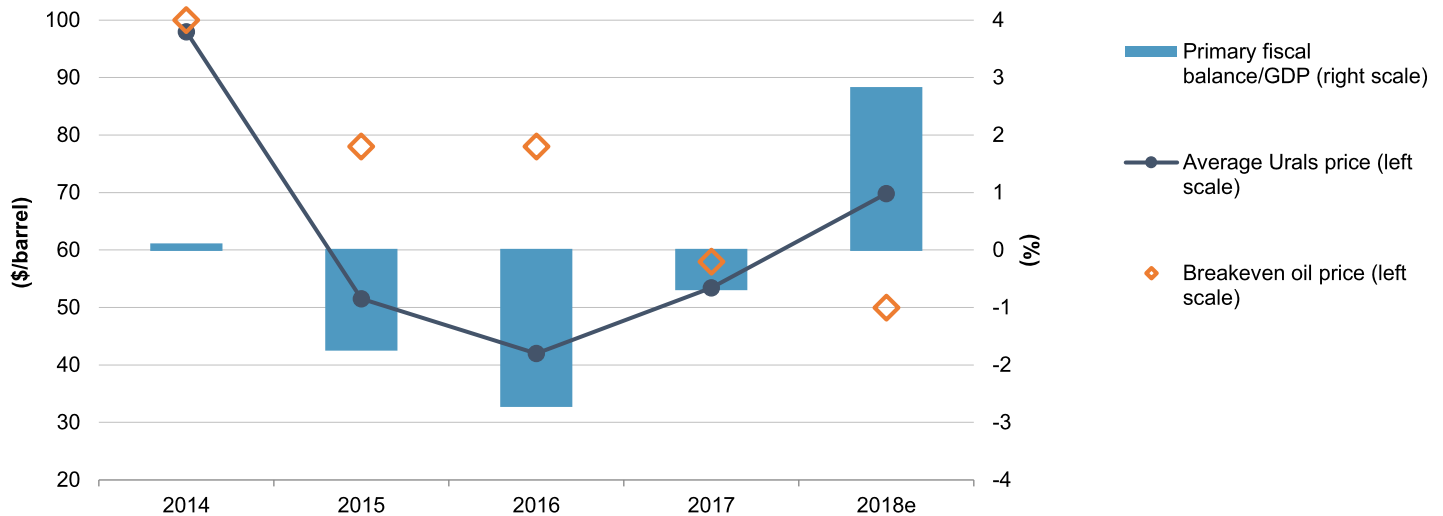
Dutch Disease: The Economy Appears To Be In Remission

The correlation between oil prices, the exchange rate, and output has recently moderated, as the charts above show. Notably, we saw an unusual combination of rising oil prices and a depreciating exchange rate during most of 2018. We believe two factors were at play: government policies and international sanctions.

Under Russia's new fiscal rule, the government now targets a modest primary budget deficit of 0.5% of GDP, calculated at a very conservative benchmark oil price of \$40 a barrel in 2017 prices (the benchmark oil price is adjusted upward by 2% annually). This has delinked fiscal expenditures from windfall oil revenues. It has also resulted in a significant fiscal adjustment over the past few years, with the break-even oil price for the federal budget (the oil price required to achieve a zero primary budget balance) dropping from almost \$100 a barrel in 2014 to \$50 in 2018 (see chart 6). That is one of the lowest break-even oil prices of all oil exporters that S&P Global Ratings rates.

Chart 6

Russian Federal Budget's Breakeven Oil Price*



e-Estimate. *Oil price under which the federal budget is balanced at the primary level. Sources: Russian Ministry of Finance, S&P Global Ratings estimates.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

The new fiscal framework also supports a broader macroeconomic objective of decoupling domestic economic and financial conditions from volatile oil prices. During a period of high oil prices, saving a large share of windfall revenues reduces the oil-related fiscal stimulus to the economy and mitigates inflationary pressures. The fiscal framework also helps to prevent "Dutch disease," and smooth the volatility of REER. The government is now required to use all excess fiscal revenues above the benchmark oil price to purchase foreign exchange, accumulating it in the National Welfare Fund (NWF). Since the beginning of 2018 until late August, the CBR purchased about \$34 billion on behalf of the government--almost one-half of the reported current account surplus in the first three quarters of 2018. This alone has significantly reduced the appreciation pressures that stronger commodity prices exert. The CBR temporarily suspended fiscal rule-related foreign exchange purchases in late August, in response to financial market volatility. The government continued to accumulate excess fiscal revenues in the NWF, purchasing foreign currency directly from the central bank. The CBR resumed regular fiscal rule-based foreign currency purchases from Jan. 15, 2019.

Less Procyclical Capital Flows Are Also At Work

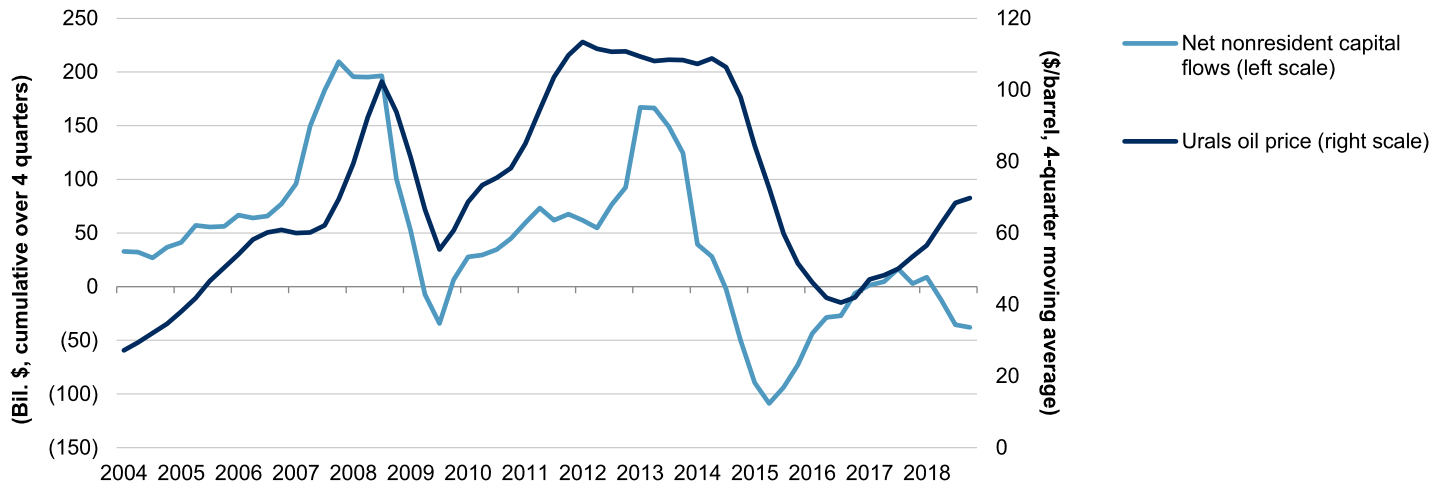
Another factor that explains the divergence between oil prices and REER over the course of 2018 is capital flows, which have become less procyclical in the past few years.

Historically, foreign financial flows into Russia surged during commodity booms and retreated when oil prices fell (see chart 7). In 2007, amid soaring oil prices, foreign inflows into Russia exceeded US\$200 billion, or 15% of GDP. This amplified the impact of rising oil prices on the exchange rate and, more broadly, domestic economic and financial conditions. Vice versa, the

periods of falling oil prices were associated with a sell-off of Russian assets by foreign investors.

Chart 7

Nonresident Capital Inflows Into Russia And The Price Of Oil



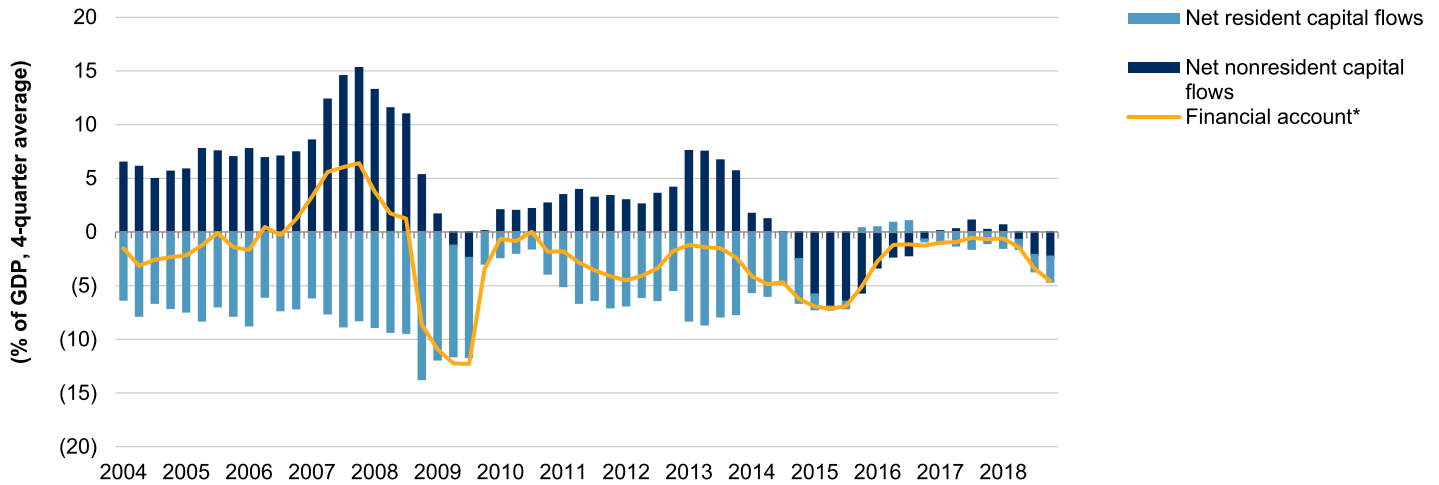
Sources: Central Bank of Russia, Datastream, S&P Global Ratings calculations.
Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Meanwhile, Russian banks and corporates tended to increase their investment abroad when oil prices were high (which amounts to capital outflows). As an example, Russia's outward foreign direct investment grew markedly in 2010-2013, partly financed by foreign borrowing. After the decline in oil prices that commenced in the second half of 2014, outward FDI has moderated (which may also be linked to geopolitical tensions).

On balance, over the past 15 years, Russia has been a net exporter of capital to the rest of the world. Only during a brief period, 2006-2007, did foreign flows into Russia exceed outflows by Russia's residents (see chart 8). On average, net capital outflows amounted to about 2% of GDP over the period. But the magnitude of net capital outflows has varied widely over the years, with net outflows moderating during periods of high oil prices and accelerating when oil prices were declining.

Chart 8

Russia's Capital Flows



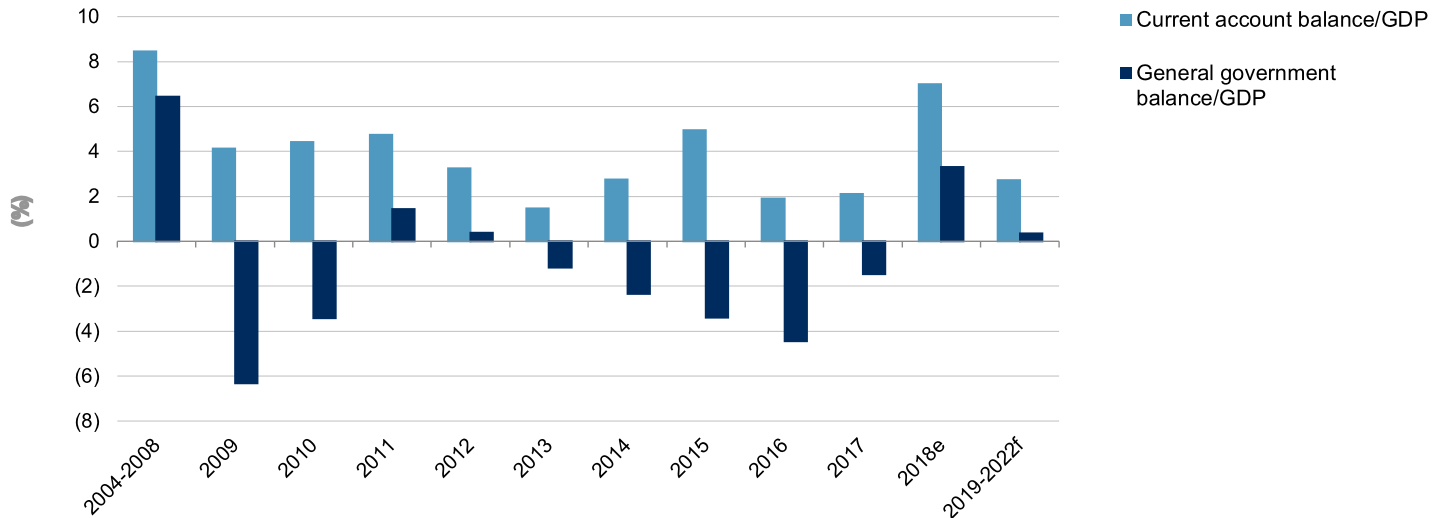
*Including errors and omissions. Sources: Central Bank of Russia, S&P Global Ratings calculations.
Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

In the past three years, however, Russia's financial flows have been driven by factors other than oil prices and oil-related investor sentiment. These include international sanctions that limit access of the Russian private sector to international financial markets and reduce prospects for foreign direct investment inflows, irrespective of oil price movements. At the same time, relatively high interest rates in Russia compared to the rest of the world and prospects for Russian bond yields to decline amid successful disinflation efforts by the central bank supported significant speculative investor interest in the Russian local currency debt market, even in the environment of low oil prices. The interplay between these factors changed the pattern of capital flows, which became less procyclical over the past few years. The result was a weakening of the link between oil prices and the exchange rate. As chart 2 shows, while oil prices were recovering in 2016, the ruble appreciated much more than the historical correlation between oil prices and the exchange rate can explain, and which we instead attribute to the inflow of foreign capital, particularly into the local bond market. Vice versa, in 2018, U.S. sanctions against the world's largest aluminium exporter, UC Rusal, introduced in April, as well as additional sanctions proposed in August, led to an outflow of foreign capital out of Russian assets, notably from local currency government bonds, despite a surge in oil prices.

The unusual combination of higher oil prices and a weaker ruble has strengthened Russia's fiscal and external accounts and led to a return of the "twin surpluses" (see chart 9). Indeed, Russia's budget balance turned into a surplus, while the current account surplus reached an historical high of \$US115 billion in 2018 in absolute terms.

Chart 9

Russia Is Back To Twin Surpluses



e--S&P Global Ratings estimate; f--S&P Global Ratings forecast. Sources: Central Bank of Russia, Russia's Ministry of Finance, S&P Global Ratings forecasts.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

The Sovereign Rating Implications Of A Less Sensitive But Still Oil-Dependent Economy

Russia is more resilient to external shocks than three to four years ago: The economy's net external asset position is large, the ruble exchange rate is floating, and the government's balance sheet is strong. This has improved the country's sovereign creditworthiness and contributed to the upgrade of the sovereign to 'BBB-' in February 2018 (see "S&P Global Ratings Analysts And Economists Discuss What's Behind Our Recent Sovereign Rating Action On Russia," published on March 8, 2018).

However, while the government has succeeded in weakening the transmission mechanism of oil price swings to domestic economic and financial conditions, Russia remains structurally dependent on commodities exports, which is a rating weakness. Oil and gas still account for some 20% of GDP, 45% of central government revenues, and close to 60% of goods exports (with metals another 10%). That said, non-energy exports have picked up recently, supported by the improved price competitiveness of domestically produced goods. Agricultural exports have performed particularly well, while exports of machinery and transport equipment also rose in 2018 (see table 1). Still, the share of these export categories remains relatively low. Furthermore, we believe Russia faces a long road ahead before non-energy exports drive its exports performance. This will require investment in new capacity and technology to make the country's products competitive on quality and on other nonprice measures.

Table 1

Russia's Merchandise Exports 2014-2018

	2014 (Bil. \$)	2018 (Bil. \$)	Share 2014 (%)	Share 2018 (%)
Agricultural products	18.9	24.9	3.8	5.5
Mineral products	350.9	291.5	70.5	64.8
Energy (including oil, gas, coal)	346.2	286.7	69.5	63.7
Oil	153.9	128.3	30.9	28.5
Oil products	115.9	78.3	23.3	17.4
Natural gas	55.2	49.5	11.1	11.0
LNG	5.2	5.4	1.1	1.2
Chemicals	29.1	27.4	5.8	6.1
Wood, pulp and paper	11.6	13.9	2.3	3.1
Textiles and footwear	1.1	1.2	0.2	0.3
Precious stones and metals, jewelry	11.8	10.1	2.4	2.2
Metal and metal products	40.5	44.5	8.1	9.9
Machinery and transport equipment	26.3	29.1	5.3	6.5
Other	7.6	7.4	1.5	1.6
Total merchandise exports	497.8	450.0	100.0	100.0
Urals oil price, \$/barrel	98.0	69.8		

Source: Federal Customs Service of Russia, Datastream, S&P Global calculations.

Although the existing economic policy framework should allow Russia to absorb future terms-of-trade shocks, a fall in oil prices for an extended period below \$40 a barrel will likely lead to a sizable depreciation in exchange rates, a spike in inflation, and weaker business confidence, which will weigh on growth and public finances. If not addressed by an adequate policy response, which would most likely imply additional fiscal adjustment, this will likely pressure sovereign creditworthiness.

This is not to say that commodity dependence is incompatible with higher sovereign credit quality. Russia itself was rated higher at 'BBB+' in 2007-2008. We also currently rate a few sovereigns with even more pronounced commodity dependency in the 'A' and 'AA' categories (Qatar, Saudi Arabia, and Kuwait). Their rating strength rests not least on those governments' substantial net asset positions, which we believe could help lessen oil price shocks. These fiscal buffers, represented by liquid external financial assets, in some cases reach 100% of GDP (see "Government Liquid Assets And Sovereign Ratings: Size Matters," published on Aug. 27, 2018). Although Russian liquid fiscal assets have been increasing recently, they are still relatively low at below 10% of GDP. Building fiscal buffers further would certainly help the government to tackle risks coming from swings of commodity-related fiscal revenues.

Another way of shielding the economy from oil price volatility is to improve the competitiveness of noncommodity sectors, facilitate export diversification, and sustainably boost economic growth. If anything, modest GDP per capita growth rates are one of the key constraints on our sovereign ratings at present. This path would require sustained reform efforts aimed at addressing the challenging business and regulatory environment, as well as low levels of competition and innovation. The recently established policy framework, which mitigates sensitivity of domestic

Hooked On Oil: Is Russia Breaking Free?

economic and financial conditions to oil price volatility, creates a supportive macroeconomic environment for such a strategy.

Related Research

- Russia 'BBB-/A-3' Ratings Affirmed; Outlook Stable, Jan. 18, 2019
- Sovereign Risk Indicators, Dec. 13, 2018; a free interactive version is available at <http://www.spratings.com/sri>
- Government Liquid Assets And Sovereign Ratings: Size Matters, published on Aug. 27, 2018
- S&P Global Ratings Analysts And Economists Discuss What's Behind Our Recent Sovereign Rating Action On Russia, March 8, 2018
- Hooked On Oil: Russia's Vulnerability To Oil Prices, March 26, 2012

This report does not constitute a rating action.

Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.