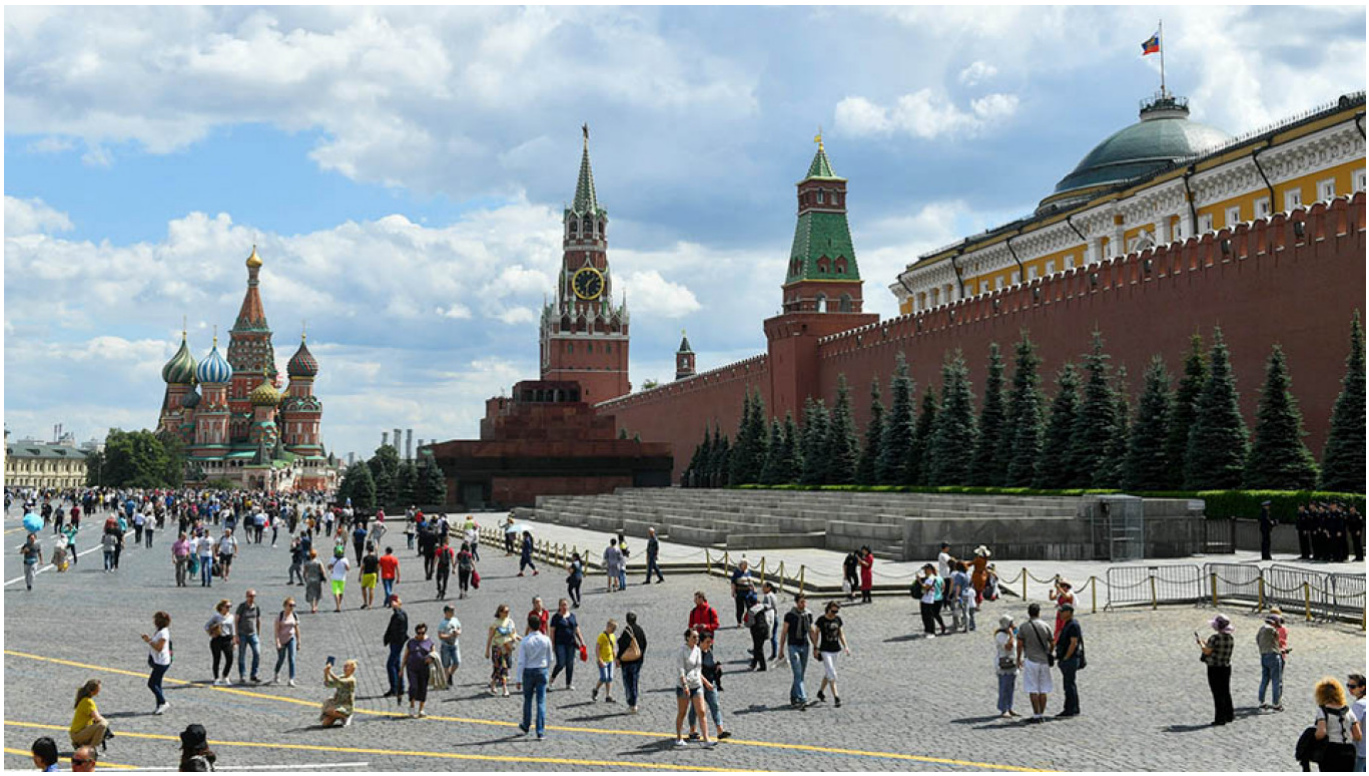
The Moscow Times
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Fitch Upgrades Russia's Rating, Returning It to 2014 Level

The rating agency cited Russia's strengthened policy mix, low external debt and robust fiscal health as reasons for the upgrade.

By bne IntelliNews

August 12, 2019



The upgrade returns Russia to its 2014 rating. **Sergei Kiselyov / Moskva News Agency**

Global rating agency Fitch upgraded Russia's investment grade rating on Aug. 9 to 'BBB' from 'BBB-', returning Russia to its 2014 rating and underscoring the ongoing easing of tensions with the west as well as Russia's improving economy.

Fitch cited Russia's strengthened policy mix, low external debt and robust fiscal health as reasons for the upgrade. At the same time, the agency said that Russia is in a better position to cope with any fresh sanctions imposed by the U.S., which has also contributed to its ratings upgrade.

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“Russia has entrenched a credible and consistent policy framework that will deliver improved macroeconomic stability, reduce the impact of oil price volatility on the economy, and support increased resilience to external shocks. Fitch considers that Russia's strengthened policy mix, underpinned by a more flexible exchange rate, a strong commitment to inflation-targeting and a prudent fiscal strategy, and its robust fiscal and external balance sheets will help the sovereign to cope with heightened sanctions' risk,” Fitch said in a press release.

The continued threat of sanctions' escalation will weigh on Russia's external financing flexibility, investment and growth prospects, according to the rating agency. However the sanction fears are retreating. The U.S. imposed new sanctions on Russia last week connected to the poisoning of Sergei Skripal, a former Russian spy living in the U.K., but investors shrugged them off as largely symbolic. The U.S. banned American investors from participating in any new issues of sovereign debt on the primary market but left existing debt untouched and also didn't ban buying the debt on the secondary market or owning it.

Russia’s Ministry of Finance doesn't rely on the Eurobond market for funding and issues these bonds more as a benchmarking exercise for Russian corporate that issue on the international capital markets.

More importantly, the new sanctions do not include the Russian Ministry of Finance ruble-denominated OFZ treasury bills, which is the workhorse bond for funding the Russian budget and also widely held by international investors, who own 30% of the outstanding notes. Fitch acknowledged the Kremlin’s successful attempts to sanction proof the economy.

“Increased exchange rate flexibility and compliance with the fiscal rule support the economy's capacity to absorb real, financial and geopolitical shocks, and limit the impact of oil price volatility on the economy,” Fitch said

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Russia’s finance ministry welcomed Fitch’s decision to increase Russia’s ratings saying it was an acknowledgement of the country’s rock solid macro fundamentals.

"This decision [by Fitch to upgrade Russia's rating to BBB] serves as another confirmation that Russia's economy has fully adapted to existing challenges and is capable of reaching new growth rates.” Russian First Deputy Prime Minister and Finance Minister Anton Siluanov said. “We believe that the Fitch decision will become a legitimate reason for raising Russia’s credit sovereign rating by the rest of the Big Three rating agencies,” the ministry said in a statement.

While President Vladimir Putin has pursued an aggressive and combative foreign policy, the liberal ministries and central bank that actually run Russia’s economic policy have shown themselves to be both extremely competent and prudent.

“Inflationary pressures have eased and average inflation will remain close to Russia's

inflation target of 4% in 2020-2021. After responding decisively to increased inflationary risks in late 2018, the Central Bank of Russia (CBR) has reversed this monetary tightening through 25bp cuts in June and July, bringing its key rate to 7.25%. Fitch expects the central bank to remain focused on achieving a sustainably low level of inflation through a prudent easing cycle, strengthening transmission mechanisms, cementing institutional credibility and sustainably anchoring expectations," Fitch said.

Since 2017 Fitch had maintained ratings on Russia's debt at 'BBB-', with a positive outlook, but analysts were not sure the agency would increase the rating in the face of the lacklustre growth of the Russian economy and the looming global recession. Russia's economy expanded by only 0.5% in the first quarter of this year, well below even the most pessimistic forecasts, and the 12 national projects programme that should boost growth is off to a very slow start.

However, Fitch said it expects fiscal policy to remain conservative and guided by the fiscal rule, supporting improved macroeconomic stability, continued fiscal surpluses and reduction of the non-oil federal fiscal deficit.

"After a 2.6% GDP surplus in 2018, the federal budget will remain in surplus in 2019 (1.8% of GDP) and at least through 2021, albeit at a lower level, supported by higher-than-budgeted oil prices, continued non-oil revenue growth, which will accommodate planned expenditure increases related to the National Projects," Fitch said. "Russia's prudent fiscal policy has reduced the federal budget breakeven oil price from $110 in 2013 to $43 in 2018, while the non-oil budget deficit has declined to 6.0% of GDP from 9.4% over the same period, and will fall further to 5.6% by 2021."

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The fall in the non-oil budget deficit — the deficit that the government would have if all the oil tax revenues magically disappeared — is the best test of the health of the Russian budget. In the boom years the government set the non-oil deficit at 4% of GDP. In other words the Kremlin was consciously using the oil revenues to subsidize budget spending but at the same time prudently limited the spending. A non-oil deficit of 9.4% is still uncomfortably high and suggests the government is trying to boost growth with heightened spending and that the economy is not out of the woods yet.

Russia's debt is rated at investment grade by all three big international rating agencies, including S&P Global Ratings and Moody's as well as Fitch, which helped Moscow borrow money on the global markets by issuing Eurobonds this year.

Earlier this week, S&P Global Ratings said the latest U.S. sanctions on Russian U.S. dollar-denominated sovereign debt will have no immediate impact on Russia's investment grade credit rating.

Fitch also predicted that gross international reserves (GIR) will increase from the current $520 billion to $537 billion by the end of the year and to $591 billion by the end of 2021, fuelled by the 5.2% current account surplus in 2019 that will remain positive in the coming years, but will fall to 2.5% of GDP in 2021. Russia has a remarkable 13.6 months of future

import cover as reserves — a level it is likely to maintain for the coming years, according to Fitch.

Russia's external debt position is equally strong. The government external debt is currently 14.9% of GDP (12.7% of federal external debt), and if the corporate and banking external debt is factored in then the total net external debt is a very modest 35% of GDP, according to Fitch. However, even this low figure is likely to fall further. Russia continues to see net capital flight that was running at $25 billion in the first half of this year. But rather than that being oligarch money fleeing for warmer offshore havens, the bulk of this money is Russian banks paying down their international obligations or building up reserves overseas. Indeed Fitch says that the sovereign's net foreign assets will strengthen to 29% of GDP in 2019, which is a sizeable piggy bank of reserves held outside of the country.

In addition to the government's GIR that underpin the currency, it has also been building up the National Welfare Fund (NWF), which doubled in size this month to 5.7% of GDP. Fitch believes that the NMF will pass the 7% of GDP threshold this year, after which the government can spend the excess as it likes.

"The fund will then be able to diversify investments towards higher yielding but less liquid FX assets abroad. Discussions are underway regarding the possibility of allocating a portion of these investments to finance projects in Russia. Fitch's base case is that the scale of this domestic investment will not reverse the progress in terms of macro stability gains or the reduced impact of oil price volatility in the economy," Fitch said.

Related article: Russia's National Welfare Fund Doubled in July to $124 Billion

What the agency is alluding to in this statement is the CBR's fears that too much of the excess will be spent on huge infrastructure projects and drive up inflation as a result. The debate over how best to spend this extra money is currently raging fiercely.

In an otherwise sparkling report card, the one black mark Fitch assigns Russia is for its anaemic growth.

"Russia's weak growth outlook is a credit weakness. Growth slowed markedly in 1H19 (0.7% year-on-year based on Ministry of Economy estimates). While faster budget expenditure execution, recovering private consumption and improved external demand will lift annual growth to 1.2% in 2019, Fitch expects growth to average 1.9% in 2020-2021, below the forecast 3.1% 'BBB' median.

Government plans to increase growth by addressing labour market and investment constraints face risks in terms of delays in investment projects' execution, limited progress in increasing private investment, as well as reducing uncertainty and the state's role in the economy. Perceived failure to raise growth and living standards could increase political and social pressures on the policy framework to provide greater support for domestic economic activity," Fitch said.

Behind this statement is the root of Russia's current problems. As Fitch laid out in detail the macro economic numbers are as good as or better than any other major economy in the world.

But where Russia falls down is both international and domestic investors lack confidence in the government and are consequently unwilling to invest. At the same time the population have suffered from almost six years of austerity and falling real income levels and so are not spending.

Without this investment and spending Russia's economy is doomed to stagnate, which is what happened in the first quarter. Growth in the first half of this year was a little better at 0.7%, but this too is in effect stagnation.

The lack of dynamism in the Russian economy poses a political problem for Putin and the Kremlin and has already led to heightened social tension as weekend protests on the streets of Moscow go into their fourth week in a row this weekend.

The Kremlin has bet on the spending on the 12 national projects as the solution to this problem and the way to return to some noticeable prosperity, but the jury remains out on its chances of success.

This article first appeared in bne IntelliNews.

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