RUSSIA'S RESERVE FUNDS: IMPLICATIONS OF ACCELERATED SPENDING

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Summary

Russia's gold and currency reserves (FX reserves) remain one of the key anchors of the country's financial credibility and the clear focus of the international rating agencies. On October 16 Fitch will report on Russia's sovereign rating.

The Bank of Russia (CBR) aims to accumulate FX reserves of $500 bln within 5-7 years, which would rank the country fifth globally. At the same time, according to the draft federal budget for 2016, the government plans to spend RUB 2.1 trln from the Reserve Fund, which is partially included in FX reserves.

This raises three main questions:

1) Will the Reserve Fund be spent too quickly (during 2016-17) in order to finance the budget deficit?

2) What is the possible impact of spending from the Reserve Fund on domestic interest rates, the FX market and inflation?

3) Is the current level of FX reserves sufficient?

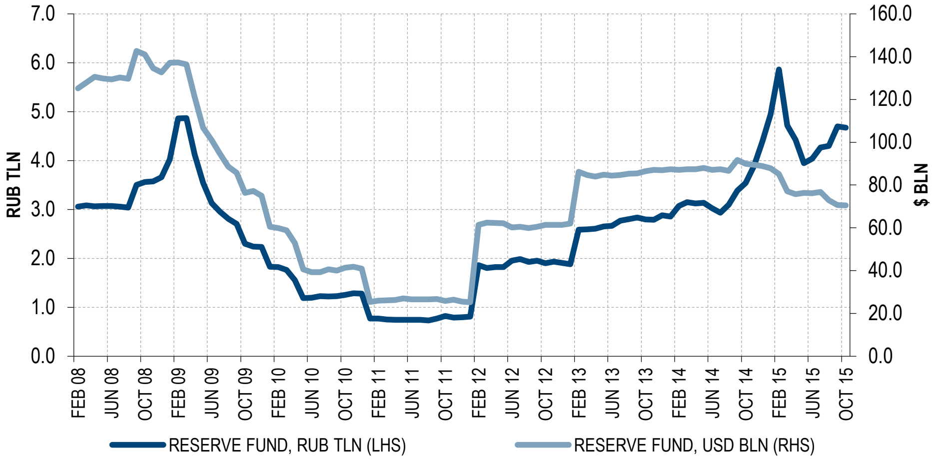
Conclusions

- The likelihood that the Reserve Fund will be exhausted by end 1H18 is significant amid the freezing of the "budget rule" for 2016. Achievement of the target level of RUB 2 trln by end 2017 seems very challenging.
- In case of further large-scale spending from the Reserve Fund, CBR efforts to absorb excessive liquidity will be needed in order to avoid the risk of higher inflation and interest rates.
- Due to planned significant spending of the Reserve Fund in 2016, a corresponding decrease in CBR FX REPO operations can be expected. The likelihood of an increase in CBR reserve requirements is immaterial.
- Russia's FX reserves remain sufficient and appear solid in comparison with other G-20 countries.
- Russia's FX reserves target of $500 bln seems excessive even though Russia, as a resource-based economy (and thus dependent on commodity prices), must maintain higher FX reserves than developed countries.

1. Reserve Fund as part of FX reserves: potential for exhaustion

According to Finance Ministry data, as of October 1, the Reserve Fund in ruble terms totaled RUB 4,671 bln (6% of GDP), or 5.6% below the January 2015 level. In dollar terms, during the same period the Reserve Fund decreased more significantly, by 19.8% to $70.5 bln. This raises the questions of how long the Reserve Fund can be used and when the government might resort to greater use of FX reserves in order to finance the federal budget deficit.

Reserve Fund dynamics (RUB vs. USD equivalent)

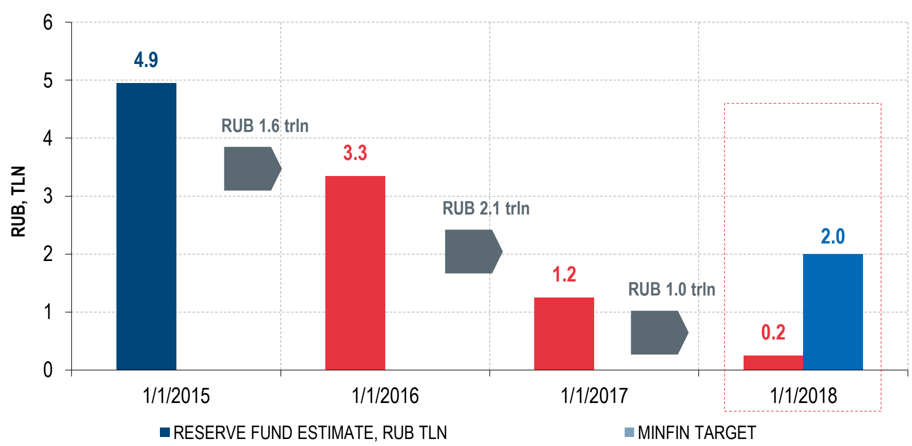


Source: MinFin, Gazprombank estimates

According to MinFin projections, the amount of the Reserve Fund to be spent in FY15 is RUB 1.6 trln, or 32.4% of the total amount as of end 2014. Given that the MinFin is prepared to spend from this source RUB 2.1 trln in 2016 and up to RUB 1 trln in 2017, we estimate that the fund might be exhausted by end 1H18.

In September, the government voted to freeze the "budget rule" for 2016, which serves as the basis for replenishment of the Reserve Fund in case of positive oil price dynamics. The limitation of budget spending growth in case of increased oil revenues will not be applicable next year. Thus, the freezing of the budget rule minimizes the possibility of compensation of Reserve Fund withdrawals in 2016, even if the trend in oil prices is positive.

Esimated use of Reserve Fund



Source: Finance Ministry, Gazprombank estimates

The next question is how to achieve the MinFin's Reserve Fund target of RUB 2.0 trln equivalent as of end 2017 amid a federal budget deficit of 3% GDP in 2016 (RUB 2.4 trln according to the draft federal budget, which is still under discussion).

There are two possible scenarios for achieving this target level:

- additional government borrowing; or
- spending via the National Wealth Fund.

We consider additional government borrowing amid a moderate debt/GDP ratio (13.4% as of 2014) as the most feasible method of financing the budget deficit. Domestic government bonds seem the most applicable instruments, but in this case foreign investors are needed – for example, Chinese investors. However, in case of extra net government borrowing amounting to more than RUB 2 trln in 2016, the domestic market would suffer due to the crowding out of non-government issuers, even in case of attraction of foreign investors. According to our estimates, the capacity of Russia's domestic bond market in 2016 will be no more than RUB 1.3 trln, which will make it difficult to fill the budget gap without having to tap both the Reserve Fund and the National Wealth Fund and thus FX reserves.

2. Potential impact of Reserve Fund spending on Russia's financial markets

Spending of the Reserve Fund: CBR to absorb extra liquidity in order to prevent domestic interest rate volatility

Given that a significant amount of the Reserve Fund is held in dollars, a material drawdown could affect Russia's FX market and interest rates should the CBR refrain from engaging in liquidity sterilization measures.

This year the CBR has been "spending" the Reserve Fund not directly, but rather by reducing its own credit operations. According to the CBR, in case of large-scale spending of FX reserves, it will have to sterilize the increased money supply. We can assume that spending equivalent to RUB 2.1 trln within one year is material, as average daily CBR FX REPO operations with Russian banks are estimated at RUB 1.8 trln. According to our estimates, the most likely method for absorbing the significant FX liquidity inflows to the local money market would be to scale back CBR FX REPO operations with banks. In this case, neither the RUB/USD exchange rate nor interest rates would be impacted significantly.

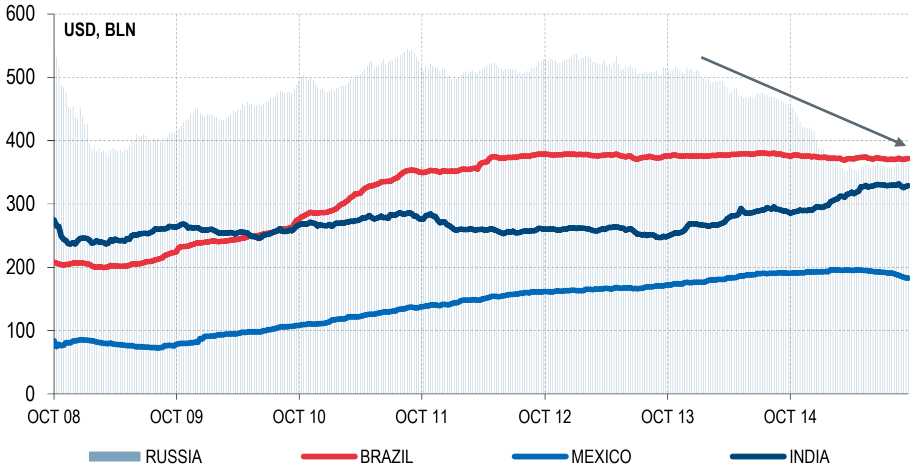
The next question is whether Russia's FX reserves remain sufficient.

3. Sufficiency of Russia's FX reserves

At the moment Russia ranks eighth globally in terms of FX reserves after China, Japan, Saudi Arabia, Switzerland, Taiwan, Brazil and South Korea. As of October 1, the country's FX reserves amounted to $371.3 bln, down 3.8% YTD. Since January 1, 2014, Russia has spent 27.1% of its FX reserves amid high market volatility. As of October 1, the reserves remain 13% below the December 2008 level.

Up until end 2012, Russia along with other BRICS countries (excluding India, which spent 7% of its FX reserves in 2H11) boosted FX reserves thanks to high oil prices. Contrary to the popular view that Russia's FX reserves began to fall significantly from 3Q14, we note that this process actually started one year earlier (from 3Q13) amid fading surpluses to other BRICS countries (except China, which holds about 32% of the world's FX reserves).

Russia's FX reserves vs. select EM countries



Source: IMF, Bloomberg

According to the CBR, the target level of Russia's FX reserves within a 5-7 year horizon stands at $500 bln (the level of 2010-13). During May-July 2015, the CBR was gradually buying dollars on the domestic market and managed to increase its reserves by only 0.45%. Given that periods of moderate RUB/USD volatility have become atypical, the probability of significant replenishment of Russia's reserves within the next 12 months is rather low.

Economists operate with various criteria when evaluating a country's FX reserves sufficiency. We utilized these criteria to perform a stress test of Russia's FX reserves in current conditions according to the following benchmarks:

Criteria governing national FX reserves sufficiency

CRITERIA	THRESHOLD LEVEL	COMMENT
FX reserves to external short-term government debt ratio	**100%**	This criterion, known as the Greenspan-Guidotti rule, is one of the most widely used by economists and assumes that FX reserves must be sufficient to cover government debt on a short-term horizon.
FX reserves to M2 ratio	**20%**	The logic of this criterion assumes that the monetary base should be covered by highly liquid assets, and FX reserves can clearly be considered as some kind of guarantee. This criterion is especially sustainable for resource-based economies such as Russia's (despite efforts to promote import substitution).
FX reserves to quarterly import ratio	**100%**	This benchmark is important for countries that are highly import-dependent, exposed to current account shocks and have limited access to capital markets (Russia is a good example given the sanctions environment).
FX reserves to GDP ratio	**10%**	A sufficient measure that reflects the sustainability of FX reserves vis-a-vis the scale of the country's economy.

Russia's FX reserves remain sufficient

According to the above criteria, we conclude that Russia's FX reserves are sufficient and mostly compare favorably to G-20 averages.

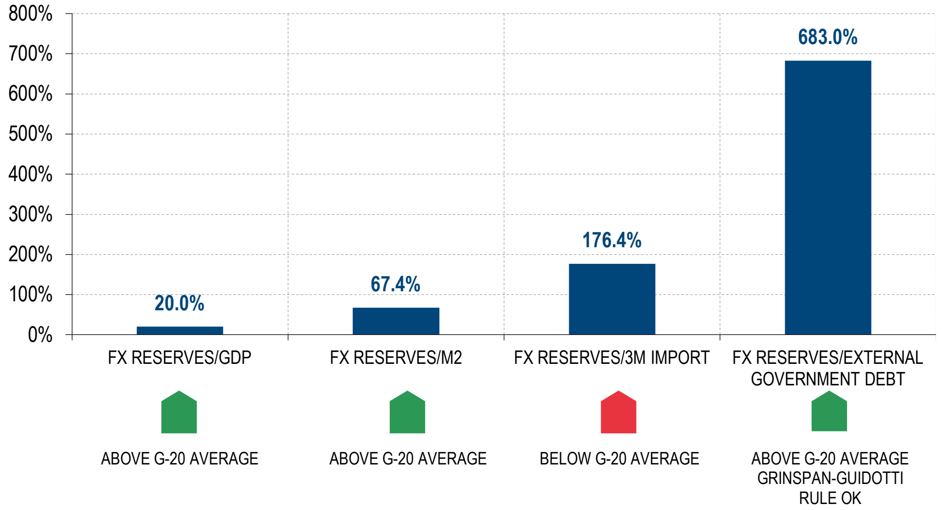
As of October 1, Russia's FX reserves exceeded the entire amount of external government debt by 6.8x, which indicates a high ability to redeem the full amount of external debt (including short-term) even in expectation of possible withdrawals to finance the budget deficit.

Quarterly imports are also well covered by Russia's FX reserves: the ratio is close to 1.8x, which we consider quite respectable.

Russia's FX reserves/M2 ratio is more than triple the threshold level of 20% (as well as the G-20 average), which is an additional positive factor.

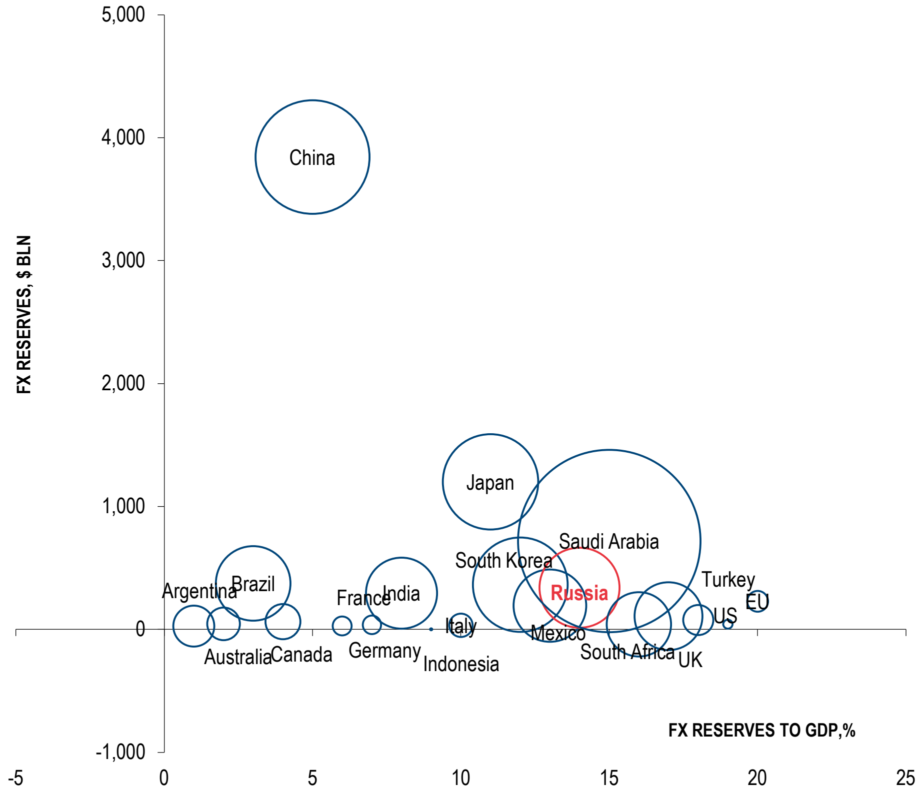
The FX reserves/GDP ratio is also rather high and remains at a level of 20%, which is about 5 pps above the figures of Mexico, India and Brazil, but below China's level of 34.3%.

Russia's FX reserves sufficiency: criteria analysis



Source: IMF, State Statistics Service, Finance Ministry, Bloomberg, Gazprombank estimates

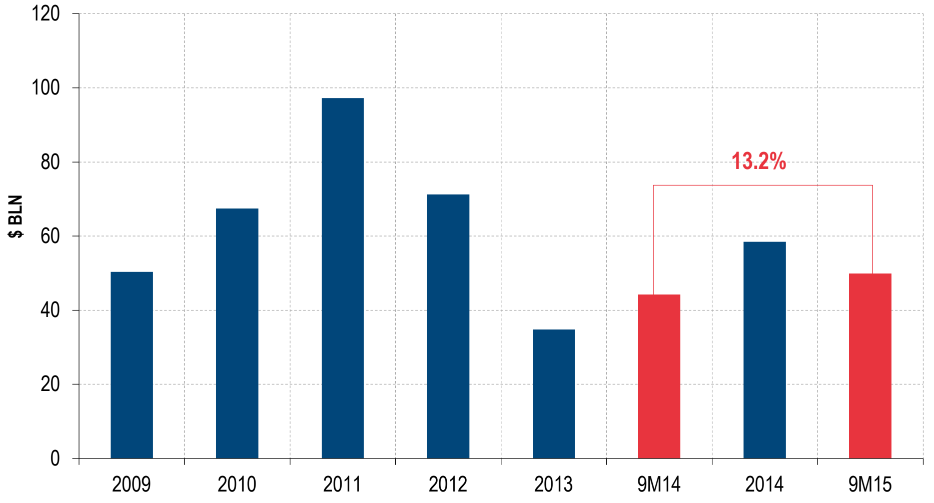
Russia's FX reserves/GDP ratio vs. other G-20 countries



Source: IMF, Bloomberg, Gazprombank estimates

Russia's current account balance remains positive and amounted to $49.9 bln as of 9M15, up 13.2% YoY due to a decrease in the capital account deficit from $10.2 bln as of September 30, 2014 to $0.2 bln as of September 30, 2015. Russia's current account position looks positive and does not require extra withdrawals from FX reserves at the moment.

Russia's current account balance



Source: CBR, Gazprombank estimates

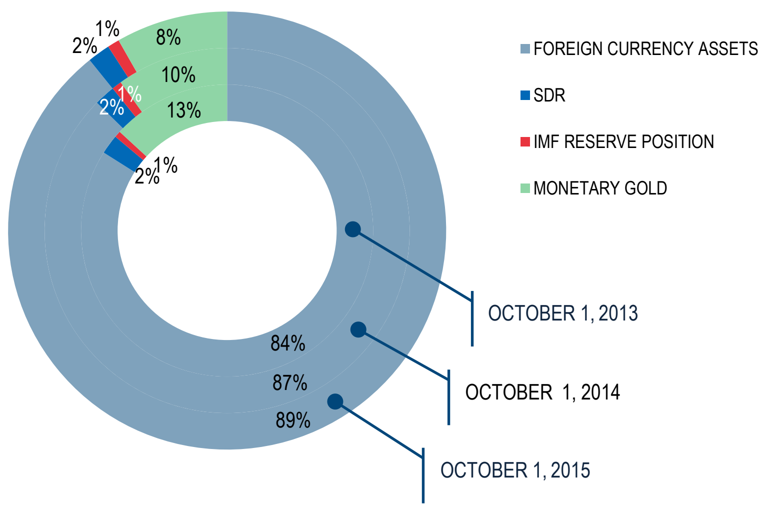
We estimate that Russia's FX reserves remain sufficiently high so that even exhaustion of the Reserve Fund would not lead to a deficit of highly-liquid reserve assets in the local economy.

4. Potential changes in Russia's FX reserves structure

The structure of Russia's FX reserves remains stable and mainly consists of highly liquid assets denominated in foreign currency (89% as of October 1) including securities, currency and deposits (for a detailed breakdown of Russia's FX reserves, see our note entitled "Central Bank's FX Reserves: a sneak peak" dated January 20, 2015).

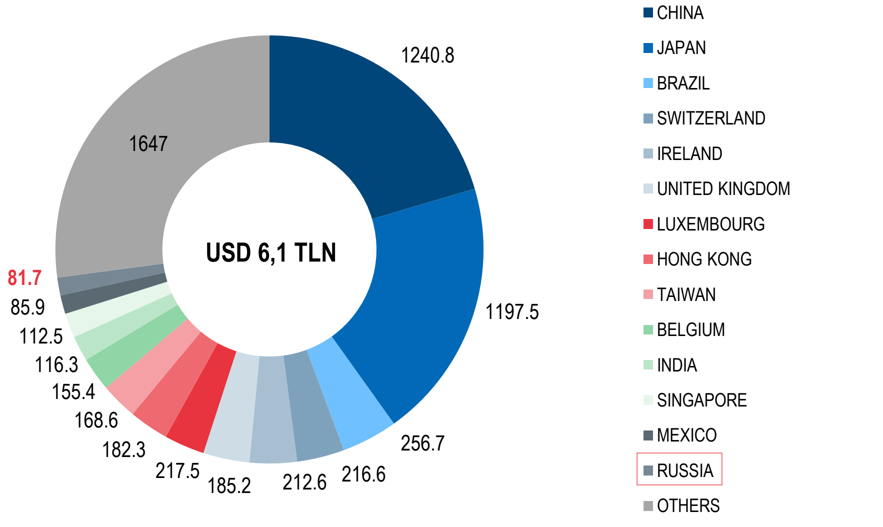
According to our estimates, about 20% of Russia's FX reserves are held in the form of US Treasuries (USTs), which has led to significant dependence of Russia's wealth on the price of these instruments. Following a sizable reduction in Russia's UST position during 2013-1Q15, the country's holdings increased significantly (+22.8%) in May-July 2015 (even as other BRICS countries were unwilling to increase their UST investment). As of July 31, Russia ranked 16th among foreign UST holders.

Russia's FX reserves structure



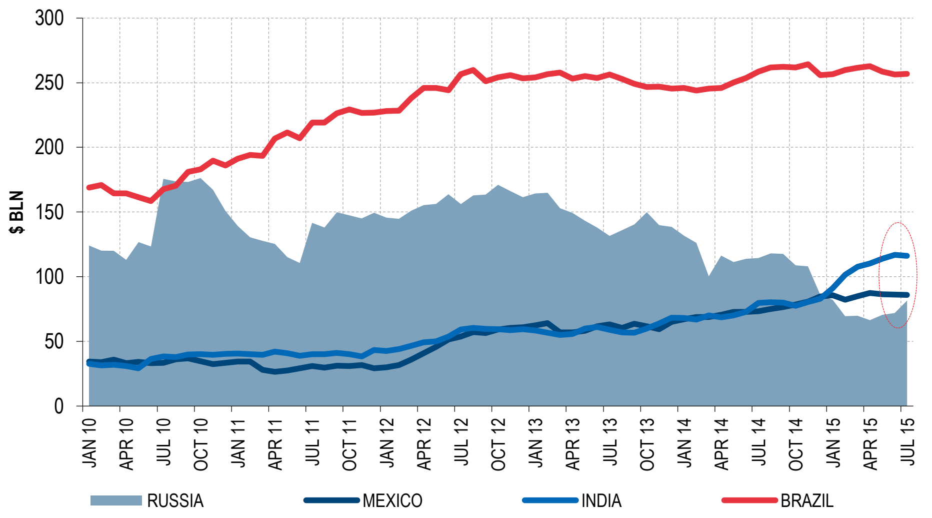
Source: CBR, Gazprombank estimates

Main foreign UST holders as of July 31, 2015



Source: Bloomberg, Gazprombank estimates

UST holders: Russia vs. select EM countries



Source: Bloomberg

Share of UST in Russia's FX reserves could be subject to reconsideration

In our view, maintenance of a significant share of USTs in Russia's FX reserves could be subject to further consideration due to the following reasons:

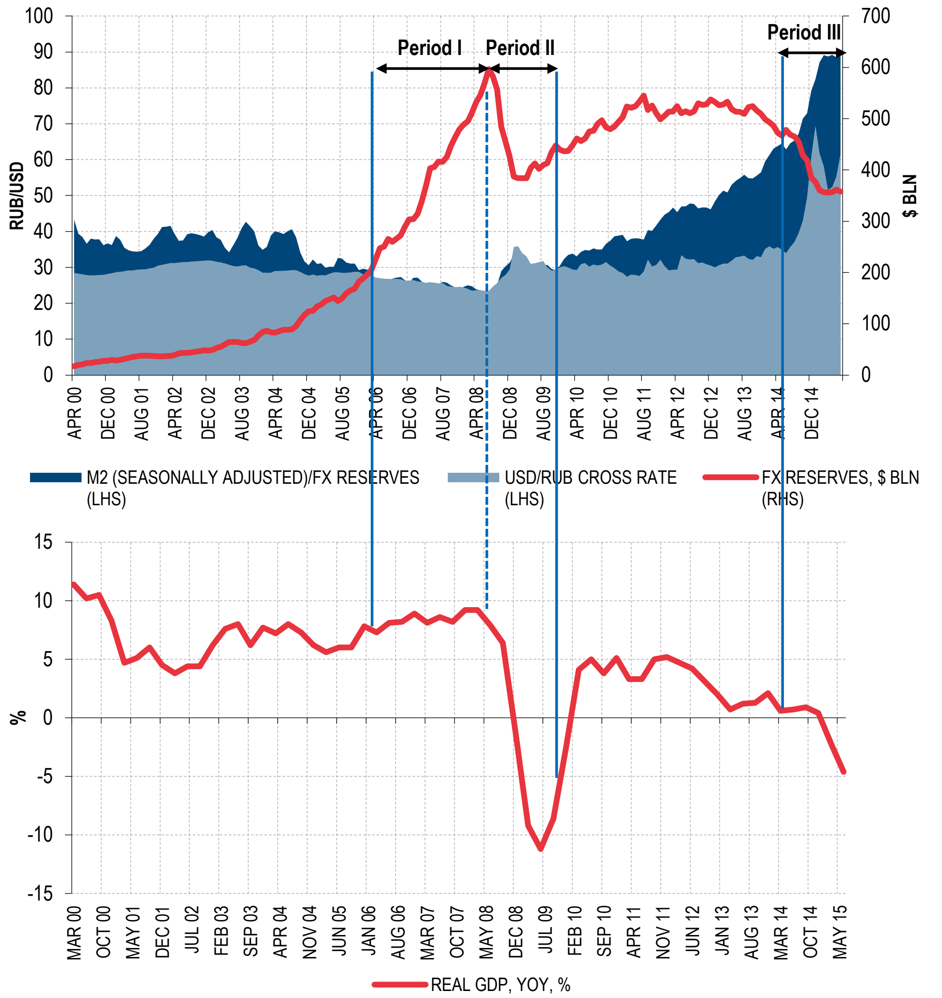
- high market volatility amid ongoing uncertainty regarding possible movements in the US federal funds rate; and
- significant selling of USTs by China, the largest foreign holder of USTs, in case of an emergency need to support its local financial markets. China's FX reserves have decreased by $329 bln YTD (an amount comparable to the reserves of both Russia and India) amid urgent financial market stabilization measures. This decrease seems to be connected with selling of USTs.

Given that not only China but other EM countries may resort to sales of USTs from their FX reserves for economic stabilization purposes, the significant share of these instruments in Russia's FX reserves (about 20%) would imply a further reduction.

5. Russia's FX reserves: side effects of sufficiency

Given that FX reserves are mostly held in the form of highly liquid assets and their movements can affect the internal money supply, we analyzed the evolution of Russia's M2 (denominated in RUB) to FX reserves (nominated in USD) ratio in comparison with the RUB/USD exchange rate. The proportion between Russia's M2 (denominated in RUB) to FX reserves (denominated in USD) can be considered as similar in composition to the RUB/USD exchange rate.

M2/FX reserves vs. RUB/USD cross rate



Source: CBR, Bloomberg, Gazprombank estimates

Current level of Russia's FX reserves may cause excessive growth in the money supply

During the period from April 2006 to December 2009, the M2/FX reserves ratio dynamic was almost equal to that of the RUB/USD rate (marked as "Period I" and "Period II" in the chart above). If we look at FX reserves over this period, their sharp contraction suggests that the CBR sought to keep the RUB/USD rate pegged to the M2/FX reserves ratio and possibly to absorb the extra money supply from the market. This period also covers the economic recession alongside a sharp increase in FX reserves in "preparation" for a crisis ("Period I") and further spending ("Period II") to facilitate support of the exchange rate.

Historically, countries that practice regulated FX policy try to maintain a lower M2/FX reserves ratio than those with a floating rate. In 2014, Russia completed its transition from a currency band to a floating FX rate regime combined with inflation targeting, but the decrease of the FX reserves/M2 ratio started much earlier.

Thus, Russia's current money supply seems out of proportion to its FX reserves, especially in an environment of economic recession and high inflationary expectations. Significant spending of Russia's FX reserves (including the relevant parts of the Reserve Fund) is linked to monetary factors and may cause (should the CBR not engage in money sterilization measures) a significant increase in the money supply, thus creating the basis for accelerated inflation.

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