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Russia would be better off if oil were to dive lower over short term

***By Chris Weafer of Macro-Advisory** February 12, 2016*

In late January, Russian officials floated the idea that Moscow could cooperate with Opec to cut the supply of oil to the world market and thus provide support for the price of oil. That proposal never had any real basis in reality and, it appears, the main purpose was to halt the sliding oil price by encouraging traders to bet on the start of a rally. It wasn't a bad tactic, as traders are very nervous of missing the bottom and the start of a long rally as happened in January 2009. It worked for a couple of weeks, but the oil price is again on the slide and Brent again looks more likely to fall through the $30 per barrel level and, possibly, to the mid-$20s in the coming weeks.

Traders will not fall for another flimsy attempt to support the price and instead are very focused on the latest report from the International Energy Agency (IEA). This showed that Opec supply averaged 32.63mn barrels per day (b/d) in January, up from an average of 32.43mn in the third quarter of last year, while US production averaged 12.61mn b/d, down from 13.0mn b/d in the third quarter. It had been hoped that the oil price decline would have cut production, especially amongst the US shale producers, more steeply. It means that there is still an excess supply of almost 1.5mn b/d and it is going down far too slowly. In the battle for market share, it seems nobody is as yet ready to blink.

Perverse as it may sound, the best thing that could happen for oil producers, such as Russia and Saudi Arabia, is that the price of crude now falls very steeply, eg. to the mid to low $20s per barrel, as that would very likely shake out a lot of US shale production and would slow the return of Iranian oil. The low average oil price is already starting to boost gasoline demand and, if oil is still low in the spring and summer, global oil demand should rise faster than the 1.2mn b/d predicted by the IEA. Basically, it is a question of suffering short-term pain in the interest of longer-term gain. A $25 oil price in this quarter is more likely to lead to a steady price rise in the second half of the year because of the shake out of supply and the boost to demand.

Assuming that scenario of weaker oil near-term and a rally in the second half, what does that do to the ruble exchange rate and the Russian economy in 2016?

Picking through the ruble

The short answer is that the ruble-dollar exchange rate may well test the RUB90 to the dollar level in the coming weeks, but it should also end the year closer to RUB70. In other words, the ruble still has a credible chance of being one of the better performing global currencies over the course of the full year. That's a valid possibility. But nearer term it is clear that the ruble and the economy are both mired in very tough conditions that look set to get worse before improving.

Even if the ruble exchange rate again looks set to test the low point of mid-January, the Central Bank of Russia (CBR) will not intervene to provide any support. Preserving financial reserves and limiting the revenue damage to the budget are now greater priorities. The only reason the federal budget reported a modest deficit of 2.5% for 2015 was because the ruble decline matched that of the oil price. In addition, the weak ruble helped cut import demand, which helped the current account report a bigger surplus than that of 2014, and boosted demand for some domestic products. Yes, the weak ruble also adds to inflation concerns and has persuaded the CBR to become even more hawkish, both of which hurt economic activity, but that, for now, is the lesser of two evils as far as the government is concerned.

The prospect of weaker oil revenues, even though substantially offset with the weaker ruble, plus lower tax revenues from other sectors of the economy, has already led to a review of state spending and an expected 10% cut in this year's budget. The table below shows our estimate of what the budget deficit would look like at various oil price averages in 2016. Under the base-case scenario, which assumes an average oil price of $40 in 2016, the budget would run a deficit equal to 4.0% of GDP if spending was not cut or extra revenue found. At an average of $30 the deficit would expand to 6%.

But we also know that President Vladimir Putin has demanded the deficit be contained to as close to 3% as possible. That is because he does not want to risk running down the Reserve Fund before the financial sector sanctions are eased, if not removed. Hence the current exercise to find extra spending cuts is likely to be followed by extra taxes in the oil sector and a more serious effort to find strategic buyers for equity in some state companies, including Rosneft. Those assumed budget revisions would help keep the deficit at a more moderate level even as the oil revenues fell sharply.

The combination of a weaker ruble, a hawkish central bank, further budget cuts, and falling business and consumer confidence means that the economy will inevitably remain in recession through the first six months of the year. A contraction of 2-3% is very likely. What happens in the second half will depend partly on whether the oil price does indeed stage a recovery, bringing the ruble with it, and whether financial sector sanctions are eased from mid-summer. If they are eased and oil does recover, then the positive impact on the economy and on confidence would likely lead to a much more modest GDP contraction, perhaps 0.3%, for the full year and allow for growth of 1.5-2.0% in 2017.

The ban that bites

In terms of sanctions, the only one that matters – and the only one which the Kremlin is actively working to have dropped – is that which prevents the state banks and some energy companies from accessing Western debt with a maturity beyond 30 days. The effect of that sanction, imposed by the US and EU in August 2014 and which resulted in Russia's retaliatory ban on food imports, was a much more damaging voluntary ban by all Western banks on all Russia risk. The hope is that even an easing of this sanction would allow access to debt at competitive rates by non-sanctioned Russian companies and by the Ministry of Finance. Notwithstanding that the government in Ukraine is heading for a crisis and is unlikely to be able to pass the legislation required to allow elections in the Donbas region that is held by pro-Russian separatists, there have been some encouraging actions since the start of the year which supports increased optimism for at least financial sector sanctions to change in July. The hawks in the US and Europe will still be able to hang onto the Crimea and other sector sanctions. For the Russian economy those sanctions don't matter.

Realistically, the scenario of short-term pain in oil revenues, the budget and the ruble, which then gives way to a better trend in the second half, is probably the best Russia can hope for this year. It could certainly be worse if, for example, the oil price stays in the $30-35 range all year. That would imply a ruble initially at around the RUB80 level against the dollar, but then drifting towards the RUB90 level by year-end and with less optimism for 2017. If financial sector sanctions are also extended into 2017, the economy could easily see a third year of recession in 2017.

To make any assumption of a much quicker and sustainable oil price rally from current levels one would have to assume a big supply outage, for example an outbreak of war in an oil-producing region or one which disrupts oil transit other than for the short term. History tells us that such a threat should not be entirely dismissed, but it is hardly the basis for either a trading or budget strategy.

The reality is that Russia would be much better off if the oil price were to dive lower over the short term. That would cut into the excess supply and boost consumer demand for oil and create a more solid foundation for a steady and sustainable rally in the ruble and in economic activity through the second half.