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# Russia: All Good Things Must Come to an End

Back in 2014, the oil price collapse and U.S. sanctions shocked Russian markets. The USD-RUB cross went from 35 to 85 and dollar bond spreads widened from 200 to over 550 basis point (bps). The Russian authorities responded forcefully with tighter monetary and fiscal policy which encouraged a swift rebalancing of the economy. Five years later, Russia stands out as one of the few major emerging markets (EM) boasting both fiscal and current account surpluses. The ruble has been the best performing EM currency year to date on a total return basis, and local-currency bond yields are plumbing new lows. But as is always the case in markets, the question is not where we've been but where we're headed. There are growing signs that future economic policy will shift focus to the potential detriment of asset prices. Let's focus briefly on policy rates and balance of payments dynamics.

The Central Bank of Russia (CBR) has built up its credibility substantially as a result of its reactions to the 2014 crisis. The key rate was hiked to 17% in late 2014, reduced to a more "normal" 11% in 2016, and monetary easing since then has been extremely gradual with the policy rate still standing at a high 7%. The yield pickup relative to other EMs has supported the ruble despite geopolitical noise throughout the period. Monetary policy may be about to become a lot less restrictive with inflation falling below the 4% target; 2020 will likely be another benign inflation year given favorable base effects related to this year's value added tax hikes. The CBR now has room to engage in a substantial easing cycle with policy rates likely to approach 5.5% by next summer. Monetary easing will eventually have a favorable impact on growth, but on a first-order basis may erode the ruble's yield support.

Balance of payment dynamics trends have also started to reverse. After a brutal decline in 2014-15, imports seem to have bottomed. Non-energy exports improved significantly starting in mid-2016, but have rolled over given weakness in its main export market, Europe. The price of Russia's main export, energy, remains challenged as global demand concerns outweigh OPEC supply cuts. Income outflows are set to pick up as Russian companies switch from using cash to repair balance sheets and restart dividend payments. As a result, analysts expect the current account to erode from an impressive 7% of gross domestic product to closer to 4% by 2020.

However, Russia remains in a good spot. The sovereign has room to draw on fiscal savings to invest in infrastructure and boost growth. Better loan affordability has ended years of painful deleveraging. The central bank has ample reserves in the event of another crisis. It's more of a question of how much of the good news is already baked into the currency and what the future holds.

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