Q&A-Russia's reliance on oil likely to increase amid focus on Arctic projects, which are likely to be unviable: Christopher Granville, TS Lombard

The Russian economy's reliance on oil exports for economic growth and stability is set to rise in the coming years, at a time when the world tries to trim its fossil fuel use, **Christopher Granville, Managing director for EMEA and global political research at TS Lombard,** told the Reuters Global Markets Forum on Thursday, May 6.

Granville said Russia's decision to subsidise large investments in new Arctic oil projects, which are likely to be economically unviable, means the country will have greater exposure to oil in the next decade, even though the government has been leaning on the private sector to cut emissions.

Following are edited excerpts from the conversation:

Q: What are your thoughts on the Russia's reliance on oil revenue for the economy's stability?

A: This reliance is going to be intensified rather than reduced -- as would be desirable -- by the Russian government's decision to subsidise huge investments -- 10% of 2019 gross domestic product over the next decade -- in new Arctic oil projects that are very unlikely to be economically viable.

Q: Does that mean even the Arctic ship routes opening up due to climate change don't make prospecting there worthwhile?

A: The Northern Sea Route in itself could be interesting regardless of Russia's oil and gas production in the Arctic region, simply as a competitive transit option between Asia -- especially China -- and Europe. This competitive potential was highlighted by March's blockage of the Suez Canal. However, the lack of coastal support systems in that extreme inhospitable environment is one major remaining problem. And, getting back to Russian oil and gas production in the region, and the transport of that oil and LNG in the Arctic - this is important to provide critical mass and economies of scale to the Northern Sea Route.

Q: Is the Russian government wilfully setting itself up for potential economic instability going ahead?

A: To start by adding to my previous comment, the synergy between Arctic oil production and developing the Northern Sea Route is one reason why the Russian government is so keen on the Arctic oil developments. Another factor is that Arctic oil projects will generate equipment orders for that substantial part of Russian manufacturing industry that is linked to the defence sector and that will be suffering from depleted order books now that Russia's big rearmament push of the 2010s has passed its peak. So, one can see why, from the Russian government's point of view, what we at TS Lombard are calling the "Arctic oil policy error", points to stable development.

However, the stability risk that you refer to stems from the high likelihood of long-term oil price weakness on steadily declining global demand for crude oil. Subsidising inherently unviable oil projects in the Arctic will not only waste resources but result in the rouble exchange rate being kept stronger in real terms than it otherwise would have been, thereby hampering the wider economic diversification that is crucial for true stability. In other areas, however, the Russian government is showing an awareness of the importance of diversification away from hydrocarbons, preparing for the European Union’s mooted Carbon Border Adjustment Tax.

Q: How are companies reacting to the government's stance on this policy?

A: Our trusted sources in Russian company boardrooms tell us that the government is putting pressure on companies to demonstrate a lower carbon footprint. Many Russian companies are making progress here, but the big breakthroughs depend on a shift to hydrogen. Options here include Gazprom's research and development focus on "purple hydrogen" using pyrolysis technologies and/or the generation of green hydrogen by the electrolysis of water using the electricity generated by Russia's nuclear power plants. Seriously, pyrolysis could prove very exciting, admittedly, on the usual long -10 year - view.

Q: With the heavy tilt in Russia's market capitalisation to energy and mineral companies, is there a divergence between them and the world, in terms of investor pressure on firms to give dividends versus ploughing it into capital expenditures?

A: President (Vladimir) Putin's annual state of the nation address on April 21 contained an important signal on dividends, which have been a big driver of the resource-dominated Russian equity market in recent years. The signal was that more of the profits being enjoyed by the exporting companies -- oil and gas, and miners -- in present environment of healthy global commodity prices and a weak rouble, good for profitability -- should be directed into new capex, which is the only way the Russian economy can grow, rather than paid out in dividends that amount to capital outflows. A potentially negative signal for Russian equities, though we wait to see how/when the government is going to translate Putin's call into practice.

Q: As global finance becomes more ESG-centric, do you feel there will be more unhappiness at international investors holding Russian debt? How will investors reconcile these differences, and could they ditch Russian debt altogether?

A: Absolutely! The drive for capex is bad for diversification. What is really needed is an improved investment climate, leading to new private investment in various sectors. But a better investment climate requires more impartial courts -- true rule of law -- and less geopolitical tensions, among several other things!

The domestic political picture is also negative for this key question of improving the investment climate. On the other hand, macroeconomic policy remains highly orthodox, which should, other things being equal, retain fixed income investors' interest in Russian bonds. That said, this macroeconomic orthodoxy is now up against a much worse than expected inflation challenge, with which the central bank is racing to catch up (to), having fallen behind the curve.

Q: Do you think Governor Elvira Nabiullina and the Central Bank of Russia will see off challenges to their independence?

A: On this point, I am bullish, yes. Elvira Nabiullina has clearly won a high degree of confidence from President Putin over the years, and she can be confident, I think, of Kremlin support in the face of the inevitable sniping at the tough monetary tightening now just beginning - sniping that will come from some quarters of the government and big business.

Q: Given the Russian government's stance of subsidizing Artic oil operations, does it risk resigning itself to a bit part role in the future world order -- due to a policy gaffe, if the world successfully weans itself of oil in the decades ahead?

A: Never underestimate Russia's ability to learn from mistakes. But, if I may generalize with a broad brush, Russia tends to make the mistake first, rather than as would be preferable, avoid the mistake, and then feel the pain, and only then correct in response to that pain! The investment moral of this story, is to keep powder dry, wait for risks to play out, as they tend to be overpriced by markets, and buy on weakness. In this respect, Russia still is a classic emerging markets play!

Q: In closing, do you have any things to watch out for? Any views on the possibility of tighter U.S. sanctions on Russia?

A: A couple of things: The digital reconfiguration of the supply side is going from strength to strength. Take e-commerce: the great Ozon IPO will be followed by others: watch out for Wildberries.

Second: The rotation of the top leadership. If Putin decides to go for a managed power handover in 2024, or perhaps even earlier, that would kindle a big hope rally in Russian markets. Totally impossible to predict, but an early power transit could happen.

On sanctions, at least we have a breathing space for the next few weeks before the Putin-Biden Summit in June. Nothing bad will happen before then.