

# Column: Even before price plunge, hedge funds were abandoning oil



LONDON (Reuters) – Even before the OPEC+ output agreement broke down on Friday, sending oil prices into a tailspin, hedge funds had launched a second wave of oil-related selling and established one of the most bearish positions since the price crisis of 2014-2016.

Hedge funds and other money managers sold the equivalent of 133 million barrels in the six most important petroleum futures and options contracts in the week ending on Tuesday.

Funds were sellers of Brent (60 million barrels), NYMEX and ICE WTI (31 million), U.S. gasoline (25 million), U.S. diesel (4 million) and European gasoil (12 million).

Over the last eight weeks, portfolio managers have sold a

total of 579 million barrels, more than reversing purchases of 533 million in the final quarter of 2019.

The hedge fund community's overall long position had been slashed to just 392 million barrels by March 3, down by 60% from 970 million at the start of the year, and the lowest since the start of 2019.

Fund managers have a in-built bullish long bias: they have never held a net short bearish position at any point in the last seven years, according to an analysis of data from regulators and exchanges.

But the data can be adjusted to remove "structural" elements from long and short positions (the minimum number of long and short positions which never change) to show the underling "dynamic" position more clearly.

On March 3, portfolio managers had a dynamic position that was net short by 99 million barrels, the most bearish since the start of 2019 ([tmsnrt.rs/38xhDyp](https://tmsnrt.rs/38xhDyp)).

Overall, funds now hold just two bullish long positions for every bearish short, down from a ratio of almost 7:1 at the start of the year, and among the most bearish ratios at any point in the last seven years.

Portfolio managers have become especially negative about the outlook for distillate fuel oils such as diesel and gasoil, the refined products most closely connected with the business cycle.

Unusually mild winter weather throughout the northern hemisphere has cut heating oil consumption; now the coronavirus epidemic threatens an extended slowdown in global manufacturing and trade.

As a result, funds' long-short ratio in middle distillates has fallen to just 0.7:1, compared with 2.4:1 in crude and 5.3:1

in gasoline.

Funds are more bearish on distillates than at any time since the global economy was still struggling to emerge from the commodity slump and mid-cycle manufacturing slowdown of 2015/16.

These bearish positions in crude and fuels had all been established before Saudi Arabia and Russia failed to agree on extending and/or deepening their output cuts at the OPEC+ meeting on Friday.

The combination of unrestrained production and weakening consumption has sent Brent prices down by a further \$16 per barrel (31%) since Tuesday as investor sentiment has soured on the economy and oil even further.

Since Friday, Brent prices have experienced their sharpest one-day fall since U.S. forces moved to end Iraq's occupation of Kuwait in January 1991, as traders respond to the unexpected collapse of the OPEC+ supply accord.

With Russia and Saudi Arabia now likely to lift output cuts and produce at their maximum capacity, prices will adjust down to the level set by the marginal producer, which in the last five years has been U.S. shale.

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- Hedge funds paused oil sales, before coronavirus prompted second wave of selling (Reuters, March 2)
  - Oil traders price in coronavirus-driven recession (Reuters, Feb. 28)
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# What the ECB's Strategy Review Must Do



The European Central Bank's new strategy review must recognize that economists are still a long way from understanding the dynamics of low inflation. Given this uncertainty, the ECB should aim to adopt robust policies that cause the least damage under a broad range of scenarios.

LONDON – With her recent announcement of the European Central Bank's long-overdue strategy review, new ECB President Christine Lagarde has generated high expectations. The review's outcome will be the first important signal of how Lagarde intends to lead the institution – and of how the ECB is likely to address persistently low inflation in the eurozone.

The world is very different than it was in 2003, when the ECB's strategy was last revised, and the institution has itself undergone deep changes since the 2008 financial crisis. Faced with a global recession and then the 2011-2012 eurozone debt crisis, the ECB abandoned the traditional approach of passively meeting banks' demand for liquidity – its initial response to the financial crisis. Instead, the ECB started

actively managing its balance sheet in order both to ease monetary policy and stabilize the financial system.

Furthermore, the ECB has radically expanded its operational tools. In 2014, it introduced negative interest rates on banks' deposits with national central banks, and began providing the market with "forward guidance" concerning its future policies. And, since 2015, the ECB has engaged in asset purchases (known as quantitative easing, or QE), causing its balance sheet to double compared to 2008. Finally, the ECB has assumed larger prudential supervisory responsibilities *vis-à-vis* European banks under the Single Supervisory Mechanism.

The first phase of the ECB review will be narrow, focusing on defining the bank's inflation target, the role of monetary aggregates as signals of medium- to long-term inflation, and communication. This is expected to be concluded in the first half of 2020, to be followed by a second phase of reflection.

Any meaningful review of these issues must objectively and critically analyze the decade since the financial crisis, during which average eurozone inflation has been well below the ECB's objective of "below, but close to, 2%," and also lower than in the United States and the United Kingdom. In particular, the review should quantify the costs of tolerating a systematically below-target level of inflation, relative to pursuing other policy options.

There are at least three hypotheses to explain the ECB's inability to achieve its inflation objective. The "policy mistakes" hypothesis maintains that the ECB should have implemented more aggressive policies – in particular, QE – between 2012 and 2014. If these "mistakes" stemmed from an ill-defined ECB strategy, then its strategy will have to be adjusted; if they were the result of political constraints, then its decision-making process should be changed.

The second explanation highlights the inadequate coordination

of fiscal, financial, and monetary policy in the eurozone. In 2009, for example, monetary easing was accompanied by a delayed cleanup of the banking sector and fiscal austerity, leading to a second recession that the ECB was late to identify. And in 2012-2014, a neutral fiscal stance was coupled with both insufficient monetary stimulus and banking-sector deleveraging.

Both hypotheses suggest that the ECB would have fared better had it clearly committed to a symmetric quantitative target for inflation or nominal GDP. That would have implied, for example, not increasing interest rates in 2011 (as the ECB did) in response to the temporary inflationary effect of higher oil prices. It also would have implied starting asset purchases in 2012 instead of 2015, and not stopping them in 2018.

The third hypothesis, favored by some central bankers, is that persistently low eurozone inflation reflects structural factors such as adverse demographics, low growth expectations, and the associated increase in demand for safe assets. This explanation thus draws parallels between the eurozone and Japan, where aggressive monetary and fiscal policies since 2013 have failed to lift the economy out of its two-decade-long slough of low inflation.

Advocates of the structural view argue that it would be better for the ECB's policymakers to adopt a lower inflation target rather than try to engineer a monetary stimulus that ends up inflating asset prices and jeopardizing financial stability. After all, their argument implies, there is little evidence that stable low inflation is bad for welfare.

But this third hypothesis can lead to two alternative policy recommendations. The first is a "do-nothing" approach, coupled with a downward adjustment of the ECB's inflation target in line with actual inflation. Such a course of action is justified if policymakers assume that potential output growth

in the eurozone has declined independently of past fiscal and monetary stabilization policies. The second option, as under the first two hypotheses, is to maintain an accommodative monetary policy, possibly in coordination with fiscal policy. This would be the right thing to do if policymakers believed that persistent slack in the real economy would end up affecting potential output.

Most analyses imply that ECB policy has in general been too cautious during the last decade. Moreover, even if one accepts the structural explanation for trend inflation and takes the view that inflation expectations have fallen independently of past policies, the “do-nothing” option is likely to cause expectations to spiral further downward, possibly leading to a deflationary trap. One then has to consider the costs linked both to the associated relative price adjustments and to the effect that the resulting upward pressure on the real interest rate would have on the burden of private and public debt. These costs are likely to be greater than those associated with the financial-stability risk of doing “too much,” which in any case can be addressed using prudential tools.

The ECB’s new strategy will have to be based on the kind of quantitative analysis needed to answer these questions. But it also must recognize that economists are still a long way from understanding the dynamics of low inflation. Given this uncertainty, the ECB should aim to adopt robust policies that cause the least damage under a broad range of scenarios.

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## **EU Overcomes Nuclear Divide**



# to Reach Key Green-Finance Deal



The European Union agreed on a landmark green-finance regulation, advancing the bloc's push to embed environmental goals in standards for banks, money managers and insurers.

EU lawmakers approved an accord on the list of sustainable activities late Monday, following an agreement by the bloc's member states earlier in the day. Policymakers had to overcome last-minute divisions over the kinds of technologies that should be eligible to be classified as green, with nuclear-energy proponents, including France, seeking revisions to an earlier version of the proposed rules.

"With this deal, we now have a common language and new rules for financial markets," Pascal Canfin, a French member of the EU parliament, said in an email. The final compromise means both nuclear and gas "are neither included nor excluded in principle" from parts of the list, and – like all other activities – would feature only if they comply with the so-called "do no significant harm" principle, he said.



The EU's definitions of sustainable activities for investment purposes, dubbed "taxonomy," are the centerpiece of its plan to regulate the fast-growing market of green finance, in the hope of directing trillions of euros to fund a radical overhaul of the region's economy. It's meant to define what's green and what's not, an effort that could find a range of uses and serve as an example for governments around the world.

The back-and-forth over the rules shows what kind of obstacles the EU has to overcome to meet its ambitious climate targets. Leaders last week agreed that the bloc should achieve zero net emissions by 2050, paving the way for a flurry of legislation that's needed for the unprecedented clean-up of the economy.

## **Green Investment**

The agreement on the taxonomy is a vital step as it's meant to help countries shoulder the cost of fighting global warming. "This is the much-needed enabler to get green investments to flow and help Europe reach climate neutrality by 2050," Valdis Dombrovskis, the European Commissioner in charge of financial-services policy, said on Twitter.

Monday's agreement on the green investment catalog is just the first step of the process, setting out the overall framework. The concrete list of activities will be drawn up based on recommendations by a panel of experts and adopted by the European Commission, the EU's executive arm.

All financial products will need to make clear to which extent they comply with the new framework, though issuers can opt-out if they don't pursue any environmental goals. The first set of definitions will be applied from the end of 2021, with the rest following a year later.

"We are delighted that there is progress in the approval of the EU taxonomy," Nathan Fabian, chief responsible investment officer at Principles for Responsible Investment, said in an

email. “Investors in Europe and around the world see the taxonomy as a major reform in investment practices and are keen to understand their obligations under the framework.”

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## Spain smooths way for LNG to boost biggest storage hub in Europe



Spain is undergoing the biggest overhaul of its liquefied natural gas system in an effort to boost its role as a key storage and trading hub for the fuel. With more LNG terminals than any other country in Europe, Spain is turning its domestic-focused network into one more accessible to global traders. Starting next year, the country plans to reform its storage limits and fees that have in the past deterred shippers from stockpiling and reloading LNG there. The timing couldn't be better as new plants from the US to Russia add ever more LNG to a market in a market that's already testing storage limits. That supply glut resulted in a record number of LNG cargoes sailing to Europe last month, a trend poised to continue through the rest of the year.

“The high costs of using Spanish infrastructure meant that Spain largely lost out to other European countries in the reload arbitrage to Asian markets in 2017-18,” said Leyra Fernández Díaz, a global gas analyst at Energy Aspects Ltd. “This will likely no longer be the case after the reforms.” Spain's terminals have about the same combined storage capacity as its two closest rivals, Britain and France, put together, according to Gas Infrastructure Europe. Spain also

boasts the oldest working terminal in Europe, with its Barcelona facility in operation since 1968. From October next year, LNG traders using Spain's terminals won't need so-called bundled deals that oblige them to deliver gas into the nation's grid. They'll also be able to tender for space over set periods, a common practice at other European hubs. "LNG storage capacity will be offered as an unbundled service through regular auctions as standard products: yearly, quarterly, monthly, daily and intra-daily," said Agustin Alonso of Spain's National Commission of Markets and Competition.

"Users will have to pay the price resulting from the auction for the whole amount of the capacity booked, regardless of whether they use it or not." It's a departure from the present system, which is geared toward supplying Spain, the European Union's sixth-biggest gas user. Daily fees are charged for storage and stiff penalties are imposed for those who exceed set thresholds including how long they hold supplies. Abolishing those penalties will cut about \$0.56/mmbtu from the cost of storing a cargo for a month, according to Energy Aspects. That's about 10% of the current benchmark rate for LNG in Asia, the biggest user of the fuel. That would be welcome news to LNG traders who this summer and autumn had little choice but to dump cargoes in Spain as a wave of incoming supplies filled Europe's storage sites. While Spain did import LNG as utilities burned more gas, what traders often need is a place to keep fuel for re-exporting or for use in the future. A reduction in tariffs still needs to be approved by the CNMC. Capacity products will be available from October 1, and the first auction of the yearly products will take place in September. Spain may still have a way to go to rival the trading hubs of Britain's National Balancing Point and the Title Transfer Facility in the Netherlands.

Both have extensive cross-border pipeline links and liquid trading markets that Spain lacks. "This initiative might

increase trading in Spain a little bit but will it make any difference to European gas trading? I doubt it,” said Patrick Heather, a senior research fellow at the Oxford Institute for Energy Studies. Even so, the reforms complement plans unveiled earlier this year to treat all of Spain’s LNG terminals as a single virtual hub. The aim is to boost trading between the ports and reduce congestion at a particular location. Current rules make traders trade within a specific terminal. “Storing at onshore LNG terminals in Spain is to become more competitive than floating storage,” Energy Aspects’ Fernandez Diaz said. “The creation of the virtual LNG hub will abolish costly penalties for storing LNG.”

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## The ECB needs a new mandate



BERLIN – The European Central Bank’s (ECB) decision in September to pursue more monetary-policy easing was controversial, with one board representative, from Germany, resigning over the move. But one of the most

remarkable features of the ECB's position has not gotten enough attention: the admission that inflation expectations have become de-anchored, and that without fiscal-policy support, the central bank will probably fail to fulfill its price-stability mandate for the foreseeable future.

In fact, many observers, and even several members of the ECB's governing council, now argue that the bank needs to adapt its mandate with a new definition of price stability in mind. They are right, but there is one crucial caveat.

Since central-bank independence was strengthened in the 1990s, it has become clear that, in normal times, the specific mandate does not matter much. The United States Federal Reserve managed to guide expectations and achieve price stability with its dual mandate, price stability and maximum employment, just as well as the Bank of England or the ECB, with their narrower price-stability mandates.

After the global financial crisis, however, the traditional mandate proved inadequate to cope with large-scale financial instability, fickle market confidence and political paralysis. Developed-country central banks had to devise policies on the fly, without a guiding framework. Each in its own way pursued unprecedented monetary easing, massively expanding its balance sheet, in order to provide much-needed support to the economy.

In many ways, these measures succeeded: Monetary expansion played a major role in pulling the economy back from the brink. But, over time, central banks' capacity to affect the real economy declined. Today, and for the foreseeable future, domestic inflation is increasingly affected by global, rather than local, developments, and financial (in)stability and fiscal policy are far more influential than monetary policy.

For the ECB, this generates a particularly serious challenge. After all, unlike other central banks, it must account for the preferences of 19 sovereign national governments, with little

to no structural or fiscal-policy coordination. The eurozone is also highly fragmented financially, lacking a common capital market, a unifying safe asset or macroeconomic stabilisation tools.

The ECB needs a more realistic and flexible mandate. Given the eurozone's fragmented nature, that mandate should probably still be centered on price stability. But it should also recognise that the current definition of price stability, "below, but close to, 2 per cent inflation over the medium term", is too narrow.

A broader definition is needed, according to which the ECB pursues a symmetric inflation target of 2 per cent, within a 1.5-2.5 per cent band, over a longer time horizon. Some advocate an even higher target: For example, Olivier Blanchard, a former International Monetary Fund chief economist, has proposed re-anchoring expectations at 4 per cent. A different proposal, from New York Federal Reserve President John Williams, is to target a price level, rather than an inflation rate.

A commitment to more broadly defined price stability in the long term would give the ECB more space during times of crisis, thereby enabling it to account better for risks to financial stability and the real economy. This would help it to stabilise prices more quickly, bolstering its credibility.

By contrast, when the ECB consistently fails to meet its price-stability objective, as it has for the last five years, it loses credibility. And, indeed, the ECB has faced harsh criticism, sometimes warranted, often not, over its implementation of untested expansionary monetary policies since 2008, partly because the measures were often poorly understood by the public. The loss of credibility has undermined the ECB's capacity to fulfill its objectives, creating a vicious circle that threatens its de facto independence.

This is why the timing of any mandate change must be chosen very carefully. If the ECB tries to move the goalpost while it is missing the shot, the short-term blow to its already diminished credibility could be serious. Given this, the ECB must work to strengthen its standing before it adjusts its mandate, including by attempting to reach the existing price-stability objective after years of failure.

At the same time, the ECB must communicate better what its capabilities are. Some have urged the ECB to try addressing the solvency problems of banks or governments during the crisis. Others would like the ECB to discipline governments to do the “right” thing and consolidate spending. A central bank must do neither and would utterly fail if it tried. But these attempts have hurt the ECB’s standing, particularly in Germany, and have diminished its credibility.

Clarifying the contents of the ECB’s policy toolbox, including sovereign-bond purchases and other non-standard measures, would go a long way toward protecting the ECB from such attacks in the future. And when the time comes to shift its objectives, the ECB must communicate the change, which, to be sure, may not need to be as big as many believe, clearly and thoroughly.

US President John F. Kennedy was right: the time to repair the roof is when the sun is shining. The ECB cannot revise its mandate until the current storm has passed. But, with water pouring in, it cannot afford to wait very long. The sooner the ECB does what is needed to restore its credibility, the sooner it can do what is needed to protect itself from future storms.

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# Essar Steel case: SC clears way for ArcelorMittal to complete \$5.8 bn deal



ArcelorMittal won approval from India's top court to complete its \$5.8 billion purchase of a bankrupt steel mill, clearing the way for tycoon Lakshmi Mittal to enter the world's second-biggest market.

The Supreme Court allowed Arcelor to make the payment for Essar Steel India Ltd. and set aside a bankruptcy appellate tribunal's order that had given secured and unsecured creditors equal right over the sale proceeds. The lenders' panel of a bankrupt company has discretion in the distribution of funds in insolvencies, a three-judge bench headed by Justice Rohinton F Nariman said Friday.

The acquisition of Essar Steel India Ltd will make Arcelor the fourth-biggest producer in a nation where the government is investing trillions of rupees in infrastructure. The verdict is likely to be the final approval in a more than yearlong battle by Arcelor to take over Essar. While companies can seek a review of decision by the same bench of judges, the success of review petitions is rare.

The world's largest steelmaker, ArcelorMittal and its partner Nippon Steel Corp had offered to pay Rs 420 billion (\$5.8 billion) in cash to creditors and pump another Rs 80 billion in the mill last year. While that offer was approved by a bankruptcy tribunal in March under the insolvency process, the payment was kept on hold by the Supreme Court after a dispute arose between lenders on the distribution of funds.

The ruling will set a precedent for other insolvencies that are awaiting resolution over the distribution of funds between different class of creditors.

India's rupee, and creditors to Essar extended gains after the ruling. The rupee rose 0.3% at 11:06 am, while State Bank of India added 4.2% and Canara Bank surged as much as 7%.

The Supreme Court on Friday also said the timeline for insolvencies can be extended in exceptional cases.

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**US, China 'close to finalising' parts of trade pact Phase 1**



US and Chinese trade officials are “close to finalising” some parts of an agreement after high-level telephone discussions yesterday, the US Trade Representative’s office said, adding that deputy-level talks would proceed “continuously.”

In a statement issued after the call, the USTR provided no details on the areas of progress.

“They made headway on specific issues and the two sides are close to finalising some sections of the agreement.

Discussions will go on continuously at the deputy level, and the principals will have another call in the near future,” it said.

The call came as Washington and Beijing are working to agree on the text for a “Phase 1” trade agreement announced by US President Donald Trump on October 11.

Trump has said he hopes to sign the deal with China’s President Xi Jinping next month at a summit in Chile. Beijing was expected to request cancellation of some planned and existing US tariffs on Chinese imports during the phone call, people briefed on the negotiations told Reuters.

In return, China was expected to pledge to step up its purchases of US agricultural products.

The world’s two largest economies are trying to calm a nearly 16-month trade war that is roiling financial markets,

disrupting supply chains and slowing global economic growth. "They want to make a deal very badly," Trump told reporters at the White House. "They're going to be buying much more farm products than anybody thought possible."

So far, Trump has agreed only to cancel an October 15 increase in tariffs on \$250bn in Chinese goods as part of understandings reached on agricultural purchases, increased access to China's financial services markets, improved protections for intellectual property rights and a currency pact.

But to seal the deal, Beijing is expected to ask Washington to drop its plan to impose tariffs on \$156bn worth of Chinese goods, including cell phones, laptop computers and toys, on December 15, two US-based sources told Reuters.

Beijing also is likely to seek removal of 15% tariffs imposed on September 1 on about \$125bn of Chinese goods, one of the sources said.

Trump imposed the tariffs in August after a failed round of talks, effectively setting up punitive duties on nearly all of the \$550bn in US imports from China.

"The Chinese want to get back to tariffs on just the original \$250bn in goods," the source said.

Derek Scissors, a resident scholar and China expert at the American Enterprise Institute in Washington, said the original goal of the early October talks was to finalise a text on intellectual property, agriculture and market access to pave the way for a postponement of the December 15 tariffs.

"It's odd that (the president) was so upbeat with (Chinese Vice-Premier) Liu He and yet we still don't have the December 15 tariffs taken off the table," Scissors said.

US Treasury Secretary Steven Mnuchin last week said no decisions were made about the December 15 tariffs, but added: "We'll address that as we continue to have conversations."

If a text can be sealed, Beijing in return would exempt some US agricultural products from tariffs, including soybeans, wheat and corn, a China-based source told Reuters.

Buyers would be exempt from extra tariffs for future buying

and get returns for tariffs they already paid in previous purchases of the products on the list.

But the ultimate amounts of China's purchases are uncertain. Trump has touted purchases of \$40bn to \$50bn annually – far above China's 2017 purchases of \$19.5bn as measured by the American Farm Bureau.

One of the sources briefed on the talks said China's offer would start at around \$20bn in annual purchases, largely restoring the pre-trade-war status quo, but this could rise over time.

Purchases also would depend on market conditions and pricing. US Trade Representative Robert Lighthizer has emphasised China's agreement to remove some restrictions on US genetically modified crops and other food safety barriers, which the sources said is significant because it could pave the way for much higher US farm exports to China.

The high-level call came a day after US Vice President Mike Pence railed against China's trade practices and what he termed construction of a "surveillance state" in a major policy speech.

But Pence left the door open to a trade deal with China, saying Trump wanted a "constructive" relationship with Beijing.

While the US tariffs on Chinese goods has brought China to the negotiating table to address US grievances over its trade practices and intellectual property practices, they have so far failed to lead to significant change in China's state-led economic model.

The "Phase 1" deal will ease tensions and provide some market stability, but is expected to do little to deal with core US complaints about Chinese theft and forced transfer of American intellectual property and technology.

The intellectual property rights chapter in the agreement largely deals with copyright and trademark issues and pledges to curb technology transfers that Beijing has already put into a new investment law, people familiar with the discussions said.



More difficult issues, including data restrictions, China's cybersecurity regulations and industrial subsidies will be left for later phases of talks.

But some China trade experts said that a completion of a Phase 1 deal could leave little incentive for China to negotiate further, especially with a US election in 2020.

"US-China talks change very quickly from hot to cold but, the longer it takes to nail down the easy phase 1, the harder it is to imagine a phase 2 breakthrough," said Scissors. Pages 2, 3 & 12

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## **Rosneft switches contracts to euros from dollars due to U.S. sanctions**



VERONA/MOSCOW (Reuters) – Russia's largest oil company Rosneft

(ROSN.MM) has fully switched the currency of its contracts to euros from U.S. dollars in a move to shield its transactions from U.S. sanctions, its Chief Executive Igor Sechin said on Thursday.

Rosneft's switch to the euro is seen as part of Russia's wider-scale drive to reduce dependence on the dollar, but it is unlikely to quickly boost the euro's role for Russia given the negative interest rates it carries.

"All our export contracts are already being implemented in euros and the potential for working with the European currency is very high," Sechin told an economic forum in Italy's Verona.

"For now, this is a forced measure in order to limit the company from the impact of the U.S. sanctions."

Reuters reported earlier this month that state-controlled Rosneft set the euro as the default currency for all its new export contracts.

Washington has threatened to impose sanctions on Rosneft over its operations in Venezuela, a move which Rosneft says would be illegal.

Moscow has been hit by a raft of other financial and economic sanctions from Washington over its role in the Ukrainian crisis and alleged meddling in the U.S. elections. Russia denies any wrongdoing.

Last year, Rosneft exported oil and oil products worth 5.7 trillion roubles (\$89 billion), according to its reports.

Russia's largest producer of liquefied natural gas Novatek (NVTK.MM) also said on Thursday it had switched to euros in most of its contracts in order to avoid the impact of U.S. sanctions.



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Rosneft's switch to the euro comes amid attempts by Russian companies to work out ways to carry out international transactions without the U.S. dollar.

Russian President Vladimir Putin has called for de-dollarisation that should help limit exposure to the lasting risk of more U.S. sanctions, while the Russian central bank has lowered the amount of U.S. Treasuries in its reserves in 2018.

The switch to the euro has its downside as, under the current policy of the European Central Bank, financial institutions are required to pay interest for parking excess reserves with the bank, known as negative interest rates.

"There is no sense in storing money under negative interest rates," said Alexander Losev, head of Sputnik Asset Management.

Given the negative rates, Rosneft's switch to operations in euros is capable of increasing the amount of euro conversion as Rosneft will seek to ditch the currency for those that are of more use for its operations, market experts say.

The euro's share in Russia's exports has been on the rise since 2015 but Rosneft's adoption of it is unlikely to have an impact on the Russian currency market, said a manager at one of Russia's state-controlled banks.

Other experts agree, saying that Rosneft will still need to convert its euros for tax payments and other needs in Russia.

A senior forex dealer at a state-controlled bank also said the impact of Rosneft's move on the rouble will be negligible.

The Moscow Exchange (MOEX.MM) said Rosneft's move will increase the euro share in its overall trade turnover.

Previously, the share of euro trade on the Moscow Exchange has been increasing only marginally. Over the past year, the euro/rouble share in overall FX turnover on Russia's main bourse stood at 12%, up from 11% in 2017 and 9% in 2016.

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## **Eskom risk premium eases as Treasury offers bailout conditions**



Bloomberg/ Johannesburg

Credit default swaps for Eskom Holdings SOC Ltd, South Africa's state-owned power company, are trading near the cheapest level in almost three years relative to the sovereign risk after the Treasury published proposed conditions for

funds to bail out the utility.

That suggests investors are comfortable a turnaround plan for the debt-ridden company, which President Cyril Ramaphosa says will be presented to cabinet shortly, will include a sustainable framework to deal with its \$30bn of debt. The government has said it won't allow Eskom to fail or bondholders to take a haircut.

"It's about 10 years too late, but better than nothing," said Rashaad Tayob, a money manager at Abax Investments Ltd in Cape Town. "It's positive that there will be oversight on Eskom's capex, and a requirement that they must work to recover debtors in arrears. But nothing on energy and staff costs, so we must wait for the special paper/white paper to understand the long term plan to fix Eskom."

Eskom, which supplies about 95% of South Africa's electricity, has been granted 128bn rand of state bailouts over the next three years to help it remain solvent.

Amounts of 26bn rand and 33bn rand will be allocated in portions to Eskom in the 2020 and 2021 financial years on dates determined by the finance minister, the Treasury said in a presentation on its website Wednesday.

The conditions offered include that Eskom publish separate financial statements for its generation, distribution and transmission units. Treasury will also require daily liquidity position updates and for no incentive bonus payouts to be made to executives in the years where equity support is provided.

"The market is taking comfort from the fact that there is increased government oversight," said Bronwyn Blood, a fixed-interest portfolio manager at Granate Asset Management Ltd in Cape Town. "Conditions imposed on Eskom will ultimately allow for more certainty around repayment of debt, thus minimising the risk of default."

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# Italy's biggest bank wants to become less Italian



MILAN (Reuters) – The chief executive of UniCredit (CRDI.MI) has a plan to revive his company's ailing share price – make it less Italian.

Italy's biggest bank is looking at whether it can distance itself from its home country's stagnating economy and fractious politics by putting some of its most prized assets under one roof in Germany, people familiar with the matter said.

Jean Pierre Mustier will unveil on Dec. 3, as part of his new business plan, a scheme to set up a new sub-holding company in Germany to house the bank's foreign operations, the sources said.

By keeping its assets in Germany, Austria, Eastern Europe and Turkey away from Italy, UniCredit could reduce their Italian identity – and associated credit rating – making their funding cheaper, the sources said.

Mustier, a Frenchman appointed in July 2016 to reinvigorate the then weakly capitalized Milanese bank, has sold businesses, cut jobs and shut branches to strengthen UniCredit's balance sheet. Sources earlier this year said the bank had put on ice a possible bid for German rival Commerzbank (CBKG.DE).

But UniCredit, which describes itself as pan-European, operates in 14 countries and makes just over half of revenues outside Italy, is still essentially perceived by investors as a risky Italian institution.

The new plan is an indication of Mustier's belief that the Italian economy is holding back UniCredit's share price and risks pushing up the bank's funding even more if the economic outlook deteriorates.

"Who can say for sure that Italy's debt won't be downgraded to junk?" said one source, speaking on condition of anonymity and describing the corporate reorganization as an insurance policy if Italy's economy continues to perform poorly.

"The bank has to be ready for that kind of possibility," the person said, noting Moody's currently rates the euro zone's third biggest economy – burdened with the second highest debt to GDP ratio in the single currency bloc – just one notch above non-investment grade. Germany has a triple-A rating with all major credit ratings agencies.

## **SOVEREIGN DEBT PROXY**

Italian banks – which are struggling with bad loans, a sluggish economy and political instability – have traditionally been seen as a proxy for the country's sovereign debt because they hold vast amounts of government bonds.

UniCredit trades at 0.5 times book value, among the lowest levels in the industry, despite having a better than average return on equity. Its share price has fallen 30% since April

last year, wiping out much of the rally it had after Mustier took charge.

To place a \$3 billion, five-year bond in November last year, when a sell-off in Italian assets sent borrowing costs for the country's banks soaring and shut all but the strongest names out of the funding market, UniCredit had to pay a steep 7.8% coupon.

"UniCredit is by size one of Europe's leading banking groups but, because of its Italian roots, investors associate it with the Italy risk to an extent which is in my opinion excessive given its geographical diversification," Stefano Caselli, banking and finance professor at Milan's Bocconi University.

"It's clear that UniCredit pays a price both in terms of regulatory capital and cost of funding for being Italian," he said. "So a diversification strategy aimed at allowing the bank to link its cost of funding to the countries where it is present makes total sense."

Some other Italian companies with big foreign operations, including car maker Fiat Chrysler (FCHA.MI) and broadcaster Mediaset (MS.MI), have moved or are in the process of moving their legal headquarters to the Netherlands as part of a pivot away from Italy.

he European Central Bank would have to approve the plan to set up the holding company in Germany – where UniCredit already owns lender HVB – potentially taking at least a year, meaning the shift would not happen for sometime.

## **CUTTING EXPOSURE**

Mustier has repeatedly said that UniCredit will remain listed and headquartered in Milan and reiterated the bank's commitment to its home country.

But since May he has steadily cut the bank's exposure to

Italy, including by selling its stake in online broker FinecoBank (FBK.MI) and announcing it would reduce its 55 billion euros (\$61.37 billion) portfolio of Italian government bonds.

The bank is also considering cutting 10,000 jobs, or around 10% of its workforce, as part of the new 2020-2023 plan, almost all of them in Italy, sources said in July.

UniCredit has said any workforce reduction will be handled through early retirement.

But the planned cuts, together with a wider management reshuffle earlier this year, have helped to create a perception among some employees and rivals that the bank is less focused on its Italian operations.

"You can tell that the Italian commercial business is not a priority for them, they are not aggressive, they are not chasing clients," said the chief executive of another Italian bank.

A UniCredit spokesperson said that figures from the bank's divisional database showed customer deposits for Italy's commercial banking operations rose by 4.3% in the second quarter of 2019 from a year earlier, while customer loans increased by 1.7% over the same period.