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Research Report on Russia

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Introduction

The Russian economy slowed-down in 2014 as a result of Western sanctions and a sharp drop in oil prices. While government authorities have put in place a number of fiscal and monetary measures to overcome the current situation, the country is having a hard time finding its way to recovery. Budget revenues, which depend heavily on oil and gas taxation, declined following the downturn in oil prices. As a result, depreciation of the Ruble alongside a significant outflow of capital forced the Central Bank of Russia (CBR) to prevent further panics by surrendering a large portion of its reserves. Even though, a side effect of recent Ruble devaluation was evidenced in the substantial inflation of foreign-currency-denominated debt, total government debt remained at tolerable levels during 2014. Inflation rate was constrained until the first months of 2014, but the lagged effects of sanctions alongside Ruble devaluation drove a significant increase of import goods prices which translated in a loss of Russian citizens' purchasing power.

Main Economic Indicators of Russia

Macro indicators	2012	2013	2014*
Gross pub. debt, bill RUB	7871	9286	10660
Nominal GDP, bill RUB	62218	66755	70976
Nominal GDP growth, %	11,2	7,3	6,3
Gross gov. debt/GDP,%	12,7	13,9	15,0
Deficit (surplus)/GDP,%	0,4	-1,3	-2,2
Inflation rate,%	6,6	6,5	11,4
Curr. Account balance/GDP,%	3,6	1,6	4,5

Development indicators	2014
Inequality adj. HDI	0,69
GDP per capita (Thou. of USD)	24,8

Default indicator	As of 12.02.2015
5-Year CDS spread (Bp)	549
10Y Gov Bond Yield, %	12,9

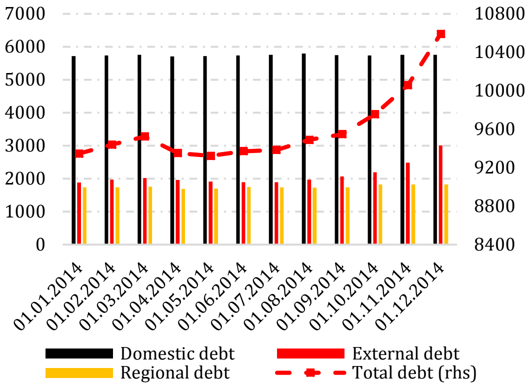
Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg
* Assessment of RAEX (Europe) based on current data provided by Ministry of Finance of the Russian Federation, Russian Federal Treasury and IMF.

Total government debt of the Russian Federation stands at tolerable levels. While domestic and regional debt remained almost unchanged during 2014, the sharp devaluation of Ruble resulted in an increase of the foreign-currency-denominated external debt, which reached a load of 3 010 billions of Rubles by the end of the year (see graph 1). As a result, total government debt amounted to 10 660 Billions of Rubles for the whole year, which represented 15% of annual GDP and 45,5% of total budget revenues. Additionally, short-term debt showed low figures in 2014 (2 182 billions of Rubles), accounting for 3% of annual GDP and 9,3% of budget revenues. As a consequence of high uncertainty of future economic developments, investors are demanding a yield of 12,9% on the 10-year Russian government bonds (RUGE10Y), which contributes negatively to the overall creditworthiness of the country.

Driven by strong dependence of fiscal revenues on oil and gas, Russian consolidated budget deficit increased in 2014. The deficit registered in the Russian consolidated budget of 2014[1] (1 548 billions of Rubles), represented 2,2% of annual GDP and an 83% increase compared with 2013 fiscal deficit (848,2 billions of Rubles). Such negligible figures seem to pose no risk to the creditworthiness of the country, but when the non-oil fiscal balance (excluding revenues from oil and gas taxation) is

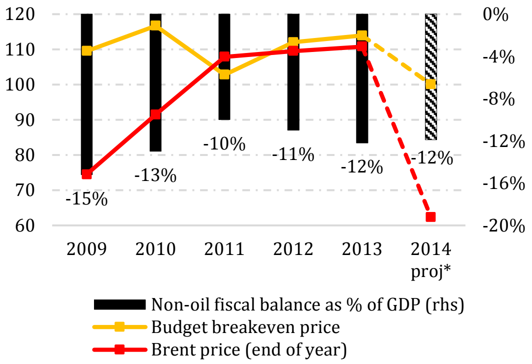
[1] Preliminary assessment based on the execution of consolidated budget as of 01.12.2014.

Graph 1: Break-down of Russian government debt (Bill. of RUB)



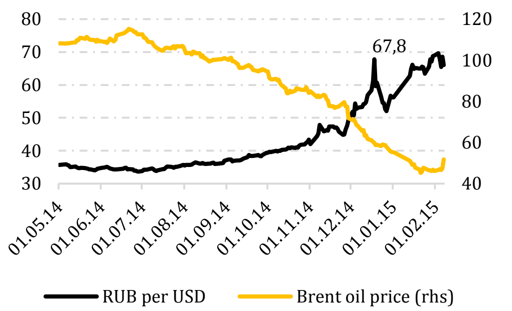
Source: RAEX (Europe) calculations based on data from Ministry of Finance of Russia

Graph 2: Consolidated fiscal budget Performance



Source: RAEX (Europe) calculations based on data from IMF and Deutsche Bank Research. *IMF, July 2014.

Graph 3: Exchange Rate vs. Oil Price



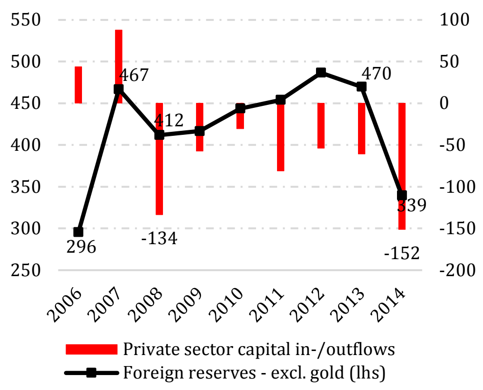
Source: RAEX (Europe) calculations based on data from EIA and Central Bank of Russia (CBR)

considered, the scenario looks more disturbing (see graph 2). Non-oil and gas fiscal balance showed a deficit of 12% of GDP in 2013 and is projected to show a similar figure for 2014. With such a negative trend in oil price, depreciation of Ruble against foreign currencies was inevitable and reached a peak of 67,8 Rubles per dollar by end of 2014, which was immediately controlled by monetary authorities (see graph 3). An additional weakness that contributes negatively to the creditworthiness of the country is the gap between the budget breakeven oil price and the spot Brent oil price. In 2014 this gap was 2,6 USD larger than the gap which emerged in 2009 after the drop in oil prices that took place in the aftermath of 2008 crisis. However, recent positive estimates of US employment as well as expenditure cuts of oil production drove the pick-up of oil prices which lowered pressure on Ruble. While future developments in the oil and gas market are still uncertain, oil prices are not expected to suffer a sharp decline like the one evidenced in 2014.

External position of Russia has deteriorated significantly as a result of strong capital outflows during 2014. The overall financial turmoil and economic uncertainty evidenced in Russia during 2014 fueled the outflow of private capital which amounted to 152 billion of USD by the end of the year. The outflow of capital which took place in Russia during 2014 was even stronger than that evidenced in the aftermath of the 2008 crisis, when a total of 134 billion of USD flew out of the Russian financial system (see graph 4). Additionally, the amount of foreign exchange reserves that the CBR lost during 2014 to face such a capital outflow (131 billion of USD) more than doubled the amount lost in 2008 (55 billion of USD). Given that oil price could be bottoming out after a seven month decline, further runs against the Ruble are not expected in the near future. However, Russia's external position will remain weak as dollars will not flow into the economy as readily as they did during the period 2009-2013.

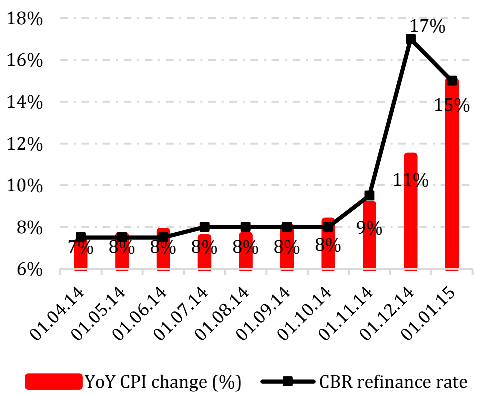
Upward inflationary pressure was fueled by lagged effects of sanctions and Ruble devaluation on import goods. Since October 2014 the Consumer price index (CPI) started showing a positive trend as a consequence of lagged effects of sanctions on import goods and a sharp devaluation of Ruble (see graph 5). During 2014, the US and the European Union imposed a number of sanctions on Russia which ranged from visa requirements and travel bans to financial restrictions for major Russian enterprises and banks. As a way of reprisal, Russian authorities imposed bans on imports of US and EU goods. While such restrictions represented sizeable costs to the European economy, Russia ended up bearing higher consumer prices since Russia's import from this region represents 47% of total imports for the country. The immediate policy response of the CBR was to consequently increase its refinance rate until it reached a value of 17% by mid-December. While this policy slightly mitigated the

Graph 4: Net capital in-/outflows vs. Foreign reserves (Bill. of USD)



Source: RAEX (Europe) calculations based on data from Rosstat and CBR

Graph 5: Inflation rate vs. CBR refinancing rate



Source: RAEX (Europe) calculations based on data from Rosstat and CBR

devaluation pressure on the Ruble, it did not prevent the CPI to reach a YoY increase of 15% by January 2015 (twice as high as the average CPI increase reported between April-November 2014).

The government efforts to strengthen its control over strategic companies keeps hampering the business environment in Russia. Apart from direct and indirect impacts of sanctions and oil price on the economy, Russia's overall business environment has been deteriorating as the government intends to bring strategic companies under its control. The hostile seizure of Bashneft after its owner, Vladimir Yevtushenkov, refused to come to terms for the sale of its company to Rosneft represents one of the most recent cases which harmed the investors' sentiments of the country. The current business environment of Russia contributed negatively to the assessment of the protecting investors ranking provided by doing business which places the country in position 100 out of 180 countries.

Conclusion

Even though the Russian economy was already slowing down in recent years, the conflict with Ukraine and the sanctions imposed by Western countries contributed significantly to the current economic situation of the country. The sharp decline of oil prices curtailed fiscal revenues at a federal level, which in turn deepened the budget deficit. While oil price seems to be bottoming out after a sharp decline over the past seven months, there is still a long way for Russia to reach a full recovery. Russia's current foreign currency position is much weaker than a year ago and inflation has soared significantly driven by higher prices of imported goods. Further large capital outflows are not expected under the current oil price scenario but lagged effects of sanctions on prices and economic growth could still be observed during the next months.