Research Report on Russia

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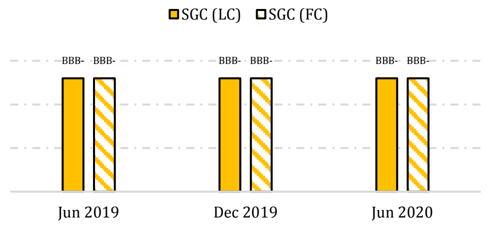
Ratings

Sovereign Government Credit (LC)	BBB-
Sovereign Government Credit (FC)	BBB-
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Russia

Macro indicators	2017	2018	2019
Gross gov. debt, RUB bn	14 243	15 171	16 060
Nominal GDP, RUB bn	91 843	104 630	110 046
Real GDP growth, %	1,8	2,5	1,3
Gross gov. debt/GDP, %	15,5	14,5	14,6
Deficit (surplus)/GDP, %	-1,5	2,9	1,9
Inflation rate, %	2,5	4,3	3,0
Current Account Balance/GDP, %	2,1	6,9	3,8
External debt, USD bn	-	-	450*

Development indicators	2019
Inequality adj. HDI	0,74**
GDP per capita, USD th	29,9

Default indicator	12.06.2020
5-Year CDS spread, Bp	99
10Y Gov Eurobonds Yield	2,29***

*As of March 2020; ** 2018; *** with maturity in 2029;
Source: RAEX-Europe calculations based on data from the IMF, WB, Rosstat, CBR, Ministry of finance of the Russian Federation, Ministry of the economic development of the Russian Federation, Cbonds.

Summary

The Agency confirmed the sovereign credit ratings of Russia at 'BBB-', with a change in outlook from positive to stable. This reflects our view on the balance and development of factors, which can be crystallized in the upcoming years.

The negative impact of the current oil market's volatility and the restrictive response to the pandemic outbreak has worsened and we have adjusted the forecasts of economic growth, the perspective of the banking system and the dynamics of the budget. At the same time, the rating is still restrained by the long-standing structural economic problems, the significant footprint of the state in the economy, excessive concentration of exports on the hydrocarbon industry and the risks arising from sanctions.

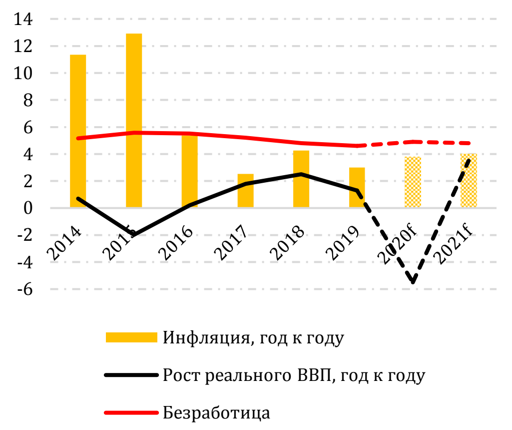
Factors that support the rating and provide resilience in the face of ongoing turbulence include the low government debt burdens, as well as strong external position with buffers of international reserves that can cover current government spending. Moreover, an effective and consistent monetary policy with adherence to a flexible exchange rate and the fiscal rule smooth out the impact of external shocks.

Strong decline in GDP in 2020 caused by the impact of the pandemic. GDP growth in 2019 was 1,3%, slightly above our forecast in the previous report[1]. However, the slower economic growth compared to 2018 was primarily caused by a significant decline in exports due to weakening external demand, as well as by restrictions on oil production under the OPEC+ agreement. Secondly, household consumer activity slowed down, mainly due to an increase in the VAT rate at the beginning of the year. At the same time, there were trends towards higher annual growth rates of capital investment, which were associated with the realization of national infrastructural projects.

The economy entered 2020 with an acceleration triggered by the intensification of national projects and the relaxation of the monetary policy. However, under the conditions of restrictive measures aimed at combating the pandemic, in the 2Q 2020 business and consumer activity in the Russian economy declined, whereas unemployment hiked. With the relaxation of quarantine restrictions, economic activity will gradually

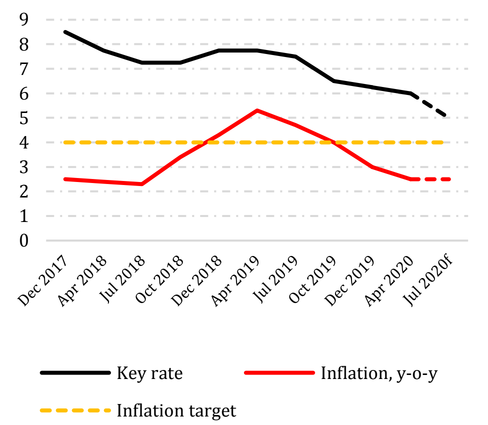
[1] https://raexpert.eu/reports/Research_report_Russia_13.12.2019.pdf

Graph 1: Macroeconomic indicators, %



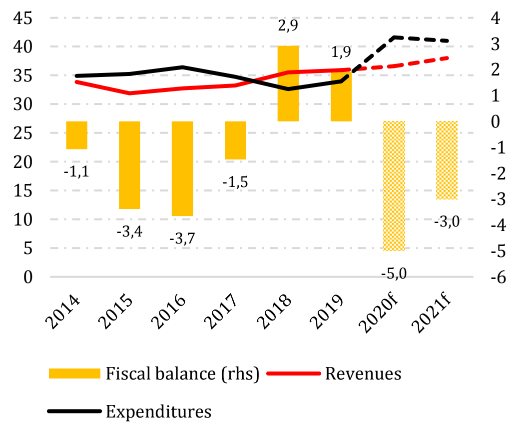
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Monetary policy metrics, %



Source: RAEX-Europe calculations based on data from the Rosstat and CBR

Graph 3: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the IMF and Ministry of finance of the Russian Federation

recover, however, the projected year-end GDP contraction could be of up to 5%-6% (see graph 1). Prospects for growth will largely depend on the timeliness, size, and effectiveness of the implementation of measures to support the economy, which according to various estimates will amount to 3% to 5% of GDP.

Effective and consistent monetary policy of the Central Bank of Russia (CBR) supports macroeconomic stability. Annual inflation slowed to 3% in 2019 after the effect of the VAT increase was exhausted, as well as supported by a reduction of food prices' pressure, RUB appreciation and fading domestic demand. This forced the CBR to gradually make a transition to an easing cycle, which continued in 2020 amid the disinflationary effects of weaker demand. As a result, as of 4M 2020 the key rate has been cut by 75 b.p. down to to 5,5% (see graph 2). With disinflation risks prevailing, mainly due to the uncertainty surrounding the coronavirus pandemic in Russia and globally, the CBR is likely to continue the easing. We expect that decisions on the direction of monetary policy vector will be balancing between the need to stimulate economic growth and keeping annual inflation within a 4% target.

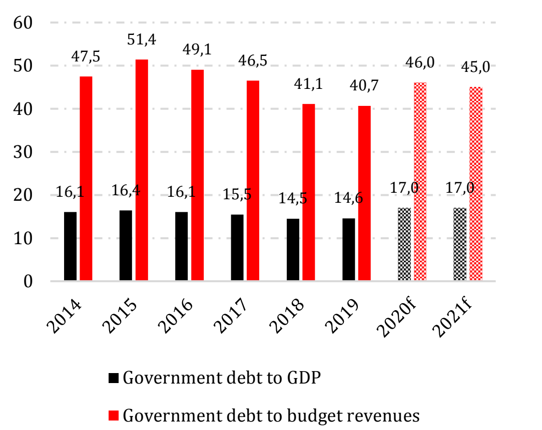
Government finances: transition from surplus to deficit on the back of falling revenues and stimulus policies. The general government budget surplus reached 1,9% of GDP in 2019, due to a strong non-oil revenue growth, which compensated the decline in oil and gas revenues combined with the ruble appreciation, while expenditures grew by 9% y-o-y fostered by stimulus fiscal policy, aimed to expand capital expenditures of the government in the 2H 2019 (see graph 3). The non-oil and gas deficit continued to decline to 5,3% of GDP in 2019, compared to 7,9% in 2017.

The budget for 4M 2020 was in surplus, although it was primarily facilitated by the transfer of funds from the National Wealth Fund (NWF) as a part of the deal with Sberbank shares[2]. Meanwhile, the budget revenues are stagnating and continuing to decline. Moreover, the anti-crisis package adopted so far includes a number of measures to reduce tax revenues. On the contrary, budget expenditures are expected to be increased in order to finance anti-crisis measures. Despite the worsening state of the federal budget, the continued building up of the NWF reserves is encouraging. The volume of the fund was estimated at 11% of GDP as of April 2020, and funds exceeding 7% of GDP can be used to support public spending. However, the ability to use this resource is strictly limited by the current budget rule and can only compensate for the shortfall of the oil related revenues. In 2020, we anticipate a transition from a surplus to a

[2] The Sberbank ownership transfer from the CBR to the government for RUB 2,14 tn, was paid for from the National Wealth Fund, forming CBR profit, and then transferred back to the Fiscal budget in the form of revenue.

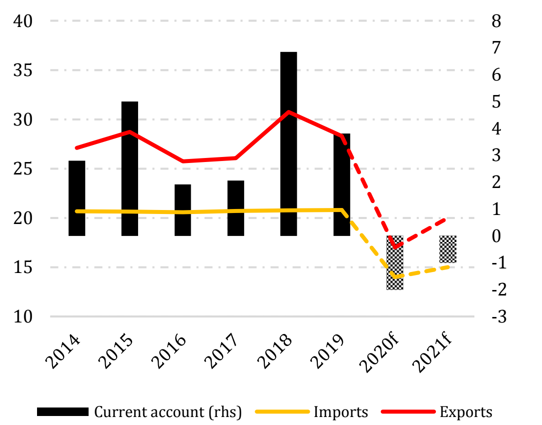
budget deficit that may exceed 5% of GDP, but the scale of its widening will depend on the amount of funds allocated to finance anti-crisis activities.

Graph 4: Government debt dynamics, %



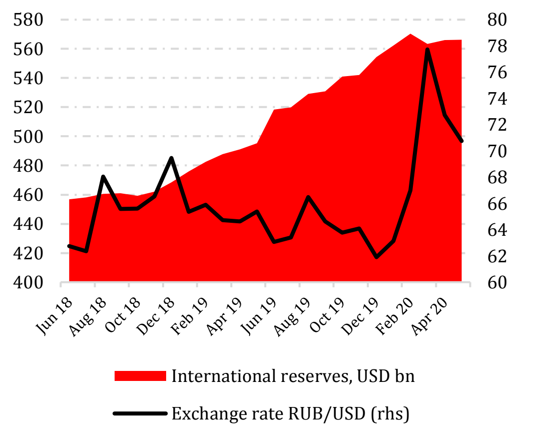
Source: RAEX-Europe calculations based on data from the IMF, CB and Ministry of finance of the Russian Federation

Graph 5: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from IMF and WB

Graph 6: International reserves and FX-rate



Source: RAEX-Europe calculations based on data from CBR

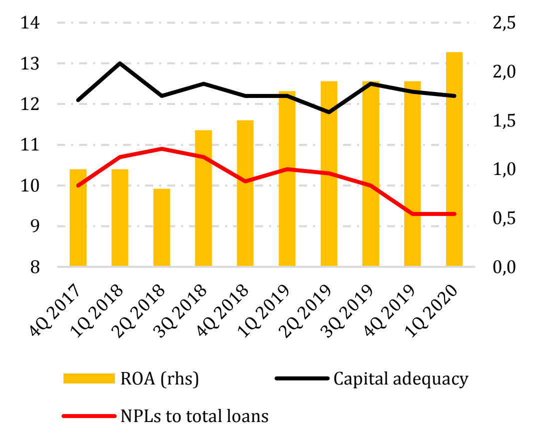
Government debt is at a low level and with a favorable structure. Although in 2019 both external and internal debt rose by 11% and 10% respectively, gross government debt amidst ruble appreciation increased only slightly and maintained at 14,6% of GDP and 40,7% of budget revenues at the end of 2019 (see graph 4). The share of FX debt is only 21,3%, as of 1 January 2020, which poses low exposure to currency risk. In addition, the debt structure remains favorable by maturity, with the share of short-term liabilities up to one year being 7,1% of gross government debt in 2020. The low level of debt creates a wide space for the government to maneuver and mobilize additional financial resources to cover the shortfall in budget revenues and implement anti-crisis measures to support the economy. The main source of new sovereign borrowings remains the issue of domestic government bonds, and we project a moderate rise in the new borrowings in this market. At the same time, we expect the conservative debt policy, which is determined by the budget rule framework, to remain in place.

External position maintains resistance to shocks. The current account surplus contracted to 3,8% of GDP in 2019, versus 6,8% in 2018 (see graph 5), influenced by two factors. Firstly, in regard to the trade balance, exports declined owing to lower world prices for hydrocarbons and metals, while imports, on the contrary, expanded supported by the strengthening RUB. Secondly, there was an outflow of investment income as Russian companies increased dividend payments to foreign investors. In 2020, the trade surplus continues to shrink more sharply as a result of the fall in exports of goods caused by a significant drop in world prices and an overall worsening of external demand amidst the pandemic. We expect a negative current account balance for this year, including outflows, on investment accounts related to dividend payments.

Nevertheless, Russia's external position remains resilient, supported by the accumulated international reserves, estimated at USD 566 bn as of May 2020 (see graph 6). The expected worsening of the fiscal position is also protected by the conservative budget rule, under which the government will compensate for the deficit from the NWF, which as of April 2020 amounted to 11% of GDP. Additionally, the budget rule mechanism smooths out RUB fluctuations in the case of price volatility in the oil market and has a stabilizing macroeconomic effect.

The banking system is being tested for strength. In 2019, the banks' soundness strengthened and the sector continued to improve in terms of profitability and capitalization, while the number of market participants

Graph 7: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the CBR. *The share of loans classified as 4th and 5th quality categories according to the CBR regulation (two categories with the lowest credit quality) was used as a proxy for the indicator "Share of bad loans in total loans".

continued to shrink. Banks' total assets increased by 2,7%, supported by lending activities, which led to a 4,6% increase in the total loans of the sector in 2019, mainly due to the expansion of the retail segment. However, the low domestic credit-to-GDP ratio, which we estimate at 54,7% in 2019, reflects the weak inclusion of the financial sector regarding the corporate sector.

By the beginning of 2020, the banking sector had a more favorable quality of its loan portfolio, with the level of NPLs decreasing to 9,3% as of December 2019 against 10,1% a year earlier (see graph 7). The expansion of unsecured consumer lending began to slow down under the influence of restrictive measures of the CBR. However, in 2020 we expect an increase in NPLs due to worsening financial situation and customer defaults caused by the impact of the pandemic, as well as lower export revenues. To compensate for the consequences of the loan portfolio deterioration, the CBR responded by introducing a relaxation in the provisioning for restructured loans, and this year banks have already restructured 5% of sector loans as of June 2020 according to the CBR estimates.

ROA and ROE in the banking sector strengthened to 2,2% and 19,7% in 2019, although the improved profitability was partly due to one-off adjustments associated with the IFRS 9 introduction. We expect the banks to generate lower net profits in 2020 in the face of interest income shortfalls. The next factor supporting the banking sector's resistance to current risks and uncertainties is the level of the bank's capitalization and liquidity. The regulatory capital adequacy strengthened to 12,2% as of March 2020, whereas the minimum threshold for systemically important banks is 11,5%. Besides the accumulated macro-prudential buffers, banks also have a significant capital stock, which according to the CBR's estimates, constitutes 5% of the sector's assets. Despite the structural surplus of liquidity in the sector, the regulator prudently launched 1-month and 1-year REPO auctions and softened short-term liquidity requirements for systemically important banks.

International sanctions constrain the credit rating. We continue to assess the potential of risks' materialization arising from sanctions as moderately strong, weighing on Russia's credit ratings. The threat of sanctions remains as in late 2019, the U.S. imposed additional sanctions on Nord Stream-2. In addition, sanctions packages for new public debt, state banks and the energy sector are still under discussion of the US Congress.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

https://raexpert.eu/reports/Press_release_Russia_12.06.2020.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.