Research Report on Russia

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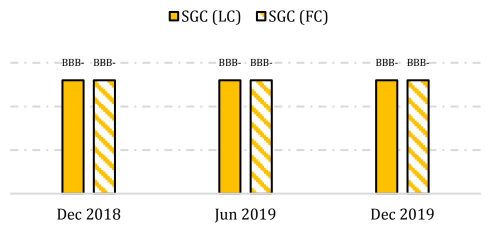
Ratings

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

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Russia

Macro indicators	2016	2017	2018
Gross gov. debt, RUB bn	13 830	14 243	15 171
Nominal GDP, RUB bn	86 149	92 037	103 876
Real GDP growth, %	0,3	1,6	2,3
Gross gov. debt/GDP, %	16,1	15,5	14,6
Deficit (surplus)/GDP, %	-3,7	-1,5	2,9
Inflation rate, %	5,4	2,5	4,3
Current Account Balance/GDP, %	1,9	2,1	6,9
External debt, USD bn	-	-	480*

Development indicators	2018
Inequality adj. HDI	0,74
GDP per capita, USD th	28,8

Default indicator	13.12.2019
5-Year CDS spread, Bp	53,51
10Y Gov Eurobonds Yield	2,94

*as of 1 July 2019; 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 has decided to maintain the sovereign government credit ratings of Russia at 'BBB-', while the outlook was changed to positive. Our actions reflect the improved macroeconomic stance, increased efficiency of the monetary policy, the robust external position with rising international reserves and continued deleveraging of the private sector, as well as the strengthening of public finances with adherence to the fiscal rule. At the same time, the rating is 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 restrictions imposed by the sanctions.

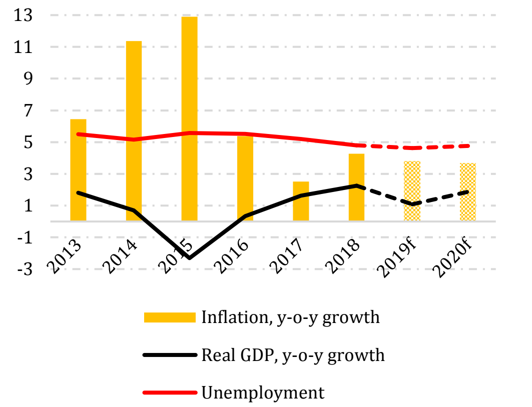
However, in our view, the solid external buffers along with a commitment to the current monetary and fiscal policy can help to mitigate the external shocks and increase resistance to the consequences of the sanctions. Moreover, the focus on the implementation of the national infrastructure projects can help to address the existing structural problems and ensure long-term economic growth prospects of the economy.

Despite the global slowdown, there is a room for growth in the Russian economy. In 2018, the Russian economy continued to recover, facilitated by favorable oil price dynamics and a weak RUB, which led to a substantial increase in energy exports. On the other hand, private consumption was supported by positive dynamics in real wages and soaring consumer lending during last year. Even though the fiscal policy was conservative and the monetary policy was tightened in 2H 2018, real GDP growth surpassed the forecast and reached 2,3% (see graph 1), due to one-off effects, such as the completion of a large construction project in the energy sector.

In 1H 2019, economic growth slowed down significantly amid lower global demand and commodity prices, as well as weak investment activity caused by delays in the implementation of national projects[1]. The annual GDP growth rate is forecast at 1,1% in 2019 supported by the acceleration of budget expenditures and the easing of monetary policy. Despite further slowdown in the global economy, in the medium term, we expect GDP growth to increase to an annual average of 1,9%, with the support of the

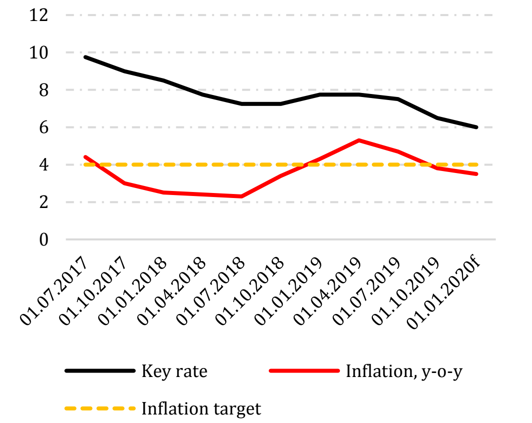
[1] 13 national projects, including increased public spending on infrastructure, health and education.

Graph 1: Macroeconomic indicators, %



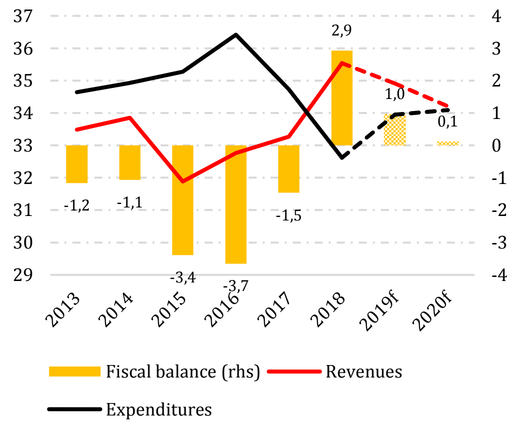
Source: RAEX-Europe calculations based on data from the IMF

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

further implementation of national projects aimed at increasing productivity and domestic consumption.

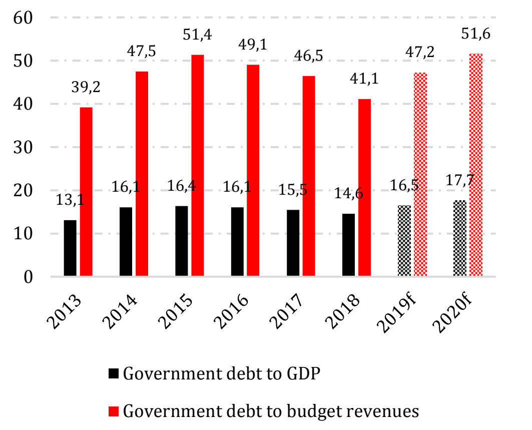
Easing monetary policy on the back of subdued inflation. The Central Bank of Russia (CBR) has demonstrated efficiency and consistency of the conducted monetary policy, keeping the inflation rate close to the target level of 4%. After reaching a peak of 5,3% in April 2019, annual inflation is gradually declining as the effect of the increase in VAT was exhausted along with domestic demand weakening during 2019. As a result, starting from June 2019, the CBR switched to a more relaxing monetary policy, gradually reducing the key rate by 150b.p. to the current level of 6,25% (see graph 2). Given the restrained growth rate of the economy, as well as the continued decline in inflationary expectations, we anticipate further relaxation in 2020 in order to create conditions for lower market interest rates and to boost lending in the real sector of the economy.

Improved fiscal stance and low government debt burden. We view the efficiency and commitment to the current fiscal policy as a positive signal, which has led to progress in creating buffers that enhance resilience to external shocks. Within the framework of fiscal consolidation amidst favorable oil and gas prices, in 2018 the conditions for a notable improvement in public finances were created, resulting in the overall general government budget surplus of 2,9% of GDP compared to the deficit of previous years (see graph 3). Budget revenues also benefited from improved tax administration, which led to an increase in customs tariffs and the resource extraction tax. The conservative government expenditures fostered broaden of the fiscal surplus. In addition, due to strict adherence to the fiscal rule, the accumulation of the National Welfare Fund (NFW) doubled in 2019, reaching USD 122,6 bn as of 1 October 2019.

In 2019, the general government budget surplus has continued to widen, reaching 5% of GDP during 9M 2019, compared to 4,7% of GDP in the same period last year, supported by an increase of non-oil revenues and an expansion in VAT revenues as the tax base expanded. However, we anticipate the government budget surplus in 2019-2020 will shrink to a modest 1-1,5% due to the extension of the government spending[2] on infrastructure that is currently being implemented at a slower pace than planned. We also expect the oil revenue to gradually decline in the mid-term as price and demand deteriorate, while non-oil revenues remain stable.

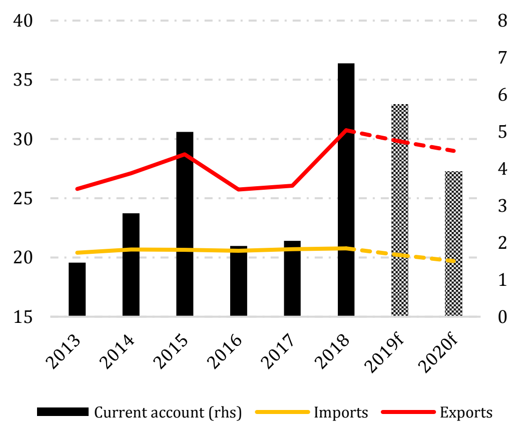
[2] Infrastructural projects will be financed by a temporary relaxation of the fiscal rule by 0,5% of GDP

Graph 4: Government debt dynamics, %



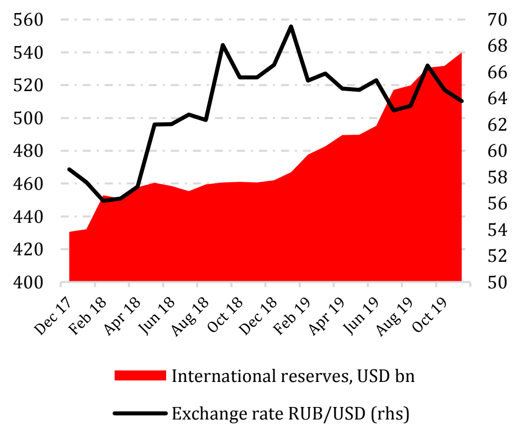
Source: RAEX-Europe calculations based on data from the IMF, CB and Ministry of finance of the Russian Federation

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

We observe a reduction of the government's debt burden over the last four years: the level of the general government debt shrank gradually to low 14,6% of GDP and 41,1% of budget revenues as of end-2018 compared to 15,5% and 46,6% in 2017 respectively (see graph 4). Moreover, the maturity and currency structure of the government debt is favorable and does not represent a risk to the creditworthiness of Russia. The short-term share of the government debt, taking into account the planned repayments up to one year, was 1,7% of GDP and 4,74% of budget revenues at the end of 2018. However, we expect the government to be active in the new borrowings, taking into account the necessity to implement the priority national projects, the annual expenditures of which are estimated up to 1,5% of GDP.

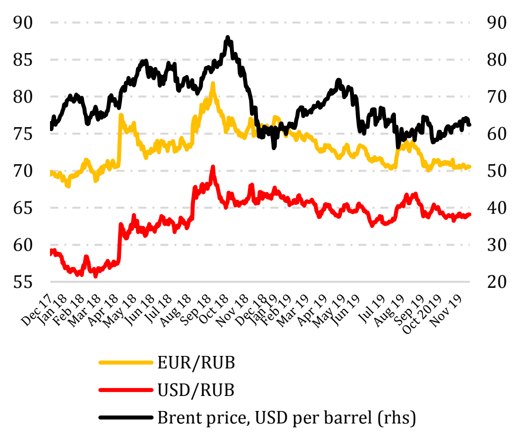
The planned increase in borrowings will not push debt up significantly. We estimate that it will cause debt to increase by approximately 3% of GDP until 2020. The new debt issues will be placed predominantly in the domestic market, as the U.S. has imposed in August 2019 new sanctions, under which U.S. banks are banned from participating in the primary market of Russian sovereign FX debt and from providing loans to the Russian government. Nonetheless, we do not see any obstacles to raising funds in the domestic market; moreover, non-residents are actively involved in buying of domestic bonds. The share of foreign holders of domestic bonds has increased up to 31% in October 2019, which confirms the positive sentiments regarding Russia's financial position.

The strong current account, deleveraging of the private sector and accumulation of reserves strengthened the external position. Russia's external position has been significantly strengthened over several years, driven by an intensive deleveraging of the public and private sector and, on the other hand, an active build-up of foreign exchange reserves. Driven by sanctions, the private sector entities, especially banks, reduce the use of externally borrowed funds, and their external debt has decreased by almost 34% in 2018 down to 16,5% of GDP.

Benefiting from favorable pricing, the expansion of oil and gas exports significantly strengthened the trade balance and led to a record current account surplus of almost 7% in 2018 (see graph 5). It also created conditions to accumulate FX reserves. We anticipate the strong trade balance to prevail in the mid-term, however, trending towards a smooth narrowing as exports are shrinking with lower oil prices, while imports are expected to widen through investment in national projects.

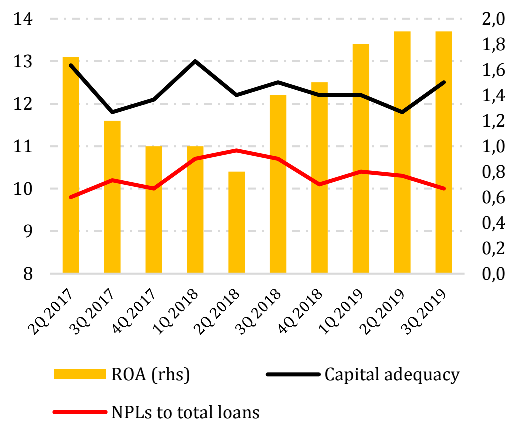
International reserves, due to the purchase of FX currency under the fiscal rule with the purpose to sterilize the excess of oil-related revenue,

Graph 7: FX-rates and oil price



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

Graph 8: 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".

continue to increase and gained USD 542,9 bn as of 1 October 2019 (see graph 6), covering more than 19 months of imports. After the sharp devaluation in 2018, the RUB strengthened, its volatility decreased and there is almost no correlation with oil prices, reflecting the effectiveness of the fiscal rule (see graph 7).

Banks improve profitability, but there are still heightened concentration risks. In 2019, the banking system continued to demonstrate an improvement in profitability, capitalization, and liquidity amid a reduction in the number of market participants. Despite still active retail lending, the growth rate of banks' assets in 3Q 2019 was subdued at 1,5% against 4,6% in the same period last year. The number of smaller banks will continue to decline due to license revocations and mergers with larger players. Meanwhile, there are growing risks of concentration on large state-owned banks, which account for almost 70% of total assets. The significant presence of the government and the concentration of loan portfolios on state-owned companies increase the risks of materialization of liabilities, especially in light of possible new sanctions.

The profitability of the banking system improved in 3Q 2019 with ROA and ROE at 1,9% and 17,9%, respectively, although the major contribution was from the largest SOBs. The capital adequacy ratio improved to 12,5% as of September 2019 from 12,2% in 2018, reflecting the outpacing growth of capital compared to risk-weighted assets (see graph 8). However, we expect that after the harmonization of regulatory standards with IFRS 9, the recalculation of prior years' profit will put pressure on the capital adequacy metrics. We observe stability in the quality of assets, although the current level of NPL remains elevated at 10% as of September 2019. It is expected that through dilution by new loans, the current level of NPL will remain stable, but in the medium term, the pressure will be exerted from the quality of consumer loans, which will deteriorate due to the growth of the debt burden of the population, outpacing the real disposable income.

Potential risks and uncertainties stemming from the new U.S. sanctions persist. We continue to assess the sanctions risks as a moderately strong stress-factor downgrading Russia's credit rating due to ongoing geopolitical tensions and lack of progress on a number of issues that have already caused the imposed sanctions. At the same time, we emphasize Russia's significant progress in creating external buffers, mix of flexible monetary and conservative fiscal policies, which together form the basis for increasing the resilience of the economy to possible new restrictions on access to foreign capital markets.

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_13.12.2019.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.