Research Report on Russia

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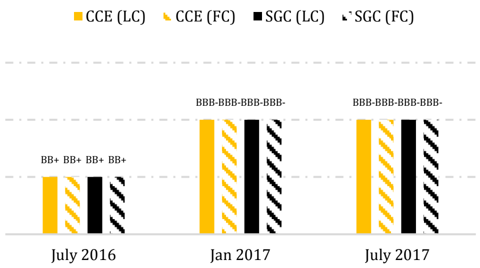
Ratings

Sovereign Government Credit (LC)	BBB-
Sovereign Government Credit (FC)	BBB-
Country Credit Environment (LC)	BBB-
Country Credit Environment (FC)	BBB-

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Russia

Macro indicators	2014	2015	2016
Gross gov. debt, RUB bn	12389	13271	14630
Nominal GDP, RUB bn	79200	83233	85881
Real GDP growth, %	0,7	-2,8	-0,2
Gross gov. debt/GDP, %	15,6	15,9	17,0
Deficit (surplus)/GDP, %	-1,1	-3,4	-3,7
Inflation rate, %	11,4	12,9	5,4
Current Account Balance/GDP, %	-	-	1,9
External debt, USD bn	-	-	39,1

Development indicators	2015
Inequality adj. HDI	0,71
GDP per capita, USD th	26,5

Default indicator	12.07.2017
5-Year CDS spread, Bp	164
10Y Gov Bond Yield, %	4,1

Source: RAEX (Europe) calculations based on data from the IMF, WB, ROSSTAT, CBonds.

Summary

The ratings of Russia at BBB- remain positively influenced by encouraging macro indicators which translate into low inflation rate levels, stable government debt metrics and a consolidating fiscal balance. However, the unpredictability of oil prices, combined with western sanctions on Russia and increasing non-performing loans (NPLs) in the banking system affect the ratings negatively.

The new fiscal rule introduced by Russian authorities combined with measures to replenish the Reserve Fund are likely to contribute to the fiscal consolidation and the creation of fiscal buffers. We expect inflation rate to approach the Central Bank's target this year. However, the stability of prices will ultimately depend on the long-term oil price trends

Macroeconomic outlook linked to external conditions. In 2017 Russia's ongoing signs of improvement in the country's main macroeconomic indicators supported the rating assessment of the country. As forecasted in our previous research report, real GDP growth returned to positive ground and was reported at 0,5% in 1Q 2017 mainly supported by a lagged effect of the recovery in oil prices which took place in 2016. Additionally, unemployment rate declined to 5,2% driven by stronger activity.

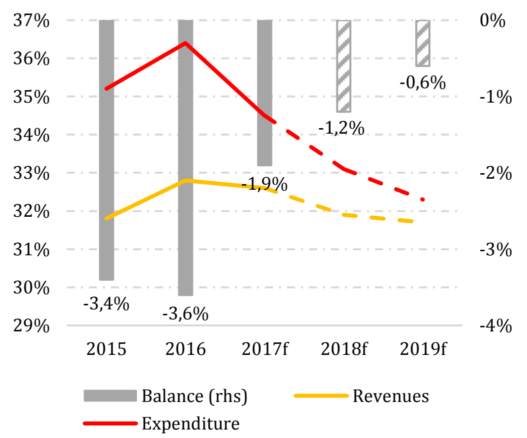
Fiscal deficit is set to narrow. The Russian fiscal deficit continued to widen, reaching 3,6% of GDP in 2016. This came as a result of a higher pace of increase in expenditures than in revenues. However, the deficit is set to narrow in 2017 driven by lower expenses, following the government's medium term fiscal adjustments outlined in the latest federal budget, as well as the introduction of a new fiscal rule. If accomplished, the adjustments are expected to derive in a fiscal deficit reduction of around 3p.p. through 2019 (see graph 1).

The 2017-2019 federal budget approved in November 2016 includes conservative spending and revenues assumptions; at the same time, it assumes a realistic oil price of USD 40 per barrel. Spending ceilings were introduced, which assume that rising social payments and debt services are counterbalanced by cuts in other sectors, especially in defense, in the range of 6% to 9% yearly. Furthermore, a number of measures were introduced to increase fiscal revenues which range from increasing dividends of state-owned enterprises up to 50% of their profits to higher excise and mineral extraction taxes.

The design of a new fiscal rule is another major innovation which will aim at consolidating the fiscal balance in the long run. This rule is planned to be introduced in 2019, when the budget is expected to be close to balance and considers a fixed oil price benchmark at USD 40 per barrel and a zero-primary balance target, instead of a backward-looking price formula and a 1% overall deficit considered under the old rule. In our view, the new approach is more stable and stringent than the old one, given that the future oil price may not follow previous trends.

Additionally, the Ministry of Finance (MoF) implemented a new mechanism which aims to replenish the Reserve Fund (RF), by saving the difference between actual oil revenues and those that would have been accrued had the budgeted price materialized. We consider that this mechanism will be beneficial to create fiscal buffers since the RF will likely be refurbished as a result.

Graph 1: Fiscal balance, % GDP



Source: RAEX (Europe) calculations based on data from the IMF

Banking sector metrics still mixed. The Russian banking sector kept showing mixed results through April 2017, with assets declining by 0,7% and increasing NPLs, alongside positive profitability indicators and stronger liquidity metrics (see table 1).

Despite NPLs having increased constantly since 2013 up to 9,4% in April 2017, the loan loss provisions has grown at a slower pace reaching 8,5% by the end of 2016 and remaining flat thereafter. This presents a growing risk for the entire banking system, as NPLs continue to accumulate, the amount of restructured loans is high and coverage metrics become insufficient.

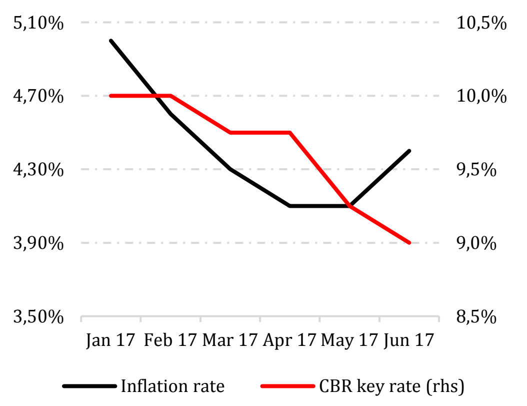
Table 1: Banking sector indicators

Factors	2013	2014	2015	2016	April 2017
NPLs	6,0%	6,7%	8,3%	9,4%	9,8%
Loan loss provisions	5,9%	6,5%	7,8%	8,5%	8,5%
ROA	1,9%	0,9%	0,3%	1,2%	1,7%
Asset growth	16,0%	35,2%	6,9%	-3,5%	-0,7%
Liquid assets to ST liabilities	78,7%	80,4%	139,3%	144,9%	170,1%

Source: RAEX (Europe) calculations based on data from the IMF

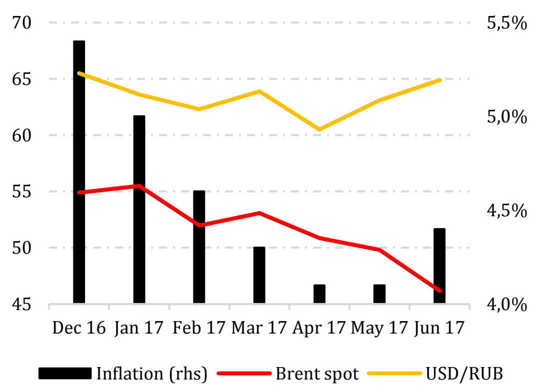
Low and stable debt metrics. Russia's government debt load remained low and stable at around 17% of GDP and 53% of budget revenues in 2016, with short-term obligations representing as low as 5% total debt. In our view, these metrics are likely to remain subdued in the long term as the fiscal adjustments introduced in the latest federal budget and the introduction of the new fiscal rule are expected to consolidate government

Graph 2: Inflation rate vs. CBR key rate



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

Graph 3: Oil price vs. Exchange rate



Source: RAEX (Europe) calculations based on data from the IMF, CBR and FRED

finances. Consequently, the yield on the 10Y government bond in foreign currency stood around 4% in June 2017.

Monetary policy slowly easing. The recovery of oil prices through 2016 drove a steady appreciation of RUB against major world currencies. As a consequence, this supported the decline of inflation rates, which were reported at 5,4% y-o-y in 2016. During 2017, the inflation rate kept declining down to 4,1% in May, slightly above the 4% target set by the Central Bank of Russia (CBR), driven by weak consumption demand, strengthening of the RUB and lower food prices.

The negative trend in inflation rate, combined with declining inflation expectations and improving economic activity motivated the CBR Board to cut the key rate in March, May and June by a cumulative 1p.p. to 9% (See graph 2). These facts reinforced our view that the CBR's monetary policy management keeps proving adequate to macroeconomic conditions in the country.

However, in June 2017 the inflation rate reverted its trend, reaching 4,4% y-o-y, mainly fueled by the devaluation of the RUB which followed the continued decline of oil prices (see graph 3). We consider that the volatility of oil prices remains the main source of uncertainty on the level of prices in the economy, and could ultimately risk reaching the CBR's inflation target in 2017 as well.

Uncertainty over sanctions. Even though authorities have reacted with proper fiscal and monetary policies which cushioned the effects on the Russian economy of sanctions, we consider that their prolongation are still hampering the ratings of the country. The suspected involvement in the U.S. election of parties linked to the Russian government has recently fueled the debate in the U.S. Senate to push for new sanctions on companies contracting with Russian state-owned companies. If this additional set of sanctions is approved by the lower House and the president's administration, they could hit a number of parties involved with Russian businesses and potentially put a halt on major gas transportation projects, such as the North and the Turkish stream, ultimately introducing further uncertainty on Russia's economic prospects.

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:

http://www.raexpert.eu/reports/Press_release_Russia_14.07.2017.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.