Research Report on Russia

Responsible Expert:

Vladimir Gorchakov
Rating Associate

**For further information contact:**
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
         www.raexpert.eu

Ratings

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

* These ratings are unsolicited

Ratings dynamics

□ SGC (LC)   ▨ SGC (FC)

BBB- BBB-	BBB- BBB-	BBB- BBB-
Jan 2018	Jul 2018	Dec 2018
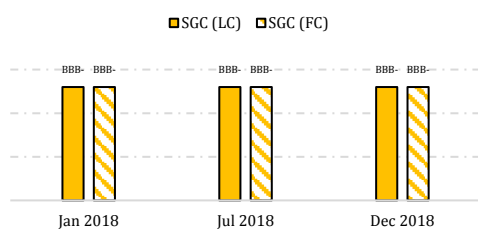
Main Economic Indicators of Russia

Macro indicators	2016	2017	2018f
Gross gov. debt, RUB bn	13827	14293	15848
Nominal GDP, RUB bn	86149	92037	101160
Real GDP growth, %	-0,2	1,5	1,7
Gross gov. debt/GDP, %	16,1	15,5	16,1
Deficit (surplus)/GDP, %	-3,6	-1,5	2,2
Inflation rate, %	5,4	2,5	3,9
Current Account Balance/GDP, %	1,9	2,2	2,8
External debt, USD bn	-	-	63,1

Development indicators	2017
Inequality adj. HDI	0,73
GDP per capita, USD th	27,9

Default indicator	21.12.2018
5-Year CDS spread, Bp	145,3
10Y Gov Bond Yield, %	5,1

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. 2018* - expectations.

Summary

The Agency confirmed the credit ratings of Russia at 'BBB-' with a stable outlook. This reflects our view on the balance of negative and positive factors, which can be crystalized in the upcoming year. Imposing of new material sanctions by the U.S. government related to the Russian government debt, state-owned banks or energy companies in 1H 2019, can have a strong adverse effect on the country's creditworthiness.

However, solid fiscal, debt and macroeconomic position can partly mitigate the risks. While the concrete range of sanctions to be imposed is hard to predict, we forecast that materialization of the worst-case scenario, such as restrictions on operations with state debt and SOBs, can trigger a negative rating action on credit rating or outlook. Even though we consider the probability of such scenario as low, we expect these to continue to weigh in the country's financial and FX-metrics within the next 6 months. Therefore, we have increased the impact of the stress factor of the international sanctions from moderately weak to moderately strong, taking into account this uncertainty.

Debt position will remain strong despite external volatility. We consider that the general government debt ratios will remain stable by end-2018 as compared to 2017 at 16% of GDP and 45% of general government revenues (see graph 1). We do not expect growth of these metrics in 2019 due to accumulated fiscal buffers, expected budget surplus and government debt policy. The debt structure also represents a low risk factor, as short-term debt is expected at 1,9% of GDP and 5,4% of budget revenues in 2018.

We reconsidered our assessment of the volume of the government's contingent liabilities as well as the probability of their materialization to a more conservative assessment. This is mostly based on the sharply increased share of State owned banks (SOBs) in the banking system. In addition, there is a risk that the government will have to provide financial support to some of them in case of new sanctions.

Strong fiscal surplus and an increased fiscal buffer support the ratings. The federal budget surplus for 11M 2018 increased to RUB 3,4 tn or 3,7% of GDP. Based on these metrics, and taking into account local budgets and off-budget funds' performance over the year, as well as projected December balances, we estimate the consolidated budget

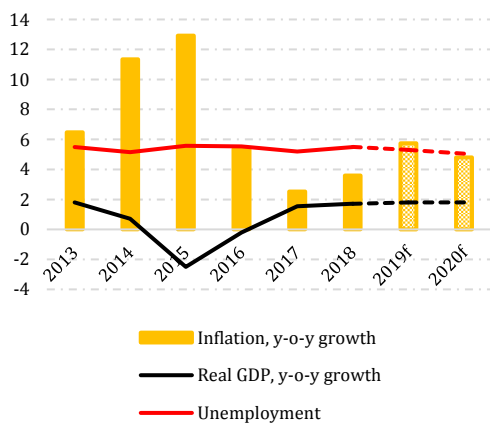**Graph 1:** Government debt dynamics, %
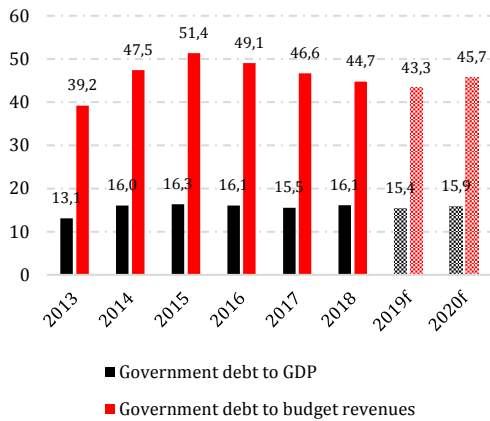
Source: RAEX-Europe calculations based on data from the IMF, CBR and Ministry of finance of the Russian Federation.

Graph 2: Fiscal budget dynamics, % of GDP
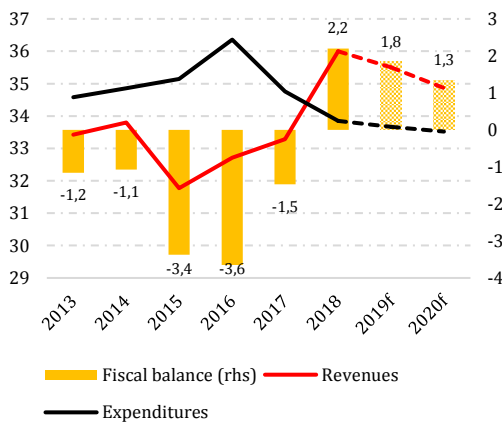
Source: RAEX-Europe calculations based on data from the IMF and Ministry of finance of the Russian Federation.

Graph 3: Macroeconomic indicators, %

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

surplus at 2,2% by the end of 2018 (see graph 2). Such a positive dynamic reflects higher-than-budgeted oil prices, continued non-oil and gas revenue growth and expenditure cuts.

The hike of the value-added tax to 20% from 18% in January 2019; new taxes for so called "self-employed" employees, as well as already increased taxation of the energy sector; raising the retirement age and cutting some spending, support our assessment of fiscal surplus for 2019. We estimate this metric will be around 1,8% of GDP. However, a potential significant and prolonged oil price decline over the next year, as well as materialization of contingent liabilities, can deteriorate the fiscal position of the government by end of year.

We consider the quality of the fiscal policy of the government as a positive factor, since the modified fiscal rule showed its efficiency for the mitigation of commodities' price shocks. This, alongside the oil price dynamic, helped to increase the size of the National Wealth Fund to 4,6% of GDP as of November as compared to 3,8% at the beginning of the year. Despite the fact that the government plans a temporary relaxation of the fiscal rule in 2019-2024 as well as post-election spending proposals of about 1,5% of GDP annually over the next six years, we do not consider this to negatively affect the sovereign's creditworthiness as current fiscal buffers are solid.

Our assessment of the government's ability and plans of privatization was reassessed to more conservative due to the ongoing increase of state share in economy and the recent authority's rhetoric, confirming that the government will not initiate any large-scale privatization until sanctions risks persist.

The economy growth in 2019 may be lower than expected. The country's GDP recorded a decline of 0,4% in the 3Q 2018 as compared to 2Q 2018 (with exclusion of seasonality factors); however, the indicator keeps showing a positive dynamic y-o-y (1,3% as compared to 3Q 2017). We still consider that end of year GDP growth will be in the range of 1,7-1,8% (see graph 3) restrained by weak internal demand, increased tax pressure and negative oil price dynamic in 4Q 2018. Our current expectations about 2019 GDP growth of 1,7% can be reassessed down in case of further oil price decrease, spillover effects from trade wars and U.S. sanctions strengthening. In the long-run, our expectations of the country GDP growth are still limited to 1,5-2% due to moderately low productivity, negative demographic trends, structural imbalances and moderately low institutional development. The effect from the announced government
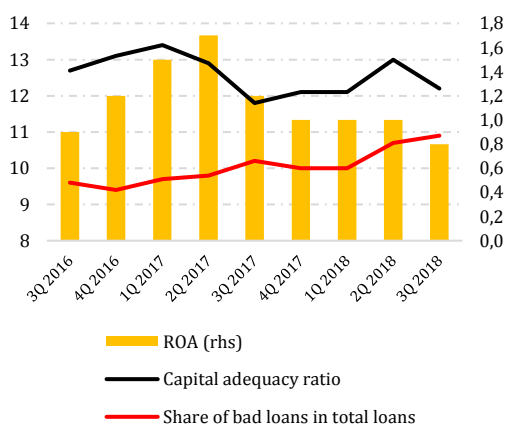
Graph 4: Monetary policy metrics, %
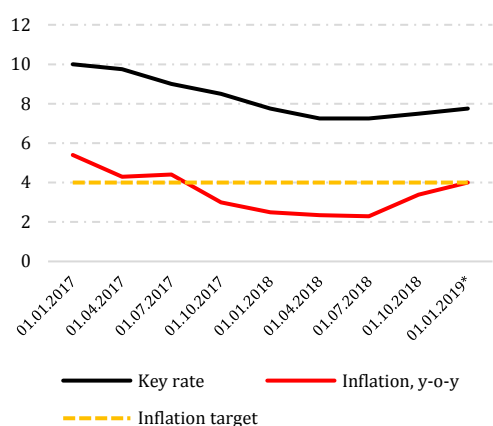
Source: RAEX-Europe calculations based on data from the Rosstat and CBR
*Expectations.

Graph 5: 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".

Graph 6: External sector indicators, % of GDP
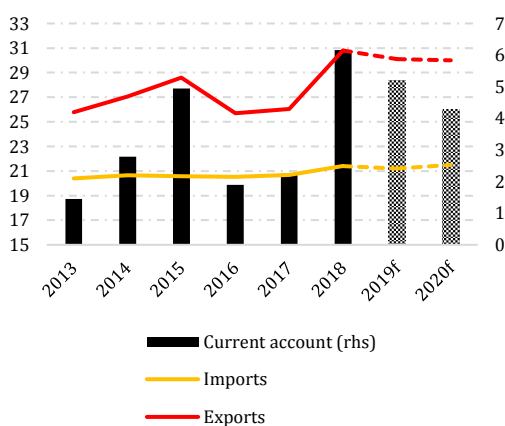
Source: RAEX-Europe calculations based on data from IMF and WB

plans to increase public investments in infrastructure will be limited by the aforementioned factors.

Monetary policy was tightened due to increased FX-rate and inflation volatility. After gradual easing of the monetary policy over the last 3,5 years, the CBR increased its key rate two times in September and December 2018, setting it at 7,75% by the end of year (see graph 4). This decision was driven by increased recorded inflation in 3-4Q 2018, inflation expectations and overall volatility on the financial markets. Final inflation level for 2018 is expected to be in line with the CBR target of 4% or slightly exceed it due to the aforementioned factors. Driven by the same factors together with the VAT hike and the announced increase in tariffs, we expect inflation levels at around 5% by the end of 2019. Our overall assessment of the quality of the monetary policy remains positive, since the CBR has reached credibility over the past few years for its response to the oil price shocks and effective disinflation efforts. In addition, the Central Bank confirmed its commitment to free-flow exchange rate regime, and we do not expect any FX-restrictions to be imposed even if the external environment deteriorates significantly.

Banking system concentration and the state's share keep increasing. Since our previous revision in July 2018 the concentration risks in the system increased, as the share of three largest banks in assets hiked from 47% to 53% during 2018. We expect this process to continue within the next year as the CBR keeps withdrawing licenses of private banks (mostly small regional institutions), as well as M&A processes continue led by large SOBs. Therefore, we estimate that their share in the assets will exceed 70% by end 2019. This is considered as a strong negative factor as it restrains competition on the financial markets, increase risks of systematic crisis and contingent liabilities of the government.

We still assess the banking system profitability and capitalization metrics as a positive factor. The Russian banks showed an improvement of financial results by end of 3Q 2018 with a ROA and ROE at 0,8% and 6,8% respectively (graph 5), and we expect these metrics to improve by the end of year. Capital adequacy metrics despite a slight decline over 3Q 2018, remained high at 12%.

The level of NPLs to total loans is expected to slightly increase to 11% by end-2018 in comparison to 10% in 2017, restraining the rating assessment. Moreover, we still consider that these levels can be underestimated taking into account widespread roll over and prolongation practices on the market. In addition, if the announced U.S. sanctions are imposed in 1Q 2019 in the strictest way, this can trigger a
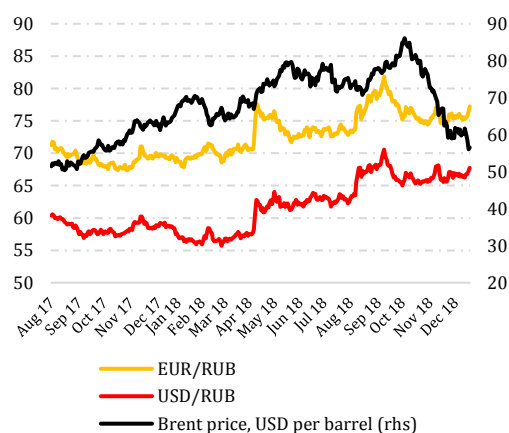
Graph 7: International reserves and FX-rate, %
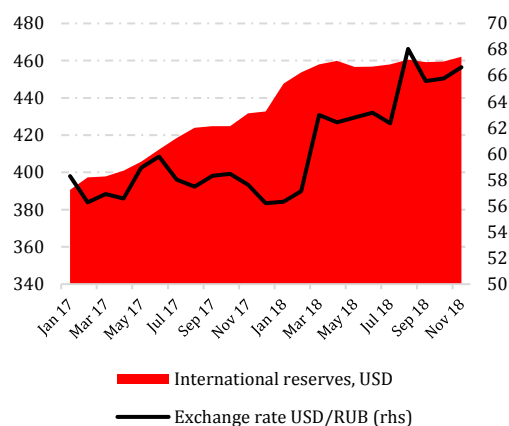
Source: RAEX-Europe calculations based on data from CBR

Graph 8: FX-rates and oil price

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

hike of NPLs, taking into account the aforementioned dependence on large state-owned financial institutions.

Russia's external position remains a credit strength, while FX volatility increased. Since 2014 the Russian economy has continued to deleverage externally partly due to the imposed sanctions. As a result, the net foreign assets of the country improved to an estimated 37% of GDP in 2018 from 32% a year ago. Due to the favorable market conditions over the first three quarters of 2018, the Russian trade balance and current account are expected to improve in the current year as compared to 2017 results (see graph 6). However, we expect lower results for 2019 due to the expected volatility on the oil market as well as potential slowdown of global growth. International reserves rose to USD 462 bn by December 2018, due to higher oil prices and a strong current account surplus (see graph 7), forecast to cover almost 200% of gross government debt and 16 months of expected 2018 imports, supporting the rating assessment.

The CBR announced that it will once again buy foreign currency on the FX market in January 2019. This, together with the uncertainty regarding U.S. sanctions, the FED's policy direction and the recent oil price decline (see graph 8), exerts pressure on the local currency.

Uncertainty about new sanctions restrains the rating assessment. The U.S. Senate decision to postpone the final discussion on sanctions from November 2018 to 1Q 2019, did not eliminate the risks and creates more uncertainty for the investors. We consider that the latent risk of the imposition of sanctions may constrain foreign investors from holding and transacting in new sovereign debt of Russia. However, we also consider that the probability of this happening is low. Nevertheless, we believe that a strong fiscal and external position, as well as low government debt, helps the government to partly mitigate these risks. At the same time, the uncertainty regarding the type and scope of future sanctions continues to weigh on growth prospects, stability of the national currency and financial markets. Therefore, we increased the impact of stress factor of international sanctions from moderately weak to moderately strong, taking into account this uncertainty.

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://www.raexpert.eu/reports/Press_release_Russia_21.12.2018.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.