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Research Report on Russia

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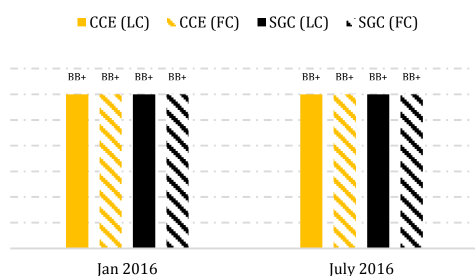
Ratings

Sovereign Government Credit (LC)	BB+
Sovereign Government Credit (FC)	BB+
Country Credit Environment (LC)	BB+
Country Credit Environment (FC)	BB+

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Russia

Macro indicators	2013	2014	2015
Gross gov. debt, RUB bn	9286	12723	14243
Nominal GDP, RUB bn	71055	77893	80413
Real GDP growth, %	1,3	0,7	-3,7
Gross gov. debt/GDP, %	13,1	16,3	17,7
Deficit (surplus)/GDP, %	-1,2	-1,1	-3,5
Inflation rate, %	6,5	11,4	12,9
Current Account Balance/GDP, %	-	-	5,2
External debt, USD bn	-	-	30,6

Development indicators	2015
Inequality adj. HDI	0,71
GDP per capita, USD th	25,4

Default indicator	20.07.2016
5-Year CDS spread, Bp	228
10Y Gov Bond Yield, %	8,5

Source: RAEX (Europe) calculations based on data from the IMF, WB, UN, CIA, Trading Economics

Summary

Russia's ratings at BB+ reflect the government's low debt and manageable fiscal position, as well as our expectation that the oil price will continue to increase and EU sanctions could be gradually lifted after January 2017. The banking sector is stable and remains profitable with comfortable amount of assets and sufficient capital coverage. However, the raising share of non-performing loans in the total loan portfolio could deepen the risks for the sector if the country's economic performance remains weak.

Negative real GDP growth rates, combined with high levels of inflation contributed negatively to the rating assessment. These risks have been reflected on Russia's 10Y government bond yield. In our view, Russia will benefit from higher oil prices in the mid- and long run, ultimately improving the country's terms of trade, propelling the economy and relieving pressure on prices.

Outstanding debt position. Russia's Gross government debt load remains stable and manageable at around 18% of GDP and 54% of fiscal revenues. As of June 2016, total government debt amounted to RUB 12,9 tn, which represents an 8,4% increase y-o-y. Short-term debt exposure remains negligible, but the yield on the 10Y government bonds at 8,5% is showing the market's perception of long-run risks in the economy.

Debt metrics increased temporarily during 1Q 2016 as a result of FX-driven effects on external debt. However, the appreciation of RUB during 2Q 2016 helped debt metrics to resume their downward trend (see graph 1). In our view, government debt is going to remain low in the short run. Nonetheless, mid-term risks can arise as the Russian government announced its plans to increase its domestic debt exposure as an alternative to Eurobonds issuance.

Furthermore, the minor but still decreasing trend in both sovereign funds (Reserve Fund and National Wealth Fund) represents an additional risk for the financing alternatives of the government. We can expect further deterioration of these funds since the government has been using these funds to cover budget deficits.

Bearable fiscal stance with long-term risks. Mainly dominated by the sharp decline of oil prices during 2015, Russia's fiscal budget rounded up that year with a deficit of 3,5% of GDP. We expect 2016 to end with a

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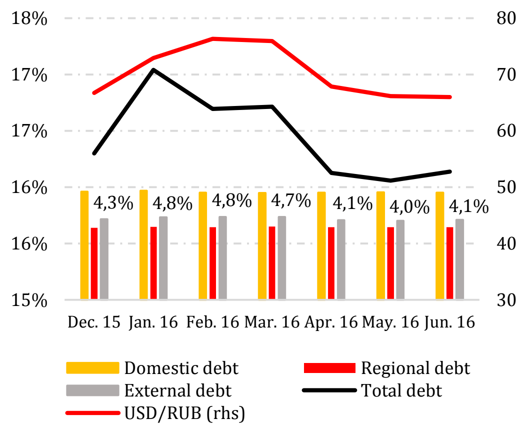
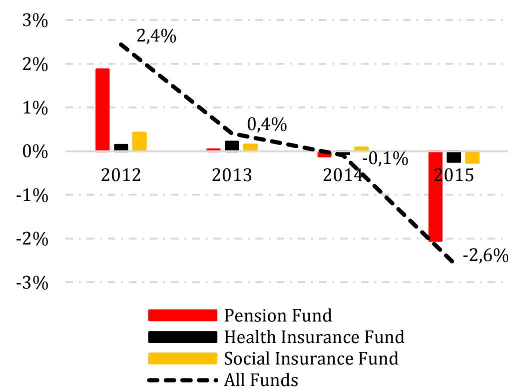
Graph 1: Government debt (% of GDP) vs. exchange rate



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

Graph 2: Off-budget government funds balances, % of fiscal revenues



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

similar figure than in 2015 and to start narrowing in 2017 as we expect oil prices to maintain its upward trend.

However, there are a number of off-budget accounts which ultimately are financed by the government and represent a much longer-term risk for the Russian economy. The most significant of these accounts are the pension, health and social insurance funds whose balances have been falling over the past four years (see graph 2). With an ever ageing population, this risk is likely to become stronger with time.

There have been some official proposals to reduce the fiscal deficit in the short and midterm such as freezing fiscal expenditure for two years. Officials have argued that if such proposals are not instrumented, one of the two sovereign funds could be exhausted over the next two years. However, there is still no final confirmation on these actions and is too early to forecast how the deficit is going to develop in the mid run.

Liquid banking sector with downside risks. The Russian banking system remains stable with assets at 103% of GDP, ROE still positive around 3% (ROA almost negligible) and average capital to assets ratio at 9,3% and growing. Such indicators are a result of the authorities' policy response which included capital support and temporary regulatory forbearance since mid-2015.

The Russian Deposit Insurance Agency (DIA) allotted RUB 190,4 bn for banks' recapitalization out of the RUB 802,7 bn received by the Federal government by end-2015. This does not only show that the recapitalization plan was less ambitious than expected, but also that there is still room for further recapitalizations with current DIA's funds.

A major risk that Russian banks are currently facing is connected to the large and rising amount of NPLs in their loan portfolio. The share of NPLs amounted to 9,2% in 1Q 2016 and we expect this figure to continue growing on the back of weak GDP growth perspectives for the short and mid run (see graph 3).

External position remains sound. Russian countersanctions on EU imported goods alongside weak GDP growth, drove a sharp decline of goods imports since the beginning of 2015. This, combined with a slight narrowing of the primary income deficit were the main drivers of the significant improvement of the current account balance, which stood by end-2015 at 5,2% of GDP (see graph 4).

Additionally, FX reserves at USD 392 bn in May 2016 covered external debt by 12x and 15 months of 2015 imports. Even though oil price remains

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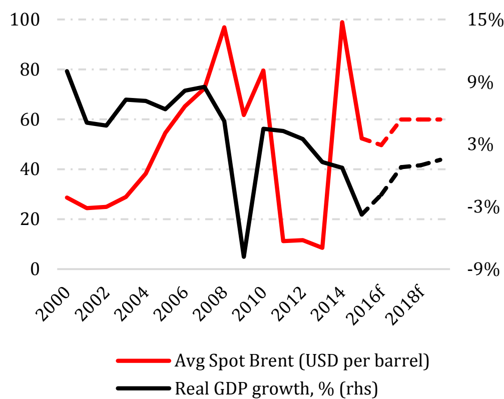
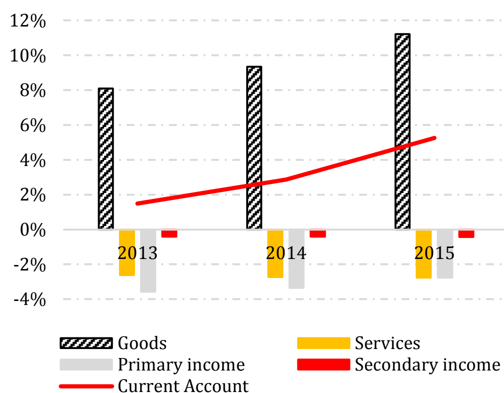
Graph 3: Real GDP growth vs. Average Brent oil price



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

Graph 4: Current Account, % of GDP



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

low, it has been recovering since January 2016. This is likely to refurbish CBR FX reserves and reduce the pressure on RUB exchange rate.

Monetary policy normalization remains overdue. The monetary policy enforced by the Central Bank of Russia (CBR) has been approximately on hold since August 2015. However, the CBR decided to reduce its key interest rate slightly in June 2016 from 11% to 10,5% as a response to lower inflation expectations and reduced FX exchange rate volatility.

Inflation rate rose sharply in 2014 and 2015 up to 11,4% and 12,9% respectively as a result of the lower oil-price-driven RUB depreciation. Nonetheless, inflation rate in 1Q 2016 stood at 8,5% y-o-y, well below the 12,6% observed in 1Q 2015. In our view, higher oil prices and low exchange rate volatility will contribute to reduce inflationary pressures until the end of 2016.

The timing of full monetary normalization is yet difficult to predict as there is still a risk of an increase in oil price and exchange rate volatility. Russia's higher-than-expected inflation rate for June 2016 at 7,5% y-o-y, is likely to encourage the CBR to keep interest rates unchanged at this month's Council meeting. In our view, monetary policy easing is likely to resume towards the end of the year once inflation falls back.

EU sanctions on Russia were extended. In July 2016 EU sanctions on Russia were extended through January 2017 after the European Council assessed that the Minsk agreements concerning military actions in Ukraine have not been enforced. With this decision, a number of financing and trade bans are prolonged to Russia's five largest state-owned financial institutions as well as three major Russian energy and three defense companies.

However, a number of EU Foreign Ministers have raised their voice in favour of lifting the sanctions on Russia, and a final UK withdrawal from the EU ("Brexit") could accelerate such process. It is not yet clear what impact "Brexit", if finally enacted, may have on the EU's ability to maintain sanctions in the long term.

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_22.07.2016.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.

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