Research Report on Russia

6 July 2018

Responsible Expert:

Gustavo Angel
Rating Associate

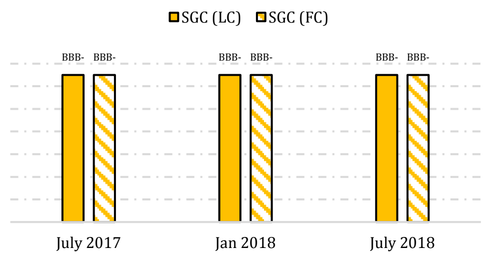
For further information contact:
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

Ratings

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

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Russia

Macro indicators	2015	2016	2017
Gross gov. debt, RUB bn	13271	13463	16056
Nominal GDP, RUB bn	83387	85918	92082
Real GDP growth, %	-2,5	-0,2	1,5
Gross gov. debt/GDP, %	15,9	15,7	17,4
Deficit (surplus)/GDP, %	-3,4	-3,7	-1,5
Inflation rate, %	12,9	5,4	2,5
Current Account Balance/GDP, %	5,0	2,0	2,6
External debt, USD bn	-	-	55,8

Development indicators	2017
Inequality adj. HDI	0,73
GDP per capita, USD th	27,8

Default indicator	03.07.2018
5-Year CDS spread, Bp	139,5
10Y Gov Bond Yield, %	4,3

Source: RAEX-Europe calculations based on data from the IMF, UN, Russian ministry of finance.

Summary

The credit ratings of Russia are confirmed at 'BBB-' on the back of improving macroeconomic fundamentals, higher oil prices, low inflation rates, modest and stable government debt metrics and narrowing fiscal deficit.

Higher oil prices helped to reduce fiscal pressure and contributed significantly to the fiscal consolidation. Going forward, a potential approval of the pension reform is likely to reduce fiscal pressure as well. With reduced financing needs, government debt metrics remained low and stable.

As monetary policy becomes neutral, its pace of normalization is slowing-down. This was evidenced by the noticeable reduction of interest rates cuts done by the Central Bank of Russia (CBR) along 1H 2018 as compared to the same period in 2017.

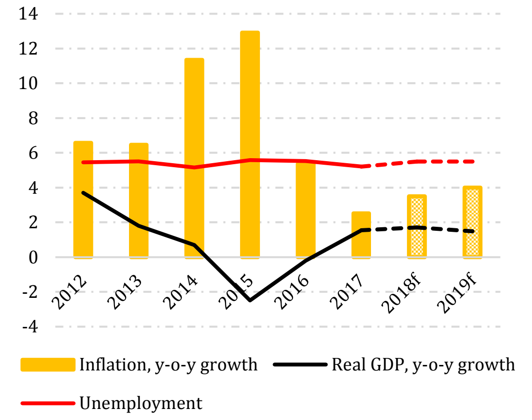
The stable rating outlook is supported by our view that key macroeconomic variables are likely to remain unchanged in the mid-term perspective. Even though oil prices are likely to remain high and keep contributing to fiscal consolidation during 2H 2018, the country's significant dependence on this commodity and ongoing sanctions keep posing a risk for the continuation of the country's smooth recovery.

Encouraging macroeconomic position. The robust macro stance of Russia (see graph 1) remains supported by higher and stable oil prices which ultimately translated into strong real GDP growth at 1,3% in 1Q 2018 and stable annual inflation rate at 2,4% in May 2018. Going forward, we expect GDP growth and inflation rates to reach 1,7% and 3,5% respectively by the end of 2018. Despite remaining low, the inflation rate is likely to reach the CBR's 4% target only after 2019 reflecting the effects of a neutral key interest rate[1] and the one-time impact of the value added tax (VAT) increase.

As a result of the aforementioned conditions, the unemployment rate is still low and stable at around 5,2% in 2017 and we expect it to remain flat at around 5,5% in 2018 and 2019. Also, the better economic environment contributed to boost confidence in the country, causing an increase in FDI of USD 12,4 bn in 2017. While on the one hand this inflow of funds reflects

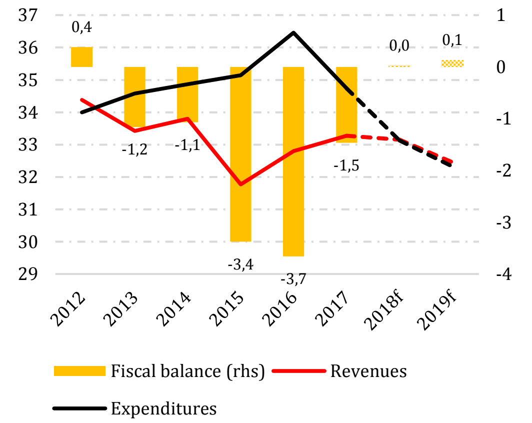
[1] A neutral key rate would not either decelerate or accelerate inflation, relative to the target level of 4 percent.

Graph 1: Macroeconomic indicators, %



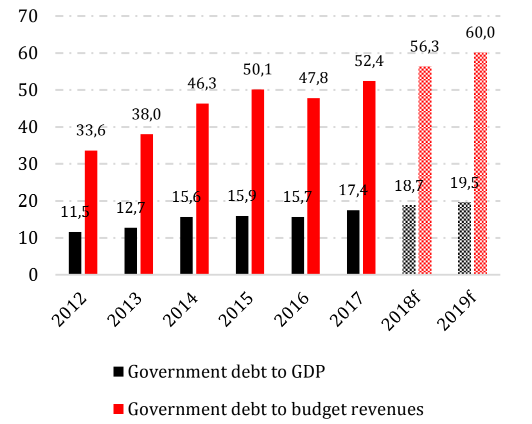
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Fiscal budget dynamics, % of GDP



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

Graph 3: Government debt dynamics, % of GDP



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

a decline of uncertainty in the business environment, on the other hand can be also explained by capital round-tripping[2].

Ongoing fiscal consolidation. As forecasted in our previous research report, in 2017 Russia's fiscal deficit reverted the widening trend it showed in the previous year. For the first time since 2012 the fiscal deficit narrowed sharply to 1,5% and, in our view, the Russian fiscal balance is likely to pose a positive figure in 2018 and follow a positive trend from 2019 onwards fueled by a decline in expenditures (see graph 2).

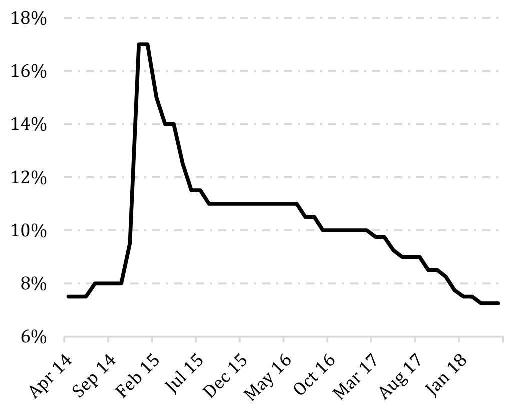
This improvement is the result of the government's fiscal adjustments outlined in the latest federal budget, as well as the introduction of a new fiscal rule, which decouples expenditures from volatile commodity-based revenues. Under the new rule, fiscal expenditures should not be cut and would flow smoother in case of a wider range of oil price changes. Moreover, the new rule aims to narrow the non-oil & gas deficit, which averaged 10% between 2009 and 2016, and to reduce real federal budget expenditures by 4,5%-5% during the period 2016-2020. Going forward, a potential approval of the pension reform is likely to reduce fiscal pressure as well.

Additionally, the Ministry of Finance (MoF) used the remaining USD 17 bn left in the Reserve Fund by the end of 2017 to narrow the fiscal deficit. Going forward, the oil and gas revenues in excess of the benchmark price set by the government will be absorbed by the National Welfare Fund (NWF), which stood at USD 65,1 bn as of January 2018. Since this date, the government changed the formula for currency interventions of the NWF. The new formula uses the spot exchange rate to determine oil and gas revenues in excess of the benchmark price, as opposed to forecasted exchange rate used in the previous version. This, we expect, will allow the government to collect a larger share of the oil and gas revenue windfall in the future and ultimately create stronger fiscal buffers.

Debt metrics remain low. As forecasted in our previous research report[3], gross government debt stood slightly above 17% of GDP and 52% of budget revenues in 2017. These metrics remained low and stable following the reduced financing needs of the Russian government and the combined effect resulting from narrowing fiscal deficit and higher fiscal buffers built as a result of the country's strong macro position. Going forward, the trend of government debt will depend on the stability of fiscal and macroeconomic metrics, but we can anticipate that if the status-quo

[2] Round tripping of FDI refers to the capital belonging to a country, which leaves the country and then is reinvested in the form of FDI. Round-tripping plays a crucial part in temporarily inflating the market capitalization of companies. However, in international scenarios, round tripping is generally used for tax evasion and money laundering.
[3] Research report on Russia from 12 January 2018 (https://raexpert.eu/reports/Research_report_Russia_12.01.2018.pdf).

Graph 4: CBR key rate



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

remains in place in the long-term, the government debt to GDP ratio is likely to remain subdued (see graph 3).

Slower pace of monetary policy easing. Encouraged by a combination of low and stable inflation rate, high oil prices and positive GDP growth, the CBR lowered the key interest rate through 2017 by 225 b.p. 2017 saw the sharpest interest rate cut after 2015, when it declined by 600 b.p. to 11%. In contrast, the pace of interest rate cuts declined significantly through 1H 2018 (only 50 b.p.), as the CBR key rate approached pre-2015 figures (see graph 4). The CBR also noted that the estimated neutral interest rate has moved closer to its upper bound within the range of 6-7%, due to the increased country risk premium and an increase of interest rates in advanced economies (mainly the U.S.). This suggests that in the mid-term perspective, it will be unlikely to see further interest rate cuts.

More stringent sanctions. As predicted in our previous research report, new sanctions were imposed by the U.S. government on Russia in April 2018, particularly on a group of top oligarchs and their companies. This new set of sanctions, coupled with increased geopolitical and trade tensions, cased a substantial sell-off of Russian financial assets which triggered a sharp contraction of the stock market and a devaluation of the RUB against major currencies. Sanctions on Russia (as well as countersanctions from Russia) remain one of the main obstacles for trade and stronger growth for the country and present a limit to the improvement of the credit ratings.

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_06.07.2018.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.