Euler Hermes Economic Research

Country Report

# Russia

## Recession has deepened amid continued high RUB volatility

## General Information

| | |
|---|---|
| **GDP** | USD1,861bn (World ranking 10, World Bank 2014) |
| **Population** | 143.82mn (World ranking 9, World Bank 2014) |
| **Form of state** | Federation |
| **Head of government** | President Vladimir Vladimirovich PUTIN |
| **Next elections** | 2016, legislative |

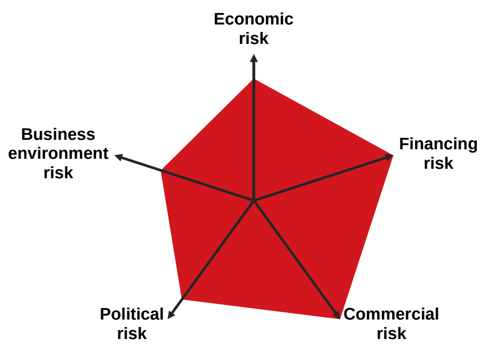
## Strengths

- Abundant natural resources, in particular oil and gas
- 15 years of continued current account surpluses (including the crisis year 2009)
- Low public debt
- Still comfortable foreign exchange reserves

## Weaknesses

- Far-reaching structural reforms still outstanding
- High vulnerability to global oil prices shocks
- Capital flight
- Ongoing currency crisis; strong exchange rate volatility and vulnerability to continue
- Banking sector under pressure from declining asset quality
- Poor rule of law and high level of perceived corruption
- Despite attempts to boost corporate governance, corruption remains an issue
- Geopolitical risk: conflict with Ukraine and serious dispute with the West over that conflict (including sanctions and counter-sanctions)

## Country Rating C4




Source: Euler Hermes

## Trade Structure

By destination/origin (% of total)

| Exports | | Rank | | Imports |
|---|---|---|---|---|
| China | 7% | 1 | 18% | China |
| Germany | 6% | 2 | 14% | Germany |
| Ukraine | 5% | 3 | 5% | Belarus |
| Netherlands | 4% | 4 | 5% | Ukraine |
| United States | 4% | 5 | 4% | Italy |

By product (% of total)

| Exports | | Rank | | Imports |
|---|---|---|---|---|
| Crude Oil | 30% | 1 | 7% | Cars And Cycles |
| Natural Gas | 20% | 2 | 5% | Engines |
| Refined Petroleum Products | 20% | 3 | 4% | Pharmaceuticals |
| Iron Steel | 3% | 4 | 4% | Miscellaneous Hardware |
| Non Ferrous Metals | 3% | 5 | 4% | Vehicles Components |

Source: Chelem (2013)

# Economic Overview

## Four-fold crisis: politics, confidence, oil revenues and currency

Since Q1 2014, Russia has faced a political crisis and a sharp loss of market confidence, as a result of the annexation of Crimea, its continued involvement in the conflict in east Ukraine, and the ensuing response of Western nations in the form of sanctions against it. In H2 2014, sharply falling global oil prices adversely impacted Russian exports and government revenues which was exacerbated by an equally sharp depreciation of the RUB. The economic fall-out has been severe.

## Sharp contraction in Q2, more to come

The economy has been in recession since mid-2014 as real GDP shrank by -2% q/q in Q2 2015, marking the fourth consecutive quarter of decline. In annual terms, GDP dropped by -4.6% y/y in Q2, after -2.2% in Q1. On the supply side, manufacturing fell by -4.8% y/y in Q2, construction -6.9% and mining -0.1%. Retail trade plunged by -9.9% y/y, indicating that private consumption remained very weak. The real estate sector shrank by -5.7% y/y, transport and communication -4.1% and financial services -5.2%. Only agriculture (+2.1% y/y), utilities (+1%) and public administration and defence (+1.2%) increased modestly in Q2. Early indicators for Q3 signal continued weakness: In July, industrial production fell by -4.7% y/y, fixed investment -8.5% and retail sales -9.2%. In August, the manufacturing PMI fell to 47.9 points (48.3 in July) and the services PMI to 49.1 (51.6 in July). Since oil prices have remained low, Euler Hermes expects Q3 to be similarly weak as Q2, before the recession may perhaps bottom out in Q4, and forecasts full-year 2015 GDP to contract by -4%. In 2016, the recession is forecast to continue, but due to base effects GDP should decline at a more moderate pace of about -0.3%.

## Currency risk to continue

The "perfect storm" of sanctions, capital flight and, in particular, falling oil prices has had a severe impact on the Russian currency. During 2014, the RUB lost 72% of its value against the USD (51% against the EUR), despite heavy foreign exchange (FX) interventions by the Central Bank of Russia (CBR). In 2015, the RUB has remained very volatile: After falling further by end-January (USD1:RUB69), it recovered markedly until mid-May (USD1:RUB49), in part thanks to a less worse than expected economic performance in Q1. Thereafter it has sharply weakened again, mainly for two reasons: (i) the deepening recession in Q2 and Q3; and (ii) the renewed slump in global oil prices. On 11 September the exchange rate stood at USD1:RUB68, i.e. the RUB was down by -81% y/y. Going forward, the course of the RUB will depend more on developments on the oil price and economic sanction fronts than on CBR actions, including interest rate changes. Under the assumptions of our baseline scenario that sanctions against Russia do not change substantially in 2015 and the average Brent oil price is USD55/barrel, the USD:RUB exchange rate could average at around 1:68 during the remainder of the year. However, volatility will remain high, also in 2016, and the USD:RUB rate could temporarily still reach as much as 1:100, especially if the oil price falls to below USD40/barrel for a sustained period.

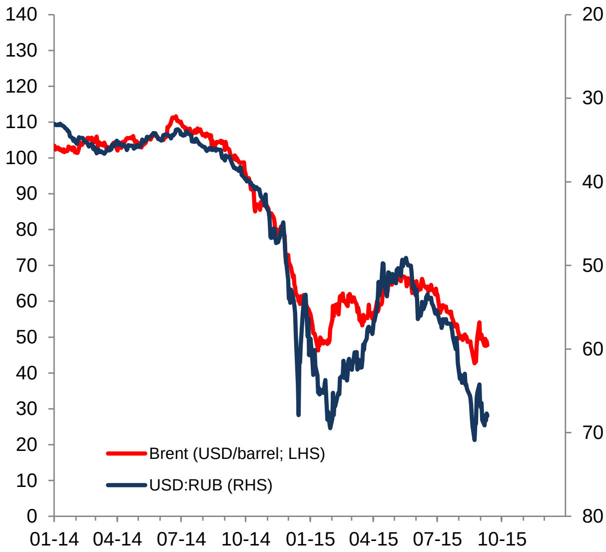
The sharply weakened RUB will continue to have a severe impact on companies that have significant FX-denominated liabilities and will have difficulties to refinance maturing debt. Taken together with the effects of the deep recession, EH expects corporate insolvencies to surge by +30% in 2015.

**Key economic forecasts**

| | 2013 | 2014 | 2015f | 2016f |
|---|---|---|---|---|
| GDP growth (% change) | 1.3 | 0.6 | -4.0 | -0.3 |
| Inflation (%, end-year) | 6.5 | 11.4 | 13.0 | 9.0 |
| Fiscal balance (% of GDP) | -1.3 | -1.2 | -3.2 | -2.5 |
| Public debt (% of GDP) | 14.0 | 17.9 | 19.0 | 20.0 |
| Current account (% of GDP) | 1.6 | 3.1 | 5.9 | 3.8 |
| External debt (% of GDP) | 35.1 | 32.3 | 44.5 | 43.7 |

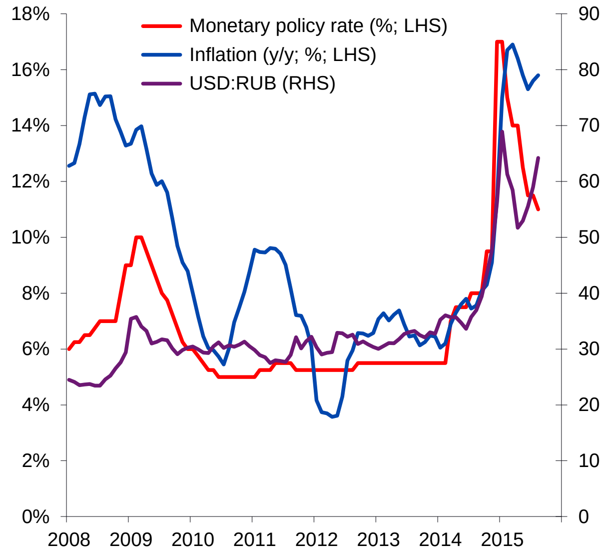
Sources: National sources, IHS, IMF, Euler Hermes

**Brent oil price and USD:RUB exchange rate**




Sources: Bloomberg, Euler Hermes

**Monetary policy interest rate, inflation rate, and exchange rate**

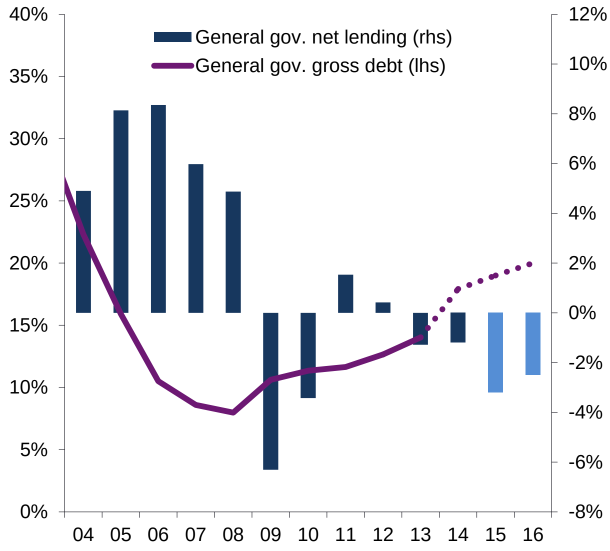



Sources: National sources, IHS, Euler Hermes

## Inflation to remain in double-digits

Due to the RUB depreciation as well as increased food prices in the wake of Russia's ban on certain food imports from the EU, inflation accelerated from 6.5% at end-2013 to a peak of 16.9% y/y in March 2015. In line with the RUB exchange rate, it then eased slightly until June (15.3%) before rising again to 15.8% in August. During 2014, the CBR had raised its key policy interest rate by a cumulative 1150bps to 17% and announced an inflation-targeting plan after the free floating of the RUB in November. Despite this we expect inflation to average 15.4% in 2015 and 10% in 2016 due to the much weakened currency. As the CBR's measures were not successful in containing depreciation and inflation, but probably also because of political pressure, it has cut the policy rate to 11% in five steps from February to August 2015, shifting its focus to address concerns about the banking sector and economic growth.

**Public finances (% of GDP)**




Sources: IMF, Euler Hermes

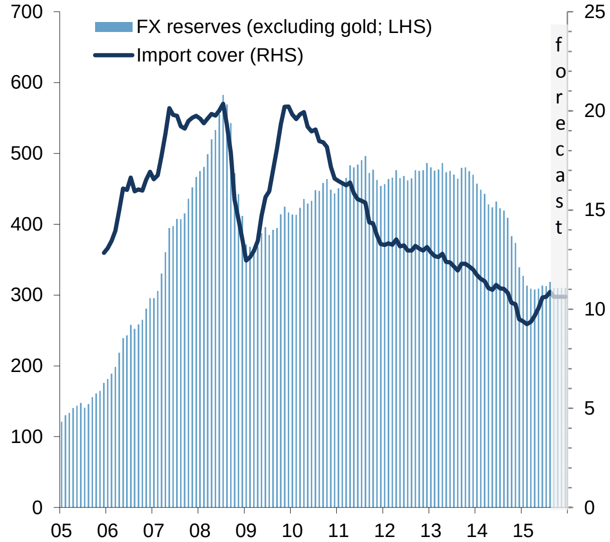
## Banking sector remains fragile

Russia's banks have been hit by higher interest rates and understandably rising non-performing loans. The government has announced a USD35 bn anti-crisis programme and the CBR also rolled out a number of measures, mostly aimed at supporting large banks and companies. While the amount may be insufficient and need to be increased, the authorities should have the resources to avoid a systemic crisis and we are not concerned at present about their resolve to provide support. However, many of the 900 odd smaller banks will be at risk of bankruptcy or losing their licence.

## Sovereign default unlikely in 2015

Russia’s fiscal position remains robust. Public debt will remain low (forecast at 19% of GDP in 2015) even if the fiscal deficit is expected to increase from -1.2% of GDP in 2014 to -3.2% in 2015 before moderating to -2.5% in 2016. Moreover, two Sovereign Wealth Funds worth about USD144 bn (13% of GDP) will provide resources to finance a fiscal deficit and anti-crisis measures in 2015-2016.

**Foreign exchange reserves (USD bn) and import cover (months)**




Sources: National sources, IHS, Euler Hermes

## Capital flight weakens external position

The current account surplus will increase further from +3.1% of GDP in 2014 to about +6% in 2015, because the decline in imports due to the RUB’s collapse will exceed the drop in exports. However, the surpluses since 2014 were more than offset by net capital outflows of the private sector which amounted to USD153 bn in 2014 and USD53 bn in H1 2015. As a result, FX reserves have dropped from USD470 bn at end-2013 to USD313 bn in February 2015, though they have remained fairly stable since then. While the current level of FX reserves is still comfortable in terms of import cover (11 months) or in relation to external debt falling due in the next 12 months (estimated at USD150 bn), the future development has to be monitored closely and is not fail safe.



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