Euler Hermes Economic Research

Country Report

Russia

Currency crisis and deep recession in 2015

General Information

GDP	USD2,015 bn (World ranking 8, World Bank 2012)
Population	143.53 mn (World ranking 9, World Bank 2012)
Form of state	Federation
Head of government	President Vladimir Vladimirovich PUTIN
Next elections	2016, legislative

Strengths

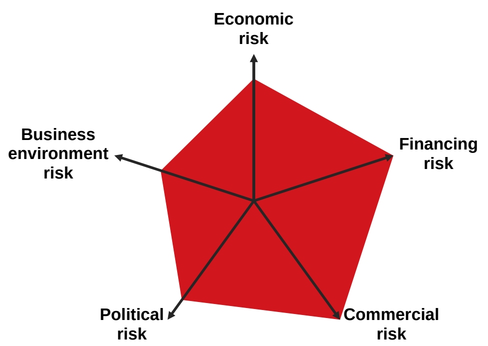
- Abundant natural resources, in particular oil and gas
- 15 years of continued current account surpluses (including the crisis year 2009)
- Low public debt
- Still comfortable foreign exchange reserves

Weaknesses

- Far-reaching structural reforms still outstanding
- High vulnerability to global oil prices shocks
- Capital flight
- Currently experiencing a 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
Germany	9%	1	17%	China
China	7%	2	14%	Germany
Ukraine	5%	3	6%	Belarus
United States	5%	4	5%	Ukraine
Belarus	5%	5	4%	Japan

By product (% of total)

Exports		Rank		Imports
Crude Oil	31%	1	7%	Cars And Cycles
Natural Gas	19%	2	4%	Engines
Refined Petroleum Products	17%	3	4%	Miscellaneous Hardware
Iron Steel	3%	4	4%	Commercial Vehicles
Non Ferrous Metals	3%	5	4%	Telecommunications Equipment

Source: Chelem (2012)

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.

Deep recession forecast in 2015

A preliminary estimate indicates real GDP increased by +0.6% in 2014. Support for this modest growth came mainly from moderate private consumption (+1.9%) and from net exports (+1pp) due to a plunge in imports (-6.8%). Exports fell also (-2%), as did fixed investment (-2.5%). Inventories subtracted 1pp from overall growth. Data and details for Q4 2014 are not available as yet but given that GDP grew by +0.8% y/y in Q1-Q3 and was flat in q/q terms in each of the first three quarters, it is likely that the economy entered recession at the end of the year.

In our baseline scenario, Euler Hermes expects a sharp contraction of GDP by -5.5% in 2015. High inflation and the weakened currency will hit private consumption and lower oil revenues will dent public spending. The already negative investment situation will further deteriorate given the political and economic prospects for 2015. Real exports are likely to decline as well due to much lower oil revenues even though some other export sectors may benefit from the RUB depreciation. But real imports will drop much sharper owing to the weakened RUB. As a result, net exports will provide some mitigation of the overall contraction of GDP but this will only mask the weakness not remove it.

Currency crisis with severe impact

The "perfect storm" of sanctions, capital flight and, in particular, falling oil prices has had a severe impact on the Russian currency. Since the start of 2014, the RUB has lost about half of its value against the USD, despite heavy foreign exchange (FX) interventions by the Central Bank of Russia (CBR). In mid-December 2014, the RUB dropped to new record lows against the USD (1:73) and the EUR (1:92), before it recovered somewhat to USD1:RUB60 and EUR1:RUB72 by the end of 2014, in part because the government obliged the country's largest state exporters to sell part of their FX revenues. In 2015 year-to-date, the RUB has remained volatile but is currently just -2% down against the USD (1:62 on 11 March). 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 USD64/barrel, the USD:RUB exchange rate could stabilise at around 1:65 at some point in H2 2015. In H1 volatility will remain high and the USD:RUB rate could temporarily reach as much as 1:100, especially if the oil price falls back to below USD50/barrel for some time.

The sharply weakened RUB will 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 expected deep recession, EH expects corporate insolvencies to surge by +30% in 2015.

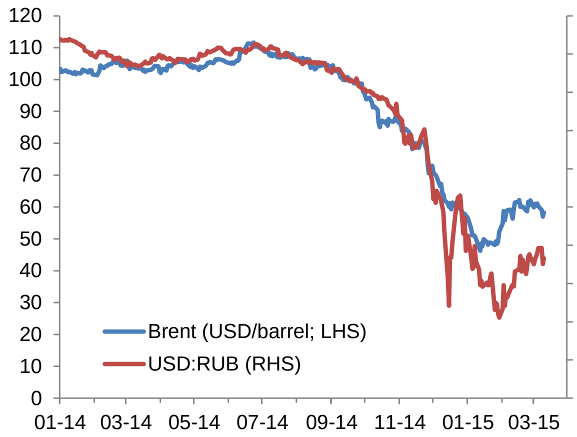
Key economic forecasts

Russia	2013 weight		2013	2014	2015	2016
GDP	101%		**1.3**	**0.6**	**-5.5**	**-4.0**
Consumer Spending	52%		*4.9*	*1.9*	*-5.0*	*-4.0*
Public Spending	20%		*1.1*	*0.5*	*-0.5*	*-2.0*
Investment	21%		*1.4*	*-2.5*	*-15.0*	*-10.0*
Stocks	3%	*	*-2.2*	*-1.0*	*-3.9*	*-1.5*
Exports	28%		*4.6*	*-2.0*	*-5.0*	*-1.0*
Imports	23%		*3.8*	*-6.8*	*-25.0*	*-10.0*
Net exports	6%	*	*0.5*	*1.0*	*4.2*	*2.0*
Current account (% of GDP)			1.6	3.0	2.9	2.7
Net capital outflows (USD bn)			61	152	80	65
RUB vs USD (aop)			31.9	38.5	65.0	64.0
RUB vs EUR (aop)			42.3	50.8	72.5	73.9
FX reserves (USD bn, eop)			**470**	**338**	**250**	**200**
Import cover (months)			11.9	9.5	9.1	8.0
FX / annual external debt due (%)			305	244	199	167
Inflation (%, eop)			6.5	11.4	11.0	9.0
General gov. balance (% of GDP)			**-1.3**	**-1.5**	**-2.0**	**-2.0**

Change over the period, unless otherwise indicated. * contribution to GDP growth

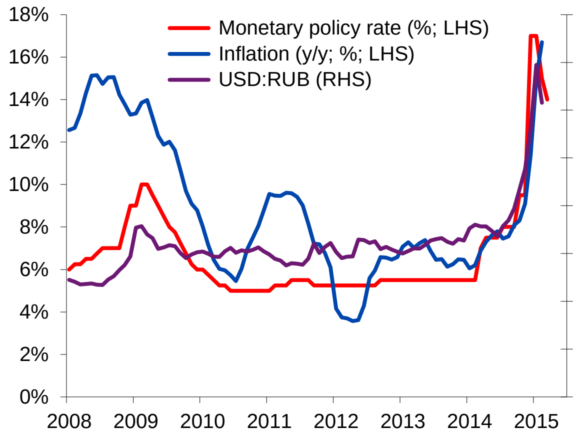
Sources: National sources, IHS, IMF, Euler Hermes

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 while monetary policy focus shifts to growth

Due to the RUB depreciation, inflation accelerated from 6.5% at end-2013 to 11.4% at end-2014 and 16.7% y/y in February 2015. 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 14% in 2015 and 10% in 2016 due to the much weakened currency as well as increased food prices in the wake of Russia's ban on certain food imports from the EU. As the CBR's measures were not successful in containing depreciation and inflation, but probably also because of political pressure, it cut the policy rate to 15% in February and 14% in March 2015, shifting its focus to address concerns about the banking sector and economic growth.

Banking sector remains vulnerable

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.

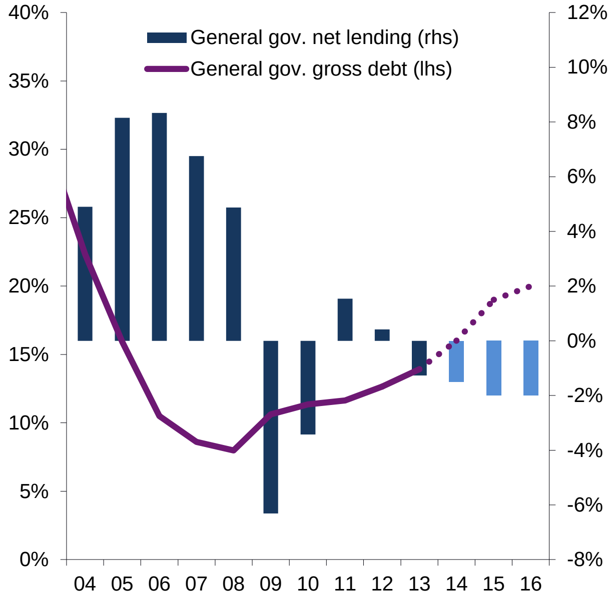
Sovereign default unlikely in 2015

Russia's fiscal position remains robust. Public debt (16% of GDP in 2014) will remain low even if the fiscal deficit increases from -1.5% of GDP in 2014 to an expected -2% in 2015. Moreover, two Sovereign Wealth Funds worth about USD152 bn (12% of GDP) will provide resources to finance a fiscal deficit and anti-crisis measures in 2015.

Capital flight weakens external position

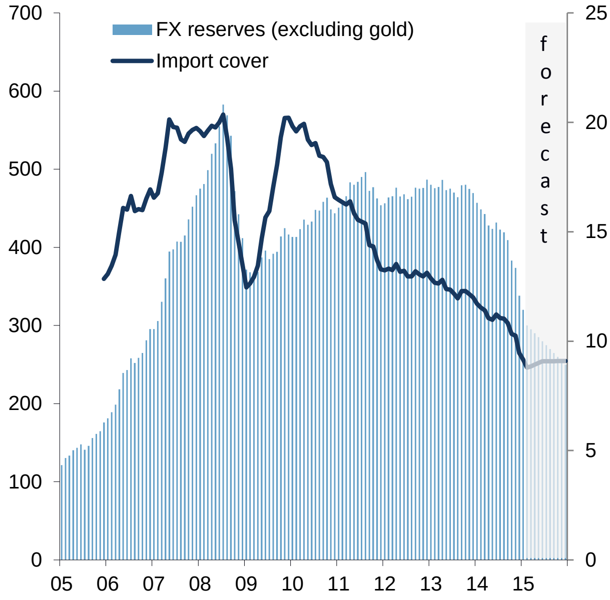
The current account surplus increased from +1.6% of GDP in 2013 to +3% of GDP in 2014, mainly due to the drop in imports due to the RUB's collapse. In 2015 we see a surplus of more than +2% of GDP. However, the 2014 surplus was more than offset by net capital outflows of the private sector which surged from USD61 bn in 2013 to USD152 bn in 2014. As a result, FX reserves have dropped from USD470 bn at end-2013 to USD313 bn in February 2015. While the current level of FX reserves is still comfortable in terms of import cover (9.2 months) or in relation to external debt payments falling due in the next 12 months (estimated at about USD150 bn), the future development has to be monitored closely and is not fail safe.

Public finances (% of GDP)



Sources: IMF, Euler Hermes

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



Sources: National sources, IHS, Euler Hermes

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