Euler Hermes Economic Research

Country Report

Russia

Return to modest growth in 2017 while risks remain

General Information

GDP	USD1,326bn (World ranking 13, World Bank 2015)
Population	144.1mn (World ranking 9, World Bank 2015)
Form of state	Federation
Head of state	Vladimir Vladimirovich PUTIN (President)
Next elections	2018, presidential

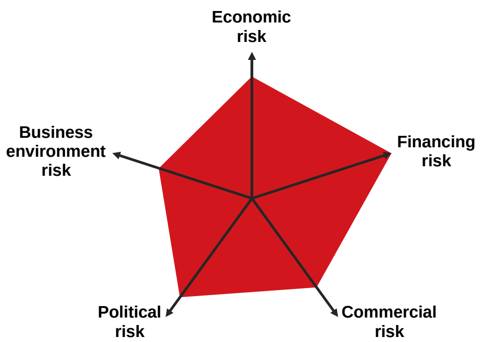
Strengths

- Abundant natural resources, in particular oil and gas
- 16 years of continued current account surpluses (including the crises years 2009 and 2015-2016)
- Low public debt
- Still comfortable foreign exchange reserves

Weaknesses

- Far-reaching structural reforms still outstanding
- High vulnerability to global oil price shocks
- Prone to capital flight
- Exchange rate remains vulnerable to volatility and sudden depreciation
- Prolonged recession has adversely affected corporate profitability
- Poor rule of law and high level of perceived corruption
- Geopolitical risks: Conflict with Ukraine and serious dispute with the West over that conflict (including sanctions and counter-sanctions). Also involved in Syria crisis

Country Rating C4



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
China	9%	1	22%	China
Germany	8%	2	12%	Germany
Turkey	5%	3	5%	Belarus
Belarus	4%	4	4%	Italy
United States	4%	5	4%	France

By product (% of total)

Exports		Rank		Imports
Crude Oil	23%	1	5%	Engines
Natural Gas	18%	2	5%	Other Edible Agricultural Prod
Refined Petroleum Products	17%	3	5%	Pharmaceuticals
Non Ferrous Metals	4%	4	4%	Telecommunications Equipm.
Iron Steel	4%	5	4%	Miscellaneous Hardware

Source: Chelem (2015)

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Recession to give way to modest growth

The economy has absorbed the triple shocks of Western sanctions over the Ukraine conflict, the sharp decline in global oil prices and the equally sharp depreciation of the RUB which emerged in 2014 and caused a lasting recession in 2015-2016. Although sanctions have remained in place to date and oil prices are still well below the level in early 2014, signs of a gradual recovery have strengthened.

A preliminary estimate indicates real GDP declined by -0.2% in 2016, after contracting by -2.8% in 2015. The breakdown of GDP shows that consumer spending decreased by -5% in 2016 (-9.8% in 2015), government spending -0.3% (-3.1% in 2015) and fixed investment -1.4% (-9.4% in 2015). However, inventory restocking added about +1.1pp to 2016 growth (-1.4pp in 2015). Further, net exports contributed +1.7pp to annual growth in 2016 as real exports increased by +2.3% (+3.7% in 2015) while imports declined by -5% (much improved from the -25.5% collapse in 2015). Quarterly data are not available as yet but we assume that real GDP grew again in Q4 2016. However, only parts of the economy are in recovery mode, for now. High frequency data suggest that industrial production and confidence in the manufacturing sector (PMI) seem to be firmly back into growth mode while consumer confidence and retail sales are still in contraction mode (see Figure 2). We forecast full-year GDP growth of +1.3% or so in 2017 on the back of recovering investment and, with some delay, consumer spending. Base effects will also play a role as the level of annual GDP is now well below the pre-crisis level. The possibility of renewed global oil price weakening poses a downside risk to this forecast.

Currency risk is not over yet

The "perfect storm" of sanctions, capital flight and, in particular, falling oil prices had a severe impact on the Russian currency. In January 2016, the RUB hit an all-time low of 1:84 against the USD, having lost -59% of its value at mid-2014. A gradual recovery began in February 2016, though exchange rate volatility remained, both in line with oil price movements. Euler Hermes expects the course of the RUB will continue to depend mainly on oil price developments while changes on the economic sanction fronts and actions by the Central Bank of Russia (CBR) should have only limited impact on the exchange rate. Under the assumptions that sanctions against Russia do not change substantially in 2017 and the average Brent oil price is USD57/barrel, the USD:RUB exchange rate is forecast to average around 1:58 during the year, which will be -45% below the pre-crisis average of 1:32 in 2013. Moreover, volatility will remain significant. Again, the possibility of renewed global oil price weakening poses a downside risk to this forecast.

The impaired RUB will continue to have adverse effects on weaker companies that have significant FX-denominated liabilities and will have difficulties to refinance maturing debt. Taken together with the lagged effects of the recession, we expect corporate insolvencies to rise by +2% in 2017 (+4% in 2016).

Low inflation allows monetary easing

Owing to the RUB depreciation as well as increased food prices due to 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 and averaged 15.6% in 2015 as a whole. Thanks to base effects and the gradual RUB recovery, inflation eased to an average 7.1% in 2016 and further to a

Figure 1: Key economic forecasts

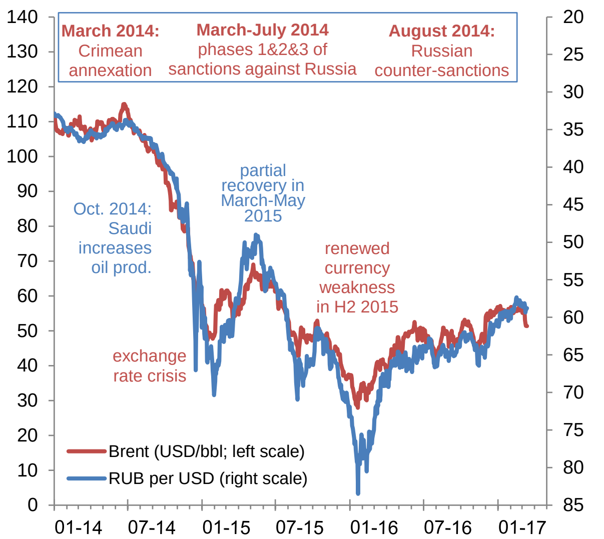
	2015	2016	2017f	2018f
GDP growth (% change)	-2.8	-0.2	1.3	1.6
Inflation (%, year-average)	15.5	7.1	4.7	5.3
Fiscal balance (% of GDP)	-3.5	-4.0	-3.0	-2.5
Public debt (% of GDP)	16.4	17.5	18.0	19.0
Current account (% of GDP)	5.3	1.7	2.0	2.1
External debt (% of GDP)	39.1	40.3	36.7	35.5

Sources: National sources, IHS, Euler Hermes

Figure 2: Growth of industrial production and real retail sales (y/y; quarterly averages)

Sources: IMF, Euler Hermes

Figure 3: Brent oil price and RUB exchange rate



Sources: IHS, Euler Hermes

56-month low of 4.6% y/y in February 2017. As base effects fade, inflation is forecast to stabilize around an average 4.7% or so in 2017.

This should allow further monetary easing, with the key policy interest rate forecast to be reduced from currently 10% to around 8% by end-2017.

Banks remain under pressure

In late 2014, Russian authorities launched a one-year RUB830bn bank capital support program, aimed at supporting large banks, which helped to stabilize the banking system. However, the IMF notes in a recent report that profitability has declined markedly (ROA 0.4% and ROE 3.4% in March 2016) and capital will remain under pressure. Asset quality has deteriorated, with non-performing loans up to 9.2% of total loans in 2016 from 6% in 2013, and the IMF indicating that the reported numbers may be too low. Private sector credit growth came to a near standstill at end-2016, though lower interest rates may help a turnaround in 2017.

Russian authorities continue to have the resources to avoid a systemic banking crisis and we are not concerned at present about their resolve to provide support. However, smaller banks remain at risk of bankruptcy or losing their license: the number of banks fell to 623 at end-2016 (923 at end-2013).

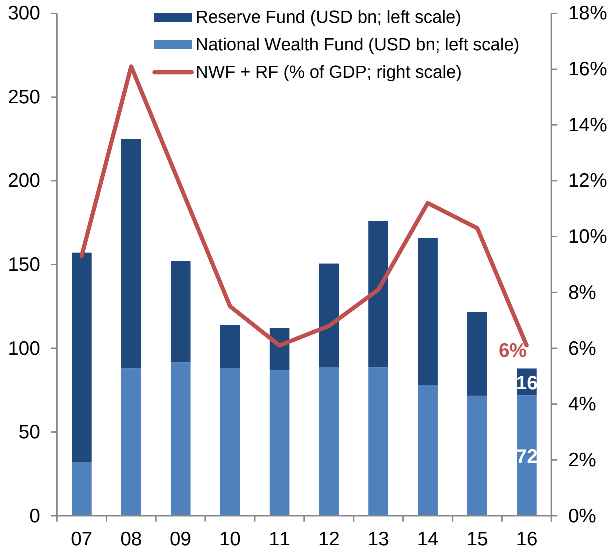
Reserve Fund depleted by fiscal deficits

As a result of the protracted recession, the fiscal deficit rose to -3.5% of GDP in 2015 and an estimated -4% in 2016. These deficits were heavily co-financed by drawing on the Reserve Fund which was created for this purpose in earlier years of high energy revenues. As a result, the Fund has been almost depleted from USD88bn (5.9% of GDP) at end-2014 to USD16bn (1.1%) in February 2017, and thus will be insufficient to finance the entire deficit in 2017 (forecast at -3%). However, the National Wealth Fund is still worth about USD72bn (4.8% of GDP) and should provide a further cushion, if needed (see Figure 4). Positively, public debt will remain low, forecast at 18% of GDP in 2017.

External liquidity position stabilized

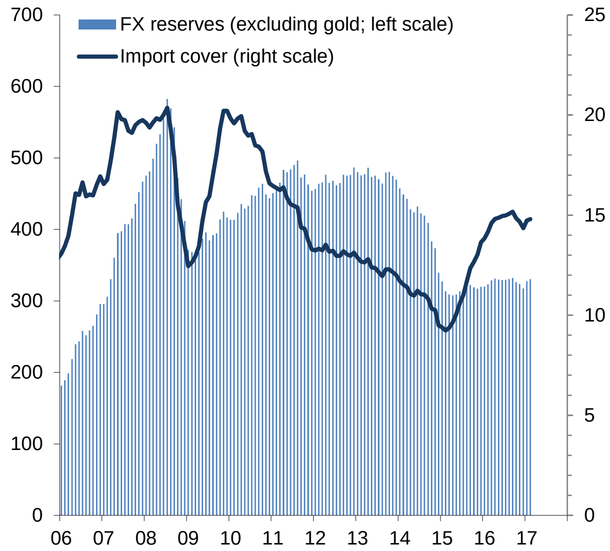
The current account surplus narrowed from +5.3% of GDP in 2015 to about +1.7% in 2016 – as imports stabilized (-1%) due to the RUB's steadying while exports continued to fall (-18%) – and should pick up to +2% in 2017. Meanwhile, annual net capital outflows of the private sector declined to just –USD15bn in 2016, well below the long-term average of –USD47bn. Accordingly, FX reserves have stabilized at around USD320bn since mid-2015, after having dropped from USD470bn at end-2013. While current FX reserves are still comfortable in terms of import cover (14 months), the future development needs to be monitored closely and is not fail safe.

Figure 4: Sovereign Wealth Funds



Sources: Ministry of Finance Russia, Euler Hermes

Figure 5: Foreign exchange reserves (USD bn) and import cover (months)



Sources: National sources, IHS, Euler Hermes

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