Euler Hermes Economic Research

Country Report

Russia

Heading for recession as sanctions begin to take effect

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	2018, presidential

Strengths

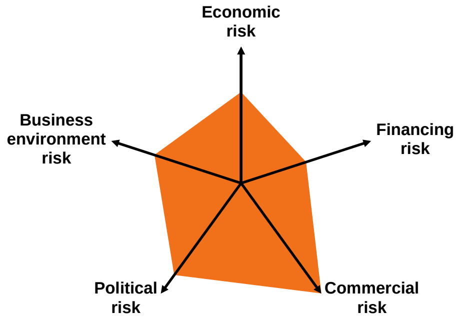
- Abundant natural resources, in particular oil and gas
- 15 years of continued current account surpluses (including the crisis year 2009)
- Low public debt
- Ample foreign exchange reserves

Weaknesses

- Far-reaching structural reforms still outstanding
- Heavy reliance on world market prices of mineral products, in particular oil and gas
- Exchange rate volatility and vulnerability
- Banking sector
- Poor rule of law and high level of perceived corruption
- Corporate governance
- Geopolitical risk: conflict with Ukraine and serious dispute with the West over that conflict (including sanctions and counter-sanctions)

Country Rating

C3



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)

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Recession expected in H2 2014

Preliminary estimates indicate that Q2 real GDP grew by +0.8% y/y, down from +0.9% in Q1 and +1.3% in full year 2013. In seasonally-adjusted q/q terms, Q2 GDP increased by +0.2%, slightly up from +0.1% in Q1 (which was revised up from -0.3% q/q previously). Production side details show a sharp -4.3% q/q drop of the financial sector in Q2 (+4.5% in Q1) as well as continued contraction of real estate (-1.4% q/q) and manufacturing (-0.2% q/q). Construction and trade returned to modest q/q growth in Q2 but continued to decline in y/y terms. Overall the details suggest that the geopolitical tensions with the West over Ukraine have already affected consumer and investor confidence and ultimately the Russian economy in H1. Since the West has deepened sanctions against Russia in Q3 and the tensions are not expected to subside in the near term, Euler Hermes now forecasts Russia to slide into recession in H2, resulting in a contraction of full-year 2014 GDP of -0.6%, in our baseline scenario. The forecast for 2015 has been revised downwards to +1%.

Euler Hermes has also developed an escalation scenario (assumption: intensification of sanctions in Q4 such that trade between Russia and the West would be halved and oil prices would rise by 20-30%), in which Russian GDP would contract by about -1.8% in 2014 and -4.5% in 2015.

Exchange rate risk has increased

The exchange rate of the Russian RUB has shown considerable vulnerability to external shocks in recent years. In 2013 the RUB fell by 10% against a USD+EUR basket, as a result of weakening Russian growth prospects and the worsened global market sentiment towards emerging markets in the wake of the US Fed's taper talk. In the first two and a half months of 2014, the RUB depreciated by another 12% against the USD+EUR basket, on account of a continued weak growth outlook and deteriorating investor sentiment over the potential economic costs for Russia of the intensifying conflict with Ukraine. Heavy foreign exchange (FX) intervention and a total 200 bps hike of the key monetary policy interest rate to 7.5% prevented an even sharper RUB decline and helped the RUB to regain two thirds of the Q1 losses by end-June. However, as the West has stepped up sanctions against Russia in Q3, the RUB has fallen again by 11% against the USD+EUR basket (14% against the USD) in Q3 to date. Euler Hermes does not expect a serious currency crisis in the foreseeable future thanks to the ample official FX reserves of the Central Bank of Russia (CBR), but ongoing currency volatility and further depreciation are highly likely as long as the conflict lasts, posing considerable difficulties for companies that have to serve large amounts of short-term debt denominated in FX.

Rising inflation suggests further monetary tightening to come

The RUB depreciation has pushed inflation up from 6.5% at end-2013 to 7.7% y/y in early September 2014, well above the CBR's 5% target. Euler Hermes expects annual inflation to reach 9% at end-2014, further undermining domestic demand. On 12 September, the CBR kept its monetary policy rate on hold at 8% after a 50bps hike in July, but further increases by year-end are likely.

Banking sector remains vulnerable

The Russian banking sector – which is still oversized and generally weak – is particularly vulnerable to external shocks and a sharp RUB depreciation, and small and medium-sized banks may still collapse. However, a

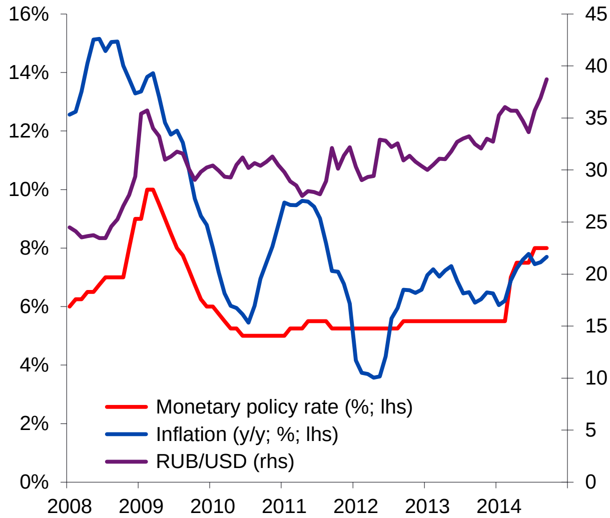
Key economic forecasts: Baseline vs Escalation scenario

		Baseline scenario		Escalation scenario	
	2013	2014	2015	2014	2015
GDP	1.3	**-0.6**	**1.0**	**-1.8**	**-4.5**
Consumer Spending	*4.7*	*3.0*	*3.0*	*2.5*	*1.0*
Public Spending	*-0.1*	*0.5*	*1.0*	*1.5*	*3.0*
Investment	*-0.3*	*-9.0*	*-2.5*	*-12.0*	*-15.0*
*Stocks **	*-0.9*	*-1.7*	*-0.5*	*-2.0*	*-2.5*
Exports	*3.8*	*0.8*	*1.5*	*-5.0*	*-15.0*
Imports	*5.9*	*-5.0*	*0.5*	*-12.0*	*-20.0*
*Net exports **	*-0.2*	*1.3*	*0.3*	*1.2*	*0.0*
Current account (% of GDP)	1.5	**2.5**	**2.0**	**1.0**	**0.5**
Net capital outflows (USD bn)	63	**120**	**75**	**150**	**200**
RUB vs USD+EUR basket (eop)	38.5	**44.0**	**48.0**	**50.0**	**60.0**
FX reserves (USD bn)	463	**400**	**375**	**350**	**200**
Import cover (months)	11.7	**11.3**	**10.4**	**10.1**	**7.7**
Unemployment rate (%)	5.4	5.5	5.6	5.7	7.0
Inflation (%, eop)	6.5	9.0	7.5	12.0	15.0
Fiscal balance (% of GDP)	-0.7	-1.5	-1.7	-2.5	-5.0

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

Sources: National sources, IHS, IMF, Euler Hermes

Monetary policy interest rate, inflation rate, and exchange rate



Sources: National sources, IHS, Euler Hermes systemic banking crisis appears unlikely as the authorities will support large banks (especially those targeted by sanctions), if needed. Non-performing loans as a share of total loans have moderated to 6.3% in Q3 2013 from 9.6% at end-2009 (by Russian reporting standards which are about one third lower than generally accepted international standards). But concerns remain about asset quality, even though private sector credit growth has slowed to 13.5% y/y in June 2014 from a recent peak of 18.4% in January.

Public finances not a problem in the short term

The fiscal policy stance has been relatively neutral in recent years, but owing to weak revenue growth amid the slowing economy, the annual fiscal balance shifted to a small deficit of -0.7% of GDP in 2013 which is forecast to widen to about -1.5% in 2014-2015 in our baseline scenario. This is not a concern thanks to a very low share of public debt in relation to GDP (currently about 15%). The situation could change in the escalation scenario though as the fiscal deficit could reach up to -5% of GDP in 2015. However, two Sovereign Wealth Funds currently worth about USD170 bn provide a cushion if needed.

Capital outflows undermine external position

The annual current account surplus has narrowed from +3.6% of GDP in 2012 to +1.5% of GDP in 2013 but is forecast to widen again to more than +2% in 2014-2015 as imports are falling due to RUB depreciation and Western sanctions. However, the 2013 surplus was more than offset by capital outflows, resulting in a decrease of FX reserves. Net capital outflows of the private sector increased from USD55 bn in 2012 to USD63 bn in 2013 and surged to USD74 bn in H1 2014 alone, the latter clearly reflecting a loss of investor confidence amid the conflict with the West.

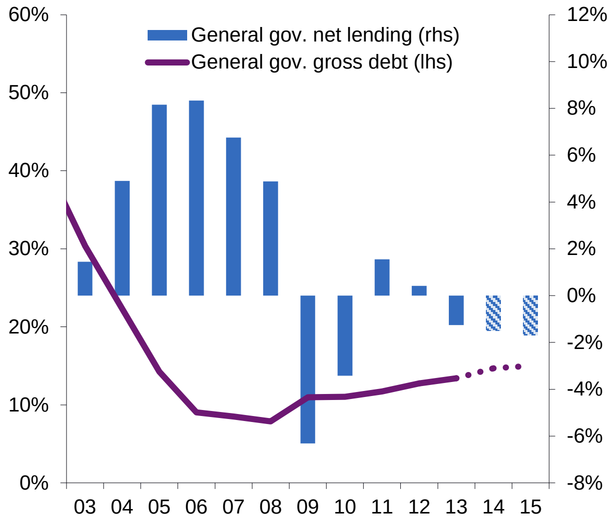
Gross external debt decreased by USD8 bn during H1 and stood at USD721 bn in June 2014, which is moderate in relation to GDP (about 35%) and export earnings (120%). The debt-service ratio is forecast at about 15% in 2015.

FX reserves declining but still ample

FX reserves have decreased by -11% from USD470 bn at end-2013 to USD419 bn in August 2014, as a result of FX intervention by the CBR to stabilise financial markets and capital flight owing to deteriorating investor sentiment (see above). Nonetheless, the current level of FX reserves is still very high in terms of import cover (11 months) or in relation to external debt payments falling due in the next 12 months (estimated at about USD160 bn).

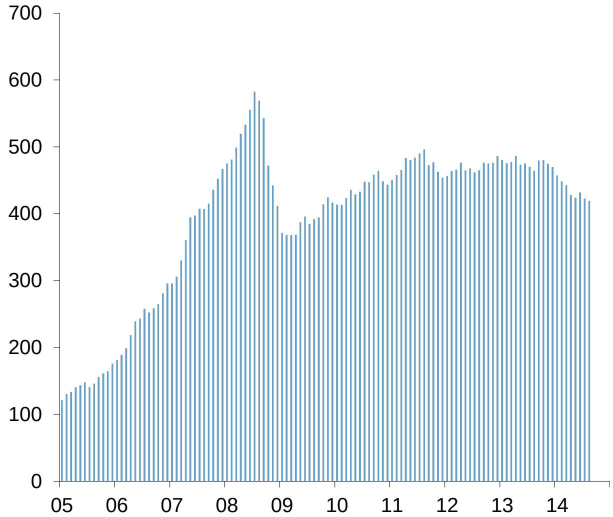
From a microeconomic perspective, however, it should be noted that the refinancing risk associated with maturing external debt has increased, especially for private-sector companies that are overleveraged in FX.

Public finances (% of GDP)



Sources: IMF, Euler Hermes

Foreign exchange reserves (USD bn)



Sources: National sources, IHS, Euler Hermes

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