Euler Hermes Economic Research

Country Report

Russia

Recession to continue in 2016 as oil prices remain low

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

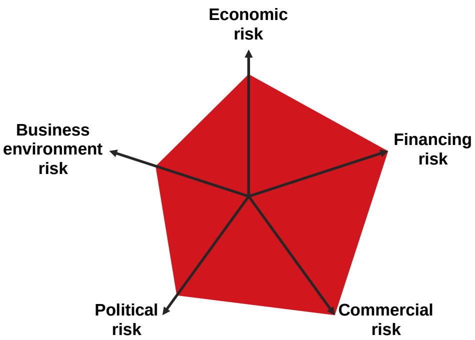
- Abundant natural resources, in particular oil and gas
- 15 years of continued current account surpluses (including the crises years 2009 and 2015)
- Low public debt
- Still comfortable foreign exchange reserves

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
- Prolonged recession with adverse effects on corporate profitability
- 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	18%	China
China	8%	2	13%	Germany
Japan	4%	3	5%	Belarus
Netherlands	4%	4	4%	Italy
Turkey	4%	5	3%	Ukraine

By product (% of total)

Exports		Rank		Imports
Crude Oil	28%	1	6%	Cars And Cycles
Refined Petroleum Products	20%	2	5%	Engines
Natural Gas	17%	3	4%	Miscellaneous Hardware
Non Ferrous Metals	4%	4	4%	Pharmaceuticals
Iron Steel	3%	5	4%	Electrical Apparatus

Source: Chelem (2014)

Four-fold crisis to continue: 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. Since Q4 2015, the synchronised fall of oil prices and the RUB has intensified once again.

Recession to drag on in 2016

A preliminary estimate indicates real GDP declined by -3.7% in 2015. The strongest downturn came in gross capital formation (-18.3%), reflecting a -7.6% fall in fixed investment and a sharp drop in inventories which subtracted -3.3pps from full-year growth as companies sold off stocks in the wake of diminishing demand for their products. Private consumption plunged by -10.1% as households were hit by the sharp RUB depreciation, falling real wages and a reduction in working hours. Government consumption was down by -1.8%. Net exports mitigated the overall contraction of GDP somewhat, making a positive contribution of +6.7pps or so. However, this was the result of a collapse in real imports by -25.6% while real exports still grew by a modest +3.1%, thanks to the weakened RUB. The outlook for 2016 remains dismal against the backdrop of the renewed falls in oil prices and the RUB at the start of the year, though due to base effects annual GDP should decline at a more moderate pace. Euler Hermes projects a contraction by -0.9% in 2016. However, the possibility of very low global oil prices for longer poses a downside risk to this forecast.

Currency risk remains high

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 fell by -72% against the USD (-51% against the EUR), despite heavy foreign exchange (FX) interventions by the Central Bank of Russia (CBR). In 2015, the RUB remained very volatile and, in the second half of the year, depreciated once again strongly, mainly due to the renewed slump in global oil prices, but also because the CBR discontinued large-scale FX interventions in order to halt the decline in its FX reserves, which indeed have stabilised at around USD320bn since mid-2015. At the end of 2015, the RUB was down by another -30% y/y against the USD (though unchanged y/y against the EUR). In early 2016, the RUB's downtrend continued before a moderate recovery began in mid-February, both in line with oil price movements. Euler Hermes expects the course of the RUB will continue to depend mainly on oil price developments. Changes on the economic sanction fronts and CBR actions will have only limited impact on the exchange rate. Under the assumptions that sanctions against Russia do not change substantially in 2016 and the average Brent oil price is USD38/barrel, the USD:RUB exchange rate is forecast to average at around 1:74 during the year. However, volatility will remain high.

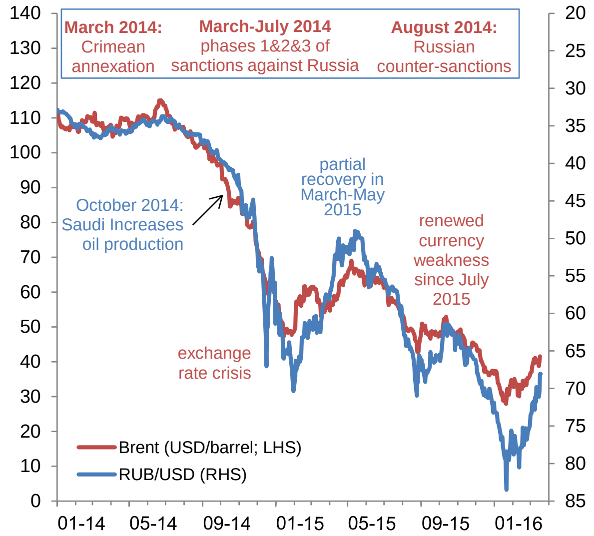
The sharply weakened RUB will continue to have a severe impact on companies that have significant FX-denominated liabilities and will have difficulties to refinance maturing debt. Taken together with the effects of the deep recession, EH expects corporate insolvencies to rise by +7% in 2016 (+7% in 2015).

Key economic forecasts

	2014	2015	2016f	2017f
GDP growth (% change)	0.7	-3.7	-0.9	1.0
Inflation (%, end-year)	11.4	12.9	8.5	7.0
Fiscal balance (% of GDP)	-1.2	-3.5	-4.0	-2.5
Public debt (% of GDP)	17.8	19.0	20.0	21.0
Current account (% of GDP)	3.1	5.1	3.4	3.2
External debt (% of GDP)	32.2	39.6	44.2	43.5

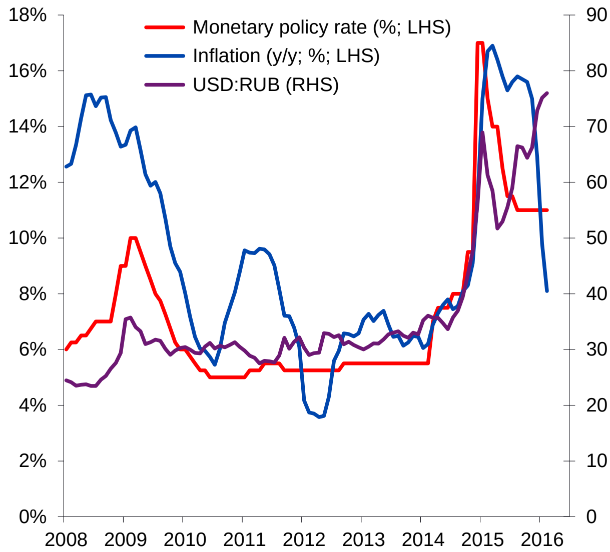
Sources: National sources, IHS, Euler Hermes

Brent oil price and USD:RUB exchange rate



Sources: IHS, Euler Hermes

Monetary policy interest rate, inflation rate, and exchange rate



Sources: National sources, IHS, Euler Hermes

Inflation is 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. 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 of that year. However, 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 11% in five steps from February to August 2015, shifting its focus to address concerns about the banking sector and economic growth. As inflation has fallen to 8.1% y/y in February 2016, mainly thanks to base effects, further moderate rate cuts are likely this year.

Challenging times for banks

In late 2014 a RUB830bn bank capital support programme was launched, aimed at supporting large banks. It has helped to stabilise the banking system and – although profitability and capital will remain under pressure – the IMF believes that the programme is sufficiently large. A credit crunch has been avoided so far and non-performing loans have increased only slightly to 8% of total loans in 2015 from 6% in 2013. Russian authorities continue to have the resources to avoid a systemic 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 licence: the number of banks fell to 733 at end-2015 (923 at end-2013).

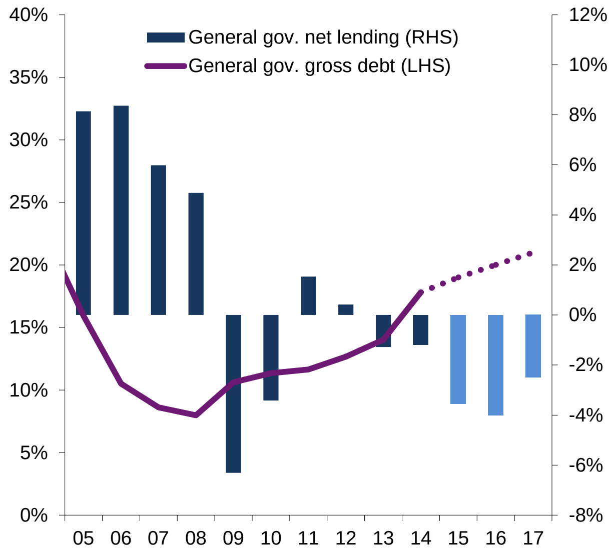
Sovereign default unlikely in 2016

Russia’s fiscal position remains robust. Public debt will remain low (forecast at 20% of GDP in 2016) even if the fiscal deficit could rise to -4% of GDP in 2016. Moreover, two Sovereign Wealth Funds worth about USD121bn (11.6% of GDP) will provide resources to finance the fiscal deficit and further anti-crisis measures in 2016.

Capital flight weakens external position

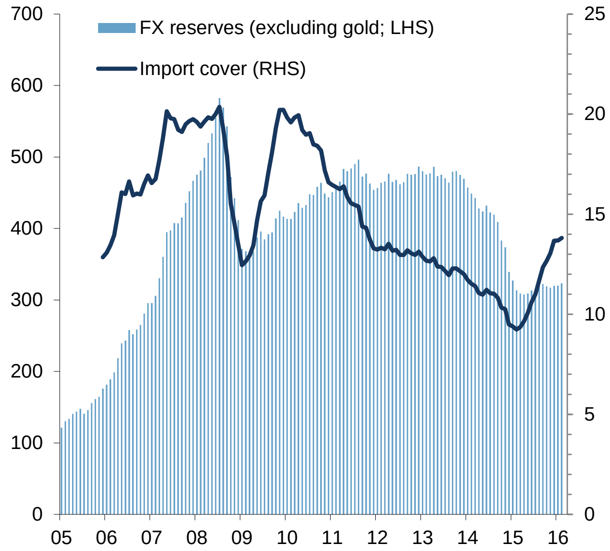
The current account surplus increased from +3.1% of GDP in 2014 to about +5% in 2015, because the decline in imports (-35%) due to the RUB’s collapse exceeded the drop in exports (-31%). However, the combined surplus of 2014-2015 was more than offset by net capital outflows of the private sector (USD153bn in 2014 and USD57bn in 2015). As a result, FX reserves dropped from USD470bn at end-2013 to a low of USD308bn in April 2015, though they have stabilised at around USD320bn thereafter. While current FX reserves are still comfortable in terms of import cover (13 months) or in relation to external debt falling due in the next 12 months (estimated at USD140bn), the future development needs 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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