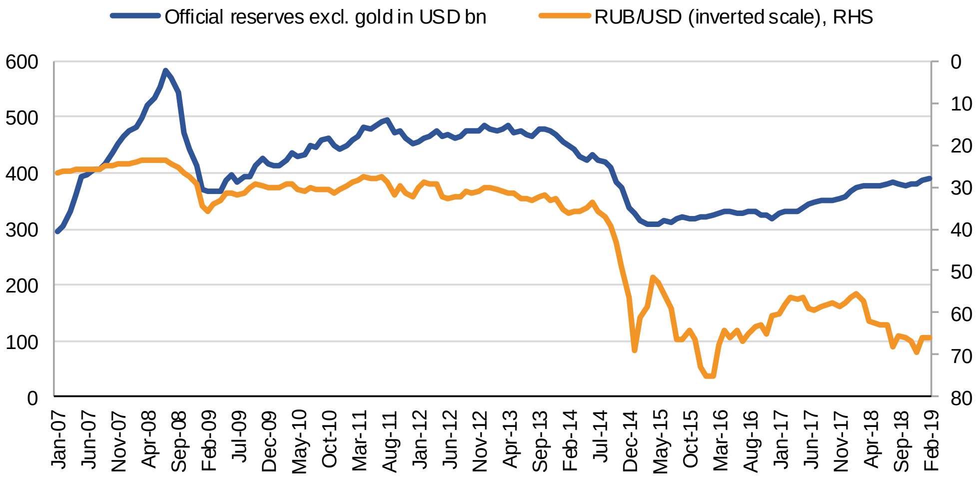
28 March 2019

Russia's credit outlook: Relative resilience to sanctions leaves structural weaknesses unattended

The intensified use of sanctions on the Russian Federation has permanently lowered capital flows to the country, thus weighing on the country's already low growth potential. Tight budgetary and monetary policies and higher oil prices have cushioned the economic impact of sanctions in place since 2014. We believe the impact of potentially deeper and broader sanctions will be mitigated by Russia's strengthened fiscal and external positions though they would exacerbate the country's structural weaknesses over the long term.

In October 2017, Scope upgraded Russia's ratings to investment-grade (BBB-/Stable Outlook), supported by a recovering economy, robust public finances and a rebolstered macroeconomic policy framework, which have strengthened the country's ability to weather external shocks. However, Scope's ratings on Russia remain constrained by the country's low growth potential, reflecting structural weaknesses in the form of demographic challenges and weak governance. In our 2019 outlook, we highlighted intensified sanctions on Russia as a key risk to the country, in addition to pronounced oil price volatility, protectionist measures in world trade, and escalating geopolitical tensions.

Figure 1: Exchange rate and FX reserves



Source: Central Bank of Russia, Scope Ratings GmbH

Scope's stable outlook balances the country's strong external resilience, increased exchange rate flexibility and low public finance risks on the one hand, and domestic constraints and rising geopolitical risk on the other:

Robust external economic risk-profile: The impact of sanctions on Russia's external economic risk profile is likely to be contained over the medium term, given the country's large reserves and our expectation that oil revenue will remain sufficiently high to cushion against the economic effects of sanctions. A net external creditor position further underpins the ability of Russia's economy to remain resilient against intensified external shocks.

Low public finance risks: Prudent fiscal policy focused on rebuilding buffers over past years has materially improved the country's capacity to withstand economic sanctions and has provided greater room for countercyclical fiscal manoeuvre.

Elevated domestic economic risks: Intensified sanctions are likely to exacerbate Russia's structural growth weaknesses such as chronic underinvestment, overexposure to commodity prices, unfavourable demographics and weak governance.

Rising risk of sanctions: US legislators have proposed new sanctions in recent months, which, if passed, could lead to widened and deepened sanctions on Russia.

Analysts

Jakob Suwalski
+49 69 6677389-45
j.suwalski@scoperatings.com

Levon Kameryan
+49 69 6677389-21
l.kameryan@scoperatings.com

Team leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Media

André Fischer
+49 30 27891-147
a.fischer@scopegroup.com

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Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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#1: Rising risks of sanctions owing to geopolitical tensions

Sanctions on Russia have slow-burning characteristics

Sanctions against Russia have intensified since 2014, prompted by the Ukraine crisis. The Western sanctions[1] on Russia have a multipronged character and involve the following three groups of measures: i) *political/diplomatic measures*, such as the exclusion of Russia from the G8, suspension of EU-Russia summits, the suspension of negotiations on Russia's accession to the OECD and the International Energy Agency; ii) *sanctions against individuals and entities* including visa bans and asset freezes; iii) *economic sanctions and sanctions related to the Crimea*, including bans on the trading of financial instruments issued by major state-owned Russian banks and companies, thereby inhibiting systemically important Russian companies from accessing global debt-capital markets. It is our view that the economic sanctions, by their design, are intended to put long-term pressure on the Russian economy, for example by denying Russian oil companies access to Western technology needed in order to modernise.

Risk of further sanctions

US legislators have proposed new sanctions bills in recent months. A reintroduced bill called the 'Defending American Security from Kremlin Aggression Act (DASKAA) of 2019' seeks to broaden and deepen the US sanctions regime on Russia, in response to Russia's interference in US elections, actions in Syria and seizure of Ukrainian Navy vessels. The original bill was introduced in August 2018 and had a significant market impact, resulting in high capital outflows of USD 67bn in 2018. However, the outflows were comfortably covered by Russia's current account surplus, and the approval of the sanctions bill has been delayed since then. In principle, DASKAA 2019 includes sanctions on sovereign debt[2] and financial institutions[3] which have been modified compared to the previous sanctions bills (DASKAA 2018) but also additional ones. Additional measures include those on Russian liquefied natural gas and state energy projects and the shipbuilding industry. The new sanctions could, if passed, significantly impact existing commercial relationships and potentially jeopardise energy projects with Russian partner companies. In our view, the new, recently proposed sanctions indicate that the geopolitical confrontation between the governments of the US and the Russian Federation is likely to last a long time and, going forward, will be likely increasingly characterised by unilateral economic sanctions focussing on Europe's dependence on Russian energy imports.

Sanctions risks are counter-balanced by strengthened external resilience

Scope expects the DASKAA 2019 bill to be adopted in some form over the course of this year. However, measures targeting oil and gas projects may be softened and subject to implementation of various exceptions for US companies involved in trading with Russia's oil and gas sector. While Scope views risks regarding restrictions on Russia's sovereign debt issuances to be credit-negative as these add to the cost of financing, Scope considers Russia's enhanced resilience to external shocks to be a counter-weight cushioning the impact. Scope does not expect that restrictions on new Russian sovereign debt, if implemented, would weigh significantly on Russia's debt service ability, given low financing needs that could be easily met by local financing and government cash deposits.

While Scope noted in its October 2017 rating action that the ratings could be downgraded if "geopolitical risks escalate, diminishing Russia's means for effective policy making," Scope could also consider upside action on Russia's ratings/outlook in the future should

[1] https://europa.eu/newsroom/highlights/special-coverage/eu-sanctions-against-russia-over-ukraine-crisis_en; https://www.state.gov/e/eb/tfs/spi/ukrainerussia/

[2] Similar to its predecessor, DASKAA 2019 would prohibit US persons from dealing in new Russian sovereign debt. DASKAA 2019 describes "Russian sovereign debt," which includes: (1) bonds issued by the central bank, the National Wealth Fund, or the Federal Treasury of the Russian Federation, or agents or affiliates of these entities, with a maturity of more than 14 days; (2) foreign exchange swap agreements with these entities with a duration of more than 14 days; or (3) any other financial instrument of more than 14 days' maturity that was issued by a Russian financial institution on behalf of the Russian government or that the US government determines to represent Russian sovereign debt.

[3] DASKAA 2019 would authorise blocking sanctions against any Russian financial institution that provides "financial or other support" for the Russian government's interference "in the democratic process of elections of any country other than the Russian Federation." Notably, DASKAA 2018 would have potentially resulted in blocking sanctions against significant Russian financial institutions, regardless of any other circumstances.

Russia's external resilience be further bolstered. In addition, Russia has implemented various preventive measures in a bid to make itself more resilient in the event of sanctions. These include the central bank's sale of most of its US treasury bond holdings and warnings to banks to find a back-up payment partner in case Russia is cut off from SWIFT.

Economic ties with EU remain close

Despite geopolitical tensions, economic ties between Russia and the EU remain close as the EU is Russia's largest trading partner by far. While EU-Russia trade has grown only marginally since 2014, Russia remains strategically important in the energy sector. With regard to planned energy projects and in view of the suspension of EU-Russia summits, Russian-European relations are likely to be determined by a number of bilateral agreements with individual EU members.

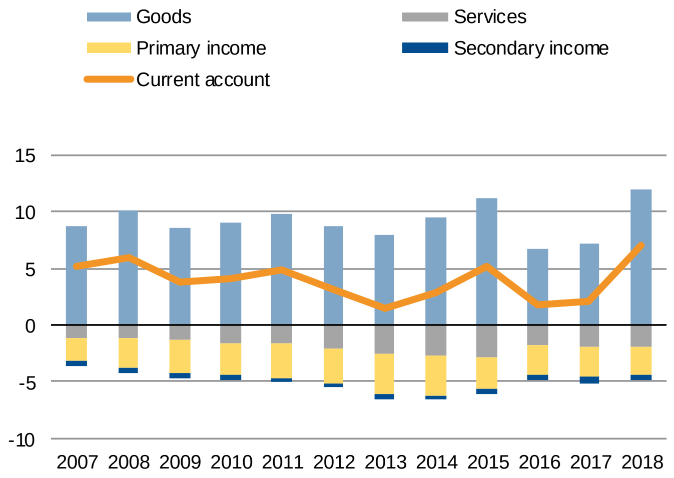
#2: Impact of sanctions is mitigated by Russia's strong external position

Sanctions have permanently lowered capital flows

Russia's high foreign-exchange reserve adequacy, robust current account surpluses, and net external creditor position underpin the ability of its economy to remain resilient in the face of intensified external shocks. The impact of sanctions on Russia's external economic risk profile is therefore likely to be contained as long as oil revenue remains sizeable.

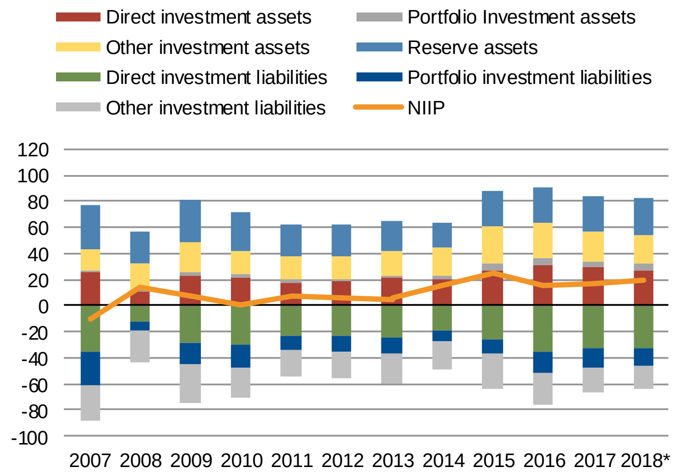
Although Russia faced severe economic challenges between 2014-2015, including its longest recession in almost 20 years, this owed more to the collapse in oil prices than the impact from sanctions. The combination of declining oil prices and sanctions ultimately forced the Central Bank of Russia to float the rouble and significantly hike interest rates in 2014. This change to monetary policy: i) abandoned the dual-currency trading band and increased exchange rate flexibility; ii) ended Russia's policy of daily foreign exchange interventions at the expense of reserves; iii) helped the rouble to stabilise on the foreign exchange market; and iv) significantly strengthened Russia's resilience to external shocks. Since then, the Central Bank has accumulated sizeable foreign exchange reserves and demonstrated a strengthened institutional capacity and credible adherence to a new inflation-targeting floating exchange rate regime.

Figure 2: Current account balance, % of GDP



Source: Central Bank of Russia, Scope Ratings GmbH

Figure 3: Net international investment position, % GDP



Source: Central Bank of Russia, Scope Ratings GmbH. *As of 2018 Q3.

In 2015-2016, already-lowered capital flows to Russia made the country less prone to further capital flight. Recovering oil prices in 2017-18 have cushioned the economic impact of sanctions, adding to Russia's high foreign exchange reserves. Finally, increased exchange rate flexibility has acted as an important shock absorber against rising risk aversion in 2018.

High ability to withstand external shocks

Substantial foreign exchange reserves give Russia ample room to manage the cost of further sanctions. Russia's foreign exchange reserves amounted to USD 380.8bn or 18 months of import cover as of February 2019. The government's external debt (2.7% of GDP in 2018) is the lowest of any major economy in the world. A net external creditor position (NIIP of 19.1% of GDP in Q3 2018) further bolsters the Russian economy's ability to maintain stability in the scenario of intensified shocks.

Impact of sanctions on Russia's external economic risk profile will remain contained over the medium term

Despite our expectation of moderating oil prices, Russia's oil revenues will remain large enough to cover debt amortisation through 2019. The still relatively weak rouble (63-65 RUB/USD) does not play an important role in terms of Russian foreign trade. This is because exports are typically denominated in EUR or USD, thereby constituting 'natural hedges' against foreign exchange risk.

These external strengths could support upside to Russia's outlook in the future.

#3: Prudent fiscal policy focused on rebuilding buffers has improved Russia's capacity to withstand external shocks

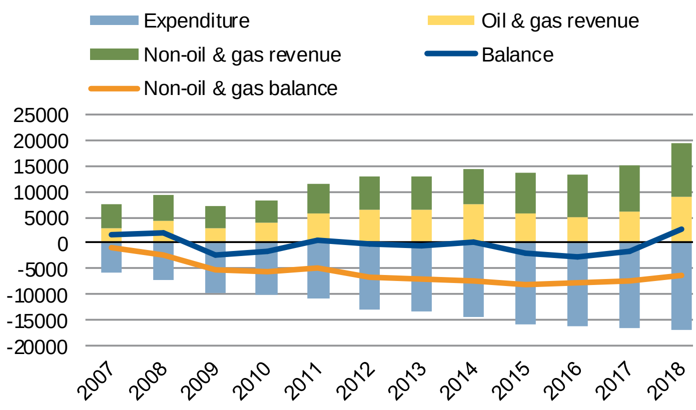
Russia's experiment in austerity has resulted in large fiscal buffers

Prudent fiscal policy focused on rebuilding fiscal buffers (which are part of official foreign-exchange reserves) over the past years has materially improved the Russian government's capacity to withstand external shocks. A new budget rule, implemented in 2018, which facilitates rapid adjustments to drops in oil prices is a core component of Russia's fiscal strategy. The new rule mandates setting aside a portion of oil export revenues in a government reserve fund, making funds available to smoothen GDP cycles and improve the predictability of fiscal policy.

Prudent fiscal policy despite higher than budgeted oil prices

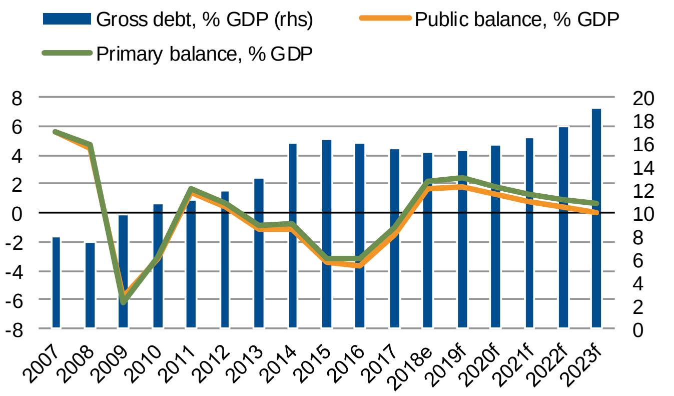
Higher than budgeted oil prices in 2018 resulted in a federal fiscal surplus of 2.7% of GDP, which was Russia's first budgetary headline surplus since 2012. In addition, the government has benefitted from improvements in tax collection. In keeping with the prudent fiscal policies, the Ministry of Finance has used the windfall revenue to cut borrowing plans.

Figure 4: Federal budget, RUB bn



Source: Russian Ministry of Finance, Scope Ratings GmbH

Figure 5: Fiscal developments, % of GDP



Source: IMF

Medium-term planning includes higher public investment

According to Russia's medium-term financial planning, the government intends to relax the budget rule in 2019-2024 in order to fund its planned investment programme, given the sizeable accumulation of fiscal buffers over the last few years. Instead of targeting balanced fiscal accounts (at the benchmark oil price of USD 40 per barrel in 2017 prices), the fiscal rule now targets a primary deficit of 0.5% of GDP.

Russia's prudent budgetary policy and build-up of fiscal buffers support the rating outlook going forward.

#4: Sanctions exacerbate Russia's weak growth potential

Structural weaknesses weigh on Russia's growth prospects

While short-term risks from low oil prices have decreased as a result of an effective policy response and adaptation of the economy to a lower-for-longer oil price environment, Russia's growth prospects remain structurally constrained and subdued. This is a core issue constraining its BBB- ratings.

Modest medium-term growth outlook

In 2018, the economy posted the fastest growth since 2012, at 2.3%, according to the Russian statistics agency (Rosstat). However, the medium-term growth outlook remains challenging, at an estimated potential rate of 1.5%[4,5]. In its latest World Economic Outlook, the IMF forecasts growth of just 1.6% and 1.7% for 2019 and 2020 respectively. In our view, Russia's weak potential growth is the result of: i) adverse demographics; ii) an overreliance on the commodities and energy sectors; iii) structural challenges posed by weak infrastructure, poor business and investment environments, and weak governance; as well as iv) sanctions.

Adverse demographic trends

Adverse demographic trends in the form of a shrinking working-age population are key factors that weigh on Russia's growth potential and rating outlook. According to the most recent data published by Rosstat, the Russian population declined in 2018 for the first time in a decade by almost 100,000 to 146.8mn. Furthermore, the old-age dependency ratio (number of persons aged 65+ per 100 persons aged 15-64) deteriorated to 21.5, from 20.8 in 2017. The UN forecasts that this ratio will deteriorate further to 30.5 by 2030[6]. The falling working-age population will weigh on economic performance going forward, unless it is counterbalanced by productivity gains. In response, Mr. Putin approved a State Migration Policy concept for 2019-2025[7] aimed at attracting Russian-speaking migrants from post-Soviet states. According to a World Bank research paper by Yoki Okawa and Apurva Sanghi, potential growth could rise by 0.2 pp if this migration policy is successful, increasing annual net migration to 289,000 by 2028[8].

Moreover, population ageing is expected to put pressure on long-term public finances through higher spending on pensions and healthcare. In order to address this issue, authorities adopted a pension reform in October 2018, raising the retirement age by five years to 60 and 65 for women and men respectively[9]. The reform came into effect in January 2019 and will be implemented gradually over the next 10 years. The pension reform is expected to increase the potential growth rate by 0.3-0.4pp over 2020-2028 by enlarging the workforce[10].

Overreliance on commodities and energy sectors

The oil and gas industries together accounted for 46% of federal budget revenues and more than 60% of goods exports in 2018. Decreasing the overreliance of the economy on the oil and gas industry and structural diversification are key to enabling sustainable long-term growth. However, in our view, this will prove to be challenging, given the relative competitiveness of this industry over other tradeable sectors. This is in part due to: i) the increasing oil prices prior to the financial crisis, which resulted in the appreciation of the rouble, and reduced the price-competitiveness of other tradeable goods; and ii) Russia's 'substitution strategy' of imports with national products. The share of oil and gas products in total goods exports decreased to 63% in 2018 from 70% in 2013. However, this development was mainly driven by lower oil prices – the price for Brent oil fell to USD 71.1 per barrel in 2018 from USD 108.6 per barrel in 2013.

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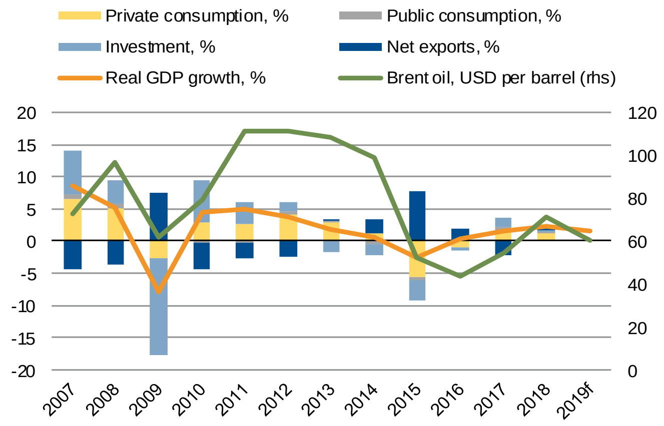
4 IMF Article IV Russian Federation, September 2018
5 http://documents.worldbank.org/curated/en/437251543855591590/Potential-Growth-Outlook-and-Options-for-the-Russian-Federation.
6 https://population.un.org/wpp/DataQuery/
7 http://kremlin.ru/events/president/news/58986
8 http://documents.worldbank.org/curated/en/437251543855591590/Potential-Growth-Outlook-and-Options-for-the-Russian-Federation
9 http://kremlin.ru/acts/news/58703
10 http://documents.worldbank.org/curated/en/437251543855591590/Potential-Growth-Outlook-and-Options-for-the-Russian-Federation

Poor governance performance and weak infrastructure

Poor governance, in particular with regard to corruption and the rule of law, also weighs on the outlook for Russia. In addition, high regulated tariffs on natural monopolies together with interconnected, state-owned companies in the mining, manufacturing and services sectors (including real estate and banking) undermine competitiveness and weigh on investor confidence. At the same time, the World Bank's Ease of Doing Business Index 2019, which assesses business regulation and administrative procedures, ranks Russia a high 31st, between Spain and France, among 190 global economies[11].

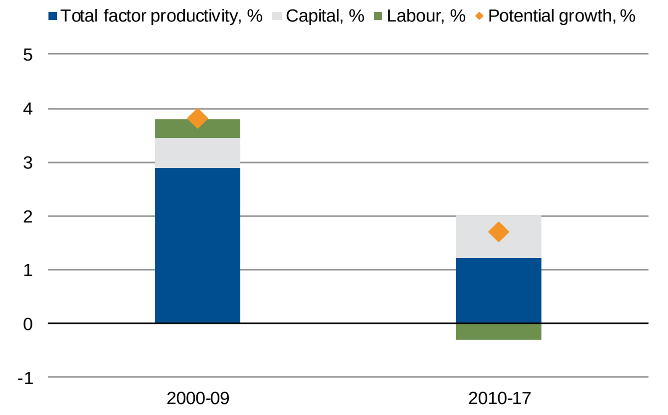
Weak infrastructure and regional economic disparities remain important structural challenges. The Global Competitiveness Report ranks Russia 51st out of 140 countries on the quality of infrastructure and emphasises the limited depth of the financial system, which constrains investment in value chains[12]. Based on the projections of the Ministry of Economy and Development to 2025 and an extrapolation afterwards, the investment-to-potential GDP ratio will increase by more than 10pp to 34% by 2028, which results in a 0.2pp and 0.6pp higher potential growth for 2020 and 2028 respectively[13].

Figure 6: Oil price developments and real annual growth by component



Source: Russian Federal State Statistics Service, EIA, Scope Ratings GmbH

Figure 7: Potential growth



Source: World Bank, Scope Ratings GmbH

Sanctions weigh on an already weak investment environment

Western sanctions have contributed to a deterioration in the already weak business and investment climate in Russia by discouraging investment, both domestic and foreign. The sanctions also restrict capital market access for the private sector, thus raising the cost of capital. In 2015, the IMF estimated that prolonged sanctions could lead to a cumulative output loss of up to 9% of GDP over the medium term[14]. We believe that the full economic ramifications of sanctions on Russia are yet to materialise. The ultimate impact will depend on: i) the government's reaction (e.g., countersanctions and reforms); ii) global oil and commodity price developments; and iii) other direct and indirect costs for Russia, such as higher costs of the integration of Crimea into the Russian economy and military spending.

These factors suggest that, while Russia's economy has largely adapted to external shocks due to its prudent economic policies, a solution to the country's structural domestic challenges is still seriously lacking – acting as a core constraint on the ratings.

[11] http://www.doingbusiness.org/en/data/exploreeconomies/russia
[12] http://www3.weforum.org/docs/GCR2018/05FullReport/TheGlobalCompetitivenessReport2018.pdf
[13] http://documents.worldbank.org/curated/en/437251543855591590/Potential-Growth-Outlook-and-Options-for-the-Russian-Federation
[14] IMF article IV Russian Federation, August 2015

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
1 Cour du Havre
F-75009 Paris

Phone +33 1 82 88 55 57

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

www.scoperatings.com