

Oil price war and Covid-19: three factors supporting Russia's resilience amid the crisis

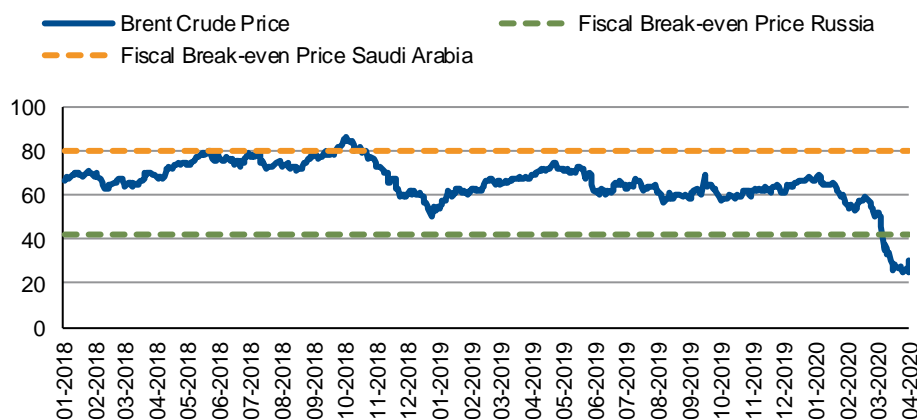


Russia (**BBB/Stable**) faces the dual impact of the oil price war with Saudi Arabia and the global economic fallout from the Covid-19 pandemic, which have pushed crude prices below sustainable levels for all oil-exporting countries from a fiscal break-even perspective. While the decline in the rouble's value has limited the damage to Russia's foreign exchange reserves, the country's capacity to absorb the economic impact of lower crude prices, protect ample reserves and sustain increases in public debt will be crucial for the sovereign's ratings in 2020.

The pandemic's global economic fallout and the fall in Brent crude oil prices below USD 34 a barrel precipitated a drop in the rouble against the dollar, by 18% since March, which has helped to cushion the blow to Russia's foreign exchange reserves due to the free-floating exchange rate regime. Even if an agreement to cut global production was reached, the crude price is unlikely to return to start-2020 levels given sizeable oversupply and falling demand due to the Covid-19 pandemic. The economy remains highly dependent on oil prices, but less than it was six years ago before the government had to adapt to international sanctions. Fiscal austerity, with a balanced budget at an oil price of around USD 42 a barrel, has shored up government finances – at the cost of slower economic growth - while deleveraging of Russian corporates has prepared the private sector for absorbing severe shocks.

Russia's export products are mostly basic goods, making the export sector less vulnerable to disruptions of global supply chains, while its oil and gas industry benefits from well-established and efficient distribution networks. Russia's countersanctions on agricultural imports have strengthened self-reliance. Russian oligarchs have increased domestic real investments as opposed to their previous preference for foreign portfolio investments, particularly in US dollars, which now risk being frozen.

Figure 1: Oil price and fiscal break-even oil prices, Brent Crude USD per barrel



Source: IMF, FT, Scope Ratings GmbH

For now, Russia's ample reserves, the government's cash holdings and a high level of liquid assets held in a rainy-day fund underpin our Stable Outlook for the sovereign's creditworthiness. Still, the oil price war and Covid-19 crisis set the broader context for determining the rating outlook for Russia in 2020, as we see three crucial rating drivers:

1. the *resilience of the Russian economy* in an environment of an oil price war and serious macroeconomic risks posed by the Covid-19 pandemic;
2. the *government's budgetary capacity* for undertaking countercyclical measures; and
3. the *maintenance of adequate currency reserves* amid growing risk aversion among investors and a shift in expectations about long-term oil prices.

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Key factor # 1: Enhanced resilience of the Russian economy

Real GDP growth revised to -3.3% for this year

We have reduced our forecast for Russian GDP growth to -3.3% for this year due to the dual impact of the oil price war and the global economic fallout from the Covid-19 pandemic, which have together pushed crude prices below sustainable balanced budget levels for all oil-exporting countries. While we expect Russia's GDP to return to moderate growth of 2.3% in 2021, the country's longer-term growth potential remains at just 1.3%, acknowledging moreover the low likelihood of major growth-enhancing structural economic reforms.

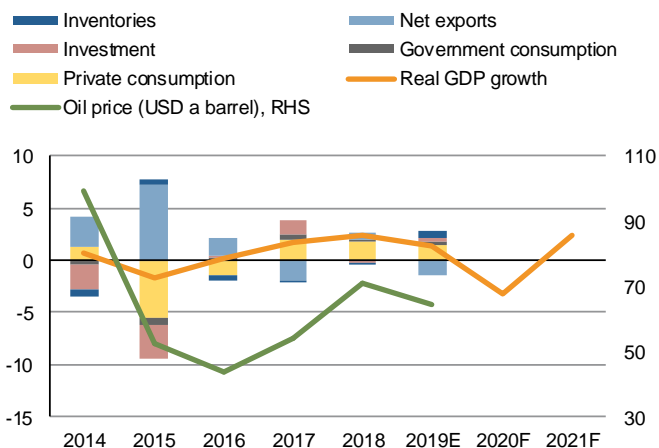
Russia's semi-isolation has led to sluggish growth, but strengthened the economy's resilience to external shocks

Russia's macroeconomic policy has strengthened the country's resilience against external shocks including against Western sanctions in recent years, which, together with structural headwinds such as low investment and productivity growth have, nonetheless, led to sluggish growth over past years despite low per-capita GDP levels (see **Figure 2**).

Western sanctions incentivised banks and corporates to focus on the domestic market

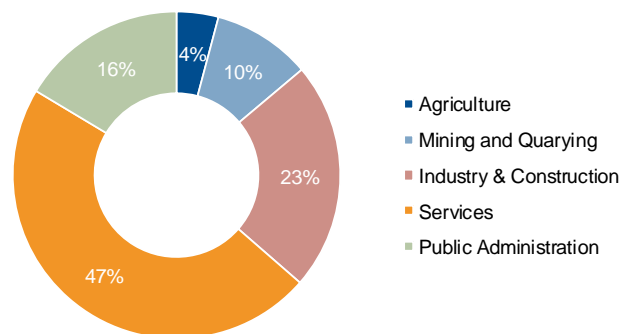
Due to the financial sanctions on Russia, its banking sector has become less integrated with global markets, with foreign debt continuously declining since 2014 and a higher reliance on Russian deposits. Moreover, Russian countersanctions against European agricultural imports have led to a growing, modernised agricultural industry, which has bolstered the country's self-reliance in recent years.

Figure 2: Contribution to real growth (pps of GDP) and average oil price (Brent crude, USD per barrel, rhs)



Source: ROSSTAT, Scope Ratings GmbH

Figure 3: Share of total gross value added by sector, 2019



Source: ROSSTAT, Scope Ratings GmbH

COVID-19 pandemic will significantly slow the economy, with downside risks

While the large share in the economy of the crude oil extractive sector (around 10% of gross value added in 2019, see **Figure 3**) will lead to significant GDP losses in 2020, the economy's oil and gas industry benefits from tax rates linked to the oil price and well-established and quick distribution networks, which are not affected by disruptions in global value chains.

Russia has implemented stricter COVID-19 containment measures...

On 2 April, Russian President Vladimir Putin announced that the containment measures, including all non-vital workers being on paid leave for originally one week in March, are extended until the end of April. Potential further measures include a declaration of a state of emergency in heavily affected regions.

... and announced fiscal stimulus of up to 2% of GDP.

The Russian government so far has announced a modest fiscal stimulus of 1-2% of GDP, including: i) support for individuals via a credit holiday (suspension of fines on unpaid mortgages to borrowers whose incomes decrease by more than 30% due to the pandemic); ii) support for businesses via a six-month moratorium on bankruptcy applications for companies hit by the pandemic; and iii) support for small and mid-sized businesses to postpone credit and tax payments.

Key factor # 2: Material fiscal capacity to enact countercyclical measures

Significant fiscal space to support the economy

While the growth shock and likely additional countercyclical fiscal measures to be announced will have medium-run implications for the robustness of Russian public finances, we expect public debt-to-GDP to remain low (see **Figure 5**). Prudent fiscal policy to rebuild buffers has helped build up cash reserves, which provides the Russian government with significant fiscal space to support its economy and counter the impact of the coronavirus pandemic and lower-for-longer oil prices. With such fiscal support, there is, as such, upside risk to the -3.3% growth currently forecasted for 2020.

Reformed fiscal framework has led to continued budget surpluses

Russia's reformed fiscal policy framework in place since 2018 has weakened the link between changes in oil prices and changes in budgetary expenditures and led to continued budget surpluses. After a 2.9% of GDP fiscal surplus in 2018, Russia's federal budget will likely have recorded a 2.0% of GDP surplus in 2019 (see **Figure 4**), supported by increasing tax compliance, continuous cost controls, higher-than-budgeted oil prices and lower-than-budgeted public investments due to delays in project implementation.

Russia announced a revision to its budget to cope with oil prices of USD 20 a barrel!

On 3 April, the Russian government announced that it is revising its initial budget for 2020 (which targeted a surplus of 0.8% of GDP) to prepare for oil prices of USD 20 a barrel. Consequently, we expect a budgetary deficit of around 3% of GDP for 2020 and Russia to increase its borrowing significantly this year. The upcoming referendum on changes to the Constitution and the approaching Duma elections in 2021 put additional pressure on the government to increase public sector spending, given that real incomes have fallen since 2014.

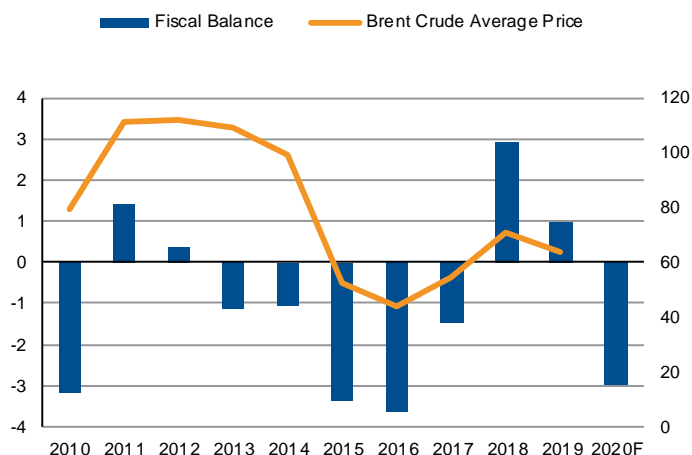
Low debt and high savings provide significant budgetary leeway

The additional expenditure does not pose a meaningful risk however given Russia's conservative budgeting which has helped to build up cash reserves, providing significant fiscal space to support the Russian economy. Specifically, Russia benefits from sizeable governmental savings in the form of cash in deposits with the central bank, which in 2019, fully covered its gross public debt in 2019, strengthening budgetary flexibility.

Rainy-day fund covers maturing debt through 2024

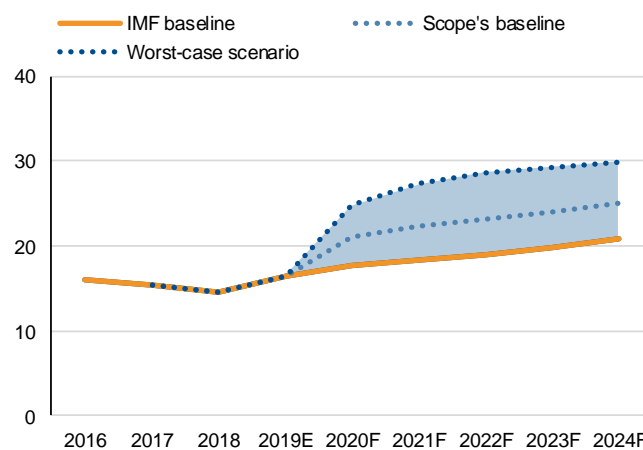
In addition, the Russian National Wealth Fund has liquid assets of 7.3% of GDP as of 1 March, which would allow the Russian government to enact additional fiscal spending to support the domestic economy with minimal recourse to new debt issuance. Russia's maturing public debt in the years ahead is low (totalling 5% of GDP through 2024).

Figure 4: Russia's fiscal balance (% of GDP) and average Brent crude oil price (USD per barrel, rhs)



Source: IMF, EIA, Scope Ratings GmbH

Figure 5: Russia – public debt under different scenarios, % of GDP



Source: IMF, Scope Ratings GmbH

Low currency risk

Finally, FX risk is low, given the high share of sovereign obligations denominated in roubles (around 75% of total debt obligations in March).

Key factor # 3: Ample reserve adequacy and flexible exchange rate

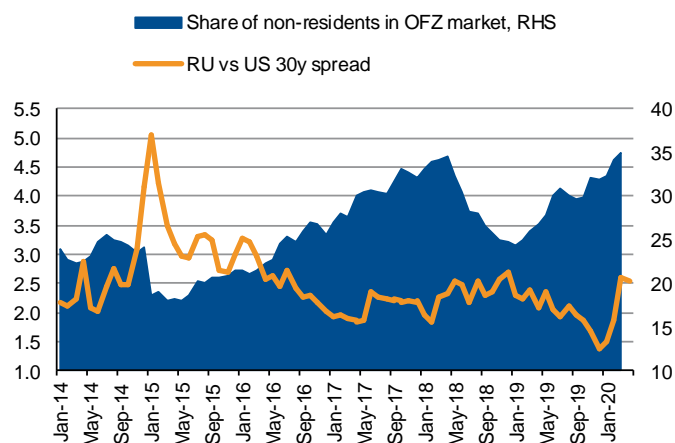
Unchanged market risk assessment of Russia

Russia's 10- and 30-year US dollar bond spreads to US Treasuries have declined to 250bps at the beginning of April 2020 after a pick-up in mid-March to around 330-340bps when Brent prices fell below USD 30 a barrel. Comparing current spreads to April 2019 levels, however, Russian spreads are roughly unchanged.

Increased foreign ownership share of Russian assets

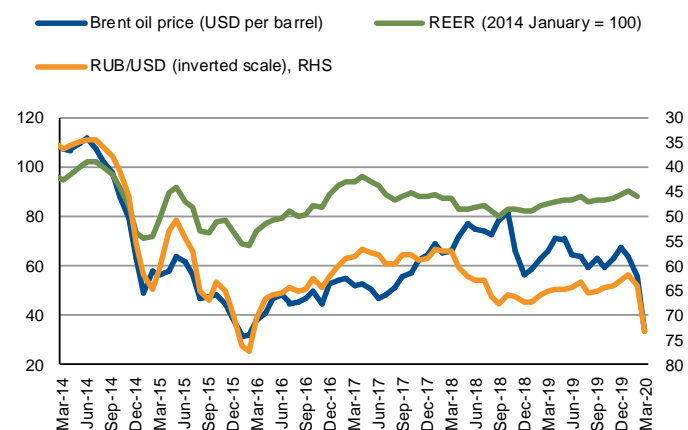
Russia's domestic capital market has grown strongly from January 2019, with high demand from non-residents. The size of Russia's federal rouble-denominated bond (OFZ) market increased by around RUB 1.5trn from the beginning of 2019 to RUB 8.8trn in February 2020. Foreign investors increased their shares of OFZ bonds to 34.9% of the total outstanding from 25% in February 2019, which indicates that their concerns regarding sanctions have abated somewhat (**Figure 6**). Given that Russia's financing needs are met predominantly by local borrowing, the government is issuing Eurobonds as a means of facilitating benchmarks for Russian corporates that issue on international capital markets.

Figure 6: Russian 30-year bond spread (%) and share of non-residents in OFZ market (%) (rhs)



Source: CBRF, Bloomberg, Haver Analytics, Scope Ratings GmbH

Figure 7: Exchange rates and oil price



Source: CBRF, EIA, Haver Analytics, Scope Ratings GmbH

Strengthened external position

Russia has strengthened its resilience against external shocks over past years, reflected in improved reserve coverage ratios and current account surpluses.

- Russian foreign exchange reserves rose to USD 570bn in February 2020 from USD 433bn in 2017, equal now to five times short-term external debt (including long-term external debt due in one year or less) or 33% of GDP, the latter ratio up from 27% in 2017¹.
- Russia's de-dollarisation strategy in recent years along with its build-up of gold reserves have further strengthened Russia's balance sheet against external shocks.
- Russia has very low external debt levels, at 28% of GDP as of end-2019, down from 32.5% at end-2017.

Flexible exchange rate provides an important buffer

Russia's free-floating exchange rate regime provides an important buffer for the absorption of external shocks. In addition, the partial delinking of the rouble's value from oil prices since 2018 has supported the external position (**Figure 7**).

¹ IMF's reserve adequacy metric (ARA metric), which is a composite index assessed by comparing the level of reserves to short-term external debt (including long-term debt due to be paid in one year), broad money, and imports, shows that Russia had reserves well above the adequacy range of 100-150% of the ARA metric in 2019, at 314%. The same metric stood at a lower 259% in 2017.

We work with scenarios based on a GVA calculation of GDP

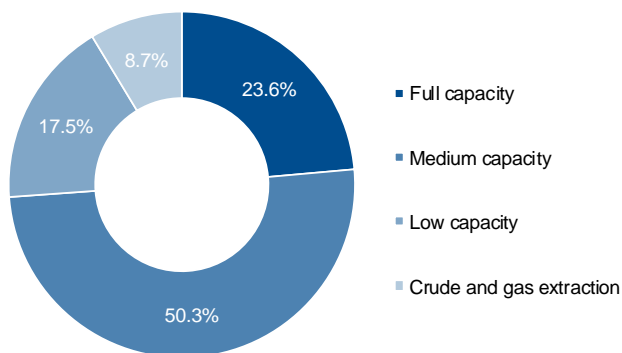
We make assumptions about monthly levels of output and length of sectoral shutdowns

Annex: How we forecast Russian growth

For 2020, we use a model based on a gross value-added calculation of GDP and run three scenarios (baseline, stress and worst-case) defined by the timing of “normality” resuming across industry sectors. We classify Russia's industry sectors into the crude oil extractive sector to capture the impact of lower oil prices, and for the other sectors into categories as operating over the crisis either at (i) near-full capacity, (ii) medium capacity or (iii) low industry capacity by assessing the severity of the crisis across sectors (see **Figure 8**).

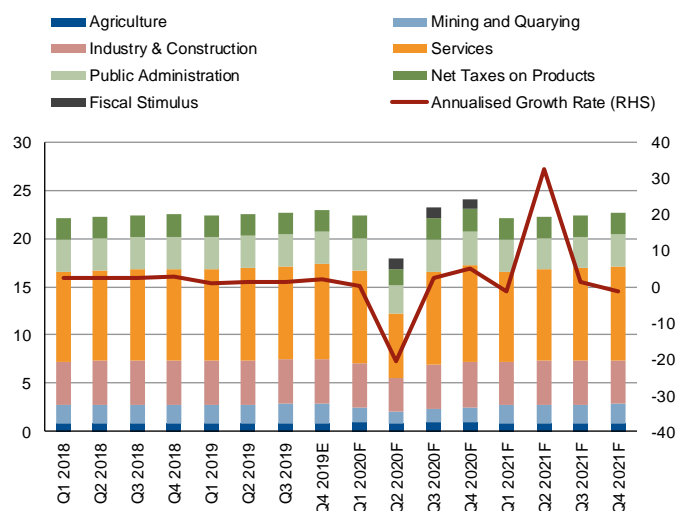
To assess the impact on the Russian economy of lower-for-longer oil prices and the impact of the Covid-19 pandemic, we run a scenario analysis for the Russian economy. We make assumptions about monthly levels of productive output compared to pre-crisis levels for each of the three classifications for industries' relative sensitivities to this crisis and consider fiscal countermeasures as announced to date by the Russian government. For 2021, we assume that the Russian economy is operating near its end-2019 levels.

Figure 8: Shares of sectors in total gross value added by capacity categorisations



Source: ROSSTAT, Scope Ratings GmbH

Figure 9: Real GDP and 2020-2021 Scope baseline forecasts, trn RUB and YoY change (%), rhs)



Source: ROSSTAT, Scope Ratings GmbH

Our base case includes the following conservative assumptions: i) an average Brent crude price of USD 35/barrel in 2020 (vs USD 64/barrel in 2019); ii) the shock from the Covid-19 pandemic and containment measures on the economy seeing gradual relief starting by the second half of this year; and iii) a GDP boost from announced fiscal and monetary support measures. The baseline scenario sees real GDP growth in 2020 of -3.3% and 2.3% in 2021 (see **Figure 9**).

In a worst-case scenario, in which lockdown measures are maintained until the end of the year and oil prices stay at USD 20/barrel, the Russian economy could contract by up to 11% in 2020.

Figure 10: Scope real GDP growth forecasts for Russia, YoY %

Year	Scope Baseline	Scope Stress Scenario	Scope Worst-Case Scenario
2019E	1.3		
2020F	-3.3	-8.8	-11.3
2021F	2.3	n/a	n/a



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