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Russian Federation

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS Dec 16, 2013

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Economic slowdown is set to accelerate in 2013 leaving growth at only 1,4%. Hopes for higher growth in 2014 are based on an uncertain recovery in main export markets including Europe and a rebound in investments hostage to political stability including intra-Kremlin politics.

Country Risk Analysis

Summary and conclusions

Following a rapid recovery from the GFC, the slowdown has been ongoing since 2011 and accelerated since late 2012. In 2013Q2 it declined to 1,2% annual growth due to falling public sector investments and reduced fiscal stimulus. The drop in 2013 to only half of the previous year's growth would have been deeper still but for a bumper harvest in agriculture. In return, the trailing economy has aided central bank efforts to rein in inflation, which may well fall to 6%. That should shut the door on any residual risks of hyperinflation and will happen in spite of high capacity utilization and low unemployment. In contrast, the current account surplus will drop to 1,6%/GDP, still supportive of strong reserves at $500bn.

While the macro-picture may appear on the right track, at least if forecasts of a bounce back of activity materialize in 2014-15, structural issues remain sticking points with adverse impact on the economy. Investments, not least in the oil sector -- Russia's industrial backbone, is held down by weak tax incentives and political and regulatory uncertainties while reports of new geological opportunities should tell another story. Same factors combined with rampant corruption are oft-cited reasons for failure to develop the country's manufacturing sector.

The political situation is complicated. On the surface this may appear as a standoff between authorities and a vocal but fragmented opposition with main support from the urban middle class of major cities. While declining but still above 60%, the approval rates of the president, Mr. Putin, is still enviably high to many peers. Seasoned observers pay as much attention to the assumed power play going on behind Kremlin's walls. This play is likely to involve high monetary stakes with the potential to destabilize the country's financial system. The central bank has apparently begun a much needed clean up among the country's 900 banks where a number of the smaller ones may be suspected of bad business. Recent bank closures have reportedly caused local disturbances and bank-runs.

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With the budget in reasonable balance and government debt at a low 9% of GDP, sovereign ratings have remained stable around a strong triple-B. Country risk, however, casts the net wider and may face more challenges going forward

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Recent developments

Macro economic stabilization has had some success but partly at the cost of weaker growth.

Growth weakening fast. Economic activity in the first half of the current year fell far short of expectations rising only by 1,3% in the first nine months. Hopes are that a bumper harvest in agriculture and continued calm in global financial markets will support some bounce back in the last months of the year, but only enough to lift growth to a modest 1,4% for the whole year. That will be 2 percentage points (pp) below last year's result and the sharpest slowdown since 2009. Investments present the main drag in such a development. Several large investment projects, including the North-Stream gas pipeline to Europe have been commissioned while the construction works for the winter Olympics in Sotchi are coming to an end. There are few new public projects of comparable scale and private projects are normally of much smaller size. Private consumption, by contrast, has held up better and is estimated to grow by 5% in 2013, down 1 pp from last year, supported by still high credit and real wage growth

Inflation subsides despite tight labour market: Helped by less aggressive hiking of utility tariffs and the damping effect of rising supply of agricultural products this fall, chances are now good for the central bank to meet its annual inflation target, this year within the 5-6% range.. That is despite the rouble depreciation of 10% which may have added some 1 pp to the CPI and still ongoing rapid wage and salary hikes -- up an estimated 6% in real terms -- reflecting tight labour market conditions with unemployment still below 5,5%. However, it has been noted that core inflation picked up in the first half of the year to 6,6%, slightly higher than the headline number, casting some doubt on the sustainability of easing price pressure.

External surpluses weaken: Despite a recent improvement to the trade balance in Q3, we still project whole year imports to outpace exports reducing the surplus on the trade balance to $173bn. from $192bn. in 2012. That will be the result of weakening terms of trade (import prices growing faster than export prices: oil, gas and metals -- combined with a 2% drop in energy deliveries to foreign customers. The total deficit on the service and income balances will likely grow $19bn, to $139bn., eating into the current account surplus which will fall to $34bn. only 1,6% of GDP, a marked drop from previous years.

Rising loan repayments weigh on the capital balance: The reduced current account surplus will combine with capital inflows at almost $50bn. to help finance large loan repayments, rising to $71bn. from $65bn in 2012. That should leave the level of reserves almost unchanged at $0,5trillion -- enough to repay two thirds of Russia's gross foreign debt or cover import payments for a year and a half. However, large reserves may be warranted bearing in mind the combination of Russia's open capital account and the undiversified nature of her exports which is dominated by oil and gas with a history of volatile prices. This combination has caused sudden and large capital outflows in the past.

Policies

Recent years have seen fiscal and monetary policies gradually strengthened but so far short of establishing a proper track record and raise market confidence in their sustainability.

New fiscal rule aims at keeping a much needed lid on the budget balance: Since new budget rules passed the Duma (Parliament) in December 2012, fiscal policies have followed a rule that limits expenditures to budgeted revenues plus maximum one percent of GDP additional financing. Because oil dominates almost a third of total revenues the budgeted oil price is calculated as a rolling average of the preceding five years. The point is to contain new pressures on the budget which used to be in a strong surplus in the 2000s but suffered large deficits due to government stimuli policies during the GFC. In 2011 and 2012, the budget balance returned to surplus but will once again show a deficit in 2013 estimated at 0,9% of GDP, just within the fiscal rule, i.e. 1% of GDP. Calculated without volatile oil and gas tax revenues the budget would be in a deficit of more than 10% of GDP. Before the GFC the rule was to keep the non-oil deficit below 4,7% of GDP.

Rebuilding of the National Reserve Fun on the back-burner: The rule-based budget price of crude in the current year is $91/barrel -- clearly below the actual market price of Russian oil. The excess is supposed to be allocated to the National Reserve Fund which used to be around 7% of GDP, but was halfway depleted during the GFC. This year presents a good opportunity to rebuild it to serve as a rainy day reserve fun. However, new proposals have been tabled to use a part of it for long term fixed investments, including in infrastructure. While that could sound wise, doubts are if these investments will be administered efficiently or rather end up in wasteful spending. Such proposals also mean that the fund will in part consist of illiquid assets and no longer be available on demand. When the GFC struck the National Reserve Fund was filled to the brim and ready to be used against a potentially much deeper recession. Leaving the fund too illiquid or too small will not facilitate the repeat of such an operation. Nevertheless, the Russian finances are still in quite an enviable position compared with many peers. With a total debt of less than 10% of GDP of which only a quarter is denominated in a foreign currency and two thirds are held by residents, the government may still if needs should arise be a preferred borrower on international markets.

Monetary policies at crossroads: Due to the relatively high dollarization of the economy presently around 20%, monetary policies have traditionally paid much attention to the exchange rate. The central bank describes its present stance as a managed float, in contrast to the appreciating crawling peg exchange rate policy pursued with meagre results before the crisis. Then as now, the main objective of the combined exchange rate and monetary policies has been to bring nominal developments of GDP, in particular the CPI, under control at a reasonably competitive exchange rate.

Is inflation targeting the way ahead? For whatever reason, the new policies have apparently achieved the goal to ease price pressure with more success than expected. However, continued rapid credit extension from banks, in particular to households to the tune of 30% a year is a reminder that the jury is still out. By the end of 2014, the central bank plans to turn its monetary policy into direct inflation targeting, apparently with little or no regard to the exchange rate. Based on the experience of other countries, although more advanced than Russia, this could prove an effective policy depending on how much confidence the monetary authorities can instil with markets that it will persevere with inflation targeting and that only. Experience of other countries is often evidence of temptation to side step principles, including resorting to sterilized interventions, when the "going gets going" and markets begin to test the central bank's resolve.

Fuel to the fire? Against that background, one may doubt the advisability of recent months' actions of the central bank. Since the middle of the current year, the rouble has come under renewed pressure. For the stated purpose of smoothing the path of the exchange rate, the central bank has intervened in the foreign exchange markets by selling $14,2bn dollars in the domestic market in the period July to September. Suspicion is that this has not only been done to make up for a seasonal bump in demand for foreign exchange including for scheduled debt repayments but also for capital flight. That might still have been justified had the interventions remained unsterilized. Apparently they were not. It is an old wisdom in financial markets – including Russia -- that sterilized interventions often end in bringing more fuel to the fire. (Conf. Box 1)

Box 1: What happened in 2008/2009?

Russia has its own unfortunate experience with sterilized interventions. In late 2008, speculators started a massive attack on the rouble in anticipation that it eventually would depreciate sharply. Because the central bank continued to support the semi-fixed exchange rate, speculators were able to buy the dollar "on the cheap". Moreover, that was largely with money borrowed from the central bank itself (i.e. "sterilized interventions"), evidenced by the rise in its claims on other banks of almost $130bn. In late December of the same year, the central bank gave in and let the rouble depreciate sharply. It had then lost $140bn of reserves and some speculators may have been able to buy back more roubles with now stronger dollars than they borrowed in the first place.

Is the banking sector beginning to feel the pain? Following a fantastic borrowing binge where retail lending has been hiked up a multiple times, although from initially very low levels, households are beginning to feel financial pain. Officially, non-performing loans (NPL) of banks are still not high, but they appear to be growing faster than loan books. NPLs have reportedly reached 6% for retail lending and 4,5% for companies. Retail credits (including consumer loans and mortgages) represent about a third of total bank lending. They are contracted at interest rates in the range of 20-30% pa, that is well above likely future rates of inflation. With the announced freezing of public sector wages next year followed by expected wage moderation for others, growing numbers of households could begin to default on their loans. In that case many banks would be ill-equipped to face a situation of higher interest rates should the central bank choose to fend off a new run on the rouble with such.

Cleaning up a fractured banking sector: Being recently mandated with full supervisory powers, the central bank has begun a clean-up operation of Russia's fractured banking sector. This is dominated by a handful of large banks, most of them state-owned. They are generally considered profitable and well managed. However, in the 1990s smaller banks mushroomed and were often established to serve special interests of companies or local markets. Since long their rationale has come under growing scrutiny, but the supervisory authorities have apparently been deterred to address the problem head on. It has been noted that gangs have murdered two central bank officials in recent years in cases seemingly related to their duties vis-a-vis mismanaged banks. In recent months the central bank, under its new governor, Ms. Naibiulina, has closed or reorganised almost 30 banks causing local turmoil in several cities. Even though these banks represent a small part of the total in terms of assets it could still prove a mounting challenge to improve the banking system. It may be argued that such clean-up should preferably be accomplished before the central bank considers proper inflation targeting.

Structural policies: has privatization been shelved? The Russian budget for 2013 stipulates ambitious privatization plans, but so far market conditions have not allowed the government to make much progress. Observers frequently refer this to Russia's weak investment climate. That is reflected in improving but still poor scorings in international surveys such as the Corruption Prevention index where Russia is ranked 133 from the top out of 173 countries and the World Bank's "Doing business" indicator where Russia is ranked 112 from the top out of 180 countries. Essentially this is much of the same picture as we have commented on before on these pages and we refer interest to previous annual reviews on www.seb.se/mb.

Politics

The standing of President Putin is undeniable: Observers, including among the opposition, do not dispute polls showing Putin's approval ratings still high at above 60% although down from more than 80% during his first presidency and with disapproval ratings up accordingly. A vocal and often well-articulated opposition is able to catch headlines in global media but seems a phenomenon with limited support outside the educated middle class of major cities which probably means their support is too shallow to win national elections.

Is the Putin-system sustainable? Of more concern is the stability of the so-called "Putin's system" as named by the reputable think-tank Oxford Analytica of the UK and others. That hints at a system comprised of vested interests among Russia's ruling bureaucrats, elite politicians and the managements of major enterprises, including state-owned. They champion Mr. Putin to the extent that he maintains the "system" and can legitimize it by winning elections even if those are disputed. Should they have doubt in him as arbiter for their interest, including ability to benefit from public contracts etc. , the "system" could be destabilized with the result to paralyze decision-making and even prise open personal and/or factious conflicts. Among the various Kremlin factions, outsiders fear that "dark" forces could be in the ascendance. The government recently released many imprisoned members of the opposition, including Mr. Khodorovski, founder of the oil company Yukos. How the authorities respond to possible political actions of these individuals once at large, may add to insight into the game for power presumably going on inside the Kremlin.

Outlook

Prior to the GFS Russia grew at an accelerating clip reaching almost 9% in 2007. At the same time the oil price rose from the 20's to the 90's in terms of US$/barrel. However, it is misleading to say that this was all due to the rising price of crude. In fact, the main driver was rather the catch up of industrial production as idle capital was brought back into action. This was the time when oil output soared from 6,5mn. barrels/day to almost 10mn. barrels/day. Such a development cannot be repeated regardless of future oil prices. In fact, what will be holding back Russia in coming years is lack of new investments to raise production capacity of the economy.

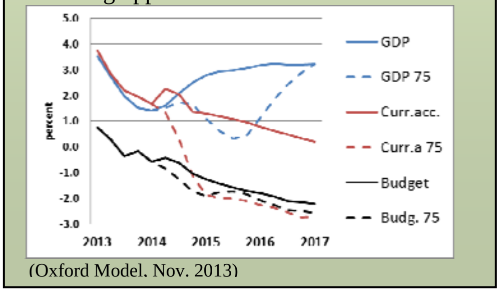
For the short to medium term, 2014 and 2015, we have a hard time following most analysts who chime in with the government's projection showing growth rates back at 3% a year. We fear that investments and private consumption could become a continued drag and cut growth closer to 2% a year. High spending households, a total of only 5 million persons mainly in Moscow and St. Petersburg, have become overly leveraged and will have to cut back on spending to service loans as disposable incomes fail to keep up with debt servicing. Private investments, in return, could prove slow to pick up under unfavourable circumstances with regulatory, political and financial sector uncertainties. Public investments, by contrast, are bound to decelerate sharply as also investments in Sochi come to an end in early 2014. Announced new projects including modernization of the Trans-Siberian Railways, a high speed route Moscow-Kazan and a new central ring around Moscow, are estimated to cost $14b, 1% of annual GDP, but to be implemented over several years. In fact, investments could see a new fall following and estimated drop of 1,4% in 2013. In return, the external environment might improve led by the US to hold up export markets including for oil and gas better than projected.

Oft-cited main risk factors for the next few years are still

1. a slide or an abrupt fall in the oil price
2. domestic financial stability as the central bank force ahead with "clean-up"
3. political instability

Box 2: Effects of an oil-price drop:

Should the oil price drop to $75/barrel in 2014 and stay at that low level through 2017, 30% below the average of $109/barrel in the base line scenario, GDP growth would suffer just avoiding recession, while impact on the budget would be marginal. The current account balance, by contrast, would turn into a growing deficit, albeit still within reasonable financing opportunities.



(Oxford Model, Nov. 2013)

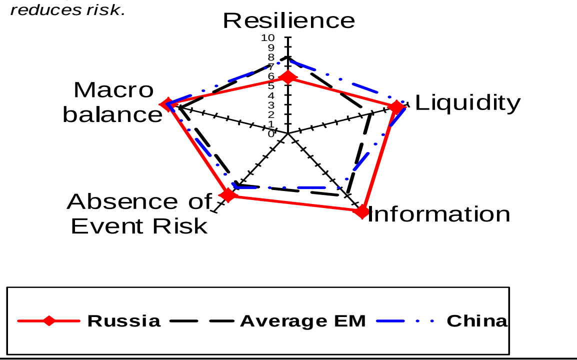
Regarding the first point: The direct threat to Russia's economy of a drop of the global oil price can sometimes seem overstated. At least in the medium term Russia would be supported by "automatic stabilisers". For one thing, a lower oil price will spur global demand to the benefit of the other half of Russia's exports -- metals, raw materials, military hardware etc. It would also depreciate the exchange rate to support competitiveness and the government budget which counts oil revenues in roubles. In fact, our run on the Oxford global econometric model shows that for a drop of the oil price to 75$/barrel, GDP weakens but only by 2 pp in 2014 and 2015, thus avoiding recession. (Box 2). That does not mean Russia is immune to oil price changes. Indirect effects, such as a collapse in market sentiment could cause large capital flows and financial turmoil.

Regarding the second point: The effects of financial sector turmoil among Russia's myriad of small banks is harder to determine, but the result would probably be in the same ballpark as the oil price drop in terms of growth.

Regarding the third point: The effect of factious Kremlin politics coming out in the open is anybody's guess. The point here is, however, that these three risk factors could be mutually interdependent. (1) may trigger (2) or (3) while (2) and (3) may trigger each other. It may be argued that such has been the situation for several years. It is still worth noting that inherent system instability may develop fatigue and come to a breaking point. In this case, it is noted that the global oil price could be ripe for a downside correction, a revamp of the banking system could prove messy and that the resilience of Russia's political system is untested. A low growth scenario for coming years may increase breaking point susceptibility.

Key ratios	**2013**
Population (mill)	142.8
GDP growth	1.4%
GDP/capita (US$)	14886
Inflation	6.7%
Curr.Acc.Balance/GDP	1.6%
Reserves/imports (months)	16
Investments/GDP	22.1%
Government debt/GDP	8.9%

How to read the chart?
Moving out from the center reduces risk.



External ratings:
Moody's: Baa1
Fitch: BBB
S&P: BBB

Peers:
Brazil
India
Lithuania

Graph: Russia's risk profile is "flater" than average stronger on *liquidity* and *macro balance*, but weaker on long term factors: *resilience*. The slight oil price fall has so far not threatened political stability, reducing our event-risk indicator.

Key data:	2008	2009	2010	2011	2012	2013	2014	2015
GDP (bill.US$)	1665	1229	1524	1897	2012	2125	2241	2412
GDP/capita (US$)	11582	8553	10612	13233	14063	14886	15733	16978
GDP (%chg)	5.2%	-7.8%	4.5%	4.3%	3.4%	1.4%	1.9%	2.2%
Investments/GDP	22%	21%	21%	22%	23%	22%	22%	22%
Budget balance/GDP	4.9%	-6.3%	-3.4%	1.5%	0.4%	-0.9%	-1.6%	-2.1%
Govt debt/GDP	6%	7%	7%	8%	9%	9%	11%	12%
CPI inflation (% chg)	14%	12%	7%	8%	5%	7%	5%	5%
Money demand (%chg)	21%	-2%	34%	23%	16%	14%	5%	6%
Stock prices Avg.	143713	143707	143592	143367	143085			
Interest rates	10%	14%	6%	6%	7%	8%	7%	7%
Exch. Rate ($)	25	32	30	29	31	32	33	33
Trade/GDP (%)	45%	39%	42%	44%	43%	41%	41%	41%
Oil price (Brent)	$97	$62	$80	$111	$112	$108	$103	$105
Millions US $								
Export of goods	466 298	297 155	392 674	515 408	528 005	524 385	528 369	557 771
Imports of goods	288 672	183 924	245 679	318 555	335 709	351 115	387 975	424 071
Other:	-73 690	-62 848	-79 542	-99 579	-120 281	-139 232	-116 589	-120 885
Current account ($ mill)	**103 936**	**50 383**	**67 453**	**97 274**	**72 015**	**34 038**	**23 805**	**12 815**
(% of GDP)	6.2%	4.1%	4.4%	5.1%	3.6%	1.6%	1.1%	0.5%
FDI	19 400	-8 100	-8 600	-14 300	-9 000	-7 000	-4 500	-4 500
Loan repayments	-48 531	-51 181	-42 526	-52 396	-65 321	-71 062	-75 671	-79 935
Net other capital flows	24 924	-99 487	29 445	-1 158	7 486	48 537	72 611	96 293
Balance of payments	**99 729**	**-108 385**	**45 772**	**29 420**	**5 180**	**4 513**	**16 245**	**24 673**
Reserves	502 165	393 780	439 552	468 972	474 152	478 665	494 910	519 583
Total debt	509 775	463 400	471 550	528 800	590 850	715 235	787 709	861 509
o/w short term debt	95 425	54 875	58 075	67 775	77 775	91 902	107 802	123 557

Source: OEF (Oxford Economic Forecasting) and SEB estimates.

Rating history					
Fitch (eoy)	BB+	BBB-	BBB	BBB	BBB
Moody's	Baa1	Baa1	Baa1	Baa1	Baa1
SEB (eoy)	8	7	7	7	7

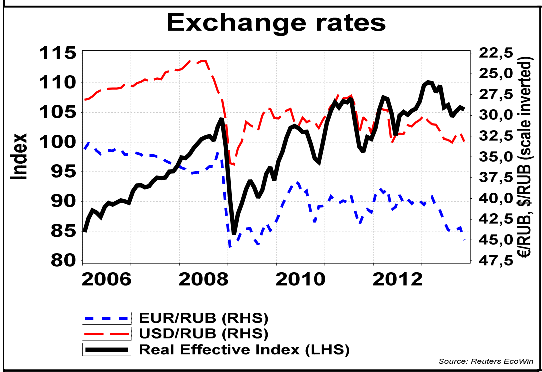
Type of government: Presidential democracy

Next elections Presidential elections 2017

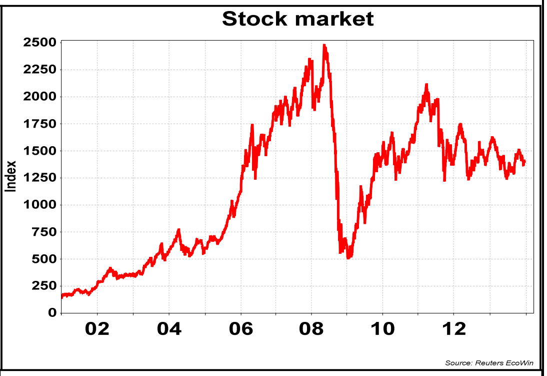
Other:

Latest PC deal 1999/active

Latest IMF arrangement 1998/SBA



Source: Reuters EcoWin



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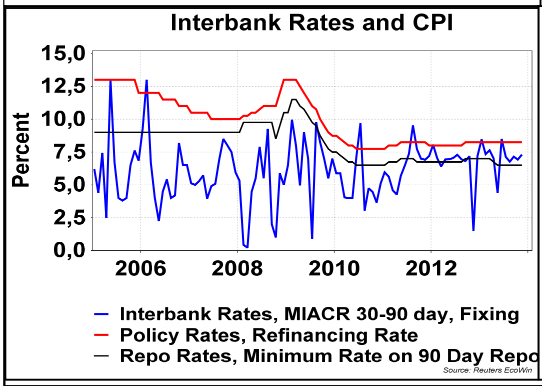

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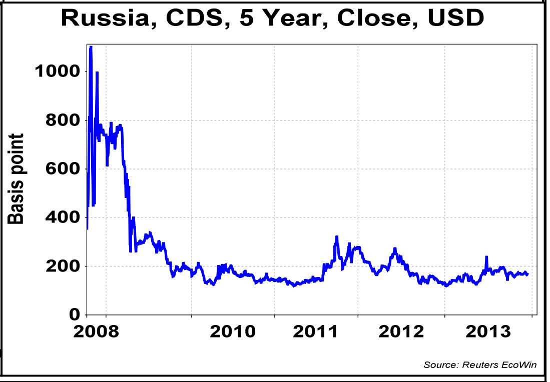

Source: Reuters EcoWin

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