Russian Federation

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2.3% growth in 2018 was the highest on record for the last six years although – as a fly in the ointment – it was mainly driven by the energy sector as sanctions and high funding costs continue to dent investor appetite for non-oil activities. Macro stabilization, in return, has been accomplished successfully. The government now prioritizes financial stability over growth.

Country Risk Analysis

Higher growth than first expected brought total economic expansion up to 2,3% in 2018 according to newly revised national account numbers. That revision much reflected stronger investment demand in energy related sectors and also healthy contribution from net exports buoyed by high oil revenues and World Cup tourism. Only weak consumer sentiment appears to have exerted a drag on the economy 2018, a negative force that will continue into the New Year.

Following the global oil market collapse in 2014-15 the government has focused on rebuilding reserves and tackling government and banking sector imbalances. The annual government budget has been consolidated and brought back to a small surplus while reserves have almost been rebuilt. Monetary metrics, including price pressure, had been tamed well within the 4% target before the VAT hike hit at the beginning of the current year. Policies have been directed at achieving financial stability while growth-enhancing structural policies have received less attention. A most important but socially contentious pension reform still hangs in the balance.

Russian politics have remained overall stable and predictable over the recent 12 months period. Only two events have rocked the calm: Foreign sanctions against alleged misbehavior of the country's politicians and national security services on the one side and proposed pension reform on the other. The latter is probably the more important as the fallout will have profound consequences for the economy in the coming decade with potential to destabilize the state budget if not duly implemented.

The outlook for Russia in a short to medium term scenario is reasonably favorable. Moderate but steady growth will continue at least in the 1-2% annual range barring a combination of new US/EU sanctions and oil prices undershooting the state budget's $40/barrel assumption. That scenario is supported by continued respect for prudent fiscal and monetary policies keeping fiscal and external balances in check. -- The longer term future is more challenging. The recent rescue of smaller banks – admittedly the larger among private ones, may have put a lid on financial sector concerns for now, but could provide fertile ground for excessive risk-taking on a more distant horizon. Finally, Russia is facing adverse demographics and continues to struggle with an undiversified economy too dependent on oil and gas.

The rating of Russia is a conflict between a reasonably up-beat short/medium term future and the more vulnerable longer term. Having so far proved able to manage the deep fall in the oil price of four years ago and the gradual intensification of sanctions up to last fall, all rating agencies have now upgraded the country into investment grade. As to the country as such, we see risks somewhat higher but gradually improving as well.

Recent developments

Higher growth than first expected due to statistical errors, brought total economic expansion up to more than 2% in 2018.

Growth surprises on the upside: An 11th hour statistical revision in early 2019 is suddenly showing last year's economic performance as the best since 2012. It appears that the statistical authorities had omitted the construction of a major LNG complex in Russia's Far East region from statistical recording. That revision raised investment demand from 1,6% to 5,7% for the year as a whole compensating for a poor harvest in agriculture. The year was otherwise buoyed by extra demand for hospitality services during the World Cup arrangement in the summer and supported by healthy exports of goods and services. Notwithstanding low unemployment, relative price stability and moderate real wage growth private consumption once again began to trail despite a small Fillip towards the end of the year reflecting some hoarding behavior among households in anticipation of the announced VAT hike in 2019.

Can higher growth be sustained? Early high frequency data for the New Year indicates that the VAT hike may have had less of an impact on private consumption which remains the main engine of the economy. If so, the present year may carry on with GDP growth at almost 2% depending on whether higher than expected investment demand can be sustained against the backdrop of looming new sanctions.

Price behavior has so far remained well-tamed: After the deep depreciation of the ruble four years ago, the central bank has managed to get price pressure under control. Last year the consumer price index (CPI) slowed further and at 2,9% annual growth ended well within the target of 4%. However, in the last three months of the year it ticked up somewhat responding to new ruble weakness and it is still a question mark going forward how it will face a relatively tight labor market with unemployment at only 4,8% in addition to the noted VAT hike. Nevertheless, it appears that the reaction to the latter could prove more benign than feared. The weekly CPI in the new year shows price pressure up by somewhat more than one pp (percentage point) slightly lower than most observers and the central bank had expected underpinned by core inflation rising to only 4,1%

Record current account surplus: Last year's current account surplus is estimated to have ended at more than $24bn, up threefold from 2017, thus marking a record since "the beginning of time". That was much helped by somewhat higher oil production and sharply higher global oil prices, up almost by a third from $55 to $70/barrel in terms of Brent. But also exports of non-fuel goods have begun to grow stronger, admittedly from a still moderate level of some $150bn a year, on the back of improved competitiveness provided by the steep exchange rate devaluation in 2014-15. Those exports are still only a third of total merchandise exports with oil and gas at some $250bn in the balance. Export of services saw more than 8% increase mostly reflecting increased inflows of fans to the World Cup. Less than 3% growth of goods and services imports also contributed to last year's record current account surplus.

Capital flows in overall balance: Last year the central bank of Russia (CBR) added a total of $36bn to its international reserves as it bought excess dollar inflows mainly from the country's oil and gas exporters. Although revaluation effects may have contributed to that number when reserves are counted in US dollars the balance between reserve growth and the current account surplus also meant overall balance in capital inflows and outflows over the whole year. That was in stark contrast to the pre-crisis period when portfolio inflows clearly outweighed outflows. Inward foreign direct investment (FDI) also dropped substantially but has since the crisis remained relatively stable around $30bn. notwithstanding increasingly tighter sanctions. 2018 ended with reserves standing at $468bn. enough to cover more than a year's worth of imports and almost the total of Russia's external debt. So far in 2019, CBR has continued to buy dollars from the market in an endeavor -- one would assume -- to limit any upward pressure on the exchange rate, although the CBR and local economists appear keen to describe this activity in terms of the new fiscal rule to avoid association with currency manipulation. It is notable that when fears rose of further tightening of the US sanctions regime the CBR suspended the «fiscal rule» as of last August before reactivating it at the beginning of the current year.

Policies

Following the oil market collapse in 2014-15, that nearly caused a financial crisis for many global oil producers including Russia, the government has been focused on rebuilding reserves and restore government and banking sector balances.

Government deficit turns into surplus: Since the 2014-15 crisis fiscal policies have been focused on bringing the government budget back into balance at a low oil price of only $40/barrel. Last year that was achieved earlier than many had expected as the oil price rose to more 50% above the budget assumption, That combined with continued expenditure restraint yield a surplus of 1,6% of GDP. The non-oil deficit also declined to less than 7%/GDP in 2018. That was still higher than desired but the lowest in a decade much helped by healthy growth of non-oil tax revenues rising 14%. For the current year the budget surplus is set to decline slightly to 1,4%/GDP under the same oil price assumption. That could prove very conservative, meaning that the budget could once again easily overshoot the target. The slight decline of the estimated budget surplus may surprise after the Duma (National Assembly) last December approved the government's VAT hike to 20% (essential goods only 10%) but a major part of that gain will be allocated to infrastructure program via the newly established RUB 3,5tr. infrastructure fund.

The national wealth fund set to receive new allocations: Much of the 2018 budget surplus was put into the National Wealth Fund which is meant to guarantee future pension liabilities. That was according to the new fiscal rule which demands the government to save any oil revenues higher than budgeted. It is currently worth a total of $70bn. and at the present oil price is expected to grow by another $60bn in 2019 lifting its total assets to 8%/GDP. That is still a modest amount against future demographic challenges. In 2018, the government also approached international capital markets with a well-received euro-issue the proceeds of which was also saved for the most part.. Notwithstanding this borrowing, foreign holdings of government debt appears to have shrunk in 2018 from 30% to 28% of GDP corroborating rumors that the issue was primarily picked up by domestic investors. At the end, government debt rose slightly to 12%/GDP while total debt of other government entities, including local governments, stood at 4%/GDP, leaving total (general) government debt at 16%/GDP – a low ratio by almost any international comparison.

Rising contingent liabilities: Last year the government chose to rescue three private banks despite these not being considered well-managed by peers while being relatively small and hardly systemically important. That action was seen as a precautionary step not to challenge financial stability against the back drop of potentially more disrupting US sanctions. While fending off the immediate threat more such operations could have undesired longer term consequences for the banking system. Experience from other countries suggests that such rescues not related to external events beyond the control of the failing banks often cultivates moral hazard and imprudent risk taking by the banks' management.

Monetary policies poised to stay tight: Since 2017, subsiding inflation has allowed the CBR to cut interest rates by a cumulative 200bsp to 7,75%pa. but in last April it

paused further easing as the sanctions debate in the US heated up again and caused new volatility in the ruble market. A few months later CBR also stopped purchases of excess oil revenues with the effect to ease dollar liquidity in the local money market. Before the end of the year and prompted by incipient price pressure following a 15% depreciation of the exchange rate vis-a-vis US dollars CBR hiked its policy rate back to 7,75% also taking into account the price shock that could follow from the planned VAT hike. The central bank governor, Ms. Elvira Nabiulina, recently explained these policy actions as follows
Domestic demand is expanding at a moderate pace without posing any inflation risks and annual wage growth has also slowed considerably, but oil glut risk in 2019 and VAT hike will contribute between 0,9 and 1,5 pp to inflation. Inflation expectations remain unanchored and in March-April inflation could peak at 6%.[1]

This reinstates the impression of a general tight monetary policy bias although one should be excused to quip that such fine-tuning might also look somewhat excessive and leave markets with mixed guidance. Recent macro-prudential measures focused on retail lending, have also reinforced the tightening bias.

Weaker ruble*:* Since early 2018, the ruble began to weaken against the US dollar and ended the year about 15% lower. That trend has so far reversed direction and in the first six weeks of 2019, the ruble regained a few percent of last year's loss. The central bank apparently keenly monitors the ruble rate quite keenly not least as an indicator of market sentiment while its general monetary policy setting is to allow the ruble to float freely

Structural policies. As noted before, the Russian economy continues to suffer from inadequate infrastructure, excessive regulations, governance and institutional weaknesses and adverse demographic trends. The state's footprint is deep and wide with a 30-35% state share in GDP. .Decisions made at large quasi government corporations and banks can be heavily influenced by political considerations. Government ownership of the economy is estimated at 70% among which 500 SOEs of a total of all 32500 SOEs (state owned enterprises) represents 85% of revenues. Over the years repeated attempts at turning around this trend has so far yielded few results. The state has rather continued to expand, often by default, as when three private banks last year had to be taken over by the government.

A new push? In 2018, the government launched a new push to improve Russia's notorious poor infrastructure. A dedicated program was launched to beef up infrastructure, healthcare and education to the tune of RUB8tr. over six years – about 1%/GDP per year -- with the objective to increase non-oil exports by more than 3% a year till 2025. In order to achieve this, the plan is to raise the share of investment in GDP further by 2pp to 25%/GDP while labor shortages are tackled by lifting the retirement age by 5 years to 60 for women and to 65 for men.

The banking sector – improvements but also set-backs: The authorities continue to clean up the banking sector from its legacy problems with roots in the "free for all" decade of the 1990s. Over the last two years they have closed about 150 small and unviable banks reducing the total number to around 450 down from almost 1000 units only a decade ago. A few more years at such a pace and Russia will find itself with a more rational financial system. That is provided no more banking failures as seen over the last couple of years when three of the largest private banks failed and were subsequently bailed out by the state. That represented a set-back in a double sense. The state was already a major stake holder in the country's banking system and these rescue operations raised its footprint to 65% by assets, up 10pp from end-

[1] Elvira Nabiullina, "Review of recent inflation developments in Russia and economic outlook, Moscow December 14, 2018, BIS central bankers' speeches.

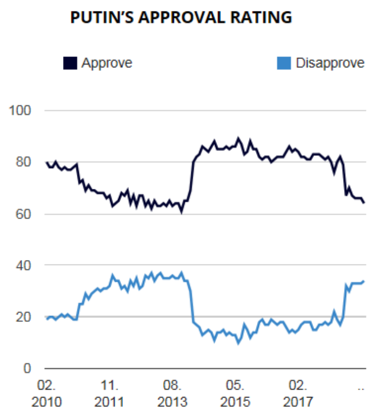
2017. Eventually, the state rescued the financial system from potential financial contagion but at the cost to its structure and 2% of GDP in bail-out money.

Well capitalized but high NPL threatening to grow further: With capitalization at 13% – 5pp above the regulatory minimum – Russian banks are on average well capitalized although by no means over-capitalized. In early 2018, 10,7% of their loan books were regarded non-performing (NPL) up 1pp from 12 months earlier. Of this, two-thirds were reportedly covered by reserves. That may still seem adequate barring any further weakening of loan quality, but in recent years retail lending has expanded fast starting at an annual rate of 17% in 2016. That activity slowed to 11% in early 2018, but was still ways above the rate of inflation at 3%. Against the background of weak wage and salary growth observers have begun to question loan affordability among households. Last year, the annual IMF report on Russia[2] warned that *Accelerating credit growth including unsecured household loans could lead to a build-up of NPLs.* The CBR prudently demanded that banks increase their risk weights for consumer loans and mortgages. Corporates, by contrast, which often gained grossly from the sharp ruble depreciation in 2014-15, have rather used new money from domestic lenders to repay foreign banks and bond holders.

Politics

Russian politics have remained overall stable and predictable over the recent year.

EU and US sanctions against Russia have a history over many years. The recent round started after Russia annexed the Crimea peninsula from the Ukraine in 2014. Last year new US sanctions followed on allegations that Russia had been meddling in the 2016 US Presidential elections and were in particular focused on business interests among the entourage of the Russian president. These were followed by new sanctions last August on allegations that the Russian security services had been involved in the unsuccessful poisoning of a former Russian intelligence officer on UK soil, and were this time directed at Russian state-owned banks and energy companies. The sanctions have created uncertainty among investors and increased volatility on Russian interbank and foreign exchange markets. As a result they have raised funding costs for investors -- as pointed out by the CBR, but so far had less direct effects on trade and investment flows. Last year the Russian sovereign was still able to issue a $4bn loan on international capital markets at a reasonable rate around 5%pa. The issue was almost twice oversubscribed. It repeated the exercise in last November with a 3bn. euro-loan at a yield of 3%pa.



As important for Russian politics in coming months will be the reaction to proposed pension reforms, which have remained more or less unchanged in structure since Soviet times including low retirement ages at 55 years for women and 60 years for men. Such were possible at a time when the country had a younger and growing population. Today the working age population has begun to decline, so far at a relatively modest pace of 0,1% a year, but that will speed up to 0,9%/year from the middle of the next decade. Russia is therefore facing a growing labor shortage that a higher minimum retirement age could ease. That will also support the budget depending on the compensation the government eventually can offer to sweeten the pill. What has been put on the table so far has not been enough to stop country-wide

[2] IMF Article IV country report on Russia, Washington DC, June 2018

demonstrations and apparent simultaneous change in Pr. Putin's approval rating although still at a relatively high 60%+. (Conf. graph on this page from the Levada-Center, Moscow)

Outlook

The outlook for Russia in a short to medium term scenario is reasonably favorable. Moderate but steady growth will continue at least in the 1,5-2% annual range barring an intensification of the US and European sanctions debates and that the oil price stays above the state budget's conservative $40/barrel assumption.

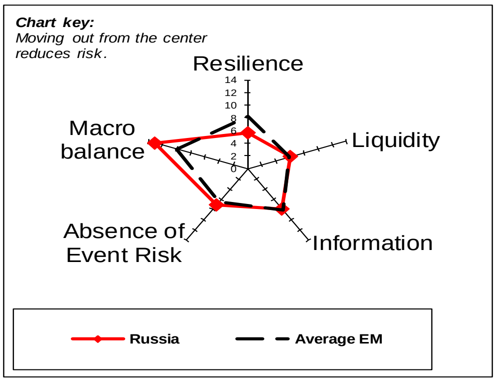
Next year we expect growth to moderate to around 1,5%, barring the discovery of other "forgotten" investment projects. That growth will be spearheaded by real investments, mainly in infrastructure and exports much dependent on the global oil market.

Last year growth ticked in at a higher than expected rate of 2.3%, when a major investment project was included in the national accounts only at end of the year, but it remains to be seen if this was merely a flash in the pan or the beginning of a new growth path. The completion of other construction projects, the Kerch Bridge and the World Cup facilities, would indicate the former alternative, while the government's new infrastructure initiative would support the latter. Most observers pencil in economic expansion for 2019-20 at around 1.5%-2%, i.e. in the upper range of the central bank's 1,2%-1,7% estimate of last December. Under any circumstances that trajectory will be spearheaded by investments and exports. That is in contrast to private consumption that is poised to remain lackluster as households begin to look more critically on recent years' debt accumulation. However, a new intensification of the sanctions debate in the US and Europe combined with a new bout of very low oil prices could disrupt that scenario and send growth approaching the 0-1% range. We regard that as a low probability scenario, but one that cannot be excluded.

For the medium term future into the first years of the next decade, Russia could experience some uptick in economic activity toward its estimated potential annual growth rate of 2-2,5%. That depends on the government's continued adherence to its new fiscal rule as fully implemented in 2018 – i.e. the saving of excess oil revenues in the National Wealth Fund, continuation of a flexible exchange rate policy combined with an underlying steady and reasonably tight monetary policy thereby maintain recent years' success in macroeconomic stabilization. In addition the government should spur private sector to cooperate on revamping Russia's infrastructure and make sure its new fund for this purpose is utilized with speed and efficiency.

Further into the next decade Russia is facing mounting challenges. For one thing; its financial sector may have been stabilized for several years into the 2020s now that the government has proved it can and will save even smaller and not always well managed banks. But at the same time that perception could breed *moral hazard* as bankers are emboldened to take on more risks. Second; from the middle of the decade the wave of elderly entitled to pension rights will grow rapidly and not only deprive the economy of workers, but also threaten the stability of government finances. At that time the equilibrium of the global oil market could be rocked should green technology make further advances and or the opposition to fossil fuels takes on large proportions. Russia has so far cleverly adjusted to lower oil prices, but there are obvious limits to how far that can go.

Key ratios	**2019**
Population (mill)	143,9
GDP growth	2,1%
GDP/capita (US$)	11529
Inflation	4,3%
Curr.Acc.Balance/GDP	7,5%
Reserves/imports (months)	16
Investments/GDP	21,6%
Government debt/GDP	11,8%



External ratings:
Moody's: Ba1/Pos
Fitch: BBB-./Pos
S&P: BBB-

Peers:
Brazil
Hungary
Morocco

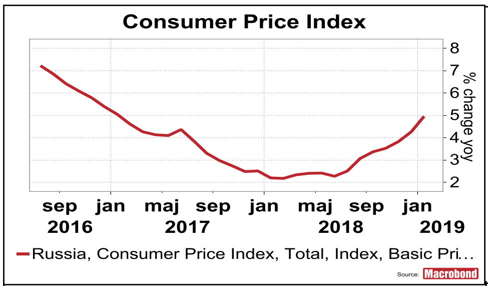
Graph: Compared with the average EM, Russia's risk profile is weaker on *resilience*, at par in terms of liquidity but stronger on *macro balance*. Ongoing hostilities in the war between Ukraine and Russian backed rebels despite a formal truce has raised the *absence of event risk* score to the EM average.

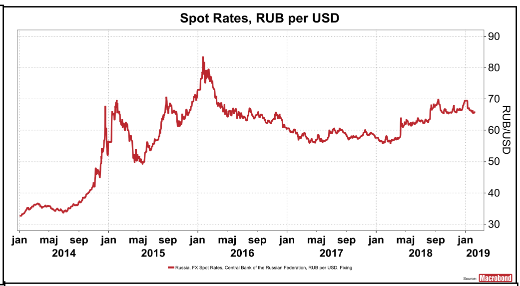
Key data:	2014	2015	2016	2017	2018	2019	2020	2021
GDP (bill.US$)	2080	1373	1296	1578	1608	1659	1740	1821
GDP/capita (US$)	14468	9544	9006	10958	11175	11529	12101	12681
GDP (%chg)	0,7%	-2,5%	-0,2%	1,5%	2,3%	2,1%	2,0%	1,9%
Investments/GDP	23%	21%	21%	22%	22%	22%	21%	21%
Budget balance/GDP	-1,1%	-3,4%	-3,6%	-1,5%	-0,8%	-0,9%	-0,3%	-0,2%
Govt debt/GDP	9%	10%	10%	11%	11%	12%	12%	11%
CPI inflation (% chg)	8%	16%	7%	4%	3%	4%	4%	4%
Money demand (%chg)	6%	7%	11%	10%	9%	-1%	2%	3%
Stock prices Avg.	1430	1685	1930					
Interest rates	10%	14%	11%	9%	7%	7%	7%	7%
Exch. Rate ($)	38	61	67	58	60	61	61	61
Trade/GDP (%)	39%	39%	37%	38%	44%	46%	44%	43%
Oil price (Brent)	$99	$52	$44	$54	$75	$77	$73	$73
Millions US $								
Export of goods	496 806	341 419	281 709	353 547	450 736	481 415	479 351	489 382
Imports of goods	307 875	193 021	191 494	238 126	259 474	273 503	288 559	300 525
Other:	-131 418	-80 621	-65 698	-79 985	-82 600	-84 009	-85 928	-86 874
Current account ($ mill)	**57 513**	**67 777**	**24 517**	**35 437**	**108 662**	**123 903**	**104 864**	**101 983**
(% of GDP)	2,8%	4,9%	1,9%	2,2%	6,8%	7,5%	6,0%	5,6%
FDI	22 031	6 853	32 539	28 684	24 839	29 277	35 702	42 301
Loan repayments	-68 661	-81 731	-51 555	-62 551	-64 496	-63 909	-63 747	-64 015
Net other capital flows	-80 438	-82 570	5 315	16 719	-46 871	-96 391	-71 081	-70 263
Balance of payments	**-69 555**	**-89 670**	**10 816**	**18 288**	**22 134**	**-7 120**	**5 738**	**10 006**
Reserves (avg.of J-D yr)	405 832	316 162	326 978	345 266	367 400	360 280	366 018	376 024
Total debt	682 358	542 253	518 304	524 059	526 167	565 671	586 446	609 554
o/w short term debt	76 570	49 158	49 822	60 191	66 222	84 767	104 261	124 765

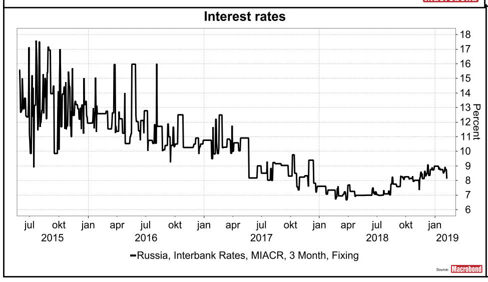
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

Rating history					
Fitch (eoy)	BBB	BBB	BBB-	BBB-	BBB-
Moody's	Baa1	Baa2	Ba1	Ba1	Ba1

Type of government:
Next elections
Other:
Latest PC deal
Latest IMF arrangements







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