Research Report on Russia

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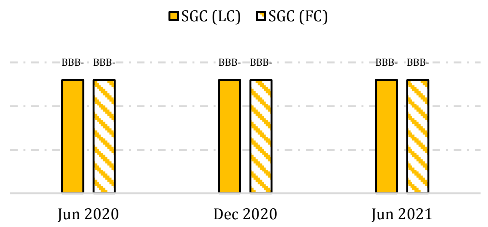
Ratings

Sovereign Government Credit (LC)	BBB-
Sovereign Government Credit (FC)	BBB-
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Russia

Macro indicators	2018	2019	2020
Gross gov. debt, RUB bn	14146	15068	22387
Nominal GDP, RUB bn	103862	109193	106607
Real GDP growth, %	2,8	2,0	-3,1
Gross gov. debt/GDP, %	13,6	13,8	21,0
Deficit (surplus)/GDP, %	2,9	1,9	-4,1
Inflation rate, %	4,3	3,0	4,9
Current Account Balance/GDP, %	-	-	2,2
External debt, USD bn	-	-	467,9

Development indicators	2020
Inequality adj. HDI	0,74
GDP per capita, USD th	27,9

Default indicator	11.06.2021
5-Year CDS spread, Bp	92,6
10Y Gov Bond Yield, %	5,3*

Source: RAEX-Europe calculations based on data from the IMF, WB, Rosstat, CBR, Ministry of finance of the Russian Federation, Ministry of the economic development of the Russian Federation, Cbonds.
* USD-denominated with maturity in 2030.

RAEX-Europe confirmed at 'BBB-' the credit ratings of Russia. The rating outlook is stable.

RAEX-Europe confirmed the sovereign government credit ratings (SGCs) of Russia at 'BBB-' (Moderately high level of creditworthiness of the government) in national currency and at 'BBB-' (Moderately high level of creditworthiness of the government) in foreign currency. The rating outlook is stable which means that in the mid-term perspective there is a high probability of maintaining the rating score.

Summary

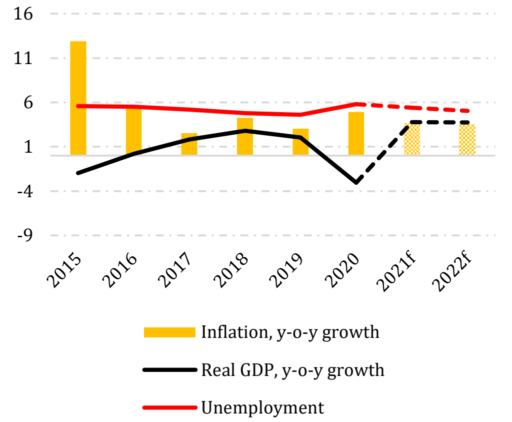
The sovereign credit ratings of Russia were confirmed at 'BBB-' with a stable outlook mainly reflecting the country's resiliency to absorb the shocks caused by the pandemic. The Russian economy contracted in 2021, but the external position remains solid, public finances deteriorated at bearable levels and the banking system remained sound. The Russian government and the CBR implemented policies and programs in order to cushion the pandemic shocks as much as possible. Those efforts have proven adequate so far.

On the other hand, one of the main threats to the creditworthiness of the government is the lingering state of western sanctions and their potential tightening.

Strong economic contraction in 2020, but recovery expected for 2021. Real GDP shrunk by 3,1% y-o-y in 2020 as a result of the negative effects of the pandemic on the economy (see graph 1). The lockdown imposed in the country throughout 2020 had a negative effect on consumer demand, reducing private consumption, as well as on production. In addition, real growth was also affected by a substantial decline of exports resulting from weaker external demand, and from the OPEC-led oil production cuts. However, the contraction was moderate relative to other countries as the government implemented measures to support households and businesses in the wake of the coronavirus crisis.

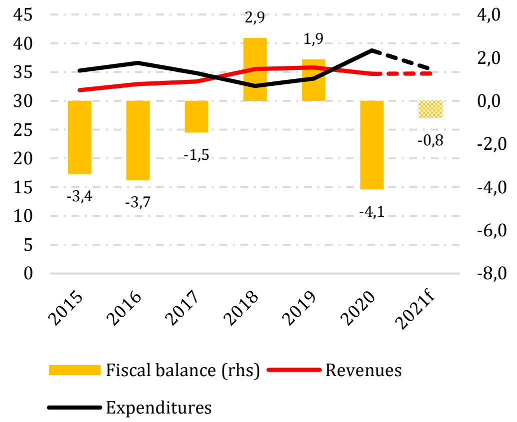
We anticipate a slight recovery in 2021 driven by higher oil prices as well as the slow but steady recovery from the pandemic. Despite this, a tighter monetary policy resulting from high inflationary pressures may slow down credit growth and, thus, investment and consumption. Therefore, we anticipate real GDP to grow at around 3,8% y-o-y by the end of 2021.

Graph 1: Macroeconomic indicators, %



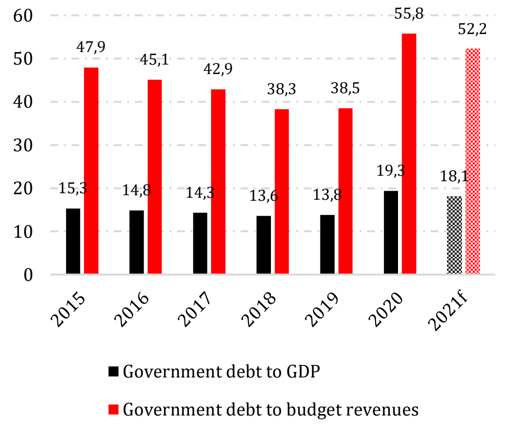
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the IMF and Ministry of finance of the Russian Federation

Graph 3: Government debt dynamics, %



Source: RAEX-Europe calculations based on data from the IMF, CB and Ministry of finance of the Russian Federation

The unemployment rate stood at 5,3% as of April 2021, slightly declining from the level posted in 2020 (see graph 1).

The economic competitiveness of Russia remains average according to the Global Competitiveness Index from the World Economic Forum (Russia ranked at 43rd position out of 141 countries in 2019). Moreover, lingering international sanctions against Russia remain in place with no end in sight, which continues to constrain the creditworthiness of the country. In addition, risks arising from the sanctions have already materialized, as investment has been limited and financial costs for the government have been high. Finally, we believe that the threat of sanctions, from both the U.S. and Europe, remains in place and is highly unpredictable.

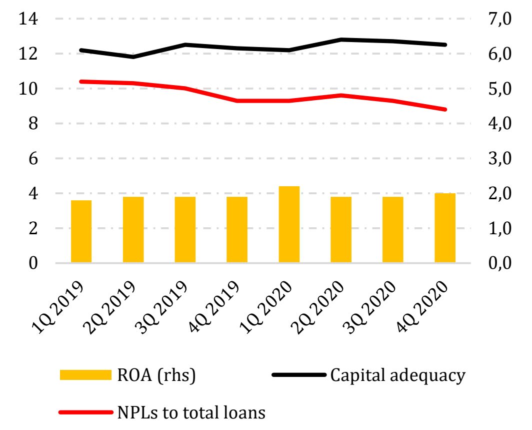
Budget balance turned negative in 2020. As a result of the coronavirus crisis, the budget turned to a deficit of 4,1% in 2020 (see graph 2). This result was mainly due to a combination of higher expenditures in order to support the economy in absorbing the effects of the pandemic, and a decline of revenues due to lower consumption and overall business activity, as well as lower oil production. On the expenditure side, the package of government support included extended unemployment and leave benefits, increased compensation for key medical staff, increase on child benefits, among others. All these measures accounted for around 3,5% of GDP in 2020 and we expect the execution of the same package in 2021 in the amount of around 1,5% of GDP. In regard to revenues, we saw a decline mainly resulting from lower economic activity, as well as subsidies and tax breaks for SMEs in order to cushion pandemic shocks. Moreover, lower oil output also caused revenues to drop.

In 2021, we anticipate the budget to recover and to post a deficit of around 0,8%. This will mainly be a consequence of a lower need of government support towards the economy as conditions improve going forward. However, we expect the authorities to be ready to provide additional capital injections or tax cuts and subsidies, if needed. Moreover, the recovery of the oil price in 2021 will support better performance of public finances. All in all, we still consider the government to have very strong fiscal buffers as funds in the National Wealth Fund (NWF) stood at around 13% of GDP as of April 2021. Finally, we anticipate the government to go back to the fiscal rule in 2022.

Government debt increased slightly but remains bearable. Government debt increased up to 19,3% of GDP and 55,8% of budget revenues in 2020 as a result of RUB depreciation, and nominal GDP contraction (see graph 3). Despite this, the level remains very low relative to emerging market peers. In terms of debt structure, the share of FX liabilities remains low at 19% as of March 2021, which poses low exposure to currency risk. Moreover, the share of short-term liabilities is also low, standing at 3,9% of total debt as of the same date. The main sources of new borrowings remain loans from domestic banks and issuance of local government bonds.

The Central Bank of Russia (CBR) has started to tighten monetary policy. As a result of increasing inflation and inflationary expectations, the CBR started to tighten the monetary policy at the beginning of 2021. After trimming the reference rate by 25 b.p. back in July 2020 down to 4,25%, the regulator decided to increase the metric by 25 b.p. in March 2021, by 50 b.p. in April 2021 and once again by 50 b.p. in June 2021, which led to the current level of 5,5%. The strong tightening of the monetary conditions has been a response to an increase in the inflation rate which stood at 5,8% as of March 2021 and also to increasing inflation expectations from the population. We anticipate the CBR to continue with monetary flexibility to adapt to any changes in inflationary expectations going forward. The inflation rate is forecasted to end 2021 at around 3,7%.

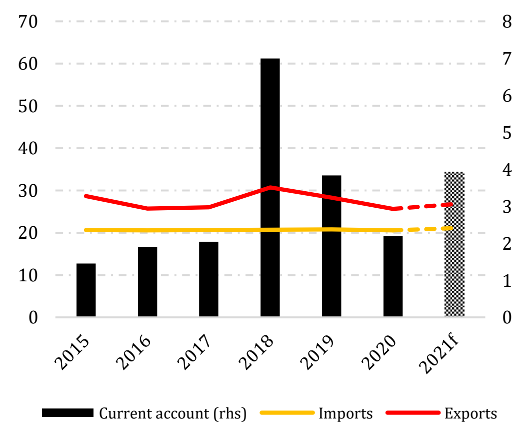
Graph 4: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the CBR.

Banking system remained fairly stable. Bank assets to GDP and private credit to GDP increased at a favorable pace in 2020 and stood at 97,4% and 80,6% respectively. This was mostly propelled by the government subsidized mortgage increase. In addition, financial soundness indicators remained favorable, profitability in the banking sector persists, with ROA and ROE at 2% and 17,5% as of end-2020. Capitalization was also at a comfortable level as the regulatory capital adequacy ratio was 12,5% as of the same date. Finally, NPLs to total loans ratio remained stable at 8,8%, but we expect the reading to increase going forward (see graph 4). Thus, we consider that the deterioration of loans' quality is still a potential risk to the banking system in the medium term, as well as a risk of materialization of contingent liabilities for the government, as SOBs comprise almost 70% of banking sector assets.

Graph 5: External sector indicators, % of GDP

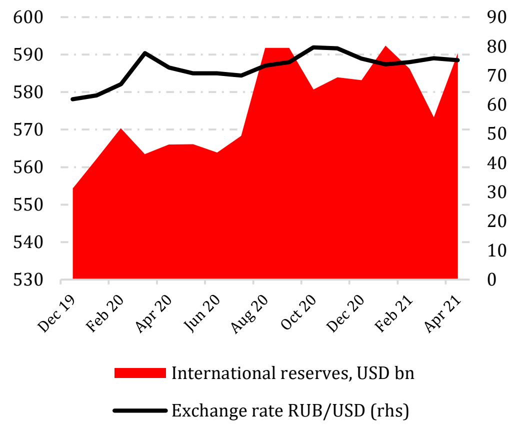


Source: RAEX-Europe calculations based on data from IMF and WB

In order to support the banking system through the pandemic, the CBR implemented regulatory easing and favorable treatment of FX loans in 2020. Moreover, the CBR also let banks delay the creation of reserves for restructured SME loans, while the regulator also introduced a RUB 500 m facility to support the refinancing of SMEs. Also, the contribution to the Deposit Insurance Fund was slashed from 0,15% to 0,1% and new credit risk assessment methods were introduced to propel lending to the economy.

Russia's external position remains solid. The current account balance stood at 2,2% of GDP in 2020 compared to 3,8% of GDP for the same period last year (see graph 5). The major determinant was a significant weakening of the trade surplus, which stood at 5,1% as of end-2020,

Graph 6: International reserves and FX-rate



Source: RAEX-Europe calculations based on data from CBR

caused by a decrease of export commodities due to depressed oil prices and production cuts. However, the drop was not as pronounced due to the strong decline in services imports. Amid volatility in oil markets in the 2Q 2020, the CBR sold foreign currency from reserves as part of the budget rule, which helped to absorb external shocks and stabilize the exchange market. Nevertheless, international reserves have continued to increase and stood at USD 600,9 bn as of May 2021 (see graph 6). This amount covers more than 195% of gross government debt and almost 17,5 months of imports.

Stress factors:

- The high concentration of tax revenues in the oil and gas industry due to the industry's dominance in exports with a 57% share; oil and gas revenues accounted for 20,1% of total consolidated budget revenues in 2020 (moderately weak stress-factor);
- The threat of sanctions risks remains high, with additional sanctions imposed by the U.S. and the EU (moderately strong stress-factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Increase in the oil prices higher than our base scenario to support GDP growth and the external trade position;
- Faster and stronger than initially anticipated recovery from the current economic crisis with higher non-oil GDP growth and improvement of non-oil fiscal balance;
- Relaxation of sanctions regime could be an incentive for the revival of the investment climate and reverse the outflow of the foreign capital.

The following developments could lead to a downgrade:

- Significant deviation from current monetary and fiscal policies, which may lead to macroeconomic instability;
- Weakening of the banking system, which would materialize contingent liabilities of the government;
- Increasing pressure from international sanctions against large state-owned banks and the oil and gas sector, which may lead to materialization of implicit contingent liabilities.

ESG Disclosure:

Inherent factors

- Quality of fiscal policy; quality of monetary policy; natural resources; natural and climatic threats; environmental threats; level of corruption, CPI; Government Effectiveness Index; quality of the business environment; position in Doing Business Ranking; level of investment in human capital, adjusted for inequality; Rule of Law Index; transparency of government policymaking Index; level of information transparency of the government; Political Stability and Absence of Violence/Terrorism Index; natural disasters, constant exposure to difficult natural conditions.

Next scheduled rating publication: 10 December 2021. The full sovereign rating calendar can be found at [Sovereign Rating Calendar 2021]

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
11.12.2020	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
12.06.2020	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
13.12.2019	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Positive	Positive
14.06.2019	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
21.12.2018	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
06.07.2018	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
12.01.2018	Scheduled revision of both types of ratings for the country	BBB-	BBB-	NA	NA
14.07.2017	Scheduled revision of both types of ratings for the country	BBB-	BBB-	NA	NA
20.01.2017	Scheduled revision of both types of ratings for the country	BBB-	BBB-	NA	NA
22.07.2016	Scheduled revision of both types of ratings for the country	BB+	BB+	NA	NA
29.01.2016	First assignment of both types of ratings for the country	BB+	BB+	NA	NA

Minute's summary

The rating committee for Russia was held on 11 June 2021. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: https://raexpert.eu/files/Methodology_Full_Sovereign_V5A_August2020.pdf (from August 2020). Descriptions and definitions of all rating categories can be found under the Rating scale section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

The definition of default can be found on the Agency's website in the section for Internal policies.

These ratings are unsolicited. The rated entity did not participate in the rating process.

Main sources of information: IMF, WB, Central Bank of Russia, Ministry of Finance of the Russian Federation, World Federation of Exchanges, Russian Federal State Statistic Service, International Monetary Fund, World Bank, Trading Economics, World Economic Forum, Doing Business, United Nations, Moscow Stock Exchange (MOEX), Cbonds.

ESG Disclosure

We consider Environmental, Social, and Governance (ESG) risks and opportunities in the creditworthiness analysis of our Sovereign entities. The disclosure document can be found on the Agency's website in the section: ESG factors in RAEX-Europe's Credit Ratings

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Regulatory use

SGC ratings can be used for regulatory purposes according to the ESMA definition.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

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Risk warning

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Office responsible for preparing the rating

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