MOODY'S
INVESTORS SERVICE

Rating Action: Moody's upgrades Russia's rating to Baa3 from Ba1; changes outlook to stable from positive

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New York, February 08, 2019 -- Moody's Investors Service ("Moody's") has today upgraded the Russia, Government of issuer and unsecured senior debt ratings to Baa3 from Ba1 and its other short-term rating to Prime-3 (P-3) from Not Prime (NP). The outlook on its issuer rating has been changed to stable from positive.

The upgrade of Russia's ratings reflects the positive impact of policies enacted in recent years to strengthen Russia's already robust public finance and external metrics and reduce the country's vulnerability to external shocks including fresh sanctions. The stable outlook reflects evenly balanced upside and downside credit risks.

In a related decision, Moody's has raised Russia's country ceilings on foreign currency debt to Baa2/P-2 from Baa3/P-3, its country ceilings on foreign currency bank deposits to Baa3/P-3 from Ba2/NP and its country ceilings for local currency debt and deposits to Baa1 from Baa2. Generally speaking, each of these ceilings indicates the highest possible ratings level that can be assigned to the relevant liabilities.

RATINGS RATIONALE

Recent actions on Russia's credit rating -- to change to a stable outlook in February 2017 and a positive outlook in January 2018 -- reflected effective governance by policy institutions which successfully contained the economic and financial impact of the twin shocks created by the fall in the oil price and the imposition of international sanctions. However, the underlying vulnerability to further external shocks, whether reflecting Russia's ongoing, albeit reduced, exposure to the oil price or still-high geopolitical tensions, slowed a return to investment grade.

The main driver behind today's upgrade of Russia's ratings to Baa3 with a stable outlook is Moody's conclusion that the sovereign's vulnerability to such shocks has indeed materially diminished and no longer constrains the rating to sub-investment grade. More specifically, the impact of likely new sanctions -- which is the most likely source of such a shock in the coming months -- could, in the rating agency's view, be contained without material damage to the country's credit profile.

In Moody's view, there is a reasonably high likelihood of further sanctions being applied by the US Congress in the coming months. Any additional sanctions are likely to include prohibitions on US and US-domiciled entities from buying, and possibly from holding, local- and foreign-currency government bonds and bonds issued by some state-owned banks and non-financial companies. Further sanctions beyond those cannot be ruled out.

However, in Moody's view, the government's capacity to withstand external shocks including further sanctions has improved since the sovereign rating was downgraded to Ba1 in 2015. The ongoing reduction in external vulnerability is reflected in the sovereign's still-strong balance sheet and increasingly robust external position, both of which Moody's expects to be sustained. These strengths are attributable in large part to the authorities' policy response to the terms of trade and sanctions shocks that have negatively impacted the economy since 2014. More recently, the adoption of pension reforms shifts labor force trends in a positive direction and will support fiscal strength over the longer term.

Russia's external finances are more robust than a year ago and in some respects stronger than in 2014 when the external shocks initially struck the country. The central bank's foreign exchange reserves cover 80% of external debt (including direct investment), compared to 57% of external debt in June 2014. Even though capital outflows including net external debt payments rose last year, they were more than covered by the current account surplus, which widened to $115 billion or 7% of GDP, significantly strengthened by higher oil prices and a strong performance from non-oil exports.

A core element in the government's response has been its new fiscal rule, which limits the amount of oil revenues allowed to be spent in the budget and mandates that the excess is saved in foreign currency. Adherence to the fiscal rule last year was one of our criteria for an upgrade: as well as supporting the government's efforts to contain the stock of debt -- at an estimated 15% of GDP -- and replenishing the government's cash reserves that were heavily depleted between 2015 and 2017, continued adherence reflects revealed strengths in its policy apparatus that support the credit.

Fiscal consolidation and shifts in sources of investors in government debt mean that the government's borrowing plans could, if needed, be executed domestically. Uncertainty related to sanctions has already sharply reduced cross-border financing of Russian entities. Non-resident holdings of Russian sovereign domestic debt have dropped by roughly one-third since April 2018, and roughly two-thirds of remaining non-resident holdings are denominated in rubles. Moreover, with the introduction of the fiscal rule and oil prices above the budget's breakeven price, the budget is currently in surplus so the government's net borrowing needs are in any event very small.

Even were sanctions to be expanded beyond primary auctions or beyond sovereign debt holdings, or in the event of other external shocks such as a further fall in the oil price, the fiscal space available to the government and the buffers in place offer considerable capacity to respond without undermining core strengths of the sovereign's credit profile. The central bank's very large FX reserves offer further latitude to support other sectors should that be needed.

RATIONALE FOR CHANGING THE OUTLOOK TO STABLE

The stable outlook on the Baa3 rating captures the balance of Russia's credit strengths against the ongoing pressures exerted by domestic and international sources. Very low public debt, substantial public assets and steadily shrinking national external debt vis-a-vis the country's foreign currency assets provide a significant degree of resilience amidst ongoing structural challenges the country faces. These include slow growth potential, the lack of popular support for structural economic reform and the imminent risk of expanding US sanctions.

WHAT COULD CHANGE THE RATING UP/DOWN

Any further upgrade of Russia's ratings will likely be conditioned in part on further declines in the country's vulnerability to external shocks including through the continued build-up of fiscal space and financial buffers and the avoidance of actions which materially increase geopolitical tensions and therefore the likelihood of shocks. However, a further condition is likely to be the enactment of policies which enhance other aspects of Russia's credit profile including through economic reform to raise productivity and potential growth, and through fiscal reforms to secure the government's finances in the coming years including against demographic shifts.

Russia's ratings could be downgraded if the country's public finance or debt metrics were to deteriorate, such that its capacity to absorb another oil price shock or unexpectedly severe sanctions were materially diminished. A downgrade could also result from a severe and unanticipated external shock, including the imposition of harder-than-expected sanctions that materially impair the government's ability to service and refinance its debt or that undermine Russia's finances or economy in some other way. Also negative would be if the lending capacity of the banking system is impaired such that banks could not provide adequate financing to the government and Russian companies.

GDP per capita (PPP basis, US$): 27,893 (2017 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 1.6% (2017 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2.5% (2017 Actual)

Gen. Gov. Financial Balance/GDP: -1.5% (2017 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 2.1% (2017 Actual) (also known as External Balance)

External debt/GDP: 32.8% (2017 Actual)

Level of economic development: Moderate level of economic resilience

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 05 February 2019, a rating committee was called to discuss the rating of the Russia, Government of. The main points raised during the discussion were: The issuer has become less susceptible to event risks.

The principal methodology used in these ratings was Sovereign Bond Ratings published in November 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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