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Research Update:

Russia Foreign Currency Ratings Lowered To 'BB+/B'; Outlook Negative

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Research Update:

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Overview

- In our view, the Russian Federation's monetary policy flexibility has weakened, as have its economic growth prospects.
- We are therefore lowering our foreign currency sovereign credit ratings on Russia to 'BB+/B' from 'BBB-/A-3' and our local currency sovereign credit ratings to 'BBB-/A-3' from 'BBB/A-2'.
- At the same time, we removed these ratings from CreditWatch, where they were placed with negative implications on Dec. 23, 2014.
- The outlook is negative, reflecting our view that Russia's monetary policy flexibility could diminish further. We could lower the ratings if external and fiscal buffers deteriorate over the next 12 months faster than we currently expect.

As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on the Russian Federation are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Calendar Of 2015 EMEA Sovereign, Regional, And Local Government Rating Publication Dates," published Dec. 30, 2014, on RatingsDirect). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation.

In this case, the reason for the deviation is a significant change in our perception of Russia's monetary flexibility over the 2015-2018 forecast horizon and the effect we expect Russia's weakening economy to have on its financial system. As a result, we have revised downward our expectations on key macroeconomic indicators.

The next rating publication on Russia is scheduled for April 17, 2015, according to our calendar.

Rating Action

On Jan. 26, 2015, Standard & Poor's Ratings Services lowered its long- and short-term foreign currency sovereign credit ratings on the Russian Federation to 'BB+/B' from 'BBB-/A-3'. We also lowered the long- and short-term local currency sovereign credit ratings to 'BBB-/A-3' from 'BBB/A-2'. In addition, we removed these ratings from CreditWatch, where they were placed with negative implications on Dec. 23, 2014. The outlook on the long-term ratings

is negative.

At the same time, we revised the transfer and convertibility (T&C) assessment on Russia to 'BB+' from 'BBB-'. We affirmed the long-term national scale rating on Russia at 'ruAAA'.

Rationale

The downgrade reflects our view that Russia's monetary policy flexibility has become more limited and its economic growth prospects have weakened. We also see a heightened risk that external and fiscal buffers will deteriorate due to rising external pressures and increased government support to the economy.

We believe that Russia's financial system is weakening and therefore limiting the Central Bank of Russia's (CBR's) ability to transmit monetary policy. In our opinion, the CBR faces increasingly difficult monetary policy decisions while also trying to support sustainable GDP growth. These challenges result from the inflationary effects of exchange-rate depreciation and sanctions from the West as well as counter-sanctions imposed by Russia. We project Russia's real GDP per capita growth to average less than economies with comparable levels of per-capita income over our 2015-2018 rating horizon.

In December 2014, the CBR increased its key interest rate by 750 basis points over five days to 17%. This was to stem the sharp depreciation of the ruble and curb inflation. The ruble briefly appreciated against the dollar but has since continued to depreciate, reaching about 66 rubles to the dollar (as of Jan. 26, 2015), compared to about 35 a year ago. The interest rate on interbank loans increased substantially, to well above the key rate--although it has since moderated. We see such movements in financial instrument rates as strong indicators of a weakening monetary transmission mechanism. We expect that credit to the economy will be curtailed, which will likely further undermine growth.

We also understand that during 2014 the Russian public had been converting rubles into foreign currency, thereby fueling depreciation. Given the pass-through of more expensive imports to domestic prices generally, we now expect that inflation will rise above 10% in 2015.

We anticipate that asset quality in the financial system will deteriorate given the weaker ruble; restricted access of key areas of the economy to international capital markets due to sanctions; and economic recession in 2015. Asset quality deterioration may not be immediately apparent in reported figures, however, due to temporary measures introduced by the CBR that allow Russian banks to apply more favorable exchange rates when valuing foreign-currency denominated assets and apply more flexible provisioning policies.

We project that the economy will expand by about 0.5% annually in 2015-2018, below the 2.4% of the previous four years. We see this muted projected growth

partly as a legacy of a secular economic slowdown that had already begun before the recent developments in the Ukraine. It also reflects a lack of external financing due to the introduction of economic sanctions and the sharp decline in oil prices. Ruble depreciation will subdue GDP per capita in dollar terms, which we forecast at \$8,600 in 2015. We also expect that declining domestic purchasing power as a result of exchange rate depreciation and rising inflation will likely hamper Russia's growth prospects.

Balance-of-payment pressures have hit the economy; Russia is experiencing a severe terms-of-trade shock (see "Standard & Poor's Revises Its Crude Oil And Natural Gas Price Assumptions," published Jan. 9, 2015). We nevertheless expect that Russia's current account will remain in surplus over 2015-2018 due to import compression (a consistent drop in import demand).

In our view, balance-of-payment pressures center on the financial account. Private-sector net capital outflows averaged \$57 billion annually during 2009-2013; they increased to \$152 billion in 2014. Stresses could mount for Russian corporations and banks that have foreign currency debt service requirements without a concomitant foreign currency revenue stream.

We estimate Russia's gross external financing requirement for 2015 at close to 85% of current account receipts (CARs) plus usable reserves. We expect that some of this requirement will be accommodated by dollar sales by the CBR, potentially exerting additional downward pressure on CBR reserves. Our figure for CBR usable reserves deducts from the CBR's reported foreign currency reserves:

- Investments made by the CBR on behalf of the government;
- The CBR's foreign currency swaps;
- Funds received under repos with nonresidents; and
- Accounts of domestic banks that are counted as reserves.

By this definition, we forecast that reserve coverage of current account payments will decline to about three months by 2017, from seven months in 2014.

That said, Russia maintains a net external asset position. We expect a narrow net external asset position of about 9% of CARs over the 2015-2018 forecast horizon (liquid external assets held by the public and banking sector minus external debt).

On Nov. 10, 2014, the CBR modified its exchange rate regime. It moved from an operational band--with regular interventions on and outside the borders of the band against a dual currency basket--to a freer float, with foreign currency interventions permissible in case of financial stability threats. This change should afford the CBR greater ability to conserve reserves. Historically, there is usually a strong correlation between the external value of the ruble and oil prices; this has once again been the case over the past 12 months.

To mitigate oil-price vulnerability, in 2013 the government instituted a fiscal rule that caps government spending based on long-term historical oil

prices, while targeting a central government deficit of less than 1% of GDP. This rule is designed to lead to asset accumulation when oil prices are high, and to allow the government to draw on assets when prices are low, thereby reducing the pro-cyclicality of fiscal policy. We expect fiscal policy to significantly loosen as the sharp decline in oil prices, compared to historical prices, allows for higher deficits.

Ruble depreciation supported the government's fiscal position in 2014 because about half its revenues come from hydrocarbons and are priced in U.S. dollars. The U.S. dollar oil price decline of 55% since the start of 2014 was only 10% in ruble terms. As a result, we estimate that the central government posted a small deficit of 0.5% of GDP last year. However, we expect a deterioration in local and regional government balances, which bear the brunt of the government's increased spending on public-sector wages. Overall, we estimate that the general government will post a deficit of 1.3% of GDP in 2014 and an average annual deficit of 2.5% over 2015-2018. Support to the banks through the placement of RUB1 trillion (about 1.4% of GDP) in government bonds was approved in 2014 and is accounted for in government expenditure, though not yet utilized.

We view the modest general government net debt position as a rating strength, as we do its low interest burden as a percentage of revenues. The central government's Reserve Fund and National Wealth Fund, together total about 14% of GDP (although we believe about 1% of GDP of this is invested in non-liquid domestic assets). In our opinion, the central government will progressively use these two funds to increase its support to the economy and the financial system. We understand that RUB500 billion (about 0.7% of GDP) will be taken from the Reserve Fund and put on Ministry of Finance deposit accounts with the domestic banks to improve their liquidity. In our view, this will add to the non-liquid portion of the government's reserve assets, although we understand that at some point in the future these funds could be used for deficit financing.

We view Russia's institutional and governance effectiveness as a rating weakness. Political power is highly centralized with few checks and balances, in our opinion. We do not currently expect that the government will be able to effectively tackle the long-standing structural obstacles (perceived corruption, the weak rule of law, the state's pervasive role in the economy, and the challenging business and investment climate) to stronger economic growth over our 2015-2018 forecast horizon.

Outlook

The negative outlook reflects our view that Russia's monetary policy flexibility could diminish further.

For example, the imposition of exchange controls, if implemented, could further hamper monetary flexibility. We could also lower the ratings if external and fiscal buffers deteriorated at a materially faster pace over the

next 12 months than we currently expect.

We could revise the outlook to stable if Russia's financial stability and economic growth prospects were to improve.

Key Statistics

Table 1

Russian Federation - Selected Indicators												
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Nominal GDP (bil. US\$)	1,300	1,661	1,223	1,525	1,905	2,015	2,079	1,892	1,235	1,346	1,467	1,545
GDP per capita (US\$)	9,102	11,631	8,568	10,671	13,330	14,092	14,509	13,194	8,605	9,376	10,205	10,745
Real GDP growth (%)	8.5	5.2	(7.8)	4.5	4.3	3.4	1.3	0.7	(2.6)	1.9	2.0	1.2
Real GDP per capita growth (%)	8.8	5.2	(7.8)	4.4	4.3	3.3	1.0	0.6	(2.7)	1.8	1.9	1.1
Change in general government debt/GDP (%)	1.7	1.0	2.1	1.4	2.2	1.2	1.5	5.1	1.4	2.1	1.8	2.8
General government balance/GDP (%)	6.8	4.9	(6.3)	(3.4)	1.5	0.4	(1.3)	(1.3)	(3.4)	(2.1)	(2.2)	(2.2)
General government debt/GDP (%)	8.3	7.7	10.2	10.0	10.4	10.7	11.5	15.6	16.7	17.4	18.0	19.7
Net general government debt/GDP (%)	(10.8)	(13.5)	(6.5)	(1.3)	(2.1)	(2.2)	(0.8)	1.1	5.5	7.2	8.7	10.7
General government interest expenditure/revenues (%)	1.3	1.2	1.7	1.6	1.6	1.6	1.8	2.3	3.8	3.7	3.9	4.1
Other dc claims on resident nongovernment sector/GDP (%)	39.3	43.2	47.0	44.6	46.9	50.6	55.8	58.4	64.8	65.3	67.1	69.5
CPI growth (%)	9.0	14.1	11.7	6.9	8.4	5.1	6.8	7.8	13.5	6.5	6.0	6.0
Gross external financing needs/CARs plus usable reserves (%)	67.8	57.2	74.6	65.9	65.5	68.1	74.3	76.6	85.6	93.7	96.1	94.5
Current account balance/GDP (%)	5.6	6.3	4.1	4.4	5.1	3.5	1.6	3.0	1.1	2.6	2.6	2.1
Current account balance/CARs (%)	16.3	17.5	13.2	13.8	15.4	10.9	5.2	8.8	3.1	6.9	6.8	5.7
Narrow net external debt/CARs (%)	(29.2)	(22.6)	(44.5)	(42.9)	(37.9)	(36.7)	(28.5)	(21.2)	(10.0)	(8.3)	(8.6)	(8.2)
Net external liabilities/CARs (%)	33.7	(43.2)	(27.4)	(3.6)	(22.9)	(21.0)	(19.3)	(21.5)	(29.5)	(31.8)	(34.5)	(37.7)

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Russian Federation - Ratings Score Snapshot	
Key rating factors	
Institutional assessment	Weakness
Economic assessment	Weakness
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Strength
Monetary assessment	Neutral

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section VB of Standard & Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Sovereign Rating Methodology, Dec. 23, 2014
- National And Regional Scale Credit Ratings, Sept. 22, 2014
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Emerging Markets Sovereign Rating Trends 2015, Jan. 21, 2015
- Standard & Poor's Revises Its Crude Oil And Natural Gas Price Assumptions, Jan. 9, 2015
- Calendar Of 2015 EMEA Sovereign, Regional, And Local Government Rating Publication Dates, Dec. 30, 2014
- Sovereign Risk Indicators, Dec. 15, 2014 (an interactive version of the Sovereign Risk Indicators can be found at www.spratratings.com/SRI)
- Russia's Economic Risks Will Compound Weak Local And Regional Government Finances, Dec. 14, 2014
- Sovereign Rating And Country T&C Assessment Histories, Dec. 4, 2014
- Sovereign Ratings Score Snapshot, Dec. 4, 2014
- Emerging Markets Sovereign Rating Trends Third Quarter 2014 Update, Oct. 8, 2014
- Risks Mount For A Longer Downturn In Russia, Oct. 8, 2014
- The Fallout Between Russia And The West Puts European Corporates In A Bind, Sept. 18, 2014

- Sanctions Will Increasingly Weigh On Russian Banks' Funding And Liquidity Profiles, Sept. 18, 2014
- Sovereign Defaults And Rating Transition Data, 2013 Update, Sept. 17, 2014
- Understanding Standard & Poor's Russia National Scale Ratings, Sept. 14, 2014
- Banking Industry Country Risk Assessment: Russia, June 17, 2014
- Russia Foreign Currency Ratings Lowered To 'BBB-/A-3' On Risk Of Marked Deterioration In External Financing; Outlook Neg, April 25, 2014
- What Is Threatening Russian Local And Regional Government Ratings, April 23, 2014
- Credit FAQ: What's Behind Standard & Poor's Outlook Revision On Several Russian Corporate GRES? April 10, 2014
- What's Behind Standard & Poor's Outlook Revision On Several Russian Corporate GRES?, April 10, 2014
- Russia-Ukraine: An Unfolding Crisis, March 28, 2014
- Russian Federation Outlook Revised To Negative On Rising Geopolitical And Economic Risks; Ratings Affirmed, March 20, 2014
- Policy Risks, Not Tapering, Are Key To Emerging Market Sovereign Ratings, March 5, 2014
- Outlooks: The Sovereign Credit Weathervane, Year-End 2013 Update, Feb. 4, 2014
- Russian Federation, July 8, 2013
- Change At The Helm Of Russia's Central Bank Has No Effect On The Sovereign Rating, March 13, 2013
- Opening Of Russian Domestic Government Bond Market To Foreign Investors Has No Impact On The Sovereign Rating, Feb. 7, 2013
- Can Russia Drop Its "Spend To Befriend" Fiscal Policy?, Oct. 15, 2012
- Hooked On Oil: Russia's Vulnerability To Oil Prices, March 26, 2012
- Emerging Markets Sovereign Debt Report 2014: Borrowing To Remain Broadly Unchanged This Year, Feb. 17, 2014
- Global Sovereign Credit Trends: Downgrades Are Likely To Outnumber Upgrades Again In 2014, Dec. 17, 2013

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that economic structure and growth and monetary policy flexibility had weakened. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Russian Federation		
Sovereign Credit Rating		
Foreign Currency	BB+/Negative/B	BBB-/Watch Neg/A-3
Local Currency	BBB-/Negative/A-3	BBB/Watch Neg/A-2
Transfer & Convertibility Assessment	BB+	BBB-
Senior Unsecured	BB+	BBB-/Watch Neg
Senior Unsecured	BBB-	BBB/Watch Neg

Ratings Affirmed

Russian Federation	
Russia National Scale	ruAAA/--/--

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