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Research Update:

Russia Foreign Currency Ratings Lowered To 'BBB-/A-3' On Risk Of Marked Deterioration In External Financing; Outlook Neg

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Overview

- In our view, the large capital outflows from Russia in the first quarter of 2014 heighten the risk of a marked deterioration in external financing, either through a significant shift in foreign direct investments or portfolio equity investments. We see this as a risk to Russia's economic growth prospects.
- We are therefore lowering our foreign currency ratings on Russia to 'BBB-/A-3' from 'BBB/A-2', lowering our local-currency long-term rating to 'BBB' from 'BBB+', and affirming our local-currency short-term rating at 'A-2'.
- The outlook on both the foreign and local currency ratings remains negative. If we perceived increased risks to Russia's creditworthiness stemming from much weaker medium-term economic growth or due to reduced monetary policy flexibility, we could lower our sovereign ratings on Russia further. We could also lower our ratings on Russia if tighter sanctions were to result in additional weakening of Russia's net external position.

Rating Action

On April 25, 2014, Standard & Poor's Ratings Services lowered its long- and short-term foreign currency sovereign ratings on the Russian Federation to 'BBB-/A-3' from 'BBB/A-2'. At the same time, the long-term local currency sovereign rating was lowered to 'BBB' from 'BBB+', while the short-term local currency sovereign rating was affirmed at 'A-2'. The outlook on both long-term ratings is negative.

We also revised down the transfer and convertibility (T&C) assessment to 'BBB-' from 'BBB'.

At the same time, we affirmed our 'ruAAA' long-term national scale rating on Russia.

Rationale

On March 20, 2014, we said that we could reassess the risks to Russia's creditworthiness based on its deteriorating external profile. Today's downgrade reflects the risk we perceive of a continuation of the large financial outflows observed in the first quarter of 2014, during which the size of Russia's financial account deficit was almost twice that of the current account surplus.

In our view, the tense geopolitical situation between Russia and Ukraine could see additional significant outflows of both foreign and domestic capital from the Russian economy and hence further undermine already weakening growth prospects.

Over the past decade, current account surpluses in Russia have averaged about 6% of GDP. Nevertheless, Russia's net external position vis-à-vis the rest of the world has been volatile, ranging from a net asset position of about 43% of current account receipts (CARs) in 2008 to a marginal 4% in 2010. This is explained by net outflows of private sector capital, resulting from what we view as a weak business environment. These outflows have averaged $57 billion annually in the five years to 2013, and $51 billion already in the first quarter of 2014 (or $64 billion including foreign currency transactions between Russian banks and the central bank), in our view largely due to the increased geopolitical tensions.

We expect Russia's current account surpluses to disappear by 2015, owing to imports rising faster than exports. We note however, that further ruble weakness could weigh on imports and postpone or even prevent the current account from shifting into deficit. Dependence on commodity exports results in terms-of-trade volatility, although past experience has shown that imports tend to adjust strongly, offsetting part of a commodity price-induced drop in export revenues.

Measured in terms of narrow net external debt, that is, external debt minus liquid external assets held by the public and banking sector, we expect Russia to be in a marginal net asset position by 2017, from a relatively strong net asset position of 23% of CARs in 2014. Although we expect some accumulation of external assets resulting from capital flight, we largely attribute these assets to the nonfinancial private sector. We view these assets as less liquid and do not include them in the calculation of narrow net external debt. We estimate that gross external financing needs (CARs plus short-term external debt by remaining maturity) will amount to about 75% of CARs and usable reserves in 2014-2017.

We estimate Russia's usable foreign exchange reserves at about $450 billion in 2014, sufficient to cover about 70% of total external debt. We adjust headline foreign exchange reserves down to take account of about $30 billion in required reserves for banks' foreign currency deposits, central bank foreign currency swaps, repurchase agreements, and corresponding accounts of resident banks that are counted as reserves. We have also revised our treatment of Russia's international investment position following the Central Bank's application of the sixth edition of the International Monetary Fund's Balance of Payments and International Investment Position Manual.

Economic growth in Russia slowed to 1.3% in 2013, the lowest rate since 1999, excluding the economic contraction in 2009. Under our base case, we expect GDP growth to average 2.3% in 2014-2017, well below the pre-financial-crisis years of 2004-2007, when growth averaged around 8%. We anticipate that real domestic demand growth is likely to remain weak, averaging about 3% over 2014-2017, having averaged about 8% over the earlier strong growth period of 2004-2007. In our view, if geopolitical tensions do not subside in 2014, there is significant downside risk that growth will fall well below 1%.

In our view, the Russian central bank's management of the ruble exchange rate has increased following a change in the parameters that result in an automatic shift in the floating operational band within which the currency is expected to trade. On March 3, the central bank increased the amount of sales or purchases that would automatically result in a shift in the band to $1.5 billion from $350 million. However, we continue to expect the central bank to transition to a floating exchange rate regime by 2015. If political or financial market volatility hinders these plans, and we were to view the transition to a fully flexible exchange rate as having stalled, we could lower the local currency sovereign ratings on Russia and equalize them with our foreign currency sovereign ratings.

At an extraordinary meeting on March 3, 2014, the central bank announced that it was "temporarily" increasing the key interest rate to 7% from 5.5%, aimed at preventing the risks of inflation and financial instability arising from increased financial market volatility. We view the central bank as being confronted with increasingly difficult policy decisions with regard to addressing inflationary pressures resulting from financial market volatility, while at the same time attempting to support sustainable GDP growth.

Over the past several years, fiscal dependency on commodity receipts has intensified. Whereas in 2008 the budget was balanced at an average oil price of about $55, we estimate that the oil price necessary to balance this year's budget would be close to $110.

In 2013, to mitigate this vulnerability, the government instituted a fiscal rule, which caps government spending based on long-term historical oil prices. This fiscal rule is designed to lead to the accumulation of assets in times of high oil prices, and to the drawing on fiscal assets in times of low oil prices, reducing the procyclicality of fiscal policy. As suggested in our March 20, 2014, rating action, in our view, the government's commitment to this fiscal rule will likely be significantly tested by the recent further deterioration in growth prospects.

We estimate Russia's 2013 general government budget will have recorded a deficit of 0.6% of GDP. Based on our expectation that commodity revenues will decline somewhat on the back of a slightly weaker oil price, we think the general government deficit will gradually worsen, reaching 1.5% of GDP by 2016, just outside the level targeted by the current fiscal rule, and implying an average annual change in general government debt of 1.5% of GDP over 2014-2017. We expect the Brent oil price to fall to about $95 by 2015 (see " Standard & Poor's Revises Its Crude Oil And Natural Gas Price Assumptions," published Nov. 20, 2013, on RatingsDirect). We estimate that the Urals oil price has traded at an average discount to Brent of about $1 during the past five years. Nevertheless, low levels of gross debt imply low general government interest payments, at about 2% of revenues during 2014-2017.

In our view, Russia's political institutions remain comparatively weak and political power is highly centralized. Protesters, opposition members, nongovernmental organizations, and liberal members of the political establishment have come under increasing pressure. We do not expect the government to decisively and effectively tackle the long-standing structural obstacles to stronger economic growth over our forecast horizon (2014-2017). These obstacles include high perceived corruption, comparatively weak rule of law, the state's pervasive role in the economy, and a challenging business and investment climate.

Outlook

The negative outlook reflects our view that we could lower our ratings on Russia over the next two years should we assess the risks to Russia's creditworthiness as having increased, based on much weaker economic growth than we currently expect. If we were to view the sovereign's ability to coordinate monetary policy with fiscal and other economic policies to support economic growth as having weakened, it would put downward pressure on the ratings, as would a significant increase in inflation beyond 10% annual growth. We could also lower the ratings if tighter sanctions were to be imposed on Russia and further significantly weaken the country's net external position.

In addition, if we were to perceive that Russia's transition toward a more flexible exchange rate regime had stalled, we could lower the local currency ratings on Russia and equalize them with the foreign currency ratings.

We could revise the outlook to stable if Russia's economy proved resilient to the current challenges, if its external and fiscal buffers remained in line with our current expectations, and we were to view the monetary authority as able to fulfill its mandate of price stability alongside sustainable economic growth.

Key Statistics

Russian Federation Selected Indicators

	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f	2017f
Nominal GDP (US$ bil.)	1,300	1,661	1,223	1,525	1,905	2,017	2,097	2,084	2,155	2,348	2,564
GDP per capita (US$)	9,102	11,631	8,568	10,671	13,330	14,108	14,632	14,532	15,017	16,352	17,841
Real GDP growth (%)	8.5	5.2	(7.8)	4.5	4.3	3.4	1.3	1.2	2.2	2.8	3.0

Russian Federation Selected Indicators (cont.)											
Real GDP per capita growth (%)	8.8	5.2	(7.8)	4.4	4.3	3.4	1.1	1.1	2.1	2.7	2.9
Change in general government debt/GDP (%)	1.7	1.0	2.1	1.4	2.2	1.2	1.1	1.2	1.5	1.8	1.8
General government balance/GDP (%)	6.8	4.9	(6.3)	(3.4)	1.5	0.4	(0.6)	(0.9)	(1.2)	(1.5)	(1.5)
General government debt/GDP (%)	8.0	7.4	9.9	9.7	10.3	10.5	10.8	11.4	12.0	12.8	13.5
Net general government debt/GDP (%)	(11.1)	(13.1)	(6.2)	(1.0)	(1.9)	(2.2)	(1.5)	(0.6)	0.5	1.8	3.1
General government interest expenditure/revenues (%)	1.3	1.2	1.7	1.6	1.6	1.8	1.6	2.0	2.1	2.2	2.3
Other dc claims on resident nongovernment sector/GDP (%)	39.3	43.2	47.0	44.6	46.9	50.5	55.3	57.0	60.5	62.7	64.9
CPI growth (%)	9.0	14.1	11.7	6.9	8.4	5.1	6.8	6.8	5.7	5.5	5.5
Gross external financing needs/CARs +useable reserves (%)	68.4	57.5	55.1	56.3	59.8	62.7	66.4	70.6	76.6	79.2	82.0
Current account balance/GDP (%)	5.5	6.3	4.1	4.4	5.1	3.5	1.6	1.1	(0.2)	(0.8)	(1.4)
Current account balance/CARs (%)	16.1	17.5	13.2	13.8	15.4	10.9	5.0	3.6	(0.8)	(2.8)	(4.9)
Narrow net external debt/CARs (%)	(29.1)	(22.6)	(44.4)	(42.9)	(37.4)	(36.7)	(30.6)	(23.4)	(14.7)	(8.5)	(2.5)
Net external liabilities/CARs (%)	33.6	(43.2)	(27.4)	(3.6)	(22.4)	(23.5)	(26.6)	(28.9)	(26.2)	(20.5)	(15.1)

e--Estimate. f--Forecast. 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. CPI--Consumer Price Index. CARs--Current account receipts.

Related Criteria And Research

Related Criteria

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- 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
- Understanding National Rating Scales, April 14, 2005

Related Research

- Sovereign Defaults And Rating Transition Data, 2013 Update, April 18, 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
- Sovereign Risk Indicators, March 24, 2014. Interactive version available at http://www.spratings.com/sri
- Russian Federation Outlook Revised To Negative On Rising Geopolitical And

Economic Risks; Ratings Affirmed, March 20, 2014
- Standard & Poor's Revises Its Crude Oil And Natural Gas Price Assumptions, Nov. 20, 2013
- Russian Federation, July 8, 2013
- Banking Industry Country Risk Assessment: Russia, May 15, 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
- Policy Risks, Not Tapering, Are Key To Emerging Market Sovereign Ratings. March 5, 2014
- Emerging Markets Sovereign Debt Report 2014: Borrowing To Remain Broadly Unchanged This Year, Feb. 217, 2014
- Global Sovereign Credit Trends: Downgrades Are Likely To Outnumber Upgrades Again In 2014, Dec. 17, 2013
- Outlooks: The Sovereign Credit Weathervane, Year-End 2013 Update, Feb. 4, 2014
- Sovereign Rating And Country T&C Assessment Histories, March 10, 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 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.

Ratings List

Downgraded

	To	From
Russian Federation		
Sovereign Credit Rating		
Long-Term Foreign Currency	BBB-/Negative	BBB/Negative

Short-Term Foreign Currency	--/--/A-3	--/--/A-2
Long-Term Local Currency	BBB/Negative	BBB+/Negative
Senior Unsecured		
Foreign Currency	BBB-	BBB
Senior Unsecured		
Local Currency	BBB	BBB+
Transfer & Convertibility Assessment	BBB-	BBB

Ratings Affirmed

Russian Federation	
Sovereign Credit Rating	
Short-Term Local Currency	--/--/A-2
Russia National Scale	ruAAA/--/--

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