COUNTRY REVIEW

Russia

10 June 2010

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EULER HERMES COUNTRY RISK GRADE: C

Country Risk Grades are on a scale of AA, A, BB, B, C, D

where AA is the lowest and D the highest risk.

Strengths

- Abundant natural resources, in particular oil and gas
- Ample foreign exchange reserves
- Manageable gross external debt burden

Weaknesses

- Political uncertainties (relations with the West; dealing with regional conflicts)
- Far-reaching institutional and economic reforms are still outstanding
- Growing trend of resource nationalism
- Heavy reliance on world market prices of mineral products, in particular oil and gas
- Monetary policy
- Deteriorating fiscal position
- Exchange rate volatility and vulnerability
- High level of short-term private-sector external debt
- Banking sector
- Poor rule of law and high level of legal uncertainty
- Burdensome bureaucracy and endemic corruption
- Insufficient corporate governance

KEY RISKS

- **Refinancing risk (particularly for private-sector banks and companies)**
- **Exchange rate risk**
- **Risks stemming from low/falling commodity prices (including oil)**
- **Banking sector illiquidity**

Country Risk Assessment

Ratings	**Russia**		**Median**	**Peers**		
	Latest	**Previous**	**Grade C**	**Hungary**	**Cameroon**	**Indonesia**
Systemic Political Risk:	**P3+**	**P3+**	**P2-**	**P2+**	**P3-**	**P3+**
Systemic Economic Risk:	**E5**	**E5**	**E5**	**E5**	**E5**	**E5**
ME rating:	ME5	ME5	ME5	ME5	ME4	ME5
Structure	*4.0*	*4.0*	*5.9*	*1.6*	*6.0*	*4.2*
Policy	*6.0*	*6.0*	*5.2*	*5.8*	*4.3*	*4.3*
Solvency	*3.9*	*4.6*	*3.0*	*4.6*	*2.0*	*5.6*
External Liquidity	*2.8*	*3.3*	*4.8*	*6.0*	*2.8*	*4.2*
SBE rating:	SBE5	SBE5	SBE4	SBE2	SBE5	SBE5
COUNTRY GRADE:	**C**	**C**		**C**	**C**	**C**

Nomenclature:
Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Moscow
Population:	141.39 mn (2008)
GDP:	USD 1676780 mn (2008)
Currency:	Russian rouble (RUB)
Form of state:	Federation
Head of government:	President Dmitry MEDVEDEV (since 7 May 2008)
Next elections:	Duma: 2011 / Presidential: March 2012

Major Industries (% of GDP at market prices, 2008)	
Services	55.7%
Industry	38.6%
Construction	9.6%
Agriculture	5.7%

Global Assumptions	2009	2010
Real GDP grth (% yr/yr) *	-3.9	0.9
Inflation (%, av) *	-0.1	1.3
Dated brent (USD/b)	61	80

* Major economies

Main Merchandise Exports (% of total, 2008)	
Mineral products	69.6%
Metals, precious stones	13.3%
Chemicals, rubber	6.5%
Machinery & transport equipment	4.9%

Main Merchandise Imports (% of total, 2008)	
Machinery & transport equipment	52.7%
Food & agricultural products	13.2%
Chemicals, rubber	13.1%
Metals, precious stones	7.3%

Lead Export Markets (% of total exports, 2008)	
Advanced economies	55.7%
Euro zone	39.4%
US	2.9%
Emerging economies	44.3%
Turkey	5.9%

Lead Import Markets (% of total imports, 2008)	
Advanced economies	57.0%
Euro zone	30.9%
US	5.2%
Emerging economies	43.0%
China	13.0%

Basic indicators

Selected economic indicators	2006	2007	2008	2009	2010f
Nominal GDP (USD mn)	989,463	1,294,507	1,676,781	1,363,387	1,583,375
Population (mn)	142.53	141.94	141.39	140.87	140.37
GDP per capita (USD)	6,942	9,120	11,859	9,679	11,280
Real GDP growth (% yr/yr)	7.7	8.1	5.6	-7.9	3.2
Inflation (%, eop)	9.0	11.9	13.3	8.8	6.0
Fiscal balance (% of GDP)	8.3	6.8	4.3	-6.5	-4.5
Current account balance (% of GDP)	9.6	5.9	6.1	3.6	4.5
External debt/GDP (%)	31.7	36.4	28.6	34.6	31.6
External debt/Exports of goods & services (%)	93.6	119.6	91.7	136.7	118.2
Debt-service ratio (%)	20.4	13.9	12.7	22.8	20.4
Foreign exchange reserves (USD mn)	295,277	466,376	410,695	405,825	440,000
Import cover (months)	17.0	19.8	13.4	19.2	17.5
Exchange rate assumption, RUB:USD (av)	27.2	25.6	24.9	31.7	29.9
Exchange rate assumption, RUB:EUR (av)	34.1	35.0	36.4	44.1	37.4
Exchange rate assumption, RUB : USD-EUR basket (av)	30.3	29.8	30.1	37.3	33.3
f: CRU central forecast					

Sources: Central Bank, Statistical Office, IMF, World Bank, ECB, Euler Hermes Economic Studies

Political Stability

The handover of the presidency to Dmitry Medvedev from Vladimir Putin, who took the jobs of the prime minister and leader of the ruling United Russia party, in May 2008 was smooth and has not disrupted policy continuity. Some policy differences between the two leaders have become visible and it has turned out that Medvedev is not just a puppet of Putin as many analysts had speculated initially. However, a destabilising split between the duumvirate appears unlikely. In the near term, the country's leadership continues to face the economic and social problems associated with the global and domestic economic downturns in 2008-2009. Popular discontent at deteriorating economic conditions and the risk of social unrest has increased as reflected in occasional public protest since late 2008. And the popularity of the two leaders appears to have fallen somewhat though it is still high overall.

Relations between Russia and the West cooled to their lowest level in recent history in August 2008, owing to the war with Georgia, the subsequent formal recognition of the independence of the separatist Georgian regions of South Ossetia and Abkhazia, and the continued Russian military presence in those regions. Meanwhile, international relations have improved again, largely thanks to changes in US policy towards Russia under Barack Obama. Domestically, attempts to stabilise the volatile North Caucasus, which is part of Russia, appear to make little if any progress. While separatism in Chechnya seems to be curtailed, violence in other parts of the region, particularly in Ingushetia, has been rising.

Overall, the political system is not at risk but policymaking is sometimes ineffective and regional conflicts tend to dent Russia's international reputation every now and then.

Economic Stability

The economic structure is highly unfavourable. The economy has been heavily dependent on oil prices, capital inflows and external borrowing by banks and companies. Favourable conditions, in particular large windfall oil revenues, have supported a lasting boom in recent years, but also aggravated the narrow economic structure. Non-commodity sectors (in particular manufacturing and agriculture) have suffered from a loss of competitiveness while the economy's dependence on commodities—accounting for 80% of exports and half of government revenues—has increased further, even though the oil and gas sectors have struggled with state-imposed burdens and capacity bottlenecks resulting from insufficient investment over the last decade. The lack of willingness to improve the unfavourable economic structure in good times backfired heavily in H2 2008 and 2009, as the global financial and economic crisis resulted in sharply lower oil prices, capital outflows and banking illiquidity.

Russia has experienced a severe recession as lower oil prices, declining external demand, tighter credit and shrinking consumption have curtailed economic output sharply. Following annual average growth of 7%+ in 2003-2007 and the first three quarters of 2008, real GDP was flat yr/yr in Q4 2008 and contracted sharply by 7.9% in 2009. Industrial production shrank by about 12% yr/yr in 2009. The preliminary estimate of 2.9% yr/yr real GDP growth in **Q1 2010 points to a fairly modest recovery so far**, especially as inventory restocking and base effects supported the outcome. The acceleration of industrial production growth to 10.4% yr/yr in April 2010 from an average 5.1% in Q1 indicates that the recovery will gain momentum in Q2. However, thereafter the economic performance faces several potential downside risks, in particular uncertainties about the oil price trend and weaknesses in the Euro zone which accounts for about 40% of Russian exports. We forecast about 3.2% growth in calendar 2010 and 2.8% in 2011.

Monetary policy has not appeared to be very effective. The Central Bank of Russia (CBR) was unable to curb or unconcerned over excessive private sector credit growth in recent years (it was still at 36% yr/yr at end-2008 and 29% in Q1 2009). The CBR was also unable to control inflation which returned into double digits in October 2007 and reached a recent peak of 14.1% yr/yr in March 2009. Moreover, although the CBR has openly prioritised exchange rate management, it failed to avert the sharp depreciation of the rouble (RUB), the local currency, between August 2008 and February 2009. Having said this, the more recent improvements in inflation, credit growth and the exchange rate are largely results of other factors than central bank policies. Inflation has gradually eased over the past year to 6% yr/yr in April 2010, largely owing to faltering domestic demand, lower import prices and the strengthening of the RUB. The CBR has taken the opportunity and reduced the benchmark refinancing rate 14 times between April 2009 and June 2010, by a total of 525 bps to 7.75%. Lower policy interest rates have also resulted in lower nominal borrowing costs for firms—the average rate on RUB loans to firms fell to 12.8% in Q1 2010 from 16.6% a year earlier—however, real borrowing costs have actually increased as inflation has dropped more. Private sector credit growth has dropped sharply to just 2% yr/yr in Q4 2009. While the rapid decline appears positive from a macroeconomic perspective in the wake of earlier excessive credit growth, it also indicates a current lack of funding and refinancing on the corporate level.

Exchange rate risk has moderated since February 2009 but remains significant. The RUB is traded in a band around a central parity against a currency basket (55% USD and 45% EUR). From early August 2008 to mid-February 2009, despite heavy intervention by the CBR, the RUB depreciated by 38% against the basket, 54% against the USD and 25% against the EUR, largely owing to then rapidly falling oil prices, capital flight and rising risk aversion to emerging markets in general and to Russia in particular. From early November 2008 to mid-January 2009, the CBR enacted 18 mini-devaluations of the RUB against the currency basket (by small widenings of the trading band). Then, it widened the trading band against the basket by 4.3% to 26-41 and announced that this would hold for several months. Thereafter the RUB lost 10% against the basket in a fortnight, quickly testing the new trading floor of 41 in early February. Since then, however, the currency has gradually recovered and stood at around 34.5 against the basket in early June 2010, though it has remained volatile. The recovery of the RUB was significantly supported by anew rising oil prices, the weakening of the USD in H2 2009 and the weakening of the EUR in 2010 to date. That said, downside risks remain considerable, in particular owing to the exchange rate's dependence on oil prices. At current levels of around USD70-75/barrel for Urals Blend, the RUB is likely to remain fairly stable. But should the oil price fall again to USD60/barrel or less, another significant RUB depreciation is possible. It is also noteworthy that the RUB is currently still around 35% down against the USD and 18% against the USD-EUR basket, though just 4% against the EUR as compared to early August 2008. These figures reflect, for instance, that servicing USD-denominated external debt is still much higher than two years ago. Overall, banks and companies continue to face exchange rate risk with respect to both (unhedged) foreign currency-denominated loans and foreign trade credits.

Russia's previously sound fiscal position has rapidly deteriorated. Windfall oil revenues helped to achieve annual fiscal surpluses in 2000-2008 and to reduce total public sector debt (including external liabilities of state-controlled entities) to about 15% of GDP at end-2008. In 2009, shrinking revenues owing to lower oil prices and the recession as well as massive fiscal stimulus to tackle the economic crisis has resulted in a large federal government fiscal deficit of 5.9% of GDP (the general government fiscal deficit is estimated somewhat higher but data are uncertain). In 2010 we forecast a fiscal deficit of 4-5% of GDP. So far the deficit has been financed by drawing on the Reserve Fund—created for this purpose in earlier years of high energy revenues. As a result, the Fund has been depleted by almost USD100bn from USD136bn in March 2009 to USD39bn in May 2010. As this pace of depletion of the Fund would not be sustainable much beyond 2010, the government resumed foreign borrowing in April 2010 for the first time since the 1998 financial crisis and sovereign default. It successfully placed USD5.5bn in five-year and ten-year bonds at yields just 125-135 bps above equivalent US Treasuries. Russia may eventually need to raise more foreign debt in 2011-2012 and may do so earlier as it is uncertain how long the currently still fairly positive investor sentiment towards emerging markets endures. Ultimately much will depend on oil prices and the strength of Russia's economic recovery. However, in the case that external borrowing turns out to be problematic, resources from the National Wealth Fund—in principle dedicated to support Russia's pension system and currently containing about USD86bn—might be used to bridge a fiscal gap. Meanwhile, total public sector debt (including external liabilities of state-controlled entities) is estimated at about 18% of GDP in 2010.

The **current account** surplus narrowed from 6.1% of GDP in 2008 to 3.6% in 2009. Lower oil prices and plunging external demand led to a 34% contraction of exports while falling domestic demand caused a 31% drop of imports. We forecast the current account surplus to widen again to about 4.6% in 2010. Official **foreign exchange (FX) reserves**—which fell by about 37% from a peak of USD582bn in July 2008 to USD367bn in March 2009, mainly owing to accelerating capital flight and central bank attempts to prop up the RUB—have since stabilised and recovered somewhat, to USD419bn at end-May 2010. This is still very high in terms of import cover (17 months) and in relation to external debt payments falling due in the next 12 months (estimated at about USD86bn).

Russia's gross **external debt** stood at 35% of GDP or 137% of export earnings at end-2009. These ratios, which still appear manageable, are forecast to decline slightly in 2010.

Overall, from a macroeconomic perspective, external liquidity and external debt indicators appear moderate.

However, the **refinancing risk associated with maturing external debt**—which became a particular problem for private-sector banks and companies in the wake of the intensified global liquidity tightening in Q4 2008—**remains a concern**, especially for companies as many of them are still overleveraged. And, as mentioned above, real domestic borrowing costs for firms have actually increased and private sector credit growth has sharply dropped since early 2009. Hence Russian companies could still face problems to pay back or refinance maturing external debt and interest payments due, which are estimated at about USD100bn in the next 12 months. An estimated two thirds of the debt due is owed by private-sector companies, the other third is debt of state-controlled banks and firms. In principle, the state has still ample FX reserves, which provides room to bail out weak private firms. However, several strategies to channel money to the companies in need have largely failed in 2008-2009. Hence, there is still a probability that a restructuring of some private-sector debt may be necessary, as an alternative to outright bankruptcy. While smaller banks and firms are more likely to succumb to debt servicing problems in the next year or so, the example of UC Rusal, the world's largest aluminium producer, shows that large companies are not exempt from the refinancing risk. Facing insolvency, UC Rusal had attempted to restructure its total debt of about USD17bn—USD7.4bn of which was foreign debt (in arrears)—since early 2009, but the finalisation of a deal was repeatedly postponed until December 2009.

Structural Business Environment

The structural business environment is well below average, with serious impediments to strong, sustainable growth. The wide range of deficiencies includes extensive and rising government interference in the economy, unpredictable policy actions, an inefficient public administration and excessive bureaucracy, endemic corruption, the role of vested interests and the existence of large oligarchic business conglomerates. Moreover, the lack of an independent and efficient judicial system results in a weak rule of law, making enforcement of regulations, rules and property rights difficult. Many regulatory decisions still appear largely arbitrary and unpredictable and occasionally politically directed. Corporate governance is still inadequate, such that transparency of corporate balance sheets remains a problem.

Risks in the banking sector are also high. The lack of an efficient, well-supervised banking system has long been identified as a constraint on long-term, sustainable growth. The dominant position of the state-owned Sberbank is a major impediment to the development of a competitive banking sector. Most of the other 1,000-odd operative banks—too many for an efficient system—have remained under-capitalised and serve the interests of only one company, which raises doubts about credit risk assessment. Credit risk increased over the past few years owing to excessive private sector credit growth, a large share of which was denominated in FX. In the early stages of the intensified global financial crisis and the domestic economic downturn, the banking system appeared at risk of collapse. In October 2008, a run on deposits of small- and medium-sized banks forced the state to bail out several of them. Meanwhile, several banks have been closed or merged. However, a systemic banking crisis looks unlikely now, especially since the government has set aside resources to recapitalise the three state-owned banks (Sberbank, VTB and VEB) and to support the largest 8-10 private banks. Nevertheless, bank balance sheets remain under considerable strain and profitability continues to erode. The CBR estimates that nonperforming loans (as measured by generally accepted international standards) increased to 13% of total loans by end-2009. Banks will need to increase their provisions for future loan losses which will hamper credit growth and dampen economic recovery. In particular smaller banks will face increasing financial stresses, and more bank failures and considerable consolidation in the banking sector are still to be expected.

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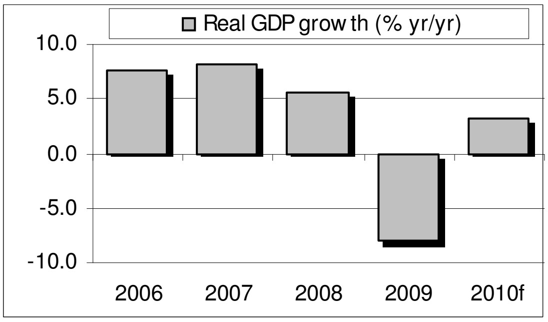
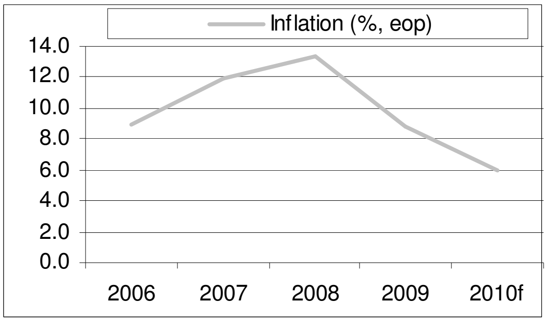
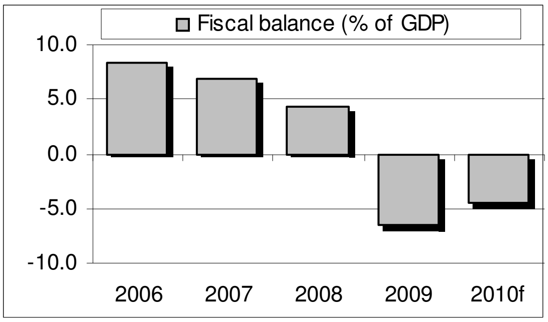
Charts



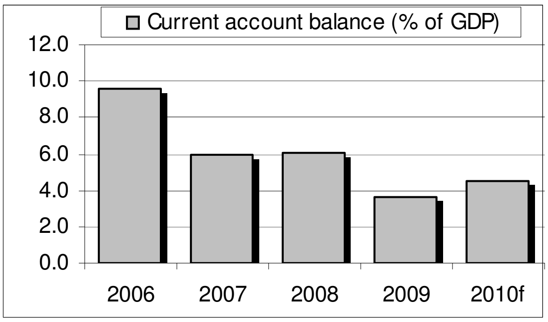
Real GDP growth (% yr/yr)
10.0
5.0
0.0
-5.0
-10.0
2006
2007
2008
2009
2010f



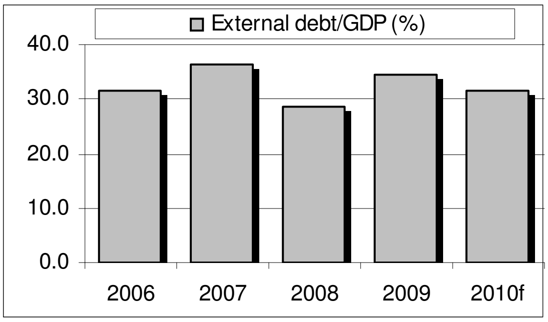
Inflation (%, eop)
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
2006
2007
2008
2009
2010f



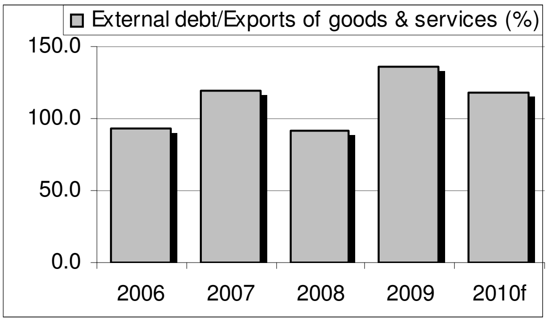
Fiscal balance (% of GDP)
10.0
5.0
0.0
-5.0
-10.0
2006
2007
2008
2009
2010f



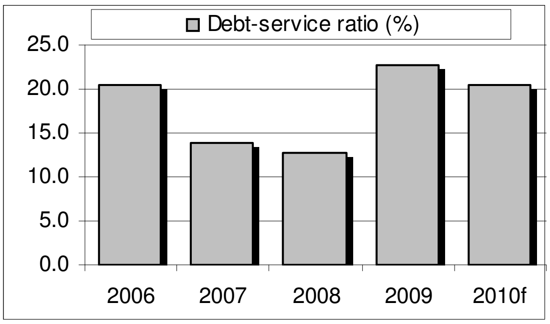
Current account balance (% of GDP)
12.0
10.0
8.0
6.0
4.0
2.0
0.0
2006
2007
2008
2009
2010f



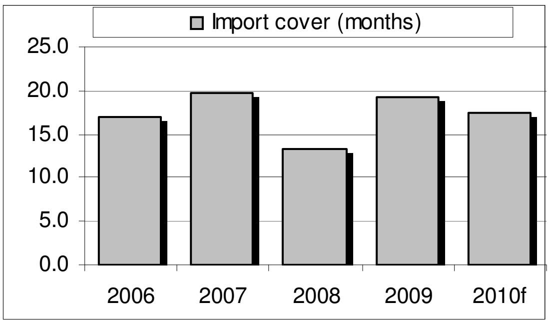
External debt/GDP (%)
40.0
30.0
20.0
10.0
0.0
2006
2007
2008
2009
2010f



External debt/Exports of goods & services (%)
150.0
100.0
50.0
0.0
2006
2007
2008
2009
2010f



Debt-service ratio (%)
25.0
20.0
15.0
10.0
5.0
0.0
2006
2007
2008
2009
2010f



Import cover (months)
25.0
20.0
15.0
10.0
5.0
0.0
2006
2007
2008
2009
2010f