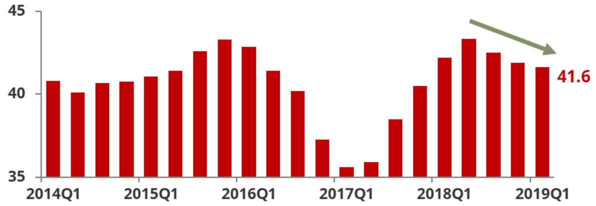
Country Focus – Russia: expect the currency to depreciate in line with future declines in oil prices, but macro resilience remains

Russia has been able to weather the consequences of international sanctions, thanks to the recovery in oil prices during 2017-18, resulting in correct macroeconomic performances and balanced policies and translating into a modestly improving average Economic & Financial Risk Rating. In 2019, our scenario of declining oil prices and slower world growth combines with poorer risk measures for the short-term horizon to suggest stronger pressures on the Ruble (RUB) over the next few quarters. However, a rather sound macro environment, the assumption of a permanent adjustment of the exchange rate to oil prices and large room-to-maneuver on the fiscal policy front point to a solid economic resilience. The key medium-term uncertainties remain therefore related to geopolitical, political and governance issues.

Improvement in Economic & Financial Risk rating aided by favorable oil prices

After a rapid deterioration in Russia's average Economic & Financial Risk rating between 2017Q3 and 2018Q2, a favorable reversal brought the average metric to 41.6-C in 2019Q1. Incorporating our Ratings' traditional 2-year time-lead on actual risk materialization, this suggests more turbulences over the next few quarters. This is confirmed by a higher risk rating for the shorter horizon (44.1 against 40.2 for 3-to-5 years ahead), and fully consistent with our scenario of oil prices declining to 50$/bl by the end of 2019. With Russia's entrenched policy of adjusting the exchange rate to oil price movements, and taking into account the *neutrally valued* exchange rate (at around USD/RUB 66) as well as a higher reading for the Exchange Rate risk, this would point to a potential value above USD/RUB 75 by year-end.

Russia: Economic & Financial Risk Rating History



Russia: Economic & Financial Risk Rating Details

Overall Economic & Financial Risk Rating	41.6-C
By Horizon	
Less than 1 year	44.1-C
1 to 3 years	41.5-C
3 to 5 years	40.2-C
By Type	
Payment	40.0-B
Exchange rate	44.2-C
Activity	41.5-C

Source: TAC ECONOMICS

Recovering economic conditions

Russia's sound macroeconomic fundamentals and recovering global oil prices have provided an appropriate basis for the economic recovery (GDP growth at +1.5% in 2017 and +1.7% in 2018) after two years of recession. This was associated with a booming current account surplus (USD 115bn in 2018). The latter allowed continuing a trend of rebuilding forex reserves (USD 398bn in March 2019, covering 7 months of imports), and lowering external debt (USD 668bn end-2013, around USD 450bn end-2018). Despite the 13% RUB depreciation during 2018, inflation was contained (+5.5% y/y in March, including the impact of a hike in VAT in early 2019), partly resulting from the past monetary tightening (key rate at 7.75%, +50bp during 2018).

Economic resilience affected by geopolitical and governance risks

Beyond the expected depreciation of the currency in line with oil prices during 2019, the past economic improvement, coupled with a very strong fiscal position (government budget surplus estimated at 2.7% of GDP and public debt at 15% of GDP, at the end of 2018) should ensure effective economic resilience.

However, the risk outlook must include larger uncertainties related to the inter-twinned issues of geopolitical strategy (being a permanent trouble-maker as the main instrument of global influence), financial sanctions (renewed round by the US, EU and Canada), and poor governance (Political & Governance Risk Rating at 64-d). This is resulting in declining investors' confidence, translating into large capital outflows (estimated at USD 200bn over the past 5 years, possibly USD 60bn in 2018) and vulnerabilities in the banking sector (failure of three large private banks). Contractual, counterparty and security risks remain therefore substantial.