Atradius
Managing risk, enabling trade

Russia update: economic and industry outlook

Atradius Economic Research and Underwriting - July 2015

Summary

- The economic contraction in 2015 is somewhat milder than expected before as pressure from the oil price and international tensions have slightly receded.
- Concerns in 2014 of an impending balance of payments crisis were overblown. Official reserves continue to decline, but its pace has slowed. Moreover, the relevant liquidity ratios for Russia remain relatively favourable.
- Some improvements in industry performance since early 2015, but most sectors still face tough times ahead.

First signs of the 2015 recession

The Russian economy has entered the long expected recession. The economy contracted 1.9% of GDP in the first quarter of 2015 compared to the first quarter in 2014. This was driven by a fall in consumer spending. The contraction is however less severe than previously expected. As a result the June consensus forecast predicts that Russian economy will contract 3.5% this year, compared to a previous forecast of 4.3% contraction in February. The improvement in the outlook was helped by the successive interest rate cuts by the Central Bank, from 17% in December 2014 to 12.5% in late April this year. As a result, business lending is expected to recover modestly in the second half of 2015. The economy is forecast to expand 0.5% again in 2016.

The rouble has also significantly recovered from its 42% fall against the US dollar at the end of December 2014. The oil price has strengthened and capital outflows have been lower due to a lighter debt repayment schedule and modest reduction in international tensions following the Minsk II agreement. The rouble appreciation, the recession and austerity measures taken by the government to bridle spending will take the pressure off inflation, which fell from 16.9% in March to 15.8% in May. Inflation is forecast to fall to 7% in 2016. The pressure on consumer spending power will therefore be to some extent relieved, supporting the softening of the recession.

Despite this, the recession is forecasted to take its toll on the Russian budget. The Economic Intelligence Unit (EIU), an independent forecaster, predicts a 3.5% deficit in 2015, compared with a forecast of 3.8% by the Russian government. The deficit is intended to be financed by way of the Reserve Fund –one of the two Russian sovereign wealth funds.

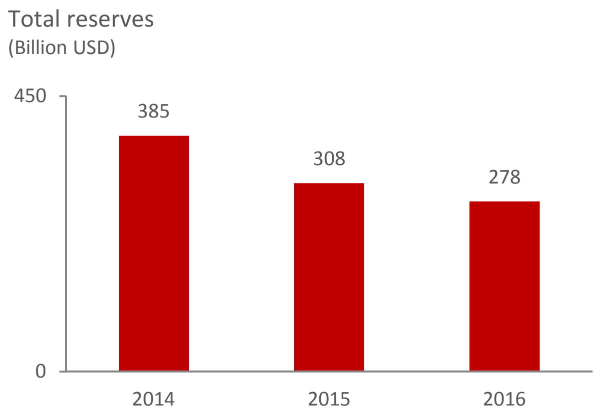
Forecast official reserves 2015-2016

In fact the rapid decline in official reserves in 2014 was a cause of concern with analysts speculating about an impending balance of payment crisis. The depletion of reserves may lead to a classic currency crisis in which a country cannot fulfil its payments in foreign currencies leading to a collapse in flows of international funds. This is potentially devastating for an economy.

But those concerns are proving overblown. In 2014 the total official reserves were USD 385 billion and are forecast to fall to USD 308 billion in 2015 according to the EIU. The latest data already shows a stabilisation of the reserves which were flat around USD 356 billion from March to May this year.

The significant slowing of the decrease in official reserves in 2015 is caused by a forecasted reversal of portfolio investment flows with an USD 28 billion outflow in 2014 expected to change to an USD 20 billion inflow. According to the EIU the reversal of the portfolio investment flows is due to the fact that the Reserve Fund will be drawn down to fund the government deficit and some of the foreign-exchange reserves of the National Wealth Fund are likely to be converted into roubles to fund investment projects. In addition, the government this year has to pay less to service its outstanding debt further reducing the pressure on reserves.

Whilst its pace has slowed, the forecasted decline of the foreign exchange reserves looks realistic. It is largely attributable to the negative capital account which has a USD 62 billion deficit. This suggest that reining in capital outflows, using capital controls, could be an effective policy instrument if official reserves development threatens to run out of control. The imposition of capital controls were discussed during the 2014 Autumn, but the government denies taking such measures. Nevertheless, anecdotal evidence suggests that soft capital controls such as a limit on foreign exchange purchases for banks and firms and 'supervisors' in the trading rooms of banks were indeed put in place.



Source: EIU

With this picture of the official reserves in mind we can proceed calculating the relevant liquidity ratios for Russia. Given that the current account shows a surplus, and the rouble is floating, official reserves are not primarily needed for imports, but rather as a buffer for refinancing external debt. Therefore, rather than considering the usual import cover ratio we consider the ratio's foreign exchange reserves/short term (external) debt and gross external financing requirement/foreign exchange reserves. The import cover ratio is provided for information. The picture that emerges presented in table 2 shows that all ratios are declining, but remain at comfortable levels in relation to the benchmarks which are indicated in the first columns. This means the reserves as well as the liquidity ratios remain at comfortable levels. That conclusion is also supported by the IMF in its latest mission statement.

Table 1 Liquidity ratios

	Critical value	2014	2015	2016
Foreign exchange reserves / short term debt	< 1	4,0	3,3	3,4
Gross external financing requirement / foreign exchange reserves	> 1,25	0,5	0,5	0,3
Import cover ratio in months	<3	10,8	11,6	9,4

Source: EIU, Atradius

Conclusion

The forecasted recession is getting Russia in its grips, albeit that the depth of the recession is somewhat milder than expected, due to a higher oil price and somewhat reduced international tensions. In addition the rapid decrease in official reserves has eased and are forecast to remain at comfortable levels in 2015 and 2016. Just like the relevant liquidity ratios. A classic currency crisis looks far away.

Industry performance:

Some improvements – but still tough times ahead

Since February 2015, the situation of the Russian economy and its main industries has significantly improved. The rouble has significantly stabilised, and the Central Bank has lowered in several steps the base interest rate, from 15% in February 2015 to 11.5% end of June.

While this substantially eases liquidity access for the banking and corporate sectors, refinancing remains a major problem for many Russian companies. Many businesses still face falling sales and profitability, whereas banks reconsider their portfolio approach and keep their interest rates high. The government focuses on supporting the banking system (mainly via major state-owned banks), whereas financing of major investment projects and state monopolies is currently limited.

Despite some stabilization since early 2015, the negative trend in the Russian economy continues – with the most suffering industries being those that are capital intensive, reliant on imports, with high external borrowing and with local investment demand.

In particular, Russian foreign trade is still severely suffering. According to the Russian Federal Customs Service, imports to Russia decreased 37% year-on-year in January and February 2015, while exports declined 26%.

Food and agriculture

Together with the economic downturn and the Rouble depreciation, Russia´s sanctions on imports of food and agricultural products hit the domestic food sector hard, in particular the fish, meat and dairy subsectors. There were quite a few defaults of import and distribution businesses, which were previously focused on supplies of European foods. At the same time, some major Russian agricultural vertically integrated holdings have been growing successfully in the last 12 months, using opportunities that state protection provides and benefitting from the sanctions on EU agricultural imports. The largest domestic grocery retailers have continued their expansion and generally have not been damaged by the sanctions.

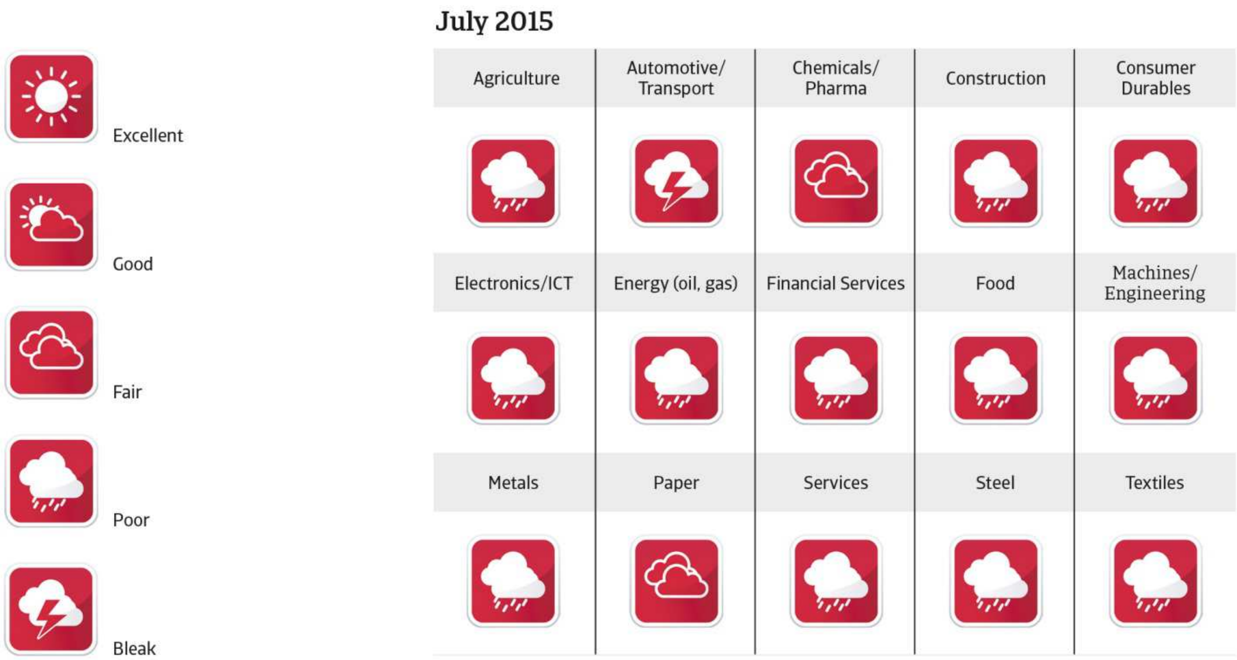
Electronics/ICT and household appliances

These sectors were significantly impacted by the Rouble depreciation. However, major players – retailers and distributors – have been able to overcome the recent market turbulence, with some of them even improving their profitability and market position. On the negative side, the market saw several major insolvencies, and we expect the current consolidation process to continue, mainly at the expense of mid-sized regional players.

Heavy industries and constructions

The combination of decreasing internal and external demand, deteriorating prices, higher currency risk and increasing capital costs has created problems for all market players - even for domestic oil and gas companies. The main concern is still with large, highly indebted businesses in the metals & mining, construction, infrastructure, transportation (especially airlines), machinery production and engineering (including automotive production) sectors. In 2014 insolvencies increased in sectors like metals and construction, and in 2015 a further increase in insolvencies in the heavy industries and construction segments is expected.

Russia industries performance outlook



ANNEX I Official reserves: further remarks

There are a number of technical issues that are relevant to assessing official reserves and liquidity ratios.

First, it is noted by the IIF that Russia is reducing its outstanding debt rapidly. Total foreign debt was at USD 560 billion by the end of Q1 2015, much lower than USD 728 billion at the end of 2013. Of the total foreign debt figure USD 440 billion is denominated in foreign currency. The issue is that international sanctions pose refinancing problems for Russian firms although they are still able to finance themselves as Autumn 2014 data confirm. E.g. 20% to 25% of external debt is held by offshore companies linked to parents in Russia. Moreover there are no formal restrictions on debt issuance to any company for less than 30 days. With USD78 billion due in May – December 2015 and a current roll over rate of 20-25%, USD50 billion should be made available from the official reserves at the Central Bank. This underscores that international sanctions weigh on Russian reserves.

Second, the Central Bank does not manage the full amount of official reserves. An amount of USD 152 billion is managed by the Russian Ministry of Finance in two wealth funds: the National Wealth Fund and the Reserve Fund (in both USD 76 billion assets by the end of April 2015). It has now become clear that the assets in the latter Fund will be used for an amount of USD 55-60 billion to finance the budget deficit. National Wealth Fund assets are intended to help e.g. finance infrastructure, recapitalisation of (the State owned) VEB Bank and major Russian corporates, such as oil producer Rosneft, to refinance maturing debt.

Third, one could consider leaving out the full amounts for the wealth funds and concentrate on the assets at the disposal of the Central Bank, as the IIF does. This approach leaves the foreign exchange reserves at the disposal of the Central Bank at USD 140 billion at the end of 2015. However, we should stress the point that is explicitly made by the IIF that such amount is the amount of foreign exchange reserves at the Central Bank available for intervention purposes, viz. to defend the rouble. That is not what we are after here, as we intent to make an assessment of the repayment capacity of Russia. For that purpose, the amounts available in the Reserve Fund and National Wealth Fund should be included. We therefore consider the comprehensive EIU approach that we have presented in this note, and therefore the calculate decline in reserves, appropriate.

Atradius Credit Insurance N.V.
David Ricardostraat 1 · 1066 JS
P.O. Box 8982 · 1006 JD
Amsterdam
The Netherlands
Telephone: +31 20 553 9111
Fax: +31 20 553 2811

www.atradius.com