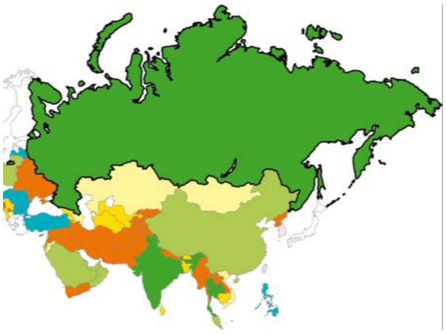
COUNTRY RISK ANALYSIS

Russia

CREATING CONFIDENCE IN YOUR EXPORTS ekn



COUNTRY RISK CATEGORY

3/7

The country risk categories range from 0 to 7. The lower the number the better the credit rating the country has.

0 1 2 3 4 5 6 7

EKN'S OUTSTANDING GUARANTEES IN THE COUNTRY

Short-term transactions: SEK 0.3 billion

Medium and long-term transactions: SEK 13.1 billion

EKN'S POLICY

Sovereign risks: Normal risk assessment

Other public risks: Restrictive risk assessment

Bank risks: Restrictive risk assessment

Corporate risks: Restrictive risk assessment

See “EKN'S POLICY” section

DATE

27/3/2014

Deteriorating outlook

Russia's aggression against Ukraine has had a negative effect on Russia's relations with the world community and financial markets, as well as the country's prospects for growth. The risk of an escalation with severe sanctions creates great uncertainty. This is occurring in a situation where Russia's growth rate has already slowed down and future prospects have grown weaker. The country is characterised by institutional and structural impediments for investments as well as a lack of diversification which make the economy sensitive to falling oil and gas prices. However, the public debt is low, the current account balance is still positive and Russia's international reserves are among the largest in the world. In other words, Russia still has substantial buffers, but the country needs to make structural reforms to turn around the negative trend. With Putin as president, it is highly probable that the country will continue down its established political and economic path instead of managing the long-term challenges. Putin's support is still strong and the opposition is divided. Overall, continuity is expected for domestic policy, but with continuing complicated relations with the world community and worse economic conditions.

STRENGTHS

- Low public and external debt
- Enormous natural resources and financial reserves
- New frameworks for fiscal policy, monetary policy and financial supervision

WEAKNESSES

- Insufficient investments hampering productivity improvements and growth
- Widespread corruption, weak and politicised institutions
- Tense relations with the world community and risk of sanctions

POLITICS

Power remains centralised

During Putin's first period as president, 2000-2008, his authority and popularity were both very strong. Strong economic growth, tougher action against oligarchs, increased influence over the media and centralisation of power contributed to his strong position. However, expressions of dissatisfaction emerged in conjunction with the 2011 and 2012 elections – when Putin regained the presidency after a term as prime minister and his party United Russia retained its own majority in the parliament. The protests have however forced Putin to reconsider his previous strategy, with the result so far mainly being that the freedom of movement for minority groups, civil society and the media has contracted.

Putin's popularity ratings have fluctuated, but he has still remained Russia's most popular politician, with the support of both elite society and a large portion of the population, which have benefited economically under his reign. The opposition has largely been divided between nationalists and communists and there have not been any prominent alternatives to Putin and United Russia. In the crucial Moscow mayoral election in 2013, nationalist opposition politician Navalny did get unexpectedly high support with 27 per cent of the votes. But following a court order, his political future is uncertain and there are not any other strong challengers. The main challenge for Putin is instead expected to be balancing different interests within his own party, not least as economic conditions worsen.

Power in Russia is centralised in Moscow, and Russian politics continues to be characterised by a lack of transparency in the decision-making processes. This means that the country's long-term domestic policy is shrouded in great uncertainty as many issues are handled by spheres of influence behind the scenes of the Russian Parliament. Institutional reforms are taking a long time, as they are unpopular with a large portion of the political and financial elite. Several of the regions, particularly in the North Caucasus, which are calling for an increased degree of autonomy, have instead seen the opposite in terms of development under Putin's rule. Promises of direct elections of regional leaders have not been made good on, and previous attempts to have dialogue with separatists have been replaced by more repressive measures. Conflicts flare up periodically between Moscow and the regions, which is likely to continue to be the case in the future. To date, these conflicts have been dealt with by force. Escalated regional conflicts, including armed ones, are likely to be fought resolutely from Moscow.

Aggression against Ukraine elicits reactions

Russia's relationship with the world community has been complicated for a long time. Especially with respect to the other former Soviet republics, where Russia's geopolitical ambitions and the desire to increase Eurasian cooperation have increasingly left their mark. By making promises of trade agreements, discounted gas prices and economic and military support on the one hand, and trade barriers and threats of cutting back on gas deliveries on the other, Russia has drawn several of its neighbouring countries closer. After Putin was given discretion to deploy troops in Ukraine by the parliament in March 2014 and after Russia took control of the Crimean Peninsula, the stakes have increased and uncertainty in the region has intensified. The aggression against Ukraine, support for the disputed referendum in Crimea and the decision to annex the peninsula has elicited sharp international criticism. Increased geopolitical risks and sanctions from the EU and the US are expected to have an effect on both the political and economic development of the country. Although Putin's popularity has grown stronger during the first weeks following the aggression, the chain of events is aggravating the country's already weak future prospects, and there is therefore a risk of discontent among the population in the long term.

Overall, Russia has developed in a more repressive direction, while its conduct in its immediate surroundings has increased political risks. The centralised power under Putin will probably result in stable development in the medium term, but at the cost of political openness, local influence and badly needed institutional and structural reforms.

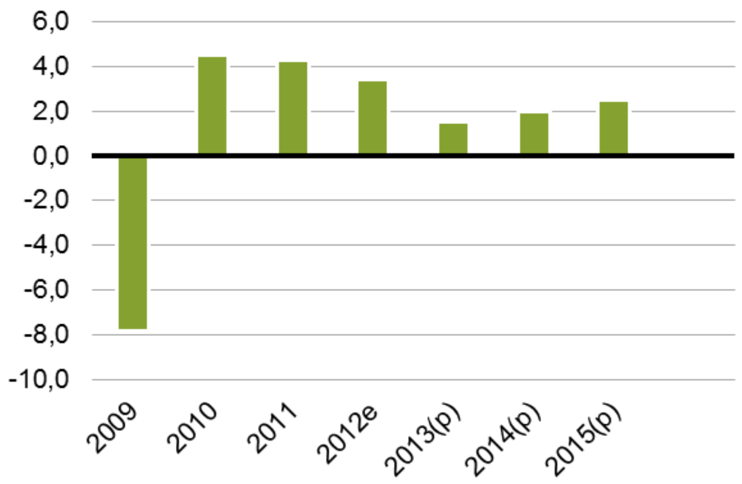
ECONOMY

Structural growth impediments and increased uncertainty

The Russian intervention in Crimea is expected to have negative effects on the Russian economy, which already had weak future prospects. Although the economy has recovered since the financial crisis, growth has not gotten back to the rapid rate between 1999 and 2008 which was boosted by rising oil prices, increased capacity utilisation and rapidly increasing private consumption. The expected growth rate declined significantly in 2013. Although the strict fiscal position, the weak trend of the world economy and the negative demographic trend may have a certain effect, the political leadership's lacking ability to manage Russia's structural deficiencies is what is starting to make an impact. One sign of this is that growth is weak in spite of there being low unemployment and inflationary pressure of 6 per cent.

There are several structural causes. As a result of the weak business climate and the uncertain regulatory environment, investment levels are low in proportion to the capital-intensive industry's extensive needs for modernisation. The industrial structure is largely obsolete and the state's intervention into the economy is often harmful to competition. Attempts at economic diversification have often been misguided and have failed to reduce Russia's dependence on the oil and gas sector, which accounts for two thirds of its exports and over half of federal revenues. Stagnating oil production, declining oil prices and worse competitiveness in other areas of the economy accentuate these deficiencies. It is estimated that the growth rate in 2013 was only 1.3 per cent. Before the aggression against Ukraine, a gradual recovery to a long-term growth rate of 2.5 per cent was expected. The reigning uncertainty, with a risk of additional sanctions, financial turbulence and reduced investments, makes substantial downward adjustments probable.

GDP GROWTH (%)



Growth has slowed down following the economic recovery. Continuing downward adjustments of the forecasts are expected.

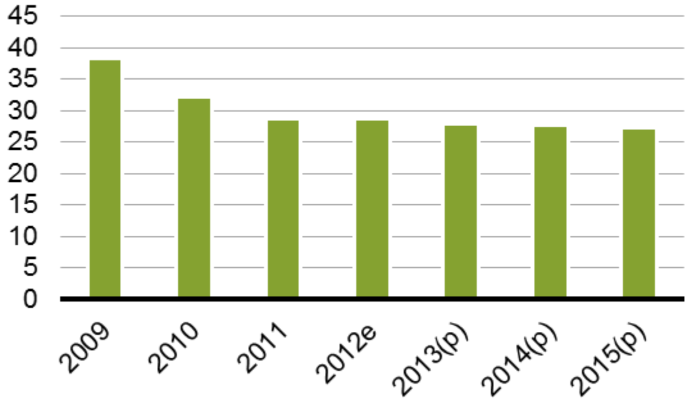
Revenue from the oil and gas sector has contributed to Russia's strong public finances, with low debt and considerable fiscal buffers. Reductions in revenue going forward are however weakening public finances. This means that the price of oil needed to balance the budget has risen from around 50 dollars to 110 dollars between 2008 and 2013. Consequently, this increases the vulnerability of the country to a possible decline in the price of oil. In the event of a new recession, the state will have less scope for fiscal stimulus than it had in 2008. A fiscal regulatory system was introduced in 2013 to manage this risk. The regulatory system limits public expenditure in proportion to historical oil prices and the surplus is invested in reserve funds. If the government succeeds in staying within the frameworks of this regulatory system, continuing fiscal restraint is expected in the coming years, and more stable public finances in the long term. Given Russia's institutional weaknesses and its weak future prospects, the probability of deviations is high.

BALANCE OF PAYMENTS AND DEBT ISSUES

Large international reserves but falling current account surplus

Russia's external balance is generally good. However, its external debt has increased more than expected. Since the IMF's forecast in August 2013, the forecast debt level has been adjusted up by 10 percentage points to around 40 per cent of GDP. The majority of it is private sector debt. Given that the rouble has fallen by 15-20 per cent between March 2013 and 2014, the debt may cause problems on the corporate and bank level, but the debt level is estimated to be manageable for the economy as a whole. Russia's international reserves are among the largest in the world and are equivalent to around ten months of import coverage.

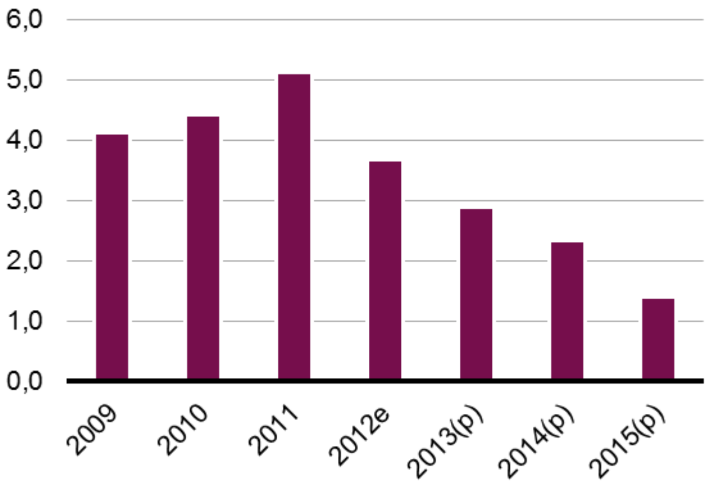
EXTERNAL DEBT (% OF GDP)



Since the IMF's forecast in August 2013, data has emerged showing that Russia's external debt is increasing.

Oil production has gradually increased since the fall of the Soviet Union and oil and gas revenues make up nearly two thirds of Russia's exports. In spite of volatile commodity prices, Russia has had a current account surplus since 1999. The surplus is however falling and is expected to transform into a current account deficit in a couple of years. This is mainly due to service imports increasing, primarily in the form of an increased outflow through the Russians' extensive traveling. The expectation is that travel will remain a significant factor in the future as the emerging middle class gladly spend money on holidays abroad. In addition, the trade balance is being weakened, as goods imports are increasing faster than exports.

CURRENT ACCOUNT BALANCE (% OF GDP)



The current account surplus is shrinking and has been revised downwards additionally since the IMF's forecast in August 2013.

Extensive capital outflows

Capital outflows from Russia have been substantial for a long time. They are seen as a sign of tax evasion as well as a weak investment climate and a lack of confidence in local institutions. Although foreign direct investment in Russia has increased, it is overshadowed by Russian investments abroad. The majority of the incoming FDI comes from offshore centres, where many Russian companies are based for tax reasons, and thus is probably made up of Russian reinvestment. During the entire period from 2000 to 2009, net outflows have been covered by extensive current account surpluses, except for an exceptional outflow during the crisis year of 2008. 2013 marked a trend shift, when the capital outflow of 63 billion dollars was more extensive than the current account surplus. This outflow accelerated after the US central bank's announcements of a return to a more normalized monetary policy.

Past expectations of a reduction in capital outflow have been put to shame after the military aggression in Crimea. The financial markets have initially had strong reactions, with falling stock markets, currency depreciation and capital outflows. According to early forecasts, it is probable that capital outflows in the first quarter of 2014 exceeded flows for the whole year in 2013. No turnaround is expected as long as the political uncertainty and threats of expanded sanctions remain. However, in the medium term, it is estimated that capital outflows will be manageable thanks to the international reserves buffer.

Overall, the weakening of the current account balance and the outflow of capital will result in Russia's external position deteriorating. The country's strong starting position is in jeopardy of being undermined if sanctions are expanded substantially.

CURRENCY POLICY

New currency policy tested by depreciation pressure

Since the 2008-2009 financial crisis, when the rouble initially fell against the dollar by 50 per cent, the central bank has changed its focus from exchange rate stability to inflation targeting. This shift is occurring gradually with the objective of the inflation target being the monetary policy anchor from 2015. It has been expected that the central bank will continue to pursue a strict monetary policy to show its relative political independence and boost confidence in its new framework. The initiative, which also involves a more flexible exchange rate, has, at least through 2013, helped to reduce inflation and improve economic stability. The central bank still intervenes to reduce exchange rate fluctuations, but without a target rate for the rouble. Instead, the exchange rate is allowed to fluctuate within a range, which is adjusted gradually. During the past years, the currency has been allowed to get both stronger and weaker in response to, for example, changes in the price of oil. This has both boosted credibility for the new currency policy and softened the effects of price changes on the real economy.

The pressure on the Russian rouble, which emerged after the US central bank announced a reduction in quantitative easing and which intensified after the Russian intervention in Crimea, has however put the new currency policy direction to the test. Between March 2013 and 2014, the rouble fell 15-20 per cent in value, in spite of considerable interventions by the central bank. In March 2014 alone, it is reported that the central bank spent 20 billion dollars to defend the currency. In addition, the interest rate has been increased substantially for the purpose of reducing depreciation and increasing financial stability. Continuing instability will likely result in a delay in the transition to the new monetary framework. Fears that capital controls will be instituted have grown in 2014. Authorities such as the central bank have rejected capital controls and they are not estimated to be the most likely scenario, but cannot be ruled out. The currency has had a high degree of convertibility for several years and can be assessed by EKN in local currency transactions.

FINANCIAL SECTOR

Banking sector dominated by state banks

The Russian banking system includes over 900 banks, but is dominated by a few large state-owned banks and some prominent privately owned banks. The banks' assets have grown rapidly and are equal to 80 per cent of GDP. Lending without collateral in particular has experienced rapid growth. Combined with the country's weaker economic development, the rapid growth in credit contributes to the expectation that the supply quality will get worse. Due to narrow and shallow capital markets, one fifth of lending is in foreign currency, which creates an additional risk factor. The proportion of bad loans in the entire banking sector has gone down since the financial crisis and is currently at just over six per cent. Meanwhile, official data shows that provisions just about cover the bad loans in full. The figures are probably not completely accurate as loans to households and companies who cannot pay are often renegotiated. With an increasing proportion of bad loans, provisions will need to be increased. Profitability and capitalisation, which are already at a low level, are also expected to be negatively affected. The risk scenario is more favourable for state-owned banks or banks with strong foreign parent banks, as these banks can usually count on support from the state or their owners. State support for private banks is more unpredictable and can generally not be counted on. The central bank is working on compiling a list of systematically important banks, for which it is probable that both regulations and the probability of support will be bolstered.

Risks related to weak transparency, unsatisfactory regulation and supervision, and related company lending have long been typical of the Russian banking system. They draw attention on a regular basis, such as in 2011 when financial problems were revealed at the Bank of Moscow, the country's fifth largest bank, necessitating a government bailout. The problems in the sector largely remain, but since the Russian central bank took over the role of regulatory authority in 2013, regulation and supervision have been tightened. Stricter capital adequacy and provision requirements are among other regulations expected in the coming year. Thus far, over 30 banks have lost their licences – most of them were relatively small and located outside of Moscow. Given the large number of banks and their considerably varying quality, continuing closures and consolidations are to be expected, not least among smaller, regional banks. In the long term, it is estimated that this will benefit the banking sector, but there is a risk of reduced liquidity on the interbank market and individual companies being impacted.

US and European sanctions as a result of Russia's aggression against Ukraine have primarily targeted individuals initially. However, as of 23 March, a bank, Bank Rossiya, has been included on the US sanctions list due to connections to senior Russian officials. There is a risk that more banks will be subject to sanctions. In addition to the direct effects of these measures, the risk of sanctions also increases uncertainty and complicates access to financing abroad.

BUSINESS ENVIRONMENT

Unpredictable regulatory environment

Russia is a problematic country for lenders and investors. The business climate is hampered by extensive bureaucratic impediments, an unpredictable regulatory environment and weak institutional capacity. In addition, there are major corruption problems and a weak and partisan legal system. Russia is ranked number 127 out of 176 in Transparency International's corruption index. It is far behind comparable emerging countries such as Brazil, India, China and South Africa, which are ranked between 72 and 94. Russia has been working on improving its position in the World Bank's Doing Business rankings for a couple of years. Thus far, the country has advanced to 92nd place out of 189 places by reducing bureaucracy to a certain degree. There are however no signs of deeper, structural improvements, and the business climate is therefore expected to remain difficult.

The transparency of the financial status and ownership of companies is poor and groups of companies are often complex. Pursuing court cases and bankruptcy proceedings can be unpredictable and time consuming, especially outside of Moscow. Investor protection is generally weak. Regulatory changes are commonplace and generate uncertainty for businesses. Local knowledge and quick action in the face of payment problems are therefore important factors.

Weak public and political institutions are generating uncertainty in terms of the ability and willingness of public buyers to pay. Russia consists of a variety of regional and local entities and the allocation of accountability between them and the federation is often unclear. Some regional and local entities have credit ratings and should therefore be regarded as relatively transparent.

EKN'S EXPOSURE

Large exposure in the telecom sector dominates

Russia is Sweden's fourth largest export market outside the EU and exports to Russia account for around two per cent of Sweden's total exports. The majority of the exports consist of vehicles, machines and telecom equipment. There is major potential for substantial exports to the commodities sector, infrastructure, agriculture and food production.

EKN OFFERS AND GUARANTEES TO RUSSIA (AT DECEMBER 31)

Strong and steady increase in EKN's exposure.

EKN's outstanding guarantees to Russia were about SEK 13.5 billion. This makes Russia one of the largest countries in EKN's portfolio. Most of the guarantees are in the telecom sector. There is also significant exposure in the power sector and the paper/pulp industry. The largest flow in terms of number of transactions is in the transport sector and the construction industry.

PAYMENT EXPERIENCE

Mixed experience

EKN's experience guaranteeing transactions to Russia is generally good, but there are exceptions. Late payments are not uncommon, especially in SME export transactions with Russian customers. The considerable effect of the financial crisis on the Russian economy has triggered payment problems in certain industries sensitive to the economic climate, especially the transport sector. The problems have led to delays, rescheduled payment plans and, in some cases, indemnifications. Equipment has also been repossessed. EKN's experience of indemnification and recovery processes in the country is ambiguous, but, overall, the impression is that it is satisfactory. Over the 2010-2013 period, EKN had indemnification payments amounting to SEK 136 million.

EKN'S POLICY

Increased restrictions

EKN has classified Russia in country risk category three since 2007, an assessment undertaken in collaboration with the OECD. However, as a result of the financial crisis, Russia was classified in country risk category four by the OECD in 2009/2010. EKN opted at that time to differ from the OECD classification and keep the country in country risk category three.

Some form of restriction is in place for all buyer categories in except sovereign risks. A guarantee from the ministry of finance or a bank may be required for other public buyers, such as ministries or government agencies. For companies and banks, the policy means that EKN, in addition to assessing the risk on its own merit, has adopted a more restrictive approach from the beginning. EKN prefers that any transaction is fully transparent and there are buffers in place, particularly in foreign currency, at the company or bank. The financial turbulence and the country's weakened prospects have led to the introduction of additional restrictions in March 2014.

SOURCES FOR THE GRAPHS: IMF, EKN's own assessments

COUNTRY RISK ANALYSIS **Russia**	DATE 27/3/2014	CREATING CONFIDENCE IN YOUR EXPORTS ekn

OFFICIAL COUNTRY DATA AND CREDIT RATINGS

OFFICIAL COUNTRY DATA

Area: 17,075,400 km² (38 times Sweden)

Population: 143.5 million (2012)

Population growth: 0.4% (2012)

GDP: USD 2,015 billion in 2012 (Sweden USD 524 billion in 2012)

GDP/capita: USD 14,037 in 2012 (Sweden USD 55,041 in 2012)

CREDIT RATINGS

	COUNTRY CEILING	SOVEREIGN RATING
Moody's:	A2	Baa1/Stable
S&P:	BBB	BBB/Negative
Fitch:	BBB+	BBB/Negative

COUNTRY ANALYST

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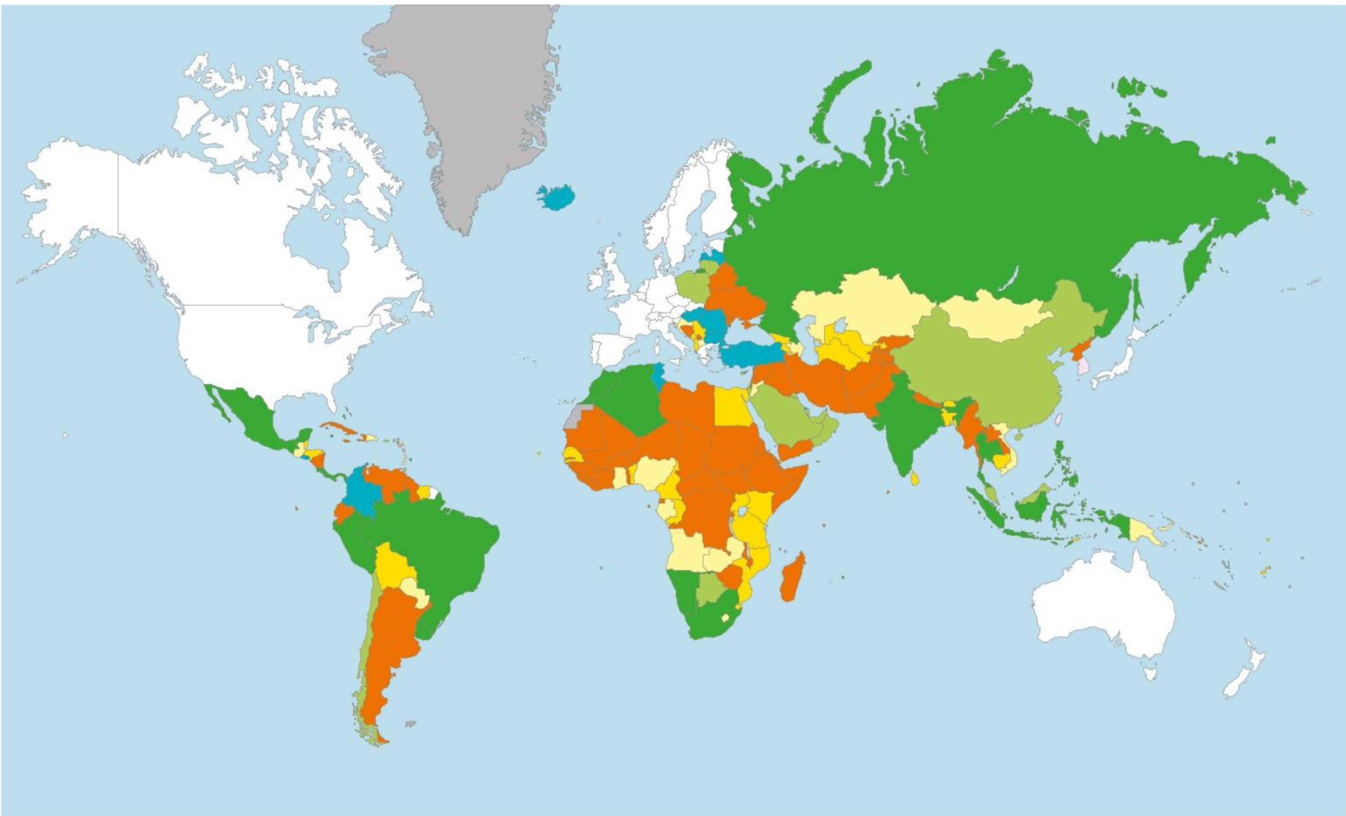
DISCLAIMER

The country analysis is based on a range of sources and reflects information that is relevant to EKN at the time of publication. The responsibility for how the information is used or interpreted rests solely with the user, and EKN cannot be held responsible for any loss or damage.

EKN'S VIEW OF THE WORLD



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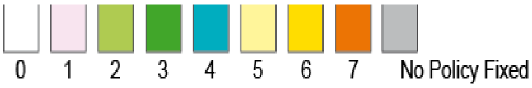

EKN – CREATING CONFIDENCE IN YOUR EXPORTS

EKN is a government agency that supports Swedish exports and the internationalisation of Swedish industry. This we do by offering exporting companies and banks guarantees for payment and financing, together with advice on business structure and risk management. Our services provide an extra level of confidence, increased competitiveness and more opportunities for successful export transactions.

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