Special Russia

Raiffeisen RESEARCH

12 March 2014

Crimea Stand-off and the threat of sanctions: Impact on Russia

- **Russia exposed to potential sanctions via EU trade and substantial global financial integration**
- **Already threat of sanctions to increase uncertainty, capital outflows, dampen FDI and slow down economy**
- **Main scenario of moderate sanctions; full-fledged trade and financial sanctions less likely**
- **GDP forecast in 2014 cut from 1.7% to 1.0% on weak economy and current events; temporary 5-10% RUB depreciation**

Content

Wrap-up of the conflict	1
Key impact factors	1
Exposure of Russia by trade	2
Focus on: Feasibility of EU trade sanctions on oil and gas	3
Focus on: Comparing EU and US economic relations with Russia to other BRIC economies	4
Financial market integration and capital flows	5
Focus on: The impact of the Ukraine crisis on the Russian banking sector	6
Impact on the economy and outlook	7
Monetary policy and rouble outlook	8
Extreme cases: Full scale sanctions	9

Financial analysts
Gunter Deuber
gunter.deuber@raiffeisenresearch.at
Elena Romanova
elena.romanova@raiffeisenresearch.at
Andreas Schwabe, CFA
andreas.schwabe@raiffeisenresearch.at

Maria Pomelnikova
maria.pomelnikova@raiffeisen.ru
ZAO Raiffeisenbank, Moscow

Wrap-up of the conflict

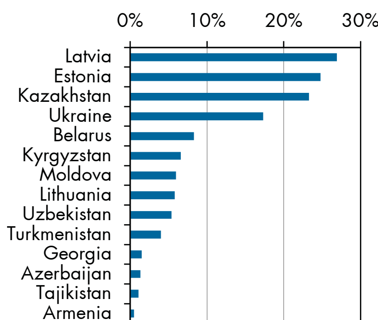
Only weeks after the Viktor Yanukovych was toppled by protesters in Kiev and fled the city, the events in Ukraine escalated into the harshest political clash between the West (i.e. USA and the EU) and Russia since the end of the cold war 25 years ago. Russia so far strongly opposes and does not recognize the new provisional government in Kiev, while the West, on the contrary, is backing the government politically and financially. On the grounds of protecting the Russian minority in Ukraine, the Russian parliament quickly granted Russian President Putin a permission to deploy troops to Ukraine (not only Crimea!). However, while Mr Putin has yet not officially used this permission, unmarked – but apparently Russian – troops have appeared on the southern Ukrainian peninsula Crimea, where also the Russian black sea fleet is headquartered at a leased naval base. Currently, the peninsula is on the verge of breaking away from the Ukrainian national state, heading to a referendum on joining the Russian Federation on March 16. Moreover, the pro-Russian regional parliament in Crimea approving a declaration of independence on Tuesday that will take effect if people on the Black Sea peninsula vote to unite with Russia in a referendum on Sunday. Also, Russia passed laws to enable Crimea to join.
These developments were met by strong opposition by Western countries and triggered a discussion on sanctions and the imposition of a first wave of minor sanctions against Russia. Diplomatic negotiations neither have so far nor yielded results. Other (CIS) countries in the region and China (Russia's usually ally in the UN Security Council) are closely watching the situation as well, but have abstained from voicing support for the Russian position.

Key impact factors

The escalation between Russia and Ukraine into a global stand-off between the West and Russia will have consequences for the Russian economy. Following factors will determine to which extent Russia's trade finances and growth will be affected.

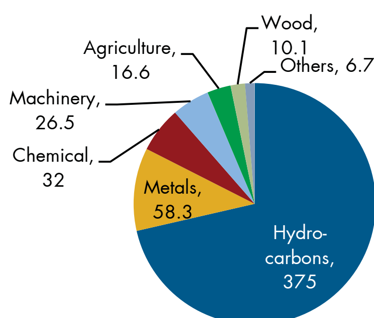
- First, **the further development of the conflict between Russia-Ukraine as such**, including the status of the Crimea. This affects bilateral trade with Ukraine, and in case Crimea is annexed this would also have budgetary implications. In our view, this mainly (but not only) depends on actions by the Russian President Putin and the Ukrainian reaction. The main downside risk in this field would be an escalation of conflict to Eastern Ukraine, e.g. by the deployment or Russian troops there.

Russian population % total



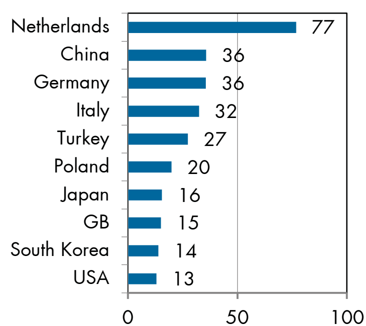
Source: National census

Russian goods exports 2012*



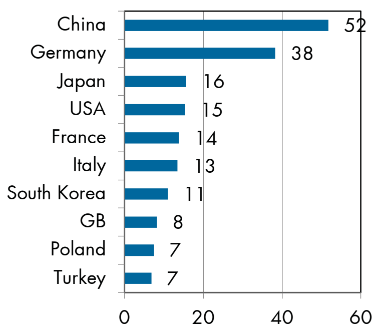
**USD bn*
Souce: Rosstat

Top-10 export countries* (USD bn)



Data as of 2012; Top-10 cover 64% of all goods exports
Souce: Rosstat

Top-10 import countries* (USD bn)



Data as of 2012; Top-10 cover 40% of all goods imports
Souce: Rosstat

- Second, the **threat and/or the application of various sanctions by the West** over Russia (and also the Russian reaction to these). Discussed options currently include targeted sanctions on individuals like travel bans and asset freezes, financial and trade sanctions, and measures of diplomatic isolation and other rather symbolic steps. Besides largely symbolic action like cancelling the preparation of the next G8 summit in Sochi, the US made already the first steps on 6 March introducing travel sanctions on individuals and officials; the EU so far stopped talks on visa deals and deeper cooperation, which had been stalled even before this crisis.
  However, additional EU sanctions like travel bans and asset freezes could be introduced as soon as next Monday right after the referendum on Crimea, according to leading European politicians on 11 March, if there is no change in Russia's position.
- Third, the sentiment towards Russian assets and **(re)assessments of Russian risk by financial markets and domestic and foreign investors**. This factor may have substantial impact both in the short and long term. In the short term prices of Russian financial assets and the rouble could be hit, while in the medium and long term a less benign assessment of Russia would decrease investment and ultimately the growth trajectory of the economy.

Exposure of Russia by trade

The most direct effect on the Russian economy by an (escalated) crisis with Ukraine would be observed via a deterioration of the bilateral trade relationship. However, the **overall exposure of Russia on trade to Ukraine is not that significant**, accounting for only about 5% of total - both in merchandise exports and imports. Exports amount to USD 24bn (of which almost half is natural gas, which is difficult to replace by Ukraine in the short- and mid-term), imports to USD 16 bn in 2013. Therefore, even in scenarios of further escalation, the Russian economy is unlikely to be hurt too much from this side.

One point of vulnerability with regard to Ukraine should be mentioned nevertheless: Traditionally, Ukraine's economic relevance for Russia has predominantly been its status as a transit country for gas supplies to Western- and Central Europe – with currently about more than half of gas exports to European customers is flowing through Ukraine. Thus, any disturbance or interruption of the oil and gas energy trade (given the escalation of the current crisis) would be negative for Russian oil exporter, Gazprom and ultimately the Russian budget. However, with the launch of the North stream gas pipeline directly from Russia to Germany, the importance of Ukraine has been reduced, but North stream cannot replace the gas transit via Ukraine completely even at full capacity (Potential transport up to 55 bcm; currently Gazprom can use 50% of this capacity, or 33% of the gas transported via Ukraine).

Trade relations with the US are also small as only 5% (USD 16 bn in 2013) of goods are imported from the USA, and only 2% (USD 11 bn) exported there. This limits the economic impact of US trade sanctions as an effective means to put pressure on Russia. Political impact will be more notable, however, as this will signal to the rest of the world of the US intention to isolate Russia economically.

In case of Europe the level of integration by trade is much higher. Around 60% of Russian merchandise exports – predominantly energy and other commodities - are directed there (USD 260 bn in 2013), while 40% of merchandise imports – machinery and consumer goods – originate from European countries (USD 130 bn in 2013). From a European perspective, the shares are smaller: Russia

accounts for 5% of extra-Euro Area exports (EUR 90 bn in 2012) and 8% of extra-Euro area imports (EUR 140 bn in 2012). The exposure of European countries to imports from Russia is concentrated in geographically and product wise – with for example Germany receiving around 35-40% of its oil and 40% of its gas supplies from Russia, CEE countries in some cases close to 100%. On the export side, Russia has become a large market for some European export oriented industries. In case of Germany, Russia takes already the 11th place in trade turnover (EUR 78 bn, 4% of total in 2013) including EU countries and the 3rd place after the China and the US excluding EU countries. For Austria, Russia holds the 10 place in both import and exports, with a share of 2.4% and 2.8% of total. Unsurprisingly imports were mainly (87% of total) fuels and energy, while the biggest export product category was machinery and transport vehicles.

Thus, there is a strong mutual trade dependency between Russia and the EU, which also explains the reluctance of Europeans and in particular Germany to use EU trade sanctions against Russia. – At the same time, Russia is highly dependent on the energy trade with Europe and revenues would be hurt significantly if exports to Europe were reduced. Moreover, in our view, European sanctions will only be imposed, if Russia is not ready to start a diplomatic dialogue (must not be very constructive), it would be relatively easy for Russia to avoid EU sanctions; however the EU might get into a situation, where it is pushed forward by the USA.

Extra-EU trade selected economies

	Share in Extra-EU trade	EUR mn
US	14.3	49,723,717
China	12.5	43,464,788
Russia	9.7	33,728,675
Turkey	3.5	12,170,141
Japan	3.4	11,822,422
Brazil	2.2	7,649,803
India	2.2	7,649,803
South Korea	2.2	7,649,803
South Africa	1.3	4,520,338
Ukraine	1.1	3,824,901

Data as of 2012
Source: European Commission

EU dominance in BRICS relationsships

BRICS Imports (2012)		BRICS Exports (2012)	
EU	17.5	EU	23.5
Japan	8	US	14.9
USA	8	Hong Kong	11.6
South Korea	7.6	Japan	6.4
Saudi Arabia	3.8	South Korea	3.8

Source: European Commission

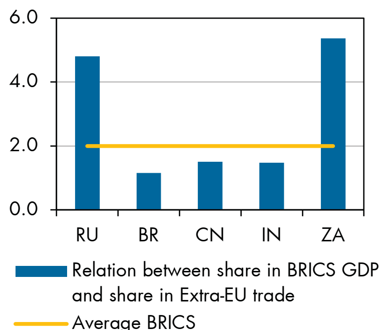
Focus on: Feasibility of EU trade sanctions on oil and gas

Possible restrictions on gas imports from Russia to EU: *A total embargo on gas imports from Russia seems not feasible, as, according to our estimates, once the EU stops gas imports from Russia, it is not able to find such large gas supply from other sources in the short period of time. However, the possibility of a partial reduction of imports of Russian gas to EU via alternative suppliers is widely discussed at the moment. We believe that such a decision is unlikely in large volumes and in short term, as it could lead to a significant increase in the cost of gas for European consumers and imbalances in the global gas market.*

Possible restrictions on oil imports from Russia to EU: *Total oil embargo in our view seems also hardly possible, as in that case we estimate that EU economy could operate on its commercial stocks replacing Russian oil&refined products imports during 96 days. At the same time partial oil ban could be considered as realistic scenario. According to our estimates EU could replace about 40% of Russian oil import by additional supplies from OPEC countries (mainly Saudi Arabia) which should increase production accordingly. In that scenario oil price should not change significantly. If Russia loses 40% of its oil&refined products exports to EU, and has no ability to cover that shortage by export in other countries (for example partial substitution could be to export oil to Asia), it would mean up to ~ USD90 bn losses of export revenues (i.e. considerable negative impact on budget revenues as well). The depreciation of rouble would significantly intensify and could reach further 10-15% short-term and should offset this negative impact only by 1/6 (about USD10-15 bn additional rouble denominated revenues due to FX effect). In that scenario imports should also fall (because of distressed economy), compensating for declining exports, that is why the net negative effect on the current account surplus would not be so acute. The inflationary risks would be limited, being neutralized by the slump in the economy.*

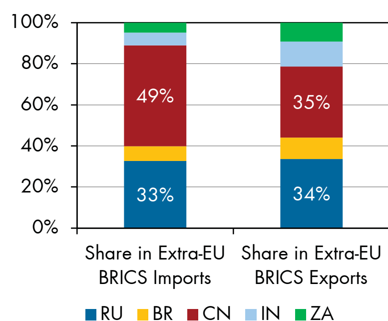
Maria Pomelnikova

BRICS in Extra-EU trade*



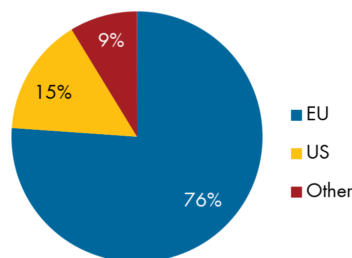
* relative importance, averages 2002-2012
Source: European Commission

Shares BRICS in Extra-EU trade*



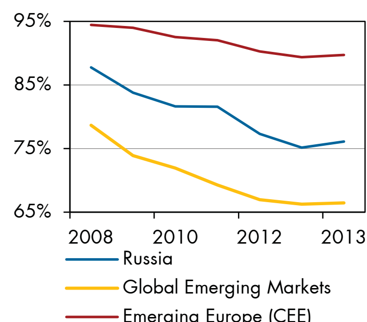
* averages 2002-2012
Source: European Commission

Cross-border claims on Russia*



* BIS reporting banks, as of September 2013
Source: BIS, Raiffeisen RESEARCH

European cross-border exposures



* BIS reporting banks, latest data point September 2013
Source: BIS, Raiffeisen RESEARCH

Focus on: Comparing EU and US economic relations with Russia to other BRIC economies

The EU rhetoric is much more cautious than the US with regards to restrictions and sanctions that could affect EU trade relations and other businesses with Russia. The more cautious EU stance reflects substantial economic interest in dealing with Russia. In terms of trade relations Russia has more or less the same importance as China for the EU. China stands for around 49% of Extra-EU imports from the BRICS economies and some 35% of Extra-EU exports to the BRIC economies (average for the years 2002-2012). In case of Russia the respective figures are at 33% (imports) and 34% (exports). Therefore, on the export side the Russian economy has for the EU as a whole more or less the same importance as China. The substantial trading relations with Russia reflect sizeable Foreign Direct Investments (FDI) in Russia, most of them targeting the Russian domestic market. In terms of market size the dependency on Russia is even much higher. The EU-trade relations with Russia are 4-5 times higher than the Russian GDP weight among the BRICS economies; in case of China the relation between share in EU-trade and GDP share among the BRICS economies stands at just 1.5, while this ratio stands at just 2.0 for all BRICS economies (including Russia) on average. That said Russia is the third largest EU economic partner in absolute terms in Extra-EU trade following the US and China. The large exposure of the EU to Russia reflects the very high openness to trade of major EU economies. Therefore, for the BRICS the importance of the EU as trading partner is twice as high as the importance of the US. In case of Russia this relationship is even more extreme. The EU is the most important source of Russian imports, while imports of the US are around nine times lower than the ones from the EU. In terms of Russian export the relation is even more extreme. Here Russian export volumes to the EU are some 40 times higher than Russian export volumes to the US. Given the exposure one could even name Russia the underestimated EU economic partner among the BRICS economies. Deep economic ties of the EU with Russia do reflect several factors, like geographical proximity or long-standing economic relationships (that have their origin even in Cold War times).

In terms of banking sector exposure (on-shore) in Russia and cross-border banking claims on Russia the situation is similar to the relationships in the real economy. As bank exposures tend to follow trade and FDI patterns European banks are also dominating forces in terms of financial links to Russia. Three out of the four largest 100% foreign-owned banks in Russia are European banks (SocGen, UniCredit, and Raiffeisen), while only Citi plays a meaningful role in terms of on-shore banking in Russia. The three leading European banks in Russia together have a market share of 4.3% (i.e. 85% market share among the leading foreign-owned banks in Russia), while the market share of Citi stands at around 0.7-0.8%. In terms of cross-border exposures on Russia European banks represent around 75% (out of some USD 240-260 bn) cross-border banking exposure on Russia, while the US represents some 15% of total. Cross-border exposure of European banks on Russia represents something like 20 per cent of overall CEE exposures (ex. Turkey). The sketched relationships represent a higher propensity of European banks to engage in cross-border banking business than US banks (with a much larger national home market than European banks). Nevertheless, indirect US exposure to Russia might be somewhat higher, as large European cross-border banking exposures on Russia also reflect the importance of the City of London as global financial center (also for US banks). The relative higher importance of Russia for European banks compared to other BRICS economies has not changed in recent years. Major European banks are currently in a tangible retreat from global business and cross-border banking. In case of Russia, the share of Western European banks in cross-border claims has also decreased from some 88% in 2008 to around 67% at present. This double-digit percentage point decrease more or less matched similar declines of the relative importance of European banks in the other BRIC countries.

Given the very deep economic relationships between the EU and US it is pretty clear that the EU cannot move as fast as the US in terms of restrictions and sanctions. Nevertheless, the threat of EU economic restrictions and sanctions on Russia remains in place as long as there is no viable diplomatic dialogue between Russia and the Western world. As sketched beforehand such political escalation would be not in the economic interest of Russia and the EU and should be therefore avoided.

Gunter Deuber

Financial market integration and capital flows

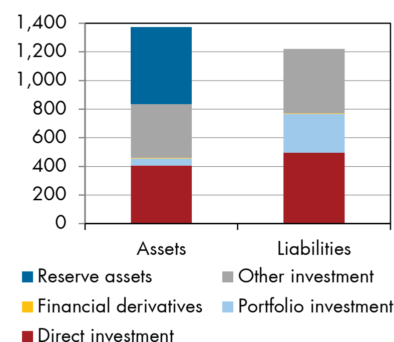
Over the last decade, **Russia has also become increasingly integrated into global financial markets**. The capital account has been open since the mid-2000. 70% of equities on the local Moscow stock exchange and around 25% of local government bonds are held by foreigners. Moreover, Russian authorities made additional steps over recent years to improve the financial market infrastructure. For example, Russian government securities became easier to trade for foreigners since early 2013 given the access to the Euroclear system.

Looking at stock variables (data as of 1/2013 if not mentioned otherwise), **Russia's external financial position shows financial assets – both public and privately owned - of almost USD 1400 bn** (of which approx. USD 500 bn are FX reserves). Liabilities and financial investments abroad amount to USD 1200 bn, resulting in a slightly positive net financial position of the country. Gross external debt of Russia has risen from USD 460 bn in 2010 to USD 730 bn as of early 2014. However, it has to be noted that that a substantial amount of Russian external assets and liabilities is created by "round-tripping" of Russian originated funds by offshore practices (e.g. to optimize taxes). Foreign direct investment (FDI) figures are equally difficult to analyse, due to the same offshore practices. The statistics show USD 500 bn of FDI stock in Russia (including retained earnings) and USD 400 bn of Russian FDI abroad. Portfolio investments, which can more easily and quicker transferred, are more skewed toward investment in Russia: These amount to USD 270 bn (USD 190 in forms of equity, USD 80 bn in debt securities), while Russians hold USD 50 bn of portfolio investment abroad (1/2013). Direct Russian exposure to Ukraine via FDI is rather insignificant. Since 2007 just USD 7 bn were invested in Ukraine. Russian officials, however, have mentioned total Ukrainian liabilities to Russian entities (sovereign and private sector) of USD 30 bn.

With regard to flow variables, Russia traditionally shows a large trade surplus, resulting in a surplus of the current account as well (which is however smaller than the trade surplus given a negative service and income balance). However, since the financial crisis, there has been a trend of deterioration in the C/A surplus. In 2013 it halved from over USD 70 bn to USD 33 bn (3.6% of GDP to 1.6% of GDP) from 2012 to 2013. At the same time there is a rather persistent block of shady capital outflows of around USD 50 bn from Russia (according to our estimates) , which is likely connected to motives of "capital flight". **This constellation increases Russia's vulnerability to external shocks of sudden capital outflows.** However, there exist also (positive) offsetting factors in the form of the increased rouble rate flexibility and substantial FX reserves, which cushions the economy in times of financial stress. The currency is let to depreciate, dampening import demand and increasing nominal budget revenues from energy exports (the same dollar amount of exports results in higher rouble tax revenues). Sales of FX reserves on the other hand slow down the depreciation. This has already been visible in early March, when foreign investors reduced their holdings, resulting in pressure on the rouble, forcing the Russian Central Bank (CBR) to step in and increase FX sales substantially, by tweaking its intervention mechanism (as well hiking the key interest rate from 5.5% to 7%).

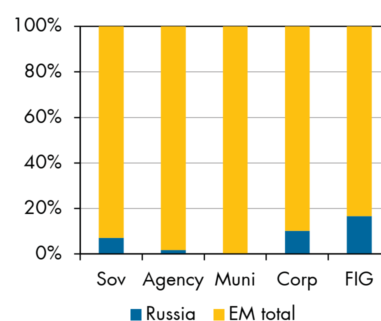
Given the financial openness of Russia, the deterioration of the crisis, the threat of sanctions or their application, may lead **to substantial further "hot money" capital outflows** in the short term and **discourage portfolio inflows and inward FDI** effective also in the longer run. With regard to domestic investors the effect is less clear: On the one hand, rising depreciation expectations and/or Russian political risk would induce investors to shift their funds towards hard currencies or to "save heavens" outside the country. On the other hand, domestic players might

Int. investment position (USD bn)



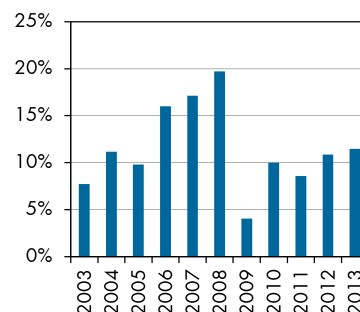
Source: CBR, Raiffeisen RESEARCH

Russia EB issuance % EM, by sectors



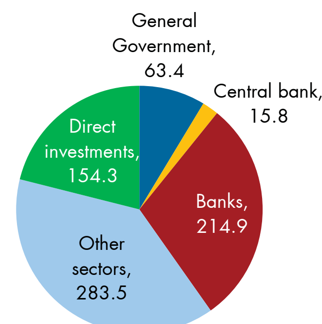
Source: Bloomberg, BondRadar, Raiffeisen RESEARCH

Russia EB issuance % EM, history



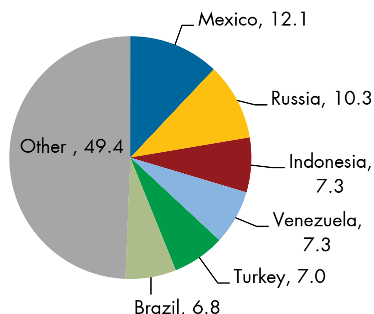
Source: Bloomberg, BondRadar, Raiffeisen RESEARCH

Gross external debt (USD bn)*



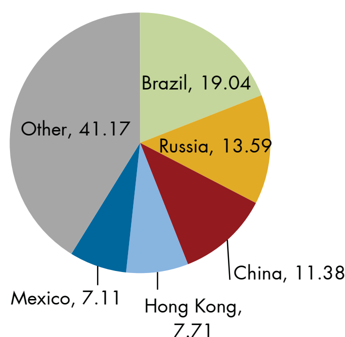
** End 2013, preliminary data; Total of USD 732 bn*
Source: CBR, Raiffeisen RESEARCH

Shares in EM sovereign bond index



Weight in Emerging Markets Bond Index Global (EMBI Global), sovereigns and quasi-sovereigns; Source: JPMorgan, Raiffeisen RESEARCH

Shares in EM corporate bond index



Weight in Corporate Emerging Markets Bond Index Broad (CEMBI Broad)
Source: JPMorgan, Raiffeisen RESEARCH

react to the threat of financial sanctions (e.g. asset freezes or operative risks) **by decreasing the use of offshore practices or repatriating funds from abroad**. Almost ironically, this reaction to the threat of sanctions also meets increased Russian official efforts for de-offshoring with several initiatives underway and to be implemented in 2014.

A real threat would be measures against the Russian banks (e.g. with presence in the USA). As it was articulated for the moment, such financial sanctions could include possible ban on certain operations, or relations with some client groups, or assets freezes. There has been yet no precision given with respect to this set of measures, and what would be the exact circumstances for their introduction. These sanctions, if introduced, and depending to which extent they would be introduced, would be quite negative for Russian banks primarily due to damaging their reputation and clients' trust. In turn, they also will have a negative spill over to the Russian banking and financial sector as a whole, adding to negative sentiment on domestic money market, FX market, and banking market.

However, as with the mutual dependency of Russia-EU in trade relations, there is also the other side of the coin with respect to financial integration. **Financial centres – the City of London predominantly in the case of Russia are not eager to lose Russian client money and financial services business.** Thus, they have a reason to lobby against the introduction of financial sanctions.

Russian financial asset prices could also suffer – temporarily or more persistently. Most prominently, the Russian rouble could depreciate more than in a scenario without the Ukraine conflict **("exchange rate or FX shock")**. Also, if Russian risk is priced higher or financial sanctions imposed, the ability and costs of external funding for Russian increases. With the CBR already pushing up the key rate and changing intervention, the domestic banking sector is affected, and to some extent also the real sector of the Russian economy is affected **("interest rate shock")**.
On the other side, the **oil price would likely go up** in phases of increased political risk, thus partly offsetting other negative effects for Russia (if oil exports volumes are not cut too much).

Focus on: The impact of the Ukraine crisis on the Russian banking sector

Not touching here upon the possible sanctions threatened to be introduced by US or EU, there are several issues on how Russian banks may suffer from the on-going events:

- *First, this is escalation of political risks going forward, and imposition of the general political uncertainty environment in Russia. Political risks in general, are the most painful for the economies and financial markets, since their consequences are resting on the undermined investors' and economic entities' confidence in the respective markets. They can hardly be cured by classical standard tools of economic regulation, and require a long time frame to the markets to settle and investors' confidence to recover. First among the others, the consequences of political risks are reflected in the undermined trust and deteriorated demand for the national currency and assets; second come the deterioration of trust in the domestic banking system, and respective panic-driven behaviour of depositors. "Dollarization" and deposit flight are the most expected consequences of such.*
- *Second, this is banks' financial losses related to exposure on Ukraine – stemming from both direct and indirect exposure, particularly among the largest Russian banks (losses via subsidiaries in UA, highly escalated risk related to loans issued to the Ukrainian companies; risks related to loans issued to Russian companies doing business with Ukraine). The banks are expected to face a significant deterioration of these loans quality, and a need to do the multiple loan restructuring (or write-downs), and to provide significant cash and capital support to the Ukrainian networks. Although the figures for direct exposure are not too striking – Ukrainian subsidiaries of both Sberbank and VTB are less than 2% of the respective groups total in assets, the indirect exposure should be several times as high in our guestimates, and that is where the major threats to the banks financial standing could be hidden.*

- *Deterioration of asset quality, and increasing cost of credit risk is also likely, due to the adverse exchange rate impact, and worsening financial standing of the borrowers, particularly those whose business is linked to Ukraine. Impact through hiking interest rates shifts cost of borrowing both for the banks and real sector companies, adding to higher costs of credit risks and shrinking margins.*
- *Structural consequences may include further concentration in the banking sector, as it happens in Russian banking market in crisis times. The already high share of state-controlled banks would increase further in this case (Sberbank, VTB, and others made up 55% of the banking assets at the end-2013).*

Elena Romanova

Impact on the economy and outlook

Russia's economy has been in a slowdown already since the beginning of 2012, with headline GDP decelerating from 4.3% in 2011, to 3.4% in 2012 and 1.3% in 2013. Industrial output and investment activity are stagnating for more than a year, if not slightly falling. More recently, consumer demand – the main pillar of Russian growth has shown signs of weakness. With energy prices high, but no longer growing, the Russian economy seems to have lost steam and is lacking further impulses for growth.

For our base case we would already assume a selective package of Western sanctions against Russia – however both full-fledged and prolonged financial and trade sanctions (think of Iran) would be avoided. Nevertheless, even in this case, this could result the Russian economy to dip into stagnation, or even limited recession. However, this would not be large enough to cause (even in case when Russia would have to replace some part of energy exports by trade with, for instance, China) sustainable recession. Whatever the outcome with sanctions may be (i.e. even if there would be no sanctions at all, but persistent expectations of their possible implementation), the Russian economy will likely suffer from deterioration in the attractiveness of investments and in households sentiment. This would be the major negative impact from the Ukraine crisis on the Russian economy.

The Ukrainian conflict could have negative impact on Russian industry via several channels. Companies which have direct exposure on Ukrainian market will be at risk first. They are Gazprom (risk to gas transit via Ukraine), major telecoms (VimpelCom, MTS), metals&mining companies (Evraz, Raspadskaya) and banks (Sberbank, VTB). Reshuffling of guiding force in Ukraine and deteriorating economic landscape could impose significant restrictions on Russia-Ukraine business relations. Cash flows would be under pressure from depressed economic conditions, UAH devaluation and political uncertainty. In the group of companies which are most vulnerable to RUB devaluation and interest rate increase we include those with high debt load and the unfavorable FX mix of revenues and debt. The majority of those companies are in metals and mining sector (MMK, Evraz, Mechel, Raspadskaya) and one chemicals (Uralkali), while the rest are rather resilient to such shocks mainly because of low FX debt.

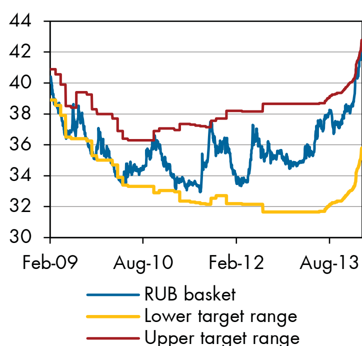
Moreover, a long period of uncertainty about package of sanctions could lead to a freeze of the investment programs by leading real sector companies: energy export oriented corporations and metal companies are especially prone of this risk. Other factors which could suppress investment activity would increase the cost of internal and external borrowing as well as inflationary risks.

The latter could also negatively affect the consumer sector. We assume that FX shock could add annual CPI about 0.7 pp of additional inflation, revising our

forecast to 5.9% in 2014. The melting purchasing power of consumers as a result of rouble depreciation could cause significant slowdown of retail sales.
In addition, even without economic sanctions the banking sector would be negatively affected by monetary policy tightening (as a response to the FX shock) and retail lending should decelerate creating the additional pressure on consumer activity.
In such a scenario, Russian fiscal policy might be loosened to some extent to partly offset the several negative effects in support of economic growth.

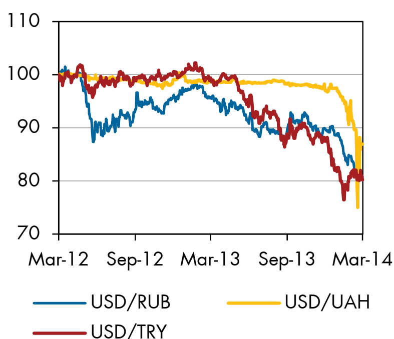
We earlier expected a minor uptick in the GDP growth rate to 1.7% this year and 2.0% next year. However, given the prevalence of economic downside risks in the current situation and the sluggish start of the Russian economy into 2014, we reduce this forecast to 1.0% in 2014 and 1.5% in 2015.

Rubel movement versus basket*



** basket consisting of 45% EUR and 55% USD*
Source: Russian Central Bank, Bloomberg

FX development over two years*



** indexed FX rates; March 2012 = 100*
Source: Bloomberg, Raiffeisen RESEARCH

Exchange rate forecasts

	06-Mar	Jun-14	Dec-14
USD/RUB	36.5	37.9	36.3
EUR/RUB	50.6	49.3	49.0
RUB basket	42.9	43.0	42.0

Current is 12 March 2014, 10:40 CET
Source: Bloomberg, Raiffeisen RESEARCH

Monetary policy and rouble outlook

As a result of the tensions on the FX market which were trigged by the Ukraine situation, the CBR already introduced a significant key rate hike by 150 bp and sharply increased the accumulated interventions (from USD350 mn to USD1.5 bn per day). The rise of the key rate (weekly REPO) to 7% along with huge urgent CBR sales of the foreign currency appeared to be effective to curb excessive devaluation expectations (both consumers and corporate sector) and to limit rouble depreciation. We believe that with further uncertainty ahead the CBR will continue a policy of large interventions to support RUB and do not rule out the possibility of more monetary policy tightening if necessary.

On this backdrop until the political factor persist and the CBR is present on the FX market, the potential for rouble depreciation would be limited, as speculative attacks would be discouraged by high cost of the CBR refinancing and interbank funding, as well as because large FX interventions. Moreover, the rouble has already lost 10% of its value to the currency basket of EUR and USD in 2013 and another 10% since the beginning of this year. This one the one hand reduced the arguably high valuation of the currency, but on the other hand spurred depreciation expectations.

Even limited further depreciation (about 5%) altogether with the depreciation in Jan-Feb, when RUB fell by 10% (QE3 tapering and Ukraine factor as well), would translate into significant positive impact on budget revenues. According to our estimates, current RUB depreciation should add up to RUB 700bn to the budget.

At the same time, we expect the C/A surplus to benefit from Jan-Feb depreciation that would lead to rising RUB-denominated oil and gas export revenues, which also increases the probability of slight rouble appreciation afterwards.

Provided our moderate scenario, we expect only 5% further RUB depreciation from current levels (in more negative case not more than by 10%) in coming months. Moreover, as such depreciation would be caused by political risk factor; we anticipate some reversal of rouble dynamics at a later stage, when this risk factor is no longer in focus.

Rating implications

Impact on sovereign rating in main scenario limited, but a change of the outlook to negative should not be fully excluded. With a very healthy balance sheet (low public debt, low headline fiscal deficit, large FX reserves) the risk to the rating is limited. This might change, if revenue stream from commodities exports is under severe threat. At the same time, policy predictability in Russia is low and recent Russian action has shown that the current government is prone to pursuing political goals without a look at economic rationale.

Extreme cases: Full scale sanctions

Our scenario is in our view no strong risk scenario. Significant financial sanctions or even more so, strong and persistent restrictions on energy exports to the EU and/or strong financial sanctions would significantly change the picture for the Russian economy and the rouble. Given the sketched vulnerabilities and international integration of Russia, this would likely cause a strong recession in Russia (similar to the one seen in 2008/2009), a serious deterioration of energy dependent budget revenues, and mounting rouble depreciation pressures. Fiscal buffers (in the form of sovereign wealth funds of USD 180 bn) and also the FX reserves (USD 490 bn) would have to be tapped. Such a scenario, we think, would also have negative implications for the sovereign rating.

Disclaimer

Publisher: Raiffeisen Bank International AG

Supervisory authority: Austrian Financial Market Authority (FMA)

This document is for information purposes and may not be reproduced or distributed to other persons. This document constitutes neither a solicitation of an offer nor a prospectus in the sense of the Austrian Capital Market Act (KMG) or the Stock Exchange Act or any other comparable foreign law. An investment decision in respect of a security, financial product or investment must be made on the basis of an approved, published prospectus or the complete documentation for the security, financial product or investment in question, and not on the basis of this document.

This document does not constitute a personal recommendation to buy or sell financial instruments in the sense of the Securities Supervision Act. Neither this document nor any of its components shall form the basis for any kind of contract or commitment whatsoever. This document is not a substitute for the necessary advice on the purchase or sale of a security, investment or other financial product. In respect of the sale or purchase of securities, investments or financial products, your banking advisor can provide individualised advice which is suitable for investments and financial products.

This analysis is fundamentally based on generally available information and not on confidential information which the party preparing the analysis has obtained exclusively on the basis of his/her client relationship with a person.

Unless otherwise expressly stated in this publication, RBI deems all of the information to be reliable, but does not make any assurances regarding its accuracy and completeness.

In emerging markets, there may be higher settlement and custody risk as compared to markets with established infrastructure. The liquidity of stocks/financial instruments can be influenced by the number of market makers. Both of these circumstances can result in elevated risk in relation to the safety of investments made on the basis of the information contained in this document.

The information in this publication is current, up to the creation date of the document. It may be outdated by future developments, without the publication being changed.

Unless otherwise expressly stated (http://www.raiffeisenresearch.at/spezialvergütung), the analysts employed by Raiffeisen Bank International AG are not compensated for specific investment banking transactions. Compensation of the author or authors of this report is based (amongst other things) on the overall profitability of RBI, which includes, inter alia, earnings from investment banking and other transactions of RBI. In general, RBI forbids its analysts and persons reporting to the analysts from acquiring securities or other financial instruments of any enterprise which is covered by the analysts, unless such acquisition is authorised in advance by RBI's Compliance Department.

RBI has put in place the following organisational and administrative agreements, including information barriers, to impede or prevent conflicts of interest in relation to recommendations: RBI has designated fundamentally binding confidentiality zones. Confidentiality zones are typically units within credit institutions, which are delimited vis-ŕ-vis other units by organisational measures covering the exchange of information, because compliance-relevant information is continuously or temporarily handled there. Compliance-relevant information may fundamentally not leave a confidentiality zone and is to be treated as strictly confidential in internal business operations, including interaction with other units. This does not apply to the transfer of information necessary for usual business operations. Such transfer of information is limited, however, to what is absolutely necessary (need-to-know principle). The exchange of compliance-relevant information between two confidentiality zones may only occur with the involvement of the Compliance Officer.

SPECIAL REGULATIONS FOR THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND (UK) AND JERSEY (CHANNEL ISLANDS): This publication has been approved or issued by Raiffeisen Bank International AG (RBI) in order to promote its investment business. RBI London Branch is authorised by the Austrian Financial Market Authority (FMA) and subject to limited regulation by the Financial Services Authority (FSA). Details on the extent of the London branch's regulation by the Financial Services Authority are available on request. This publication is not intended for investors who are retail customers within the meaning of the FSA regulations and should therefore not be distributed to them. Neither the information contained in this document nor the opinions expressed herein constitute or are to be construed as an offer or a solicitation to purchase (or sell) investments. RBI may have effected own-account transactions within the meaning of the FSA regulations in any investment mentioned herein or related investments and may thus have a position or holding in such investments as a result. RBI may act or have acted as the manager or co-manager of a public offering of any security mentioned in this report or any related security. The RBI Jersey marketing representative office is not regulated by the Jersey Financial Services Commission as it does not perform any financial services in Jersey as defined by the Financial Services (Jersey) Law 1998 (FSJL).

SPECIFIC RESTRICTIONS FOR THE UNITED STATES OF AMERICA AND CANADA: This document may not be transmitted to, or distributed within, the United States of America or Canada or their respective territories or possessions, nor may it be distributed to any U.S. person or any person resident in Canada, unless it is provided directly through RB International Markets (USA) LLC, a U.S. registered broker-dealer ('RBIM'), and subject to the terms set forth below.

SPECIFIC INFORMATION FOR THE UNITED STATES OF AMERICA AND CANADA: This research document is intended only for institutional investors and is not subject to all of the independence and disclosure standards that may be applicable to research documents prepared for retail investors. This report was provided to you by RB International Markets (USA) LLC, a U.S. registered broker-dealer ('RBIM'), but was prepared by our non-U.S. affiliate, Raiffeisen Bank International AG (RBI). Any order for the purchase or sale of securities covered by this report must be placed with RBIM. You can reach RBIM at 1133 Avenue of the Americas, 16th Floor, New York, NY 10036, 212-600-2588. This document was prepared outside the United States by one or more analysts who may not have been subject to rules regarding the preparation of reports and the independence of research analysts comparable to those in effect in the United States. The analyst or analysts who prepared this research (i) are not registered or qualified as research analysts with the Financial Industry Regulatory Authority (FINRA) in the United States, and (ii) are not allowed to be associated persons of RBIM and are therefore not subject to FINRA regulations, including regulations related to the conduct or independence of research analysts.

The opinions, estimates and projections contained in this report are those of RBI only as of the date of this report and are subject to change without notice. The information contained in this report has been compiled from sources believed to be reliable by RBI, but no representation or warranty, express or implied, is made by RBI or its affiliated companies or any other person as to the report's accuracy, completeness or correctness. Securities which are not registered in the United States may not be offered or sold, directly or indirectly, within the United States or to U.S. persons (within the meaning of Regulation S under the Securities Act of 1933 [the 'Securities Act']), except pursuant to an exemption under the Securities Act. This report does not constitute an offer with respect to the purchase or sale of any security within the meaning of Section 5 of the Securities Act and neither shall this report nor anything contained herein form the basis of, or be relied upon in connection with, any contract or commitment whatsoever. This report provides general information only. In Canada it may only be distributed to persons who are resident in Canada and who, by virtue of their exemption from the prospectus requirements of the applicable provincial or territorial securities laws, are entitled to conduct trades in the securities described herein.

If any term of this Disclaimer is found to be illegal, invalid or unenforceable under any applicable law, such term shall, insofar as it is severable from the remaining terms, be deemed omitted from this Disclaimer; it shall in no way affect the legality, validity or enforceability of the remaining terms.

Acknowledgements

Global Head of Research:
Peter Brezinschek (1517)

Top-Down CEE Banking Sector:
Gunter Deuber (5707), Elena Romanova (1378)

Research Sales:
Werner Weingraber (5975)

Economics, Fixed Income, FX:
Valentin Hofstätter (Head, 1685), Jörg Angelé (1687), Eva Bauer (5644), Gunter Deuber (5707), Wolfgang Ernst (1500), Stephan Imre (6757), Lydia Kranner (1609), Matthias Reith (6741); Andreas Schwabe (1389), Gintaras Shlizhyus (1343), Gottfried Steindl (1523), Martin Stelzeneder (1614)

Credit/Corporate Bonds:
Christoph Klaper (Head, 1652), Michael Ballauf (2904), Jörg Bayer (1909), Igor Kovacic (6732), Martin Kutny (2013), Peter Onofrej (2049), Manuel Schreiber (3533), Lubica Sikova (2139), Jürgen Walter (5932)

Stocks:
Helge Rechberger (Head, 1533), Aaron Alber (1513), Christian Hinterwallner (1633), Jörn Lange (5934), Hannes Loacker (1885), Johannes Mattner (1463), Christine Nowak (1625), Leopold Salcher (2176), Andreas Schiller (1358), Connie Schümann (2178)

Quant Research/Emerging Markets:
Veronika Lammer (Head, 3741), Björn Chyba (8161), Judith Galter (1320), Dagmar König (8017), Andreas Mannsparth (8133), Nina Neubauer-Kukic (1635), Manuel Schuster (1529), Stefan Theußl (1593)

Technical Analysis:
Robert Schittler (1537), Stefan Memmer (1421)

Layout:
Birgit Bachhofner (3518), Kathrin Rauchlatner (1518)

Translation:
David Wietstruk (6781), William Burton, Ventsislav Mishev, Sarah Fleissner, Benjamin-Zsolt Zombori

Publisher: Raiffeisen RESEARCH GmbH, A-1030 Vienna, Am Stadtpark 9, Phone: +43 1 717 07-1521

Editorial Department: Raiffeisen RESEARCH / RBI A-1030 Vienna, Am Stadtpark 9, Phone: +43 1 717 07 - 1521