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Russia-Ukraine: An Unfolding Crisis

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Russia-Ukraine: An Unfolding Crisis

Overview

- Our base-case scenario assumes a steady de-intensification of the crisis and that any flash points will be contained. Under this scenario, we expect Russia's growth to decelerate modestly to 1.2% in 2014 and improving only gradually to 2.2% in 2015. We expect the ruble to stabilize at current levels, capital outflows to decelerate to more modest rates, and inflationary pressures to gradually abate.
- We also think it plausible that the uncertainty around the resolution of the crisis could intensify before receding toward the end of 2014, which would inevitably introduce more stress into the economy and the financial system. In this alternative case, escalating tensions could lead to a new wave of sell-offs by foreign investors and capital flight by domestic residents, while the ruble could lose a further 10% of its value against the U.S. dollar. In this scenario, our expectation of growth for 2014 would be further reduced to 0.6%.
- While we have presented these scenarios as discrete, the line between them is thin, with multiple tipping points.
- Although further sanctions from the EU and the U.S. may be imposed, our expectation is that these will not be so severe as to include wide trade restrictions on Russia or sanctions on the Russian financial system. Accordingly, we do not envisage retaliation either from Russia or the West in terms of the supply of gas and oil and/or demand disruptions. We therefore currently think self-interest will prevail and that a more extreme scenario involving severe and lengthy disruption to oil and gas supplies, accompanied by the imposition of onerous financial sanctions on Russia, is unlikely to materialize.
- Depending on the severity of the scenario, we think banking and corporate sectors in Russia, Ukraine, and wider Europe will be affected according to their proximity and exposure to economic and financial risks emanating from the crisis.

Events in Ukraine have unfolded rapidly following the toppling of its former president and Russia's subsequent moves to incorporate Crimea. The escalation in geopolitical tension has already shaken markets and the negative sentiment has precipitated an acceleration in capital outflows from Russia. Having started the year on a slowing trajectory, Russia's economy is vulnerable to eroding confidence and the prospect of more severe sanctions could undermine future growth (see "Russian Federation Outlook Revised To Negative On Rising Geopolitical And Economic Risks; Ratings Affirmed", published March 20, 2014).

The fluidity of events in Russia and Ukraine and the international reaction to them inevitably create degrees of uncertainty and unpredictability. With this caveat in mind, therefore, we are presenting here our view of the most plausible scenarios and our expectations of their economic impact on Russia and Europe. While we have presented these scenarios as discrete, the line between them is thin, with multiple tipping points.

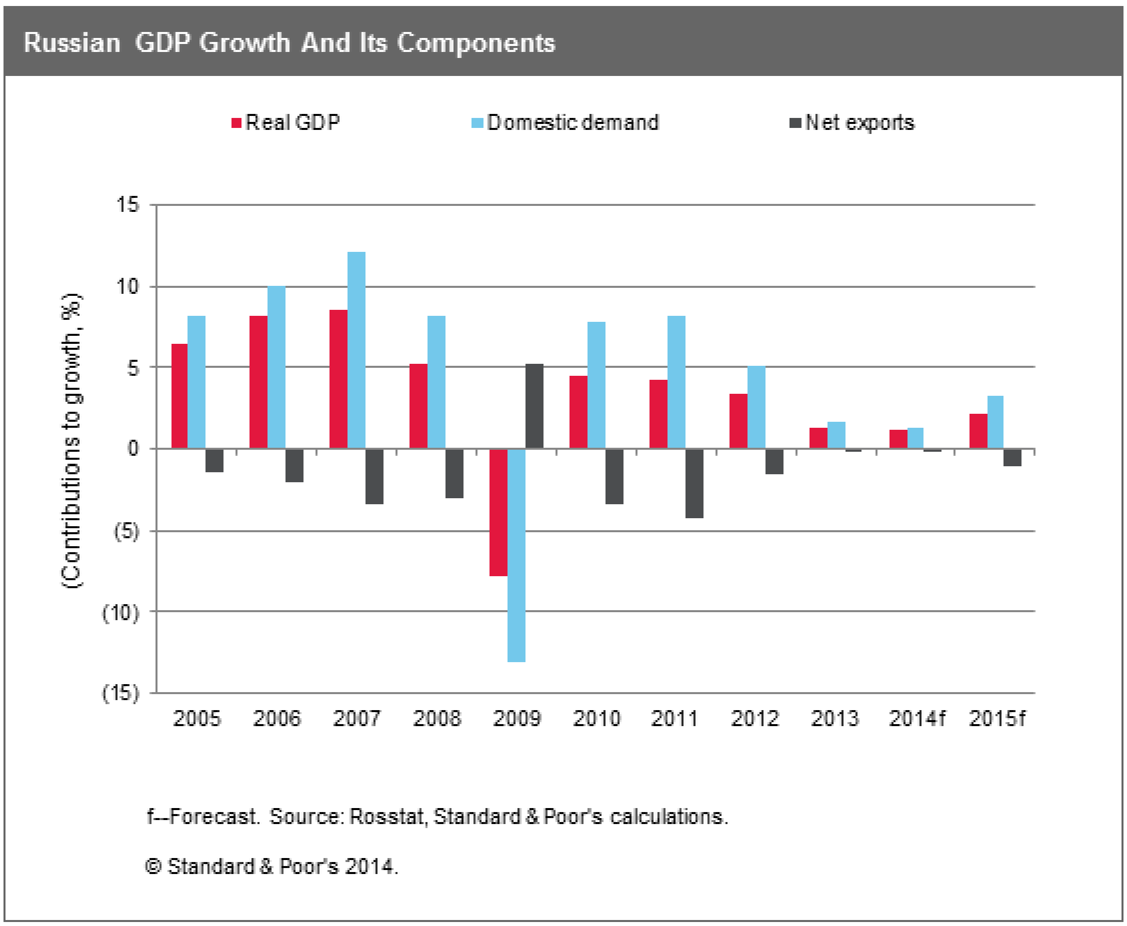
Our base-case scenario assumes a steady, but relatively quick, de-intensification of the crisis, and that any flash points are contained. Furthermore, the impact of the crisis is limited to Ukraine and Russia. We have also contemplated a scenario of prolonged uncertainty, which assumes geopolitical tensions intensify for longer and remain elevated through most of 2014. While we would expect the impact to still be mostly limited to Ukraine and Russia, the economic and financial outcomes would be more stressful.

We think a more extreme scenario involving severe and lengthy disruption to oil and gas supplies, accompanied by the imposition of heavy financial sanctions on Russia, is currently unlikely and the effects difficult to quantify. However, geopolitical events can turn very quickly, so we have also provided our broad views on the issues this scenario might raise.

Russia's Economy On The Eve Of The Recent Crisis

Even before geopolitical tensions escalated in March, Russia's economy was already slowing. Economic growth decelerated to 1.3% in 2013, compared with an average of more than 4% over 2010-2012 and over 7% during the period preceding the global financial crisis (see chart 1). The weakening of domestic demand last year was not fully offset by relatively strong exports, which were up 3.8%, led by a 10% increase in gas exports. Consumption growth slowed to 4.7% in 2013, from just below 8% in 2012. Fixed investment remained flat, dipping 0.3%, driven by a fall in investment by state-owned enterprises, while private investment increased.

Chart 1



The weak growth momentum continued into 2014, with worse-than-expected January statistics across the board, and limited improvement of some indicators in February. Over January-February, investment fell by 5% year-on-year, and retail trade growth slowed to 3.2% year-on-year. The labor market has remained tight--the level of unemployment was close to historical lows. Although wages grew by 5.6% in real terms, similar to the 2013 level, real disposable income was flat. A growing proportion of household income--about 5% according to our estimates--is used to service debt. Consumer leverage is relatively low at about 15% of GDP, but interest rates on consumer debt are very high, above 20% for most maturities. Growth in consumer loans remains strong, but has slowed from almost 50% year-on-year in mid-2012 to about 30% at the beginning of 2014.

Russia's slowdown is, to a large extent, structural. Although oil prices are stable, the country no longer benefits from continuously rising terms of trade, which fueled income growth and domestic demand in the decade preceding the global economic and financial crisis of 2008, and supported the post-crisis recovery in 2010-2011. Significant unused capacity has been largely utilized, while investment in new productive capacity has lagged. The working-age population has been on a downward trajectory, reflecting unfavorable demographic trends that have only partially been offset by net immigration. Structural weaknesses, such as the pervasive role of the state in the economy, perceived widespread corruption, and insufficient levels of competition and innovation, constrain productivity-driven growth.

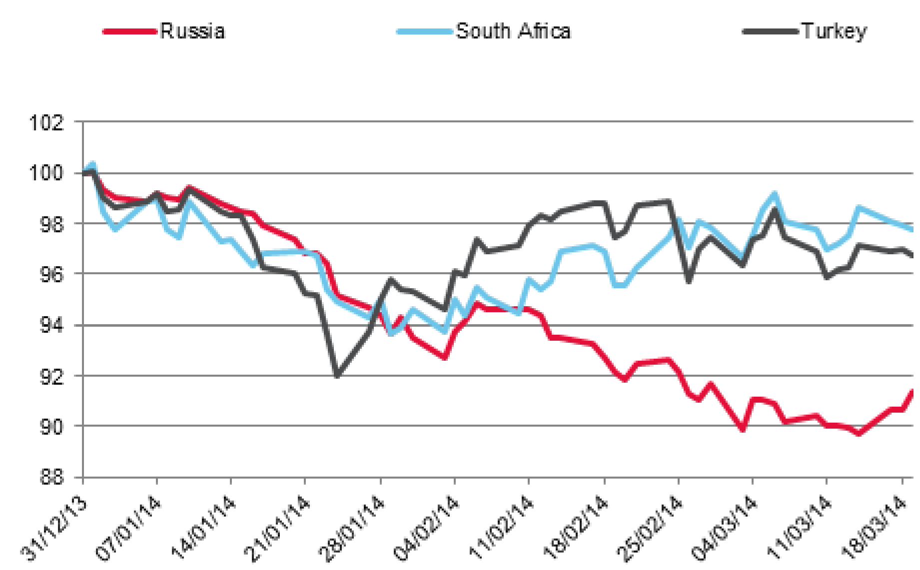
At the same time, cyclical factors have played a role in the slowdown. Several large state-owned enterprises have completed their investment cycle, and the start of the new cycle has been delayed. Since the middle of last year, the worsening global investment sentiment toward emerging markets amid the scaling down of the U.S. Federal Reserve's monthly asset purchases (the so-called "tapering of quantitative easing") has created a more challenging environment for emerging markets worldwide.

Rising Tensions Are Piling Pressure On The Ruble

Russia's strong external fundamentals--continuous, albeit diminishing, current account surpluses, a positive net external asset position, and a very high level of foreign exchange reserves--suggest that the country should not be particularly vulnerable to tighter global liquidity conditions (see "Policy Risks, Not Tapering, Are Key To Emerging Market Sovereign Ratings," published March 5, 2014). Indeed, Russia weathered the first episode of market instability in mid-2013 relatively well, with only a moderate weakening of its currency compared to its emerging market peers. During the second wave of the turmoil in early 2014, however, the ruble's fall has been deeper than that experienced by the currencies of emerging market peers such as Turkey and South Africa (see chart 2), even though both run large current account deficits and have significantly lower foreign exchange buffers. Moreover, these countries' currencies have strengthened following interest rate hikes by their central banks at the end of January, whereas the ruble has fallen further. For the ruble, cumulative losses against the U.S. dollar reached 10% over January and February, despite the Central Bank of Russia's interventions to defend the currency (see chart 3). This happened even before the heightened geopolitical risks put additional pressure on the exchange rate.

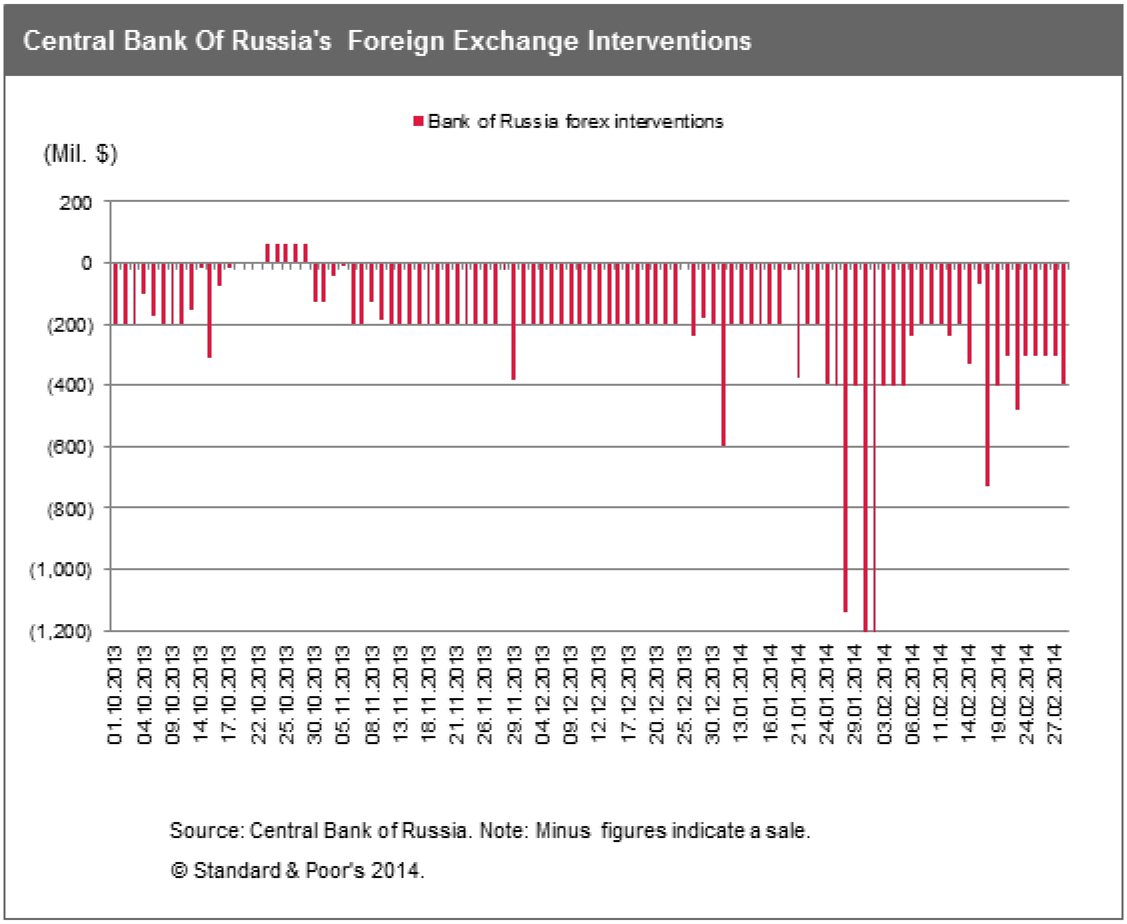
Chart 2

U.S. Dollar Exchange Rate Versus The Russian, South African, And Turkish Local Currencies



Source: Bloomberg, Standard & Poor's calculations.

Chart 3



The Central Bank Of Russia's Response Has Compounded Expectations

The Central Bank of Russia's vast foreign exchange reserves--close to 25% of GDP at the beginning of 2014--have traditionally been viewed as an important buffer against currency speculation. However, history tells us that it is difficult for any central bank to defend its currency unilaterally, and only joint action by central banks can effectively combat speculation. Moreover, in our view, the Central Bank of Russia's policy of "stepwise" depreciation created the perception of further depreciation and itself contributed to speculation against the ruble. This policy implied letting the ruble fluctuate freely within a band, but intervening when the exchange rate approaches the limits of the band. The interventions were capped at a preannounced amount; when it was reached, the limits of the band were moved. The policy aimed to reduce exchange rate volatility while not resisting fundamental trends. The policy was successful when the pressure on the ruble was short-lived, and the central bank was able to replenish reserves when the depreciation trend reversed. However, during the recent period of prolonged pressure, adjusting the exchange rate in small steps led to continuous reserve losses (see chart 3) and contributed to widespread expectations of further depreciation among foreign and domestic investors alike. Since the end of 2013, the Russian population has reacted to continuous depreciation by increasing purchases of foreign currency and converting some ruble deposits to foreign currency. This response has become more pronounced since the start of the year.

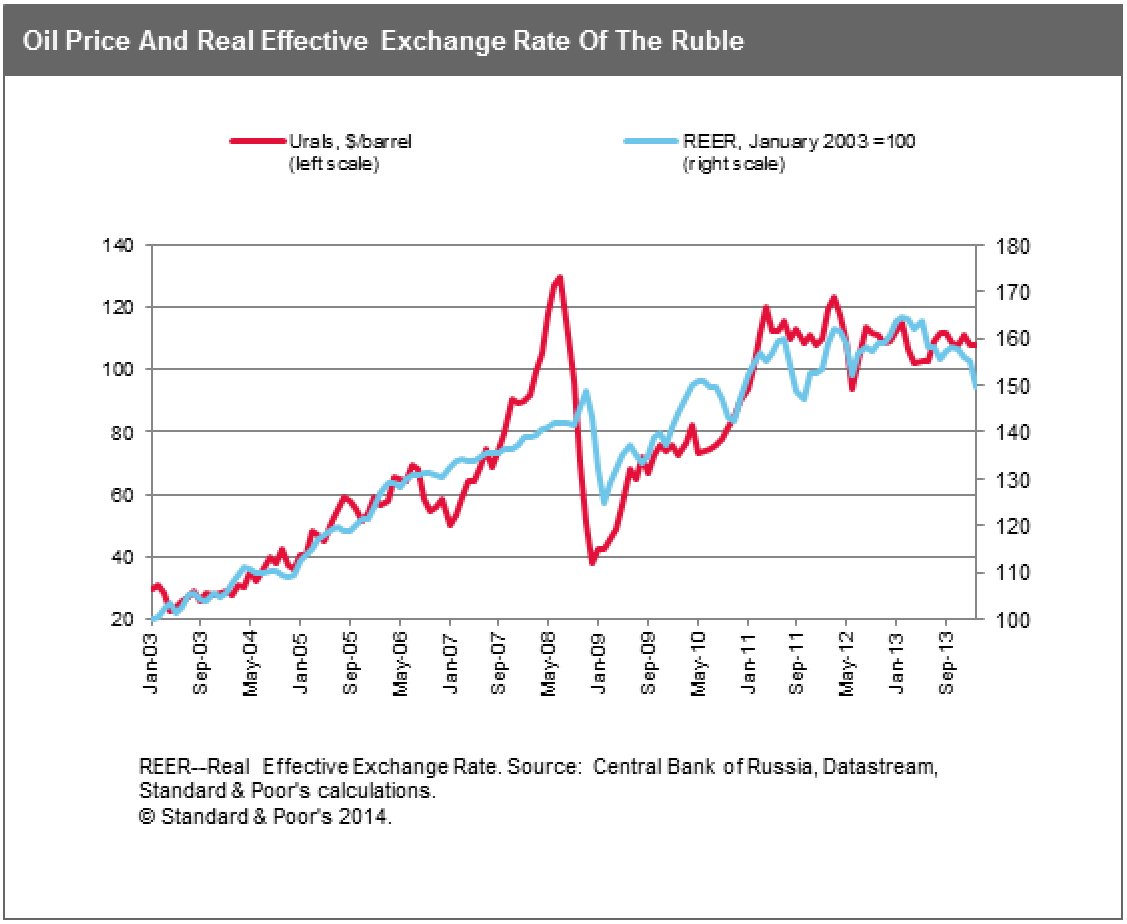
Moreover, by selling foreign exchange reserves the Central Bank of Russia has been squeezing liquidity out of the banking system. To prevent liquidity shortages and a sharp rise in interest rates, the central bank has provided liquidity to Russian banks, not only via repo operations, but also via foreign exchange swaps and against nonmarketable collateral. Since July 2013, it has provided more than 2 trillion rubles to the banks on a net basis, equivalent to more than US$60 billion. This liquidity has partly found its way back into foreign exchange markets, creating a vicious circle. This illustrates a well-known difficulty for a central bank that tries to pursue multiple objectives, some of which may become contradictory.

Recent geopolitical developments have led to another wave of downward market moves in Russia. The RTS index of 50 Russian stocks dropped 12% on March 3, and the ruble has come under intense pressure. The Central Bank of Russia acted decisively by raising its key rate from 5.5% to 7.0% and changing the parameters of its exchange rate policy implementation, allowing for higher daily interventions in the foreign-exchange market. It sold $11 billion of foreign reserves in one day, and has continued its interventions through March. Average daily interventions exceeded $1 billion in March, compared with a daily average of $400 million in January-February.

The Ruble Has Decoupled From The Oil Price

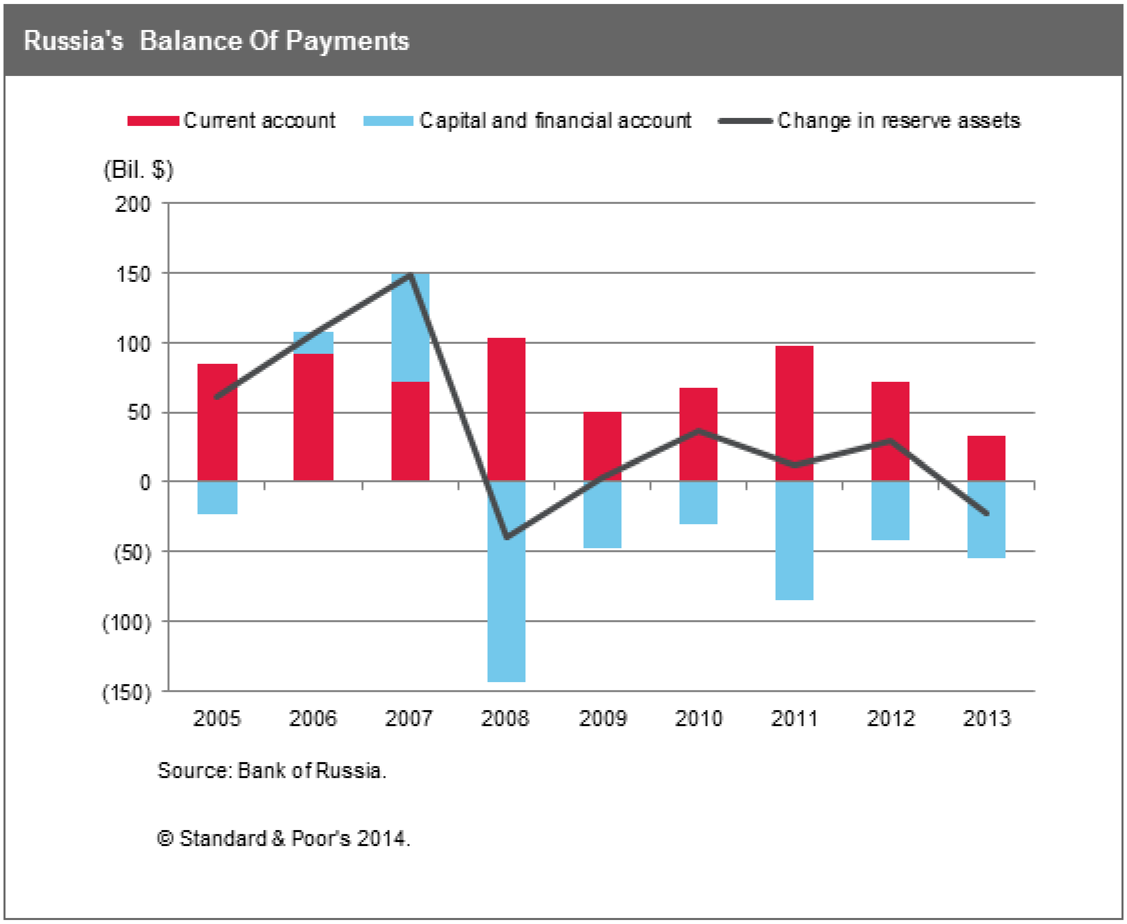
The oil price has traditionally been the key factor behind the real exchange rate dynamics of the ruble (see chart 4). This is not surprising considering oil and gas exports account for about 60% of total Russian goods and services exports, and that the gas price is linked to the oil price. Indeed, the two previous major episodes of currency depreciation occurred amid sharp drops in oil prices, in 1998 and 2008-2009. During the most recent episode that started in 2013 and intensified in January, significant nominal and real depreciation occurred despite an environment of stable oil prices. This is a new situation that casts considerable uncertainty on the currency outlook.

Chart 4



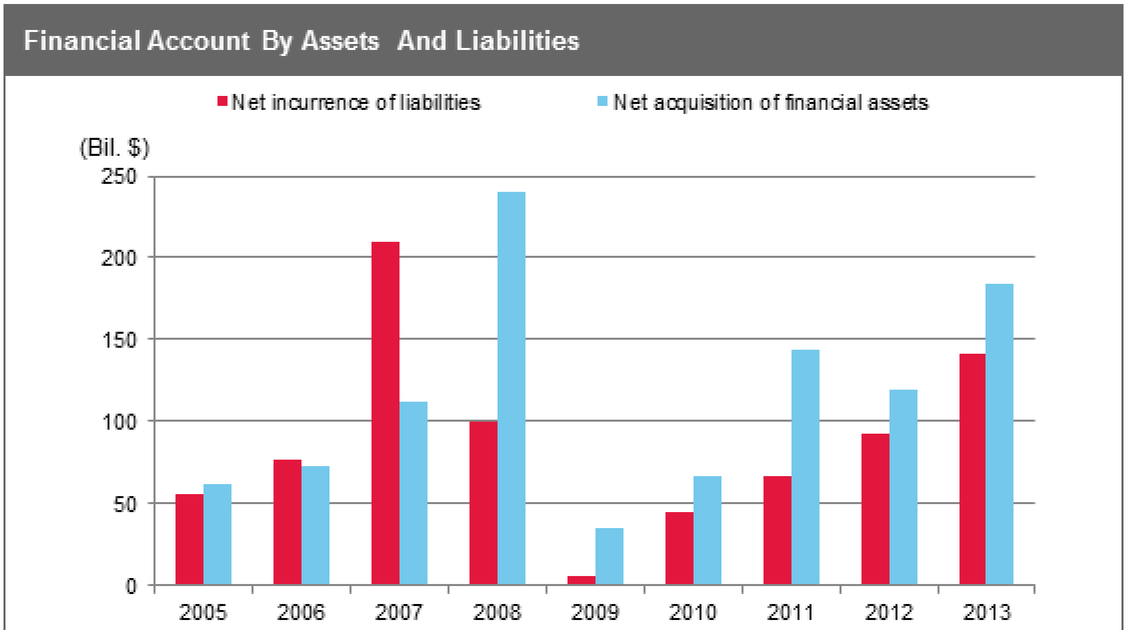
The positive correlation between the oil price and the real exchange rate appears to have broken. In our view, this is probably because of the large capital outflows over recent months. We estimate that net capital outflows reached US$60 billion in the first quarter of 2014, close to the total for the whole of 2013. This is an exceptional situation over the last decade (see chart 5). Only during the 2008-2009 crisis did Russia experience such significant--and even larger--outflows, but this happened when oil prices fell sharply, so that the relationship between the oil price and the real exchange rate still held.

Chart 5



The question is whether large-scale capital outflows will become a new norm, or if instead the pattern will be of moderate net outflows. Aggregate capital flow numbers mask the trend that emerged after the 2008-2009 crisis. Since 2010, foreign capital inflows to Russia have risen steadily, but at the same time, Russian corporates and banks have strived to improve their net foreign asset positions (see chart 6). Outward direct investment has grown, averaging US$60 billion per year over 2010-2012. In 2013, foreign direct investment abroad soared to US$100 billion, driven by a one-off deal where Rosneft acquired TNK-BP. In the new environment of geopolitical tensions and potential financial sanctions on Russia, we expect slowing flows in both directions. On the one hand, foreign flows into Russia are likely to reduce significantly. At the same time, Russian investment abroad may also decrease, in part because investors may become more cautious about investing in foreign financial assets in light of potential sanctions.

Chart 6



Note: Net incurrence of liabilities refers to the difference between the acquisition and disposal of domestic financial assets by non-residents. Net acquisition of financial assets refers to the difference between the acquisition and disposal of foreign financial assets by residents of an economy. Source: Central Bank of Russia.

At the current juncture, we do not expect that sustained large-scale capital outflows will become a new norm and therefore expect the Russian currency to stabilize at current levels. This will imply appreciation in real terms over the forecasting horizon due to higher inflation in Russia compared to its major trading partners. That said, in the short term, continuing capital outflows remain a risk, which we discuss in our alternative scenario. In this scenario, the ruble will depreciate further in nominal and real terms.

Where Next For Russia's Economy?

The base-case forecast: The Ukraine tensions recede gradually

In our base-case forecast, we expect:

- Russia's macroeconomic performance to remain weak in the first half of 2014 and see only a gradual improvement in the latter part of the year, resulting in real GDP growth averaging 1.2% in 2014 and 2.2% in 2015 (see table 1).
- Capital outflows to decelerate to modest levels, roughly to the level of the current account surplus. The ruble will stabilize at current levels and inflationary pressures gradually abate. There is no need for monetary authorities to defend the currency. The most recent policy rate hike does not lead to a widespread increase in lending rates to final borrowers. These rates are only loosely related to the policy rate and are already high, especially for consumer

loans. The policy rate is cut in the second half of the year.
- Consumer demand to moderate amid slower real income growth and a slowdown in consumer credit growth that has so far supported consumption.
- A revival in investment to be only gradual. Many large state-owned enterprises have completed their previous investment plans, and the commencement of a new investment cycle has been delayed for many state-owned enterprises, not least in response to regulated tariff freezing imposed by the government to keep inflation in check. Private investment is being held back by poor business sentiment and uncertainty, including over exchange rate developments.
- Export-oriented industries to benefit from the weakening of the currency through improved profit margins. Import growth will slow due to the deceleration of domestic demand growth and real depreciation.
- The 2014 budget to receive a windfall from the weaker ruble, as oil revenues are billed in foreign currency. At the same time, lower growth will hit non-oil revenues.
- The pass-through of the weaker currency to domestic prices to make it more difficult for the Central Bank of Russia to achieve its indicative inflation target of 5% in 2014, despite the freezing of regulated utility prices. We expect annual average inflation in 2014 to remain at last year's level of 6.8%. Disinflation should resume in 2015 as the effects of the currency depreciation dissipate and the central bank moves to an official inflation targeting regime.

Table 1

Base-Case Forecast

(%)	2012	2013e	2014f	2015f
GDP	3.4	1.3	1.2	2.2
Domestic demand	5.5	1.7	1.4	3.5
Private consumption	7.9	4.7	3.2	3.7
Gross fixed capital formation	6.4	(0.3)	(3.5)	5.0
Exports	1.4	3.8	1.5	2.0
Imports	8.8	5.9	2.0	7.0
Inflation (annual average %)	5.1	6.8	6.8	5.7
RUB/US$ (annual average)	31.1	31.8	35.7	36.0
Brent oil price ($/bbl)	111.7	108.6	100.0	95.0

e--Estimate. f--Forecast. RUB--Russian ruble. Bbl--Barrel.

The alternative scenario: Tensions intensify and remain elevated for most of the year

In our alternative scenario, geopolitical tensions intensify through the second quarter and remain elevated until the end of 2014. We expect this scenario would lead to:

- A new wave of sell-offs by foreign investors and capital flight by domestic residents, including "internal flight" via purchases of foreign currency and conversion of deposits to foreign currency. The ruble loses a further 10% of its value against the U.S. dollar during the second quarter and stays at this level over the third quarter (see table 2).
- The central bank hiking its key interest rate and/or executing large-scale interventions in the foreign exchange market, squeezing liquidity. This constrains credit, but also limits speculation against the ruble.
- A drop in investment that is larger than in our base case due to tighter financial conditions and further erosion of business confidence. Big state-controlled energy companies may be pushed to bring forward their investment plans.
- Households' purchasing power decreasing due to higher inflation rates that reach 7.2% in 2014, and consumer sentiment being hit by uncertainty, leading to higher savings (including in foreign currency).
- The negative impact on GDP growth being constrained by the strong adjustment of imports, reflecting lower domestic demand and significant real depreciation of the exchange rate. As a result, real GDP growth rate averages

0.6% in 2014.

- The budget receiving additional commodity-related revenues, while non-commodities revenue is lower due to lower growth. The government is likely to provide some fiscal stimulus to counteract the weakness in private demand.

In the alternative scenario, we do not assume major disruption to Russia's oil and gas supply to Europe, hence our oil price forecast remains the same.

Table 2

Alternative Forecast

(%)	2012	2013e	2014f	2015f
GDP	3.4	1.3	0.6	2.1
Domestic demand	5.5	1.7	(0.5)	4.4
Private consumption	7.9	4.7	1.3	4.0
Gross fixed capital formation	6.4	(0.3)	(7.0)	8.5
Exports	1.4	3.8	1.0	2.0
Imports	8.8	5.9	(3.5)	11.0
Inflation (annual average %)	5.1	6.8	7.2	5.2
RUB/US$ (annual average)	31.1	31.8	38.3	36.0
Brent oil price ($/bbl)	111.7	108.6	100.0	95.0

e--Estimate. f--Forecast. RUB--Russian ruble. Bbl--Barrel.

The Impact On Europe's Economies Should Be Limited

Under both scenarios--base case and alternative--we do not foresee any material impact on Western, Central, and Eastern European economies. Crucially, oil and gas supplies from Russia to Europe are not disrupted in any of these scenarios, and oil prices do not deviate from the base case. The scenarios also imply that Russia will remain integrated into the international financial system.

The potential impact on European economies is through trade channels, and, in our view, is limited in the alternative scenario. Russian imports are some 5% lower in this scenario compared to the base case, leading to lower demand for European exports. However, exports to Russia account for a relatively modest share of total exports and GDP in most European economies. EU-27 merchandise exports to Russia stood at €123 billion in 2012 (7% of total exports, or 1% of EU GDP), while exports in services amounted to €28 billion. Trade exposure is proportionally larger for some EU countries, in particular Eastern European economies and Finland (see table 3).

Table 3

EU Merchandise Exports To Russia, Selected Countries

	Merchandise exports to Russia		
	(Bil. €)	Share of merchandise exports (%)	Share of GDP (%)
Germany	37.9	3.2	1.4
Italy	10.0	2.6	0.6
France	9.1	2.1	0.4
Poland	7.7	5.2	2.0
Finland	5.7	10.0	3.0

Table 3

EU Merchandise Exports To Russia, Selected Countries (cont.)			
Czech Republic	4.8	4.7	3.1
Lithuania	4.4	18.9	13.2
Slovakia	2.6	4.2	3.7
Hungary	2.6	3.4	2.6
Latvia	2.0	19.7	8.9
Estonia	1.5	13.2	8.7
Slovenia	1.2	5.3	3.3

Source: European Commission.

The Credit Implications For Banks

Smaller Russian banks are likely to suffer the most

Under our base-case scenario, we expect the overall impact on the Russian banking system to remain manageable, especially for large universal banks. Asset quality, profitability, and potentially liquidity are set to deteriorate with generally moderate pressure on our ratings on Russian banks. However, for small banks, we expect a more pronounced impact on their financial profiles. Under the alternative scenario, we expect more of a ratings impact for small and midsize banks, and on certain larger banks with already-thin capital positions.

The five ways events are affecting Russian banks

We are monitoring how the geopolitical tensions are affecting Russian banks through five key channels: the economic slowdown, direct and indirect exposure to Ukraine, depreciation of the ruble, tighter liquidity and tougher refinancing conditions, and any relaxation of corporate governance.

1. The economic slowdown. We expect slower lending growth, lower revenues, and higher credit losses for Russian banks as a result of the economic slowdown under our base-case scenario. In our view, the more vulnerable banks are those exposed to weak sectors such as small and midsize enterprises (SMEs), construction and real estate, and unsecured consumer lending. We also think the Russian banking system's asset quality is likely to deteriorate slightly, with the ratio of nonperforming loans rising toward 9% in 2014 and 10% in 2015, from an estimated 6.5% in 2013, compared with our previous expectations of 8% and 9% (see "Adverse Economic Conditions Will Weigh On Russian Banking Sector Performance In 2014," published on Feb. 19, 2014).

2. Direct and indirect exposure to Ukraine. Russian banks have modest direct exposure to Ukraine, which we estimate at about US$25 billion-US$30 billion, or about 14%-16% of the system's total equity, and less than 2% of assets at year-end 2013. These exposures include Ukrainian subsidiaries of Russian banks, the largest being subsidiaries of Sberbank, VTB Bank JSC, and Vnesheconombank (see table 4). They also include direct exposure to Ukrainian corporates, which can be substantial. For example, Gazprombank has exposures to Ukrainian corporates totaling $4.6 billion, which on a net basis represented about 38% of the bank's equity on Dec. 31, 2013. However, we understand that the underlying risks are secured by collateral that includes the pledge of Gazprom payments related to gas transit through Ukraine to Western Europe, which in our view somewhat lessens risks. Despite this modest overall exposure to Ukraine, we believe that Russian banks may have to recapitalize or to increase liquidity support to their local subsidiaries, especially if the situation in Ukraine continues to deteriorate.

Table 4

Ukrainian Bank Assets

	Total assets of the Ukrainian subsidiary (bil. $)	Total assets/parent equity (Sept. 30, 2013)(%)
Sberbank	4.20	7.50
VTB	2.90	10.50
VEB	4.60	24.20

3. Ruble depreciation. About 20% of loans in the Russian banking sector are denominated in foreign currencies, and these are predominantly corporate loans. The share of retail loans denominated in foreign currencies is minimal. Some banks run short open foreign currency positions. However, the banking system as a whole has a net foreign asset position. We also observe that some corporate borrowers have not fully backed their foreign currency-denominated loans with foreign currency-denominated revenues. These corporates could run into difficulties in servicing their debt, with asset quality implications for their lending banks. Under our alternative scenario, we see a weakening in the confidence of depositors with accounts in the domestic currency and continued capital flight from Russia.

4. Liquidity and refinancing. So far, this risk is mostly pertinent for smaller Russian banks with modest customer franchises. In a continued flight to quality, large state-owned banks may see additional inflows of deposits, as they did in the fourth quarter of 2013. Under our alternative scenario, investor flight from Russia might reduce the country's access to international capital markets and raise borrowing costs for all banks. We estimate Russian banks' foreign debt repayments this year at about $20 billion. However, the short-term refinancing needs of the banks' Russian corporate clients are more than double that amount. If the markets can't meet their needs, these clients would call on large Russian banks for refinancing. We expect the Central Bank of Russia to remain supportive of the banking sector through the provision of liquidity. However, if banks use a substantial portion of that to buy foreign currency, further weakening the ruble, the central bank might reconsider this kind of support.

5. Corporate governance. If the situation worsens, we may see a reversal in the improvement in corporate governance we have observed over the past few years. Banks may reduce the transparency of public accounts. The state may interfere more in the lending decisions of state banks to support key sectors or corporates, especially if some lose access to international markets, and may ask for greater tolerance for the restructuring and repeated restructuring of bad loans.

A few Western European banks are exposed

The operations in Ukraine of Western European banks do not constitute a material proportion of their total exposure and revenues. They have diminished in the past two years, with the exit of a number of Western European banks: Erste Group Bank AG, Commerzbank AG, Swedbank AB, and Skandinaviska Enskilda Banken AB. However, a couple of banks operate businesses in Ukraine. One of the most exposed is Austria's Raiffeisen Zentralbank Oesterreich AG (RZB) through its subsidiary Raiffeisen Bank International AG (RBI; €3.6 billion in customer loans on Sept. 30, 2013). Another is UniCredit SpA group, mainly through UniCredit Bank Austria AG (Bank Austria, €2.3 billion of customer loans on Sept. 30, 2013). These banks announced their intention to sell their Ukrainian subsidiaries, but current events may hinder this process. Some French banks, particularly BNP Paribas and BPCE, still have operations in Ukraine, but their absolute and relative shares are materially lower. As asset quality has been weakening in Ukraine for some time already, current developments are unlikely to take Western European banks by surprise, in our view. Overall, we expect the impact on 2014 results to be negligible except for the two most exposed Austrian banks. Their impairments may, in a worst-case scenario, consume a material proportion of their annual results for 2014.

Regarding their Russian operations, under our base-case scenario, we expect the overall impact on the banking systems in Western Europe to be manageable. Under the alternative scenario, earnings at RZB and Bank Austria may take a hit from a material depreciation of the ruble. The levels of nonperforming loans of Russian subsidiaries of Western European banks are relatively low, but could start to rise if the situation deteriorates further. One factor lessening this risk, however, is that most of the exposures in question are to large corporates in Russia (see table 5). The downturn we expect under our alternative scenario is likely to affect retail and SMEs more than large corporates.

Table 5

Western European Banks' Exposure To Russia

	Total customer loans in Russia (bil. €)	Total customer loans in Russia/total loans (%)	Total customer loans in Russia/equity (%)
Societe Generale*	13.5	3.80	26.00
Bank Austria§	12.4	9.20	68.00
Raiffeisen Zentralbank Oesterreich AG (RZB)†	10.2	12.10	87.00

*Data as of year-end 2013 and outstanding amount for the "international retail banking and financial services" business segment only, not the total group consolidated figure. §Data as of September 2013. †Data as of June 2013.

There is a risk that Ukrainian and potentially Russian subsidiaries of Western European banks will face a panic-driven outflow of deposits. We believe parent banks are still likely to offer support, in the form of additional liquidity lines or capital injections, because this might ultimately be less costly than letting their subsidiaries default.

The Credit Implications For Corporates

We detail below our view on the specific impact on rated corporates that might arise under our base case and alternative scenarios, and the various channels that we have identified through which corporate credit quality could be impaired.

Our base-case scenario covers a modest further slowdown in the Russian economy, with some stabilization of the ruble at the current lower levels. The impact on the oil and gas industry would be minimal. We would expect some negative impact on sales of foreign exporters into Russia, with capital goods, autos, and discretionary consumer goods most affected.

Our alternative scenario entails a more extended downturn in Russia corresponding to escalating fears among foreign investors. This would increase refinancing risks for Russian companies, as access to international markets would most likely become highly restricted. However, we would anticipate that some local currency support would be provided for the major strategic companies by state-backed banks, with the possibility even of additional support from Chinese banks looking to establish stronger banking relations with key commodity players. Still, higher-leveraged or second-tier issuers could face liquidity risks.

The channels of risk transmission

1. Sensitivity to foreign exchange developments. Typically the macro impact of a depreciating currency translates into lower imports, and stimulates exports. In the case of Russia, the key imports (see table 6) that would be most demand sensitive would include other manufactured goods (25.3%), autos (13.6%), and chemicals (11.6%). The importance of the oil and gas industry would likely mean that importing high-skill and technology-intensive machinery would remain a priority. Also, a significant proportion of consumer goods is imported. Price competitiveness of domestic goods will increase, but for those producers that use intermediate imports for domestic production the effect will be less pronounced. Also, domestic companies will benefit from a weaker currency only if they have sufficient spare capacity to respond to the increased demand for local goods.

In contrast, 68% of Russia's merchandise exports in 2012 were hydrocarbons where there is a U.S. dollar global pricing structure. We believe that in the absence of meaningful trade sanctions there would be little impact on foreign demand for Russian oil and gas exports, at least in the short term. In the mid to long term, political pressures in Europe to replace Russian gas may increase but this would likely require development of shale gas plays in Europe, export licenses to permit U.S. liquid natural gas (LNG) to be sold to Europe, as well as large capital expenditure in infrastructure (LNG terminals, pipelines, etc.).

Table 6

Top Five Categories 2012 Russian Exports And Imports

Exports	**(Bil. $)**	**(%)**
Petroleum, petroleum products, and related materials	285.3	54.4
Gas, natural and manufactured	68.8	13.1
Manufactured goods	50.1	9.5
Primary commodities, excluding fuels	46.2	8.8
Chemicals and related products	24.6	4.7
Total Exports	524.6	
Imports	**(Bil. $)**	**(%)**
Other manufactured goods	80.0	25.3
Machinery and transport equipment	57.4	18.2
Road vehicles	43.1	13.6
All food items	40.4	12.8
Chemicals and related products	36.6	11.6
Total Imports	316.0	

Source: United Nations Conference on Trade and Development.

2. Liquidity considerations for domestic companies. Under our criteria for rating corporate entities, sovereign transfer and convertibility (T&C) and government pressures are an important element in our assessment of credit quality. This can be seen in the case of Ukraine, where the government has introduced some rules for repatriation of foreign exchange revenues and is often late in reimbursing VAT on exports. So far, we haven't seen any companies defaulting due to the current form of T&C restrictions.

Table 7

Rated Russian And Ukrainian Corporates With Identified Liquidity Issues

Company	**Country**	**ICR**	**Liquidity**	**Capital structure**
UkrLandFarming PLC	Ukraine	CCC	Less than adequate	Neutral
Lemtrans LLC	Ukraine	CCC	Less than adequate	Neutral
The State Administration of Railways Transport of Ukraine	Ukraine	CCC	Weak	Negative
MHP S.A.	Ukraine	CCC	Less than adequate	Neutral
Creativ Group OJSC	Ukraine	CCC	Less than adequate	Negative
Ukrainian Agrarian Investments S.A.	Ukraine	CCC	Weak	Negative

Table 7

Rated Russian And Ukrainian Corporates With Identified Liquidity Issues (cont.)				
OAO Koks	Russia	B-	Less than adequate	Neutral
Pioneer Group CJSC	Russia	B-	Less than adequate	Negative
Rosinter Restaurants Holding OJSC	Russia	B-	Less than adequate	Neutral
RSG International Ltd.	Russia	B-	Less than adequate	Neutral
Ural Optical & Mechanical Plant JSC	Russia	B-	Less than adequate	Negative
HMS Hydraulic Machines & Systems Group PLC	Russia	B	Less than adequate	Neutral
Oil and Gas Company Russneft OJSC	Russia	B	Less than adequate	Neutral
Moscow Integrated Power Co. JSC	Russia	BB-	Less than adequate	Negative
OJSC Novorossiysk Commercial Sea Port	Russia	BB-	Less than adequate	Neutral
SPC Katren CJSC	Russia	BB-	Less than adequate	Neutral
Rostelecom OJSC	Russia	BB+	Less than adequate	Neutral
Ferrexpo PLC§	U.K.	CCC+	Less than adequate	Neutral
Alliance Oil Co. Ltd.*	Bermuda	B-	Less than adequate	Neutral
Breboro Holdings Co. Ltd. Group*	Cyprus	B-	Weak	Neutral

*Russian offshore registered company; §Ukrainian offshore registered company. Source: Standard & Poor's. Data as of March 27, 2014. ICR--Issuer credit rating.

In the case of Russia, T&C is not currently the key constraint for most issuers under our base-case or alternative scenarios. We view as more pertinent issues relating to:

- Refinancing risk--several companies are extremely large international borrowers, but our view is that their debt maturity profiles and the support that they could expect to receive from state-backed local banks should protect against any short-term loss of access to international debt markets. The largest borrowers are government-related entities (GREs) and commodity producers whose access to financing is naturally better. The most exposed borrowers are some highly leveraged unrated private mining and materials entities. Currently, the international syndicated loan market is less accessible for Russian companies, but not completely closed. For instance Gazprom Neft JSC (long-term rating 'BBB-') recently raised $2.15 billion under its committed facility, and Metalloinvest ('BB') arranged a new $1.15 pre-export financing on March 19. Refinancing domestically may be more expensive. Corporates may be additionally affected if the domestic banking system is affected by foreign exchange fluctuations or by more difficult access to international refinancing. Still, state-owned Sberbank and VTB dominate the local credit market, which should have some stabilizing impact, at least in the short term.
- Potential foreign exchange mismatches if companies have unhedged hard currency borrowings or costs and weak local currency revenues. Companies listed in table 7 with capital structures that we assess as "negative" under our criteria could well have meaningful near-term redemptions in foreign currencies and thus could suffer a deterioration in credit quality. However, apart from Moscow Integrated Power, all these companies are rated at 'B-' or lower. Most rated Russian oil and gas companies have a natural hedge, and most companies focused on domestic markets are now funded in rubles.
- So far, we haven't seen foreign banks triggering material adverse change or material adverse effect clauses on Ukrainian or Russian borrowers. However, we cannot rule that out in the future--for example, due to tightening T&C restrictions or sanctions against certain entities or their owners.

3. Slowing economic growth could affect cyclical, domestic industries. If the current situation exacerbates the slowdown in Russia's economic growth, this could affect cyclical industries focused on domestic markets. These include construction; development; real estate; potentially media and advertising; and, to some degree, steel producers (to the extent they sell on the domestic market). If local banks are pressured by foreign exchange movements or lower availability of financing for themselves, this could affect demand for real estate (via the lower availability of mortgages, for example).

4. Impact of regulation on utilities, railways, and oil and gas. What Russia's government is likely to do with regulated utilities and railways in 2015 and beyond is still unclear. Their prices were frozen in 2014 to support economic growth and they tried hard to cut their capital investment in response to lower tariffs, to the displeasure of the government.

For oil and gas companies operating in Russia, the government may want to increase tax rates further, although these are already very high. Also, the government may try to bring back semi-informal micro-management of domestic fuel prices to avoid a hike in ruble terms. Still, the pressure is likely to be moderate, because large companies have solid lobbying power and for GREs, ongoing negative state intervention in our credit analysis can be somewhat offset by our assumption of state support.

5. Progress on corporate governance could be reversed.Russian companies have in recent years started to adopt international standards of reporting and governance to improve access to international capital markets. If they found themselves locked out, we believe this could be highly regressive for their corporate governance--a longer-term concern from a ratings perspective.

6. Meaningful country risk exposure of international companies in Russia and Ukraine. Table 8 lists those international companies that we rate with meaningful country risk exposure to Russia or Ukraine in terms of assets, revenues, or EBITDA. In line with the sector composition of Russian imports (as highlighted in table 6), we consider that several global consumer goods and food product companies could have some sensitivity to a weaker domestic economy under our alternative-case scenario.

Table 8

International Rated Corporates With Meaningful Country Exposures To Ukraine Or Russia

--International rated corporates with meaningful country exposures to Russia--				
Company	**Country**	**Sector**	**Rating**	**Outlook**
BP PLC	U.K.	Oil	A	Positive
Pepsico Inc.	U.S.	Consumer Products	A	Stable
Fortum Oyj	Finland	Diversified Energy	A-	Negative
Danone	France	Consumer Products	A-	Stable
Coca-Cola HBC AG	Switzerland	Consumer Products	BBB+	Negative
Wrigley (Wm.) Jr. Company	U.S.	Consumer Products	BBB+	Stable
Kinross Gold Corp.	Canada	Mining And Minerals	BBB-	Stable
Atrium European Real Estate Ltd.	Jersey	Real Estate	BBB-	Stable
Metro AG	Germany	Restaurants/Retailing	BBB-	Stable
Turkiye Sise ve Cam Fabrikalari A.S.	Turkey	Capital Goods	BB+	Stable
C.A.T. oil AG*	Austria	Oil	BB	Stable
VimpelCom Ltd.	Bermuda	Telecommunications	BB	Stable
DigitalGlobe Inc.	U.S.	Aerospace & Defense	BB	Stable
Vestel Elektronik Sanayi Ve Ticaret A.S.	Turkey	Technology	B-	Stable
Nico Middle East Ltd.	Bermuda	Oil	B	Stable

Table 8

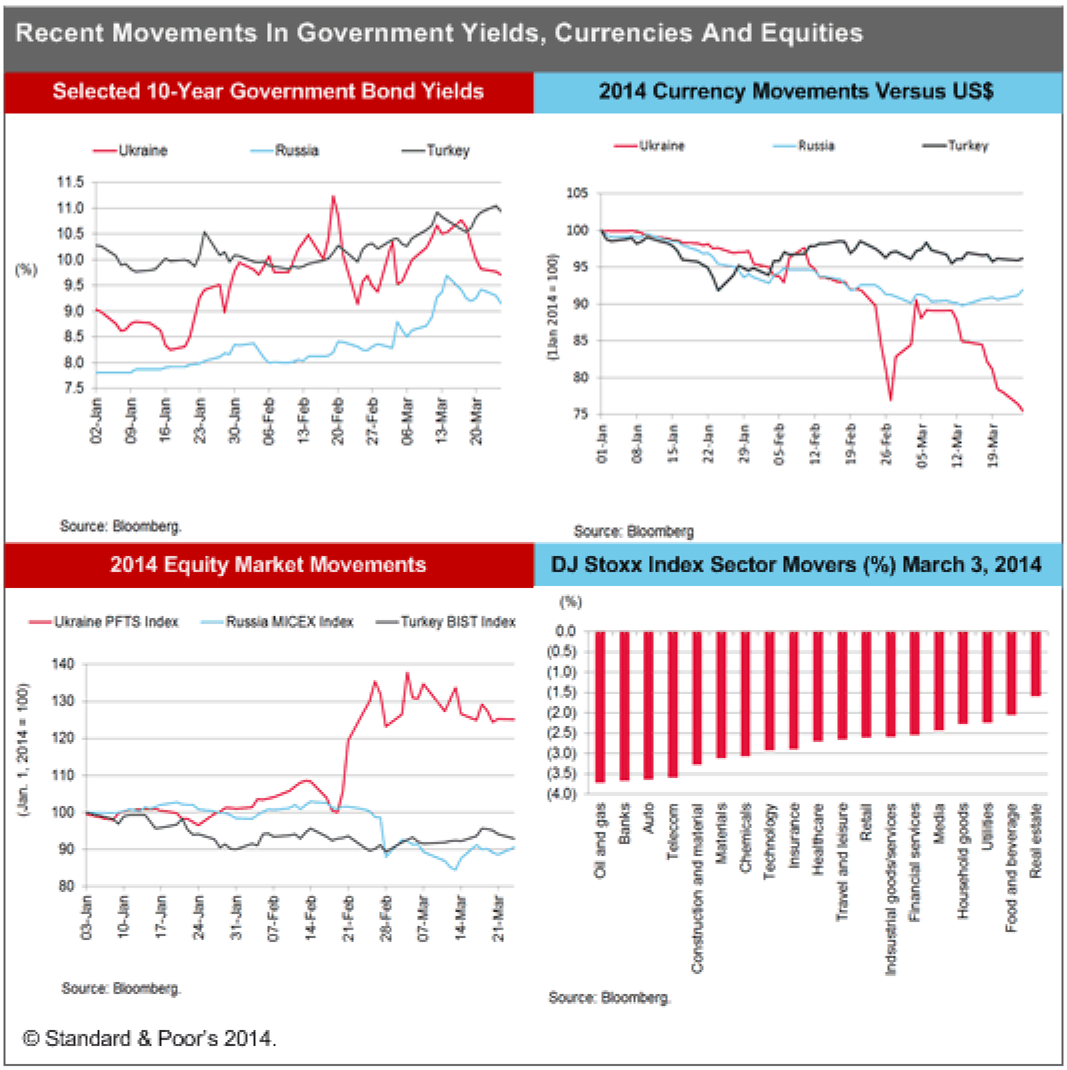
International Rated Corporates With Meaningful Country Exposures To Ukraine Or Russia (cont.)

--International rated corporates with meaningful country exposures to Ukraine--

Company	Country	Sector	Rating	Outlook
Turkcell Iletisim Hizmetleri A.S.	Turkey	Telecommunications	BB+	Stable
Mobile TeleSystems (OJSC)	Russia	Telecommunications	BB+	Stable
GCL Holdings S.C.A.	Luxembourg	Containers & Packaging	B	Stable
Ferrexpo PLC§	U.K.	Mining And Minerals	CCC+	Negative

Source: Standard & Poor's. Data as of March 27, 2014. *Russian offshore registered company; §Ukrainian offshore registered company.

7. Recent movements in government yields, currencies, and equities.



A More Severe Scenario Is Plausible, But We Expect Self-Interest To Prevail

Reflecting our revision of the outlook on our rating on Russia to negative on March 20, 2014, we believe that there is a material risk that the conflict between Russia and Ukraine could extend beyond Crimea. Should the situation deteriorate, we believe further and wider sanctions could be imposed on Russian institutions and individuals, possibly including trade restrictions.

While we consider a more negative scenario that includes disruption of oil and gas supplies from Russia to Western Europe is possible, we view it as unlikely at this juncture. However, if serious disruption were to occur--for example, because of trade sanctions imposed on Russia--this would push energy prices up, with the magnitude of the consequent economic shock determined by the severity and length of the disruption. Russia would lose at least part of its exports revenues, which would have potentially severe negative consequences on its balance of payments, budget, and growth. Europe would also be negatively affected. The share of Russian gas in total gas imports is very large in some EU countries: 100% in Baltic countries, close to that in several Eastern European countries, and more than a third in Germany. The shock to confidence would also affect financial markets across the region and possibly affect other emerging markets.

The U.S. and Europe could also impose heavier financial sanctions on Russia, such as freezing the assets of Russian institutions, not only individual citizens, or by excluding Russian financial institutions from international transactions. We assume that this would have a significant effect on the Russian economy, with possible financial spillovers, depending on the form these sanctions take.

For corporates, if trade restrictions were imposed, we would need to assess the credit impact for those sectors most affected. The main export sectors into Russia are capital and other manufactured goods. International oil majors are, in our view, not particularly exposed to the potential loss of Russian production--BP has a minority stake in Rosneft, while others have minority stakes in Sakhalin and in offshore greenfields--and likely would be net beneficiaries of higher global oil prices, similar to the scenario that unfolded following the loss of Libyan production in 2011. For oil service companies, we would not expect much impact because the sector is dominated by local players. Less foreign competition supports their profits in the short to medium- term, even though it may constrain the sector's development in the longer term.

Related Criteria And Research

- Economic Research: European Economic Outlook: Out Of Recession, Back In The Slow Lane, March 21, 2014
- Credit Conditions: Europe Is On A More Stable Path, Amid Turbulence In Emerging Markets, March 21, 2014
- Russian Federation Outlook Revised To Negative On Rising Geopolitical And Economic Risks; Ratings Affirmed, March 20, 2014
- Policy Risks, Not Tapering, Are Key To Emerging Market Sovereign Ratings, March 5, 2014
- Ukraine Foreign Currency Rating Lowered To 'CCC' On Escalation Of Political Turmoil; Outlook Negative, Feb. 21, 2014
- Adverse Economic Conditions Will Weigh On Russian Banking Sector Performance In 2014, Feb. 19, 2014