Global Hot Topics

Russia: S&P complicates the outlook. The worst may not be over yet

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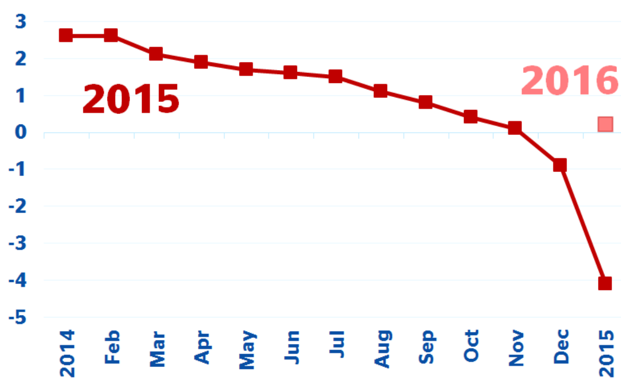
On Monday, S&P downgraded Russia's credit foreign currency sovereign credit rating by one notch to BB+ (junk), keeping the outlook as negative. The key reasons behind the decision were: i) the sharp economic relapse, ii) the central bank's constraints in achieving the monetary targets, and iii) the possibility of further EU sanctions. The rating downgrade could become a self-fulfilling prophecy for the Russian economy and its financial sector, as it puts other agencies' investment-grade ratings at risk (with potential exclusion from the big bond indices) and is triggering further exchange-rate depreciation. Given the big corporates' currency mismatch in terms of liabilities, this would lead to a faster-than-expected deterioration in the macro situation. The worst may not be over yet.

The Russian situation is becoming critical…



Collapsing oil prices, the crash of the ruble and the worsening of growth prospects are behind Russia's sovereign rating action by S&P. The downgrade implies a new step in the deterioration of Russia's macroeconomic situation as well as in its financial sector.

While Russia will retain a current account surplus that will support its external accounts despite lower oil prices, the main risks are seen on the financial side. The continuous depreciation of the ruble (since October 2014, it records 50% against euro) will lead to further pressures on the liabilities of big corporates (USD-denominated) and/or Russian Central Bank reserves to defend the currency despite the government's efforts to avoid this (as in the Rosneff case). In fact, Russia's international reserves have been falling rapidly as authorities step in to defend the currency, provide funds for strategic companies and bail out the banking sector.

Recent developments in the Russian economy have seriously damaged the situation of its domestic banks. Their liquidity position has been eroded by deposit withdrawals and sanctions have prevented foreign banks from helping them to issue debt. The economic situation is also eroding asset quality and credit demand, and therefore banks' profitability and solvency.

Since December, the government has implemented a series of forbearance measures: expanding the list of assets that can be used as collateral to obtain liquidity in foreign currency from the central bank; allowing the use of ratings as of March 2014; introducing a "temporary moratorium" on the recognition of the negative revaluation of securities portfolios; doubling the amount covered by the deposit insurance, etc. Finally, authorities have recapitalised some banks. Since December, the second-, third- and 28th- banks banks have received capital for a total of RUB300bn (0.4% of GDP). A plan to recapitalise 27 lenders (out of the existing 800 entities) will be implemented by the end of January for a maximum amount of 1.4% of GDP.

… But the worst could not be over:

Despite the Russian crisis, the situation could deteriorate further if:

- **A new loss of the Investment Grade:** If Moody's or Fitch follows the S&P action, this would lead to the exclusion of Russian bonds from Global IG benchmark indices, provoking index-related outflows and constraining the corporates' funding capacity (higher costs and restrictions to cover debt redemptions).
- **Further Western sanctions:** Due to the recent escalation of Russian-Western tensions (see our previous note), EU foreign ministers will meet on 29 January to discuss the implementation of new sanctions. In the best-case scenario, the recent escalation will rule out the possibility of any relaxation (supported by France and even Germany some weeks ago). In the worst case (risk scenario), the scope for new and more painful sanctions is still high. A further escalation of the crisis and/or any mismanagement of the conflict could trigger more serious sanctions (including SWIFT and energy trade restrictions).
- **Further sharp drops in oil prices:** extremely low oil prices could have important disruptive effects on the activity, taking account that revenues by oil exports represent around 60% of total. The performance of the domestic markets could be disruptive, intensifying the ruble depreciation (50% since last October) and increasing the financial sector vulnerabilities.

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