Russia - Macroeconomic Overview

May, 2016

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Summary - Risks and Rewards

Gradual economic recovery is expected starting from 2017:

- Lower oil prices and sanctions hit the economy in 2014-2015
- A timely and appropriate government response contributed to avoiding a stronger downturn
- Set against the weakness in retail and construction, agriculture and chemicals showed increased growth benefitted from the weak Ruble and western sanctions, resulting in import substitution
- Increasing long-term growth requires further structural reforms
- Lower oil prices and geopolitical tensions may have substantial impact on the economy owing to its dependency on commodities, though a number of mitigating factors are in place
- Gradual economic recovery is expected starting from 2017

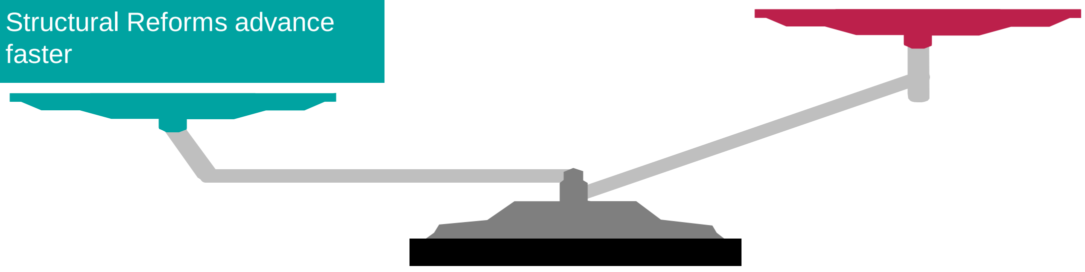
Downside risks and Upside potential factors

Downside Risks:

- Lower Oil Prices for longer and a bout of financial volatility
- Increase in Geopolitical Tensions

Upside potential:

- Oil prices rebound
- Geopolitical tensions subside
- Structural Reforms advance faster



Mitigating Factors

- Low public debt
- Large FX reserve buffers
- Low (headline) fiscal deficit
- Current account surplus
- Positive International Investment Position
- Flexible exchange rate regime
- More competitive real exchange rate level

Economic Highlights (1/5)

Contraction in GDP in 2015 was relative modest when considered against the headwinds which faced the economy in the face of oil prices' drop

Gross Domestic Product (GDP)

While the headline contraction in GDP in 2015 was relative modest (-3.8%) when considered against the headwinds which faced the economy in the face of oil prices' drop, there was a wide variation in sector performances:

— Real private consumption fell sharply (by 9.2% in 2015 comparing to 2014) as household incomes shrank and debt service costs stayed high

— Gross fixed investments fell by 8.1% in 2015 due to high cost of credit and price growth on the investment goods

— Exports benefited from the weak Ruble (net export position grew by 66.8% in 2015 comparing to 2014)

These trends are expected to be repeated in 2016 as basic economic conditions will remain largely unchanged at least until mid year due to the following factors:

— External debt finance limitations set by sanctions

— Budget and currency issues

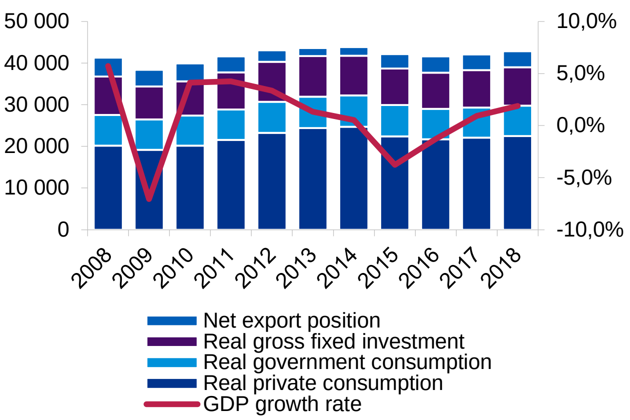
— Investments' shortage deepening

— Private consumption shrinkage

Gross added value (GAV) to GDP by the economy sectors is mostly presented by services (taking 62.5% in 2015 comparing to 62.6% in 2014). Normally services contribute more than 70%to country GDP, this leaves the potential for growth in this sector in Russia in the coming years

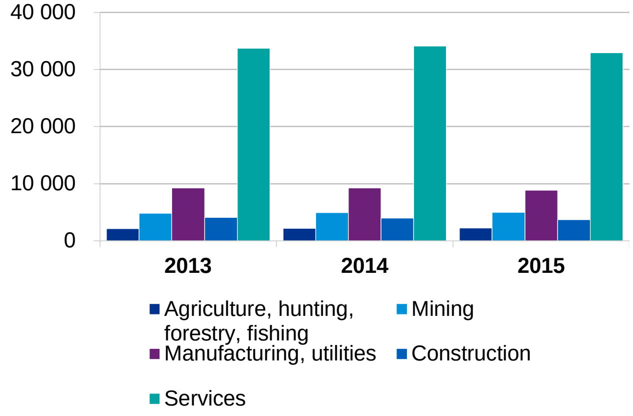
In 2015 government started building the new economic model. The measures are aimed at long-term diversification of Russian economic model decreasing oil dependency

GDP in real terms (prices 2008) by consumption, RUB bn



Source: EIU, RosStat

Gross added value (prices 2011), by economy sector, RUB bn



Source: RosStat

Russia – Macroeconomic Overview

Economic Highlights (2/5)

The consumer price and producer price indices currently are at their highest levels but substantial decrease is expected by the end of 2016

Inflation

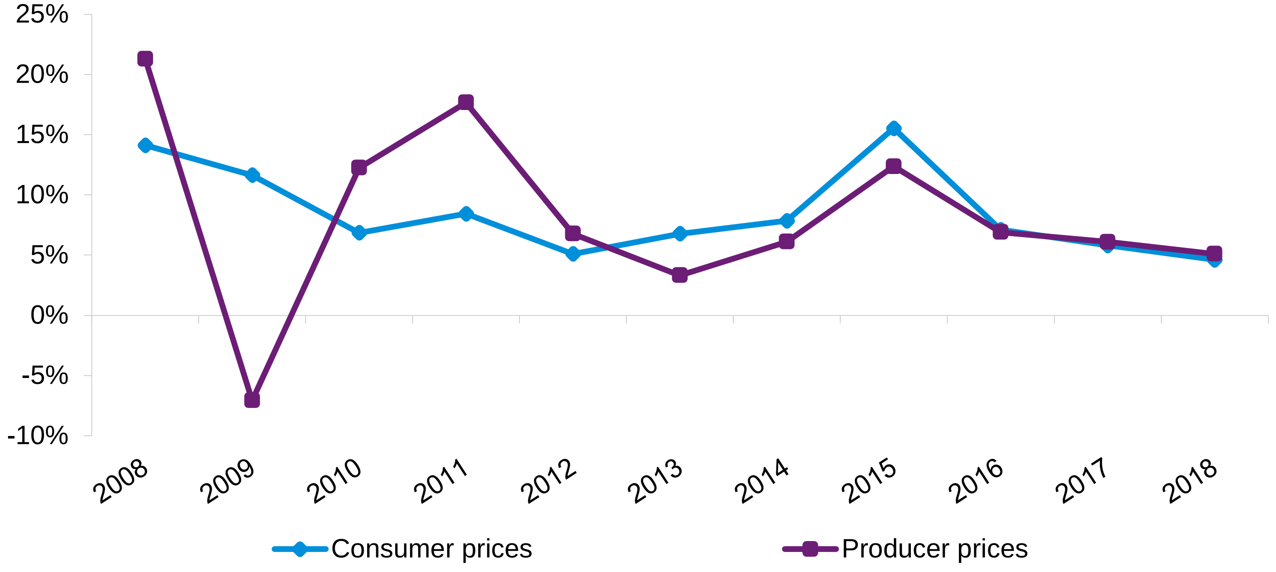
Both consumer and producer prices peaked in 2015 and reached the level of 15.5% and 12.4% accordingly, which is the maximum for the last 13 years and 4 years accordingly. This spike was partly because of the impact of sanctions on food prices and also because of the rapid devaluation of the Ruble in Q4 of the previous year

The CBR had predicted that the rate of inflation would start to decline quite sharply and would still end 2016 close to its target of 7%

The CBR has rejected the argument that domestic inflation is structural rather than demand driven and, hence, it may cut rates in support of economic activity without risking a demand spike

It is anticipated that the CBR will cut its benchmark rate in the summer 2016 only assuming oil has stabilized. This again feeds into the view that the economy will remain in recession through H1 with only a possibility for recovery in H2 2016

Consumer and producer prices' change, %



Source: EIU, RosStat

Economic Highlights (3/5)

The CBR was able to preserve the value of the Nation’s foreign exchange reserves, which have moreover have increased from USD360 billion in March 2015 to USD387 billion in March 2016

Foreign Exchange Rate (ForEx) and Oil Prices

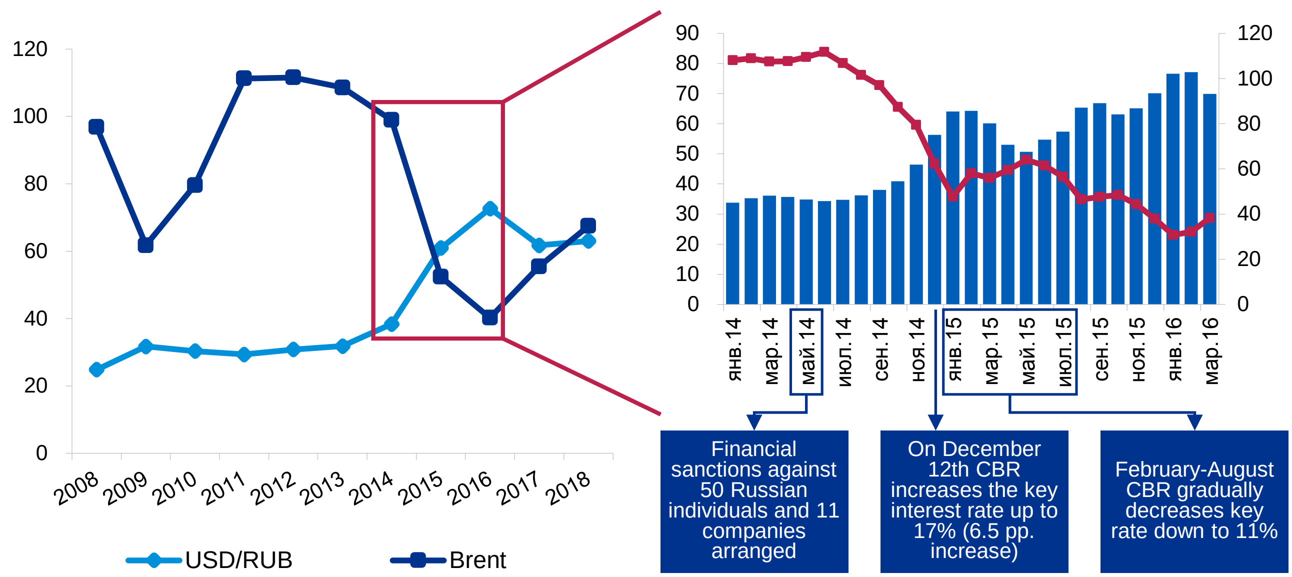
Starting from August 2014 Russian currency Ruble started depreciating comparing to the US Dollar (USD)

The depreciation of Ruble was highly correlated with oil prices’ drop. Brent price slump down to 30.7 USD/Barrel in January 2016 (comparing to 109.5 in May 2014). The correlation coefficient for the period from January 2014 to March 2016 equals 98.4%

CBR was able to preserve the value of the Nation’s foreign exchange reserves, which have moreover increased from USD360 billion in March 2015 up to USD387 billion in March 2016

The budget deficit (which in 2015 is confirmed on the level of RUB431 billion and takes up almost 1% of GDP in 2008 prices) and the active purchase of exchange reserves by CBR (non-official target level of which is approximately USD500 billion) will not let Ruble appreciate within the near future. Despite this the analysts predict the Ruble recovery in 2017-2018 due to oil prices’ recovery

Historical and Forecast USD/RUB rate and Brent Spot FOB Prices (USD/Barrel)



Source: International Energy Agency (IEA), CBR

Economic Highlights (4/5)

Capital outflows eased considerably

Foreign Direct Investments (FDI), Investment Spending and Capital Outflows

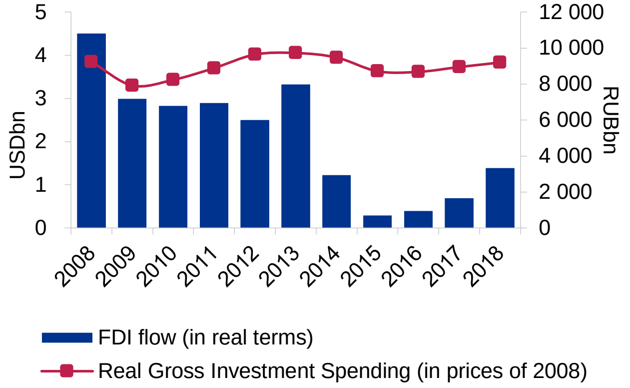
FDI inflow fell to an almost minimal level of USD20 billion in 2015. Investors remained side-lined waiting for further developments with regard to sanctions. The major inflows in 2015 were in the oil and gas sectors with the two notable events being the sale of 15.0% of Rosneft's Vankor field to ONGC of India and the sale of 9.9% equity in the Novatek controlled Yamal project to Chinese investors. Analysts expect to see a pick up in FDI in 2017 and 2018 but warn that this is predicated on an easing of the sanctions and some co-investment from government resources

Internal Gross Fixed Investment Spending declined by 2.5% YoY in 2014 and by 7.5% YoY in 2015. Slight recovery is anticipated starting from 2016

The total outflow of capital in 2015 was USD57 billion. That was much less than the Central Bank had expected and less than half the outflow recorded for 2014

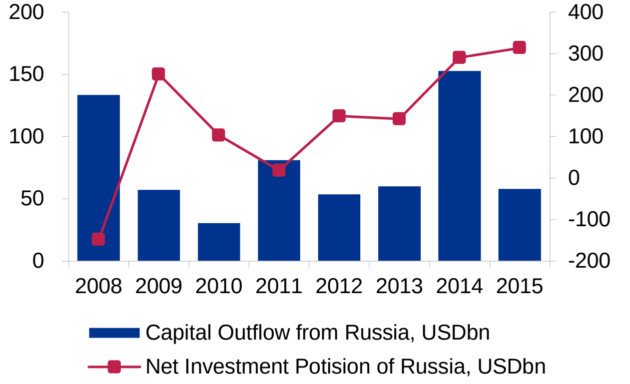
One of the explanations stands for the positive impact on the capital account as a result of the weak Ruble and the collapse in the value of imports. In 2015 the total value of imports was USD190 billion, or almost half that of two years earlier. The trade surplus was USD145 billion and that helped the current account report a surplus of USD 69.6 billion

FDI Flow and Real Gross Investment Spending



Source: EIU

Capital Outflow from Russia and Russian Net Investment Position, USD bn



Source: CBR statistics

Current Account Balance, USDbn

	2008	2009	2010	2011	2012	2013	2014	2015
Current Account Balance	103.9	50.4	67.5	97.3	71.3	33.4	58.3	69.6

Source: CBR statistics

Economic Highlights (5/5)

Access to international debt market is limited because of the sanctions. Once the sanctions are eased both the Ministry of Finance and Russian main market players confirmed there plans to participate in international debt deals

External Debt

Since November 2013 the government and Russian corporates have paid down foreign debt by almost USD220 billion. That is a direct result of the financial sector sanctions which were applied by western countries in August 2014. As a result in 2015 the total amount of external debt reduced to USD514 billion from USD731 billion in 2013

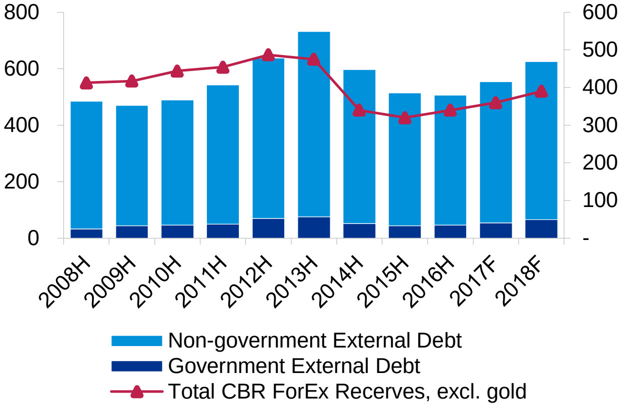
The international debt markets have re-opened to non-sanctioned Russian corporates in 2015 but with a higher interest rate compared to previous years. The former resulted in limited access to new debt for average corporates

The percentage of debt to GDP has risen from 32% in 2014 to 47% in 2016 despite the lower volume of external debt because of the effect of the Ruble devaluation on the domestic economy. Analysts estimate that the total value of the economy in 2016, will be less than USD1.1 trillion compared to USD2 trillion in 2013

The recent forecasts show a rising trend in external debt in 2016 and picking up more strongly in 2017 and 2018. Financial sector sanctions are at least expected to ease from mid year and that allows the state and the big corporates to return to the international debt market. The Ministry for Finance of Russian Federation has confirmed that it intends issuing new Eurobonds to international investors once the sanctions are eased

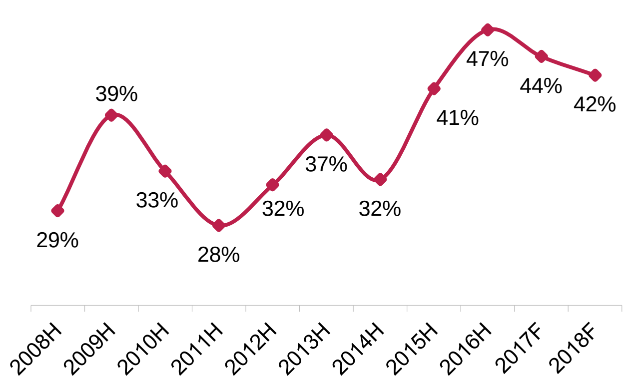
The increase of external debt (both government and non-government) is predicted starting from 2017 (up to USD564 billion in 2017 and USD625 billion in 2018)

Russia's External Debt and Total CBR ForEx Reserves, USDbn



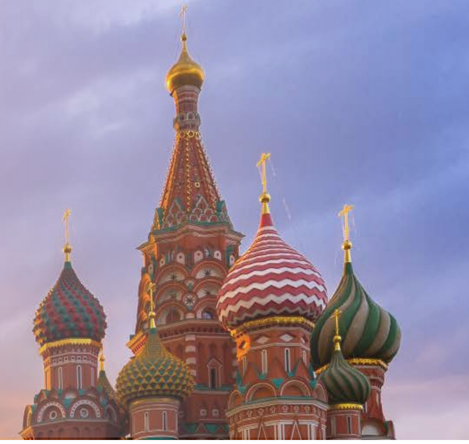
Source: CBR statistics, Sberbank, Macro-Advisory Ltd.

External Debt to GDP, %



Source: CBR statistics, Sberbank, Macro-Advisory Ltd.

Russian Credit Ratings



Standard & Poor's credit rating for Russia stands at BB+ with negative outlook. Moody's credit rating for Russia was last set at Ba1 with negative outlook. Fitch's credit rating for Russia was last reported at BBB- with negative outlook

Credit Rating of Russia

In general, a credit rating is used by sovereign wealth funds, pension funds and other investors to gauge the credit worthiness of Russia thus having a big impact on the country's borrowing costs

Following the first sanctions against Russia the Fitch agency have downgraded the credit risk for Russia from BBB Stable (set in January 2012) to BBB Negative in March 2014. Further downgrade by Fitch took place in January 2015 – down to BBB- Negative. Nevertheless, category BBB implies good credit quality

Moody's has also downgraded the credit rating of Russia – from Baa1 Negative Watch in March 2014 down to Ba1 Negative in April 2016. Category Baa implies moderate credit risk, category Ba – substantial credit risk

Latest rating according to S&P is BB+ Negative effective from January 2015. Category BB implies that the grade of investment is speculative and it faces major future uncertainties

Credit Rating of Russia

Agency	Rating	Outlook	Date
Moody's	Ba1	Negative	22 Apr 2016
Moody's	Ba1	Negative Watch	04 Mar 2016
Moody's	Ba1	Stable	03 Dec 2015
Moody's	Ba1	Negative	20 Feb 2015
S&P	BB+	Negative	26 Jan 2015
Moody's	Baa3	Negative Watch	16 Jan 2015
Fitch	BBB-	Negative	09 Jan 2015
Moody's	Baa2	Negative	17 Oct 2014
Moody's	Baa1	Negative	27 Jun 2014
Moody's	Baa1	Negative Watch	28 Mar 2014
Fitch	BBB	Negative	21 Mar 2014
Fitch	BBB	Stable	16 Jan 2012
Fitch	BBB	Positive	08 Sep 2010

Source: Fitch, Moody's and S&P agencies.

Need for Change

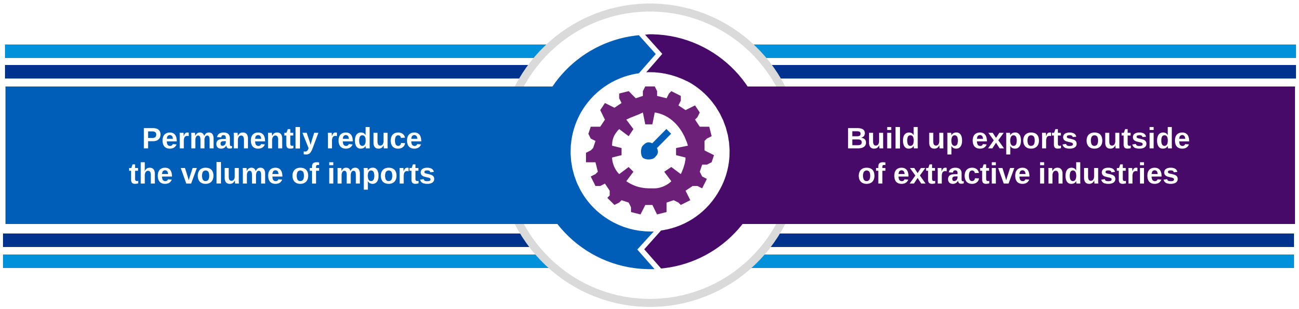
Through the course of 2015 there has been an emerging clarity concerning the government's thinking about the next driver of growth

The Russian economy survived a very challenging 2015 in relatively better shape than many had expected. Nevertheless the economy did slip into recession, Russia has all the necessary conditions for the recovery of economic growth for which it is necessary to fundamentally change the approaches to the regulation of the economy

The old model was essentially based on rising oil wealth trickling down to the broader economy via increasing incomes, social and investment programs funded by the budget and the rapid growth in consumer credit

Through the course of 2015 there has been an emerging clarity concerning the government's thinking about the next driver of growth. It started off as a discussion about import-substitution and localization of production facilities and has recently evolved into an all encompassing competitive economy strategy

Basically the government is aiming to create more competitive conditions in the economy to encourage both Russian and international companies to build a manufacturing base in the country so as to:



This, according to analysts, is expected to be the country's new industrial policy and aimed at both diversifying economic activity and restoring long-term growth

The key conditions, which government officials are highlighting as strategic priorities, in order to make this a reality include the following commitments:

- Keeping the Ruble at a more competitive exchange rate even when the price of oil recovers
- Prevention of wage costs from rising as steeply in real terms as they did in the decade 2000-2009
- No increase in the tax burden for companies
- Sustained efforts to reduce Russia's ranking in the World Bank Ease of Doing Business survey
- Co-investment by the state in infrastructure and in workforce training

The analysis agree that the commitment from the government is strong and has, in reality, arisen from an acknowledgment that there is no other way forward for the economy

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