BMI Research
A FitchGroup Company

Russia

Country Risk Report

Includes 10-year forecasts to 2027

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Contents

Executive Summary

Core Views

- Russia is emerging from recession but its long-term growth potential is subdued, closer to that of mature developed economies rather than a higher growth emerging market. This is due to the highly centralised nature of its economic model and large government footprint in key sectors, reliance on energy exports, poor business environment, weak investment growth and lack of structural reform momentum.

- While dissatisfaction with poor economic conditions and corruption appears to be on the rise, Vladimir Putin remains the clear frontrunner ahead of the presidential elections in March 2018, still benefitting from high approval ratings and a weakened opposition.

- Russia's sovereign profile is strong, given a large international reserve pile, low public debt, and stable current account and net international surpluses. That said, major fiscal reforms are needed, including an overhaul of the pension system, to ensure long-term sustainability in light of lower commodity prices and an ageing demographic profile.

- The Central Bank of Russia's shift to a free floating rouble and adoption of an inflation targeting regime has brought major dividends in terms of financial stability and a taming of inflation. Over the coming years we see inflation converging towards a long-term average of 4.0%, owing to the central bank's increased credibility as well as to Russia's very weak long-term growth potential.

- From a foreign policy perspective, while relations with the West will remain on ice, the prolongation of US and EU sanctions will not pose major headwinds to the economy. In addition to that, we expect Russia will increasingly exploit opportunities to foster closer ties with eastern nations, amongst others China, Japan, and even North Korea.

Major Forecast Changes

- Political risk has intensified on the back of diminished prospects of a rapprochement with the West in the near term.

Key Risk

- Growth drivers will be elusive in the absence of much higher oil prices or a significant ramp up in structural reform momentum, neither of which looks probable in the coming years. In addition to that, the outlook is further clouded by rising political tensions with the West. Overall, risks are tilted towards a weaker growth than we currently are forecasting, given the potential for oil prices to undershoot our forecasts.

Chapter 1:
Economic Outlook

SWOT Analysis

Strengths

- Russia maintains good external account dynamics, with limited foreign debt and high reserve holdings despite depletion in late 2014. This will continue to provide significant stability in the face of rising headwinds.
- Russia's large resource base will provide a stable foundation for foreign investment and export growth over the long term.
- The government's fiscal position, although increasingly strained due to lower oil prices, is supported by a very low public debt load and its ongoing fiscal consolidation strategy.

Weaknesses

- The economy's dependence on the oil sector makes it particularly vulnerable to a sustained decline in energy prices. This will remain a key determinant of its economic performance over the coming years.
- The deterioration of Soviet-era infrastructure is a constraint to private sector activity, especially outside of major cities.
- A high level of corruption is one of many factors weighing on the business and operating environment.

Opportunities

- A revitalisation of the structural reform agenda – including support for small- and medium-sized businesses, restructuring of the banking sector, administrative reform to tackle red tape and corruption, and sweeping privatisations- would go a long way towards developing the non-oil economy and improving long-term growth prospects.

Threats

- The Russian economy is in a state of transition as it reacts to the new dynamic of lower oil prices and the sharp depreciation of the rouble. Adapting to this new scenario will bring fresh challenges to macroeconomic stability.
- Geopolitical tensions between the West and Russia risk pushing Russia towards policies of import substitution and self-sufficiency, potentially isolating the country from global markets.

BMI Economic Risk Index

Russia's economic risk index scores compare relatively well to emerging market peers due to low public debt ratios, high FX reserves and a current account surplus. That said, growth drivers will be elusive in the absence of much higher oil prices or a significant ramp up in structural reform momentum, neither of which looks probable in the coming years. The inflexibility of the labour force means that there will be a hit to future economic growth, as labour is not as easily channelled into sectors that need more workers in a 'new' Russian economy.

	S-T Economic	Trend	Regional Rank	Global Rank
Poland	71.7	-	1	26
Lithuania	70.6	-	2	30
Latvia	68.5	-	3	37
Hungary	67.9	-	4	41
Romania	65.6	-	5	46
Russia	**65.4**	**+**	**6**	**47**
Bulgaria	63.3	+	7	56
Croatia	63.3	-	7	56
Kazakhstan	57.3	+	9	73
Macedonia	53.8	+	10	84
Turkey	52.5	-	11	90
Azerbaijan	50.6	+	12	97
Serbia	49.2	+	13	105
Moldova	49.0	-	14	106
Uzbekistan	48.5	=	15	110
Ukraine	48.3	+	16	111
Kyrgyzstan	47.1	+	17	115
Georgia	44.0	-	18	128
Montenegro	44.0	-	18	128
Albania	41.5	+	20	138
Kosovo	41.3	=	21	142
Tajikistan	41.0	+	22	143
Armenia	40.0	+	23	148
Turkmenistan	37.5	+	24	159
Bosnia-Herzegovina	35.8	+	25	166
Belarus	32.7	-	26	177

Regional ave 52.9 / Global ave 53.4 / Emerging Markets ave 49.1

	L-T Economic	Trend	Regional Rank	Global Rank
Poland	70.2	-	1	35
Lithuania	69.2	+	2	38
Hungary	68.3	-	3	40
Romania	65.9	-	4	45
Russia	**64.9**	**+**	**5**	**50**
Turkey	64.8	+	6	52
Bulgaria	64.1	+	7	54
Latvia	62.8	+	8	59
Croatia	62.0	+	9	61
Kazakhstan	58.2	-	10	74
Macedonia	55.8	+	11	85
Serbia	54.4	+	12	91
Uzbekistan	53.4	+	13	94
Azerbaijan	53.2	+	14	95
Georgia	50.7	+	15	109
Montenegro	50.6	+	16	110
Moldova	50.1	=	17	113
Albania	49.5	+	18	118
Bosnia-Herzegovina	45.7	+	19	138
Kosovo	44.4	+	20	143
Ukraine	44.3	+	21	144
Kyrgyzstan	42.3	+	22	153
Turkmenistan	42.1	+	23	154
Armenia	41.3	+	24	156
Belarus	39.8	+	25	162
Tajikistan	35.8	-	26	174

Regional ave 54.0 / Global ave 55.2 / Emerging Markets ave 51.1

Economic Growth Outlook

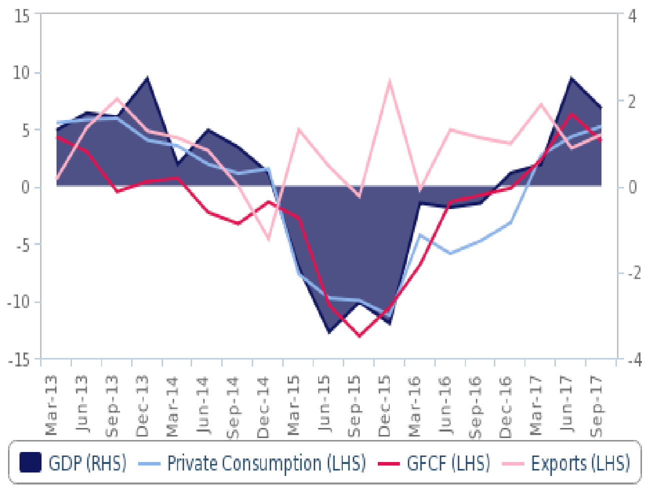
Short-Term Stimulus Will Not Take Growth To A Higher Gear

BMI VIEW

Short-term tailwinds including increased state spending ahead of the March 2018 presidential elections and the summer 2018 World Cup will drive a modest acceleration in real GDP growth in 2018. However, as the impact of these one-off factors subsides Russia will resume a low-growth trajectory.

Recovery Lost Steam In H217

Real GDP & Components, % chg y-o-y



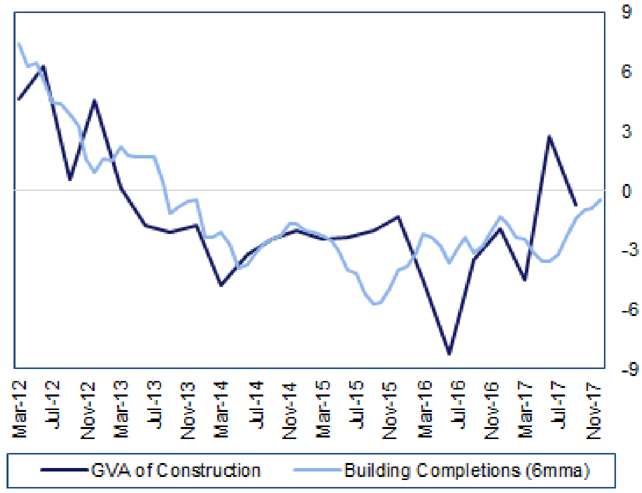
Source: Statistics Agency, BMI

Latest development suggest that Russia's economic recovery will continue on a lacklustre trajectory over the coming quarters. After expanding by 2.5% year-on-year (y-o-y) in Q217, marking a multi-year high, real GDP growth softened to 1.8% in Q317, and though GDP data is not yet available for Q417, leading indicators suggest that growth slowed further. Industrial production contracted by 3.6% y-o-y in November, in part reflecting sluggish domestic demand. Meanwhile, income data disappointed in December, suggesting continued declines in living standards. While real wage growth has recovered, coming in at 4.6% y-o-y in December, real disposable incomes contracted by 1.8%, marking six consecutive months in contraction.

State spending ahead of the March 2018 presidential elections and the 2018 World Cup will drive real GDP growth from an estimated 1.7% in 2017 to 1.8% in 2018. We expect growth momentum to gather pace in the first half of 2018 but to slow down in the second half as the impact of these factors begins to dissipate. In the longer term, despite an uptick in oil prices, growth will be unable to shift to a higher gear, capped by the continued lag in the implementation of much-needed structural reforms needed to revive investment and diversify the economy. We project growth to average 1.7% in 2019 and to linger around that figure in the years to follow, comparing poorly to emerging market peers.

Short-Term Tailwinds To Support Growth

GVA of Construction & Building Completions, % chg y-o-y



Source: Statistics Agency, BMI

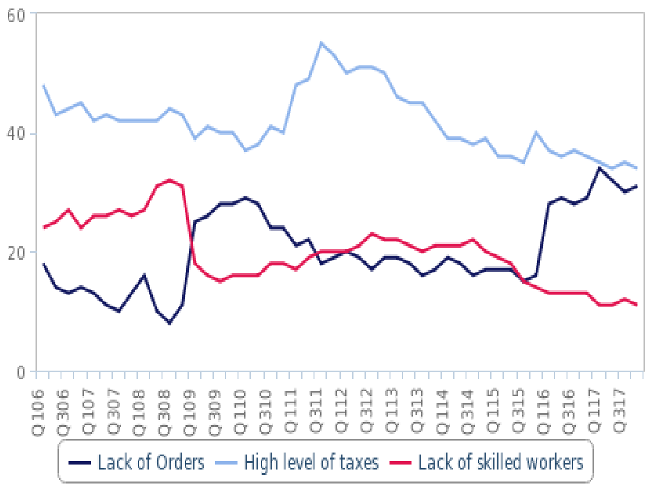
Election Pledges And World Cup To Provide Limited Upside

Ahead of the March 2018 presidential elections (*see 'Electoral Apathy Poses Biggest Challenge To Putin In 2018', October 20*), the government will attempt to lure voters with short-term fiscal stimulus. It has announced the implementation of a number of welfare measures which will contribute to a slight uptick in disposable incomes. These include a monthly allowance for poorer families on the birth of a first child and one-time payments to mothers who have a second baby and subsequent children over the next three years. The government has also passed a draft bill which will see the write-off of some RUB41bn (USD700mn) in accumulated debt for 42 million Russians. This amounts to an estimated 4.5% of total over-due household loans (in excess of 90 days), and comes at a time when growth in household debt is beginning to raise some red flags (*see 'Banking Sector: Solid Position Though Risks Persist', November 6*). According to a survey conducted by the Central Bank of Russia (CBR) in September, credit demand from higher risk profile borrowers with below-median income is stronger relative to past years, and is gradually leading to an the accumulation of vulnerabilities in the consumer lending segment.

Against a backdrop of simmering social unrest, the Kremlin has also been promoting a budget overhaul for the longer term that would prioritise expenditure in areas seen to make a positive contribution to economic development (*see 'Government To Loosen Grip On Spending', 24 January*). It aims to redistribute fiscal spending to areas such as health, education and infrastructure from so called unproductive areas – such as security, defence and public administration. That said, the scope for spending cuts is fairly limited in our view, particularly in the defence and security sectors. Further to this, the government may fall short in the implementation since such expenditures are often delegated to regional governments, many of which are constrained by unsustainable debt loads (*see 'Regional Balance Sheets A Long-Term Threat', December 12*).

Sluggish Domestic Demand Remains A Burden

Survey on Factors Limiting Production in the Construction Sector, % of respondents



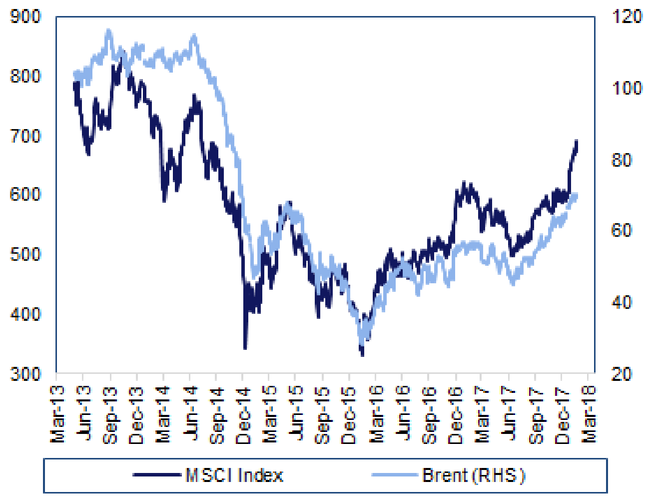
Source: Statistics Agency, BMI

The government has also allocated RUB600bn (0.7% of GDP) to offer subsidised mortgages to young families, which alongside the CBR's ongoing easing cycle, will support stronger credit growth. With state incentives, the annual interest rate on a mortgage (this will apply only to families with a second or third child born between the years of 2018 and 2022) will be lowered to a fixed 6.0% for a period of three to five years (depending on the amount of children), from a current average of 9.8%. According to the Russian Agency for Housing Mortgage Lending, more than 600,000 families across the country will be eligible to take advantage of the initiative.

More favourable borrowing conditions, alongside an uptick in project activity ahead of the FIFA 2018 World Cup to take place in Russia between June and July, will provide much needed stimulus to the country's weak construction sector. The sector was hit by the 2015-2016 collapse in domestic demand and has seen only a very sluggish recovery. According to Russian media, the government will allocate around RUB40bn for the construction and reconstruction of stadiums, and around RUB5bn for security infrastructure. In light of this, our Infrastructure team projects real growth in the sector to increase to 4.6% in 2018, from an estimated 2.8% in 2017, but anticipates the effect of the World Cup to dissipate quickly, with growth slowing down to 2.1% in 2019. Meanwhile, private investment is expected to remain sluggish, capped by the high level of perceived risk and corruption, and by a weak institutional backdrop.

Oil Upswing Buoys Sentiment

MSCI Index & Brent, USD/bbl



Source: Bloomberg, BMI

More broadly, the 2018 World Cup will result in a short economic bump financed primarily by the state coffers. The overall price of hosting the international football tournament is estimated at RUB678bn, with RUB390bn coming from the state budget, RUB92bn from regional governments and RUB196 billion from private or state-run companies. In the months ahead and during the tournament we project a modest increase in temporary jobs as well as an influx of spending by foreign consumers to support local businesses. The impact on headline GDP growth however will be moderate, forecasted to add only about 0.2 percentage points. The impact of the tournament will fade quickly and, regardless of how smoothly the competition proceeds, the World Cup is unlikely to help improve political tensions with the West.

Uptick In Oil Prices Not A Game Changer

Despite an easing of growth momentum in late 2017 evident in high frequency data, the rise in oil prices over recent quarters is supporting Russian assets and will also help up prop up the country's energy-dependent economy. Our O&G team has raised their 2018 average forecast from USD57.00/ per barrel (bbl) to USD65.00/bbl, and while this implies limited upside in the remainder of the year, prices have nonetheless outperformed previous expectations. We also project further increases in 2019, forecasting the price of Brent to average USD69.00/bbl. However, higher oil prices are somewhat of a double edged sword, as they reduce the urgency to push through much-needed structural reform and diversification efforts. We expect the bulk of investment to continue to be channelled into the energy sector, mainly towards the gas pipeline segment, restraining progress in other areas of the economy.

Meanwhile, we forecast the contribution of net exports to headline GDP growth to fall from 1.5pp in 2016 and an estimated 0.6pp in to 2017 to an average of 0.1pp over the coming five years. In the first three quarters of 2017, real import growth accelerated by 17.8% y-o-y, up from -5.4% over the previous year, while export growth was just 5.0%, up from 2.9%. The import rebound was driven by rising machinery imports, which highlights a lack of domestic production in more technologically advanced sectors and which will continue to fuel demand for foreign goods. Further to this, despite the government's import substitution strategy which aims to replace foreign imports with domestic equivalents, according to Russia's statistics agency, the share of all imported products of the consumer basket remains high, standing at about 38%.

GDP By Expenditure Outlook

Much lower average oil prices in the next decade relative to the previous one will severely depress Russia's economic growth potential amid a lack of structural reforms aimed at diversifying the economy and reducing dependence on the energy sector, tackling corruption and moving away from a centralised economic system. An ageing demographic profile will add increasing strains to the fiscal and growth outlook over the next several decades.

Private Consumption: Private consumption growth in the coming years will pale in comparison to the 10.6% average growth rates achieved from 2000-2014. Rising oil prices in the past decade helped drive a significant rise in living standards, propelling a large portion of the population in the middle-income bracket. Additionally, a retail lending push by state owned banks resulted in a consumer credit boom. Going forward, much lower average oil prices and a much more subdued credit outlook will keep a cap on the recovery in private consumption following the 2015-2016 recession, which hit households' disposable income and purchasing power especially hard. The shock to the nation's GDP per capita and productive capacity, both in dollar and real rouble terms, will limit the contribution to growth of household spending in the coming years. Additionally, high inflation and the erosion of purchasing power will be a significant setback to the poverty reduction gains the economy has made since 2000.

TABLE: GDP GROWTH FORECASTS

	2016	2017e	2018f	2019f	2020f	2021f
Nominal GDP, RUBbn	86,043.6	90,143.5	94,570.2	99,743.2	105,222.7	111,011.5
Real GDP growth, % y-o-y	-0.2	1.7	1.8	1.7	1.7	1.7
GDP per capita, RUB	597,672.3	626,040.8	656,898.8	693,163.9	731,796.2	772,862.7
	2022f	**2023f**	**2024f**	**2025f**	**2026f**	**2027f**
Nominal GDP, RUBbn	117,016.2	123,355.6	130,048.4	137,114.3	144,574.3	152,450.4
Real GDP growth, % y-o-y	1.6	1.6	1.6	1.6	1.6	1.6
GDP per capita, RUB	815,774.5	861,400.4	909,910.7	961,484.5	1,016,316.4	1,074,609.6

e/f = BMI estimate/forecast. Source: BMI/Federal State Statistics Service

TABLE: PRIVATE CONSUMPTION FORECASTS

	2016	2017e	2018f	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f
Private final consumption, RUBbn	44,273.3	47,059.5	49,785.5	52,868.5	56,195.0	59,730.4	63,428.6	67,355.8	71,526.2	75,954.9	80,657.9	85,652.1
Private final consumption, % of GDP	51.5	52.2	52.6	53.0	53.4	53.8	54.2	54.6	55.0	55.4	55.8	56.2
Private final consumption, real growth % y-o-y	-5.0	1.9	2.0	2.0	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.2

e/f = BMI estimate/forecast. Source:BMI/Federal State Statistics Service

Government Spending: The government's fiscal position sustained a severe blow in 2015 and 2016, recording the largest fiscal deficits since 2009. Lower average oil prices, weak growth and shallow domestic bond markets will remain a burden on Russia's sovereign reserves. That said, the government has embarked on a much more austere fiscal position, and aims to gradually implement a new fiscal rule which will help consolidation by restraining government spending at times of low oil prices while allowing fiscal buffers to be replenished when oil prices are high. Though the country will increasingly resort to issuing eurobond debt to cover future shortfalls, as it did in 2016 and 2017, ultimately a weaker fiscal position will ensure a relatively small average contribution to real GDP growth of government consumption in the years ahead.

Gross Fixed Capital Formation: Structural issues will continue to hamper fixed investment in Russia over the long term. Since 2008, fixed investment in Russia has been declining as a percentage of total GDP, while contracting in real terms since 2013 when oil prices were still near record highs. We expect this component to see disappointing growth over the forecast period. While Russia has some favourable economic traits, structural inefficiencies will ultimately result in a dearth of fixed investment opportunities. We see the lack of liberalised and competitive markets, prevailing corruption, and lack of commitment to developing the non-oil sector's competitiveness as the primary drags on investment. In addition to these factors, investor uncertainty regarding political stability and the direction of economic policy is likely to remain higher over the coming years, further limiting investment activity.

Net Exports: A drastic decline in imports prevented a much deeper contraction of Russian real GDP growth in 2015, although we expect the contribution of net exports to GDP to revert back to historical averages in the coming years. A weaker rouble under a floating exchange rate regime, as well as more subdued private consumption, will see import growth remain lower on average than the previous ten years. As for exports, the prolonged decline in fixed investment over the past five years and lack of economy-wide diversification away from the energy sector bodes poorly for potential export growth. In this context, further hampering the export outlook is our Oil & Gas team forecasts for hydrocarbon production growth in volume terms to remain capped below 1% beyond 2018.

TABLE: GOVERNMENT CONSUMPTION FORECASTS

	2016	2017e	2018f	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f
Government final consumption, RUBbn	15,549.4	16,225.8	16,793.7	17,515.8	18,339.1	19,182.7	20,045.9	20,948.0	21,890.6	22,875.7	23,905.1	24,980.8
Government final consumption, % of GDP	18.1	18.0	17.8	17.6	17.4	17.3	17.1	17.0	16.8	16.7	16.5	16.4
Government final consumption, real growth % y-o-y	-0.3	-0.1	-0.3	0.1	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5

e/f = BMI estimate/forecast. Source: BMI/Federal State Statistics Service

TABLE: FIXED INVESTMENT FORECASTS

	2016	2017e	2018f	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f
Fixed capital formation, RUBbn	18,112.4	19,307.8	20,408.4	21,694.1	23,039.1	24,444.5	25,911.2	27,465.9	29,113.8	30,860.6	32,712.3	34,675.0
Fixed capital formation, % of GDP	21.1	21.4	21.6	21.7	21.9	22.0	22.1	22.3	22.4	22.5	22.6	22.7
Fixed capital formation, real growth % y-o-y	-1.8	2.2	1.9	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0

e/f = BMI estimate/forecast. Source: BMI/Federal State Statistics Service

TABLE: NET EXPORTS FORECASTS

	2016	2017e	2018f	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f
Net exports of goods and services, RUBbn	4,438.5	4,864.2	4,882.4	4,963.4	4,944.2	4,943.6	4,919.3	4,873.7	4,804.5	4,708.8	4,583.8	4,426.1
Net exports of goods and services, % of GDP	5.2	5.4	5.2	5.0	4.7	4.5	4.2	4.0	3.7	3.4	3.2	2.9
Net exports of goods and services, real growth % y-o-y	5.2	5.4	5.2	5.0	4.7	4.5	4.2	4.0	3.7	3.4	3.2	2.9

e/f = BMI estimate/forecast. Source: BMI/Federal State Statistics Service

External Trade And Investment Outlook

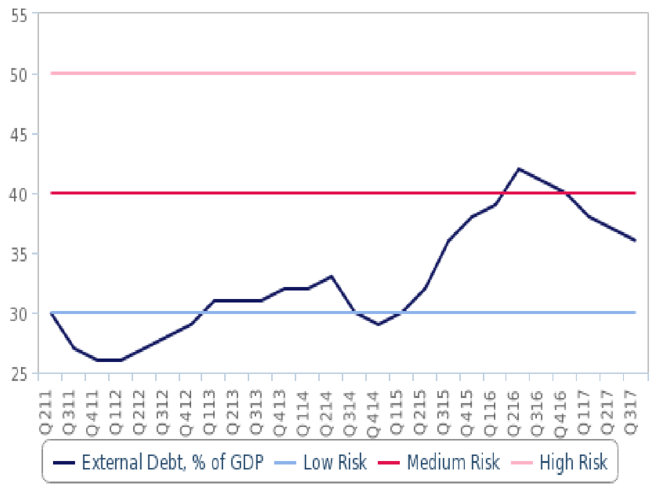
Risks To External Position Declining

BMI VIEW

In the context of elevated geopolitical tensions, Russia's robust sovereign profile will shield the country from potential external shocks. Adding to this, risks associated with the materialisation of tighter US sanctions have abated.

Risks on External Debt To Remain Contained

External Debt to GDP Ratio, %



Note: The lines represent indicative thresholds recommended by the IMF. Source: CBR, BMI

In the context of elevated geopolitical tensions – for which we see little scope for improvements in the near term – Russia's robust sovereign profile will shield the country from potential external shocks. A stable current account surplus, flexible exchange-rate regime, and 16-months of import cover worth of international reserves, will help the economy navigate through volatility driven by political turmoil.

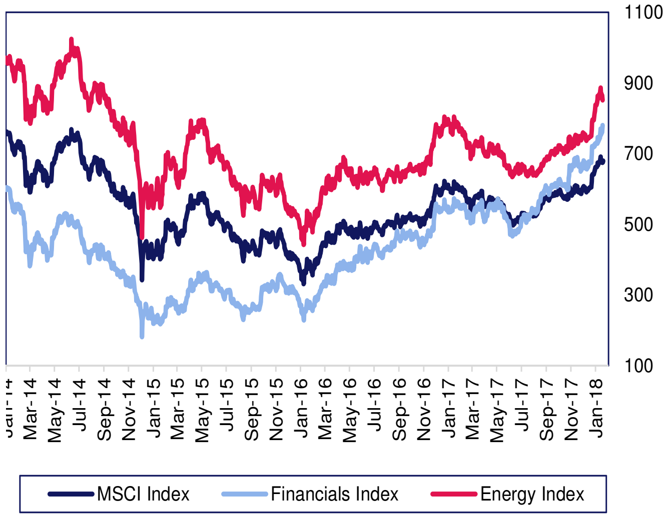
Sanctions-Related Risks Declining

Though we believe that a rapprochement with the US is unlikely in the coming years (*see 'No Major Improvement In Russia-West Relations In 2018', February 1*), risks associated with the materialisation of tighter sanctions are gradually declining as it becomes evident that the Trump administration will not pursue this course of action. On January 29 the US Treasury said that it was going to refrain from imposing new sanctions on Moscow for the time being. This applies to sanctions on Russian individuals, but in our view also to Russian sovereign debt.

Though initially feared by the Russian business community for its potential to expose corruption and potentially act as a sort of international blacklist, a report released by the US Treasury at the end of January 2018 is unlikely to lead to any major hindrances for the country's wealthy elite. As mandated by a law signed by the US Congress in August 2017 (*see 'Quick View: New US Sanctions Set For Long Haul', August 3*), the US Treasury was required to produce a list naming Russian oligarchs with close ties to President Vladimir Putin. However, the list released on January 29 contained 200 names of already well-known figures, which the Trump administration furthermore made clear would not be subject to additional sanctions. Overall, the list failed to have the impact as envisioned by the US Congress – to name and shame, interrupt the business dealings of oligarchs close to Putin, and act as a deterrent to doing business with them.

Markets Unconcerned By Political Tensions

MSCI Russia, MISCI Financials and Energy Index, USD



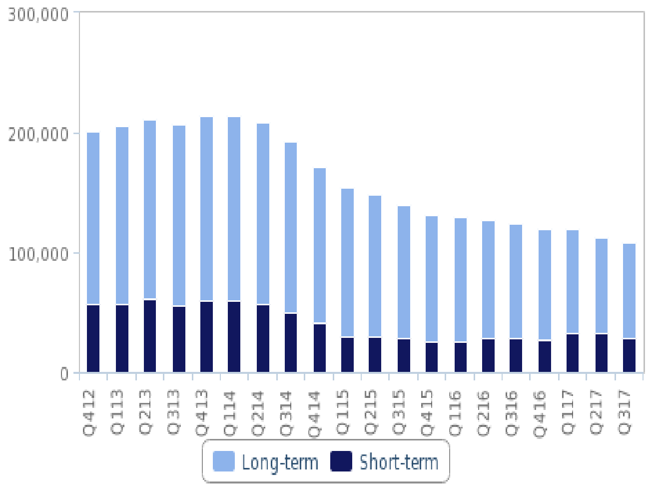
Source: Bloomberg, BMI

The recent rally in Russian assets reflects easing concerns over additional sanctions. Financial stocks have continued rallying, unperturbed by the inclusion on the elites list of German Gref and Andrei Kostin, the heads of Sberbank and VTB, the first and second largest state-owned banks in Russia. More broadly, the strong performance of bank share prices since 2016 also reflects the sector's resilience to sanctions already in place, which have largely cut it off from external funding. Ongoing deleveraging since the imposition of Western sanctions in 2014 has brought the external debt of Russian banks to the lowest level in the last decade. In the meantime, domestic deposits, supported by high interest rates, are taking up a greater share of liabilities, leaving the sector less exposed to deposit flight.

Adding to this, the Central Bank of Russia's (CBR) ongoing clean-up process and strengthened supervision will continue to underpin greater stability for the sector at the aggregate level.

For instance, by revoking the licenses of many smaller credit institutions used as vehicles to channel money outside of Russia in recent years, the CBR has managed to cap capital outflows.

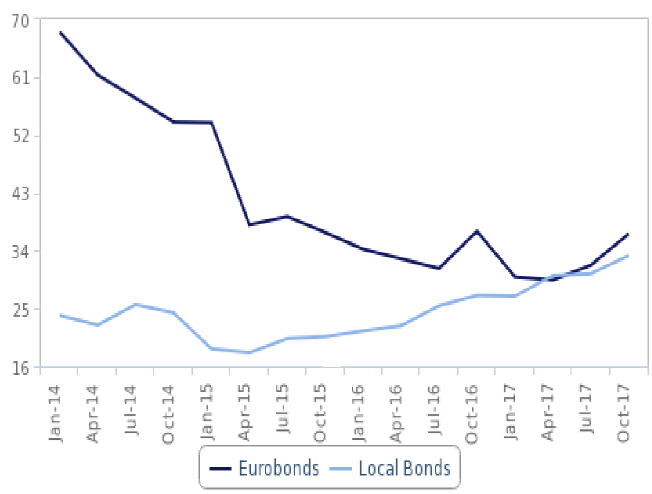
Decreasing Reliance On External Funding
Banks' External Debt, USDmn



Source: CBR, BMI

More broadly, capital outflows have remained more subdued compared to the past across the wider economy, and will remain controlled by the government's continuing 'de-offshorisation' process, which through initiatives such as tighter rules on controlled foreign companies, aims to curb the use of offshore companies by Russian businesses.

Interest in Russian Bonds Growing
Share Of Debt of the Russian Federation Held By Non-Residents, %



Source: CBR, BMI

We expect the government will step up efforts to encourage repatriation of capital, exploiting deteriorating relations with the West and the lingering threat of tighter sanctions. Amongst other initiatives, over the past several months the Kremlin has attempted to lure back capital by scrapping a 13% percent profit tax on funds repatriated from abroad, and by proposing to renew an amnesty from penalties for businesses returning capital. It has also implied that it could adjust the terms of its sovereign Eurobond issuances to allow Russian businesses abroad to use it as a means of repatriating capital. The government also noted that under tighter sanctions, domestic investors could be given priority over foreign investors in new issuances, adding that that the information (names and amounts) of those investors would remain protected from the Western financial system.

Meanwhile, the Trump administration's soft approach also reinforces our view that it will not seek to sanction Russian sovereign debt, although this will remain a possibility if Moscow undertakes any aggressive moves against other countries. The administration was required by the Countering America's Adversaries Through Sanctions Act (CAASTA) to draft a recommendation on whether to sanction Russian sovereign debt by end of January, yet nothing of the kind has appeared. This bodes well for the economy as it would have led to a spike in borrowing costs as demand for Russian assets declined among Western investors. For the time being, we expect future Russian government issuance of both local debt and Eurobonds will continue to be welcomed with excess demand from foreign investors.

Outlook On External Position

Net International Investment Position: Strong debt sustainability metrics, a positive net international investment position (NIIP), and our forecast for persistent current account surpluses in the coming years underpin our view that Russia's external account is one bright spot for the economy, and poses few systemic risks to financial stability. Data from the CBR shows that Russia registered a healthy positive NIIP of about 17% of GDP in 2016 due primarily to a large stock of international reserves.

According to World Bank data and **BMI** estimates, gross external debt has fallen from USD573bn in December 2013 to an estimated USD391bn in December 2016, largely due to Western sanctions since 2014 preventing Russian banks and other institutions from borrowing on international capital markets or rolling over external debts falling due. It should be noted, however, that as a proportion of GDP the ratio of external debt actually rose over this time, from 25.7% to 30.5%, due to a sharp contraction of the economy in US dollar terms. Nevertheless, the external debt ratio remains relatively low by emerging market standards, while a gradual rebound in oil prices will help avert any systemic problems in the servicing of external debt.

That said, there are some risk factors to consider. First, the majority of NIIP liabilities are made up of volatile short-term capital in the form of 'portfolio' and 'other' investment, which together made up 53.35% of GDP by end-2016. This compares to 42% for foreign direct investment (FDI), which by definition is long term in nature and thus less susceptible to short-term swings in investor sentiment. Gross portfolio and other investment liabilities declined considerably from 2013 to 2015 due to capital flight and rouble depreciation, contributing significantly to the economic downturn experienced over that time, and saw only marginal improvements in 2016. Meanwhile, the stock of FDI liabilities peaked in 2013 and has declined by 33% since. Demand for Russian fixed assets is likely to remain weak on account of elevated political uncertainty, a poor business environment and weak growth outlook.

TABLE: CURRENT ACCOUNT BALANCE FORECASTS

	2016	2017e	2018f	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f
Balance of trade in goods, USDbn	90.0	111.4	117.3	122.8	125.4	126.4	125.9	120.9	115.2	108.7	101.5	93.4
Balance of trade in goods, % of GDP	7.0	7.2	7.2	7.3	7.2	7.1	6.8	6.4	5.9	5.4	4.8	4.3
Balance of trade in services, USDbn	-23.9	-27.8	-31.6	-34.6	-36.9	-39.4	-42.0	-44.7	-47.7	-50.8	-54.0	-57.5
Balance of trade in services, % of GDP	-1.9	-1.8	-1.9	-2.1	-2.1	-2.2	-2.3	-2.4	-2.4	-2.5	-2.6	-2.6
Primary income balance, USDbn	-34.7	-37.5	-40.5	-43.8	-46.5	-49.3	-52.2	-55.3	-58.7	-62.2	-65.9	-69.9
Primary income balance, % of GDP	-2.7	-2.4	-2.5	-2.6	-2.7	-2.8	-2.8	-2.9	-3.0	-3.1	-3.1	-3.2
Secondary income balance, USDbn	-6.4	-7.0	-7.0	-7.0	-7.0	-7.0	-7.0	-7.0	-7.0	-7.0	-7.0	-7.0
Secondary income balance, % of GDP	-0.5	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3
Current account balance, USDbn	25.0	39.2	38.2	37.3	35.0	30.8	24.7	13.8	1.8	-11.2	-25.5	-41.0
Current account balance, % of GDP	1.9	2.5	2.3	2.2	2.0	1.7	1.3	0.7	0.1	-0.6	-1.2	-1.9

e/f = BMI estimate/forecast. Source: BMI Calculation/Central Bank of Russia

TABLE: CAPITAL & FINANCIAL ACCOUNT BALANCE

	2011	2012	2013	2014	2015	2016
Capital account, USDbn	0.1	-5.2	-0.4	-42.0	-0.3	-0.8
Financial account, USDbn	76.1	25.7	46.2	131.8	70.0	13.1
Capital and financial account, % of GDP	4.4	2.3	1.1	-0.9	5.3	1.6
Net FDI inflows per capita, USD	82.2	-12.3	120.6	244.4	106.2	-72.5
Net portfolio investment, USDbn	15.3	-17.0	11.0	39.9	26.4	-2.4
Net other Investment, USDbn	47.7	43.1	17.6	51.5	20.9	25.4

e/f = BMI estimate/forecast. Source: BMI Calculation/Central Bank of Russia

TABLE: TOP 5 GOODS IMPORTS 2015

By Country	% of Total Imports	By Product	% of Total Imports
China	17.7	Machinery, Nuclear Reactors, Boilers, etc	18.2
Germany	11.5	Electrical, Electronic Equipment	11.8
USA	6.5	Vehicles Other Than Railway, Tramway	11.0
Italy	4.4	Pharmaceutical Products	4.5
Belarus	4.3	Plastics and Articles Thereof	3.8

Source: ITC, BMI

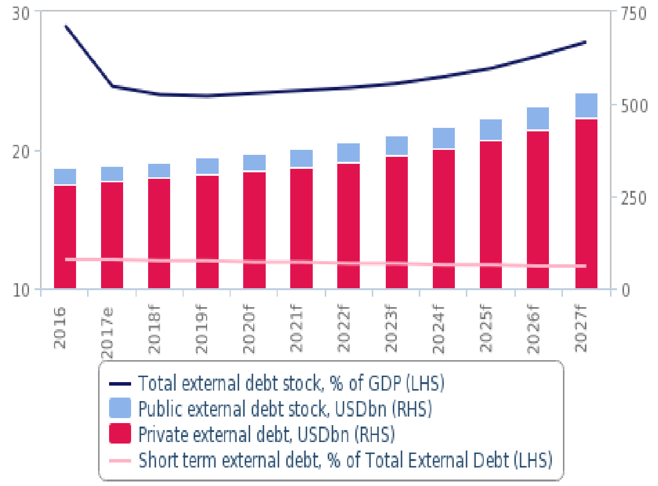
TABLE: TOP 5 GOODS EXPORTS

By Country	% of Total Exports	By Product	% of Total Exports
Netherlands	13.8	Mineral Fuels, Oils, Distillation Products, etc	69.5
China	7.6	Iron and Steel	4.1
Germany	7.5	Pearls, Precious Stones, Coins, etc	2.4
Italy	7.3	Commodities Not Elsewhere Specified	2.3
Turkey	5.0	Machinery, Nuclear reactors, Boilers, etc	1.9

Source: ITC, BMI

Second, capital flight from Russian residents has been one factor underpinning recent increases in NIIP assets, and the overall NIIP surplus. The acquisition of foreign assets by domestic residents is not in and of itself a negative development for an economy. But in Russia's case, it has been driven by elevated political and economic uncertainty as lower oil prices have severely depressed economic growth potential, while Russia's aggressively foreign policy has threatened bilateral relations with the West. With lower oil prices and a dearth of domestic fixed investment in recent years weighing heavily on growth potential, capital flight exacerbates the outlook by reducing the stock of domestic savings and investment.

External Debt Forecasts
Total External Debt (2016-2027)

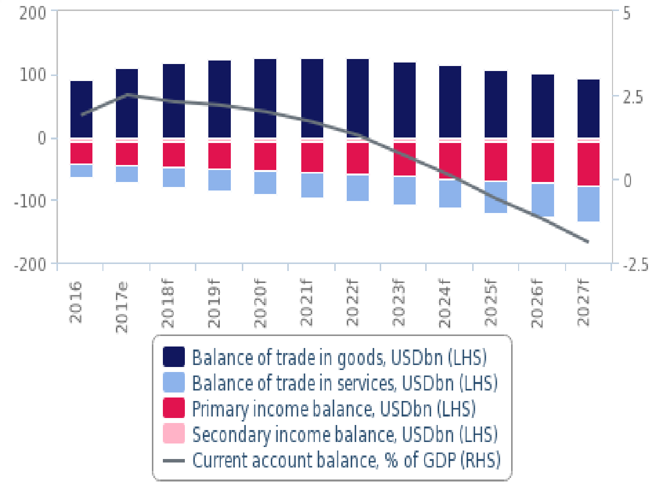


e/f = BMI estimate/forecast. Source: BMI/World Bank

Finally, we highlight that the international reserves arsenal is robust by any standard metrics such as import or external debt coverage and will remain sufficient to cover obligations over the next few years. Russia's reserves have been on an upward trend since December 2016 and stood at USD433bn by December 2017, close to the central bank's strategic goal of reserves at the USD500bn level. International reserves remain the largest component of the country's net international investment position (NIIP) surplus, a key source of macroeconomic stability for the country.

Current Account: Two important trends have influenced Russia's current account over the past decade. First, robust economic growth in China and other emerging markets sent commodity prices soaring, driving up Russia's export revenues and contributing to persistently large surpluses in the trade account. Oil, gas and derivative products make up over half of Russia's total exports while steel, wheat and other commodities are also important sources of foreign revenue. Elevated commodity prices drove persistent surpluses on the current account, but also had a counterbalancing effect by driving the real effective exchange to levels well above fair value, stoking import demand and stifling non-energy export competitiveness.

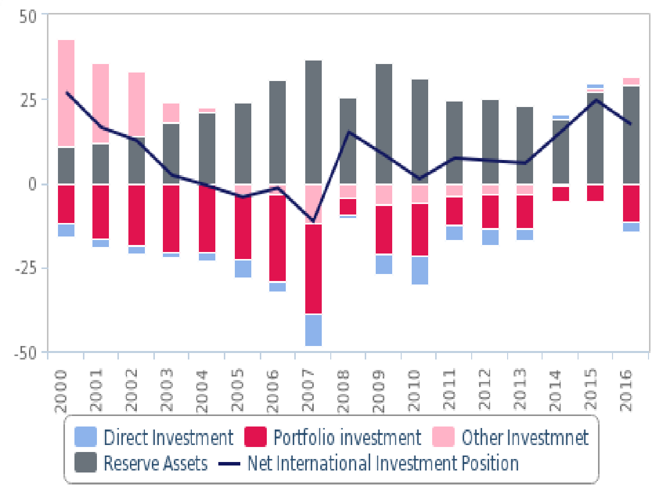
Current Account Balance Forecasts
Current Account Balance (2016-2027)



e/f = BMI estimate/forecast. Source: BMI Calculation/Central Bank of Russia

After averaging 7.0% of GDP from 2004-2011, Russia's current account balance averaged just 2.4% from 2012-2014, as widening primary income and services account deficits increasingly offset large energy trade surpluses.

Reserves Underpin NIIP Surplus
Net International Investment Position, % of GDP



e/f = BMI estimate/forecast. Source: BMI Calculation/Central Bank of Russia

Despite a sharp drop in Russia's terms of trade following the collapse in energy prices since 2014, we forecast the current account to remain in surplus over the coming years. Rouble depreciation and a deep contraction of real GDP in 2015 severely depressed import demand, sending the current account to a seven year high of 5.1% of GDP even as export revenues collapsed. Moving forward, the Central Bank of Russia's decision to free float the rouble has led to significant depreciation in both real and nominal terms, and a depreciatory trend in the coming years will keep import growth in check. Weak potential growth will also put a lid on imports.

However, developments in the energy markets will remain the primary driver of Russia's balance payments, and our forecast for only a modest increase in oil prices over the coming years underpins our expectation for a steady narrowing of the current account surplus. Furthermore, our Oil & Gas team forecasts Russian hydrocarbon production growth in volume terms to average just 0.4% from 2018-2021, falling to 0.0% from 2022-2027, compared to 2.4% from 2001-2014. Though the rouble has depreciated significantly, this has had little effect in stimulating Russia's non-energy manufacturing and export sectors. Given the lack of any serious structural reform momentum, over the long term we do not expect a significant restructuring in the composition of Russian exports, which will continue to be dominated by hydrocarbons.

Monetary Policy

Price Stability Paves The Way For Further Easing

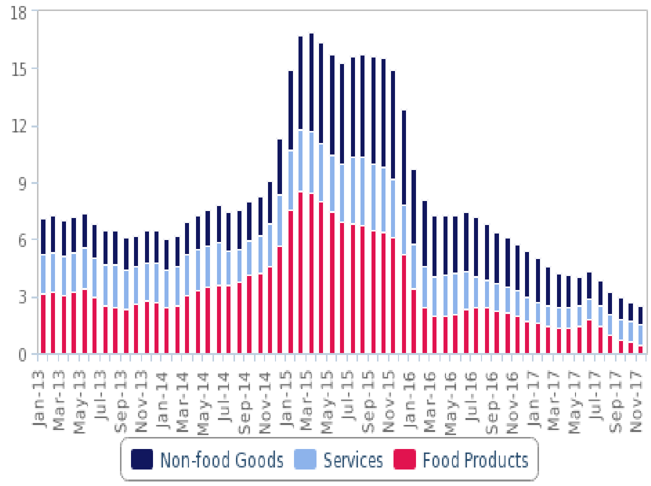
BMI VIEW

Having achieved price stability, which we expect to persist in the medium term, the Central Bank of Russia will have more scope to ease monetary policy. We expect the bank to cut its key rate by 100bps in 2018 and by 75bps in 2019, providing much needed stimulus to the Russian economy. That said, real interest rates will remain relatively high and a more aggressive easing cycle will be prevented by persistently high inflationary risks.

The Central Bank of Russia (CBR) will continue to play a significant role in supporting macroeconomic stability in Russia over the coming quarters. Tight monetary policy and a consistent focus on price stabilisation has impeded a stronger recovery following Russia's 2015-2016 economic downturn. However, by engineering a major improvement in the inflation outlook the CBR has improved the longer-term outlook for growth and investment. From a multi-year high of 16.9% year-on-year (y-o-y) in March 2015, consumer price growth stood at a historic low of 2.5% as of December 2017. The bank's focus on price stability, and its increasingly credible forward guidance, will continue to support confidence amongst households and businesses in their production and investment decisions. Inflation remained among the top concerns of Russians according to a poll conducted by OOO in FOM, although the percentage of respondents citing it fell from 57% to 43% from 2015 to 2017.

Down To A Historic Low

Headline Inflation Component Contribution, pp

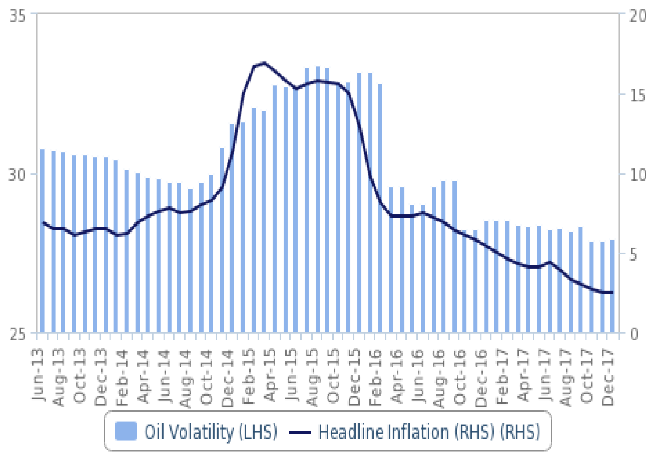


Source: CBR, BMI

From an average of 3.8% y-o-y in 2017, we forecast inflation to average 3.4% in 2018 and 4.2% in 2019. Our projections entail a modest uptick from current levels of inflation. Having bottomed out at the end of 2017, we project an acceleration in price growth to materialise in the coming quarters in line with a fading of some transitionary deflationary forces. In particular, food inflation has remained exceptionally low on the back of increased supply of farm produce, and a shortage of long-term storage facilities. The recovery in domestic demand and wage growth will also add inflationary pressures. Nevertheless, our forecasts imply that consumer price growth will remain close to central bank's 4.0% target. Several years of hitting inflation targets will enhance the bank's credibility, and begin to lower still-elevated inflation expectations particularly among households.

Against this backdrop, the CBR will have scope to pursue further monetary easing, providing stimulus to the economy. On December 15, during its last monetary policy meeting of 2017, the bank brought its key policy rate down by 50bps to 7.75%, exceeding consensus expectations for a 25bps reduction. It justified the larger-than-expected cut by citing that inflation had eased more than expected in previous months, and also noted a reduction of inflation risks over a one year horizon owing to the decision of OPEC and non-OPEC countries to extend oil production restraints to the end of 2018. The latter lowers oil volatility, which in turn reduces rouble volatility, a main source of instability for the economy. We add that the new budget rule (*see 'New Fiscal Rule Will Aid Consolidation', August 2*), which entails paying excess oil and gas revenues above a certain threshold into sovereign funds, will further shield the economy from oil unpredictability. The rule will be implemented gradually over the coming quarters. Meanwhile, the impact of higher oil prices on producer and consumer prices will remain subdued.

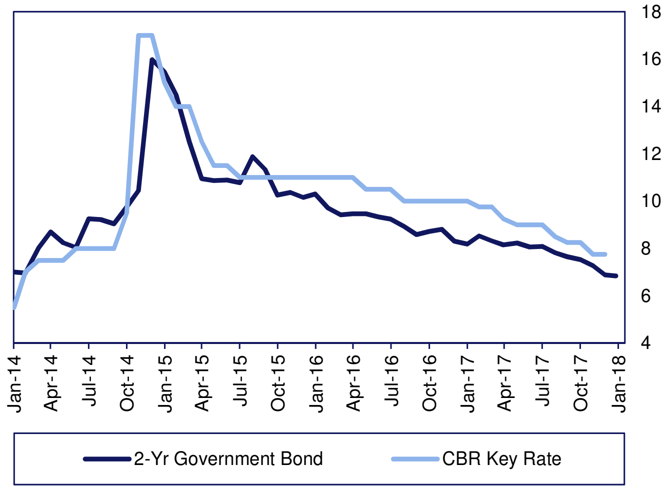
Lower Oil Volatility To Support Price Stabilization
Headline Inflation, % chg y-o-y (RHS) & Brent Crude Oil Historical Volatility, 90 days rolling



Source: Bloomberg, BMI

Looser monetary policy will be particularly important in the context of Russia's sluggish economic backdrop. Real GDP growth eased to 1.8% (year-on-year) y-o-y in Q317 from 2.5% on the previous quarter, leading indicators suggest it slowed down further towards the end of the year, and we project only marginal improvements in 2018 given the lack of momentum in the implementation of much needed structural reforms.

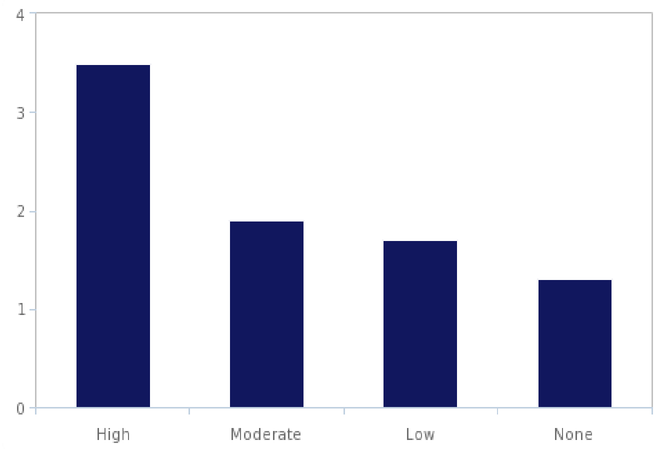
Markets Anticipating Further Easing
2 Year RUB-denominated Government Bond Yield & CBR Key Benchmark Rate, %



Source: Bloomberg, BMI

Further monetary easing will lower borrowing costs, providing a more favourable environment for investment. Since the start of monetary easing at the beginning of 2017, the average interest rate on rouble-denominated short-term loans has declined by more than 300bps for credit to individuals and by over 280bps for credit to non-financial corporations. We forecast the CBR will continue lowering its key benchmark rate through a series of 25bps cuts over the next two years, bringing the rate down to 6.75% by end-2018 and to 6.00% by end-2019. The bank has stated that more easing is on the cards in H118, and we expect another 25bps rate cut during the next monetary meeting on February 9.

Pervasive Lack Of Competition Contributes To Inertia In Inflation Expectations
Frequency of Price Changes For Domestic Products By Perceived Competition



Note: Y-axis shows perceived competition in the market; X-axis shows average number of price changes in a year. Source: The Bank of Russia survey, CBR, BMI

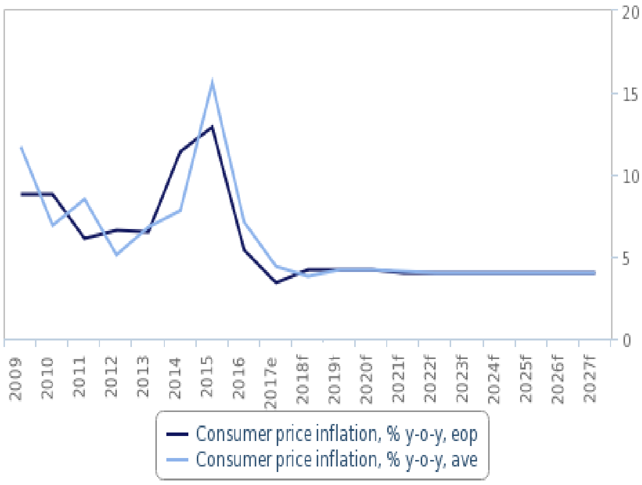
Real interest rates (as measured by the spread between the policy rate and inflation) will remain in positive territory, standing at 2.6% by end-2018 and at 1.8% by end-2019. The CBR will remain cautious in this regard, given that inflation risks remain tilted to the upside (*see 'Inflationary Risks Remain High,' October 31*). These stem from wage growth outperformance relative to labour productivity dynamics, Russian households' declining propensity to save, and from increasingly likely tax hikes in the quarters ahead. Further to this, persistently high inflation expectations of businesses and households suggest that economic agents remain somewhat sceptical that the current inflation reduction will be stable and long-lived. According to a recent study conducted by the central bank, the substantial inertia of expectations is also partly determined by inflexible pricing policies, in turn the result of Russia's uncompetitive business landscape.

Further inflationary risks stem from the potential tightening of US sanctions to include the country's sovereign debt. Although we see it as unlikely that the Trump administration will pursue this course of action, if it were to materialise, the central bank would be forced to slow the pace of monetary easing, or in a worst-case scenario, reverse it in order to shore up confidence. Fresh sanctions would dampen investor confidence, providing significant downward pressures on the rouble, and as witnessed during the past economic crisis, a devaluation in the currency will revamp inflationary pressures.

Monetary Policy Framework

Inflation Trends: Over the coming years we see inflation slowing substantially relative to the past decade, converging towards a long-term average of 4.0%. Underpinning the subdued inflation outlook is Russia's very weak long-term growth potential, which we estimate at around 1.6%, closer to developed than emerging market standards. Much lower average oil prices and the lack of any meaningful efforts to diversify the economy or structural reforms to shift away from a centralised economic system will sap investment, while weak household income growth and an ageing demographic profile also work to keep inflation at bay. The main risk facing Russia in terms of inflation remains through the FX pass-through channel, given the potential for another terms of trade shock in the coming years.

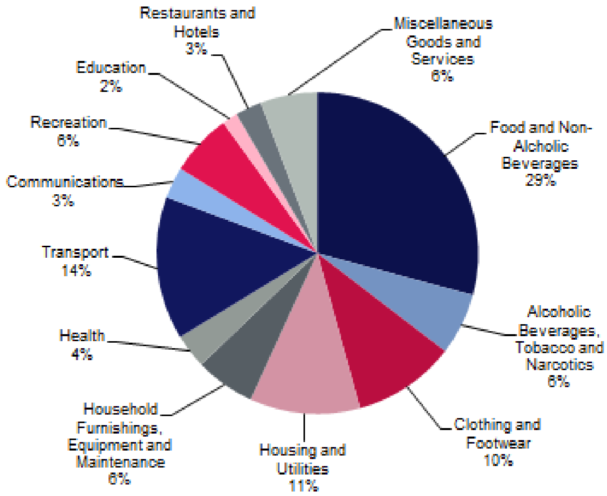
Long-Term Inflation Forecasts
Consumer Price Inflation (2009-2027)



f = BMI forecast; Source: Federal State Statistics Service

Credibility of Central Bank: The Central Bank of Russia (CBR) undoubtedly gained credibility for its response to the crisis of 2014/2015, bolstering its inflation fighting credentials and acting in a way which suggested autonomy from government influence. After initially intervening to prop up the rouble in the face of Western sanctions and collapsing oil prices, the CBR took the economically painful, but necessary steps of sharply raising interest rates and bringing forward a long standing plan to switch the rouble from a managed to a free float in December 2014. By doing so, it worsened the short-term impact on the economy, but ultimately avoided a balance-of-payments crisis and preserved the nation's stock of foreign reserves. The CBR's relatively hawkish stance in subsequent quarters, in spite of on-going recession, further bolstered the credibility of its inflation target. That said, we do not see the CBR as being impervious to government influence when it comes to buying and selling reserves, monetary policy and policies to support state-owned segments of the banking sector.

Food, Transport Hold Largest Weights
CPI Breakdown, % Weight



Source: Russia Federal State Statistics Service

Monetary Policy Regime: When the CBR shifted the rouble to a free-float in late 2014, this effectively ushered in an inflation-targeting regime which focuses on a single interest rate to set policy – a collateralised repo rate referred to as the 'Key Rate'. The CBR's monetary policy now targets 'medium-term' annual average consumer price index (CPI) inflation of 4%. The key indicators which the CBR refers to in its analysis when deciding rates are: current inflation, inflation expectations, trend inflation and money supply growth. Prospects for oil and capital inflows and outflows are also considered, due to their effect on the rouble and therefore imported inflation. The CBR has stated that while

TABLE: MONETARY POLICY FORECASTS

	2014	2015	2016	2017e	2018f	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f
Consumer price inflation, % y-o-y, eop	11.4	12.9	5.4	4.2	4.2	4.2	4.2	4.0	4.0	4.0	4.0	4.0	4.0
Consumer price inflation, % y-o-y, ave	7.8	15.6	7.1	4.5	4.2	4.2	4.2	4.1	4.0	4.0	4.0	4.0	4.0
Central bank policy rate, % eop	17.00	11.00	10.00	8.25	7.00	6.00	6.00	5.50	5.00	5.00	5.00	5.00	5.00

e/f = BMI estimate/forecast. Source: Central Bank of Russia/Federal State Statistics Service it does not target a specific exchange rate, it may still intervene in the currency market to stabilise the rouble during times of excessive volatility. Due to the heavy reliance of the Russian economy on imported goods, maintaining exchange rate stability can be seen as part of its mandate to avoid imported inflation by avoiding depreciation of the rouble. We note, however, that the CBR is not beyond preventing excessive appreciation of the currency also, as it did in Q215.

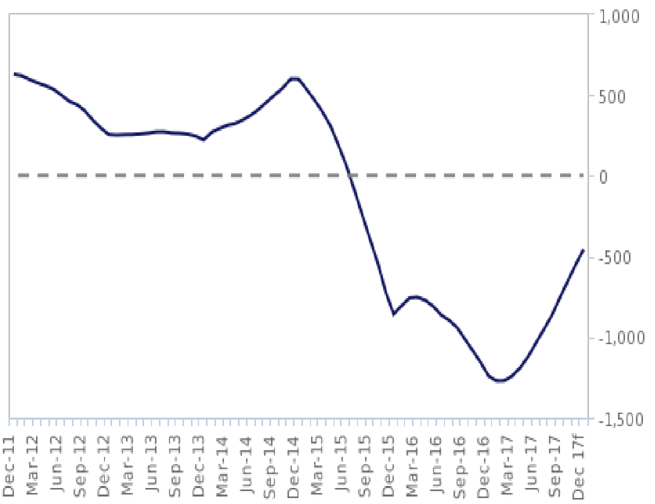
Fiscal Policy And Public Debt Outlook

Government To Loosen Grip On Spending

BMI VIEW

Russia's sluggish economic backdrop will push the government to slow the pace of fiscal consolidation over the coming years. A less austere stance will be supported by higher oil prices and falling borrowing costs, while the overall sovereign position will remain strong on account of large reserves and low public debt. The imposition of new US sanctions on Russia's sovereign debt remains an unlikely scenario in our view, however could significantly dampen this relatively stable outlook.

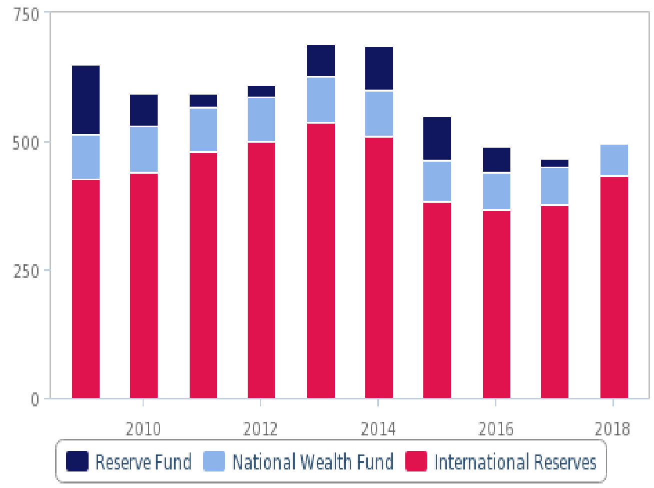
Progress To Slowdown Going Forward
Budget Balance, RUBbn (12mma)



f= BMI forecast. Source: Finance Ministry, BMI

Russia's fiscal position will continue on a healthy trajectory over the coming quarters, albeit gradually shifting towards a less austere stance. We estimate the budget deficit to have narrowed from 3.4% of GDP in 2016 to 2.2% in 2017, but expect much more gradual improvements going forward. We project the deficit to average 1.6% over the next two years, placing us below consensus forecasts of 1.1%. A slower pace of fiscal consolidation will be motivated by Russia's sluggish economic backdrop. Though the country returned to positive real GDP growth in 2017, the economic recovery has failed to pick up steam and a large share of Russians continue to see no improvements in living standards, raising the risk of a popular backlash. This is particularly relevant given the upcoming presidential elections. That said, greater spending will be facilitated by higher oil prices, the implementation of tax hikes, and low borrowing costs.

Sovereign Position Remains Robust Despite Depletion Of Reserve Fund
Sovreign Reserve Funds, USDbn



Note: Data refers to reserve amount as of January of each year. Source: Finance Ministry, CBR, BMI

Higher spending will be driven by election pledges made prior to the March 2018 presidential elections. President Vladimir Putin, who is expected to be elected to a fourth term, announced the expansion of popular subsidies for families which will cost the government a total of RUB500bn (about 0.5% of GDP) over the next three years. The programme extends current mortgage subsidies as well as payments to mothers who have a second baby and subsequent children, and introduces a new monthly allowance for poorer families upon the birth of a first child. In addition to being an enticement for voters, these measures reflect an effort to counter a long-term demographic decline that will see Russia's dependent ratio increase from about 46.6% in 2017 to an estimated 53.4% by 2022, straining the public budget. In December, the State Duma also passed a draft bill which entails the write off of some RUB41bn of tax debt for about 42 million Russians.

The government is also currently discussing a budget overhaul that would prioritise expenditure in areas seen to make a positive contribution to economic development. Though a more substantial impact is expected in the longer term, some of the measures are likely to come into effect as of late 2018. Amongst other things, the Kremlin is considering raising health, education and infrastructure outlays by 1.5-2.0% of GDP over the next three years, including as much as a 30% increase in spending for transport and roads. While it hopes to achieve this through a redistribution of fiscal spending from so called unproductive areas – such as security, defence and public administration – to productive ones, the scope for spending cuts is fairly limited in our view, particularly in the defence and security sectors. As such, spending targets outlined above are likely to prove overly optimistic.

Nearing Historic Lows

RUB-denominated Government Bond Yield, %

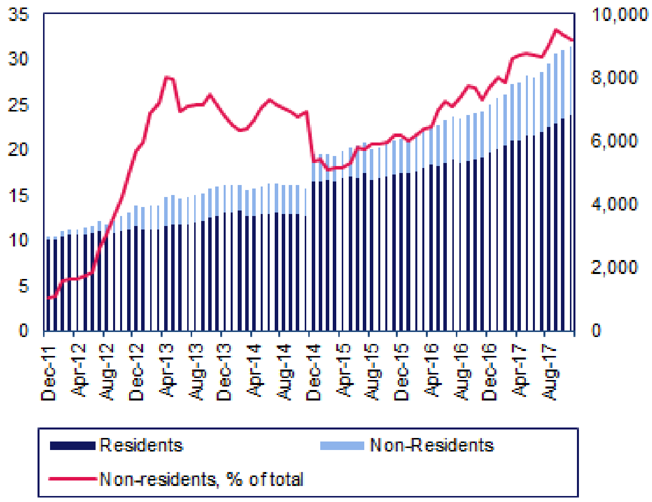
Note: Data refers to reserve amount as of January of each year. Source: Finance Ministry, CBR, BMI

The budgetary impact of these expansionary measures will be compensated by a rebound in revenues. This will be the result of tax increases, set to become a topic of discussion following the presidential elections, and of additional upticks in state energy revenues driven by higher oil prices. We note that our Oil & Gas team made a major revision to the outlook for oil prices in 2018, increasing the forecasted annual average for Brent to USD65/per barrel (bbl), from USD57/bbl previously. In the longer term, it forecasts further gradual increases until oil prices reach a level of about USD80/bbl in 2024.

The Kremlin will also continue to draw on its reserve funds to finance future deficits. Russia's Reserve Fund ceased to exist on January 1 2018, depleted by low oil prices and various bail outs throughout the years, and what remained in the fund by end of 2017, only about USD17bn, has been merged with the National Welfare Fund (NWF). The NWF was originally intended to ensure the long-term viability of the pension system, but has now been re-tasked with topping up the budget as well. The use of funds previously earmarked for the pension system raises risks with respect to sustainability of the public finances over the long term, and increases the urgency to push through a pension overhaul in order to cope with growing pressures posed by a rapidly ageing population (*see 'Fiscal Position Improving, But Long-Term Risks Persist', October 27*). That said, after reaching a historic low in 2017, Russia's sovereign reserves have returned to an upward trajectory, and their replenishment will be supported going forward by the combination of higher oil prices and a new budget rule which pays excess oil and gas revenues into the NWF (*see 'New Fiscal Rule Will Aid Consolidation', August 2*).

Domestic Demand Unlikely To Pick Up The Slack

Resident and Non-Resident Holding RUB-denominated Government Debt, RUBb



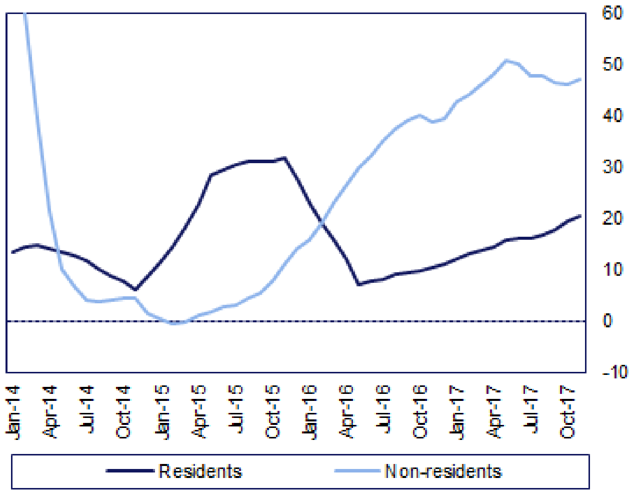
Source: Bloomberg, BMI

We expect the government to resort to more debt issuance going forward, taking advantage of falling borrowing costs. Public debt is estimated at 17.2% of GDP in 2017 and we forecast it to increase to about 19.5% by 2019, continuing to compare very favourably to other emerging market peers. Combined with still large central bank reserves and a current account surplus, Russia's overall sovereign position remains strong.

Our relatively upbeat view with respect to the country's borrowing dynamics however could be overturned by the potential impact of US sanctions on Russian sovereign debt as punishment for Moscow's alleged meddling in the 2016 US elections. The US administration will present a report in February 2018 detailing the effects of expanding sanctions on Russia to include sovereign debt and derivative products. This in turn will inform the decision of whether or not buying Russian debt will constitute a sanctionable investment.

Although we see it as unlikely that the Trump administration will pursue this course of action, if US sanctions on Russian sovereign debt were to materialize, the Kremlin would face tough choices: returning to greater austerity, further depriving the economy of much needed stimulus, or accepting a heavier debt burden which could gradually undermine the country's sovereign profile and its long-term fiscal sustainability.

Domestic Demand Unlikely To Pick Up The Slack
% chg y-o-y



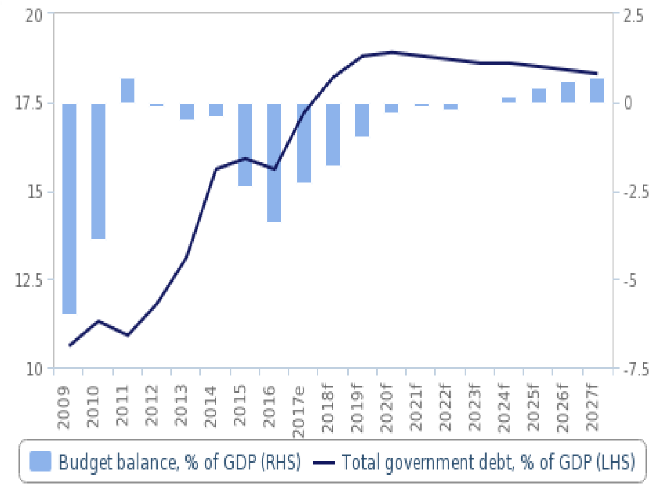
Source: Bloomberg, BMI

In mid-November, Elvira Nabiullina, governor the Central Bank of Russia, stated that sanctions would likely result in a 'short-term spike' in rates, followed by a sustained increase in rates of around 30-40 basis points (bps). We see this view as largely optimistic. The majority of respondents in a Bloomberg survey conducted in November project the increase between 50-150bps. We would expect the imposition of sanctions to dampen demand across Western investors broadly, rather than just amongst US residents, and potentially spilling to a drop in investment confidence amongst domestic investors too.

Structural Fiscal Position

Russia's once strong sovereign profile has been dented in recent years as lower oil prices and economic recession have depleted fiscal reserves, raised public debt ratios and depressed growth potential amid a lack of any serious structural reform efforts. We forecast higher average fiscal deficits in the coming years relative to the past decade, yet the government's fiscal consolidation efforts will allow Russia's fiscal position sustainable. Moreover risks of a crisis are mitigated by a strong external position and the low starting point for the public debt ratio.

Fiscal And Public Debt Forecasts
Gross Debt And Fiscal Balance (2009-2027)



e/f = BMI estimate/forecast. Source: National Sources/BMI

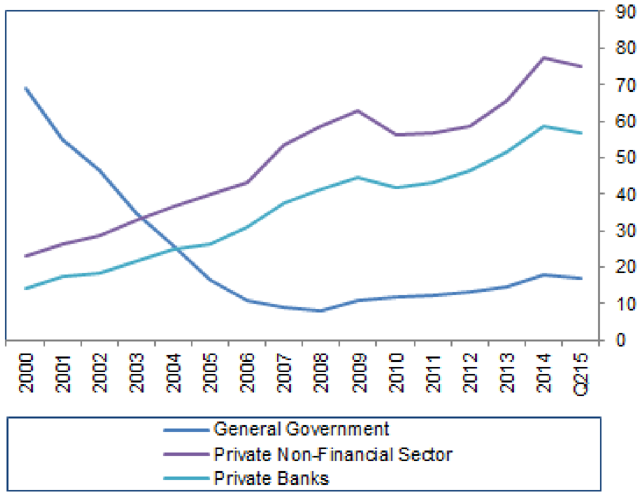
Fiscal Deficit: We forecast Russia's fiscal balance to average -1.1% of GDP between 2017-2021, below the 0.0% of GDP average from 2011-2014, during which time budget revenues were supported by elevated oil prices. Robust energy prices allowed for the expansion of social spending and the build up of large fiscal reserves, which have been nearly depleted during the recent economic crisis and for which we forecast only a modest recovery in the coming years. Though oil and gas revenues will continue to account for a large portion of total

TABLE: MAIN REVENUE & EXPENDITURE CATEGORIES 2015

Main Sources of Revenue	% of Total	Main Areas of Expenditure	% of Total
Oil &Gas Revenues	42.9	Social Policy	27.3
VAT (Domestic)	17.9	Defence	20.4
VAT (Imports)	13.1	National Economy	14.9
Import Duties	4.1	Law And Order	12.6
Excise Taxes (Domestic)	3.9	State Administration	7.1
Profit Tax	3.6	Transfers To Regional Budgets	4.4

Source: Russia Ministry Of Finance, BMI budget revenues, a new budget rule which will come into full effect as of 2019 will help curb fiscal dependency on oil. The rule will help control government spending at times of low oil prices and will allow fiscal buffers to be replenished when oil prices are high. Russia's subdued economic growth potential will continue to weighing on non-energy budget revenues.

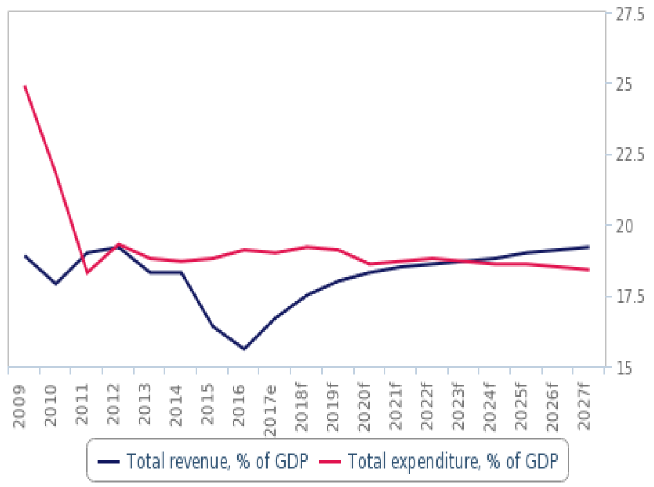
Debt Build-Up Has Been In Private Sector
Total Credit By Sector, % of GDP



Source: Bank for International Settlements

While the fiscal position has suffered from falling oil prices, the oil and gas sector has benefited from the fact that it generates revenue in hard currency while paying the majority of costs in roubles. As such, we expect the government to look increasingly to the oil and gas sector to prop up the government's financial position, for example via higher taxation. Nevertheless, the 2015-2016 recession has forced cuts in education, health and other categories of social spending, and these areas will remain under pressure in the coming years, especially in light of the government's aggressive foreign policy stance and ongoing commitment to boosting military and defence expenditures. The decision to intervene militarily to prop up the regime of Syria's President Bashar al-Assad may drag Russia into a protracted conflict at a significant cost, squeezing other areas of spending. Indeed, the trend has already played out in recent years, with defence expenditures rising from 12.6% of total expenditures in 2010 to 20.4% in 2015.

Government Spending & Revenue Projections
Government Spending And Revenue (2009-2027)



e/f = BMI estimate/forecast. Source: BMI Calculation/Ministry of Finance

Government Debt: High growth rates and rising commodity revenues facilitated a reduction in Russia's total public sector

TABLE: FISCAL AND PUBLIC DEBT FORECASTS

	2016	2017e	2018f	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f
Total revenue, RUBbn	13,460.0	15,075.2	16,507.3	17,976.5	19,234.9	20,581.3	21,816.2	23,125.1	24,512.6	25,983.4	27,542.4	29,195.0
Total revenue, RUB, % y-o-y	-1.5	12.0	9.5	8.9	7.0	7.0	6.0	6.0	6.0	6.0	6.0	6.0
Total expenditure, RUBbn	16,416.4	17,155.1	18,184.4	19,002.7	19,572.8	20,747.2	21,992.0	23,091.6	24,246.2	25,458.5	26,731.5	28,068.0
Total expenditure, RUB, % y-o-y	5.1	4.5	6.0	4.5	3.0	6.0	6.0	5.0	5.0	5.0	5.0	5.0
Budget balance, RUBbn	-2,956.4	-2,079.9	-1,677.1	-1,026.2	-338.0	-165.9	-175.9	33.5	266.4	524.9	811.0	1,126.9
Budget balance, % of GDP	-3.4	-2.3	-1.8	-1.0	-0.3	-0.1	-0.2	0.0	0.2	0.4	0.6	0.7
Total government debt, EURbn	181.6	234.8	257.6	275.7	279.5	285.7	294.1	302.7	311.6	320.8	330.2	339.9
Total government debt, % of GDP	15.6	17.2	18.2	18.8	18.9	18.8	18.7	18.6	18.6	18.5	18.4	18.3

e/f = BMI estimate/forecast. Source: National Sources/BMI debt to as low as 8.0% of GDP in 2008, from 59.9% of GDP in 2000 just after the country's sovereign default. Low public debt ratios have underpinned Russia's sovereign profile ever since, with debt rising to just 13.1% in 2013. The collapse in oil prices and prolonged domestic recession has pushed the public debt ratio up to 17.0% of GDP in 2016, forecast to rise steadily our forecast period on account of a weak growth outlook, lower average oil prices and wider average fiscal deficits.

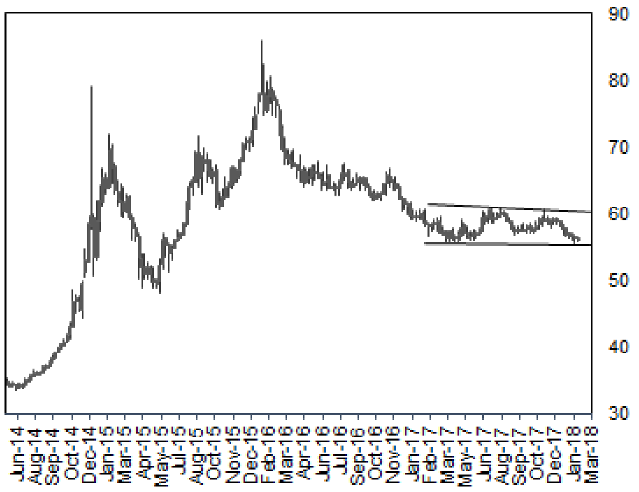
Currency Forecast

RUB: Stability Followed By Depreciation

BMI VIEW

The Russian rouble will trade sideways in the short term on the back of limited further gains in oil prices and government intervention aimed at ensuring stability in the exchange rate. We expect some depreciation in the longer term as downside pressures, stemming largely from the Central Bank of Russia monetary easing and the US Federal Reserve tightening, intensify.

More Sideway Trading
Exchange Rate – RUB/USD



Source: Bloomberg, BMI

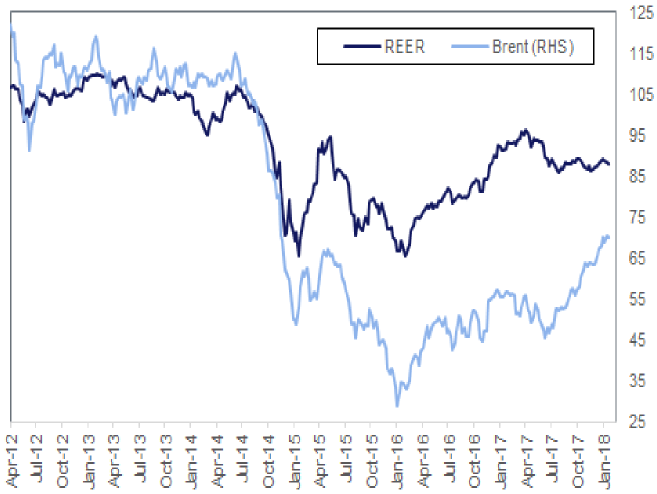
Short-Term Outlook (three-to-six-months)

We have revised up our forecasts for the Russian rouble in 2018 to reflect recent appreciation driven by a rally in oil prices, a weakening US dollar, and easing risks related to US sanctions. From a previous estimate of RUB60.40/USD, we now project the unit to average RUB58.00/USD in 2018, though we remain more bearish relative to Bloomberg consensus of RUB56.70/USD. Going forward, while our O&G team has revised up their forecasts for oil prices in 2018 from USD57.00/per barrel (bbl) to USD65.00/bbl, this implies limited further gains in the short term given that Brent is currently trading at USD68.62/bbl. Furthermore, we believe that the US dollar is poised for a short-term rebound. As a result, we forecast no further appreciation this year, and expect the unit will continue broadly sideways trading in the coming quarters.

Long-Term Outlook (six-to-24-months)

While our longer-term oil prices forecasts remain supportive of the rouble, upside pressures will be offset by government interventions. The Finance Ministry will continue to intervene to curb excessive currency strength through a programme which entails the purchase of foreign currency with extra budget revenue earned when oil prices are above USD40/bbl. Such interventions would run in reverse if crude plunged below USD40/bbl. The government's broader aim is to reduce volatility and insulate the currency, and thus economy more broadly, from swings in oil prices. Indeed, the correlation between RUB and oil prices has diminished in the past year, despite remaining significant. Adding to this, scope for further gains are further reduced by the fact that the rouble looks overvalued on a real effective basis and relative to oil prices.

Still Overvalued In Real Terms
Real Effective Exchange Rate & Brent Crude, USD/bbl

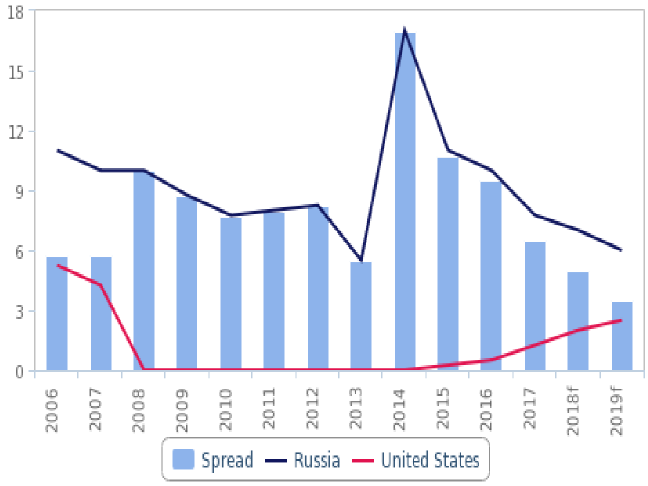


Source: Bloomberg, BMI

We forecast depreciation in 2019, forecasting an average exchange rate of RUB59.09/USD. Against a backdrop of sluggish growth, the Central Bank of Russia (CBR) will pursue further monetary easing. Having achieved broad price stability (*see 'Price Stability Paves The Way For Further Easing', January 31*), the bank now has more scope to lower interest rates and will proceed with a series of 25bps cuts over the next two years, bringing its benchmark rate down to 6.75% by end-2018 and to 6.00% by end-2019. This in turn will curb real rates (as measured by the spread between the policy rate and inflation) to 2.6% by end-2018 and to 1.8% by end-2019 (from an average of 3.7% in the last two years), diminishing the currency's carry trade appeal.

Yield Differentials Less Appealing

Russia & US Central bank policy rates, % eop



f = BMI forecast. Source: Federal Reserve, CBR, BMI

Further to this, as the Federal Reserve (Fed) embarks on a steady tightening cycle, yield spreads move steadily in favour of the US dollar. Recent dollar weakness provides more scope for the Fed to tighten, and we forecast 75bps worth of hikes in 2018 bringing the key rate to a range of 2.00-2.25%, and 50bps in 2019, bringing the rate to 2.50-2.75%. Our forecasts stand above the expectations of financial market participants (*see 'Six Reasons For Three Fed Hikes In 2018', January 5*).

Risks To Outlook

Though risks towards a weaker rouble have abated following the US administration's decision on January 29 to refrain from imposing new sanctions on Moscow for the time being (*see 'Risks To External Position Declining', February 1*), the geopolitical backdrop remains the main downside risk to the currency's outlook. Our core view is that Russia and the West are unlikely to see any major improvements in the upcoming months, and that the Trump administration may still toughen its stance if Moscow undertakes any aggressive moves against other countries, or if pressure from the US Congress to act continues, which in turn could weaken the currency mainly by dampening investor confidence towards Russian assets.

Chapter 2:
10-Year Forecast

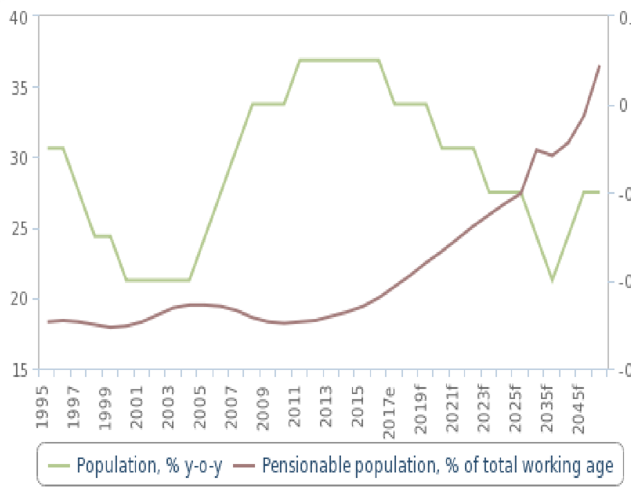
The Russian Economy To 2027

Long-Term Economic Stagnation Without Reforms

BMI VIEW

Russia's growth potential is much lower in the next decade than it has been in the previous 10 years, dragged down by the country's commodity dependence, rapidly ageing population, and prolonged slump in investment. However, the biggest drag on growth will remain the state's tight grip on key sectors of the economy and society more broadly, and lack of meaningful progress towards a more liberal economic system.

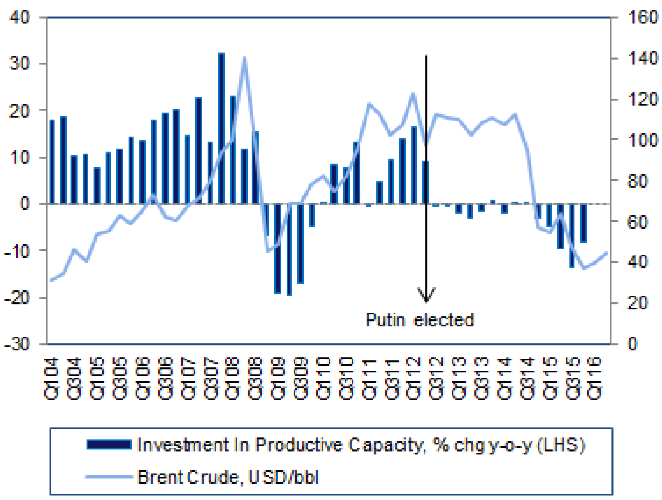
Major Demographic Challenges
Population & Pensionable Population



e/f = BMI estimate/forecast. Source: BMI/UN

We forecast real GDP growth in Russia to be much lower over our 10-year forecast period than in the previous decade, averaging just 1.7% from 2018-2027. The energy sector was the key driver of robust growth from 2001-2012, but this will be unsustainable over the long term due to stagnating hydrocarbon production and much lower average oil prices. While we forecast modest oil prices increases over the coming years, these will be insufficient to drive a robust economic expansion in the absence of more concerted efforts at structural reform and economic diversification, of which we see little scope for over the coming years.

Investment Crash Precedes Oil Crash
Investment In Productive Capacity & Brent Crude Oil Price



Source: Russia Federal Statistics Service, Bloomberg, BMI

Since the early 2000s, rising oil revenues propped up government receipts and flooded the domestic banking sector with liquidity, allowing for a significant expansion of per capita income, public services and living standards. However, minimal efforts at economic liberalisation and diversification were undertaken

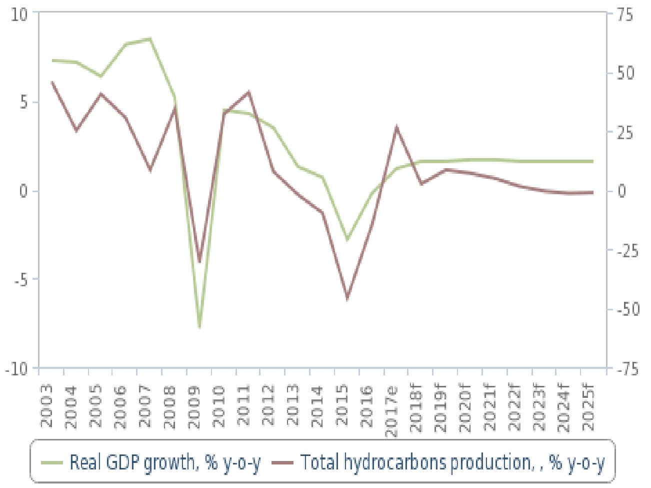
TABLE: LONG-TERM MACROECONOMIC FORECASTS

	2018f	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f
Nominal GDP, USDbn	1,630.5	1,688.1	1,733.1	1,779.7	1,839.2	1,900.8	1,964.7	2,030.8	2,099.3	2,170.3
Real GDP growth, % y-o-y	1.8	1.7	1.7	1.7	1.6	1.6	1.6	1.6	1.6	1.6
Population, mn	143.96	143.90	143.79	143.64	143.44	143.20	142.92	142.61	142.25	141.87
GDP per capita, USD	11,325	11,731	12,053	12,390	12,821	13,273	13,746	14,240	14,757	15,297
Consumer price inflation, % y-o-y, ave	3.8	4.2	4.2	4.1	4.0	4.0	4.0	4.0	4.0	4.0
Current account balance, % of GDP	2.3	2.2	2.0	1.7	1.3	0.7	0.1	-0.6	-1.2	-1.9
Exchange rate RUB/USD, ave	58.00	59.09	60.71	62.38	63.62	64.90	66.19	67.52	68.87	70.25

f = BMI forecast. Source: National Sources/BMI over that time, and from a political perspective progress has recently been towards greater, not lesser state influence over the economy and society more broadly. The pitfalls of Russia's commodity dependence were illustrated by the sharp recession of 2015 coinciding with a collapse in oil prices, which reduced per capita income by 40% in US dollar terms from 2013 levels.

Low Oil Prices, Stagnant Production Weighing On Growth

Real GDP & Hydrocarbon Production Growth



e/f = BMI estimate/forecast. Source: National Sources/BM

Investment Collapse Precedes Oil Crash

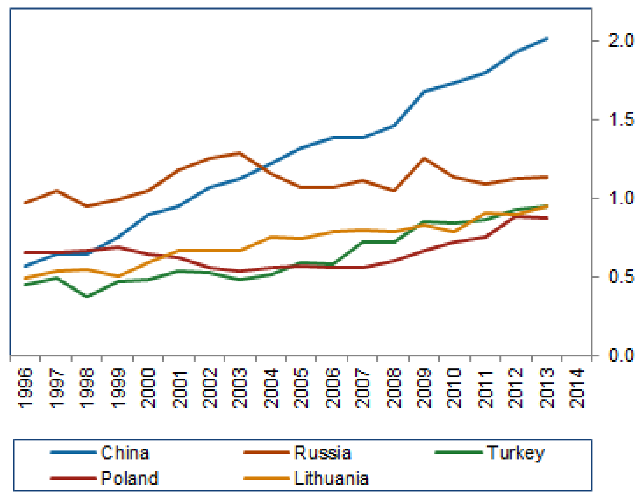
Sharp declines in commodity prices since mid-2014 have weighed heavily on all facets of Russia's economy, but the root causes of the country's economic malaise precede the oil price crash. This is most clearly illustrated in fixed investment, which entered a multi-year slump in 2012 even as oil prices remained near record highs. The decline in investment activity coincides roughly with the election of Vladimir Putin as President in 2012, which acted as a signal to investors that more liberal, reformist camps in the Kremlin would not hold greater sway over the direction of policy. This was made clear by Putin's backtracking on much of the liberal reform agenda put forward by Prime Minister Dmitry Medvedev, in favour of greater political control. The prolonged slump in investment has negative long-term consequences, and will continue to weigh on productivity growth. As measured by the OECD, growth in GDP per hour worked in Russia fell to 1.7% and 0.2% in 2013 and 2014 respectively, after 4.0% average growth from 2000-2012.

Reforms Not Far Reaching Enough

By some metrics, Russia has made relatively impressive progress in improving its business environment in recent years. For example, the country now sits at 40 out of 190 in the World Bank's 2017 Ease of Doing Business Index, up from 51 in 2016, following a series of micro reforms that have made it easier to start a business and register property, among other things. While certainly positive, we believe that these improvements do not address the main impediment to stronger levels of investment, growth and competitiveness – endemic corruption and the high degree of centralised state control over key sectors of the economy and society. The government maintains controlling stakes in the biggest energy and banking giants, and recent political trends suggest that it is unlikely to cede significant control over the coming years. Similarly, the government's tolerance for dissent and domestic opposition also appears to have waned, which when combined with endemic corruption and cronyism, will suppress the creation of a vibrant business environment capable of fostering entrepreneurialism and innovation.

Gradually Losing Edge In R&D Spending

Research & Development Spending, % of GDP



Source: The World Bank

Major Demographic Challenges

Ageing demographics present Russia with another challenge, and will entail major strains on the fiscal position and growth potential. Russia's total population posted negative growth rates for 15 consecutive years beginning in 1994, before stabilising from 2009 to 2015. However, according to our forecasts Russia's population will contract over the coming decade and will see a steady rise in dependency ratios. From an estimated 45.1% of the total working age population in 2016, Russia's dependency ratio will rise to 57.2% by 2027. Over the time, the pensionable population is expected to rise from 20.0% to 28.3% of the working age population. Ageing demographics make robust productivity gains crucial in maintaining robust real GDP rates, but in this regard we maintain a relatively downbeat view on Russia's potential. Ageing demographics will also necessitate major fiscal reforms and long-term fiscal consolidation, including raising the retirement age and scaling back benefits, which will weigh on household consumption. Fiscal constraints will also limit potential growth in public investment expenditure, which given expected weakness in private sector investment demand and foreign direct investment, bodes ill for capital formation.

Reforms Can Unlock Potential

Despite these challenges, we highlight several bright spots for the Russian economy, which together with severely depressed valuations, imply that a more robust pace of reform and/or political transformation would offer significant opportunities for investors. Russia is the sixth largest economy in the Europe region in US dollar terms with a population of over 140 million people (compared to around 340 million in the entire eurozone). Demographic challenges aside, the large size of the consumer market will remain a key selling point.

Furthermore, Russia's labour force is highly educated. Russia scores relatively well in **BMI**'s Labour Market Risk Index, due to its robust score in the Education sub-component, ranking above France and Finland. Reflecting its traditionally strong education system, Russia has consistently ranked above most emerging European peers in total research and development spending. Given these factors, a change in the direction of government policy towards a more liberal economic structure would make the country very attractive from a risk/reward perspective, boosting long-term growth potential.

BMI's long-term macroeconomic forecasts are based on a variety of quantitative and qualitative factors. Our 10-year forecasts assume in most cases that growth eventually converges to a long-term trend, with economic potential being determined by factors such as capital investment, demographics and productivity growth. Because quantitative frameworks often fail to capture key dynamics behind long-term growth determinants, our forecasts also reflect analysts' in-depth knowledge of subjective factors such as institutional strength and political stability. We assess trends in the composition of the economy on a GDP by expenditure basis in order to determine the degree to which private and government consumption, fixed investment and the export sector will drive growth in the future. Taken together, these factors feed into our projections for exchange rates, external account balances and interest rates.

Chapter 3:
Political Outlook

SWOT Analysis

Strengths

- The Russian government maintains strong public support, even after increased political protests evidenced by widespread demonstrations in the wake of President Vladimir Putin's re-election in 2012, and anti-corruption protests in early 2017.
- The ruling United Russia party won a supermajority in the Duma following the 2016 general election, which will allow it to pursue its policy agenda with fewer obstructions.

Weaknesses

- A lack of transparency in decision-making, including high levels of behind-the-scenes activity by various powerful groups, makes for a large element of unpredictability in domestic politics over the long run.
- The high degree of political authority in the executive poses a risk to further institutional development in the legislative and judicial sectors.
- The government continues to lag in reducing the state's large footprint continuing to weigh on the broader economy.

Opportunities

- The Russian government is increasingly expressing the need for economic and structural reforms to stimulate long-term growth.
- WTO accession may increase the incentive for authorities to implement stricter regulatory standards and improve transparency.

Threats

- Russia's move to increase its regional dominance in the energy sector risks a further deterioration in relations with the Western-leaning countries of the 'near abroad'.
- Rising political risks in the North Caucasus threaten to destabilise Russia's southern border.
- The ongoing conflict in Ukraine, Russia's intervention in Syria and alleged meddling in US and EU elections risk exacerbating relations with the West, and dragging the country into a prolonged, frozen conflict.

BMI Political Risk Index

The political status quo is likely to see only modest changes following the March 2018 presidential elections. With living standards having declined dramatically since 2014 alongside oil price declines, rouble depreciation and budget cuts, the prospect of greater social unrest is on the rise as evidenced by public protests across the country at the beginning of 2017. Following large scale protests amid allegations of voter fraud in the 2011 parliamentary election, the Kremlin has adopted a much tougher stance against domestic dissent and opposition voices. .

	S-T Political	Trend	Regional Rank	Global Rank
Turkmenistan	73.1	=	1	51
Latvia	72.1	=	2	56
Lithuania	71.5	-	3	59
Hungary	71.0	=	4	62
Poland	69.6	-	5	68
Kazakhstan	66.7	=	6	83
Russia	**66.5**	**=**	**7**	**84**
Bulgaria	65.2	=	8	88
Croatia	65.0	=	9	89
Uzbekistan	64.2	+	10	94
Romania	63.1	-	11	97
Azerbaijan	62.9	=	12	100
Belarus	62.5	=	13	102
Albania	59.8	=	14	115
Montenegro	59.8	-	14	115
Kyrgyzstan	58.8	+	16	119
Serbia	58.8	=	16	119
Turkey	57.1	=	18	128
Georgia	56.5	=	19	133
Macedonia	53.3	+	20	140
Armenia	52.7	=	21	145
Moldova	47.9	=	22	156
Tajikistan	47.3	=	23	159
Ukraine	41.5	=	24	171
Bosnia-Herzegovina	40.6	=	25	173
Kosovo	39.4	=	26	175

Regional ave 59.5 / Global ave 63.4 / Emerging Markets ave 59.6

	L-T Political	Trend	Regional Rank	Global Rank
Poland	81.6	=	1	25
Lithuania	78.4	=	2	32
Latvia	77.3	=	3	36
Bulgaria	72.0	=	4	50
Croatia	71.4	=	5	53
Hungary	71.4	=	5	53
Albania	71.3	=	7	55
Romania	70.6	=	8	61
Montenegro	70.3	=	9	63
Kazakhstan	66.0	=	10	79
Serbia	64.9	=	11	83
Russia	**61.7**	**=**	**12**	**96**
Armenia	61.5	=	13	98
Moldova	58.2	=	14	111
Macedonia	57.3	=	15	116
Turkey	57.3	=	15	116
Belarus	56.2	=	17	119
Bosnia-Herzegovina	55.8	=	18	120
Uzbekistan	55.8	=	18	120
Georgia	54.9	=	20	124
Kosovo	53.5	=	21	133
Turkmenistan	53.2	=	22	136
Azerbaijan	49.8	=	23	144
Kyrgyzstan	43.8	=	24	161
Ukraine	42.6	=	25	165
Tajikistan	36.2	=	26	176

Regional ave 61.3 / Global ave 62.0 / Emerging Markets ave 57.1

Domestic Politics I

2018 Election To Set Stage For Putin's Succession

BMI VIEW

With President Vladimir Putin virtually assured of re-election in March, attention will increasingly turn to administrative reform, and the all-important question of who will succeed Putin as president in 2024. Change will be limited in the near term, but the Kremlin appears to be elevating a younger generation of technocrats more attuned to resolving Russia's structural woes. This could portend greater changes over the longer term.

Despite efforts from the Russian administration to make the presidential election less predictable in order to increase voter turnout (*see 'Electoral Apathy Poses Biggest Challenge To Putin In 2018', October 20*), there is little doubt that Vladimir Putin will be re-elected for a fourth (and officially final) term on March 18. Though in our view his re-election will provide only limited scope for structural reform (*see 'Political Status Quo Remains Biggest Headwind To Stronger Growth', October 20*), we expect the next six years will set the stage for some change in Russia's political status quo.

Change will not be driven by Russia's traditional opposition, sanctioned by the Kremlin, which over the years has ceased to play a meaningful role. Recent opposition efforts to appear as a more credible alternative will provide minimal challenges to Putin's candidacy. The president continues to rank by far the highest in opinion polls. In early January, the Communist Party surprisingly nominated Pavel Grudinin as its new presidential candidate instead of 73-year old Gennady Zyuganov, who has been running for president since 1996. Grudinin, CEO of the Lenin Sovkhoz farm, is a new face who provides populist rhetoric, promises of a better life and criticism of the authorities. However, the Communist Party is a relatively weak political force that typically polls around 15% support.

A more significant driver of change instead will be simmering popular discontent. Economic hardships and endemic corruption have been fuelling dissatisfaction among ordinary Russians,

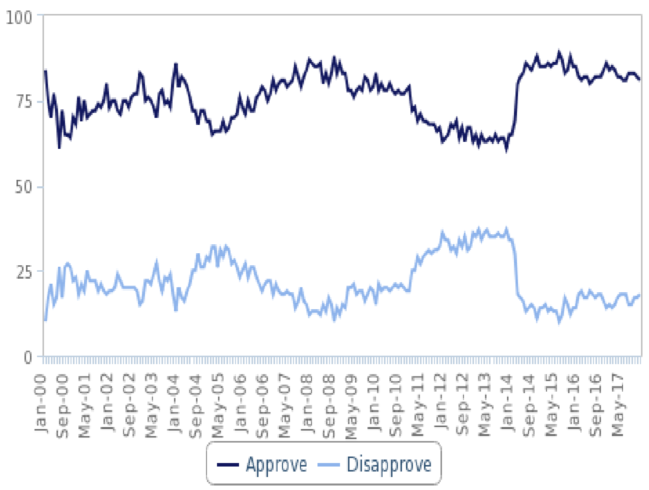
TABLE: POLITICAL OVERVIEW

System of Government	Presidential quasi-democracy, universal suffrage, bicameral legislature: 450-seat State Duma (five-year term) and 170-seat Federation Council (terms determined regionally); executive power is split between the president and prime minister.
Head of State	President Vladimir Putin (limited to two consecutive six-year terms).
Head of Government	Prime Minister Dmitry Medvedev
Last Election	Parliamentary – September 18 2016
	Presidential – March 4 2012
Composition Of Current Government	United Russia Party
Key Figures	First Deputy Prime Minister – Igor Shuvalov, Finance – Anton Siluanov, Foreign Affairs – Sergei Lavrov, Defence – Sergei Shoigu, Chairman of the Central Bank of Russia – Elvira Nabiullina.
Main Political Parties (number of seats in parliament)	United Russia Party (342 seats): Dominant party within the Russian political system. The party advocates a strong state and enhancing Russia's global political position. Led by Vladimir Putin.
	Communist Party (42 seats): Marxist-Leninist party with primary support in the rural regions and suburban Moscow. Led by Gennady Zyuganov.
	Liberal Democratic Party (39 seats): Ultranationalist, populist party that advocates the reassertion of Russian dominance in the CIS. Led by Vladimir Zhirinovsky.
	A Just Russia (23 seats): Pro-government party that advocates a more social-democratic policy than United Russia.
Extra-Parliamentary Opposition	Progress Party: Liberal party that advocates decentralisation of power. Led by Alexei Navalny.
	Yabloko: Liberal social-democratic centre-left party.
	Numerous separatist or Islamist organisations in the North Caucasus, most notably Caucasus Emirate.
Next Election	Parliamentary – September 2021
	Presidential – March 2018
Ongoing Disputes	'Frozen Conflicts' with Moldova over the Transnistria region and Georgia over the Abkhazia and South Ossetia regions. Diplomatic disputes with Latvia, Lithuania and Estonia over ethnic Russian minorities in those countries. Territorial dispute with Japan over Kuril Islands
Key Relations/Treaties	Permanent Member of the United Nations Security Council, lead member of the Commonwealth of Independent States, member of World Trade Organization.
BMI Short-Term Political Risk Score	66.5
BMI Long-Term Political Risk Score	61.7

Source: BMI

and over the past few quarters have resulted in a rise in protests. Though the anti-government rallies have not yet reached threatening numbers of participants, and thus pose no real threat to Putin in the near term, they increase the likelihood of an eventual shift in the political system in the years ahead (*see 'Protests No Immediate Threat To Putin', March 28*). Alexei Navalny, an anti-corruption campaigner at the forefront of these anti-government protests, has been capitalising on social dissatisfaction to grow his popularity and currently poses the most vocal and sound opposition to Putin. Navalny has been banned from running for election this year, on the grounds of a conviction for embezzlement, but could pose a rising threat to the current regime in the post-2024 era.

Unbeatable Popularity
Survey – Putin's Approval Ratings, %



Source: Levada Center, BMI

Appointment Of Younger Technocrats To Spur Modest Reforms

In an attempt to respond to Russians' demands for change, following the March presidential elections, we expect to see a wave of personnel changes. Though the country will remain an authoritarian state, with power centred around Putin, we expect new appointments will underpin a gradual shift towards a more technocratic rule. Supporting our view is the fact that in the face of popular discontent, the Kremlin has started focusing more greatly on the need to increase administrative efficiency and reduce conspicuous corruption. By appointing technocrats – individuals who are competent professionals but display no evident political ambitions of their own – to top positions in the government, Putin hopes to show that he aims to raise the level of general welfare with fresh ideas. As a result of this, in the coming years the president will rely more on these technocratic executives and less on his traditional inner circle of allies.

A series of high-level appointments and dismissals over the past few quarters provides evidence of the emergence of this trend. In August 2016, Putin's long-time ally and peer Sergei Ivanov, was replaced with Anton Vaino, a 44-year old, near-unknown, as the Kremlin's chief of staff, while 35-year old Maxim Oreshkin, an alumni of investment banks, was named minister of economic development in December 2016. He took over after the arrest of Alexei Ulyukaev on corruption charges, a scandal which exposed an ongoing institutional conflict among government elites. Further to this, over the past several months, numerous regional governors have been replaced with a new class of young technocrats with expertise but less political experience, and as of October 2017, almost half of all new regional leaders were technocratic figures. However, not all newly emerging figures are technocrats. Forty-five-year old Alexei Dyumin, 52-year old Dmitry Mironov, and 51-year old Yevgeny Zinichev were made governors of the regions of Tula, Yaroslavl, and Kaliningrad, respectively, and all three came from the Presidential Security Service.

Though this also reflects an attempt by Moscow to prevent a dilution of political control, given that high-level political officials, particularly across the country's regions (*see 'Regional Balance Sheets A Long-Term Threat', December 12*), are gradually seeking more autonomy and challenging decisions from the top, the nature of these new appointees may backfire. In particular, we note that this new cadre, which will be driven more by pragmatic considerations rather than political ties, may come to weaken the current regime in the longer term, gradually eroding the patronage network which has been at the base of Putin's power vertical. At the same time, these technocrats are more likely to push for more unpopular, but much needed fiscal reforms, including pension reforms and higher taxes, as well as fuel momentum for anti-corruption legislation.

Meanwhile, the rampant ineffectiveness of federal institutions originally tasked with implementing state policy will continue to fuel the emergence of other governance structures as drivers of key policy decisions. For instance, over the past few years, Russia's Federal Security Service (FSB) has gradually take on a larger role in the administrative process, including as an anti-corruption force. Similarly, the Central Bank of Russia's increased degree of autonomy in its modus operandi also points to a stark divergence from Russia's past system of consolidated control.

Attention To Turn To Putin's Successor

The impending re-election of Putin is also likely to increase speculation about who will eventually succeed him, as he is constitutionally barred from running for a further consecutive term in 2024. In our view, Putin is unlikely to immediately groom a successor, lest that person becomes too powerful too quickly and moves against Putin before 2024. Rather, Putin may elevate several individuals and mentor them for several years, before finally deciding on his successor in the early 2020s. Putin will eventually have to decide whether his successor will hail from the security establishment (like Putin himself), or be a technocratic figure. A career security official would probably seek to retain a statist economic model and highly nationalistic foreign policy, while a technocrat or economist would be more amenable to economic liberalisation and greater economic ties with the Western world.

There is also a possibility that Putin could amend the constitution to permit him a further six-year term beyond 2024, given that he would be 72 by then, which is not prohibitively old. Even if Putin fails to amend the constitution, he could assume a powerful state post to continue exerting influence in Russia.

Regardless, the personnel appointments to be made over the coming years will be crucial in determining Russia's long-term direction.

Domestic Politics II

No Major Improvement In Russia-West Relations In 2018

BMI VIEW

Russia and the West are unlikely to see any major improvements in their relations in 2018, as both sides brace for interference in each other's domestic affairs, and step up their struggle for geopolitical influence in Eastern Europe, the Middle East, and East Asia. The US Trump administration may yet be forced to toughen its stance on Russia, while the EU looks set to extend its sanctions in July 2018.

Russia's relations with the West are unlikely to see any major improvements in 2018, as political leaders in the US and Europe continue to accuse the Kremlin of interfering in their elections and domestic affairs, and Moscow retains a robust foreign policy stance as President Vladimir Putin runs for re-election in March. There are at least 10 countries in the Americas and Europe that are holding elections in 2018, which could raise concerns about Russian interference, chiefly by spreading 'fake' news stories online. The Kremlin itself is mindful of Western interference in its own presidential election. Besides the busy election schedule, Russia-West relations will continue to be strained by traditional geopolitical rivalry in Eastern Europe, the Middle East, and even East Asia (North Korea). Although US President Donald Trump came to office in January 2017 hoping to improve relations with Russia, the ongoing investigation into the extent to which the Trump election campaign had ties to Russia will continue to prevent Washington, DC, from undertaking any bold diplomatic initiatives that could lead to a rapprochement with Moscow.

Many Bones Of Contention Between Russia And The West

Europe's Geopolitical Configuration

Source: BMI

Russia Likely To Be Cautious Ahead Of World Cup

Russia is likely to behave relatively cautiously in terms of foreign policy in the first half of 2018, as President Putin gears up for re-election on March 18, and Russia prepares to hold the FIFA World Cup on June 14-July 15. Putin himself is virtually assured of victory in the election, given that his approval rating is reportedly above 70% and the most active opposition leader, Alexei Navalny, has been barred from running. Thus, Putin's main concern is a low turnout, which could result from apathy and take some of the sheen off his election to a fourth term. The Kremlin will also be mindful of protests by the opposition, which took place in a number of cities across Russia in 2017. Putin is determined to avoid the repeat of the mass demonstrations in the aftermath of the December 2011 parliamentary elections, which were the largest since the collapse of the USSR in 1991, and were prompted by suspicions that the elections were rigged. Putin perceived the US Obama administration of facilitating the protests.

TABLE: TIMELINE OF RUSSIA-WEST RELATIONS IN THE PUTIN ERA

Time Period	Event
Aug. 1999	Vladimir Putin becomes Russian prime minister; his popularity soars after Russia restarts the war against Chechen rebels following a series of terrorist bombings blamed on Chechens; Putin is elected president in 2000
Sep. 2000	Outgoing US President Clinton postpones decision on building National Missile Defense shield
Jan. 2001	George W. Bush becomes US president; he initially develops a good relationship with Putin
Sep. 2001	Following the 911 terror attacks, Putin aligns with Bush's 'war on terror' and supports US campaign in Afghanistan
2002	US-Russia relations cool, as NATO prepares to expand into Baltic states and into Balkans
Mar. 2002	US deploys troops to Georgia, marking first American military presence in Caucasus
May 2002	US and Russia sign SORT nuclear arms reduction treaty
Jun. 2002	US withdraws from 1972 Anti-Ballistic Missile (ABM) treaty, paving the way for enhanced missile 'shield' development
Mar. 2003	US invades Iraq and overthrows Saddam Hussein, ignoring objections of Russia, China, and many EU states
Nov. 2003	Russia sees the US as supporting Georgia's 'Rose Revolution', which brings a pro-Western government to power
Late 2004	Russia sees the US as supporting Ukraine's 'Orange Revolution', which brings a pro-Western government to power
Jul. 2005	US is expelled from military base in Uzbekistan after criticising Andijan massacre of protestors
Nov. 2006	Exiled Russian spy Alexander Litvinenko dies in UK from polonium poisoning; Russia is blamed
Apr. 2007	Russia is accused of conducting cyber attacks against Estonia over a historical dispute
Aug. 2007	Russia stakes its claim to territory in the Arctic, placing a flag on the seabed in the region
Feb. 2008	Kosovo declares independence from Serbia with Western backing; Russia greatly opposes this
May 2008	Dmitri Medvedev becomes Russian president, signalling warmer relations with West
Aug. 2008	Russia invades Georgia, assisting South Ossetia and Abkhazia in seceding from Georgia
Jan. 2009	Barack Obama becomes US president; he pursues a 'reset' in relations with Russia
2009	From 2009-2015, Russia served as part of a logistical route ('Northern Distribution Network') for US forces heading into and out of Afghanistan
Sep. 2009	US scales down plans for a missile shield in Eastern Europe
Jun. 2010	US and Russia sign New START nuclear arms reduction treaty
Jun. 2010	Russia backs tighter international sanctions on Iran over its nuclear programme
2011	Russia opposes NATO's deepening involvement in Libya's civil war, that results in Qadhafi's overthrow
2011	Nord Stream pipeline between Russia and Germany is opened
Dec. 2011	US criticises Russia's parliamentary election; Putin accuses US of fomenting post-election protests
Feb. 2012	Latvia holds referendum in which voters reject granting Russian status as official language
May 2012	Putin returns to the presidency, bringing a tougher stance towards West
Aug. 2012	Russia joins the World Trade Organization after 18 years of negotiations, but US imposes targeted sanctions over death of lawyer Sergei Magnitsky and other human rights abuses
Aug. 2013	Russia grants asylum to US fugitive NSA contractor Edward Snowden
Early 2014	Ukraine's pro-Russian president Viktor Yanukovych is overthrown; Russia annexes Crimea and backs Eastern Ukrainian separatists, taking Russia-West relations to lowest in 30 years; US and EU impose sanctions
Jun. 2014	US closes its military base in Kyrgyzstan after 12 years amid Russian and local pressure to leave
2014	Despite US-Russia tensions, the two countries continue to co-operate on space missions
Feb. 2015	Minsk 2 ceasefire is signed to end Ukrainian war, but fighting continues
Jul. 2015	World powers sign nuclear deal with Iran; Russia's actions contributed to the deal
Sep. 2015	Russia begins airstrikes in Syria; over subsequent 15 months Russia is accused of worsening refugee crisis and ruthlessly targeting civilians in rebel-held Aleppo
Jun. 2016	UK votes for Brexit, while populist parties gain further support in Western countries
Nov. 2016	Donald Trump is elected US president, and champions improved relations with Russia
Feb. 2017	National Security Adviser Michael Flynn resigns over his contacts with Russian officials
Apr. 2017	Trump bombs Syrian base in response to chemical attack on civilians
Spring 2017	Emmanuel Macron is elected French president; Trump-Russia accusations intensify in US
Jun. 2017	Montenegro joins NATO; Russia was previously accused of coup plot in late 2016
Jul. 2017	Trump meets Putin at G20 summit; Trump cancels US support for Syrian rebels
Aug. 2017	Trump signs into law Congress' new tougher sanctions on Russia
Dec. 2017	Trump agrees to sell Ukraine arms to fight Russian-backed separatists

Source: BMI

Meanwhile, hosting the World Cup is very important for Russia's image, owing to the event's global popularity. The tournament is intended to be a major prestige boost for Russia, and the Kremlin will thus do what it can to ensure a trouble-free event. In particular, Moscow will want to keep a lid on geopolitical disputes, lest this lead to calls for a boycott of the event. However, once the World Cup has ended, Russia could potentially adopt much more assertive behaviour, depending on geopolitical circumstances. For example, Russia began its takeover of Crimea from Ukraine at the end of February 2014, only days after receiving praise for successfully hosting the Winter Olympic Games in Sochi, in southern Russia. By contrast, Russia's actions towards the Ukrainian political crisis that unfolded in late 2013 to early 2014 were initially quite muted, perhaps mindful of jeopardising the Olympics.

US Attitude Towards Russia Hardening, As Trump Under Scrutiny

US attitudes towards Russia have hardened, amid the ongoing investigation into possible Russian interference in the 2016 election in favour of Donald Trump. Trump appears increasingly isolated in Washington, DC, in favouring a rapprochement with Moscow. Indeed, any conciliatory move by Trump would make him look soft on Russia, and would be politically risky. For its part, the opposition Democratic Party is naturally keen to discredit Trump ahead of US mid-term elections in November 2018, and the Democrats in the Senate on January 10 published a lengthy report on Russian interference in the affairs of 19 countries over the past two decades. In addition, top Trump administration officials such as National Security Adviser H.R. McMaster, Defense Secretary James Mattis, Secretary of State Rex Tillerson, and CIA Director Mike Pompeo, have all adopted hardline stances towards Russia. Indeed, the new US National Security Strategy published in December 2017, and the new US National Defense Strategy, published in January 2018, identified China and Russia as strategic rivals (which is nothing new), reflecting the reality of rising 'great power' competition. Meanwhile, Pompeo expressed concerns that Russian hackers would interfere in the US mid-term elections. Furthermore, the US Treasury in late January published a list of around 200 Russian officials and oligarchs seen as close to Putin, seemingly implying that they could eventually be subject to American sanctions (although no action was taken).

Trump, having reluctantly signed new sanctions on Russia in August 2017 at the behest of Congress, has himself adopted a few anti-Russian positions in recent times. On December 20, 2017, he approved the sale of lethal weapons (including anti-tank missiles) to Ukraine, which has been fighting a Russian-backed separatist insurgency in its east since early 2014. The planned sale marks a reversal of the Obama administration's restraint in selling arms to Kiev. A month later, Trump accused Russia of helping North Korea breach UN sanctions imposed on Pyongyang over its repeated missile and nuclear tests. In particular, Trump noted that while China was assisting US efforts to rein in North Korea's nuclear weapons programme, Russia was countering some of this. Both flashpoints could undermine US-Russia relations in 2018.

Latin America And Iran Could Also Exacerbate Russia-US Relations

Furthermore, some US opinion makers have expressed suspicions that Russia could interfere in Mexico's July 2018 general elections to provide a boost to the current frontrunner and opposition candidate, Andres Manuel Lopez Obrador (AMLO), who has adopted a tough stance towards the US over immigration and trade issues. The US-Mexican relationship has already been strained by Trump's renegotiations of NAFTA, and an AMLO victory could exacerbate ties. In addition, Russia will remain vigilant towards any US moves in support of the Venezuelan opposition to unseat the leftist anti-American president, Nicolas Maduro, who is running for re-election in April 2018 amid a prolonged economic crisis.

In the Middle East, ongoing US-Russian disagreements over the political settlement for Syria's seven-year civil war will persist. In addition, the Trump administration's hardening stance towards Iran, which could conceivably lead to a scuppering of the July 2015 P5+1 nuclear deal, could also increase strains with Russia, which has a friendly relationship with Tehran.

EU Concerns Over Russian Interference Likely To Prolong Sanctions

Despite repeated speculation over the past year or so that the EU was experiencing fatigue with its sanctions on Russia, there appears to be no signs that the measures will be lifted in June 2018, when they are next under six-month review. Although several EU members have Russia-friendly leaders, such as Hungarian Prime Minister Viktor Orban, and largely ceremonial presidents Milos Zeman of the Czech Republic and Sauli Niinisto of Finland (both of whom were re-elected in late January), none of them are willing to break the EU's collective willpower at this time. Indeed, the easing of sanctions is formally tied to the full implementation of the Minsk II ceasefire in eastern Ukraine, which remains in a state of low-level conflict. We had previously speculated that the EU could gradually relax the sanctions or the conditions for their easing, but any goodwill towards Russia appears to have been overshadowed by Russia's military campaign in Syria since 2015 and reports of Russian interference (or attempts thereof) in elections in France, the Netherlands, the UK, Germany, and the Spanish separatist region of Catalonia in 2017, by means of spreading 'fake' news stories online.

The year 2018 will see several European elections, all of which will be watched closely by the EU for signs of Russian interference. These include Italy (March 4), Hungary (April 8), Montenegro (April 15), Slovenia (by July), Sweden (September 9), Latvia (October 6), Bosnia, Georgia (both in October), and Moldova (November).

Of these, the Italian election is likely to result in a more Russia-friendly government, as the opposition 5-Star Movement and Forza Italia-Lega Nord right-wing bloc are keen on improved relations with Moscow. However, the next Italian government is still likely to be weak and more focused on domestic affairs, limiting Rome's ability to steer the EU into a more conciliatory stance towards Russia.

In Bosnia, Russia is likely to continue supporting Bosnian Serb nationalists, who favour eventual secession, as a means of retaining Moscow's influence in the Balkans. Neighbouring Serbia retained a Russia-friendly stance in 2017, when Prime Minister Aleksandar Vucic was elected president, but Belgrade is still aiming for EU membership. In Moldova, whose foreign policy orientation is finely balanced between pro-EU and pro-Russian forces, the Kremlin is likely to do what it can to ensure that the latter maximise their electoral gains, so that the country cannot make an irreversible decision to tilt towards the EU.

Long-Term Political Outlook

Putin Facing Far Greater Challenges Over 2018-2026

BMI VIEW

President Vladimir Putin will face tougher political challenges over the coming decade, as a result of a deterioration in relations with the West, a weaker economy, ongoing demographic decline, and the Islamist insurgency in the North Caucasus. Although Putin's popularity remains at near record highs, economic disruption means that his support will eventually fall, and that he will face increased opposition as Russia moves into the 2020s.

After a decade of political stability and economic prosperity in the 2000s, Russia is passing through a more turbulent period that could distract policymakers from tackling the country's immense structural challenges. The immediate priority for the Kremlin is managing the diplomatic and economic fall-out from the deterioration in relations with the West over the conflict in Eastern Ukraine. The US and EU have imposed tougher sanctions on Russia for backing the separatist rebels there, and we envisage a multi-year period of cooler relations between Russia and the West, albeit without returning to the Cold War. The Kremlin's decision in 2015 to intervene militarily to prop up the regime of Syrian President Bashar al-Assad has also strained relations with the West, and may drag Russia into a prolonged and frozen conflict.

Even before the start of the Ukrainian crisis and Syrian intervention, Russian President Vladimir Putin already faced immense challenges in the form of tackling endemic corruption, demographic decline, and militant Islamist insurgent activity in the North Caucasus. Therefore, even if these fresh conflicts had not erupted, Russia would be facing a more adverse political environment over the coming decade compared to the previous one.

Challenges And Threats To Stability And Governance

Corruption And Institutional Weakness: Russia remains a highly corrupt country, ranking 131tst out of 176 countries in Transparency International's 2016 Corruption Perceptions Index. The high degree of corruption and alleged tampering with election votes were major causes of the emergence of public protests in 2011-2012 and though attracting smaller number in various occasions throughout 2017. Russia's corruption is a manifestation of weak institutions and a lack of political accountability in the legislature and judiciary. The absence of a strong and independent judiciary and free and independent press exacerbates this weakness. Even if the Kremlin were fully committed to fighting corruption, graft is so deeply rooted in the system that it would take many years, if not decades, to overcome.

Demographic Decline: Russia's population has been shrinking and ageing. The UN's World Population Prospects 2015 database forecasts that the population will decline by 10% from 143.5mn in 2015 to 128.6mn in 2050. In addition, the proportion of Russians aged 65 and older will rise from 13.5% in 2015 to 22.1% in 2050. This is not as severe as in some other major states such as Italy, Japan and South Korea, but it is nevertheless significant. It is likely that large parts of Russia will become depopulated or populated by elderly residents, thus minimising their economic productivity.

Russians have two additional concerns regarding the country's demographic decline. The first is that Russia will be unable to meet its military recruitment requirements, owing to the shrinking pool of males of military service age. The armed forces are reportedly already having difficulty maintaining personnel levels as a result of widespread bullying and unhealthy recruits. Over the long term, this could undermine Russia's ability to defend itself.

The second concern, voiced by ultra-nationalists, is that higher birth rates among Russia's Muslim populations and immigration by Central Asians and Chinese will eventually transform the fundamental character of Russian society. This could eventually lead to regional insurgencies, as seen in the North Caucasus, or even Chinese demands on Russian territory, as a large part of Russia's far eastern region was seized from China in 1858-1860.

North Caucasus Insurgency: Russia fought two separatist rebellions in Chechnya (1994-1996 and 1999-2009) to bring the republic to heel. Yet even with Chechnya officially pacified under the pro-Russian regime of Ramzan Kadyrov, low-level violence continues. Since 2008, the insurgency has spread to the neighbouring republics of Dagestan, Ingushetia and Kabardino-Balkaria. The insurgency has manifested itself in bomb attacks, gun battles, ambushes, assassinations, and kidnappings. Violence has not been restricted to the region – in fact, Moscow has seen several deadly terror attacks in recent years. On a positive note, casualties caused by violence in the North Caucasus fell sharply in 2013-2015 (according to the Stockholm International Peace Research Institute), reflecting the fact that local Islamist militants from the region travelled to fight in Syria. However, this suggests that violence could increase, if these militants return to Russia with greater combat skills and renewed fervour.

A combination of heavy federal subsidies to improve economic conditions in the North Caucasus and a targeting of key insurgency leaders for assassination has failed to restore full stability. In addition, the Circassians of the region are becoming more politically active in promoting their nationalist aspirations and pressing their historical grievances against the Russian state. Furthermore, Russian security agencies are concerned about the possible radicalisation of Muslim populations in the republic of Tatarstan and in the broader Volga valley region in western Russia.

The North Caucasus insurgency is necessitating a more authoritarian Russian state through tighter security measures. A further consequence is that it has boosted far-right groups in Russia, leading to violence against North Caucasians and Central Asians in Russia's major cities.

Regional Disparities: Russia is a highly unevenly developed state, which is inevitable given its vast size. Much wealth and power are concentrated in Moscow and St Petersburg, although elites have emerged in other parts of Russia. A further obstacle to regional development was Putin's decision in 2005 to abolish elections for leaders of Russia's ethnic republics and administrative territories as part of a bid to centralise power after the 2004 Beslan school hostage crisis. Thereafter, regional leaders became much more beholden to the Kremlin, giving them less leeway to pursue their own economic policies. While the then-president (and now prime minister) Dmitry Medvedev reintroduced elections of regional governors in 2011, candidates still need to be approved by the Kremlin.

Also noteworthy is that several regions have shown an ability to achieve autonomy from the Kremlin since the end of the Soviet Union. These include the oil-rich Muslim republics of Tatarstan and Bashkortostan. Although Moscow has reasserted its grip on the regions, we cannot preclude renewed assertiveness later this decade.

Uncertain Geopolitical Environment: Russia is far weaker militarily than in the Soviet era and thus feels more vulnerable to external powers. The Kremlin still views the US and NATO as threats, and its fears that Ukraine would join the

EU and NATO prompted it to seize Crimea and destabilise Eastern Ukraine in early 2014. Russia also feels geopolitically vulnerable in the South Caucasus, which explains why it attacked Georgia in 2008, and Russian leaders fear the spread of Islamist militancy from Iraq, Syria and Afghanistan to Central Asia. The latter is becoming a greater concern, especially after the US and withdrew most of its forces from Afghanistan at the end of 2014 and in light of Russia's intervention in Syria. Meanwhile, some Russian military planners are increasingly worried about the rise of China, and fear that Beijing could challenge Russia's position in the Far East. Furthermore, Russia is also cognisant of the growing importance of the Arctic for resource extraction purposes. From the point of view of the Kremlin, these external threats justify a strong Russian state and powerful military – possibly at the expense of liberal democracy.

A New (Old) Tinderbox
The North Caucasus

Source: BMI

Russia's Long-Term Political Risk Scores

BMI's Long-Term Political Risk score for Russia is 61.7 out of 100.0. The country scores 38.2/100 for 'characteristics of polity', reflecting its quasi-authoritarian political system. It scores 57.5/100 for 'characteristics of society', reflecting its heterogeneous society, as evidenced by the insurgency in the North Caucasus. However, Russia scores 85.0/100 for 'scope of state', and 80.0/100 for 'policy continuity', reflecting the strong state and policy consistency under Putin.

Scenarios For Political Change

Russia has a long history of autocratic or strongman rule, and the country's political outlook will continue to revolve around the position of President Putin. We expect he will formally announce his candidacy for the March 2018 presidential elections prior to the end of 2017 and to win with a landslide majority counting on high approval ratings. That said, we caution that economic hardships will eventually erode this support. So too could any prolonged period of significantly lower oil prices, given the Russian economy's dependence on energy exports. Overall, we do not see Russia making progress with economic liberalisation as long as Putin remains in power. Below, we list three broad scenarios of how Russia could evolve politically.

Increased political competition (our core view): Despite Putin's present popularity, and regardless of whether he remains in office, we believe that Russia will move towards a more competitive political system by the early 2020s. The popular protests of late 2011 and early 2012 showed that there was considerable opposition to quasi-autocratic or quasi-one party rule in Russia. At the end of the 1990s, after a decade-long economic depression and a breakdown of law and order, many Russians craved a strong leader. However, since then, Russia has become much more prosperous and stable (even amid the 2014-2015 economic crisis), meaning that there is less need for an all-powerful political leadership. Regardless of how the economy performs, we expect the Kremlin to come under greater pressure to liberalise the political system. On the one hand, a deterioration of the economy would increase criticism of Putin and his system. On the other hand, a robust economy could make the electorate look beyond 'bread and butter issues' to matters such as political competition, transparency, and civil rights.

A move towards greater political competition would probably be triggered by increasing dissatisfaction among elements of Russia's elites about the country's quasi-pariah status as a result of the Ukraine conflict. Within the elite, there are figures who favour a political and economic system that is more open to business and foreign investment. Putin's retention of a hardline stance against the West risks driving Russia further into isolation. Yet, if his Ukraine or Syria policy comes to be seen as a disaster, he could lose credibility and authority. Either outcome could lead to a 'palace coup' against Putin. Historically, Kremlin leaders have been toppled by internal plots rather than by mass protests or military takeovers. Meanwhile, rising popular anger resulting from a weaker economy (or heavy casualties if Russia experiences a military quagmire in Ukraine or Syria), could undermine Putin's administration and the United Russia party. Consequently, we could even see an attempt at a Ukraine-style 'orange revolution', ie mass protests that topple the old establishment.

Another trigger for increased political competition could be a move by Putin to gradually withdraw from frontline political life in his next term (2018-2024), while promoting a reliable successor to safeguard his legacy. However, Putin has shown no sign of doing so.

Consolidation of hardline one-party rule: There is also a possibility that during over the coming years, the Kremlin, fearing that the West is aiming for 'regime change' in Moscow itself, will move towards hardline authoritarianism, placing ever greater restrictions on opposition parties and activists, for the purposes of perpetuating United Russia's rule under Putin and his eventual successor. Elections would still be held, but United Russia would win virtually all of the seats in the Duma, similar to the elections in the Central Asian republics.

We believe that any move towards 'hard' authoritarianism would be extremely risky, for it could provoke a powerful backlash from the public, and further tarnish Russia's international image. In the near term this will be exacerbated by greater scrutiny over the country as a result of hosting the FIFA 2018 World Cup. Moreover, there do not appear to be pretexts under which the Kremlin could justify a further reduction in democracy. Nonetheless, we cannot completely rule out this scenario.

Return of 1990s-style chaos: A third scenario could see Russia slipping back to the chaos of the 1990s, if political liberalisation fails to maintain stability or if infighting between Kremlin factions intensifies. Under such circumstances, Russia could see frequent policy shifts or reversals, and frequent changes of ministers, as competing interest groups vie for influence more aggressively in the absence of a strong political arbiter in the post-Putin era. Meanwhile, a weakening of central authority could allow regional leaders to accumulate more powers, allowing them to behave increasingly independently of the Kremlin. While decentralisation towards true federalism could arguably be desirable and democratic, there would also be a risk that regional leaders could position themselves as strongmen, thus impeding local-level democratisation. A weakening of central authority could also encourage separatist movements in the North Caucasus or Urals region. Eventually, an extended period of chaos could lead to new demands for a strong leader.

Wild card – geopolitical disaster: Finally, we present a 'wild card' scenario in which Russia overreaches itself geopolitically, by invading and occupying Ukraine, parts of Moldova, Belarus or a Central Asian state in response to 'regime change' or other unexpected developments that threaten Moscow's interests (for example, worsening relations between ethnic Russians and Kazakhs in northern Kazakhstan). Russia could also get caught up in a new war between Armenia and Azerbaijan over Nagorno-Karabakh, given that it is committed to defending Armenia. The most dangerous move by Moscow would be intervention in the Baltic states (which are NATO members) to protect ethnic Russians. Any of these scenarios could drag Russia into a prolonged military conflict – or in the Baltic region, even a 'limited' nuclear exchange – that would be economically damaging and could lead to the Kremlin leadership being thoroughly discredited in the eyes of the public. This in turn could hasten political change.

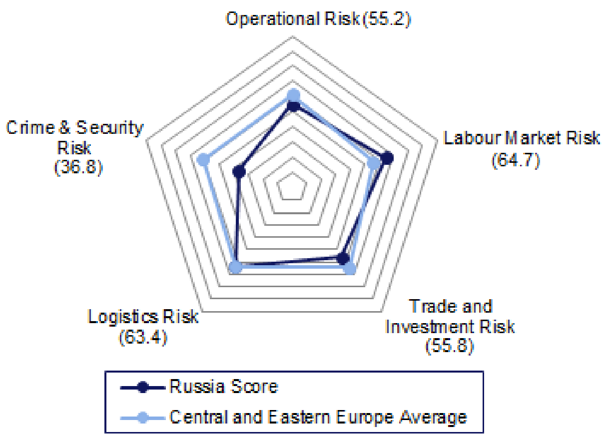
The above scenarios represent broad outlines of Russia's future, and are not necessarily mutually exclusive.

Chapter 4:
Operational Risk

Operational Risk

***BMI*'s Operational Risk report series provides a comprehensive overview of potential risks facing investors operating in a country, as well as a cross-country regional evaluation of threats and advantages. The Operational Risk service evaluates Logistics Risk, Trade and Investment Risk, Labour Market Risk and Crime and Security Risk. Below are sections from these reports.*

Weak Legal Environment, Geopolitical Risks And O Bureaucracy Encumber Business Operations
Russia & Regional Average – Operational Risk Scores



Source: BMI Operational Risk Index. 100 = Lowest risk; 0 = highest risk. Score shown in brackets is the country-specific score.

Despite access to a large labour market, vast natural resources and robust financial sector, the Russian market remains hamstrung by structural challenges that highlight the slow pace of reform over the years. Businesses operating in the country face risks stemming from high state involvement in the Russian economy, pervasive corruption, an infrastructure deficit and an ageing population. Tepid economic growth and increasingly frosty relation s with the West serve to further impair Russia's attractive ness to investors and undermine its business environment. In particular, still-low global oil prices and the imposition of Western sanctions continue to hamstring trade and economic growth while involvement in the Ukraine and Syria conflicts has heightened security risks and further dampened investor sentiment. Consequently, Russia underperforms in **BMI**'s Operational Risk Index, receiving a score of 55.2 out of 100, and placing ninth out of 11 Central and Eastern Europe states, and 73rd out of 201 states globally, ahead of Ukraine but behind Kazakhstan.

Crime And Security (36.8/100): The country has a sizeable military and a robust nuclear deterrent and is more than capable of defending itself. However, the government's assertive foreign policy, which has seen it involved in conflicts in Ukraine and Syria, threatens to damage the investment attractiveness of Russia. The greatest risk facing investors in Russia are the heightened threats from direct crime and conflict risk, and for the latter in particular, the concomitant Western-imposed sanctions that are hamstringing the operating environment. Terrorism is a growing risk, with IS claiming the attack on a Russian plane in October 2015 and attacks hitting Moscow and other major cities in the past. These show that the country's investment hub is not immune to the threat of terrorism. Furthermore, the country will likely see further bouts of political protests as the

TABLE: OPERATIONAL RISK

	Operational Risk	Labour Market Risk	Trade And Investment Risk	Logistics Risk	Crime And Security Risk
Russia Score	55.2	64.7	55.8	63.4	36.8
Central and Eastern Europe Average	61.3	56.0	64.2	63.6	61.4
Central and Eastern Europe Position (out of 11)	9	1	9	6	10
Emerging Europe Average	56.9	55.3	58.2	57.4	56.7
Emerging Europe Position (out of 31)	21	3	21	8	27
Global Average	49.8	50.2	50.0	49.3	49.9
Global Position (out of 201)	73	17	76	45	141

Source: BMI Operational Risk Index. 100 = Lowest risk; 0 = highest risk economic headwinds and anti-corruption sentiments intensify in the near term.

Trade And Investment (55.8/100): As one of the largest emerging markets globally, investment opportunities in Russia are potentially lucrative, but we caution that risks remain elevated due to numerous endogenous factors. The government continues to impose restrictions on trade flows and limits on foreign direct investment in certain sectors, while state-owned institutions are prevalent in all areas of the economy. Corruption is also widespread and the judiciary is weak and subject to political interference, which undermines trust in the legal system. Furthermore, the overall tax burden is considerable and some bureaucratic procedures remain plagued by delays, which further reduces the country's investment competitiveness. On the external front, Western sanctions imposed against Russian economic targets in response to the Ukraine crisis have disrupted trade flows, restricted access to financing and inhibited growth. Although business-friendly reforms are driving some improvements in the operating environment, Russia will remain a difficult destination for investment even after sanctions are lifted.

Logistics (63.4/100): Geopolitical risks and sluggish economic growth are filtering through to hit other pillars in the **BMI** Operational Risk Index. In Logistics Risk, for example, much needed investment in the country's utilities and transport network to modernise aging infrastructure is being scaled back or halted, as government investment is funnelled elsewhere. Businesses benefit from cheap energy costs due to Russia's wealth of natural resources, but the size of the country means that the quality of the transportnetwork is patchy. In addition, onerous trade bureaucracy in Russia is a major obstacle for investors.

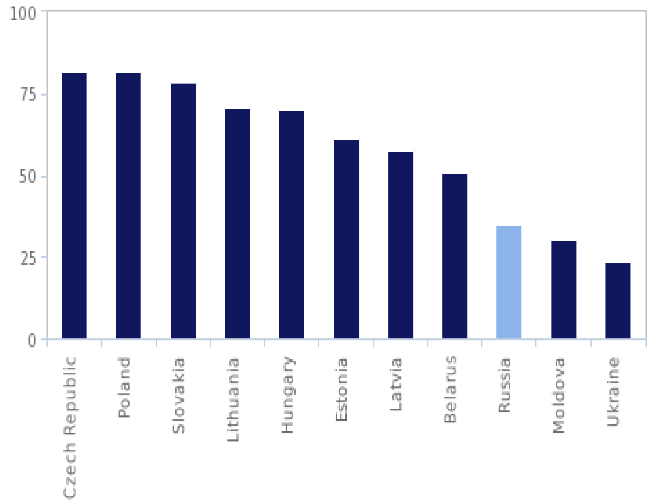
Labour Market (64.7/100): Russia's highest score in the **BMI** Operational Risk Index is for its Labour Market Risk pillar. Russia's labour market boasts a number of strengths which increase its appeal as a location for investment. Primarily, these stem from its large, well-educated and highly urbanised labour force, as well as its competitive wage costs in relation to other European states. However, in the medium-to-long term businesses will likely encounter challenges in the labour market, as labour costs are increased by mandatory social security contributions, and the shrinking labour force causes recruitment constraints.

Conflict Risk

Russia's increasing assertiveness on the global stage has seen it involved in a number of conflicts in recent years. Russia has retained an active involvement in the Syrian conflict and is involved in providing support to separatist rebels in eastern Ukraine. These interventions have heightened tensions with Western states, and the risk of misunderstandings and confrontations remains elevated in a more multi-polar geopolitical environment. Russia faces heightened risk of retaliatory terrorist attacks and intense international sanctions. Businesses in a range of sectors such as energy, finance and infrastructure face restricted trade and investment conditions in the medium term, while sanctions persist. Russia also faces an elevated terrorist risk from retaliatory attacks launched by Islamic State as well as from domestic and regional terrorists that have been capable of launching attacks on major cities such as Moscow in the past. The terrorist threat is the major short-medium term risk to foreign workers and businesses, though, given the country's current political trajectory, underpinned by increasingly tense relations with the W est and a heavy-handed crackdown on domestic dissent under Putin's rule, longer term political violence risks will weigh on domestic operations. Consequently, Russia scores 35.1 out of 100 for Conflict Risk, ranking ninth out of 11 Central and Eastern Europe states.

Heightened Terrorism Risks And Taut Geopolitical Environment Weighing On Score

Central & Eastern Europe – Conflict Risk



Source: BMI Crime And Security Risk Index. 100 = Lowest risk; 0 = highest risk.

Latest Conflict Risk Analysis:

- Political risk has intensified on the back of diminished prospects of a rapprochement with the West in the near term. In H217 the EU and US extended sanctions against

Russia, following their original implementation in July 2014. The initial sanctions were targeted at the banking, defence and energy sectors of Russia. As before, this fresh round of sanctions, which stems from Russia's 2014 annexation of the Crimea and alleged support for pro-Russian separatists in Eastern Ukraine, targets broad swathes of the Russian economy and political elite, most crucially the ability of Russian state-owned banks to raise capital in European financial markets. Tangible progress in strengthening peace in Eastern Ukraine will be necessary before the sanctions are lifted, probably on a gradual basis. Businesses must therefore monitor the situation closely in coming months to ensure that they are fully aware which sanctions are lifted and when, in order to avoid any potential penalties in their home countries.

- On July 25 2017 the US Congress passed, by a strong majority, a bill for a new round of sanctions against Russia. On August 2 2017, President Trump signed the bill, dealing a heavy blow to US-Russian relations. The latest US sanctions against Russia are far stronger than anything the US has done in the past. They involve sanctions against not only companies, national institutes and officials, but also their family members and personal relations. In essence the sanctions target the whole of President Vladimir Putin's regime. These moves are highly likely to have severe political repercussions.

- Overall, despite Russia's negative relations with the West at present, Russia has reasons to act with restraint over the short term. Although Russia's relations with the West will remain tense, relations with eastern nations such as China, Japan, and even North Korea offer opportunities for Moscow. Furthermore, we believe that Russia will exercise more caution in the spring of 2018 for fear that any geopolitical gambit could tarnish Russia's image and lead to a Western boycott of the FIFA World Cup (June-July), similar to the US's boycott of the Moscow 1980 Olympics after the Soviet invasion of Afghanistan in 1979.

- With living standards having declined dramatically since 2014 alongside oil price declines, rouble depreciation and budget cuts, the prospect of greater social unrest is on the rise. However, following large scale protests amid allegations of voter fraud in previous parliamentary elections, the Kremlin has adopted a much tougher stance against domestic dissent and opposition voices. While a weak domestic economy will encourage a continuation of the government's adversarial

TABLE: MAIN ACTIVE TERRORIST GROUPS

Terrorist Group	Targets	Region / Sector Exposure	Threat Level
Islamic State (IS)	Russian tourists, strategic infrastructure, police, public places, foreign nationals	Russian tourists travelling in the Middle East face an elevated risk, demonstrated by the crash of the Russian plane in October 2015. An attack on Russian soil is increasing likely, with foreign workers potentially exposed.	• Moderate – Russia has proven to be an attractive target for IS, heightened by its involvement in the Syrian conflict
North Caucasus Insurgents/Caucasus Emirate	Military, police, politicians	The attack on the Volgograd train station and bus bombings in December 2013 resulting in 34 deaths highlights that strategic infrastructure and crowded areas are a primary target. The group has perpetrated the greatest number of attacks in the North Caucasus region. Since 2008, the insurgency has spread to the neighbouring republics of Dagestan, Ingushetia and Kabardino-Balkaria. Violence has not been restricted to the region; in fact, Moscow has seen several deadly terror attacks in recent years.	• Moderate – Russia fought two separatist rebellions in Chechnya (1994-1996 and 1999-2009) to bring the republic to heel. Yet even with Chechnya officially pacified under the pro-Russian regime of Ramzan Kadyrov, low-level violence continues. • The insurgency has manifested itself in bomb attacks, gun battles, ambushes, assassinations, and kidnappings. The fall in casualties caused by violence in the North Caucasus in 2013-2015 largely reflects the fact that local Islamist militants from the region travelled to fight in Syria. • However, this suggests that violence could increase, if these militants return to Russia with greater combat skills and renewed fervour.
Other Russian Islamist militant groups	Public buildings, crowded urban areas	Businesses located in the regions of North Ossetia-Alaniya and North Caucasus are particularly at risk, especially if located near large public buildings.	• Moderate – Carried out complex attacks and benefit from the experience of militants who have served in Afghanistan. However, the Russian military has ramped up efforts to counter such groups.
Russian far-right extremist groups	Ethnic minorities, mosques in city centres	Businesses located in central Moscow are most at risk, which is where the most violent incident took place in December 2010.	• Low – While ultranationalists have the potential to disrupt operations, attacks are uncoordinated and unsophisticated.

Source: BMI

TABLE: POLITICAL VIOLENCE RISK

Main Causes	Key Flashpoints	Risk level and Impact on Business Environment
Sluggish economic growth	Russia's economy is emerging from recession but growth over the coming years will remain tepid when considering the scale of the downturn since 2014. Growth will be capped by the country's structural inefficiencies, amid a lack of progress in the implementation of much needed reforms.	• Moderate – Current economic woes facing Russia have left many citizens unhappy. • With declining living standards since 2014, the prospect of greater social unrest is on the rise as shown by public protests across the country at the beginning of 2017. • Substantial income inequality, particularly for minority groups, will remain key issues that could yield further support for radical groups particularly in already unstable areas (North Caucasus). • Meanwhile, the Kremlin has adopted a much tougher stance against domestic dissent and opposition voices in recent years. • Businesses operating in the country's vulnerable areas may face supply chain risk. Major cities such as Moscow can face disruptions due to protests.
Demographics	Russia's total population has been shrinking and ageing and has posted broadly negative growth rates since 1994. The UN's World Population Prospects 2015 database forecasts that the population will decline by 10% from 143.5mn in 2015 to 128.6mn in 2050. This is in line with our forecasts that Russia's population will contract over the coming decade and will see a steady rise in dependency ratios from an estimated 45.1% of the total working age population in 2016 to 50.8% by 2026. Over the next decade, the pensionable population is expected to rise from 19.7% to 27.5% of the working age population, which will require more fiscal support. Ageing demographics present Russia with a key long term challenge, and will entail major strains on the fiscal position and growth potential.	• Moderate – It is likely that large parts of Russia will become depopulated or populated by elderly residents, thus minimising their economic productivity. • The demographic decline means that Russia will increasingly struggle to meet its military recruitment requirements. Over the long term, this could undermine Russia's ability to defend itself. • Meanwhile ultra-nationalists contend that higher birth rates among Russia's Muslim populations and immigration by Central Asians and Chinese will eventually transform the fundamental character of Russian society. This could stoke regional insurgencies, as seen in the North Caucasus, or even Chinese demands on Russian territory, as a large part of Russia's far eastern region was seized from China in 1858-1860. • Ageing demographics will also necessitate major fiscal reforms and long-term fiscal consolidation, including raising the retirement age and scaling back benefits, which will weigh on household consumption and potentially raise tax obligations for firms. • Fiscal constraints will also limit potential growth in public investment expenditure, which bodes ill for capital formation and long term growth.
Uneven development and resource distribution	Russia is a vast and unevenly developed state. Much wealth and power are concentrated in Moscow and St Petersburg, although elites have emerged in other parts of Russia.A further challenge to regional development was Putin's decision in 2005 to abolish elections for leaders of Russia's ethnic republics and administrative territories as part of a bid to centralise power after the 2004 Beslan school hostage crisis. Thereafter, regional leaders became much more beholden to the Kremlin, giving them less flexibility to pursue their own economic policies. While the then-president (and now prime minister) Dmitry Medvedev reintroduced elections of regional governors in 2011, candidates still need to be approved by the Kremlin.	• Moderate – The uneven distribution of wealth that is one of the key factors driving political discontent and disenfranchisement. Several reputable studies show that Russia is the most unequal of all the world's major economies. • In spite of widespread inequality, at least in part caused by corruption, there is limited scope for serious political upheaval. • However, in 2017 the biggest protests to hit Russia for several years saw an estimated thousands people on the streets of nearly 80 urban areas. • While the numbers are small as a percentage of the whole population, there is a sense that anger may be stirring.
Corruption	Russia remains a highly corrupt country, ranking 131st out of 176 countries in Transparency International's 2016 Corruption Perceptions Index. The high degree of corruption and alleged tampering with election votes were major causes of the emergence of public protests in 2011-2012 and more recently in 2017. In June 2016 the Russian government announced that all civil servants below the position of federal minister would be required to take an oath of loyalty to serve the interests of Russian citizens above their own, any violation of which would be met with disciplinary measures. This policy is unlikely to make any difference to the level of corruption in the Russian civil service. The elimination of impunity by virtue of political affiliation will be required to eliminate the culture of graft.	• High – Russia's corruption is a manifestation of weak institutions and a lack of political accountability in the legislature and judiciary. The absence of a strong and independent judiciary and free and independent press exacerbates this weakness. Even if the Kremlin were fully committed to fighting corruption, graft is so deeply rooted in the system that it would take many years to overcome. • Significant measures to tackle corruption are not likely to materialise in the medium term, raising risks of further bouts of protests met with heavy-handed crackdowns. • Businesses will also continue to face rent-seeking behaviour by government officials which could lead to fines and reputational damage.

Source: BMI

foreign policy stance, we expect this to have diminishing returns in terms of its popular support.

- An increasingly multi-polar geopolitical environment globally means that risk of Russia becoming involved in further interstate conflicts over the medium term is heightened. At the same time, domestic political troubles in the US and internal solidarity on the part of the EU will prevent them from pursuing rapprochement with Russia over the coming quarters, leading to an extension of sanctions into late 2018.

- Russia remains committed to supporting the Assad regime in Syria, providing crucial assistance to government forces which allowed them to recapture Aleppo from rebel groups in December 2016. The Russian forces are also targeting IS militants, contributing to the group's loss of territory over the course of 2016. Despite these setbacks, however, IS and its affiliates will remain capable of launching attacks globally, and Russia will be a top target given its prominent role fighting the group.

Terrorism And Political Violence Risk

Terrorism remains a prominent risk for businesses in the Russian market. The downing of a Russian passenger jet in Egypt in

TABLE: POLITICAL VIOLENCE RISK (CONTINUED)

Main Causes	Key Flashpoints	Risk level and Impact on Business Environment
Governance risks	Government workings remain opaque and power is centralised among a few of the political elite, led by Putin. Numerous structural and personnel changes within the government occurred in 2016 as Putin sought to preserve his power ahead for the 2018 presidential race. Russia's Political Rights risk ratings declined due to the heavily flawed 2016 legislative elections, which further excluded opposition forces from the political process. While dissatisfaction with poor economic conditions and corruption appears to be on the rise, Vladimir Putin looks set to remain the frontrunner ahead of presidential elections in March 2018, still benefitting from high approval ratings and a weakened opposition.	• Moderate – Power is concentrated in the hands of President Vladimir Putin. With loyalist security forces, a subservient judiciary, and a legislature dominated by his United Russia party, Putin is able to manipulate elections and inhibit formal opposition. • The government also has strong control of the media environment, and has been able to retain domestic support despite an ongoing economic slump and strong international criticism. • The country's rampant corruption is one notable threat to state power, as it facilitates shifting links among bureaucrats and organised crime groups. • Also noteworthy is that several regions have shown an ability to achieve autonomy from the Kremlin since the end of the Soviet Union. These include the oil-rich Muslim republics of Tatarstan and Bashkortostan. Although Moscow has reasserted its grip on the regions, we cannot preclude renewed assertiveness later this decade, which could jeopardize operations in these areas.
Limited political diversity	The ability of opposition candidates to challenge Putin for the presidency will remain broadly limited, yet we see opportunities for opponents to influence the Kremlin and Putin's decision-making ahead of the 2018 elections. Traditional opposition candidates have failed to build on their meagre support since 2012. Hence, Putin's main challenger will be anti-corruption activist and leader of the Progress Party Alexei Navalny. Nevertheless, doubts remain as to whether he will be able to run as a candidate, given a 2013 conviction for fraud (which his supporters claim was politically motivated) which would block his bid, even so his popularity remains limited compared to Putin. Furthermore, restricted access to key media platforms and a lack of national debate will stifle the ability of opposition candidates to gain significant ground against Putin.	• Moderate – Russia has a long history of quasi- authoritarian rule, and the country's political outlook will continue to revolve around the position of President Putin, and speculation about whether he will seek a new term in March 2018. • Although Putin's approval rating rose to a record high of 88% in October 2014 and remained above 80% over to the start of 2017, we caution that economic hardships will eventually erode his support. Overall, we do not see Russia making progress with political or economic liberalisation (as long as Putin remains in power) in the medium term. • A move towards greater political competition would likely be triggered by increasing dissatisfaction among elements of Russia's elites about the country's quasi-pariah status as a result the country's foreign policy stance and the concomitant frosty western relations.
Ethnic tensions and restrictions on movement	Parts of the country, especially the North Caucasus area, suffer from high levels of violence. Hundreds of officials, insurgents, and civilians die each year in bombings, gun battles, and assassinations. In Chechnya, Kadyrov imposes tight control over his republic with the support of a militia and a flow of generous subsidies from Moscow. The result is superficial peace and prosperity that mask personalised and arbitrary rule, fierce repression and intimidation, economic inequality, and impunity for abuses.	• Moderate – Immigrants and ethnic minorities, particularly those who appear to be from the Caucasus or Central Asia, face governmental and societal discrimination and harassment. • The government places some restrictions on freedoms of movement and residence. Adults must carry internal passports while traveling and to obtain many government services. Some regional authorities impose registration rules that limit the right of citizens to choose their place of residence, typically targeting ethnic minorities and migrants from the Caucasus and Central Asia. More than 4mn employees tied to the military and security services were banned from travelling abroad under rules issued during 2014. • Migrant workers are often exposed to exploitative labour conditions. Both Russians facing economic hardship and migrants to Russia from neighbouring countries are subject to sex and labour trafficking.

Source: BMI

October 2015, claimed by IS, indicates the heightened terrorist threat against Russian interests and the increased likelihood of an attack on Russian soil. Terrorist attacks by smaller Russia-based groups such as the Caucasus Emirate also threaten to disrupt businesses operations. While they are most prevalent in the regions of Chechnya and Dagestan, terrorist groups have shown the ability to be able to evade Russia's security services and target major Russian cities, including Russia. Twenty terrorist attacks took place in Moscow between 1994 and 2014 – the third highest level after Chechnya and Dagestan. The number of fatalities in Moscow attacks is also higher than those in Dagestan, and incidents will likely target busy public places where foreign workers may be present. Meanwhile ongoing economic headwinds provide ample fodder for more anti-corruption and anti-government protests against the backdrop of already limited political freedom, which will further weigh on the operating environment over the medium term. In addition, immigrants and ethnic minorities, particularly those who appear to be from the Caucasus or Central Asia, face governmental and societal discrimination and harassment. Parts of the country, especially the North Caucasus area, still suffer from high levels of violence. Consequently, Russia scores just 16.8 out of 100 for Terrorism and Political Violence, ranking second from bottom in the Central and Eastern Europe region.

Terrorist Threat: Islamic State poses the most pertinent terrorist risk to Russian interests at present, despite its recent territorial losses. The main domestic terrorist group is the Caucasus Emirate, which is active in the North Caucasus and seeks the creation of a hard-line Islamist state encompassing the Muslim republics of the region and the exodus of ethnic Russians from the area. Islamist militants in the North Caucasus are also arranged in cells, making them harder to infiltrate. Aside from the Islamist threat, Russia also has several far-right groups which may target ethnic minorities and stoke social unrest.

Political Violence Risk: Businesses face particularly acute risks of outbreaks of political violence erupting and compromising the safety of business operations, despite the fact that social or political protests are infrequent and are usually quickly suppressed by government forces. Russia continues to face significant internal risk such as a demographic decline, a weak macroeconomic picture, high levels of inequality, corruption and limited political freedom.

Counter terrorism Capability: Russia boasts considerable security services which are the successors to the Soviet secret police, the KGB. The country boasts organisations which tackle both domestic and foreign security threats, and an overarching intelligence agency which analyses communications. However, the capability of the security services has repeatedly been called into question by the frequency of terrorist attacks, which suggest that the effectiveness of counterterrorism forces is lacking.

Russia has multiple intelligence and security organisations covering a full range of threats. These emerged in the early 1990s following the dissolution and reorganisation of the Soviet Union's KGB, which was an all-encompassing entity. The Federal Security Service (FSB) is the main organisation protecting the country from domestic security threats. President Putin himself

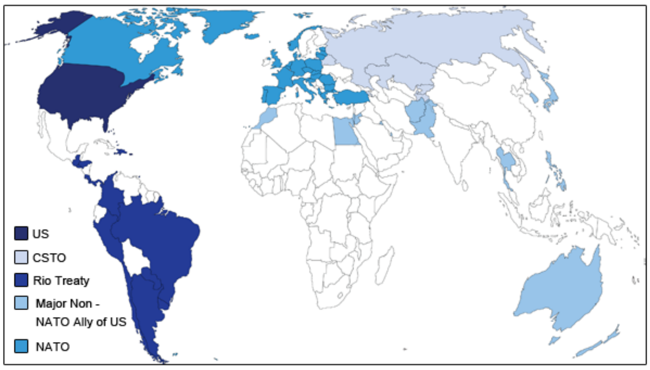
TABLE: MAJOR CONFLICT FLASHPOINTS

Protagonist	Likely Cause of Conflict	Form Such a Conflict Would Take	Likelihood of Conflict
Ukraine	Ceasefire between Ukraine and pro-Russian separatists breaks down	Resumption of intense fighting, Russia might use the breakdown as a pretext to become officially involved in the conflict under the pretext of protecting the populations of the Donetsk and Luhansk oblasts. Russia would likely use ground troops with air support and while the conflict would remain confined to the east, Russia would seek to create a buffer zone between Russia and the pro-Russian separatist's oblasts.	High – Both sides regularly accuse the other of breaking the existing ceasefire. Russia is currently facing sanctions, which will limit further overt aggression. The sanctions were introduced in the wake of the MH17 incident targeted Russia's financial institutions, defence industry, and energy sector.
Ukraine	Ukraine tries to retake Crimea	Russia would view this as a declaration of war and would engage in a full military campaign using land, sea and air forces.	Low – While Ukraine does not accept Crimea's independence it does not have the resources to retake the peninsula. Any attempt would be defeated by Russia and Ukraine would likely lose more land in the process.
Baltic States	Russia takes advantage of weakened EU/NATO to gain a foothold in Baltic states and expand area of influence	Foment of instability, invasion or covert support in defence of 'ethnic Russians'. This may elicit a response from NATO, causing a wider conflict.	Moderate – Tensions between Russia and the West are expected to ease under the Trump presidency. But Russia may take advantage of weakening US resolve to support NATO alliance to further expand its sphere of influence. If it miscalculates the strength of commitment to the alliance, this could spark a wider conflict.

Source: BMI

served as head of the FSB in the late 1990s, before he was appointed prime minister, and he thus takes a strong interest in its operations. Russia also has a Foreign Intelligence Service (SVR) and military intelligence service (GRU), which operate abroad. Furthermore, Russia has a Special Communications Service, which collects and analyses foreign and domestic communications. This body is the equivalent of National Security Agency (NSA) in the United States and GCHQ in the United Kingdom.

Global Defence Agreements



Note: The US is a member of the Rio Treaty and NATO. Kuwait and Bahrain are also major non-NATO Allies of the US. Source: d-maps.com, BMI

Despite the existence of a vast intelligence system, terrorists have staged some bold and high-profile attacks, including in Moscow itself. This has raised doubts about the efficacy of the security services. Russia has successfully eliminated a number of Chechen terrorists, including former separatist presidents Dzhokhar Dudayev (1996) and Aslan Maskhadov (2005), as well as the most notorious militant commanders, Khattab (2002) and Shamil Basayev (2006), but the insurgency has outlasted its key operatives. The Caucasus Emirate announced the death of its leader since 2007, Doku Umarov, in March 2014, but we believe violence in the region will continue, due to the cellular nature of the insurgency, which is not dependent on a single leader.

A combination of heavy federal subsidies to improve economic conditions in the North Caucasus and a targeting of key insurgency leaders for assassination has failed to restore full stability. In addition, the Circassians of the region are becoming more politically active in promoting their nationalist aspirations and pressing their historical grievances against the Russian state. Furthermore, Russian security agencies are concerned about the possible radicalisation of Muslim populations in the republic of Tatarstan and in the broader Volga valley region in western Russia.

Russia has a comprehensive counter terrorism legal framework and has broadened the definition of terrorist-related crimes in 2014 to include the dissemination of terrorist propaganda. The Russian government's anti-terrorism efforts are robust but also restrict freedom of speech and religious freedom. 'Anti-extremism' legislation has been used to prosecute peaceful individuals and organisations, including political opposition, independent media and certain religious minorities.

As economic headwinds continued to batter the Russian economy in 2016 (with modest recovery expected in 2017), the Kremlin worked to pre-empt potential domestic discontent through several means, including focusing public attention on foreign interventions. Authorities continued incorporating Crimea into the administration of the Russian Federation, maintained support for separatist militants in eastern Ukraine, and expanded military support for Bashar al-Assad's regime in Syria.

In September, the Federal Antimonopoly Service reported that the state controls 70% of the economy either directly or through state-owned enterprises. The Kremlin utilises its vast resources to pressure opposition entities and critical voices. Authorities continued to restrict the activities of civil society groups, in-

TABLE: BUSINESS RESPONSE TO CONFLICT RISK

Risk Level	Business Response
High	• Travelling to within 10km of the border with the Ukrainian Donetsk and Luhansk Oblasts, Chechnya and to all other areas of the North Caucasus, including North Ossetia, Ingushetia, Dagestan, Stavropol, Karachayevo-Cherkessiya, and Kabardino-Balkariya is not recommended without taking high security precautions. • Foreign workers must be housed in safe secure compounds and businesses should expect additional salary requirements. • Vehicle tracking technology and back up security is especially necessary for long-haul journeys. • Repatriation plans should be put in place for foreign workers in case of terrorist attacks and prolonged periods of political unrest. • Back up plans for supply chain disruption and cargo theft must be in place in the event of an attack. • Plan for delays in journeys across the country's borders as security checks at border points are becoming stricter, particularly along the Russia-Abkhazia and Russia-South Ossetia borders. • Be aware of key sectors such as energy and infrastructure that are directly impacted by western-sanctions. • Where possible, locate business in areas away from potential targets for terrorist attacks, such as national government building, foreign embassies, or generally crowded urban areas.

Source: BMI

creasing pressure on independent groups, including the Levada Center, by declaring them 'foreign agents.'

The National Guard of the Russian Federation is the internal military force of the government of Russia, comprising an independent agency that reports directly to the President under his powers as Supreme Commander-in-Chief and Chairman of the Security Council. The National Guard is separate from the Russian Armed Forces. The federal executive body was established in 2016 by a law signed by President Vladimir Putin to secure borders, take charge of gun control, combat terrorism, organised crime, protect public order and guard important state facilities. After its establishment under the formal control of the presidency in July 2016, Putin appointed his former chief bodyguard, Viktor Zolotov, as head of the new force, which is set to have a membership of 350,000-400,000 individuals, many of them former security personnel. Although the National Guard is ostensibly devoted to combatting terrorism and extremism, critics fear that it could be used to block popular protest and serve as a tool for disciplining the Russian elite.

Opposition politicians and activists are frequently targeted and in many instances with fabricated criminal cases and other forms of administrative harassment. At the same time, space for independent voices in the media continued to diminish, particularly after a series of politically motivated personnel changes at the RBC media group. There is the potential for further crackdowns on foreign influence, the internet and the social media platforms used to disseminate content critical of Putin and the Russian government. This scenario is likely as evidence of this has already been seen, with laws passed in July 2017 banning the use of virtual private networks (VPNs), used to access blocked internet sites, and restrictions on anonymous use of social media platforms.

Interstate Conflict Risk

Russia's increasingly assertive foreign policy over recent years has seen it involved in a number of conflicts, and raised the risk of a more large-scale interstate confrontation. Tensions with the West have escalated since Russia's seizure of the Crimea in 2014 and its involvement in the separatist rebellion in eastern Ukraine, as well as its prominent role in the Syrian conflict. While the election of Donald Trump to the US presidency will result in a thaw in relations between the US and Russia, an increasingly multi-polar phase of international relations means there is a heightened risk of interstate clashes over coming years. Russia's large and relatively well-equipped armed forces mean that it scores a moderate 53.5 out of 100 for Interstate Conflict Risk, ranking seventh out of 11 Central and Eastern Europe state.

Likelihood Of Conflict

Military Capability: Russia boasts significant armed forces personnel, missile arsenals and nuclear capability. The country remains a premier military power and is able to project its influence across Eurasia, as shown by its military interventions in the last decade in Georgia and Ukraine. However, the combat effectiveness of Russia's armed forces has been questioned, and the military does not compare favourably against other major powers including China and NATO members.

Size: Russia's armed forces are 1.5mn-strong, making them significantly larger than any potentially aggressive nearby state. Russia's armed forces have shown a mixed performance since the 1990s. Russian troops struggled to subdue the tiny breakaway republic of Chechnya in the 1990s, with the conflict underscoring substantial weakness in the armed forces. In particular, Russian soldiers became bogged down in urban guerrilla warfare, suffering very high casualties. The first Chechen War (1994-1996) was widely considered a failure. Russia's second Chechen War (which lasted from 1999 until the mid-2000s) was considerably more successful, but still led to many difficulties. The invasion of Georgia was a short, sharp war against a weak foe, and was thus a success, but it still revealed shortcomings in Russia's military doctrine. Russia's takeover of Crimea in 2014 was unopposed, so it is unclear if its armed forces have learned from past lessons. Military reforms have focused on reducing the bloated size of the armed forces and making the structure more flexible, while phasing out conscription. However, resistance from generals has slowed reforms. Meanwhile, corruption and bullying of new recruits remains pervasive and have undermined morale within the military. The Russian armed forces have yet to be tested against a modern, conventional force.

Russia is far weaker militarily than in the Soviet era and thus feels more vulnerable to external powers. The Kremlin still views the US and NATO as threats, and its fears that Ukraine would join the EU and NATO prompted it to seize Crimea and destabilise Eastern Ukraine in early 2014. Russia also feels geopolitically vulnerable in the South Caucasus, which explains why it attacked Georgia in 2008, and Russian leaders fear the spread of Islamist militancy from Iraq, Syria and Afghanistan to Central Asia. The latter is becoming a greater concern, especially after the US and withdrew most of its forces from Afghanistan at the end of 2014 and in light of Russia's intervention in Syria. Meanwhile, some Russian military planners are increasingly worried about the rise of China, and fear that Beijing could challenge Russia's position in the Far East. Furthermore, Russia is also cognisant of the growing importance of the Arctic for resource extraction purposes. From the point of view of the Kremlin, these external threats justify a strong Russian state and powerful military – possibly at the expense of liberal democracy.

Weaponry: The Russian military also has vast quantities of heavy weaponry, including nuclear weapons. Russia has been developing its cyberwarfare skills for many years, and has become highly adept in this regard. Russia – which includes the state, as well as patriotic hacking actors – was blamed for multi-day cyberattacks against Estonia in 2007 and against Georgia in 2008, when the Kremlin ordered a brief invasion of its southern neighbour. Similarly, Russia launched cyberattacks on Ukraine in early 2014. In March 2014, Russia too experienced cyberattacks, which temporarily affected the websites of the Kremlin, foreign ministry, and central bank. The scale of cyberwarfare between Russia and Ukraine intensified during May 2014, but there were no high-level cyberattacks aimed at crippling infrastructure, perhaps because both sides feared unintended consequences. In 2015 the most high-profile attack attributed to Russia was reports that the White House had been hacked and President Barack Obama's emails accessed, however risks have since escalated.

Mindful of the dangers of cyberwarfare, Russia has in recent years been urging an international treaty on cyber security. A Cyber Arms Limitation Treaty (CALT) would potentially resemble the arms control treaties of conventional and nuclear weapons during the Cold War. However, verification would be problematic. There is also no guarantee that the signatories of a CALT treaty would observe it, if military hostilities were in the offing or broke out. Some Western countries have opposed Russia's cybertreaty proposals, fearing that they would lead to greater suppression of the internet. In this regard, the Kremlin is well aware of the role that social media played in mobilising mass protests during the Arab Spring in 2011, and in early 2014 was preparing new rules governing the internet that would restrict the activities of bloggers and other potential opponents of President Vladimir Putin's rule.

In May 2015 Russia and China signed a cybersecurity deal, which stated that neither party would attack the other and that together they would cooperate to counter technology that might 'destabilise the internal political and social economic atmosphere' or 'interfere with the internal affairs of the state'.

Dispute Management (Bilateral): Russia's economic importance, combined with its large military and vast quantities of energy, means that it has considerable sway to pressure any smaller (in terms of politico-economic power) country. For example, the Kremlin has used sanctions on Georgia and economic pressure on Ukraine to attempt to steer their political paths. Russia's global economic significance is a major reason why European states have been reluctant to impose tough sanctions on the country in retaliation for its interference in Ukraine in 2014.

Dispute Management (Multilateral): Russia is a permanent member of the UN Security Council and can thus refer any issue it deems important to the body. As a veto-wielding member, Moscow also has the means to block resolutions proposed by Western powers against its own actions.

Russia's relationships with the US and EU will remain tense for the foreseeable future, meaning that sanctions will persist well into 2018, presenting headwinds for the Russian economy. Meanwhile, Russia's growing frustrations with the sanctions regime could prompt it to behave more aggressively, although it will be careful not to tarnish its image ahead of hosting the FIFA World Cup in June-July 2018. On a more positive note, the deadlock in relations with the West will encourage Moscow to strengthen ties with eastern nations such as China, Japan, North Korea, and Turkey, ensuring that it is far from isolated.

On July 26 2017 the US House of Representatives and Senate voted overwhelmingly in favour of a bill which imposes further sanctions on Russia, in an effort to punish Moscow for its involvement in the wars in Ukraine and Syria, and in response to allegations of its meddling in the 2016 presidential election (*see 'Quick View: New US Sanctions To Delay Rapprochement For Years', July 26*). In this context, a major improvement in US-Russia relations looks increasingly unlikely over the short-medium term. If adopted into law, the bill would make it more difficult for President Donald Trump to lift or ease the punitive measures without consent from Congress, lengthening the duration of US sanctions on Russia. Moreover, the new measures look more painful for the Russian economy than the current sanctions regime and are likely to instigate retaliation from the Kremlin. According to Russia authorities, Russia has already prepared economic and political measures that will be adopted if the White House approves the bill. This backdrop of heightened political risk further compounds our bearish view on Russian assets.

Domestic political troubles in the US and internal solidarity on the part of the EU will prevent them from pursuing a rapprochement with Russia over the coming quarters, leading to an extension of sanctions into late 2018. Although Russia's relations with the West will remain tense, relations with eastern nations such as China, Japan, and even North Korea offer opportunities for Moscow.

The extended impasse with the West will continue to prompt Russia to develop closer economic and political ties with 'eastern' nations.

Russia will enhance co-operation in the areas of energy, infrastructure, and defence, both bilaterally and under the auspices of the Shanghai Cooperation Organisation, and China will reciprocate Russian rhetoric as a means to deflect US geopolitical and trade pressures. Indeed, Chinese warships joined their Russian counterparts in a naval exercise in the Baltic Sea in late July 2017. That said, Russia will remain wary of rising Chinese influence in Central Asia, as Beijing presses ahead with 'Belt and Road'.

Moscow and Tokyo have sought improved relations under Japanese Prime Minister Shinzo Abe, despite failing to resolve the Kuril Islands territorial dispute stemming from 1945. The Abe administration also hopes that Russia can persuade North Korea to moderate its behaviour.

Russia shares a short border with North Korea and has had amicable ties with Pyongyang for seven decades. Moscow thus has a major stake in any geopolitical crisis on the Korean Peninsula. Against this backdrop, Russia could attempt to portray itself as a 'peace broker' distinct from China. While this will not resolve the nuclear dispute, Putin's possible involvement will emphasise Russia's credentials as a 'great power'. Putin could step up support for the Kim Jong Un regime as another means to pressure the US.

Turkey's relations with the West have continued to deteriorate following the July 2016 coup attempt against President Recep Tayyip Erdogan, who suspects Western involvement. Although Turkey remains a member of NATO, it is increasingly seen as an unreliable ally. As of early August 2017, Turkey was pressing ahead with purchasing Russia's S-400 air defence system, against the wishes of the US, thus signalling closer defence ties with Moscow.

Defence Agreements: Russia heads the Collective Security Treaty Organisation (CSTO), which also consists of Armenia, Belarus, Kazakhstan, Kyrgyzstan, and Tajikistan. Moscow is thus formally committed to each country's security. As regards conflict risks, Russia's security guarantee for Armenia means that it could get dragged into renewed hostilities between that country and Azerbaijan over the disputed territory of Nagorno-Karabakh. Russia is also a member of the Russian- and Chinese-dominated Shanghai Cooperation Organisation, a Eurasian security group whose membership partly overlaps with the CSTO, and also includes more observer states and dialogue partners.

Business Response: Although businesses located in major cities are unlikely to be targeted directly by terrorist attacks, there is a risk of collateral damage, while protests or coup attempts could cause supply chain disruption. Conflict risks do not generally affect day-to-day operations, but businesses must prepare for measures such as repatriation plans for foreign workers and providing guidance in the event of terrorist attacks, as well as paying higher insurance premiums.

Transport Network

Supply chains in Russia benefit from extensive transport options including roads, railways and inland waterways, which provide strong internal connections on major routes linking key cities, even though large swathes of the country are not served by any transport networks. In addition, trade flows are facilitated by excellent international connections both overland and by sea and air. Nevertheless, the transport network is facing significant capacity constraints, particularly on the road network and at ports, and congestion therefore causes supply chain delays. The continuing growth in traffic volumes, against the backdrop of limited fiscal capacity to boost rapid infrastructure development means that investment in road and railway networks is unlikely to significantly alleviate congestion over the medium term. Overall, Russia receives a score of 63.1 out of 100, placing it in a regionally uncompetitive sixth place out of 11 Central and Eastern Europe countries and 62nd out of 201 states by global comparison.

Latest Transport Network Analysis:

- In the short term, the upcoming 2018 World Cup will continue to drive development in Russia's transport infrastructure sector, as the government seeks to improve logistical connectivity between host cities with a series of rail and airport projects. In the longer term, Russia's

TABLE: ROAD RISKS

Internal Coverage	
Total road network: 1,283,387km	• The Russian road network extends to over 1.2mn km, but this is relatively small given the huge size of the country. Consequently, there are vast areas of land, particularly in the east of the country, which are not connected to the road network, and this means that Russia is ranked last regionally for road density, with 0.07km of roads per 100sq km of land. However, this is not a major issue for supply chains, as the poorly connected regions are sparsely populated and of little economic value. • Russia's road network largely serves its main centres of population in the north-west, including Moscow and St Petersburg, and along its southern border. The road network centres on Moscow, with several federal highways fanning out from the capital city. The M1 leads to the border with Belarus via Smolensk; the M2, M3 and M4 to Ukraine; the M5 to Chelyabinsk and the border with Kazakhstan; the M6 south to Astrakhan on the Caspian Sea, the M7 west to Kazan, the M8 north to Yaroslavl and the port of Archangelsk on the Arctic Ocean; the M9 to the border with Latvia and the M10 to St Petersburg. • The road network also stretches across the south of the country through Siberia to Vladivostok on the Pacific Ocean. This means that all of Russia's main ports, cities and centres of economic activity are linked by road, which benefits supply chains using this freight mode.
International Connections	
Roads connect to all neighbouring states	• Efficient road connections with neighbouring countries are available, particularly those in the west, such as Finland, Estonia, Latvia, Belarus and Ukraine, but also Kazakhstan and Mongolia to the south. • Moscow and St Petersburg are linked to the wider European transport network by Pan-European Transport Corridors 2 and 9. The former stretches from Nizhny Novgorod west via Moscow, Minsk and Warsaw to Berlin. The latter begins in Helsinki and links St Petersburg and Moscow to Kiev, Bucharest, and the Greek port of Alexandroupolis. • This means that the Russian road network is well integrated with that of key European trading partners. However, road links with Caucasus countries, Georgia and Azerbaijan, and with China are more limited, restricting trade flows with these states.
Infrastructure Quality	
27.7% of roads are unpaved	• Supply chains using the road network in Russia are exposed to risks due to the variable quality of the roads with only 72.3% of the roads being adequately paved. The most prominent is the poor quality of road surfaces, which have suffered from a lack of investment and are therefore crumbling in many cases, leading to slower transportation times as trucks have to avoid potholes and other obstacles. • New road infrastructure projects are underway, including the USD6.5bn Western-High-Speed Diameter toll road, and the M-11 Moscow to St Petersburg highway. • While these new investments are a step in the right direction, investors should beware of severe risks in the execution of the projects, ranging from engineering risks to legal and political risks, which are typical of the Russian business environment. In addition, it is not certain that these developments will significantly alleviate congestion or improve the road network's ability to handle larger volumes of traffic which are expected during major sporting events such as the 2018 FIFA World Cup.
Usage	
Accounts for 79% of total freight tonnage	• Roads carried 79% of total freight tonnage in 2016, according to BMI's Freight Transport team. • The Russian road network is mostly used to carry containerised goods and for shorter supply chains in the west of the country. This is where the best developed roads are found, connecting major cities and ports and providing cross-border links into the rest of Europe. • In 2016 we estimate that Russian road haulage volumes expanded by 1.0% from the previous year, to 5.1bn tonnes, marking the first year of positive growth since 2012, as the Russian economy has struggled in the face of various challenges, including a slump in oil prices and Western sanctions. In 2018, we expect road haulage volumes to reach almost 5.2bn, highlighting some growth recovery as private consumption and overall economic activity picks up. However, it will take some years before road haulage levels reach 2012 highs of 5.84bn tonnes.
Disruption	
18.9 road deaths per 100,000 people	• The inadequate quality of roads, combined with poor driving standards, has resulted in a high rate of traffic accidents. Russia has the highest rate of road deaths in the Central and Eastern Europe region according to the World Health Organization's road traffic death rate, at 18.9 per 100,000 people. Road-based supply chains are therefore frequently subject to delays when accidents block highways, and there is an increased risk of freight carried by road being damaged by involvement in a collision. • Traffic congestion is a significant issue, particularly in major cities. Vehicle ownership has increased, and many streets are not designed to deal with the resulting increase in traffic. Consequently, Moscow is ranked among the top 10 most congested cities in the world, and road-based supply chains in the capital and other cities are therefore subject to long delays. • Traffic congestion in large cities such as St Petersburg and Moscow increases travel times by 44% on average, causing considerable supply chain delays for goods transiting through the city. This will remain a concern on the country's road network as growing traffic volumes are not being met with adequate investment in roads and alternative transport options.

Source: BMI, CIA World Factbook, World Health Organization transport sector will be buttressed by growing levels of Chinese investment, with China viewing Russia as a key conduit for its East-West trade ambitions.

- Rail infrastructure will be Russia's fastest growing transport infrastructure segment in 2018 on the back of World Cup related spending, with our infrastructure forecast projecting 3.9% real growth in 2018. By Q317, Russian railway company RZD International had spent RUB12.8bn on the ongoing renovation of 15 railway stations and 22 platforms. By Q118, five railway stations are set to be recommissioned in Cherepanovo, Mogocha, Ruzaevka, Saransk and Kogalym. The company also plans to upgrade 17 platforms at railroad complexes in the cities hosting the FIFA 2018 World Cup matches.

- China's Belt And Road (B&R) initiative is a particular bright spot for the Russian rail freight sector. Given that Russia's geography spans the Eurasian landmass and is uniquely placed to facilitate the expansion of trans-Eurasian trade, the country will continue to be a focal point for B&R investment. Russia currently accounts for a decisive majority of B&R related investment in Europe and Central Asia.

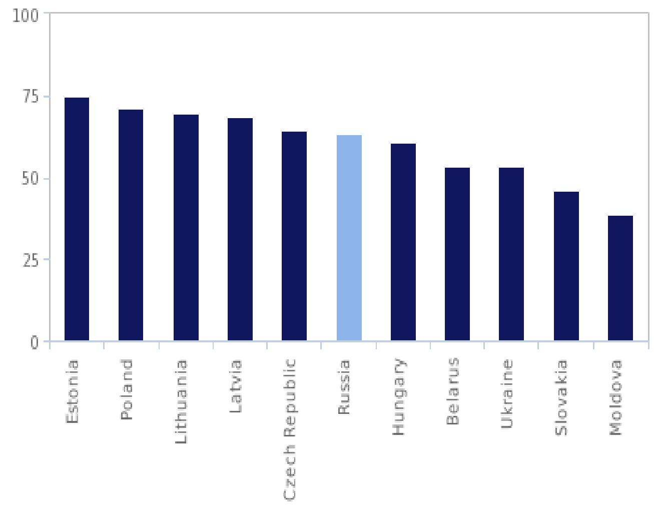
- The country's transport strategy planned through to 2030 foresees substantial investments into rail and road infrastructure to realise Russia's transit potential; however, prevailing fiscal constraints and thorny relations with the West (as shown by the continued imposition of sanctions) will limit the government's capacity to fund infrastructure projects.

Extent And Quality Of Transport Network

Despite its vast size, Russia has developed extensive road and railway networks which serve the key transport routes in the west and south of the country. It also benefits from the longest network of inland waterways in the world, and strong international maritime and air trade connections. Consequently, supply chains benefit from a variety of transport options providing both internal and international links, boosting Russia's appeal as an investment destination. Therefore, Russia is placed highly in the region for the Extent of Transport Network, ranked third out of 11 states in Central and Eastern Europe with a score of 67.1 out of 100.

Extensive Transport Network Profile Weighed Down By Congestion Risks

Central & Eastern Europe – Transport Network



Source: BMI Logistics Risk Index. 100 = Lowest risk; 0 = highest risk

The quality of transport infrastructure in Russia is somewhat

TABLE: ROAD RISKS (CONTINUED)

Planned Projects	
	• In order to ease congestion, the government has pledged to build 400km of new roads by 2020, including a multi-lane highway project in north-west Moscow, but this will likely fall short of demand, necessitating greater investment in transport diversification projects. • Work on an 8,445km transcontinental toll highway between Shanghai and the Hamburg started in 2017, following the approval of the project by the governments of China, Kazakhstan, Belarus and Russia. The USD6bn motorway, to be called the Meridian Highway, will have intersections with the Suez Canal, Northern Sea Route and Trans-Siberian Railway. Various Chinese investors, including the Export-Import Bank of China and China Development Bank, are expected to contribute a total of USD4bn for the project through a special development fund. The four-lane highway is designed for an average speed of 110km per hour. The travelling time between Pacific and Baltic coasts will be about 11 days. Work on the highway is expected to be completed by 2020. • Russian authorities are planning to build a section of North-East Expressway to reduce congestion. The section will be 13km and will provide a link between existing Dmitrovskoe and Yaroslavskoe Highways. Design work is slated to be finished by end-2018, while construction is likely to be completed by 2020. • Russia is also seeking investment from Chinese firms to partially fund construction of a 2,192km highway between Russia and Kazakhstan. The project will involve a total cost of USD11.7bn, according to the government's Federal Centre of Project Financing. The Russian government will fund about 50% of the project. The high-speed road will be part of the 8,160km Europe-Western China International Transit Corridor that will connect St Petersburg port in Russia to the Chinese port of Lianyungang. Russia's part of the corridor is expected to be divided into four concessions run by four consortiums.

Source: BMI, CIA World Factbook, World Health Organization

TABLE: RAIL RISKS

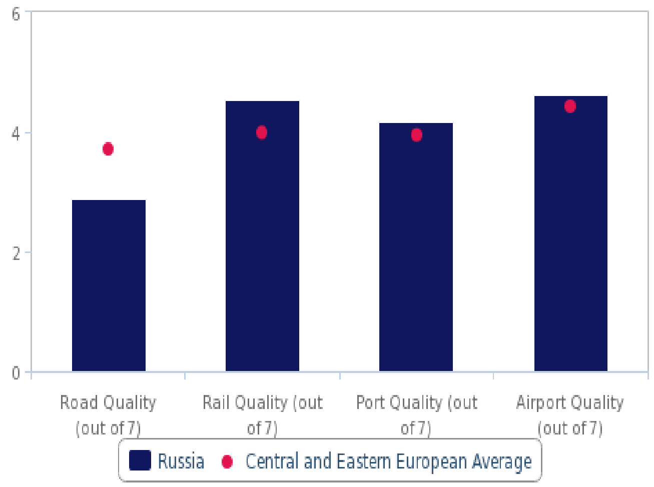
Internal Coverage	
Total railway network: 87,157km (mostly broad gauge)	• The rail network stretches to over 87,000km of broad gauge track, making it the second longest in the world after the US. This ensures that the network offers good coverage despite the large size of the country. • Railways connect all of Russia's main cities and ports, from Murmansk and Archangelsk in the Arctic Circle, through St Petersburg and Moscow and across Siberia on the Trans-Siberian Railway, linking up with Vladivostok in the Far East. Due to difficult driving conditions in some areas and the long distances involved, railways are an attractive option for supply chains which cross the interior of the country. • Metro systems are in operation in several major cities, including Moscow, St Petersburg, Nizhny Novgorod and Novosibirsk. This helps to alleviate some road traffic congestion; however, more investment is needed in order to improve alternative options for passenger transport in major cities. • Russian Railways is planning the development of the railways in Eastern Russia, the Mezhdurechensk-Tayshet and Tobolsk-Surgut lines and the North-West transport hub. These developments demonstrate a commitment to improving rail transport infrastructure and diversifying supply chain options.
International Connections	
Railways connect to: Finland, Estonia, Latvia, Belarus, Ukraine, Georgia, Azerbaijan, Uzbekistan, Kazakhstan, and Mongolia (same gauge), and China and North Korea (change of gauge).	• The railway network is well integrated with neighbouring countries, most of which are also on broad gauge tracks, which means there are limited delays or costs due to the reduced need for bogie changes at borders. The railways offer direct links to Finland, Estonia, Latvia, Belarus, Ukraine, Georgia, Azerbaijan, Uzbekistan, Kazakhstan and Mongolia. This connects Russia with the wider railway networks of Europe and Asia. • For the railway links to China and North Korea, a change of bogies is required which adds extra delays and costs to rail-based supply chains, particularly as China is a key trade partner. • The role of the railways in international freight transport is likely to increase with the development of the Asia-Europe landbridge, which connects China with Germany via Russia and reduces the shipment times and costs for supply chains between the two continents. This will further improve Russia's international connections and the role of railways in freight transport. • In December 2016, the first freight train service from the Chinese city of Xi'an to Moscow arrived in the Russian capital. This is a faster and more efficient trade route between the two countries.
Infrastructure Quality	
	• In addition to the good internal connections and international links offered by the railway network, its relatively high quality also makes it an attractive diversification option for supply chains. Privatisation of railway companies is ongoing which will further improve the quality of infrastructure and rolling stock. • The Russian Railways company is now complemented by the First Freight Company and the Independent Transportation Company (a unit of Universal Cargo Logistics Holding), which boast significant expertise in the rail freight sector, benefiting the development of railways over the medium term.
Usage	
Accounts for 19% of total freight tonnage	• Historically, road freight has always dominated the mix. Rail freight has been important, although it has historically only accounted for just below 20% of the freight mix. • Rail freight mainly caters for bulk cargo and export commodities such as oil, coal, metals and construction materials. • There are additional railway lines serving industrial production sites, showing that companies are able to invest in their own supply chain infrastructure, which does entail higher capital investment costs but results in better efficiency. • In 2016, 1.3bn tonnes of goods were transported on Russia's railway lines. Looking further ahead, we expect that a gradual reorientation of Russia's coal exports from Europe to Asia will be driven by growing demand for coal in the region. Russian miners will benefit from rising coal demand from Asia, and several major infrastructure projects are under way to facilitate greater mineral trade flows. This is a key benefit to the rail freight sector, even if the gauge change requirement increases costs.
Disruption	
	• Disruption to the railway network is less common than on the road network, as congestion is not a major issue. This considerably boosts the appeal of railways for freight transport, particularly over long distances. • The FIFA Football World Cup in 2018 will increase tourist-flows to Russia and thus increase pressure on the entire transport network. The government has consequently decided to invest heavily in high-speed rail systems to alleviate the burden from the poor-quality road system. • The total cost for the new high-speed lines between Moscow and St Petersburg is estimated at USD68bn, which will be financed via public-private-partnerships (the government will carry 70% of the construction costs of USD15bn). This expansion should allow for growing capacity of both passengers and freight on the railway network without causing overcrowding or congestion. • Growth in Russia's internal rail sector in the near term will remain constrained by the macro-economic headwinds afflicting the country's broader construction market: higher interest rates that will impede project financing, a projected fiscal deficit of 2.8% which will reduce the government's ability to fund infrastructure projects, and the ongoing effects of international sanctions.

Source: BMI, CIA World Factbook

variable. In particular, road surfaces can be sub-standard, delaying supply chains and adding to problems with traffic congestion. Inadequate port facilities also contribute to congestion at major terminals such as St Petersburg, particularly delaying imports of machinery, intermediate inputs and consumer goods. In contrast, Russia's railways offer a well-developed alternative to both road- and sea-based supply chains for internal and international freight transport. As a result, Russia scores 59.1 out of 100 for Quality of Transport Network, ranking it seventh out of 11 Central and Eastern Europe countries.

Railways Provide Important Diversification Option

Russia & Regional Average – Infrastructure Quality



Source: World Economic Forum's Global Competitiveness Index, 2017-18. 7 = highest score, 1 = lowest score

Roads: The Russian road network is the dominant mode of freight transport, mostly being used to carry containerised goods and for shorter supply chains in the west of the country. This is where the best-developed roads are to be found, connecting major cities and ports and providing cross-border links into Europe. However, we caution that road-based supply chains are subject to number of risks which are likely to cause disruption, including frequent accidents and chronic congestion.

Strong Internal And Cross-Border Rail Connections

Map Of Russia's Main Railway Links

Source: BMI

Railways: Railways are an attractive diversification option for supply chains in Russia. The railway network is a key mode of freight transport, offering better quality and more efficient connections than roads in remote areas and for long-distance supply chains. Railways also offer strong international links, which boosts Russia's role in regional trade flows. Increased development of rail infrastructure creating strong international links bodes well for Russia's trade growth in the medium-to-long term. An analysis of **BMI**'s Key Project Database lends

TABLE: RAIL RISKS (CONTINUED)	
Planned Projects	
	• In light of the Chinese government's ambitions to foster increased levels of East-West trade, Chinese capital will continue to play a major role in driving growth in Russia's transport infrastructure sector in the medium-to-long term. In June 2017, China Railway Group signed a memorandum of understanding with Ural Highway to build a USD2.5bn high-speed railway between Yekaterinburg and Chelyabinsk. The link is being styled as a part of the high-speed transit corridor crossing Berlin, Moscow, Astana and Beijing. • The potential of future high speed rail development in Russia is aptly illustrated by the planned Moscow-Kazan high speed railway project, the progress of which provides significant support for the transport sector in the run-up to the 2018 World Cup. • Building on an existing trend of increasing Chinese investment in Russia's Far East, Chinese money will also contribute to the construction of a high-speed railway connecting Vladivostok and the Chinese city of Hunchun. More broadly, the aforementioned Moscow-Kazan railway is expected to be the first link in a high-speed network that will eventually connect Moscow and Beijing at a cost of USD230bn, but owing to the uncertain long-term status and enormous scope of such a project, we have declined to factor the project into our forecast at this time. • In June 2017, it was announced that China Railway Group signed a memorandum of understanding with Ural Highway to build a USD2.5bn high-speed railway between Yekaterinburg and Chelyabinsk. The link is being styled as a part of the high-speed transit corridor crossing Berlin, Moscow, Astana and Beijing. • Russian Railways and Tuva Energy Industrial Corporation (TEIC) signed a cooperation agreement to build the 410km Elegest-Kyzyl-Kuragino railway in the Republic of Tyva, a federal subject of Russia. The line will connect the Elegest coalfield with the Russian Railways network at Kuragino and will transport up to 15mn tonnes of coking coal annually. The line is estimated to cost USD3.4bn and is expected to be completed by 2022.

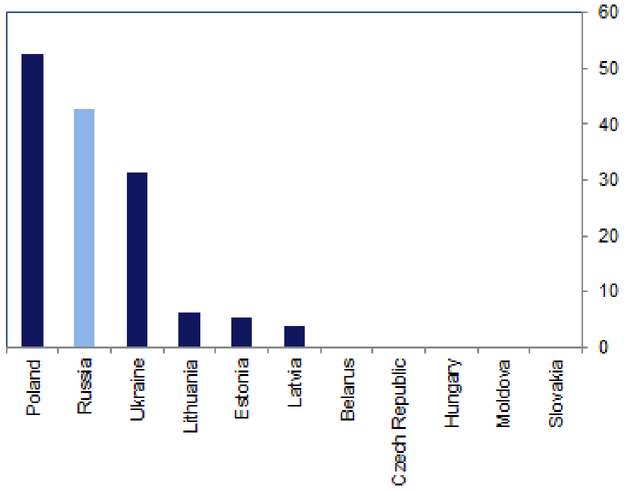
Source: BMI, CIA World Factbook

TABLE: PORTS AND INLAND WATERWAY RISKS

Internal Coverage	
Major seaports located at St Petersburg, Kaliningrad, Novorossiysk, Vladivostok, Arkhangelsk. Total length of navigable inland waterways: 102,000km including the rivers Volga, Lena, Yenisei, and Ob.	• Russia has 102,000km of inland waterways, out of which only 48,000km have guaranteed depth. Most inland waterway freight takes place in the western and southern parts of Russia, which covers a total of 72,000km. • Businesses in Russia benefit from the country's vast maritime borders which provide access to the Arctic Ocean, the Pacific Ocean, the Caspian Sea, the Black Sea and the Baltic Sea. • The largest seaport in Russia is located in St Petersburg, with other major facilities located at Archangelsk, Novorossiysk and Vladivostok. New ports are being built with the help of government funds along the coastline, such as the Port of Taman. • Russia is also home to many shipping companies, such as FESCO, Sovcomflot and the Murmansk Shipping Company. The ports and shipping lines serve the country's trade with crude oil and products, which are shipped to key trade partners, such as Germany and China.
International Connections	
Liner Connectivity: 42.57 (highest score 167.5 in 2016)	• An increasing number of shipping lines call directly at Russian ports instead of just providing feeder services. For instance, Maersk Line connects the port of St Petersburg with ports in Latin America and North Africa (mainly serving the increased demand for refrigerated transport of fresh fruit and vegetables for the domestic Russian market) and Europe Caribbean Services offers direct connections to Morocco. • The inland waterways network provides routes across the continent linking five seas: the Baltic Sea, White Sea, Caspian Sea, Sea of Azov and the Black Sea. • Consequently, Russia is the second best connected country to maritime trade routes in the Central and Eastern Europe region, according to the UNCTADstat liner connectivity index in 2016. This means that exporters and importers are less reliant on expensive and time consuming feeder services. • The increasing presence of major international shipping firms will support growth at St Petersburg. For instance, CMA CGM followed Maersk Line's lead in August 2012, when the facility was added to CMA CGM's Europe Caribbean Service (ECS). The company also offers direct links to the port on its Dunkrus Express service, which connects the port with Morocco. The interest in Russia's trade outlook has been further boosted by its entry into the WTO in 2012.
Infrastructure Quality	
	• Russia's ports are generally capable of meeting the demands of its oil export and machinery and manufactured goods import supply chains. Nevertheless, further development of seaports is necessary as the quality of ports and freight handling facilities needs investment to keep up with rising demand. • At present, congestion can result in significant supply chain delays. St. Petersburg, for instance, has struggled with congestion at its container facilities previously due to sudden spikes in throughput. • Most river ports have railway access, making it possible to tranship goods from water to railways and road transport. However, flexibility and speed of goods delivery remains inferior to other transport modes. Moreover, an increase in cargo volume without major reconstruction and substantial investments seems impossible as the main water arteries, such as the Volga-Don Canal and the Volga-Baltic waterway have exhausted their traffic capacity. This sector offers great potential to reduce the burden from the congested road network, but remains underdeveloped and an unattractive prospect for supply chains.
Usage	
Port of St Petersburg throughput: 1,757,331 TEUs (BMI 2016 estimate). Over 2017, inland waterway freight accounted for around 2% of the total freight mix.	• St Petersburg is Russia's busiest port in terms of container throughput. Its location as the closest port to Moscow, as well as the major urban areas of St Petersburg itself, mean it has developed to cater for considerable throughput volumes. In 2017 tonnage throughput and container traffic at the port of St Petersburg is estimated to increase by 16.8% to 56.8mn tonnes and 2.7% to 1.8mn twenty-foot equivalent units (TEUs) respectively. • Russia's ports are generally capable of meeting the demands of its oil exports, in addition to its machinery and manufactured goods import supply chains. Nevertheless, further development of seaports is necessary as the quality of ports and freight handling facilities needs investment to keep up with rising demand. • Congestion can result in significant supply chain delays. St Petersburg, for instance, has struggled with congestion at its container facilities previously due to sudden spikes in throughput. Additional port facilities are to be built in Murmansk. • Russia's inland waterways network is the largest in the world, although it is not used to its full capacity. Goods are carried on major rivers, such as the Volga, Lena, Yenisei, Ob, Irtysh and Amur. Russia is estimated to have 129.3mn tonnes handled in inland waterways in 2017, rising to 129.8mn tonnes by 2021.
Disruption	
	• As well as the potential for cargo congestion, additional risks for shippers mainly relate to the single-commodity focus (such as oil) of the majority of Russian ports, which can lead to break-ins in cargo throughput and revenue if there are export bans or other disruptions. • For instance, the recent geo-political clash between Ukraine and Russia has led to major disruptions of oil exports, with reciprocal sanctions imposed by the West and Russia meaning some ports in the Baltic States have seen a sharp decline in Russian ships calling at their ports, even though the Baltic States play a major role in Russia's supply chain. • The Russian government plans to dedicate about RUB220bn to its seaports over a number of development projects between 2017 and 2020. However, following the fines of unprecedented amount earlier in 2017 against some of the seaports for price fixing, compounded by the effects of Western sanctions, the development plans may be undermined as 80% of the projects' funding will be from private investors.

Source: BMI, CIA World Factbook, UNCTAD credence to our view (of the USD126bn in project value currently working its way through Russia's transport pipeline, 47% is concentrated in the rail subsector).

Strong International Connections Facilitate Maritime Trade Flows
Central & Eastern Europe – Liner Connectivity



Source: UNCTAD. 167.48 = highest score, 0 = lowest score

Ports And Inland Waterways: Businesses in Russia benefit from the country's vast maritime borders which provide access to the Arctic Ocean, the Pacific Ocean, the Caspian Sea, the Black Sea and the Baltic Sea. Thus, the country boasts many ports, offering strong maritime trade connections and efficient global links for exporters and importers. However, the port sector requires further robust investment in order to alleviate congestion, which has caused supply chain delays in the past.

Airports: Russia boasts a well-developed air transport sector, which has emerged as an important mode of passenger and cargo travel due to the huge size of the country. Several major airports offer strong domestic and international air transport links, and air cargo carriers are well established. However, airport infrastructure requires investment to improve quality, and air-based supply chains are at risk from disruption due to frequent flight delays. Russia's airport infrastructure, is set to expand over the medium term, buoyed by a relatively robust project pipeline, and is supported by a USD6.8bn investment pledge by the Russian government in 2014.

TABLE: PORTS AND INLAND WATERWAY RISKS (CONTINUED)

Planned Projects	• Royal Boskalis Westminster is building the new Bronka Port in St Petersburg, which will extend over 85 hectares and cost up to USD32.8mn. The new port facility will increase the country's capacity to handle dry and liquid bulk cargo and ease congestion at the country's busiest port. • Arctic Transport and Industrial Centre Arkhangelsk have signed an MoU with China-based Poly International Holdings to build a deepwater port 55km north of Arkhangelsk in north-western Russia. The MoU also includes the construction of the 1,161km Belkomur railway line, 449km of which already exist. The port is expected to operate throughout the year, including winters, with the help of icebreakers. • In Q116, UAE-based port operator DP World and the Russian Direct Investment Fund (RDIF) signed an agreement to set up a new joint venture firm, DP World Russia, where DP World will own an 80% stake. The new firm will target marine, dry ports and logistics infrastructure in different parts of Russia. DP World Russia is expected to potentially invest USD2bn to upgrade Russian port facilities as well as introduce international best practices in port operations to improve Russia's trade connectivity. • More broadly, investment plans for ports in northern Russia will continue to gather pace in light of the progress made on the Northern Sea Route, which allows the passage of liquid bulk as well as dry bulk cargo. Although volumes are going to be moderate compared to those seen on other shipping routes, the progress of the route has nonetheless prompted investment plans for ports and auxiliary transport infrastructure. • In this vein, the planned USD1.3bn Murmansk Transport Hub in the Barents Sea will feature a deepwater port with round-the-year navigation. This project forms part of 2003 initiative to expand the Murmansk sea port, increasing its handling capacity to 70mn tonnes of cargo. The project includes the creation of a transport infrastructure on the Western shore of the Kola Bay, with coal and oil terminals, rail infrastructure development, including construction of a branch line Vykhodnoy-Lavna, reconstruction of the coal terminal and building a container terminal on the Eastern shore of the Kola Bay. Construction reportedly started in September 2014 on the rail line, but it is not clear whether construction has started on other parts of the project. According to initial plans, construction is expected to be completed by 2019.

Source: BMI, CIA World Factbook, UNCTAD

TABLE: AIR TRANSPORT RISKS

Internal Coverage	
Total of 594 airports with paved runways, 54 have runways at least 3,047m needed for the largest planes in service to land	• The air transport sector has developed to cater for the huge distances involved with passenger and freight travel in Russia. There are consequently a total of 594 airports with paved runways, and 54 of these have runways of at least 3,047m needed to handle the largest planes in service. • This means that air transport offers excellent internal and global connections, and has emerged as an attractive option for carrying perishable goods and high-end consumer items over long distances. • The largest airports are Domodedovo International, Sheremetyevo International, and Vnukovo International, located in Moscow, and Pulkovo, located in St Petersburg.
International Connections	
0.5 air passengers carried per capita	• Russia boasts strong international flight connections which facilitate business transport. Aeroflot is the national flag carrier of Russia and one of the largest airlines in the world. In addition, other major international airlines including **Air France**, **Air China**, **British Airways**, **KLM** and **Emirates**, operate scheduled flights out of the country's airports. • As such, Russia offers strong international passenger flight connections across Europe, North America, the Middle East and Asia, as well as domestic links between major cities. This enables the country to cater for large numbers of air passengers, with 0.5 per capita, the third highest figure regionally (after Hungary and Latvia) despite the country's large population. This indicates the extent of flight connections available and the high usage of air transport country.
Infrastructure Quality	
	• Though facilities at Russia's major airports are adequate, the quality of airport infrastructure countrywide requires improvement. The large number of airports, remote locations and ageing infrastructure (many were built during the Soviet era) mean that updates are both necessary and difficult to implement. • While businesses should encounter few problems operating from major airports around Moscow and St Petersburg, regional airports will have more limited infrastructure and facilities, restricting their use for supply chains and resulting in delays.
Usage	
Air freight volumes: 5.86bntonnes-km	• Air-based supply chains benefit from Russia's AirBridgeCargo Airlines, which offers scheduled cargo flights from Moscow's airports to a range of destinations including Amsterdam, Beijing, Chicago, Hong Kong, Paris, Seoul and Tokyo. Other cargo airlines operating in the country include Emirates SkyCargo, Etihad Cargo and Lufthansa Cargo. • In addition to these international connections, there are also internal freight flights which serve more remote destinations such as Yekaterinburg and Krasnoyarsk. • Dedicated cargo terminals and handling facilities are available at several airports, and expansion of the cargo terminal is underway at Domodedovo International. • As a result of these well-developed air trade links and cargo capabilities, Russia handles the largest air freight volumes in the region and the 11th largest globally out of 201 states (ranking marginally behind Singapore). Air trade therefore constitutes an important role in the country's supply chains, although it remains limited in comparison to roads and railways.
Disruption	
	• Flight delays are a key risk to air-based supply chains in Russia. Moscow's three international airports are among the worst in Europe for on-time flight departures according to a FlightStats survey from October 2013. Domodedovo was the best performer out of the three, with 62.19% of flights leaving on time, but Sheremetyevo registered only 42.67% and Vnukovo just 40.43%, the lowest among Europe's major airports. In comparison, the best performers, including Prague, Copenhagen, Athens, Vienna and Oslo, all had over 87% of flights leaving on time.
Planned Projects	
	• Russia's airport infrastructure, is set to expand over the medium term, buoyed by a relatively robust project pipeline, and is supported by a USD6.8bn investment pledge by the Russian government in 2014. This includes plans such as the construction of a USD630mn terminal and a tunnel for Sheremetyevo International Airport in Moscow, as well as the construction of an airport at Rostov. The new airport is part of the infrastructure project designed to service the FIFA World Cup 2018 cities. It will replace the existing Rostov-on-Don Airport. • There are also plans to build a terminal and a tunnel for Sheremetyevo International Airport in Moscow, Russia. The project is estimated to cost USD630mn. • In April 2014, the Russian government approved the USD364.21mn construction of a third runway at Domodedovo Airport in Moscow. The Yermolino Airport reconstruction is moving forwards, estimated to cost USD325mn. The airport does not operate any civil aviation flights and is currently used for the Interior Ministry's flight operations. The airport is expected to start operating by Q118.

Source: BMI, World Bank

Chapter 5:
BMI Global Macro Outlook

Growth, Inflation And Rates On The Rise

- We forecast global real GDP growth of 3.3% in 2018, which is a seven-year high.
- A major increase in oil price forecasts signals higher inflation in 2018.
- Growth forecast upgrades for the US, eurozone, Brazil and Saudi Arabia.

Global real GDP growth will accelerate to 3.3% in 2018 from 3.2% in 2017, marking the fastest economic activity since 2011, and an upward revision from 3.1% previously. While we still expect aggregate developed market growth to plateau in 2018 compared with an above-trend 2017, and for emerging market economies to see accelerating activity, we have made several upside revisions across the board. These changes reflect strong momentum entering 2018, as well as reassessments of underlying fundamentals.

We have made a significant upgrade to our 2018 price forecast for Brent crude oil, and now forecast an average of USD65 per barrel (/bbl), up from USD57/bbl previously. This is a 14% increase in average prices versus our previous forecast, and this revision will have implications for the global macroeconomic outlook. We already held the view that rising commodity prices would contribute to gradually rising global headline inflation in 2018. With this oil price upgrade, we forecast global inflation to tick up to 3.0% in 2018 (an upgrade from our previous 2.8%

TABLE: GLOBAL MACROECONOMIC FORECASTS

	2017e	2018f	2019f	2020f	2021f	2022f
Real GDP Growth (%)						
US	2.2	2.6	2.2	2.0	1.9	1.9
Eurozone	2.3	2.0	1.6	1.5	1.5	1.5
Japan	1.8	1.5	0.5	0.4	0.4	0.4
China	6.8	6.5	6.2	5.8	5.4	5.4
World	3.2	3.3	3.1	3.0	2.9	3.0
Consumer Inflation (ave)						
US	2.1	2.3	2.3	2.1	2.1	2.1
Eurozone	1.4	1.7	1.8	1.8	1.8	1.9
Japan	0.7	2.0	2.8	2.9	3.0	3.1
China	1.6	1.9	2.2	2.3	2.4	2.5
World	2.7	3.0	2.9	2.8	2.8	2.9
Interest Rates (eop)						
Fed Funds Rate	1.25	2.00	2.50	2.50	2.50	2.50
ECB Refinancing Rate	0.00	0.00	0.00	0.25	0.75	1.25
Japan Overnight Call Rate	-0.10	-0.10	0.00	0.25	0.50	0.75
Exchange Rates (ave)						
USD/EUR	1.13	1.15	1.15	1.17	1.17	1.17
JPY/USD	112.15	117.00	121.00	122.00	123.00	124.00
CNY/USD	6.78	6.60	6.59	6.59	6.57	6.55
Oil Prices (ave)						
OPEC Basket (USD/bbl)	52.43	62.00	66.00	69.00	72.00	72.00
Brent Crude (USD/bbl)	54.75	65.00	69.00	72.00	75.00	75.00

e/f = estimate/forecast. Source: BMI

projection) from 2.7% in 2017, led by higher price pressures in developed markets including the US, eurozone and Japan. Importantly from a fundamental perspective, though, our new oil price forecast reflects our increasingly constructive outlook on global oil demand. Unlike a supply-side driven increase, for instance a disruption in production, the demand-side pressures are reflective of a stronger global economy, and therefore higher prices do not imply downside risks to non-oil demand.

Another key revision which will have global ramifications is to our US economic outlook. We have raised our forecasts for US real GDP growth in 2018 to 2.6% from 2.1%, and in 2019 to 2.2% from 2.0%. These upgrades incorporate several factors, including the surprising resilience of the US economy in H217, the earlier than we expected passage of tax reform, and key leading indicators of private investment increasingly pointing upwards.

In conjunction with this forecast upgrade, as well as rising inflation pressures, we now believe the US Federal Reserve (Fed) will raise the benchmark funds rate by 25 basis points (bps) three times to 2.00-2.25% in 2018. This outlook represents an upward revision in our forecast of 25bps since November 2017, but we still project 50bps of increases in 2019, bringing the rate to 2.50-2.75%, after which the Fed will tighten no further. Most importantly, our forecasts are above futures implied rates, suggesting that monetary policy will tighten more quickly than market participants expect.

This tightening path is being paralleled by others (such as Canada), and will soon be followed by the eurozone and other major economies – slowly ending a decade's worth of extraordinary monetary easing. Tighter monetary policy is sowing the seeds for the next economic downturn, particularly given high levels

TABLE: DEVELOPED STATES – REAL GDP GROWTH, % y-o-y

	2017e	2018f	2019f	2020f
Developed States Aggregate Growth	2.2	2.2	1.9	1.8
G7	2.1	2.2	1.8	1.6
Eurozone	2.3	2	1.6	1.5
EU-27	2.4	2	1.8	1.7
Selected Developed States				
Australia	2.1	1.8	2.1	2.2
Austria	2.6	2.2	1.8	1.7
Belgium	1.6	1.5	1.5	1.4
Canada	3.1	2.3	1.9	1.7
Czech Republic	4.3	3.3	2.3	2.7
Denmark	2.2	2.1	1.9	1.4
Finland	3.0	2.1	1.6	1.6
France	1.9	1.9	1.7	1.7
Germany	2.3	2.0	1.6	1.5
Hong Kong	3.7	3.0	2.5	2.5
Ireland	6.3	3.6	3.1	2.7
Italy	1.5	1.1	0.8	0.6
Japan	1.8	1.5	0.5	0.4
Netherlands	3.1	2.3	1.7	1.5
Norway	1.7	2.0	1.7	1.8
Portugal	2.5	1.9	1.3	0.9
Singapore	3.6	3.0	2.8	3.1
South Korea	3.2	3.0	3.2	3.1
Spain	2.9	2.5	2.2	2.0
Sweden	3.1	2.5	2.3	1.9
Switzerland	1.0	2.0	1.8	1.7
Taiwan	2.7	2.5	2.8	3.2
United Kingdom	1.7	1.2	1.5	1.6
United States	2.2	2.6	2.2	2.0

e/f = estimate/forecast. Source: BMI

of leverage in the US and globally. But for now, the ability of the Fed to raise rates at a steady pace is reflective of improved domestic and external conditions, and should be interpreted as a justified expression of confidence in the global economy.

Developed States

Developed markets aggregate real GDP growth will be flat in 2018 compared with 2017 at 2.2%, but the outlook for several major economies remains positive.

Apart from the upward revision to US growth, the biggest changes are to the eurozone. Eurozone real GDP growth came in at an estimated 2.3% in 2017, marking the strongest performance since 2007. The recent upswing has been broad-based across the bloc and, since Q317, our forecasts for the five largest eurozone economies have increased by an average of 0.2 percentage points (pp) for 2018. In Germany and Italy, growth has been driven by strengthened exports underpinned by a positive global backdrop. All of the economies saw a resurgence in investment, which also bodes well for the productivity outlook. France saw real gross fixed capital formation accelerate by 4.1% y-o-y in Q317, up from 2.3% a year earlier. In Spain, despite the ongoing crisis in Catalonia, economic activity remained robust which was above our initial expectations, with real GDP growth estimated at 3.1% y-o-y in 2017.

As suggested by relatively upbeat sentiment indicators at the end of 2017, including record-high service and manufacturing purchasing managers' indices (PMIs), we expect growth across the bloc to remain on a healthy trajectory. That said, our core view remains that growth will begin to ease as we progress through 2018, with real GDP forecast to come in at 2.0% for

TABLE: EMERGING MARKETS – REAL GDP GROWTH, % y-o-y

	2017e	2018f	2019f	2020f
Emerging Markets Aggregate Growth	**4.7**	**4.8**	**4.8**	**4.7**
Latin America	1.7	2.4	2.7	2.9
Argentina	2.9	3.3	3.4	3.4
Brazil	0.8	2.0	2.5	2.4
Mexico	2.0	2.1	2.2	3.0
Middle East And North Africa	1.6	2.5	2.8	2.9
Saudi Arabia	-0.5	1.6	2.1	2.4
UAE	1.8	2.8	3.3	3.5
Egypt	4.1	4.9	4.6	4.3
Sub-Saharan Africa	2.7	3.3	3.8	4.6
South Africa	0.8	1.3	1.8	1.9
Nigeria	0.9	3.0	3.7	5.5
Emerging Asia	6.5	6.3	6.1	5.8
China	6.8	6.5	6.2	5.8
India*	6.4	6.7	6.6	6.5
Indonesia	5.1	5.3	5.4	5.6
Malaysia	5.9	5.5	5.0	4.7
Philippines	6.7	6.3	6.2	6.2
Thailand	3.6	3.4	3.6	3.5
Emerging Europe	3.8	2.9	2.7	2.7
Russia	1.7	1.8	1.7	1.7
Turkey	6.9	3.8	3.3	3.0
Hungary	3.8	3.3	2.8	2.7
Romania	7.1	3.8	3.6	3.5
Poland	4.5	3.8	3.1	3.1

*e/f = estimate/forecast; *Fiscal years ending March 31 (2018 = 2018/19). Source: BMI* the year, moderately below consensus of 2.2%.

Emerging Markets

Emerging market economies are generally continuing to accelerate, bolstered by relatively firm developed market demand, rising commodity prices and positive investor sentiment towards emerging markets. Indeed, we expect emerging market growth to rise to 4.8% (in aggregate) in 2018 from 4.7% in 2017, even as developed market growth plateaus at 2.2%. The acceleration will be largely driven by the big commodity exporters which are enjoying a strong rebound thanks to recovering commodity prices, oil in particular. On this note, the most significant changes to our emerging market forecasts over the past month have been upward revisions for two major commodity exporters: Brazil and Saudi Arabia.

In Brazil's case, we have raised our projections for real GDP growth to 2.0% in 2018 and 2.5% in 2019, from 1.7% and 1.9% respectively. Over recent quarters, real export growth has been stronger than we predicted and fixed capital investment has contracted to a lesser degree than we expected, prompting us to adopt a more positive stance on growth.

We anticipate that the economic recovery will pick up steam in 2018, driven by private consumption and exports. Investment is also likely to improve, although policy uncertainty stemming from the October 2018 general election will somewhat undermine investor confidence.

For Saudi Arabia, we have revised up our forecasts for real GDP growth to 1.6% in 2018 and 2.1% in 2019, from 1.3% and 2.0% respectively. The latest data indicate that non-oil sector growth is picking up amid rising business confidence and we expect this trend to continue over the coming quarters, especially in light of the government's announcement in January 2018 that it will be introducing further spending measures.

While the commodity exporters will undergo an acceleration in growth this year, there will be a notable slowdown in emerging Europe. We forecast that aggregate real GDP growth will drop to 2.9% in 2018 from an estimated 3.8% in 2017. In Central and Eastern Europe, labour markets are tightening and inflationary pressures are rising, pointing to higher interest rates. Moreover, we believe that eurozone growth is nearing a cyclical peak, meaning that demand will likely weaken as the year progresses.

We maintain our forecast for China's real GDP growth to slow to 6.5% in 2018 from 6.9% in 2017, with the growth deceleration seen in q-o-q seasonally adjusted terms in Q417 likely to continue over the coming quarters. Increased focus by policymakers to rein in credit growth and protect the environment will likely weigh on investment growth. That said, the consumer sector will continue to provide strong support as the rebalancing in the economy continues.

TABLE: RUSSIA – MACROECONOMIC DATA & FORECASTS

	2017e	2018f	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f	2027f
Nominal GDP, USDbn	1,545.1	1,630.5	1,688.1	1,733.1	1,779.7	1,839.2	1,900.8	1,964.7	2,030.8	2,099.3	2,170.3
Nominal GDP, EURbn	1,367.4	1,417.8	1,467.9	1,481.3	1,521.1	1,572.0	1,624.6	1,679.2	1,735.7	1,794.3	1,854.9
Real GDP growth, % y-o-y	1.7	1.8	1.7	1.7	1.7	1.6	1.6	1.6	1.6	1.6	1.6
GDP per capita, USD	10,730	11,325	11,731	12,053	12,390	12,821	13,273	13,746	14,240	14,757	15,297
GDP per capita, EUR	9,496	9,848	10,201	10,301	10,590	10,958	11,344	11,748	12,171	12,613	13,075
Population, mn	143.99	143.96	143.90	143.79	143.64	143.44	143.20	142.92	142.61	142.25	141.87
Unemployment, % of labour force, eop	5.3	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Consumer price inflation, % y-o-y, ave	4.4	3.8	4.2	4.2	4.1	4.0	4.0	4.0	4.0	4.0	4.0
Lending rate, %, ave	9.5	9.3	9.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0
Central bank policy rate, % eop	7.75	7.00	6.00	6.00	5.50	5.00	5.00	5.00	5.00	5.00	5.00
Private final consumption, % of GDP	52.2	52.6	53.0	53.4	53.8	54.2	54.6	55.0	55.4	55.8	56.2
Private final consumption, real growth % y-o-y	1.9	2.0	2.0	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Government final consumption, % of GDP	18.0	17.8	17.6	17.4	17.3	17.1	17.0	16.8	16.7	16.5	16.4
Government final consumption, real growth % y-o-y	-0.1	-0.3	0.1	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Fixed capital formation, % of GDP	21.4	21.6	21.7	21.9	22.0	22.1	22.3	22.4	22.5	22.6	22.7
Fixed capital formation, real growth % y-o-y	2.2	1.9	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Exchange rate RUB/USD, ave	58.34	58.00	59.09	60.71	62.38	63.62	64.90	66.19	67.52	68.87	70.25
Exchange rate RUB/EUR, ave	65.92	66.70	67.95	71.04	72.98	74.44	75.93	77.45	79.00	80.58	82.19
Budget balance, USDbn	-35.7	-28.9	-17.4	-5.6	-2.7	-2.8	0.5	4.0	7.8	11.8	16.0
Budget balance, % of GDP	-2.3	-1.8	-1.0	-0.3	-0.1	-0.2	0.0	0.2	0.4	0.6	0.7
Goods and services exports, USDbn	365.9	393.6	421.2	445.3	467.0	485.6	500.9	516.6	532.8	549.5	566.7
Goods and services imports, USDbn	282.3	307.9	333.0	356.9	379.9	401.7	424.7	449.1	474.8	502.1	530.9
Balance of trade in goods and services, USDbn	83.6	85.7	88.2	88.4	87.0	84.0	76.2	67.5	57.9	47.4	35.9
Balance of trade in goods and services, % of GDP	5.4	5.3	5.2	5.1	4.9	4.6	4.0	3.4	2.9	2.3	1.7
Current account balance, USDbn	39.2	38.2	37.3	35.0	30.8	24.7	13.8	1.8	-11.2	-25.5	-41.0
Current account balance, % of GDP	2.5	2.3	2.2	2.0	1.7	1.3	0.7	0.1	-0.6	-1.2	-1.9
Foreign reserves ex gold, USDbn	343.0	367.0	392.6	416.2	441.2	467.6	495.7	525.4	557.0	590.4	625.8
Import cover, months	14.6	14.3	14.1	14.0	13.9	14.0	14.0	14.0	14.1	14.1	14.1

e/f = BMI estimate/forecast. Source:National Sources/BMI

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