

Credit FAQ:

How The Russia-Ukraine Conflict Is Affecting Ratings And The Global Economy

March 23, 2022

Beyond the devastating human costs, the Russia-Ukraine conflict is disrupting economic conditions and financial and credit markets--with implications for our credit ratings. Since the conflict began on Feb. 24 and the subsequent imposition of strict sanctions on Russia by the international community, many macroeconomic and credit implications have begun to reshape markets and the international order.

The prices of energy, metals, and food have soared--in some cases to record highs--as sanctions and the conflict itself disrupt the key trade flows of Russia's and Ukraine's oil and gas, palladium and nickel, wheat and corn, and other commodities. Energy supply disruptions have countries (particularly in Europe) scrambling to identify new trading partners to safeguard their energy security and supply chains. Many companies have ended operations or pulled projects in Russia. Both corporations and governments are preparing for a ratcheting up of cyberattacks between Russia and its adversaries. Market participants are concerned about how the conflict will compound persistent inflationary pressures, alter central banks' forthcoming monetary policy changes, and drag on economic growth. As a result, to date, we have taken a substantial number of rating actions on financial and nonfinancial corporations, sovereigns, and international public finance entities in which we cite the Russia-Ukraine conflict, energy prices, or both as direct or indirect factors driving the decision.

Here, we address frequently asked investor questions on the implications of the Russia-Ukraine conflict on ratings actions and the global economy, based in part on the discussion during S&P Global Ratings' March 11 webinar.

Frequently Asked Questions

How will the Russia-Ukraine conflict affect the global economic recovery?

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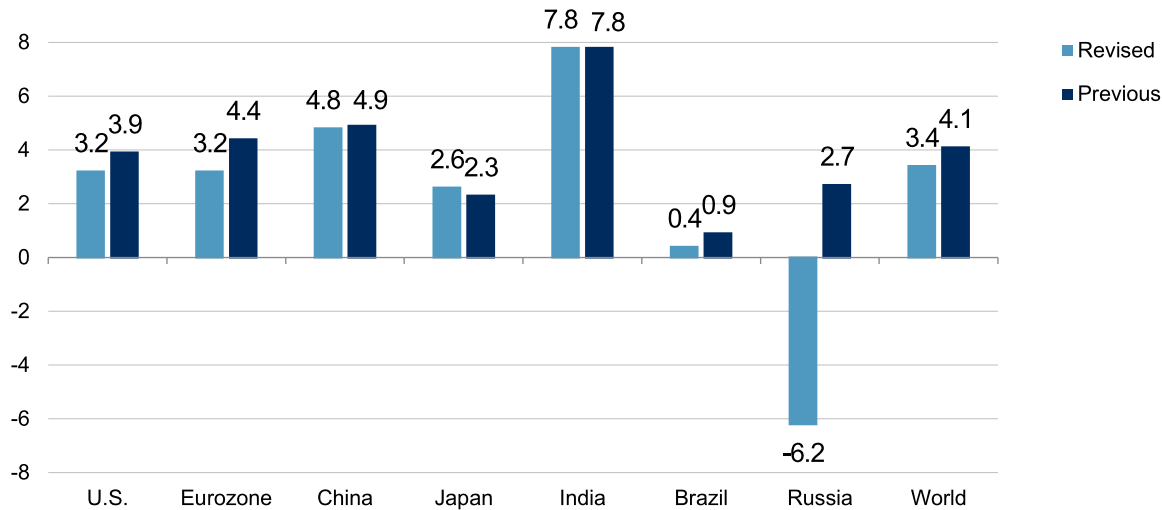
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Chart 1

S&P Global 2022 GDP Growth Forecasts

Source: CEIC, S&P Global Economics, Oxford Economics.

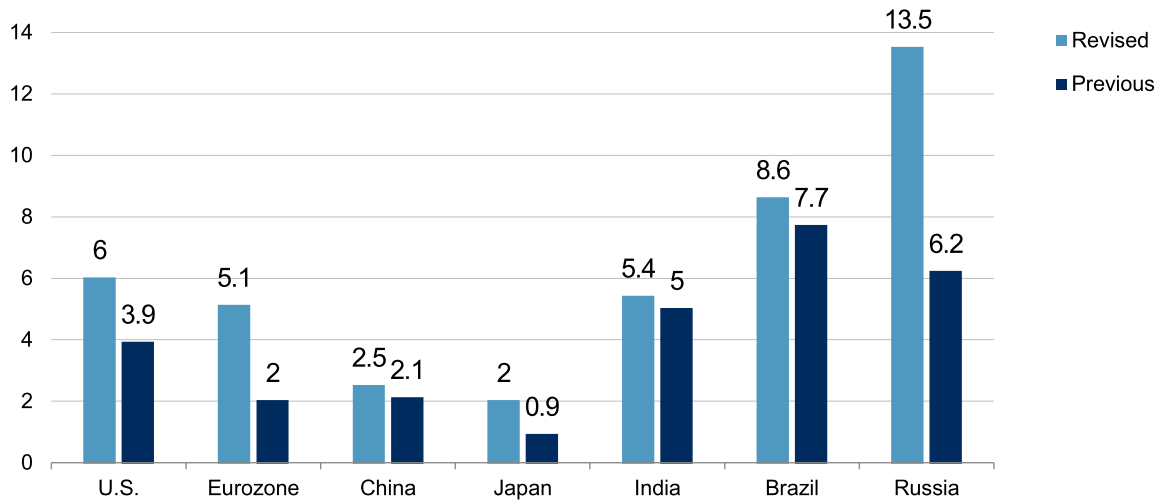
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Before the Russia-Ukraine conflict, global growth was moderately stronger than expected in most major economies because the omicron variant caused little disruption to U.S. activity, labor market outcomes in the eurozone remained robust, and China pushed past sluggish GDP growth at the end of 2021. However, the implications of the conflict and the response of Western governments have prompted changes to our preliminary view--transmitted via higher energy prices, lower Russian growth, a (soon-to-be) higher federal funds rate, and the effects of the hit to consumer confidence, with risks remaining to the downside.

We now believe that global economic growth will fall 70 basis points (bps) short of our previous forecast, to 3.4% this year (see "Global Macro Update: Preliminary Forecasts Reflecting The Russia-Ukraine Conflict," published March 8, 2022). This will largely be driven by a sharp recession in Russia, where we see GDP declining 9% in 2022; the implications of higher energy prices; and policy changes because the U.S. Federal Reserve will normalize monetary policy sooner and faster than originally expected. Europe will be the hardest hit by the economic implications of the military conflict, and we expect the eurozone to decline by 1.2% from our previous forecast this year due to its exposure to Russia and the rise of expensive energy imports. The U.S. will see limited effects, with growth about 70 bps lower, to 3.2%, and most economies across the Asia-Pacific region and emerging markets outside of Eastern Europe will experience only modest changes in their growth and inflation.

Chart 2

2022 Inflation Forecasts: Major Economics



Source: S&P Global Economics, Oxford Economics.

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The conflict is likely to cause a spike in inflation in the next two quarters as energy prices climb, followed by a decline in inflation rates as energy prices drift lower. We believe that credible central banks will be able to look through the short-term energy-driven rise in inflation and that the withdrawal of monetary policy accommodation will continue, albeit at a slower pace.

Which countries are most at risk of significant economic decline from the spillover effects of lower grain production and higher oil prices?

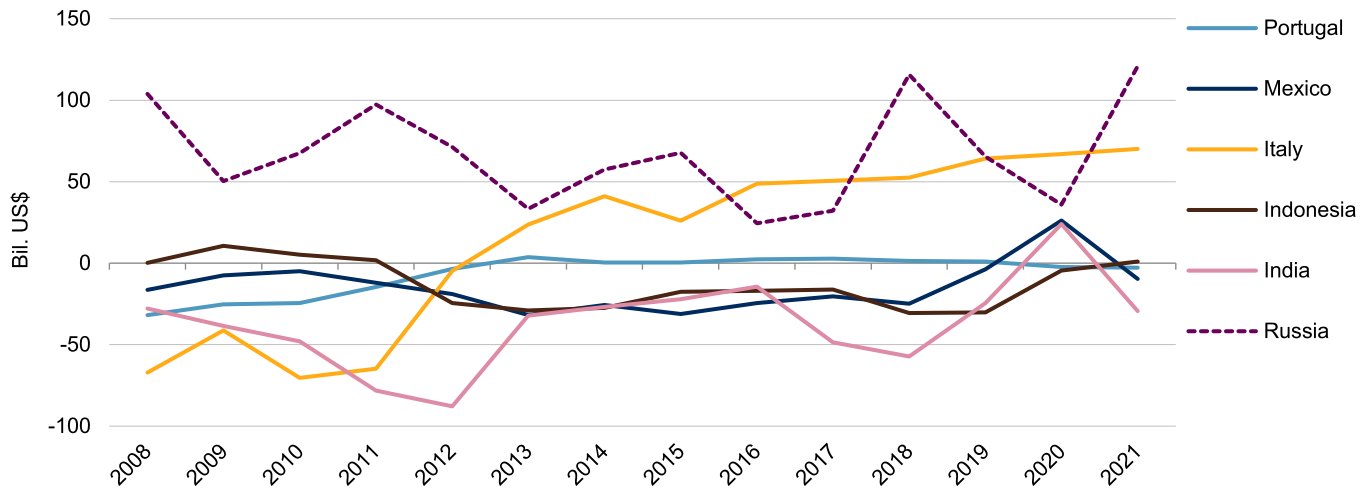
Worldwide, countries with high import dependence on oil and gas from Russia have the greatest risk of economic decline from rising energy prices. In Europe, most Baltic economies and Eastern and Central European countries have high exposure to Russia's gas markets. Asian economies--particularly Thailand, Taiwan, Korea, Japan, and India--have relatively high energy dependence on Russia because most countries in the region are large net energy importers.

Overall, the Russia-Ukraine conflict and its effects will disrupt emerging market economies' (EMs) financing conditions and could prompt investors to reconsider their capital allocations in foreign markets. In the short-term, EMs in Latin America that typically experience economic headwinds from higher hydrocarbon prices will face similar tumult during this situation. Similarly, the conflict's inflationary stresses on food prices, and disruptions to supply at the key point of the crop cycle, are likely to spur food insecurity across EMs, which, in many cases, already suffer from food shortages and may therefore endure resulting social instability in the longer term.

What is the probability, and what are the possible consequences, of Russia defaulting on its foreign debt?

Chart 3

Current Account Balance (Bil. US\$)

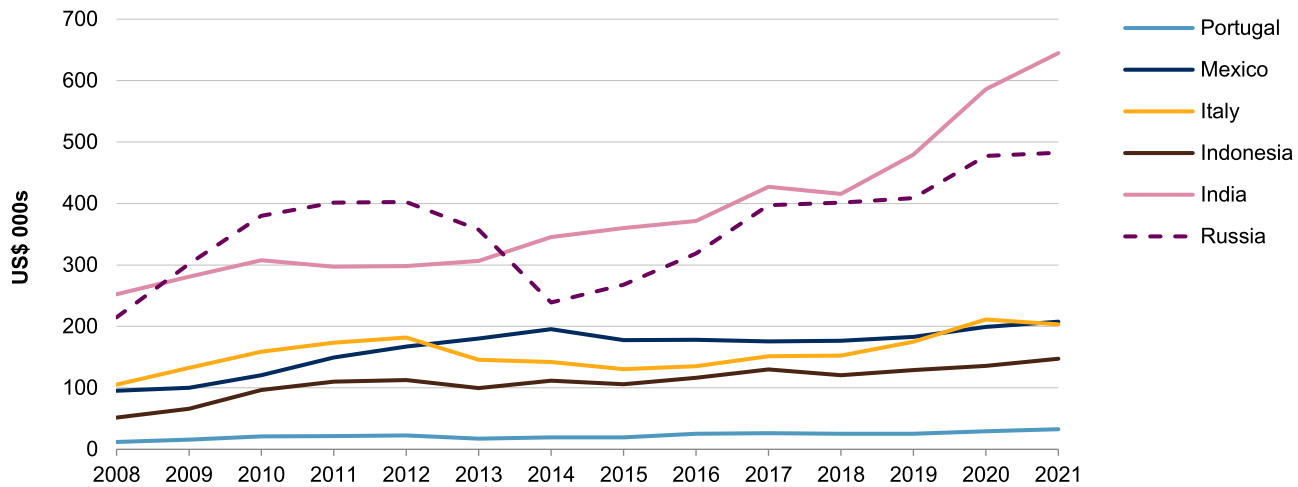


Source: S&P Global Ratings.

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Chart 4

Usable Reserves (US\$ 000s)



Source: S&P Global Ratings.

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Recent sovereign rating actions highlight how the possibility of default is strong. On Feb. 25, we lowered our long-term foreign currency sovereign credit rating on Russia to 'BB+' from 'BBB-' and

our long-term local currency rating to 'BBB-' from 'BBB' and placed them on CreditWatch with negative implications. On March 3, we then lowered our long-term foreign and local currency sovereign credit ratings on Russia to 'CCC-'. On March 17, we lowered our long-term foreign and local currency sovereign credit ratings on Russia to 'CC' from 'CCC-'. For each subsequent rating action, we kept the ratings on CreditWatch with negative implications (see "Research Update: Russia Foreign Currency Rating Lowered To 'BB+' And Put On CreditWatch Negative On Risks Related To Invasion Of Ukraine," published Feb. 25, 2022 and "Research Update: Russia Ratings Lowered To 'CCC-' And Kept On CreditWatch Negative On Increasing Risk Of Default," published March 3, 2022, and "Research Update: Russia Foreign And Local Currency Ratings Lowered To 'CC' On High Vulnerability To Debt Nonpayment, Still On Watch Neg," published March 17, 2022).

Since 2008, after the military conflict between Russia and Georgia and international sanctions were first imposed, Russia has been able to maintain a robust current-account surplus, which in turn has allowed the country to build a strong buffer on external assets of approximately \$500 billion in foreign exchange reserves and an additional \$150 billion in its sovereign wealth fund. Over this time, Russia's fiscal performance, supported by a steady flow of revenue from its hydrocarbon exports, helped it to maintain quite low debt levels and reduce its reliance on external foreign financing. These strong dynamics sustained the country's creditworthiness before the current conflict.

Now, Russia faces consequences never seen at this scale that are disrupting its credit dynamics. The Russia-Ukraine military conflict and its corresponding humanitarian toll have provoked widespread condemnation, involved a broader set of countries in imposing stronger sanctions than ever before, and pushed private sector firms to exit their operations in the country. The sanctions on Russia's foreign exchange reserves have rendered a large share of its strong buffers inaccessible, which has delivered a big blow to the economy and significantly heightened its risk of missing debt payments. Russia's willingness remains the question. As it continues exporting oil and gas, the country is still generating revenue, but stricter sanctions that entirely limit its hydrocarbon trade could curtail this financing avenue.

How is S&P Global Ratings determining a possible event of default during this conflict?

Our ratings focus on an issuer's ability and willingness to meet its financial obligations in full and on time, as well as in accordance with the terms of the obligation, including in the agreed currencies. We generally focus on whether all bondholders have received payment within the applicable grace period. If a payment is made in a currency not stipulated in the terms of the obligation, or in the place or manner prescribed by these terms, and we believe that the investor doesn't agree to the alternative payment, we could deem this a default. We are closely monitoring the development of the conflict and the possibility of additional sanctions.

We see a significant increased risk of default for Russia due to difficulties completing payments, and we will be assessing the upcoming interest and principal payments of U.S. dollar- and euro-denominated Russian sovereign bonds on March 31 and April 4.

Since the Russia-Ukraine military conflict began, we have taken a substantial number of rating actions on financial and nonfinancial corporations, sovereigns, and international public finance public entities in which we cite the Russia-Ukraine conflict, energy prices, or both as direct or indirect factors driving the decision (see "Rating Actions Waypoint: The Russia-Ukraine Conflict As Of March 18, 2022," published March 21, 2022). The ratings of more than 50 utilities and corporations domiciled in Russia have been lowered to the same level as the sovereign, due to our considerations of their ability to serve and repay the outstanding domestic and foreign debt and

the increased risk of default. In addition, the ratings on at least five companies domiciled in Ukraine have been lowered following the downgrade of the sovereign and our revision of the country risk score to 6, from 5.

How has the conflict affected our sovereign rating on Ukraine?

In addition to the devastating humanitarian crisis, the Russia-Ukraine conflict poses serious risks to the latter's financial stability, external position, and public finances. On Feb. 25, we lowered our long-term foreign and local currency ratings on Ukraine by one notch, to 'B-', and placed them on CreditWatch with negative implications. The CreditWatch indicates that we could lower the ratings if multiple uncertainties connected to the conflict were to significantly weaken Ukraine's external liquidity, financial system, or the government's administrative capacity. The government is receiving substantial financial backing from the international community that, for now, supports its creditworthiness at the current level (see "Research Update: Ukraine Long-Term Ratings Lowered To 'B-', Placed On CreditWatch Negative On Fallout From Russia's Military Attack," published Feb. 25, 2022). We are continually assessing the effects of the evolving situation and the broader implications for borrowing conditions, supply chains, and credit quality.

What are the potential sovereign credit implications for Eastern European countries?

While we recognize that the uncertainty of the developing situation makes it difficult to determine what the long-term or permanent credit implications may be, it's important to note that the physical proximity of Eastern European economies like Poland, Hungary, and Romania to the Russia-Ukraine conflict heightens their sovereign credit risks.

In the short-term, the most likely effects for these economies would be felt through trade shocks due to their substantial energy and food import/export relationships with both Russia and Ukraine. This may be offset by the significant amount of international community aid and support currently flowing into Poland and other economies to support their humanitarian efforts during the conflict. As millions flee Ukraine and settle in other neighboring Eastern European countries, such economies, which have faced labor issues from low birth rates and high levels of emigration, could in the medium-term see a boost to their economic prospects as the region seeks stabilization.

What are the implications of the conflict on credit markets regarding investors' activity amid the heightened uncertainty?

Concurrent yet related risks of rising inflation and the conflict are clearly leading to significant global market volatility and while no region remains untouched, the impact varies materially by region. Credit spreads are rising. But the increases are more pronounced in Europe and across Europe, Middle East, and Africa (EMEA) overall, where both risks are having a significant bearing on credit spreads, rather than the U.S., where inflation and the consequential outlook for monetary policy remain the primary drivers. Indeed, investment-grade spreads have widened more in percentage terms than speculative-grade spreads in the U.S. (40% versus 28%, as of March 11) as investor concerns regarding credit pricing rather than credit fundamentals remain the primary focus for now.

Volatility is also stunting global issuance, but this may not be as troublesome as it might have been in the past. Firstly, while issuance has slowed, particularly in recent weeks, it has not

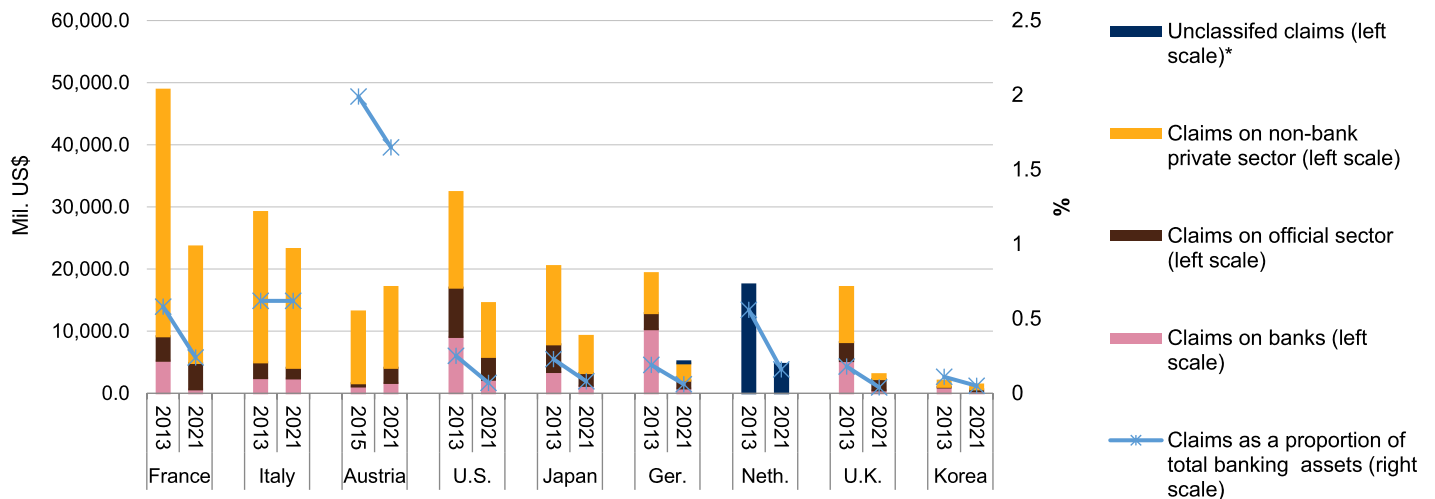
stopped. Bond issuance is down an estimated 30% in the U.S. and Europe, but this follows a record 2021 and Asia Pacific issuance has in fact risen year to date. Secondly, record recent issuance, on the back of extremely benign financing conditions over the past two years, means that the near-term refinancing risk has fallen with companies refinancing, paying down, or otherwise reducing maturities due in 2022 by about 18%.

Regional headwinds are clearly replacing global tailwinds as financing conditions tighten globally, with the extent of the future impact clearly tethered, disproportionately by region, to the outlook and ultimate outcome of these concurrent risks.

What are the financial implications of the conflict for banks that are heavily exposed to these countries?

Chart 5

Foreign Banks' Claims Against Russia By country of foreign bank and type of claim



*The BIS aggregated data for Germany (for 2021) is \$348 million higher than the amounts by type of claim, and the BIS data for Netherlands does not provide a breakdown by type of claim; we have shown these amounts as "unclassified" claims in the chart. Ger.--Germany. Neth.--The Netherlands. Source: BIS consolidated banking statistics, Bank of Japan, S&P Global Ratings estimates. Data is for December 2013 (except Austria: December 2015) and September 2021.
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The conflict and subsequent sanctions may have implications for the financial sector far beyond the battle zone. Thus far, we have taken negative rating actions mainly on financial institutions in Russia, Ukraine, and Belarus, with many of them linked to our downgrades of the sovereigns and our view of the deteriorated operating environment.

Four European banking groups (the Raiffeisen Banking Group, OTP Bank, Société Générale, and UniCredit) have sizable exposure to Russia and Ukraine, but we see this as more meaningful for some than others, and we anticipate that all will be resilient. Direct exposure for other banks in Europe, as well as globally, are limited because foreign banks' exposure in monetary terms and as

a proportion of total assets to Russia fell substantially following the 2014 sanctions in response to Russia's annexation of Crimea. We continue to closely monitor any potential rating effects on these institutions, but we remain mindful of the modest materiality in terms of the groups' total exposure and the ample local deposit funding of the subsidiaries, which historically has held up well in previous times of stress.

We see four main channels of risk for European banks with high exposure to Russia and Ukraine:

- Via their corporate borrowers' trading with Russia;
- The impact on capital markets and wealth management activities, especially if depressed asset values and client confidence durably affect revenue;
- Increasing operational risks of cyberattacks on key infrastructure or legal risks from compliance with sanctions; and
- Lower economic growth, even if we don't expect a massive deterioration in asset quality at this stage under our economists' current projections.

Nevertheless, we remain mindful of the potential for significant second-order effects from the conflict, which could yet lead us to revise our base case assumptions about the operating environment, most obviously in EMEA.

What corporate sectors will be most affected--positively and negatively--by this conflict?

The Russia-Ukraine conflict, and its ripple effects worldwide, will leave winners and losers across sectors and industries, with more of the latter than the former. Very few sectors will benefit from the current situation. Considering Russia's, Ukraine's, and Belarus' significant production of energy, metals and minerals, fertilizer, and agricultural products like wheat and sunflower oil, the global economy will feel the strain of lacking supply due to countries' crucial and complex dependence on such imports to Europe, Asia, EMs, and beyond.

The inflationary effects of the conflict's pressures on energy and food prices are intensifying already-acute pressures from supply-chain interruptions. Accounting for the median change in prices outside of COVID-19-caused disruptions in the past two years, we have seen overall combined prices of technology, precious metals and minerals, forest products, energy, and agriculture already advance by 86% from the end of 2019 to date. Now, the Russia-Ukraine conflict is creating the sharpest price shock of the decade. It's clear that the increase in energy costs is structural and will affect companies' operations and results in the next few years.

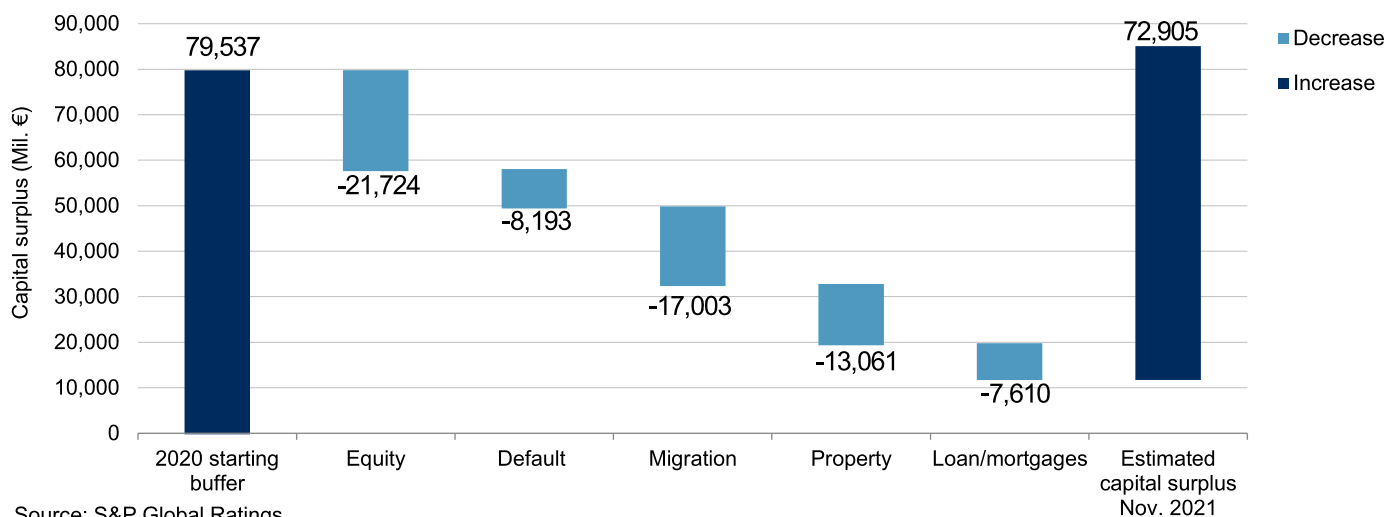
How corporations absorb these costs will be crucial. The previous year saw companies worldwide pass higher costs onto their customers and keep wage inflation down, which delivered record EBIDTA margins in 2021. Even before the conflict began, we believed it would be more difficult for corporations to pass costs on this year, and the conflict is tipping the scales even more. Overall, this year is likely to see slower profit growth and margin erosion.

Meanwhile, certain sectors--particularly defense; energy production, including oil and gas; and part of agriculture--stand to benefit from strong demand, but all will have to process higher costs and, in some cases, structural shortages. for agriculture. Over the longer term, sectors exposed to the energy transition are likely to benefit most from the world order changing because this situation could accelerate the already ongoing energy transition.

How could the Russia-Ukraine conflict affect insurers?

Chart 6

Capital Surplus Almost At Pre-Pandemic Levels



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We have downgraded Russian insurers and placed the ratings on CreditWatch because of their direct asset and liability exposure to the Russian market and because sanctions could erode their profitability and capital positions. Despite our recent actions, we rate Russian insurers two notches above the sovereign because we feel they will fulfill their commitments over the near-term see "Russian Insurers Downgraded On Severely Adverse Macroeconomic Climate," published March 7, 2022).

Many global and, particularly, European insurers and reinsurers have exposure to Russia, but most of those materially less than 1%. But capital market volatility may have significant implications for global insurance providers, since rated insurers are large investors in capital markets. We believe EMEA insurers are most exposed to capital market volatility arising from the Russia-Ukraine situation, particularly because of European dependency on oil and gas and the physical proximity to the conflict. Notably, while European insurers alone have €11 trillion invested in capital markets exposed to the volatility arising from the conflict, rated insurers navigated the storm created by COVID-19 and have since recovered a capital surplus of €74 billion on top of current rating requirements. Of the insurers we rate in EMEA, 69% have an exceptional liquidity position, with more than twice the liquidity required to pass our prospective stress scenarios. The remaining 31% have adequate coverage of above 1x under our prospective stress scenarios.

We see the rated insurance sector having a predominately stable outlook, and we expect this to continue during this new situation, especially since downgrades in the global insurance sector during the coronavirus pandemic haven't been higher than the 10-year average.

This report does not constitute a rating action.

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