Rabobank

Country update **RUSSIA**

Summary

The return of Mr. Putin to the presidency has been marred with controversy and sparked unprecedented massive anti-government street protests. The public finances continue to be in healthy shape, attributable to high oil and gas export revenues. However, the high dependence on the hydrocarbon sector remains a structural weakness of the economy. The external position continues to be in healthy shape, given the continuous and stable current account surpluses averaging 5% of GDP in the past five years, a low foreign debt level of 22% of GDP and favourable liquidity ratio's. Economic growth is forecast at around 3.7% in 2012, which is sound but is nowhere near the average 7% during the pre-crisis boom years of 2001-2007. Economic diversification and a smaller role of the government in the economy are key to increase sustainable long-term economic growth, but no rapid progress is expected in the short-term.

Things to watch:

- Possible escalation of, and the government's response to the street protests Mr. Putin's economic policy, privatization efforts in particular
- Significant and unexpected changes in global oil prices

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Russia

National facts		
Type of government	Federation	
Capital	Moscow	
Surface area (thousand sq km)	17,098	
Population (millions)	141.7	
Main religions	Rus. orthodox (15-20%)	
	Muslim (10-15%)	
Main ethnic groups	Russian (80%)	
	Tatar (4%)	
	Ukrainian (2%)	
Head of State (president)	Vladimir Putin	
Head of Government (PM)	Dmitriy Medvedev	
Monetary unit	Ruble (RUB)	
Economy		**2011**
Economic size	*bn USD*	*% world total*
Nominal GDP	1858	2.69
Nominal GDP at PPP	2386	3.01
Export value of goods and services	576	2.63
IMF quotum (in mln SDR)	5945	2.74
Economic structure	*2011*	*5-year av.*
Real GDP growth	4.3	3.7
Agriculture (% of GDP)	5	4
Industry (% of GDP)	37	36
Services (% of GDP)	59	59
Standards of living	*USD*	*% world av.*
Nominal GDP per head	13133	122
Nominal GDP per head at PPP	16865	136
Real GDP per head	6696	82

Social and governance indicators	rank / total
Human Development Index (rank)	66 / 187
Ease of doing business (rank)	120 / 183
Economic freedom index (rank)	144 / 179
Corruption perceptions index (rank)	143 / 183
Press freedom index (rank)	142 / 178
Gini index (income distribution)	42.27
Population below $1.25 per day (PPP)	2%

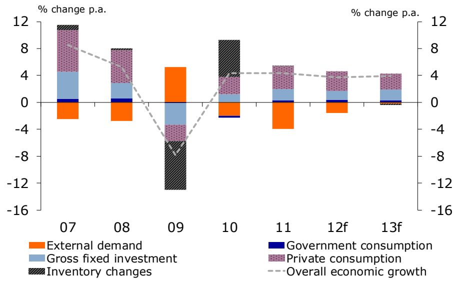
Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Germany	8	Germany	15
Netherlands	7	China	14
China	6	Ukraine	6
Italy	4	US	4
Main export products (%)			
Oil, fuel & gas			69
Metals			11
Chemicals			6
Machinery & equipment			5
Main import products (%)			
Machinery & equipment			45
Chemicals			16
Food & agricultural products			15
Metals			7
Openness of the economy			
Export value of G&S (% of GDP)			31
Import value of G&S (% of GDP)			22
Inward FDI (% of GDP)			2.7

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

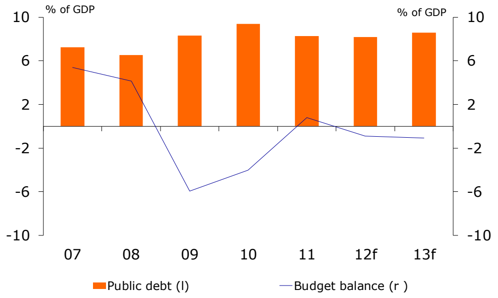
Since our latest country report on Russia, dated December 2011, the most significant change is Mr. Putin's return to presidency and the increased social unrest. While Mr. Putin already increased spending ahead of the elections, and is planning to increase government expenditures further this year, the fiscal position remains in healthy shape. In 2012, the expected budget deficit amounts to only 0.9% of GDP and public debt is low at 8% of GDP. This is mostly attributable to large oil export revenues on the back of high global commodity prices in 1H12. The high and increasing dependency on the oil revenues is a weakness of the economy. The oil and gas sector accounts for around 28% of GDP and 69% of total exports. The government is trying to raise financing via other sources, such as the privatization of state-owned enterprises. However, the privatization process proves difficult and is only a quick-fix solution; broader diversification of the economy is what is needed for higher and sustainable long-term economic growth. We have revised downwards our economic growth forecast of 4.5% in 2012 in our previous report, to 3.7%, since the negative global economic environment weighs on demand for Russia's exports. Although this is still sound, it is nowhere near the average 7% growth rate during the pre-crisis boom years of 2001-2007. The external position continues to be in healthy shape, given the continuous and stable current account surpluses averaging 5% of GDP in the past five years, a low foreign debt level of 22% of GDP, a high import cover ratio of 14 months and other liquidity ratio's also being favourable. In this update, we analyse the impact of the social unrest relating to Mr. Putin's return to presidency and the feasibility of the government's ambitious new privatization program.

Figure 1: Economic growth



Source: EIU

Figure 2: Fiscal balances



Source: EIU

The return of Mr. Putin

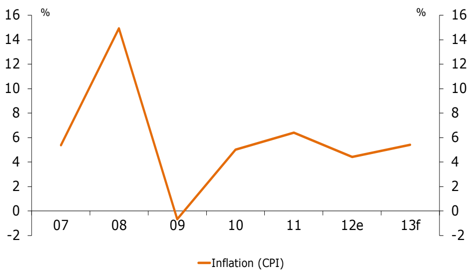
The return of Mr. Putin to the presidency has been marred with controversy. It started in December 2011, with unprecedented mass anti-government street protests after the parliamentary elections. An estimated 50,000 people protested against the results, claiming election fraud. However, the protesters' grievances were bigger than the election fraud alone. They were also protesting against Mr. Putin's United Russia Party (URP), which lost heavily in the elections after its reputation and popularity was tarnished by a series of corruption scandals. As such, the protests were also against Russian corruption in general and, more importantly, against Mr. Putin himself.

The Kremlin responded by cracking down heavily on any protests that followed. Especially the protests on 6 May, one day before the presidential inauguration, became violent, as the police clashed with protesters, which resulted in over 500 arrests. The government continued to impose draconian laws to restrict protests, including issuing fines higher than average annual Russian salaries to protesters and taking down independent media websites. Just before a planned demonstration on 12 June, Russia's National Day, the government raided the homes of opposition figures and called them in for questioning. We expect the tough stance against protests to continue, but it could be that Mr. Putin will try to come up with another way to deal with protests, as the violent crack-downs increase the risk that the opposition might radicalize, while it is also damaging to Russia's international reputation.

Mr. Putin has already experienced that dealing with these protests will be more difficult than during his previous two terms. The protests have shown he has lost a large part of his middle-class support. Also, the success in his previous terms was largely attributable to rapidly increasing oil and gas revenues. To repeat this trick will prove very difficult, as high public spending has already raised oil price needed to break-even the government budget to USD 120 per barrel this year, up from USD 40 in 2007. Furthermore, the high economic growth rate of the past decade is not likely to return. Boosting growth would require governance reform and removal of operational constraints such as corruption, ineffective state administration as well as poor judiciary. Mr. Putin pledged to tackle corruption and improve governance in his pre-election campaign, but it remains unclear how he is planning to do this. In any case, we think it is unlikely that this will occur in the vigorous manner the population desires, as this would directly hit Putin's core support base.
Also, Mr. Putin does not have the strong support from allies in this cabinet as he had previously. The composition of the new cabinet bears all the signs of a compromise between the Putin and Medvedev camps. Almost all of Mr. Medvedev's liberal economic team are still in place, including Igor Shuvalov, a first deputy prime minister; Arkady Dvorkovich, Mr. Medvedev's close ally, who is now deputy prime minister with responsibility for industry; and Anton Siluanov, the finance minister. None of the old KGB officers who previously made-up the core of Mr. Putin's closest

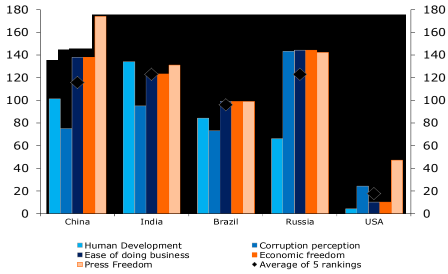
advisers is in the current government. Most notably, Igor Sechin, a former deputy prime minister who was close to Mr. Putin but had a fraught relationship with Mr. Medvedev, is no longer in the government. Mr. Putin has also allowed his former KGB and St Petersburg associates to be ousted. However, he has consolidated his hold over the "power" ministries by naming Vladimir Kolokoltsev as interior minister. Mr. Kolokoltsev is the erstwhile Moscow police chief and has at times used heavy force against protesters.

Figure 3: Banking sector capitalization



Source: EIU

Figure 4: Social governance indicators



Source: UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

We believe Mr. Putin will complete his third term. Even though the demand for change is not expected to evaporate soon, the opposition remains fragmented without a central figure to challenge Mr. Putin. Even so, he will face his toughest term yet.

Will the privatization plans remain just plans or..?

The Russian government has again come up with an ambitious plan for the speedy privatization of state-owned companies. It claims that it will sell assets worth USD 9.3bn this year, which is three times more than it did in 2011. The plan was announced at a cabinet meeting on June 6th, as well as that a new four-year timetable for privatization had been agreed. This year, sales of small stakes in the country's biggest lender Sberbank and the diamond miner Alrosa would help to triple privatization receipts from last year's very low level. However, the Sberbank sale, among others, was abandoned because stock-exchange valuations were too low. The deadline for the sale of a 15% stake in Rosneft, planned for this year, was pushed back to 2016. Also, the government plans to push through a major privatization plan stemming from 2010. So far, the implementation of this plan has been very disappointing, since there has been only one big sale: a minority stake in the country's second-biggest bank, VTB, was sold to financial investors for more than US$3bn in 2011. In the updated version of the 2010 plan, the government promises to sell stakes in a series of important companies by the end of 2013, including the shipper Sovcomflot, the United Grain Company and the high-tech investor Rusnano. The state also intends to sell its stakes in several hundred smaller companies and banks.

However, we have several reasons to believe that the privatization efforts will not go as fast as planned. Russian history has shown that such plans are rife with delays. It appears this will be the case this time as well, given the intense disagreements between the government elite.
Mr. Medvedev wants a bigger and quicker privatization program than Mr. Putin and, for example, insists that Rosneft should be completely taken out of state control by 2016. Furthermore, Andrei Belousov, the economic development minister, also says that the government will sell all of its equity in a string of big state firms by 2016. However, Mr. Putin's return as president means that

the privatization program will likely shrink in both size and scale. In the case of Rosneft, Igor Sechin, until recently the deputy prime minister in charge of the energy sector who is now the new head of Rosneft, opposes the oil giant's privatization. The delays to its sale look like a type of compromise between the rival Kremlin factions that could be repeated, making the ambitious privatization plans unrealistic in the current political setting.

On March 22nd, outgoing president Dmitry Medvedev told the central bank to prepare proposals to cut the government's stake in state banks to below 50%. As well as Sberbank, this would mean selling down the state's 75% stake in the second-biggest bank VTB and its 100% stake in a third banking giant, Rusag, the agricultural bank. There are signs that the Kremlin indeed intends to loosen its grip over banking in the country. In one of his pre-election manifestos, Mr. Putin also said that the state should dispose of all of its stakes in non-raw materials companies by 2016 - that would include the banks. However, these banks have an extraordinary importance to the government, both as a source of stability (after past banking problems scared away depositors from private banks), and as an organ of state policy implementation. Especially since private, including foreign-owned, banks continue to struggle to gain a foothold in a country that remains dominated by state-owned, communist-era, institutions. And there continue to be flagrant examples of these banks being used for political, rather than commercial, lending. Sberbank took part in a USD 1bn loan to a Belarusian company late last year, for example, helping to save an economy (and regime) threatened with collapse as foreign reserves ran low. A USD 2bn loan from VTB helped to shore up Ukraine's wobbly economy. As such, we believe that although Mr. Medvedev's has an apparent desire to give up state ownership of these banks, it is hard to imagine the Kremlin loosen its grip over the banking sector and allowing it complete operational freedom. The government has already postponed the planned sale of a 7.6% stake in Sberbank, the second-largest bank in Europe by market capitalisation, worth close to USD 6bn last September, when a weak stock market made the price too low. The sale would have reduced the state's stake to a bare majority, making talk of the government eventually giving up its controlling share more credible. The postponement of the sale, however, adds to our scepticism about the Kremlin's privatization plans for the banking sector. Taking into account the history of delayed implementation of privatization plans, intense disagreements in the government, and the strategic importance of the banking sector we expect most of the privatization plans to remain just plans in the coming years. Foreign investors will only grow more and more disillusioned with lack of progress in already difficult financial markets as a result.

Russia

Selection of economic indicators	2007	2008	2009	2010	2011	2012f	2013f
Key country risk indicators							
GDP (% real change pa)	8.5	5.2	-7.8	4.3	4.3	3.7	3.9
Consumer prices (average % change pa)	9.0	14.1	11.7	6.9	8.4	4.6	5.9
Current account balance (% of GDP)	6.0	6.2	4.0	4.8	5.5	4.4	2.6
Total foreign exchange reserves (mln USD)	466750	411750	416649	443586	453948	512890	526620
Economic growth							
GDP (% real change pa)	8.5	5.2	-7.8	4.3	4.3	3.7	3.9
Gross fixed investment (% real change pa)	21.0	10.6	-14.4	5.8	8.0	6.0	7.0
Private consumption (real % change pa)	14.3	10.6	-5.1	5.2	6.8	5.6	4.6
Government consumption (% real change pa)	2.7	3.4	-0.6	-1.4	1.5	2.0	2.0
Exports of G&S (% real change pa)	6.3	0.6	-4.7	7.0	0.4	4.9	6.8
Imports of G&S (% real change pa)	26.2	14.8	-30.4	25.8	20.3	13.6	9.4
Economic policy							
Budget balance (% of GDP)	5.4	4.1	-5.9	-4.0	0.8	-0.9	-1.1
Public debt (% of GDP)	7	7	8	9	8	8	9
Money market interest rate (%)	6.9	9.4	15.3	5.6	5.3	5.0	5.1
M2 growth (% change pa)	43	1	18	31	23	22	20
Consumer prices (average % change pa)	9.0	14.1	11.7	6.9	8.4	4.6	5.9
Exchange rate LCU to USD (average)	25.6	24.9	31.7	30.4	29.4	29.5	30.2
Recorded unemployment (%)	6.1	6.4	8.4	7.5	6.6	6.2	5.9
Balance of payments (mln USD)							
Current account balance	77768	103661	49365	71129	101327	89950	57180
Trade balance	130915	179742	111585	151393	198392	190720	160680
Export value of goods	354401	471603	303388	400131	520870	543940	553630
Import value of goods	223486	291861	191803	248738	322478	353230	392950
Services balance	-18888	-24336	-19883	-27300	-37161	-37770	-38600
Income balance	-30752	-48980	-39475	-48373	-56712	-59020	-60610
Transfer balance	-3506	-2765	-2862	-4097	-3193	-3990	-4290
Net direct investment flows	9159	19408	-7166	-9234	9500	9000	17000
Net portfolio investment flows	-30952	-50840	-213	-16561	-32947	-20780	-25180
Net debt flows	103567	46394	-19351	13663	30252	33320	35310
Other capital flows (negative is flight)	15487	-171102	-9472	-19070	-88861	-53260	-70570
Change in international reserves	175030	-52479	13163	39927	19271	58230	13740
External position (mln USD)							
Total foreign debt	361338	402726	373419	384739	418552	447280	481420
Short-term debt	72001	54801	32303	38756	33478	30690	24880
Total debt service due, incl. short-term debt	82099	139920	112659	94579	98624	102450	106580
Total foreign exchange reserves	466750	411750	416649	443586	453948	512890	526620
International investment position	-150600	254794	103431	15680	n.a.	n.a.	n.a.
Total assets	1092180	1010700	1089510	1173180	n.a.	n.a.	n.a.
Total liabilities	1242780	755906	986079	1157500	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	10.1	10.8	9.1	10.2	10.7	9.3	7.4
Current account balance (% of GDP)	6.0	6.2	4.0	4.8	5.5	4.4	2.6
Inward FDI (% of GDP)	4.2	4.5	3.0	2.9	2.7	2.4	2.7
Foreign debt (% of GDP)	28	24	31	26	23	22	22
Foreign debt (% of XGSIT)	80	68	96	79	67	68	72
International investment position (% of GDP)	-11.6	15.3	8.5	1.1	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	18	23	29	19	16	16	16
Interest service ratio incl. arrears (% of XGSIT)	4	4	5	4	2	2	2
FX-reserves import cover (months)	19.9	13.5	19.7	16.6	13.1	13.7	12.7
FX-reserves debt service cover (%)	569	294	370	469	460	501	494
Liquidity ratio	231	192	223	223	211	211	201

Source: EIU