Country report

RUSSIA

Summary

Russia's oil and gas dependent economy has started to recover slowly from the sharp downturn in 2009, with real GDP growth estimated at 4.2% and 4% in the next two years. The government stepped in heavily in 2009 to stimulate the economy and support the financial sector. As a result, the budget balance deteriorated sharply and fell into the red, showing a deficit of 5.9% of GDP in 2009 and 4.8% of GDP in 2010. Although the budget deficit is expected to narrow in the coming years, international oil prices will determine the exact size of the budget shortfall, as Russia's fiscal strength depends on potentially volatile international oil price developments. Inflation, after reaching a record low in July 2010, has started to rise again. Although it remains low by Russian standards at 6.7% in 2010 and 7.8% in 2011, vigilance is called for. Russia's current account is generally in surplus, but this surplus is declining gradually on the back of increasing imports. Russia's external position is sound, partly the due to the country's large amount of FX-reserves (USD 473bn). Even though Russia is rebounding slowly economically, poor governance, weak institutions and endemic corruption continue to undermine the country's potential.

Things to watch:

- International oil and gas prices
- Fiscal policies
- Inflation control

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Russia

National facts	
Type of government	Federation
Capital	Moscow
Surface area (thousand sq km)	17,098
Population (millions)	141.8
Main religions	Rus. orthodox (15-20%)
	Muslim (10-15%)
Main ethnic groups	Russian (80%)
	Tatar (4%)
	Ukrainian (2%)
Head of State (president)	Dmitriy Medvedev
Head of Government (prime-minister)	Vladimir Putin
Monetary unit	Ruble (RUB)

Economy		2009
Economic size	*bn USD*	*% world total*
Nominal GDP	1231	2.14
Nominal GDP at PPP	2110	3.01
Export value of goods and services	345	2.21
IMF quotum (in mln SDR)	5945	2.74
Economic structure	*2009*	*5-year av.*
Real GDP growth	-7.9	7.0
Agriculture (% of GDP)	5	5
Industry (% of GDP)	33	37
Services (% of GDP)	62	57
Standards of living	*USD*	*% world av.*
Nominal GDP per head	8672	95
Nominal GDP per head at PPP	14867	133
Real GDP per head	6100	79

Social and governance indicators	rank / total
Human Development Index (rank)	65 / 169
Ease of doing business (rank)	123 / 183
Economic freedom index (rank)	143 / 179
Corruption perceptions index (rank)	154 / 178
Press freedom index (rank)	140 / 178
Gini index (income distribution)	43.7
Population below $1 per day (PPP)	0.5%

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Germany	10	Germany	14
Netherlands	6	China	14
Turkey	6	Japan	5
Italy	5	Ukraine	5

Main export products (%)	
Oil, fuel & gas	67
Metals	13
Machinery & equipment	6
Chemicals	6
Main import products (%)	
Machinery & equipment	43
Food & agricultural products	18
Chemicals	17
Metals	7
Openness of the economy	
Export value of G&S (% of GDP)	28
Import value of G&S (% of GDP)	21
Inward FDI (% of GDP)	3.0

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

Economic structure and growth

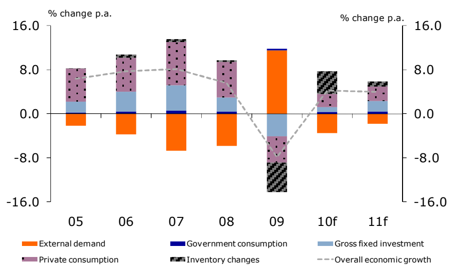
Economically, Russia is the 12th largest country in the world when measured by Nominal GDP (USD), which amounted to USD 1,231bn end-2009. With 141 million inhabitants, GDP per capita amounts to USD 8,672 or 14,867 in PPP terms. The population of Russia is shrinking, as a recent census revealed that the population has decreased from 148 million in 1991 due to an unhealthy life style and alcohol abuse among men specifically.

Although Russia's economy is somewhat diversified, the non-energy sector is largely uncompetitive. Therefore, Russia's economy is highly dependent on commodity production, particularly on the oil and gas sector. The oil and gas sector accounts for around 28% of GDP and 67% of total exports. Gazprom alone accounts for 8% of GDP, 20% of exports and 85% of total Russian gas output. The rebound of oil and gas prices in 2010 has had a positive effect on Russia's overall economic performance. At the same time, falling oil prices pose a downside risk to Russia's economic performance in the coming years.

In the first half of 2010, the Russian economy has started to recover from the deep recession in 2009, in which real GDP contracted by nearly 8%, but Russia lags other emerging markets in that regard. Domestic consumption, supported by falling unemployment and real wage increases, has been an important driver of the 2010 economic recovery, with retail sales and wholesale trade showing strong improvements. In the third quarter, however, growth slowed down markedly from 5.2% year-on-year in the second quarter to a mere 2.7%. The drought and wild-fire affected agricultural output was partly responsible for the slowdown and is estimated to have cost the

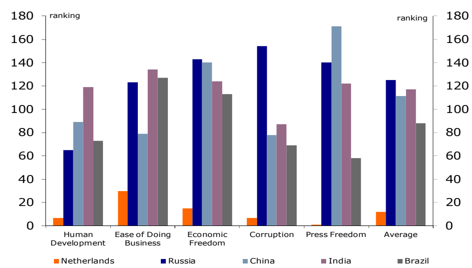
Russian economy 0.5% GDP growth. In addition, industrial production growth slowed from nearly 11% year-on-year in the second quarter to around 6% year-on-year in the third quarter. We estimate that real GDP will grow by 4.2% in 2010. Next year's economic performance will, for a large part, depend on international oil prices. Given the expectation that the global economy will slow, the oil and gas price outlook is subdued. As a result, real GDP growth is estimated to slow to around 4% in 2011.

Chart 1: Growth performance



Source: EIU

Chart 2: Social indicators



Ranking; a higher ranking implies a worse performance. Source: World Bank

The outlook for the Russian banking sector, which is dominated by state-owned banks, has improved somewhat in 2010. The 2009 financial crisis had required massive government and Central Bank support of the banking system. This support is being phased out gradually, but several support measures will remain in place in order to safeguard the recovery. Positive economic growth has and will improve banks' asset quality and profitability. In addition, higher provisions and capital should provide comfort in light of the current weak asset quality. Risks in the Russian banking sector remain high, however, as earnings remain relatively low due to strong competition, risk management is underdeveloped and the regulatory environment is weak.

Political and social situation

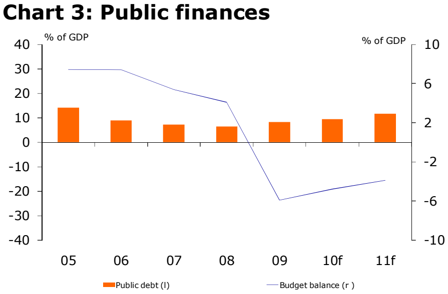
After two terms as president from 2000 to 2008, Vladimir Putin, former head of the internal federal security service, was constitutionally ineligible to run for a third term. In order to remain in a position of power, Putin pushed forward Dmitry Medvedev for the top seat in the 2008 presidential elections and more or less reserved the post of prime minister for himself. Putin is also able to exert his influence as the leader of United Russia, the most powerful party in Russia, which has a pro-Kremlin orientation. As a result, Putin continues to wield considerable power in Russia political decision making process. However, Medvedev, who is somewhat more in favour of modernisation, is not a mere puppet. Rather, the country is governed in a form of dual rule. Although some differences between the two have surfaced, their alliance remains strong and the two leaders stand united in Russia's internal competition for power. The recent dismissal of Moscow's powerful mayor, Yuri Luzhkov by President Medvedev and United Russia's victory in recent local elections, their grip on power has only become stronger. Meanwhile, the opposition remains weak and poses no real factor of power within Russia's political environment. As a result, political stability is strong and no significant change is expected as a result of the parliamentary elections end-2011. Although it is still undecided whether Medvedev or Putin will run for the presidency in the upcoming presidential elections in March 2012, he who runs will most likely win the elections, again with little political change as a result. In spite of Medvedev's calls for modernizing Russia's economy, little progress is expected regarding major structural reforms except perhaps privatization. This is unfortunate, as economic freedom, press freedom, ease of doing business, and governance is poor and a major impediment to the business climate. Corruption in particular is a large problem that is worsening, as indicated by Russia's fall from 146th place to the 154th place on Transparency International's corruption perception index in 2010.

On an international level, Russia is not a member of the WTO, but aims to enhance economic ties with neighboring countries and attract foreign investors. The customs union with Belarus and Kazakhstan is one example of this. Furthermore, the recent opening of a new oil pipeline between Russia and China is a success in this regard, but in general competition for energy export routes has intensified, with the West and Iran looking to gain influence in Central Asian states in an attempt to set up alternative, non-Russian controlled, routes. Another point of concern from a Russian point of view is the Eastward expansion of NATO since the end of the Soviet era. With NATO shelving membership applications from Ukraine and Georgia and the US abandoning its plans for a anti-ballistic missile shield in Poland and the Czech Republic, tensions decreased somewhat.

Economic policy

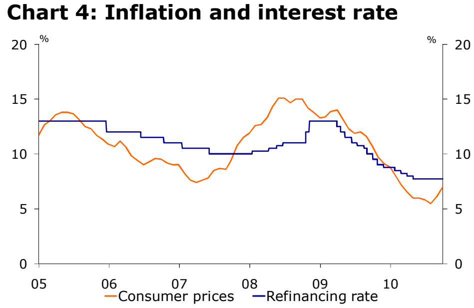
Russia's fiscal accounts have started to deteriorate after massive government stimulus - the third largest in the World - was implemented to counter the sharp economic downturn and financial sector stress in 2009. At the same time revenues declined, as GDP contracted and revenue from the oil and gas sector, which accounts for some 35% of total government revenue, fell on the back of plummeting international oil prices. From a 4.1% of GDP surplus in 2008, the budget balance deteriorated sharply to a 5.9% of GDP deficit in 2009. Given the permanent character of many of the stimulus measures and presidential elections being scheduled for 2012, withdrawal of the stimulus measures will present a challenge. Therefore, the oil price will determine the exact size of the budget deficit. In the past years, the oil price needed to balance the budget has risen from 23 USD/bbl in 2007 to 108 USD/bbl in 2010. As the oil price averaged 78 USD/bbl in 2010 (up to mid-November), a budget deficit of 4.8% of GDP is estimated this year. Due to the budget shortfalls, public debt is increasing by around USD 50bn a year, but remains relatively low at 10% of GDP in 2010 and 12% of GDP in 2011 overall. Moreover, with total public debt amounting to USD 150bn in 2010 and FX-reserves standing at USD 473bn, the government has a comfortable net creditor position. Furthermore, the public debt is well structured, with long maturities and maturing public debt will amount only to 0.7% of GDP in 2010. It is also comforting that the Russian government returned to the international capital markets with a USD 5.5bn bond issue in April this year, after having been absent since 1998. Including quasi-sovereign debt would sharply increase the public debt level, although not to unmanageable levels. On the medium term, keeping fiscal spending in check will be an important challenge for the Russian government to preserve fiscal stability, especially in case oil prices disappoint in the future.

Chart 3: Public finances



Source: EIU

Chart 4: Inflation and interest rate



Source: Reuters EcoWin

In July 2010, year-on-year inflation hit a record low of 5.5% due to the existing output gap, a result of the sharp economic contraction in 2009, and the strengthening of the ruble. However, inflation has started to rise again since. Especially food prices rose sharply in the third quarter due to the adverse effect of the severe summer drought on agricultural output. Even so, the 6.7% consumer price increase that is estimated for the whole of 2010 is low by Russian standards, as inflation averaged 11.4% from 2005 to 2009. Hence, the Russian central bank still finds that inflation risks are acceptable, and has kept its main policy rate, the refinancing rate, at 7.75% since June 2010. Before, the refinancing rate had been lowered from 13% in April 2009 to the current level against the backdrop of the (global) economic crisis. The inflation outlook foresees inflation increasing to around 8% in 2011. Russia's historically high inflation volatility continues to undermine local currency saving and available financing, the latter being named as second-most-problematic factor for doing business in Russia - after corruption - in the World Forum's global competitiveness index.

The Russian ruble exchange rate is managed by the Central Bank of Russia. Officially, the ruble is allowed to trade in a band between 24 and 41 against a 55% USD/ 45% EUR basket, but in practice the Central Bank implements a more pragmatic approach. Against the US dollar, the ruble has remained fairly stable at around 30 RUB/USD, but has depreciated some 11% against the euro since end-May due to increased imports, increased capital flight and higher FX-holdings of local banks.

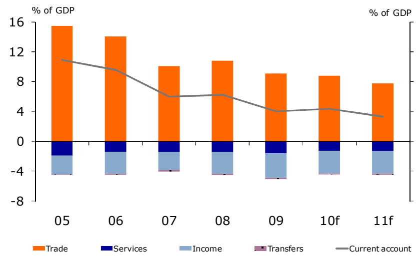
On the longer-term, Russia should seek to improve its institutional quality, as weak institutions hamper the investment climate and impede on economic freedom. In addition, pension system reform, higher taxes and improved tax collection would improve Russia's fiscal strength. Furthermore, Russia's economy has to become more competitive, and move away from raw material production. Privatization could help in this regard, and the government's renewed interest in privatizing some 5500 state-owned enterprises, among which airline company Aeroflot, is therefore a hopeful sign. As mentioned, Russia's population is declining. Moreover, the population is aging as well. This implies that the fiscal costs related to health care and pensions will increase in the years ahead, while the labor force shrinks and, hence, the burden per worker increases. Eventually, this could lead to an necessary increase of the retirement age and immigration will be needed to cover for domestic labor shortfalls. To prevent the impact, the Russian government is actively, yet unsuccessfully, promoting large families and a healthy life style to limit the effect in the long-run.

Balance of Payments

Russia's exports are undiversified and rely heavily on oil and gas exports (67% of total exports) and the export of metals (13% of total exports). Driven by these commodity exports, however, Russia's trade balance has shown a healthy surplus year after year. In the past 5 years, as import growth outpaced export growth, the trade surplus has started to narrow. Russia's current account balance has, due to the large surplus on the trade balance, also been in surplus since 1999, averaging 9.5% of GDP from 1999-2009. In 2010, the current account surplus will widen slightly to 4.3% of GDP from4% in 2009. Thereafter, in line with the smaller trade surplus and also due to an increasing deficit on the income balance, the current account surplus will narrow gradually to 3.3% in 2011 and 2.6% in 2011.

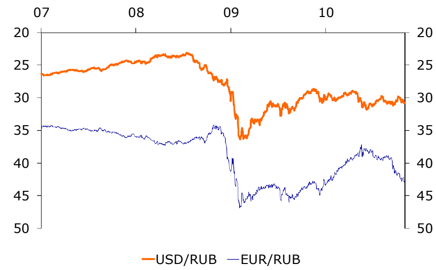
FDI inflows have recovered strongly from USD 37bn in 2009 to USD 50bn in 2010, of which about half is destined for the oil and gas sector. As a result, and because net FDI outflows fell by USD 10bn, net FDI flows improved from a USD 8bn net outflow to a net inflow of USD 14bn. In this figure, the anticipated increase of FDI inflows in 2011-2012 related to the government's planned privatization efforts is not yet taken into account. Net portfolio outflows nearly doubled to an estimated USD 5.2bn in 2010, which is still only 10% of the USD 50bn net outflow witnessed in 2008.

Chart 9: Current account



Source: EIU

Chart 10: Exchange rate



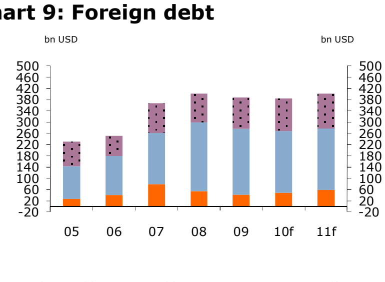
Source: Reuters EcoWin

The risk of a sudden reversal of capital inflows pose a downside risk to Russia's economy and the health of the external accounts, as Russia is prone to capital flight in times of economic stress. In the past months, as the economic performance disappointed in the third quarter and inflation was rising, capital inflows started to increase. As a result, capital flight is expected to increase from USD 13bn in 2009 to USD 22bn in 2010 and then double to USD 40bn in 2011. Nevertheless, FX-reserves will continue to increase to USD 473bn end-2010 and further to USD 504bn end-2011.

External position

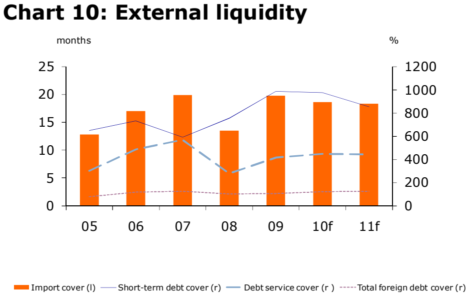
Russia's external position is good. First of all, with total external debt amounting to USD 385bn end-2010 and FX-reserves at USD 504bn, Russia is a net external creditor. The overall level of external debt, most of which private sector debt, is also relatively low at 24% of GDP and debt service is manageable at 21% of total export receipts. Furthermore, short term debt amounts to only 12% of total external debt. Moreover, the high level of FX-reserves offers ample cover against external events, covering over 18 months of imports and some 450% of debt service. Finally, due to the current account surplus and the high level of FX-reserves, the external liquidity ratio stands at above 200%.

Chart 9: Foreign debt



Source: EIU

Chart 10: External liquidity



Source: Covers offered by official FX-reserves, EIU

Russia

Selection of economic indicators	2005	2006	2007	2008	2009	2010f	2011f
Key country risk indicators							
GDP (% real change pa)	6.4	7.7	8.1	5.6	-7.9	4.2	4.0
Consumer prices (average % change pa)	12.7	9.7	9.0	14.1	11.7	6.7	7.8
Current account balance (% of GDP)	10.9	9.6	6.0	6.2	4.0	4.3	3.3
Total foreign exchange reserves (mln USD)	175891	295568	466750	411750	416649	473280	504260
Economic growth							
GDP (% real change pa)	6.4	7.7	8.1	5.6	-7.9	4.2	4.0
Russia, Gross fixed investment (% real change pa)	10.6	18.0	21.1	10.4	-15.7	4.0	8.0
Russia, Private consumption (real % change pa)	11.2	11.2	13.8	10.7	-7.6	3.8	4.1
Russia, Government consumption (% real change pa)	1.3	2.4	3.7	2.9	2.0	2.0	2.5
Russia, Exports of G&S (% real change pa)	6.5	7.3	6.3	0.6	-4.7	4.7	4.6
Russia, Imports of G&S (% real change pa)	16.6	21.3	26.6	15.2	-30.4	15.8	9.5
Economic policy							
Budget balance (% of GDP)	7.5	7.4	5.4	4.1	-5.9	-4.8	-3.9
Public debt (% of GDP)	14	9	7	6	8	10	12
Russia, Money market interest rate (%)	6.2	6.3	6.9	9.9	15.3	6.5	6.5
M2 growth (% change pa)	39	49	48	2	16	24	21
Consumer prices (average % change pa)	12.7	9.7	9.0	14.1	11.7	6.7	7.8
Exchange rate LCU to USD (average)	28.3	27.2	25.6	24.9	31.7	30.0	30.5
Recorded unemployment (%)	7.6	7.2	6.1	6.4	8.4	7.9	7.5
Balance of payments (mln USD)							
Current account balance	83348	94686	77768	103722	48971	68850	56580
Trade balance	118266	139269	130915	179742	111585	139370	133970
Export value of goods	243569	303550	354401	471603	303388	376710	393350
Import value of goods	125303	164281	223486	291861	191803	237340	259390
Services balance	-14751	-13614	-18888	-24313	-19875	-20100	-22590
Income balance	-19043	-29432	-30752	-48943	-40235	-47800	-52100
Transfer balance	-1125	-1537	-3506	-2765	-2503	-2630	-2700
Net direct investment flows	119	6551	9159	19408	-8158	14000	12000
Net portfolio investment flows	-22412	-1623	-30952	-50840	-2759	-5260	-17530
Net debt flows	38274	37252	110482	12792	-11652	1580	22770
Other capital flows (negative is flight)	-41630	-15374	8572	-137561	-13239	-22060	-40940
Change in international reserves	57699	121492	175030	-52479	13163	57110	32870
External position (mln USD)							
Total foreign debt	229911	250747	368075	402453	387698	384730	402470
Short-term debt	27131	40453	79106	54655	42294	48590	59220
Total debt service due, incl. short-term debt	58585	60631	82264	147044	100124	105780	113470
Total foreign exchange reserves	175891	295568	466750	411750	416649	473280	504260
International investment position	-31448	-38543	-150220	255474	118385	n.a.	n.a.
Total assets	516412	731590	1092560	1011380	1109160	n.a.	n.a.
Total liabilities	547860	770133	1242780	755906	990775	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	15.5	14.1	10.1	10.8	9.1	8.8	7.7
Current account balance (% of GDP)	10.9	9.6	6.0	6.2	4.0	4.3	3.3
Inward FDI (% of GDP)	1.7	3.0	4.2	4.5	3.0	3.2	3.0
Foreign debt (% of GDP)	30	25	28	24	32	24	23
Foreign debt (% of XGSIT)	79	68	82	68	100	77	78
International investment position (% of GDP)	-4.1	-3.9	-11.6	15.3	9.6	n.a.	n.a.
Debt service ratio (% of XGSIT)	20	16	18	25	26	21	22
Interest service ratio incl. arrears (% of XGSIT)	4	4	4	4	2	2	2
FX-reserves import cover (months)	12.8	17.0	19.9	13.5	19.7	18.6	18.3
FX-reserves debt service cover (%)	300	487	567	280	416	447	444
Liquidity ratio	199	226	231	189	223	216	212

Source: EIU