

Regional outlook

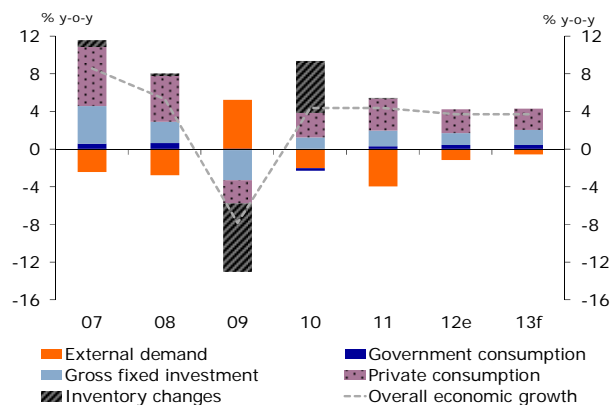
The outlook for economic growth in Russia and the CIS region for 2013 is mostly unchanged from our 2012 estimates. We discuss the economic policy options to boost economic growth next year. However, the uncertain global economic back-drop poses a significant downside risk to our forecast.

Russia's economic growth boosted by economic policy?

Russia's economic growth is estimated at 3.8% in 2012. In the strong 1H12, growth was boosted by government's pre-election spending and strong consumer demand. However, in 2H12 we estimate that growth will slow as the government's pre-election spending spree is over. Furthermore, a hike of utility prices in July and the drought and wildfires this summer, which severely affected the 2012 grain harvest, will boost inflation and decrease domestic consumption. As such, we estimate inflation to average 5.3% in 2012, and rise to 6.5% in 2013. For 2013, we forecast economic growth to remain stable at a moderate 3.9%.

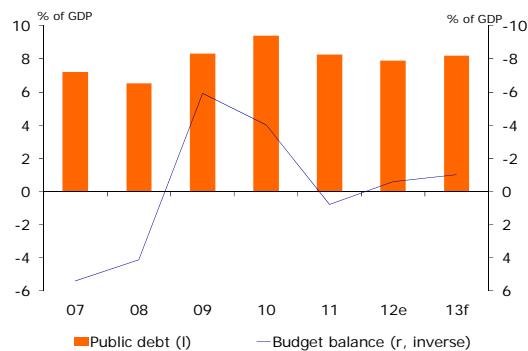
If Russia's economic policy regarding its ambitious privatization plan introduced in 2012 is successful, the subsequent additional government revenues could increase spending and boost growth above our forecast. The privatization plans are mostly for state-owned banks and companies in non-strategic sectors. However, the progress on privatization has been very slow so far, and we do not expect this to pick up soon. Especially as Russian history has shown that such plans are rife with delays and the current government elite continues to disagree on the size and scale of these plans. Fiscal policy is not likely to boost growth either, since the 2013 draft budget will actually remain mildly restrictive. The main departure from previous years is that the budget calculations are based on a formal restriction on the use of oil and gas revenue. The oil price ceiling is fixed at USD 91 per barrel for 2013. All revenue arising from prices above this ceiling will be set aside in a special fund. By contrast, the current 2012 budget projection is based on an oil price of USD 115 per barrel, which is too optimistic,

Figure 1: Russian economic growth (%)



Source: EIU

Figure 2: Russian fiscal position



Source: EIU

Outlook 2013: Russia and CIS

and it is likely the 2012 budget will record a deficit if spending is not adjusted. The proposed restriction on the budgetary use of oil revenue is significant in revenue terms, but it does little to reduce the dependency on oil revenue.

Depending on commodity exports

Not only Russia depends too heavily on energy exports, Azerbaijan and Kazakhstan as well. Structural reforms to diversify these economies away from the hydrocarbon sector are necessary to sustainably increase economic growth in the longer term. Economic reforms to improve the domestic economy are also necessary in Ukraine and Uzbekistan to reduce dependence on commodity exports. Figure 3 shows the region's main export products.

Our baseline assumption for global oil prices is that downside risks prevail in 2013 as the global economy is forecast to show tepid growth next year. Since we forecast subdued growth in the US and Europe and a soft landing in China, external demand for Russia and CIS' hydrocarbon exports is likely to weaken. From the supply side, we see an upside risk from a possible escalation of the regional tensions in the Middle East. The conflict in Syria and the tension between Israel and Iran are not likely to be resolved in the short-term. An escalation of either conflict would constrain oil production and push up global oil prices. However, the risk of an escalation is small, and the peak of the social unrest has passed in most other oil-producing Middle Eastern countries.

In Azerbaijan, oil exports constitute a large 94% of the country's total exports and economic growth averaged a high 12.5% during 2007-2010, which was attributable to large and growing oil exports. Economic growth slowed markedly in 2011 to 0.1% as oil production plateaued, which only highlights the country's overdependence on the hydrocarbon sector. Kazakhstan's main export product is

Figure 3: Russia and CIS main exports

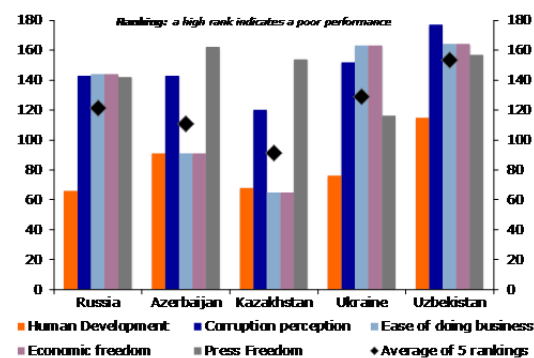
	Main export products	Major export partners
Azerbaijan	Petroleum product, food products, metals	Italy, US, Israel, Russia
Kazakhstan	Oil and oil products, metals, chemicals	China, Italy, Russia, France
Russia	Oil, fuel & gas, metals	Italy, Germany, Turkey, Netherlands
Ukraine	Non-precious metals, food, beverages and agricultural products	Russia, Turkey, China, Kazakhstan
Uzbekistan	Energy, gold, cotton	Russia, Turkey, China, Kazakhstan

Source: EIU

Outlook 2013: Russia and CIS

oil as well, and its second largest export products are minerals and ferrous metals. Kazakhstan's economy is therefore highly dependent on extractive industries and on the oil sector in particular, which accounts for 60% of total

Figure 4: Russian and CIS social and governance indicators



Source: EIU

exports and more than 25% of GDP. Ukraine and Uzbekistan have more diversified commodity export baskets than Russia, Kazakhstan and Azerbaijan. Besides re-exported natural gas from Russia, Uzbekistan exports gold and cotton. It is in fact the world's second largest cotton exporter and is gradually diversifying agricultural exports towards high value fruits and vegetables. Ukraine is the only net energy importer in the region, but also a large steel and wheat exporter.

Economic diversification efforts hamper

However, we do not envisage any significant reforms to diversify the CIS economies to materialize in 2013, due to lackluster attempts

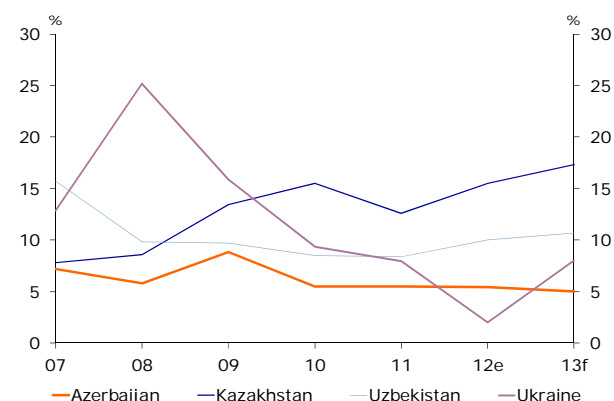
at progress on any economic reform in the region. Azerbaijan's government has made only limited progress on instituting infrastructural and market-based economic reforms in past years. Pervasive public and private sector corruption and structural economic inefficiencies remain a drag on long-term growth, particularly in non-hydrocarbon sectors. In 2013, oil exports through the Baku-Tbilisi-Ceyhan Pipeline remain the main economic driver while efforts to boost Azerbaijan's gas production are underway. Meanwhile, Kazakhstan's government has embarked on an ambitious diversification program, aimed at development of transport, pharmaceuticals, telecommunications and food processing industries. However, diversification efforts have not been as fast as expected and are undermined by symptoms of Dutch disease, which makes the non-oil and gas tradable sectors uncompetitive internationally. Also, a weak infrastructure and unreliable electricity network undermine the country's economic potential.

In Uzbekistan, the government has made some strides in economic diversification by expanding its industrial base, when it landed a significant US investment in the automotive industry in 2011. The government has also recently announced investments in infrastructure construction and a fresh round of privatizations. However, the short-term effects are not likely to be substantial and these programs are not likely to be pushed through swiftly, as the government is keen on continued development of the hydrocarbon sector to become a long-term source of economic growth. Overall, the export sector remains the largest growth contributor in the coming years. Elevated cotton and gold prices will further ensure that the export sector will remain a key growth driver in 2013. Although Ukraine had expanded its heavy industry in the past; widespread

Outlook 2013: Russia and CIS

resistance within the government halted any significant reform after the country's independence in 1991. Since then, reforms to improve the domestic economy have been lackluster. Economic activity is mostly buoyed by the country's exports.

Figure 5: CIS inflation



Source: EIU

Inflation expected to rise

As in Russia, inflation is expected to rise in the short-term in the CIS countries, apart from Uzbekistan. In Kazakhstan, policy rates are at an historic low, after inflation had fallen sharply after the global financial crisis ensued in 2008. In Azerbaijan, inflation is low at an average of 1.1% in 2012, but is expected to rise in 2013 as domestic demand is expected to pick up while food prices remain elevated. In Ukraine, inflation has been rising in 2012 due to pre-election spending of the government and rising food costs. In 2013, inflation is forecast to average 8%, due to rising food

prices. A high import bill has caused an acute need for external financing, which will remain an issue for Ukraine in the short term. This sets Ukraine apart from Russia and the remaining CIS countries, which have amassed a large level of FX-reserves, due to their energy exports, resulting in strong external positions. As such, if global investor sentiment turns sour in 2013, this could affect Ukraine the most of the countries in the CIS region. Russia and the other CIS countries will also be adversely affected when things go awry in the world economy, as this scenario bodes ill for global oil prices as well.

Global economy clouds outlook

The uncertain global economic backdrop poses a large downside risk to our economic growth forecasts, especially the struggling US economy, the continuing eurozone peripheral debt crisis and the possible slowdown in China. The US, China and larger eurozone countries such as Italy, France and Germany are the largest export markets of Russia and the CIS countries. If the growth slowdown in these economies deteriorates and even results in a protracted global slowdown, this would result in lower commodity prices and adversely affect the Russian and CIS economies. Furthermore, the CIS economies would receive fewer remittances from Russia, which has supported to economic growth in previous years.

Trade agreements a boost?

Trade with Europe could develop further, since Russia has formally joined the WTO this year and Kazakhstan is in negotiation to join. However, this is unlikely to benefit trade in 2013 substantially, since Russia's membership will have little

Outlook 2013: Russia and CIS

immediate impact on exports. Furthermore, Russia is spearheading intra-regional trade and economic co-operation via the Eurasian Economic Community (EurASEC). The current members are Russia, Belarus, Kazakhstan, Kyrgyzstan and Tajikistan. However, progress in this customs union is slow, as a EurASEC summit in the summer of 2012 made clear that an agreement on an economic union is unlikely to be made by 2015. Part of the slow progress is due to fear of the CIS countries of the next step, an economic and political union dominated by Russia. Hence, Uzbekistan left EurASEC in 2008 and for Azerbaijan, trade with Russia and the other former Soviet republics is declining in importance, as it is building trade relations with Turkey and the nations of Europe. As such, no boost from intra-regional trade is expected for the region in 2013.

Growth outlook in selected CIS countries

In Azerbaijan, we forecast a 2.2% GDP growth in 2013. In Kazakhstan, we forecast moderate growth of 5.1%, supported by increasing oil, gas and mineral output, and the government's investment program. In the Ukraine, and high global steel prices pushed the average real economic growth rate to 7.1% in the period of 2001-2008. As a result of the global financial crisis, steel prices collapsed and the economy contracted by a large 15% in 2009, and the Ukraine economy continued to struggle since and will grow by only 2.9% in 2013. For Uzbekistan, the export sector will continue to boost growth to 6.7% in 2013, on the back of continued energy sector investments and cotton exports.

Conclusion

Overall, economic growth for the region will not significantly change in 2013 as compared to 2012. For Russia, Azerbaijan and Ukraine we expect slightly higher growth and slightly lower growth in Ukraine and Kazakhstan. An upside risk to this forecast is swift implementation of the announced economic reform plans to develop the domestic economies, but these are unlikely to materialize quickly. As the region is abundant in natural resources, these countries depend highly on commodity exports. As such, a significant downside risk to our economic growth forecast is the uncertain global economic backdrop. The largest export markets of Russia and the CIS countries are the US, China and larger eurozone countries, which all face difficult economic situations. No boost from intra-regional trade can either be expected in 2013, while rising inflation will not easily allow monetary loosening.

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Outlook 2013: Russia and CIS

Data tables

Economic growth (Real GDP % change pa)							
	2007	2008	2009	2010	2011	2012e	2013f
Azerbaijan	25.0	10.8	9.3	5.0	0.1	1.1	2.2
Kazakhstan	8.9	3.3	1.2	7.3	7.5	5.8	5.1
Russia	8.5	5.2	-7.8	4.3	4.3	3.8	3.9
Ukraine	7.9	2.4	-14.8	4.2	5.2	2.0	2.9
Uzbekistan	9.5	9.0	8.1	8.5	8.3	7.1	6.7

Source: EIU

Budget balance (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
Azerbaijan	-2.3	-9.5	-14.5	-15.1	-19.1	-20.8	-20.4
Kazakhstan	-1.7	-2.0	-3.0	-2.5	-2.1	-2.6	-1.8
Russia	5.4	4.1	-5.9	-4.0	0.8	-0.8	-1.0
Ukraine	-1.1	-1.5	-4.8	-6.0	-4.0	-3.8	-3.0
Uzbekistan	2.7	1.5	0.2	0.3	0.4	-0.2	-0.2

Source: EIU

Public debt (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
Azerbaijan	7.2	5.8	8.8	5.5	5.5	5.4	5.0
Kazakhstan	7.8	8.6	13.5	15.5	12.6	15.5	17.3
Russia	7.2	6.5	8.3	9.4	8.3	8.1	8.4
Ukraine	12.3	20.0	34.8	39.9	35.9	38.8	38.5
Uzbekistan	15.7	9.8	9.7	8.5	8.4	10.0	10.7

Source: EIU

Consumer prices (% change pa, average)							
	2007	2008	2009	2010	2011	2012e	2013f
Azerbaijan	16.7	20.8	1.5	5.7	8.1	1.9	2.3
Kazakhstan	10.8	17.1	7.3	7.1	8.3	5.2	7.0
Russia	9.0	14.1	11.7	6.9	8.4	5.3	6.5
Ukraine	12.8	25.2	15.9	9.4	8.0	2.0	8.0
Uzbekistan	12.3	12.7	14.1	9.4	12.8	12.5	11.0

Source: EIU

Current account balance (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
Azerbaijan	27.3	33.7	23.0	29.0	29.7	19.2	21.1
Kazakhstan	-8.1	4.7	-3.7	1.7	7.7	6.5	4.4
Russia	6.0	6.2	4.0	4.8	5.4	4.4	2.8
Ukraine	-3.7	-7.1	-1.5	-2.2	-6.2	-5.3	-4.9
Uzbekistan	7.3	8.6	2.6	6.8	7.4	6.6	5.4

Source: EIU