Country report **RUSSIA**

Summary

The Russian economy remains too reliant on its oil and gas sector while corruption remains deeply embedded. The biggest change since our May 2011 update is the announcement that PM Putin will run for president, while he has requested incumbent president Medvedev to become the Russian PM. Since this swap was widely expected, political stability will not be significantly affected. However, the firing of pro-reform Finance Minister Kudrin is unfortunate, as concerns about the pace of economic reform are rising and could hurt investor sentiment and the government's fiscal position. While the current account records small surpluses, the export basket remains undiversified. Accumulated revenues from hydrocarbon exports and a low level of foreign debt result in a very healthy external position. In 2011, the economy is estimated to grow by a moderate 4% while inflation is expected to average a high 9%.

Things to watch:

- Progress on economic reform
- Putin's new government policy
- Upward inflationary pressures

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Russia

National facts	
Type of government	Federation
Capital	Moscow
Surface area (thousand sq km)	17,098
Population (millions)	141.9
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 (PM)	Vladimir Putin
Monetary unit	Ruble (RUB)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	1479	2.37
Nominal GDP at PPP	2226	2.98
Export value of goods and services	445	2.39
IMF quotum (in mln SDR)	5945	2.74
Economic structure	*2010*	*5-year av.*
Real GDP growth	4.0	4.1
Agriculture (% of GDP)	4	5
Industry (% of GDP)	37	36
Services (% of GDP)	59	58
Standards of living	*USD*	*% world av.*
Nominal GDP per head	10440	106
Nominal GDP per head at PPP	15709	133
Real GDP per head	6388	80

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)	43.675
Population below $1.25 per day (PPP)	0.02

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Italy	12	Germany	14
Germany	5	China	13
Netherlands	4	Ukraine	5
China	3	US	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)			30
Import value of G&S (% of GDP)			22
Inward FDI (% of GDP)			2.8

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

Economic structure and growth

When measured in nominal GDP, which amounted to USD 1,479bn end-2010, Russia is the 12th largest country in the world. With 142 million inhabitants, GDP per capita amounts to USD 10,440 or USD 15,709 in PPP terms. The population of Russia is shrinking, as a census revealed that the population has decreased from 148 million in 1991 due to an unhealthy life style and alcohol abuse among men specifically.

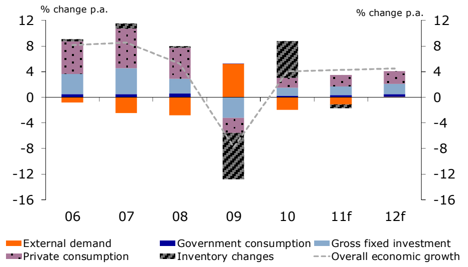
The business environment is hampered by a multitude of factors. Anecdotal evidence indicates that while foreign workers are appreciated for their skills and experience, the overall attitude is that they should be grateful to Russia for the opportunity to come and make money. The Russian labor force is skilled, but there are shortages in banking and other professional services, and unemployment is elevated at 7% of the labor force. While the level of infrastructure varies throughout the country, the roads are generally poor. Corruption is deeply embedded in Russia and is a widespread problem.

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 and 2011 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. Oil, fuel, gas and metals are Russia's main export products and Italy and Germany are the country's main export partners.

Economic growth rebounded in 2010 to 4% after the contraction of 7.8% in 2009. It is estimated to end at 4.3% in 2011, which is underpinned by the windfall gains from higher oil prices, a return to a normal harvest after a drop in agricultural output last year which had cost the economy 0.5% of GDP growth, stronger consumption supported by rising wages and pensions and a recovery in credit growth. Downside risks to this estimate are a weakening global economic activity, heightened risk aversion and a decline in commodity prices.

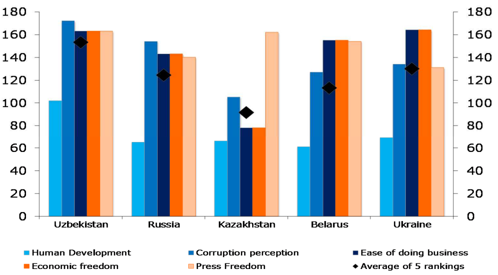
The banking system has recovered well since the depth of the financial crisis in 2008, since most banks proved able to withstand a sharp recession and a significant downturn in asset quality without requiring emergency capital support. Even so, structural weaknesses are found in poor transparency and supervision. The system is very small, as private sector credit only amounts to 44% of GDP. It is dominated by large state-owned banks and has a long tail of weak private banks. Highlighting these structural weaknesses were the financial problems and bailout of the Bank of Moscow in July 2011. The potential for negative surprises is very much present, and such episodes call into question the quality of governance at state-owned banks and the effectiveness of Central Bank supervision.

Chart 1: Economic growth



Source: EIU

Chart 2: Social & governance indicators



Source: EIU

Political and social situation

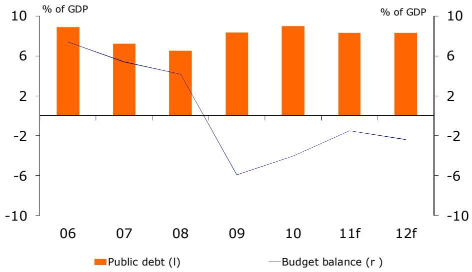
After two terms as president from 2000 to 2008, Vladimir Putin, former head of the internal federal security service, was constitutionally ineligible to run for a third term. In order to remain in a position of power, Putin pushed forward Dmitry Medvedev for the top seat in the 2008 presidential elections 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 (UR), the most powerful party in Russia, which has a pro-Kremlin orientation. As a result, Putin continues to wield considerable power in Russia's political decision making process. 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. In September 2011, Putin announced he will run for president in the March 2012 elections, and has asked Medvedev to be his prime minister. Putin's victory in the upcoming elections is a foregone conclusion given his popularity and a lack of fair elections in Russia. This swap was already widely anticipated. More concerning was the dismissal of Finance Minister Kudrin, as he has been an avid proponent of economic reforms and has guarded the windfall revenues from the country's oil exports. Kudrin was widely respected and has been the only one to keep the spendthrift ruling UR party in check. While the swap is unlikely to affect political stability, concerns on economic implications are justified.

As a large multi-ethnic state, Russia faces a number of security concerns, most of which originate from the North Caucasus region, resulting from the two bloody military campaigns in Chechnya. The guerilla fighters from Chechnya have become more religious and have included of members of Muslim Caucasian ethnic groups. Since early 2010, the number of terrorist attacks in the North

Caucasus has increased. After the March 2010 Moscow metro and January 2011 Domodedovo airport bombings, the risk of terrorist attacks remains high in larger cities, especially Moscow. Russia has improved relations with the West after the low point in 2008, following its involvement in the separatist conflict in Georgia. Especially with the US, relations improved in the field of containing Iran's nuclear ambitions and supporting the Western coalition fight in Afghanistan. The signing of a treaty to reduce the nuclear arsenal in the US and Russia last year was another milestone, further strengthened by Medvedev's historic participation in a NATO summit in November 2010. However, thorny issues remain, especially NATO's plans on an anti-ballistic missile shield in Eastern Europe are heavily opposed by Russia as these missiles could reach Russian soil. In response, Russia has set up a permanent naval base for its warships in Syria.

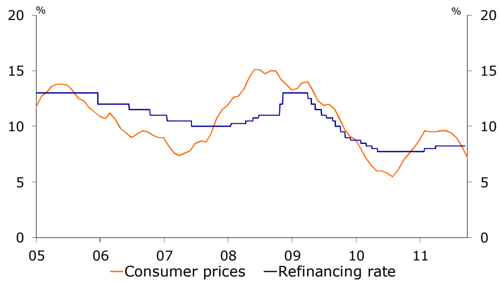
Economic policy
Russia's fiscal position has started to deteriorate after a massive government stimulus - the third largest in the world - was implemented to counter the sharp economic downturn and financial sector stress in 2009. At the same time, revenues declined, as GDP contracted and revenues from the oil and gas sector, which account 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 in the next years and is estimated at a 1.5% of GDP deficit in 2011. Expenditures have risen this year mostly in the face of expansive social spending and public sector investment programs. Restraining public spending is not a likely scenario given the upcoming parliamentary elections in December 2011 and presidential elections in March 2012. Higher than anticipated global oil prices could narrow the deficit, but the breakeven oil price is high at USD 118 per barrel. We do not expect the government itself to balance the budget in coming years. Especially after the dismissal of fiscally prudent Finance Minister Kudrin, we expect fiscal balances to deteriorate as the economic reform program is unlikely to make significant headway. A privatization drive is expected to be pushed through in coming years, to refill the state coffers after a massive USD 150bn bailout of Russian banks and companies. A large-scale privatization program of 5,500 businesses is planned. However, for this to be successful, the government needs to severely boost foreign investor confidence regarding the safety and transparency of the privatization process which is rife with corruption. Public debt is very low at 8% of GDP in 2011. After inflation hit a record low of 5.5% in July 2010, it has started to rise, mainly on the back of higher global commodity prices and higher food price inflation after the summer drought reduced agricultural output last year. The impact of these higher prices has started to fade from the peak in April and is expected to average 8.9% in 2011. The Central Bank of Russia (CBR) has been very slow to raise policy rates to combat inflation, as it wants to continue to support the lacklustre economic recovery and stimulate credit expansion. The policy interest rate was raised by only two small 25bp steps since mid-2010 to 8.25%, but further interest rate hikes are expected in the

Chart 3: Fiscal position



Source: EIU

Chart 4: Inflation and policy rate

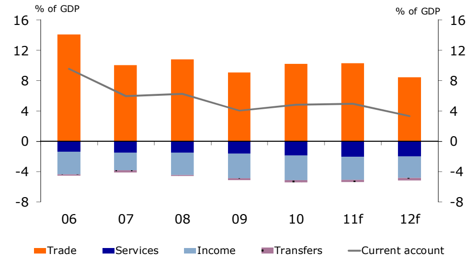


Source: EIU

remainder of the year.
The CBR's shift last year to a more flexible exchange rate regime represents an important improvement that could help reduce financial instability. Previously, the ruble was officially allowed to trade in a band between 24 and 41 against the 55% USD/ 45% EUR basket, Since last year, the CBR does not target any level of the exchange rate and allows changes to be largely driven by the market. However, the CBR maintains the rouble exchange rate against the 55% USD/45% EUR basket and leans against the wind as it allows a RUB 0.05 change in the rate for every USD600m of FX interventions it has to make. By allowing a larger two-way flexibility of the rouble this year, on the upside despite concerns about manufacturing competitiveness and on the downside amid heightened risk aversion, the CBR has enhanced the credibility of the new regime.

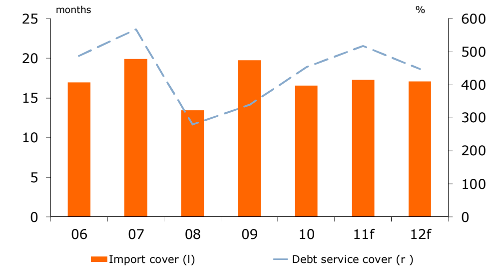
Balance of Payments
Russia's exports are undiversified and rely heavily on oil and gas exports (67% of total exports), and the export of metals (13% of total exports). Driven by these commodity exports, however, Russia's trade balance has shown a healthy surplus year after year. In the past 5 years, 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 9.3% of GDP from 2000-2010. In 2011, the current account surplus will increase marginally to 4.9% of GDP from 4.8% in 2010.
Net FDI inflows are estimated at USD 6bn in 2011, a strong recovery from the net outflow of USD 10bn in 2010. The improvement relates to the government's renewed privatization efforts. Net portfolio outflows increased to an estimated USD 20bn in 2011, as foreign investors flee Russia in times of global heightened risk aversion, currently sparked by the sovereign debt crisis of Europe's peripheral countries. However, the portfolio outflows are still only 40% of the USD 50bn net outflow witnessed in 2008. 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. Nevertheless, FX-reserves will continue to increase to USD 570bn end-2011 from USD 444bn at end-2010.

Chart 5: Current account



Source: EIU

Chart 6: External liquidity



Source: EIU

External position
Russia's external position is very healthy. First of all, with total external debt estimated at USD 436bn at end-2011 and FX-reserves at USD 570bn, 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 18% of total export receipts. Furthermore, short term debt amounts to only 12% of total external debt. Also, the high level of FX-reserves offers cover for 17 months of imports and 518% of debt service, both very sound levels. Finally, due to the current account surplus and the high level of FX-reserves, the external liquidity ratio stands at above 200%.

Russia

Selection of economic indicators	2006	2007	2008	2009	2010	2011f	2012f
Key country risk indicators							
GDP (% real change pa)	8.2	8.5	5.2	-7.8	4.0	4.3	4.5
Consumer prices (average % change pa)	9.7	9.0	14.1	11.7	6.9	8.9	7.6
Current account balance (% of GDP)	9.6	6.0	6.2	4.0	4.8	4.9	3.3
Total foreign exchange reserves (mln USD)	295568	466750	411750	416649	443586	569640	592610
Economic growth							
GDP (% real change pa)	8.2	8.5	5.2	-7.8	4.0	4.3	4.5
Gross fixed investment (% real change pa)	18.0	21.0	10.6	-14.4	6.1	6.8	7.5
Private consumption (real % change pa)	12.2	14.3	10.6	-4.8	3.0	3.6	4.0
Government consumption (% real change pa)	2.3	2.7	3.4	0.2	1.4	1.5	2.0
Exports of G&S (% real change pa)	7.3	6.3	0.6	-4.7	7.1	5.0	6.5
Imports of G&S (% real change pa)	21.3	26.2	14.8	-30.4	25.6	14.0	9.4
Economic policy							
Budget balance (% of GDP)	7.4	5.4	4.1	-5.9	-4.0	-1.5	-2.4
Public debt (% of GDP)	9	7	7	8	9	8	8
Money market interest rate (%)	6.3	6.9	9.4	15.3	5.6	4.9	5.0
M2 growth (% change pa)	48	43	1	18	31	24	18
Consumer prices (average % change pa)	9.7	9.0	14.1	11.7	6.9	8.9	7.6
Exchange rate LCU to USD (average)	27.2	25.6	24.9	31.7	30.4	28.4	27.9
Recorded unemployment (%)	7.2	6.1	6.4	8.4	7.5	6.8	6.2
Balance of payments (mln USD)							
Current account balance	94686	77768	103661	49365	71129	90510	67430
Trade balance	139269	130915	179742	111585	151393	188460	171400
Export value of goods	303550	354401	471603	303388	400131	498570	494450
Import value of goods	164281	223486	291861	191803	248738	310110	323050
Services balance	-13614	-18888	-24336	-19883	-27300	-37350	-40060
Income balance	-29432	-30752	-48980	-39475	-48373	-55190	-57430
Transfer balance	-1537	-3506	-2765	-2862	-4097	-5420	-6470
Net direct investment flows	6551	9159	19408	-7166	-10503	6000	11000
Net portfolio investment flows	-1623	-30952	-50840	-213	-13098	-20210	-20410
Net debt flows	37252	110482	12784	-19731	15146	38750	20320
Other capital flows (negative is flight)	-15374	8572	-137492	-9092	-22746	13930	-55980
Change in international reserves	121492	175030	-52479	13163	39927	128970	22360
External position (mln USD)							
Total foreign debt	250747	368075	402453	381340	393501	436640	454710
Short-term debt	40453	79106	54655	30624	38205	52840	45900
Total debt service due, incl. short-term debt	60631	82264	147023	122823	97891	110090	132400
Total foreign exchange reserves	295568	466750	411750	416649	443586	569640	592610
International investment position	-38793	-150600	254794	103431	n.a.	n.a.	n.a.
Total assets	731341	1092180	1010700	1089510	n.a.	n.a.	n.a.
Total liabilities	770134	1242780	755906	986079	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	14.1	10.1	10.8	9.1	10.2	10.3	8.5
Current account balance (% of GDP)	9.6	6.0	6.2	4.0	4.8	4.9	3.3
Inward FDI (% of GDP)	3.0	4.2	4.5	3.0	2.8	2.5	2.6
Foreign debt (% of GDP)	25	28	24	31	27	24	22
Foreign debt (% of XGSIT)	68	82	68	98	81	73	75
International investment position (% of GDP)	-3.9	-11.6	15.3	8.5	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	16	18	25	32	20	18	22
Interest service ratio incl. arrears (% of XGSIT)	4	4	4	5	2	2	2
FX-reserves import cover (months)	17.0	19.9	13.5	19.7	16.6	17.3	17.1
FX-reserves debt service cover (%)	487	567	280	339	453	517	448
Liquidity ratio	227	231	189	218	217	222	211

Source: EIU