

Russia: Expecting Strong Growth in 2008 and Beyond, but Challenges Ahead

Evgeny Gavrilentov, Chief Economist

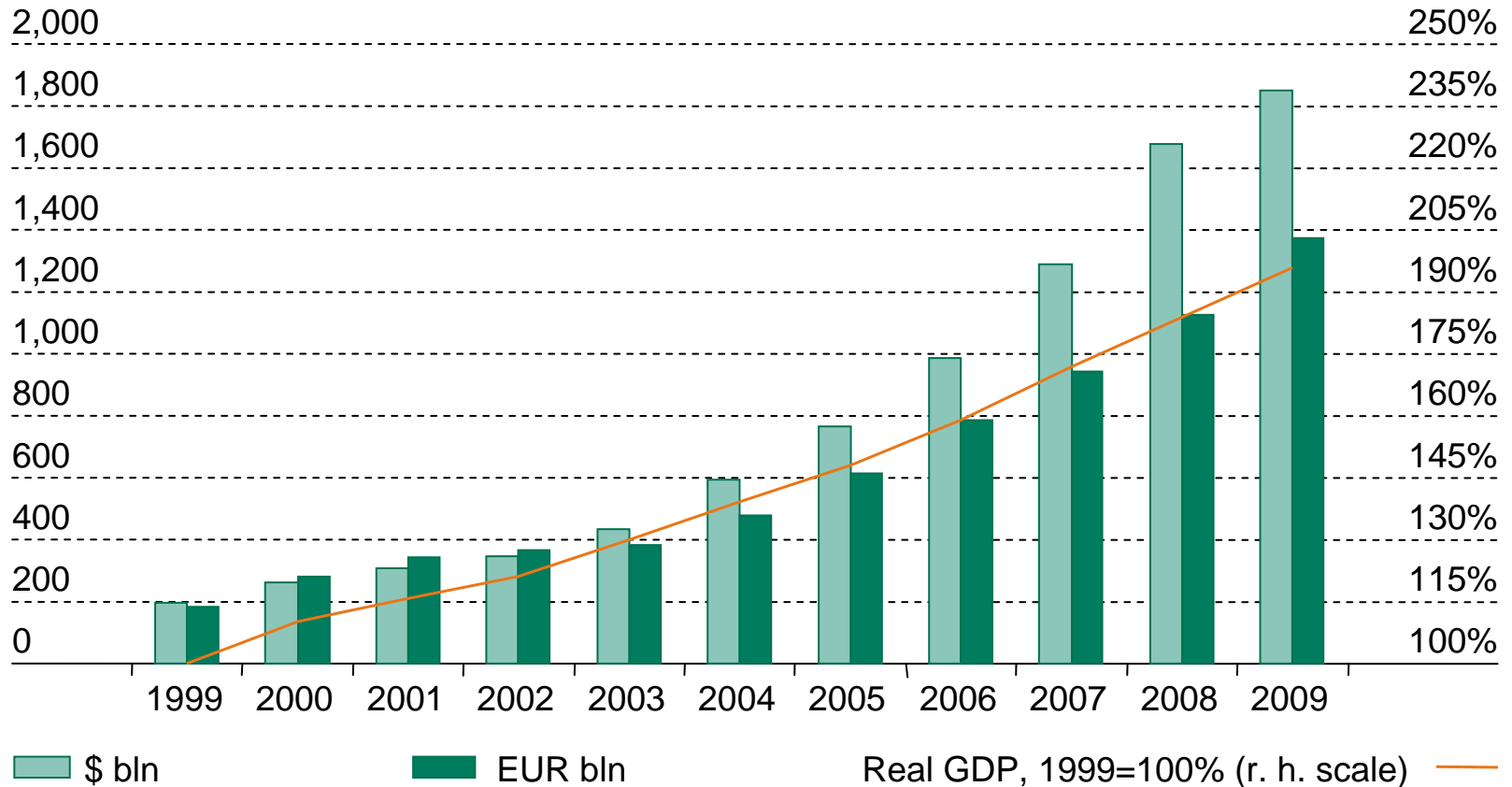
Another good year for Russia

- Economic growth has remained strong in the early part of the year: industrial output rose 6.2% y-o-y in 1Q08 (versus 7.2% in 1Q07), while basic sector output soared 8.7% (versus 8.0% a year ago). This year, GDP could grow by nearly 8% and the dollar-denominated GDP may exceed \$1.7 trln.
- International reserves (including sovereign funds) exceeded \$510 bln. Since 2000, Russia has remained a twin-surplus economy (fiscal and current account). As the oil price has beaten all earlier expectations, both surpluses will remain as high this year as they were last year.
- Growth accelerated last year due to state companies' increased investment activity.
- Inflation in Russia is rising. It is not only food prices, which are accelerating globally, that are boosting the country's CPI. Inflation is also high due to a generous fiscal policy; expenditures increased nearly 40% in 2007 and rose 45% y-o-y in 1Q08.
- Inflation reached 11.9% in 2007, accelerated to 13.3% y-o-y in March 2008, and may reach 14.3% y-o-y in April. Under an optimistic scenario, inflation will stay at around 12.5% in 2008, though a higher figure is more probable, as the government will most likely continue to increase spending.

Strong growth is a key priority of government's draft strategy through 2020

- The government anticipates average annual growth of around 6% in the long term, an attainable feat; however, the proposed mechanism of this growth raises certain questions.
- Investment activity rose more than 20% in 2007 and 3m08. Strong double-digit growth is expected this year (also close to 20%) and in the years to come. It is uncertain, however, how long the country can afford these growth rates (on which the new government strategy through 2020 relies) .
- Efficiency of investments is crucial for Russia, while mushrooming state corporations create some concerns.
- Consumer demand is expected to grow rapidly (at close to double-digit rates) going forward. Although the deliberate appreciation of the nominal effective ruble did not help contain inflation, it has contributed to a change in the growth model; a stronger currency stimulates the domestic market's development.
- Russia is gradually shifting from an export-driven growth model toward one in which domestic demand plays a greater role and is more balanced in the long term.

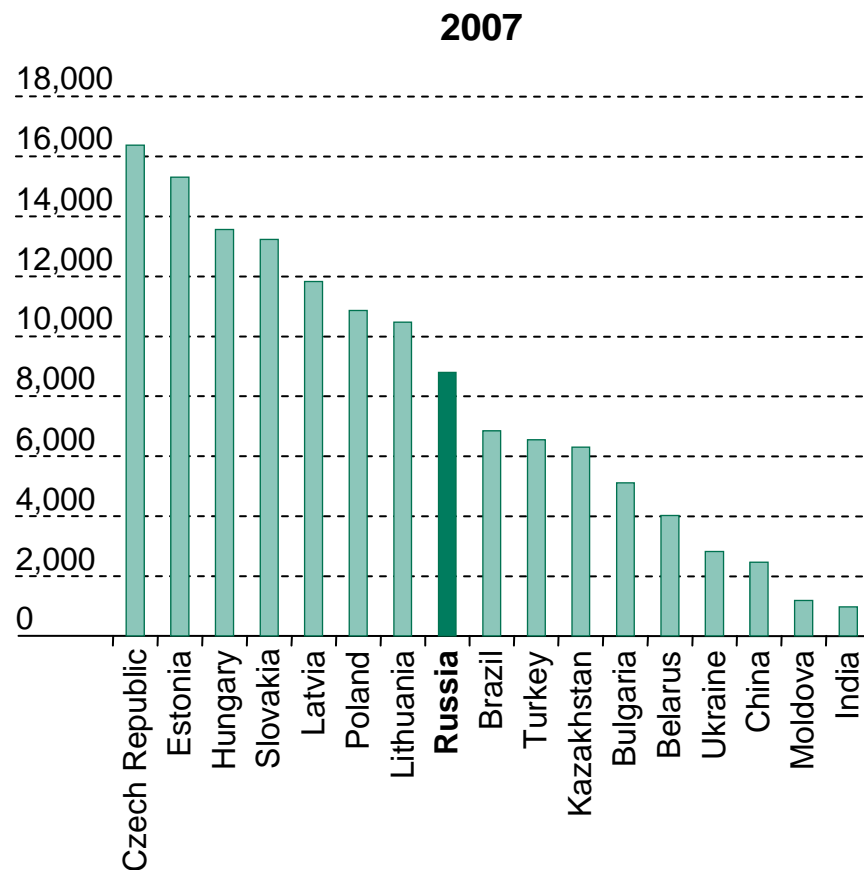
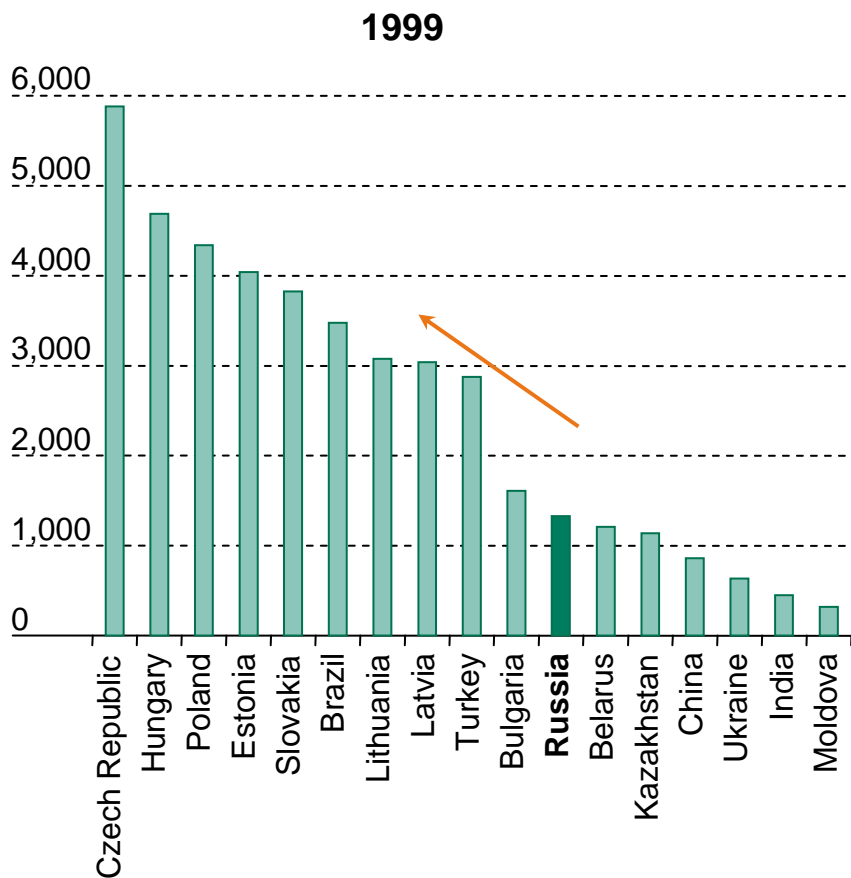
The economy continues to expand, especially in dollar terms



Source: State Statistics Service, Troika Dialog estimates

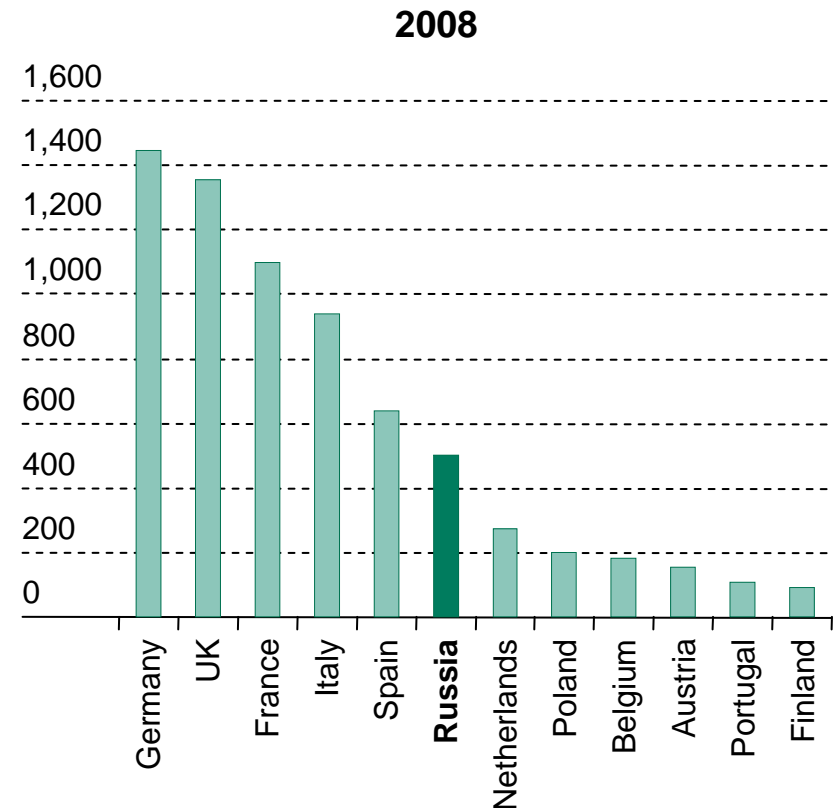
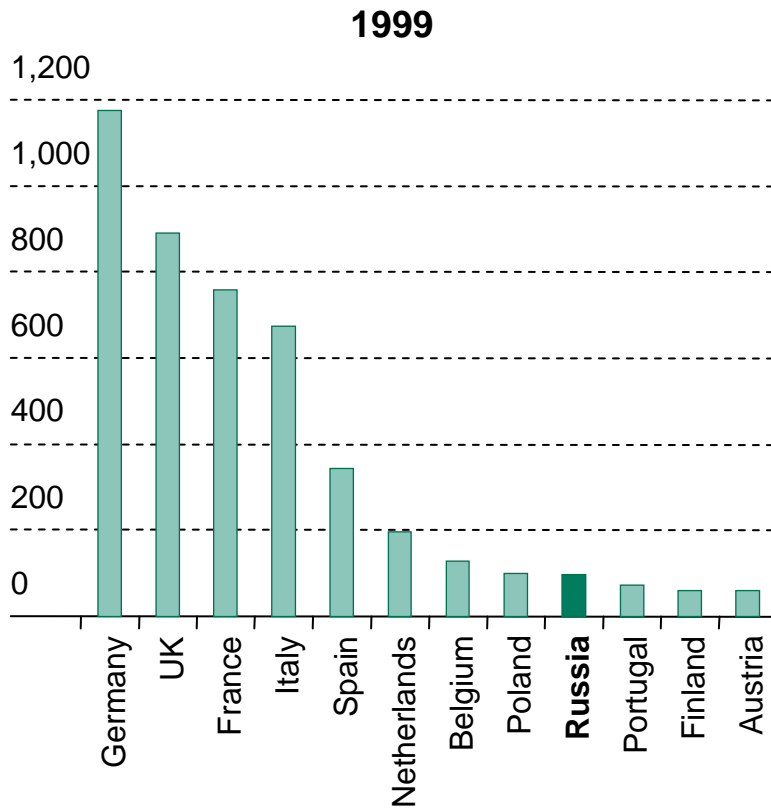
The gap between Russia's GDP per capita and that of other countries is quickly narrowing...

GDP per capita, \$



... and the consumer market is growing fast

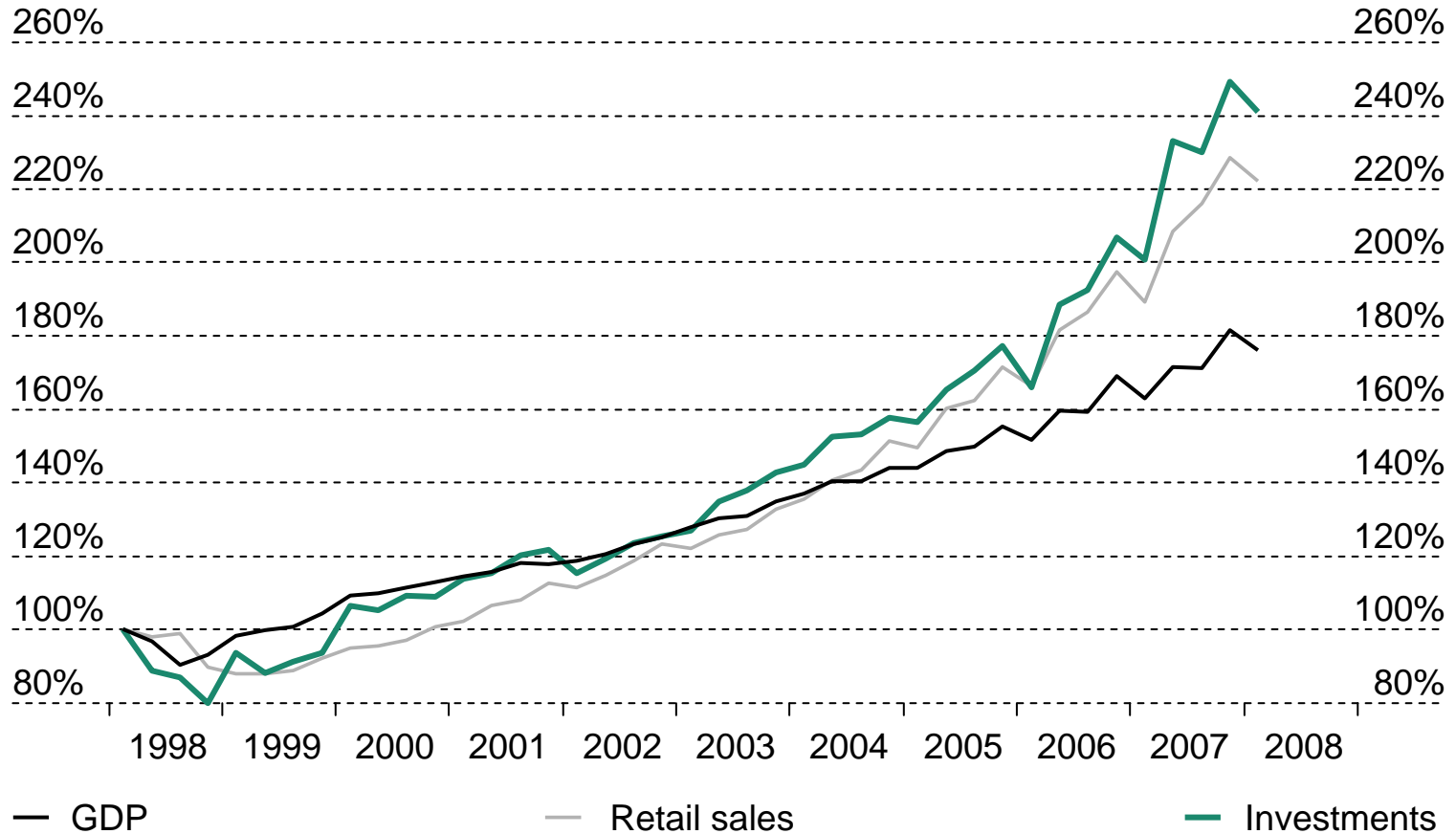
Household consumption, EUR bln



Source: IMF, Troika Dialog estimates

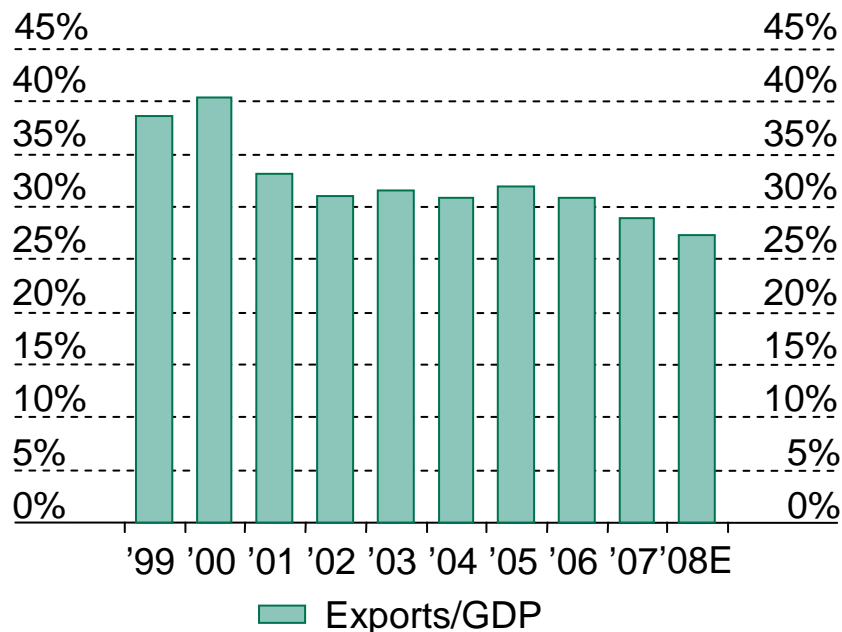
Domestic demand drives economic growth

Quarterly data, seasonally adjusted, 1Q98=100%



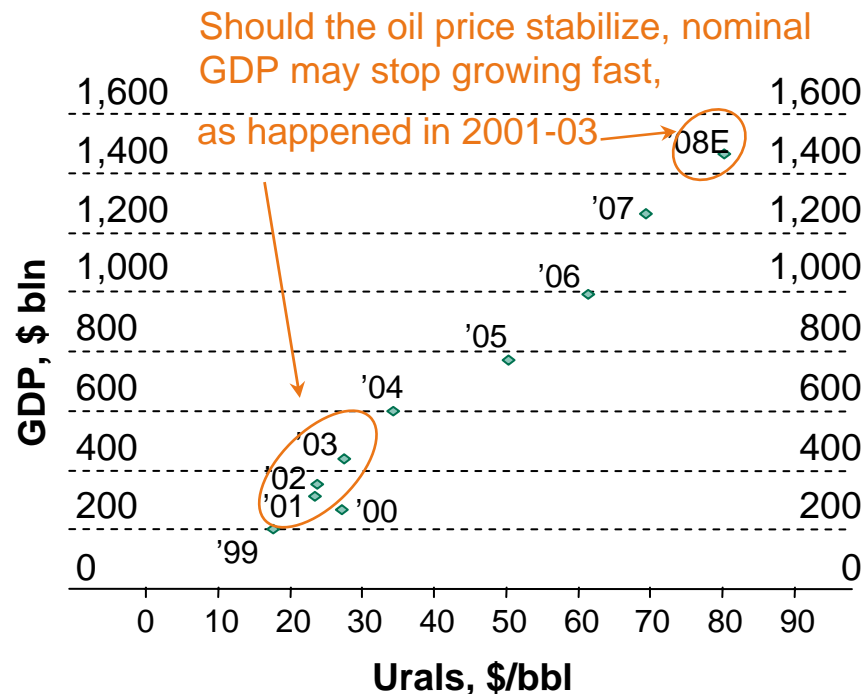
Source: State Statistics Service, Troika Dialog estimates

Export/GDP ratio gradually declined



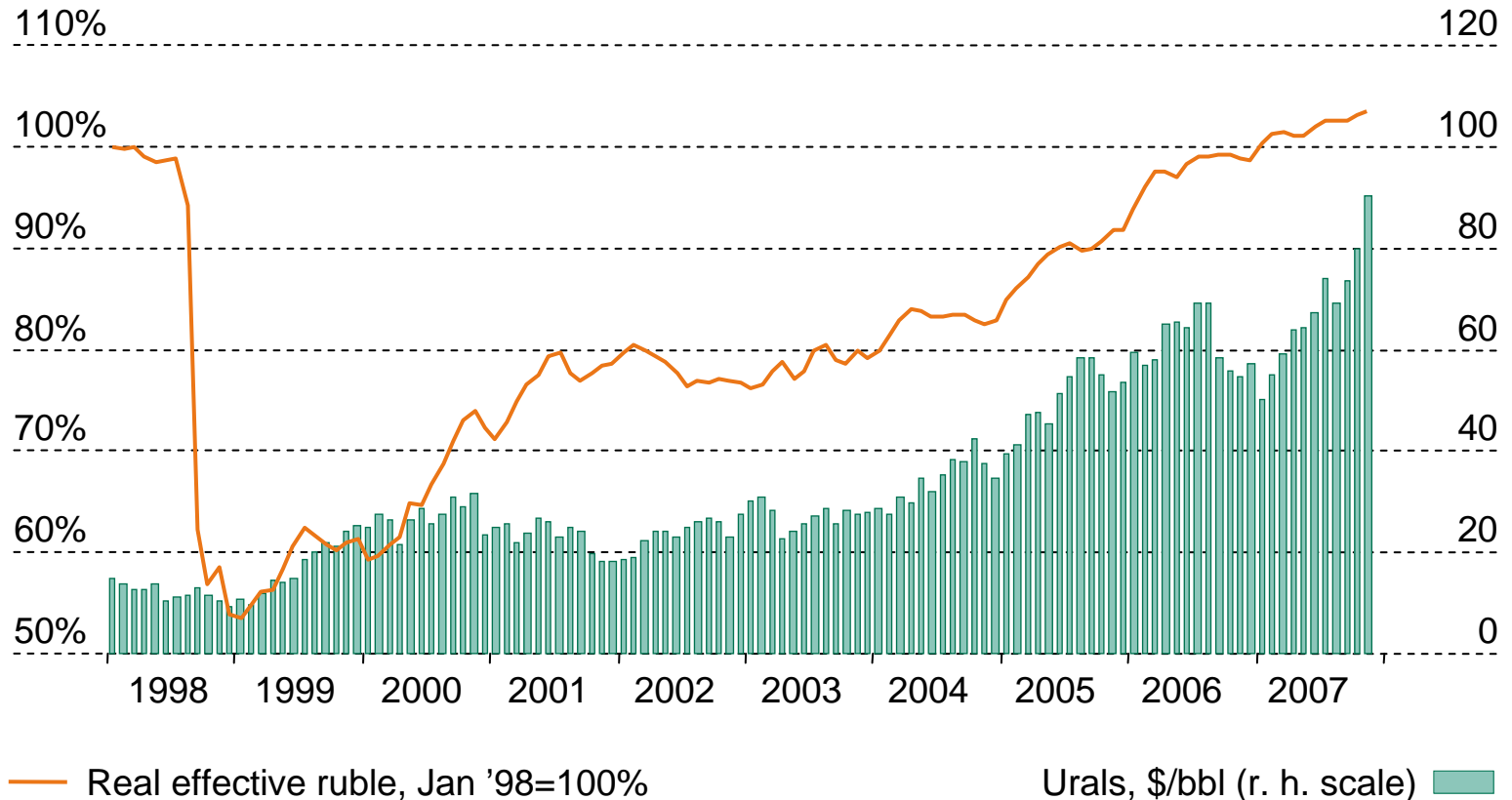
Source: State Statistics Service, Central Bank, Troika Dialog estimates

Oil price correlates with nominal GDP



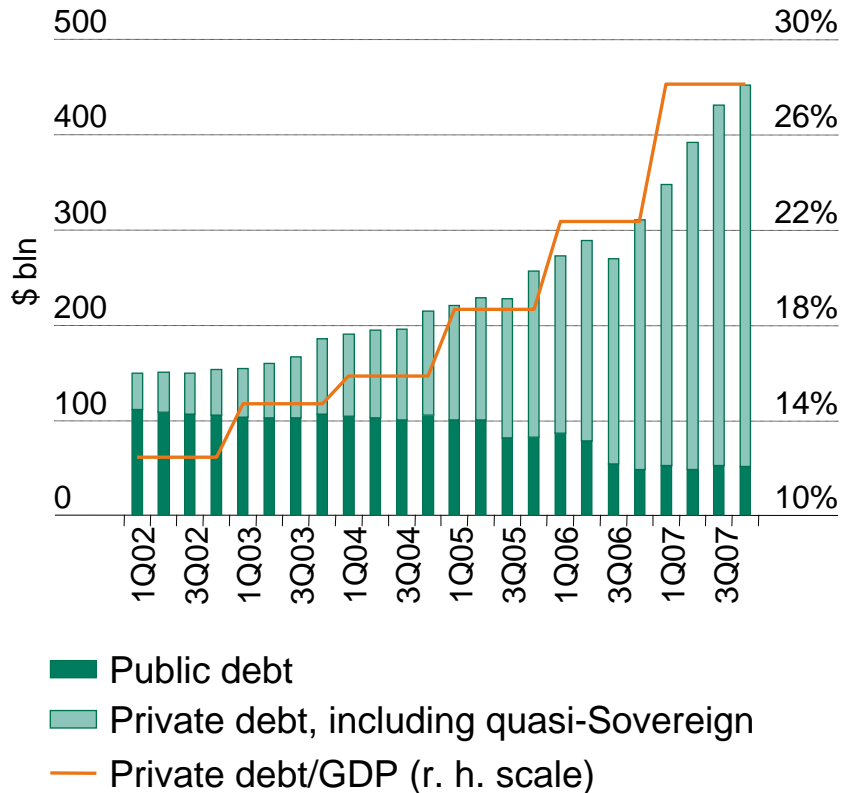
Source: State Statistics Service, Central Bank, Troika Dialog estimates

Nominal ruble appreciation will most likely stop should the price of oil and other commodities stabilize, while real appreciation will continue



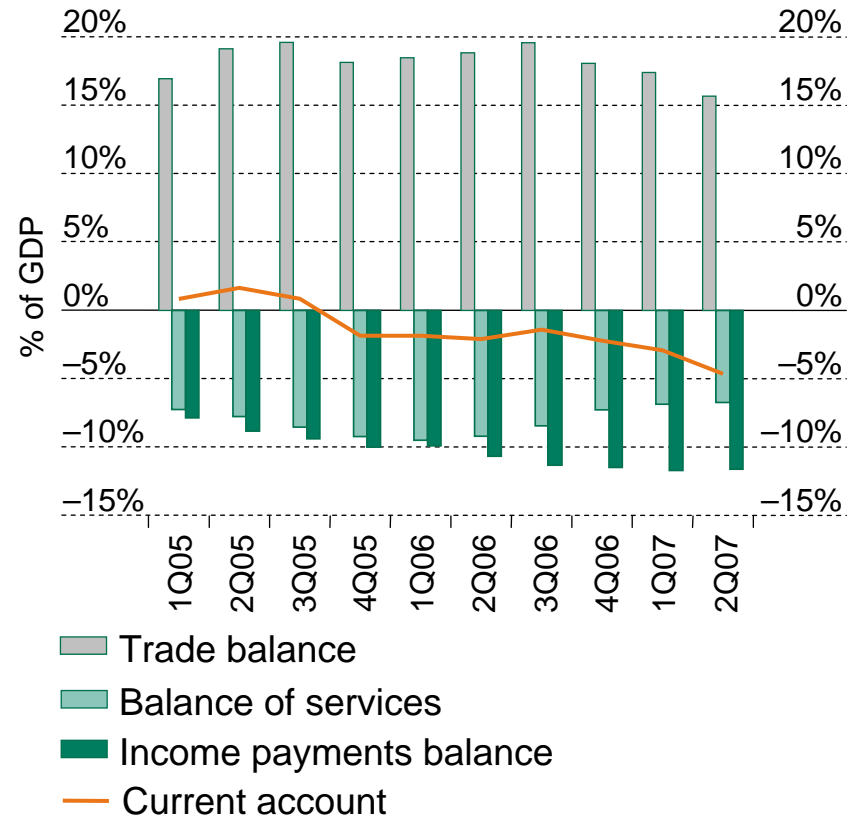
Source: State Statistics Service, Central Bank, Troika Dialog estimates

Larger Russian companies are looking for funds overseas



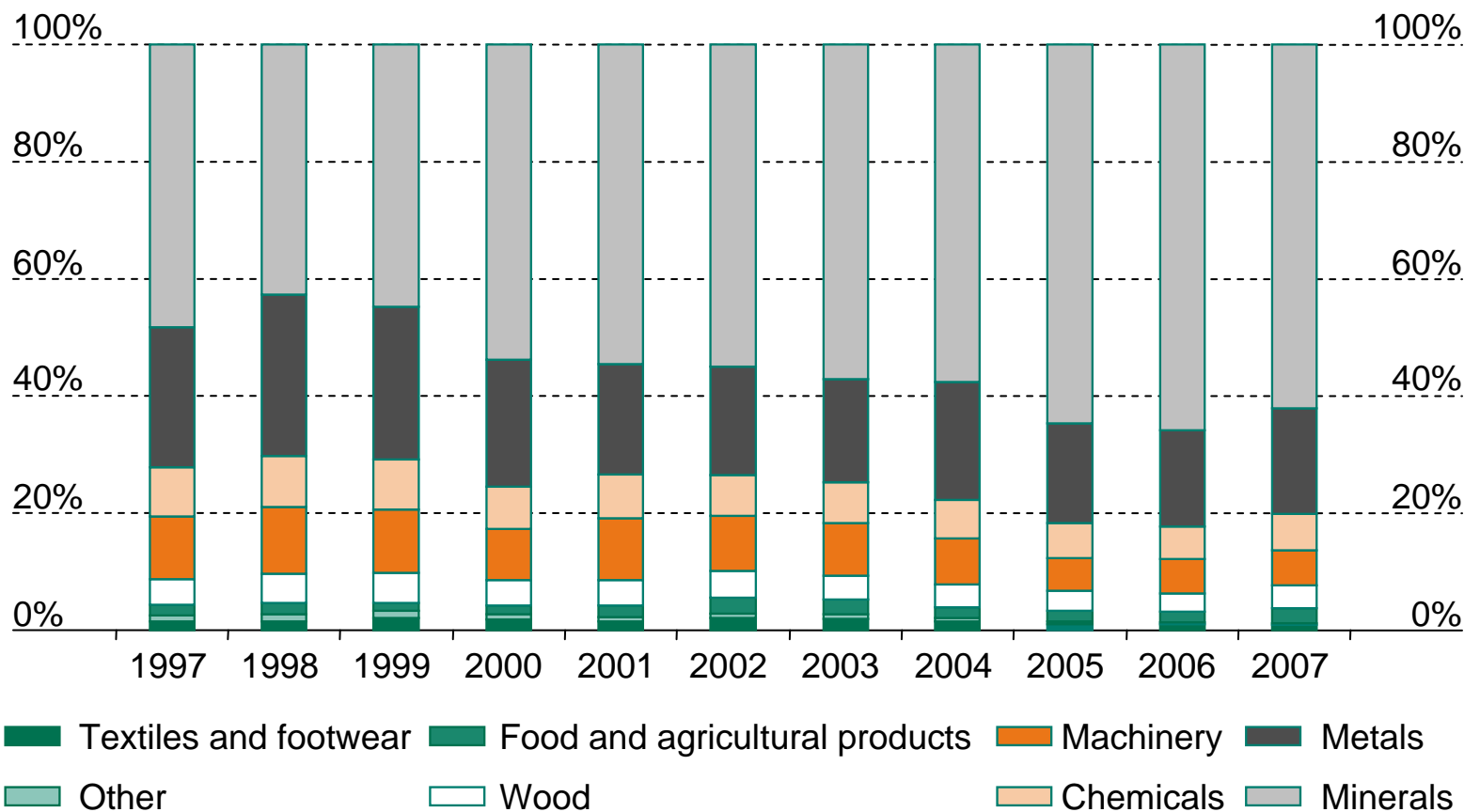
Source: Central Bank

A glimpse into Russia's avoidable future: Kazakhstan's current account is already negative due to growing foreign debt and rising net income payments



Source: Kazakh National Bank

While the structure of Russia's exports has changed little in the past decade...



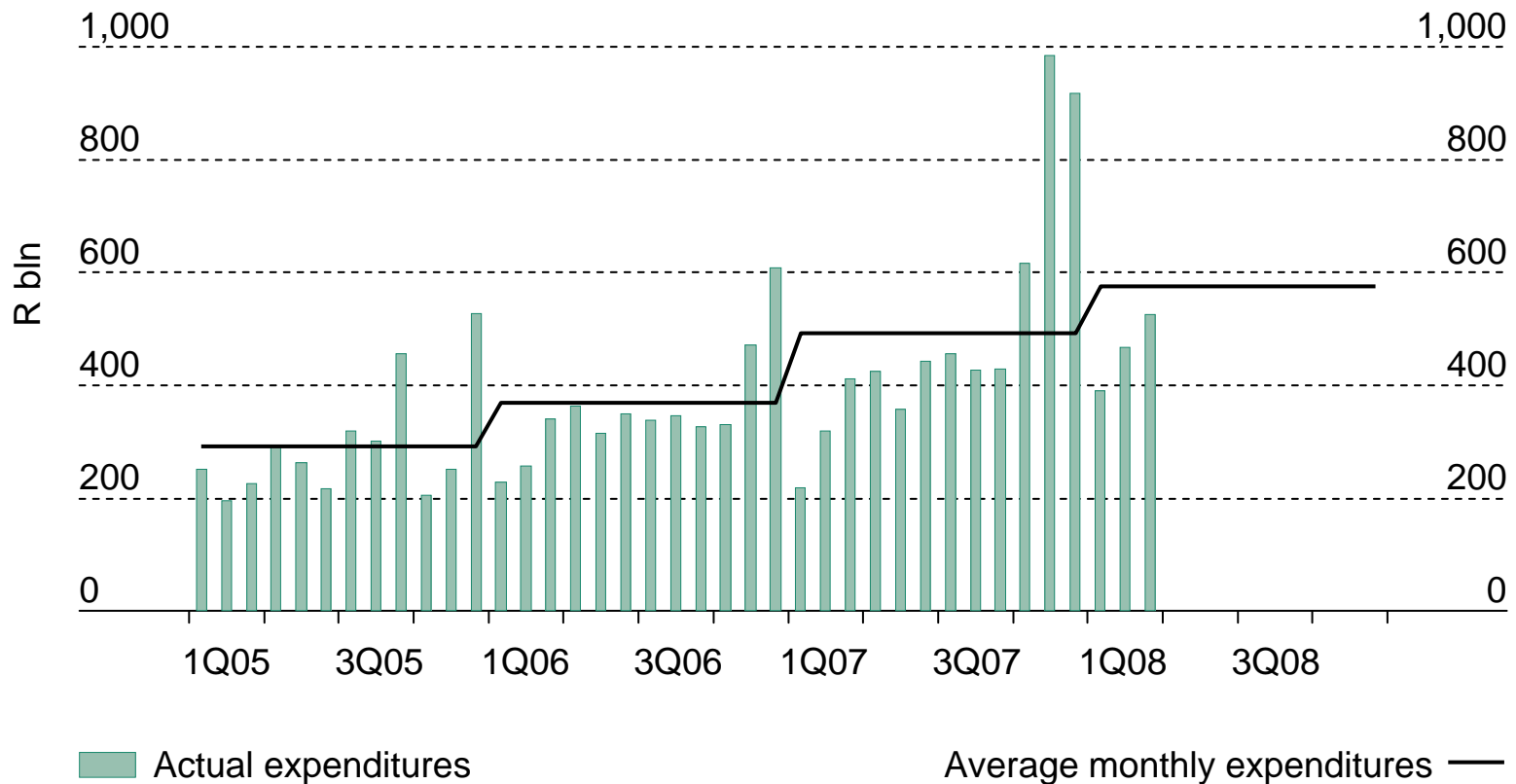
Source: State Statistics Service, Troika Dialog estimates

... the economy is gradually diversifying

	2002	2003	2004	2005	2006	2007
Agriculture, hunting, forestry	6.4%	6.3%	5.7%	5.2%	4.5%	4.5%
Fishing	0.3%	0.5%	0.4%	0.4%	0.3%	0.3%
Mining	6.8%	6.7%	9.6%	11.2%	10.6%	10.4%
Manufacturing	17.6%	17.0%	18.1%	19.3%	19.4%	19.1%
Water, gas, electricity production and supply	3.8%	3.7%	3.8%	3.4%	3.4%	3.1%
Construction	5.5%	6.1%	5.8%	5.6%	5.9%	5.9%
Wholesale, retail trade, repair services	23.0%	22.2%	20.4%	19.5%	19.7%	20.6%
Hotels, restaurants	0.9%	0.8%	1.0%	0.9%	0.9%	0.9%
Transport, communication	10.4%	10.8%	11.2%	10.3%	9.9%	9.4%
Financial services	3.1%	3.4%	3.4%	4.0%	4.3%	4.8%
Real estate	10.7%	10.8%	9.6%	9.9%	9.9%	10.4%
State administration, external security, social security	5.1%	5.6%	5.4%	5.2%	5.4%	5.1%
Education	2.9%	2.7%	2.7%	2.7%	2.8%	2.8%
Healthcare, social services	3.4%	3.2%	3.2%	3.1%	3.3%	3.4%
Communal services	1.9%	1.9%	1.9%	1.9%	2.0%	2.0%
Indirect financial intermediation	-1.9%	-1.8%	-2.1%	-2.4%	-2.4%	-2.7%
Value added (basic prices)	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

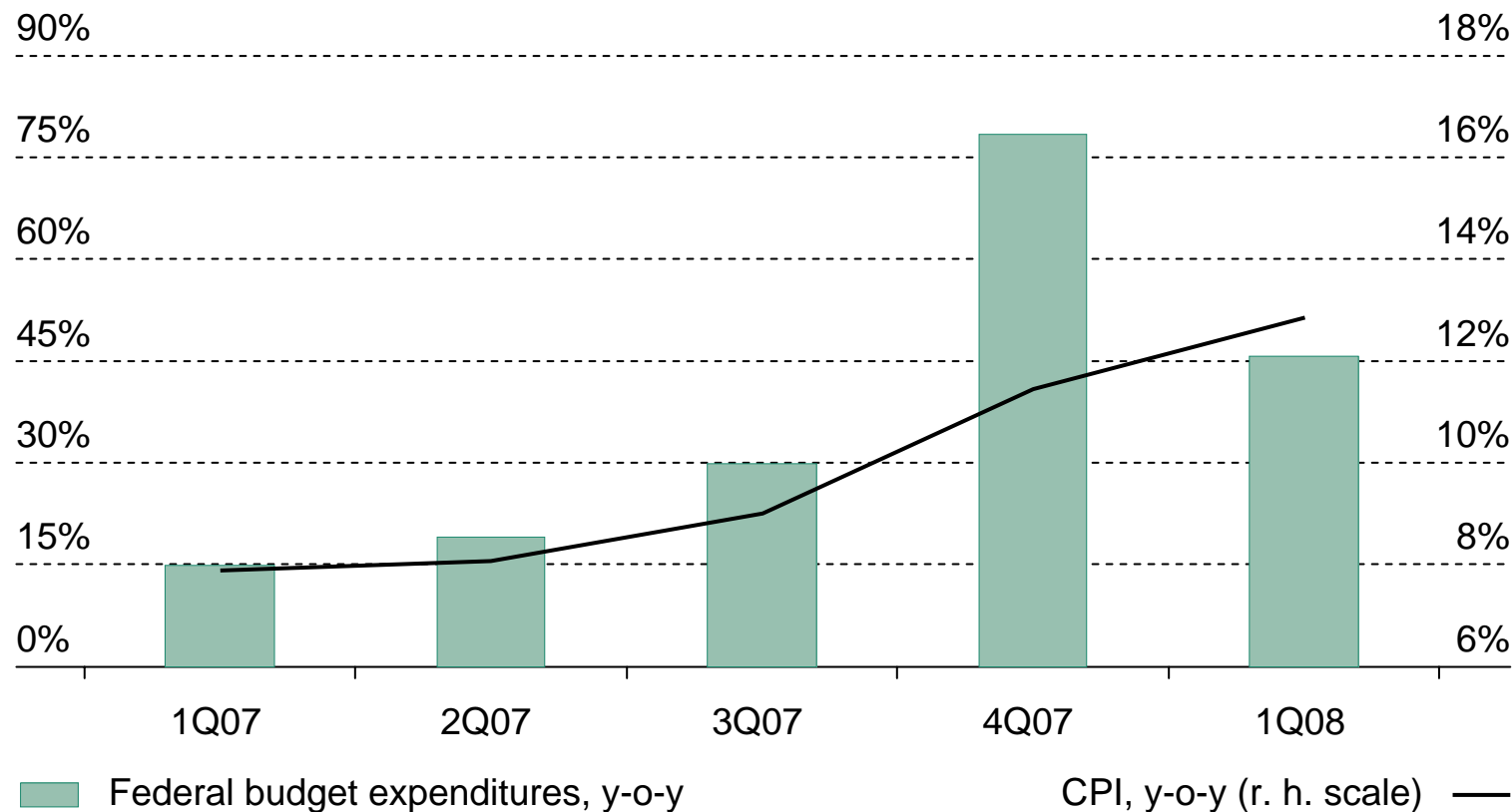
Source: State Statistics Service, Troika Dialog estimates

Budget spending, usually below target from January to September, soars in the fourth quarter



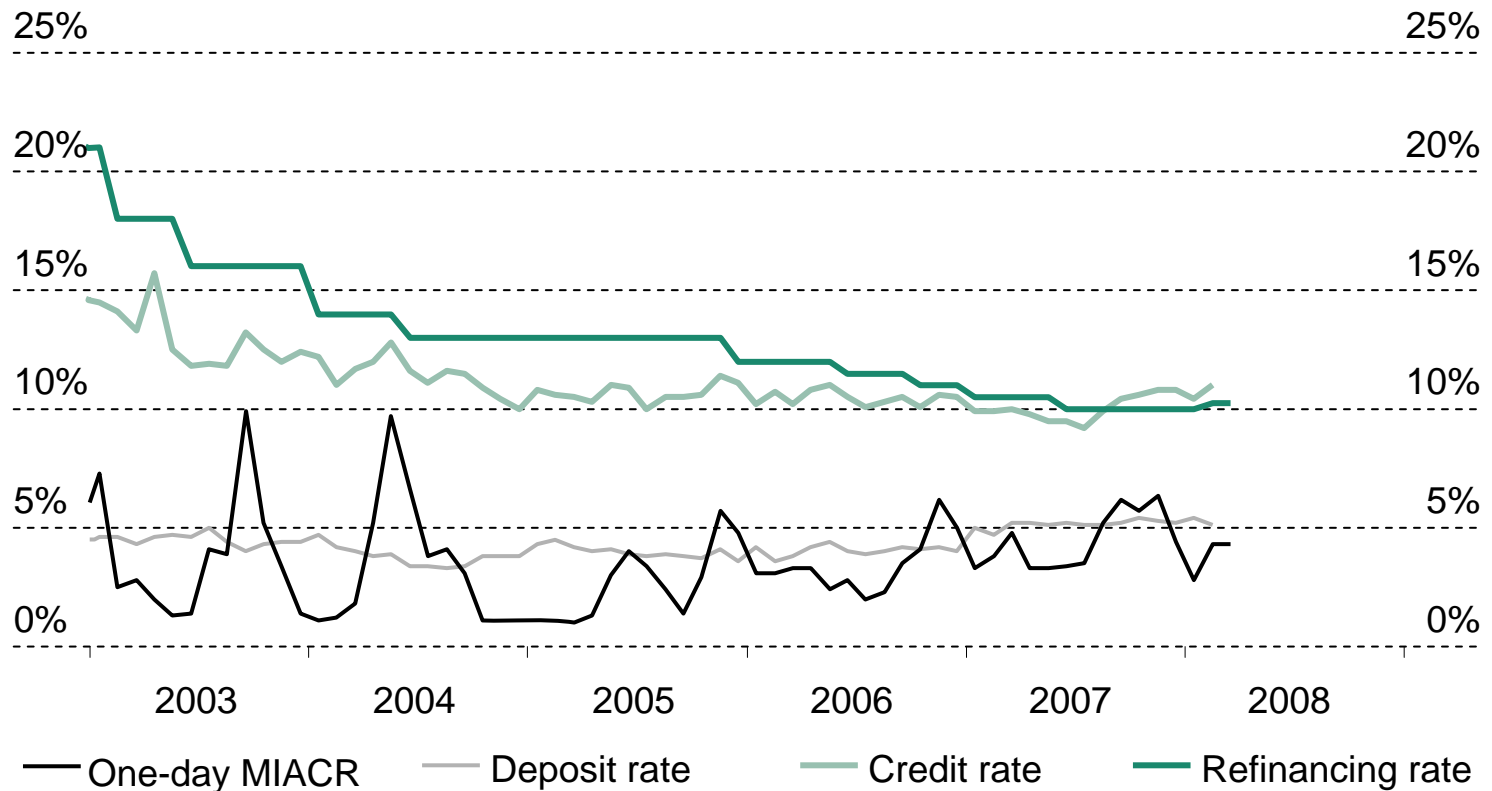
Source: Finance Ministry

Inflation accelerates on the back of rising expenditures



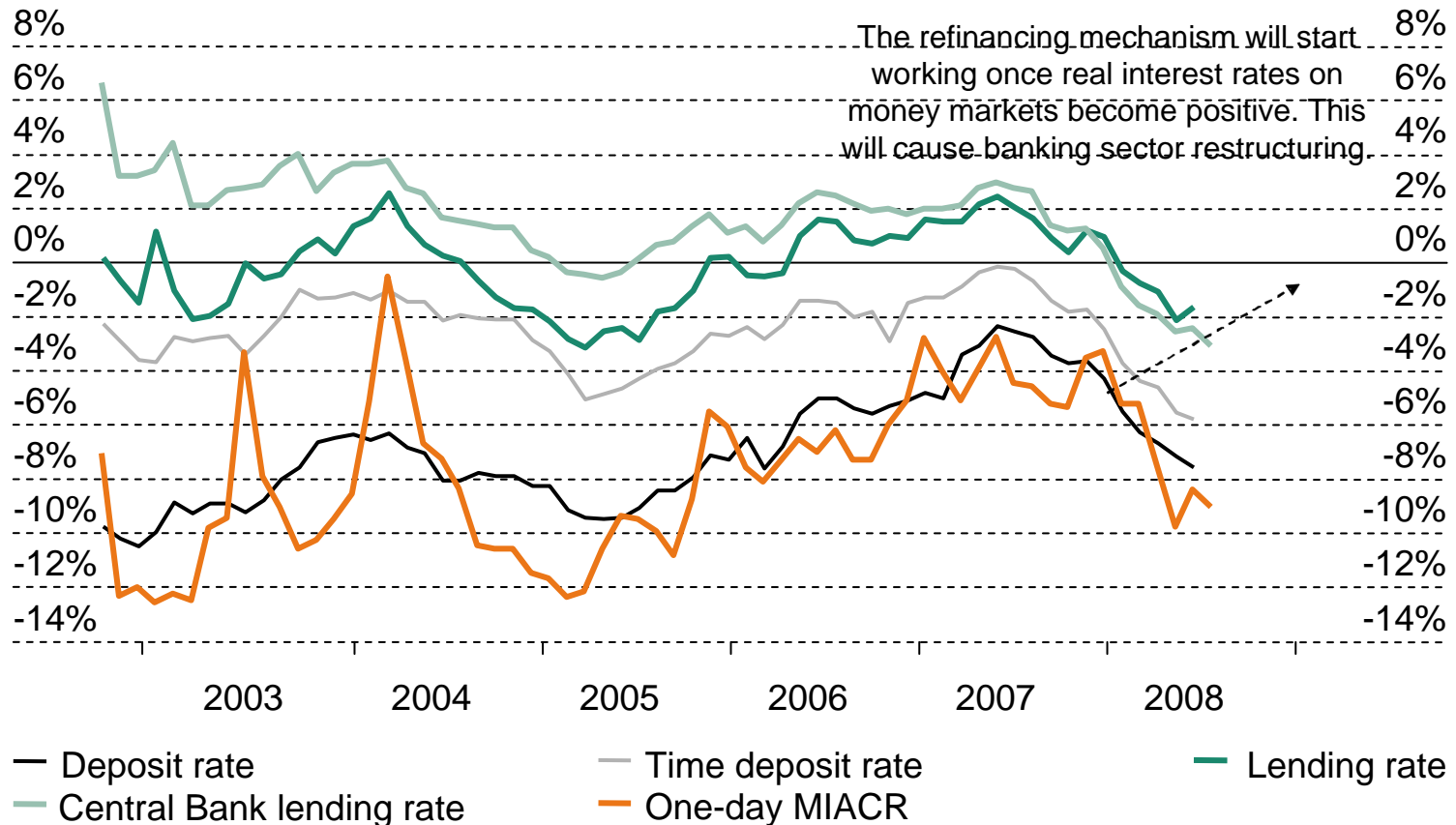
Source: State Statistics Service, Finance Ministry, Troika Dialog estimates

Money-market rates are below the Central Bank's refinancing rate



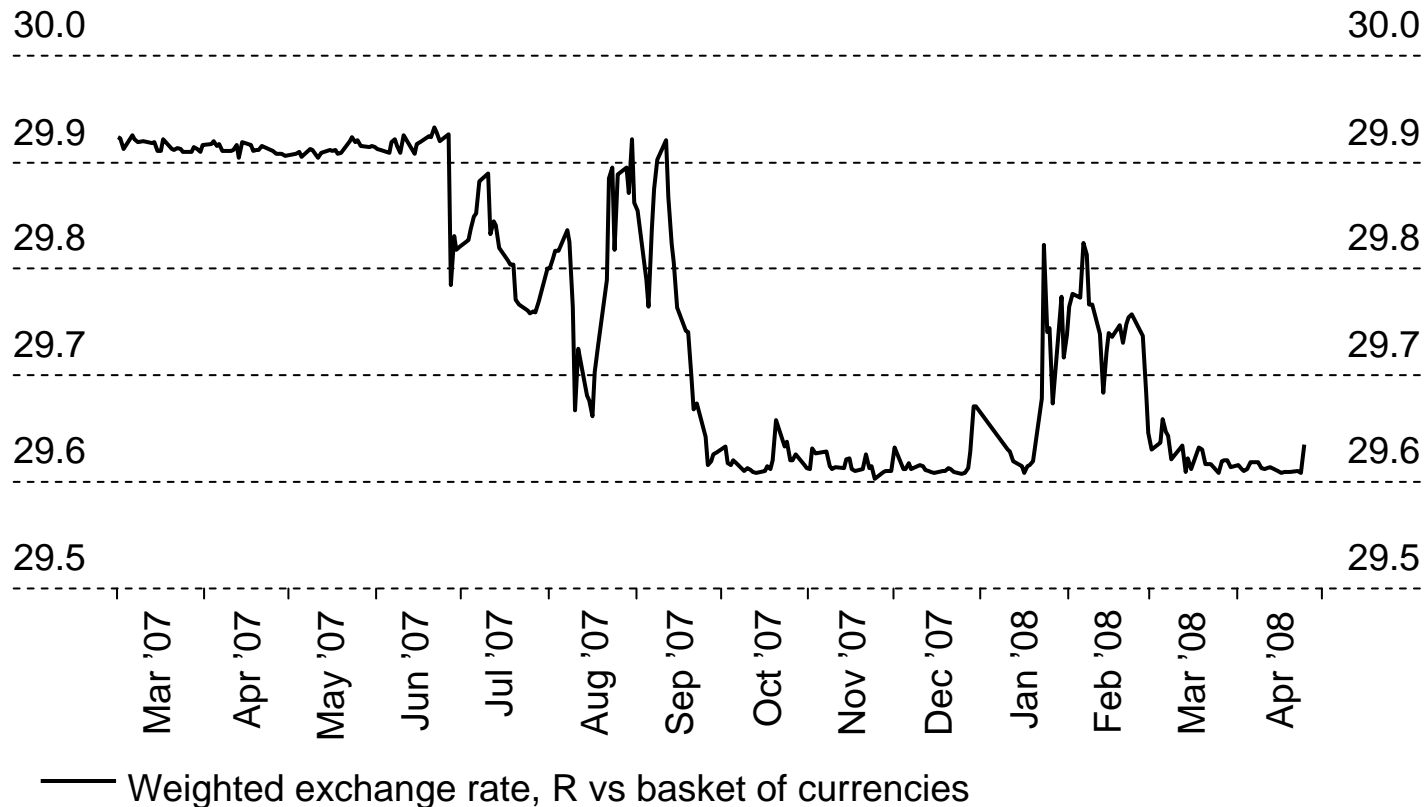
Source: Central Bank

Real interest rates remain negative in real terms, but should move toward positive territory



Source: Central Bank, State Statistics Service, Troika Dialog estimates

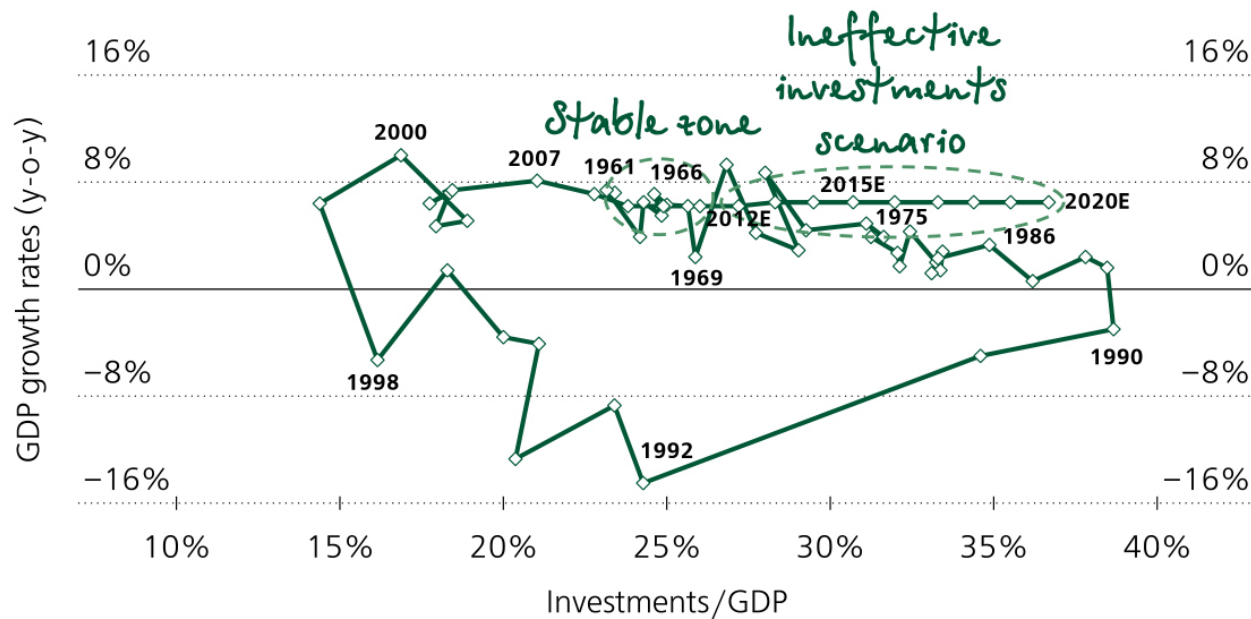
Forex market volatility will increase; the range of fluctuations of the nominal effective ruble widened in 3Q07



Source: Central Bank, Troika Dialog estimates

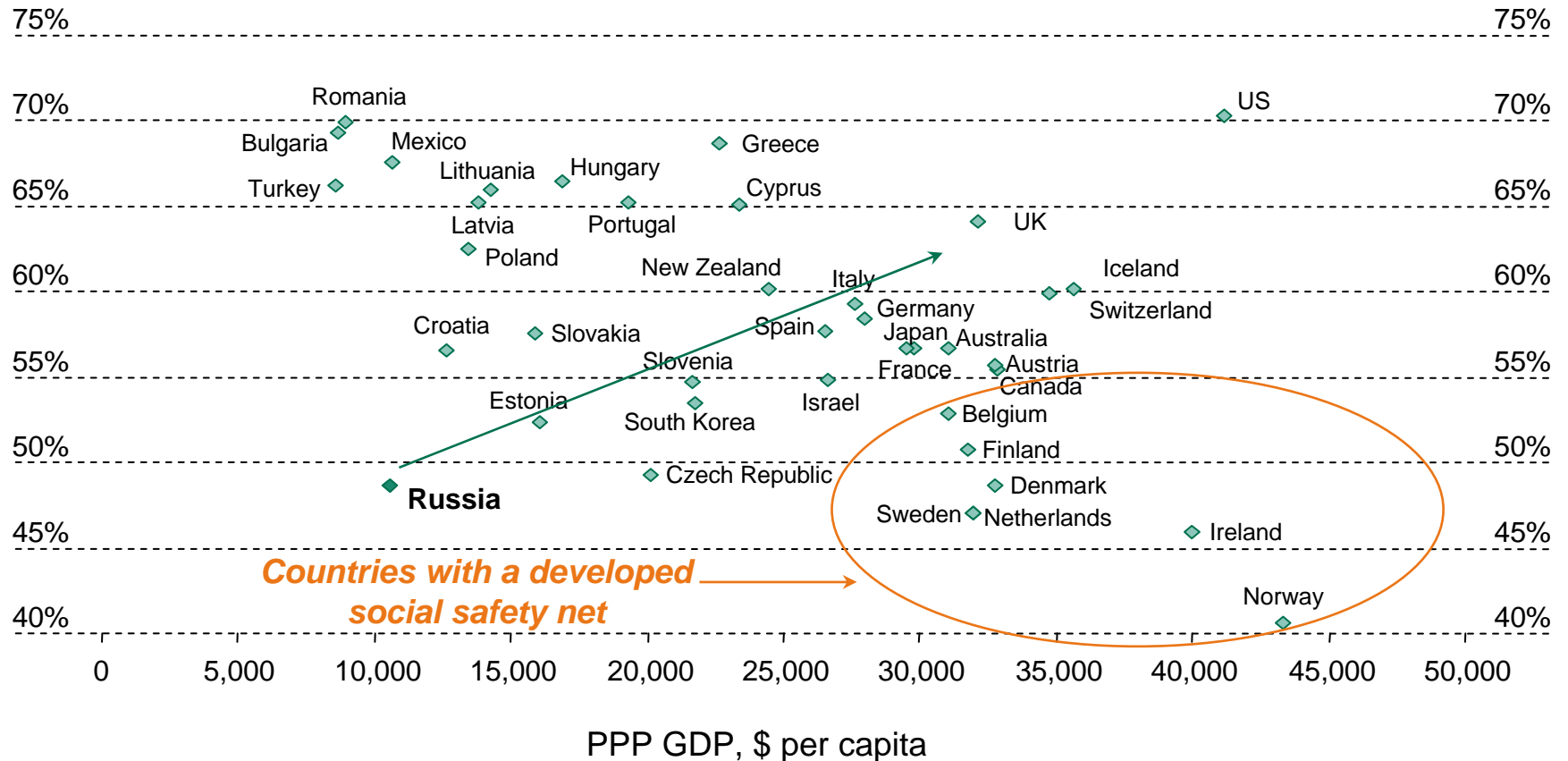
The rising investment/GDP ratio implies the ineffective investments scenario proposed by the government

Expansion of investments /GDP is hardly possible, and is undesirable



Source: State Statistics Service, Central Bank, Troika Dialog estimates

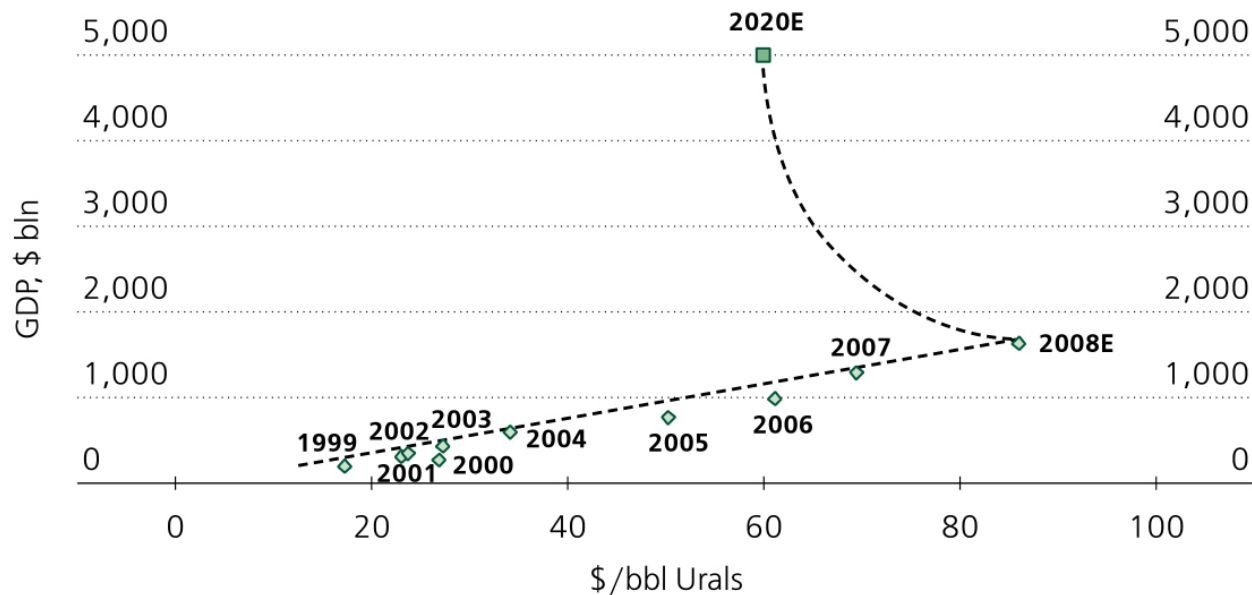
Russia's private consumption/GDP ratio is low and set to rise



Source: IMF, State Statistics Service, Troika Dialog estimates

Government expects nominal GDP to grow rapidly despite correction in oil price

Government expects nominal GDP to grow despite correction in oil price



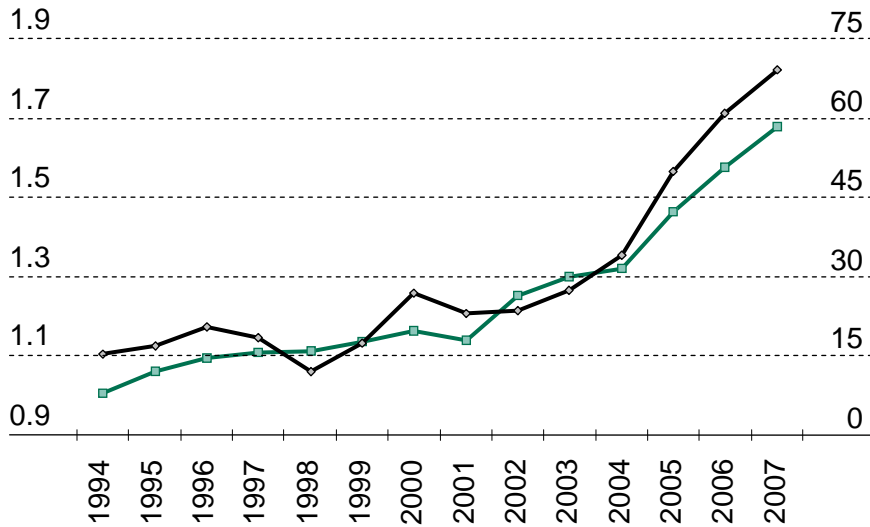
Source: State Statistics Service, Economics Ministry

Reallocation of the labor force will be more rational if economic growth continues



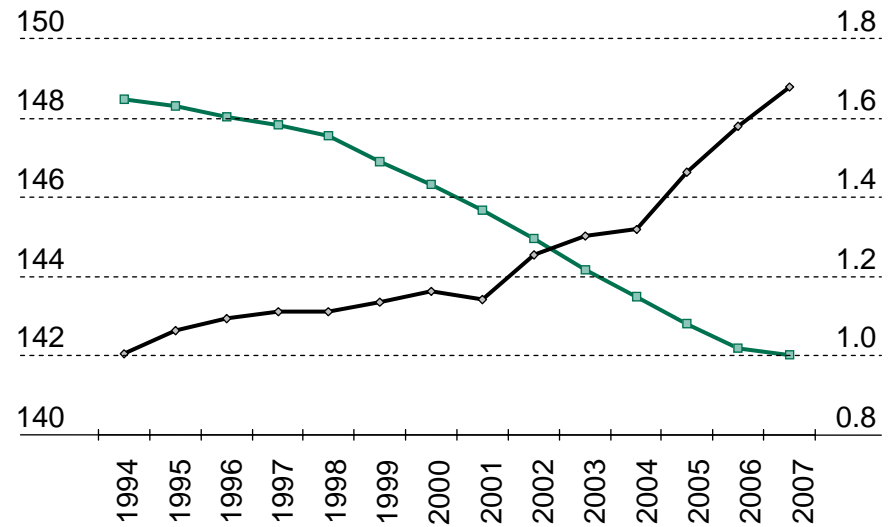
Source: State Statistics Service

The need to de-bureaucratize



—■— Government administration, mln people
 —◇— Urals, \$/bbl (r. h. scale)

Source: State Statistics Service



—■— Population, mln
 —◇— Government administration, mln people (r. h. scale)

Source: State Statistics Service