

Looking for More Balanced Growth: External Constraints Reshape Russia's Economy

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Evgeny Gavrilenko, Chief Economist

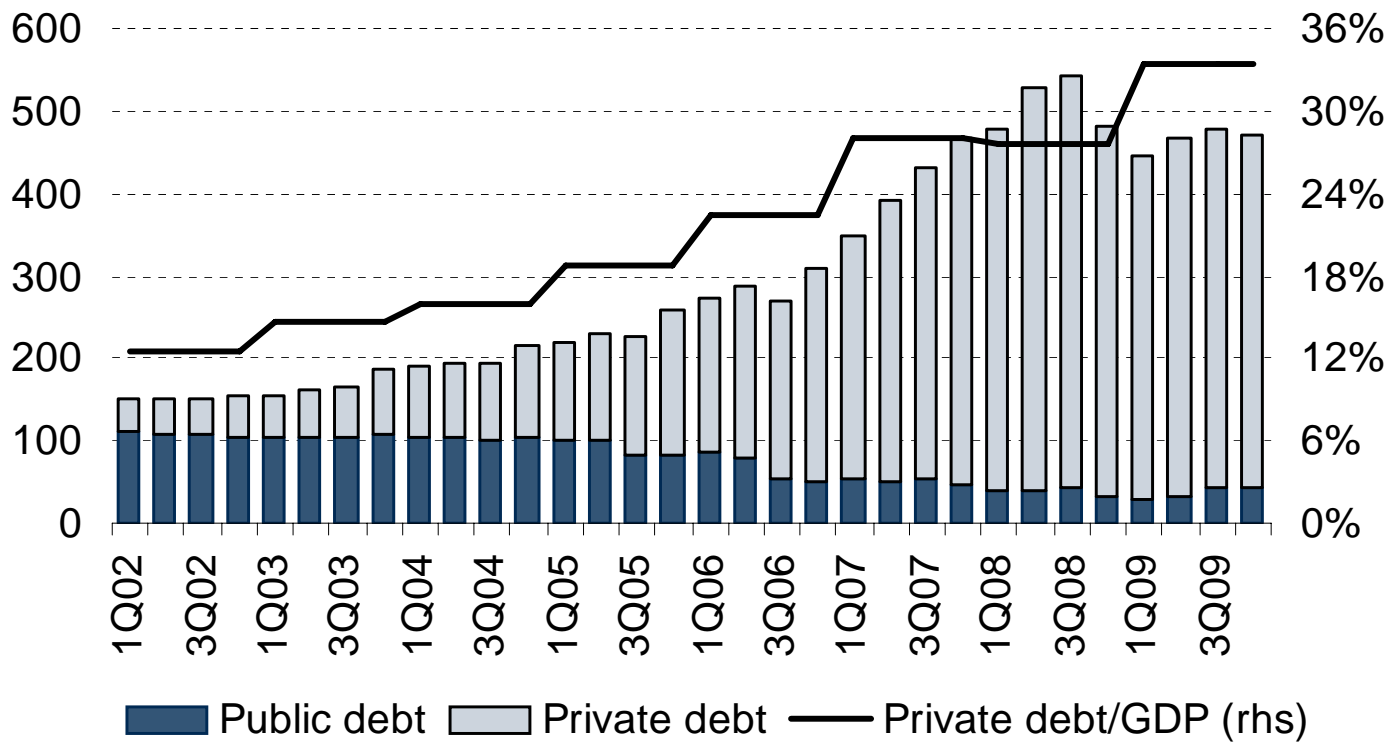


Troika Dialog

Russia needs to find a more balanced path to growth

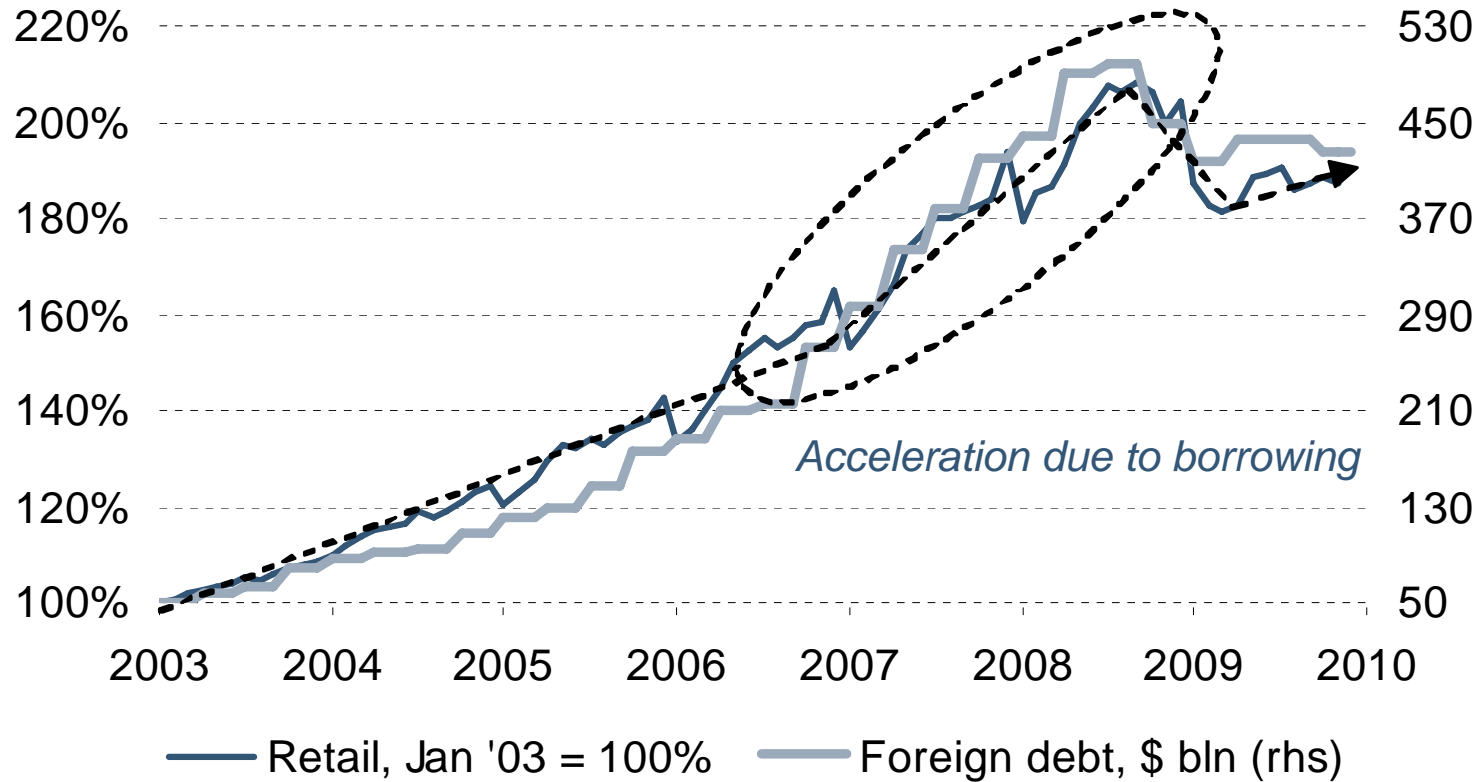
- **Russia needs to moderate growth after a period of overheating.** High and persistently rising oil prices accompanied by soaring external borrowing caused the Russian economy to overheat. The country (as well as the rest of the world) needs moderate growth in domestic demand, which was artificially inflated by excessive borrowing.
- **Russia's economy was – and still is – able to grow fast amid “low” oil prices.** However, this requires ideally a floating exchange rate, which has almost been the case since February and the end of the devaluation wave. Strong devaluation expectations and the authorities' slow reaction were to blame for “killing” growth, as money stopped circulating while the authorities gradually devalued the ruble.

Private foreign debt has been growing rapidly in recent years



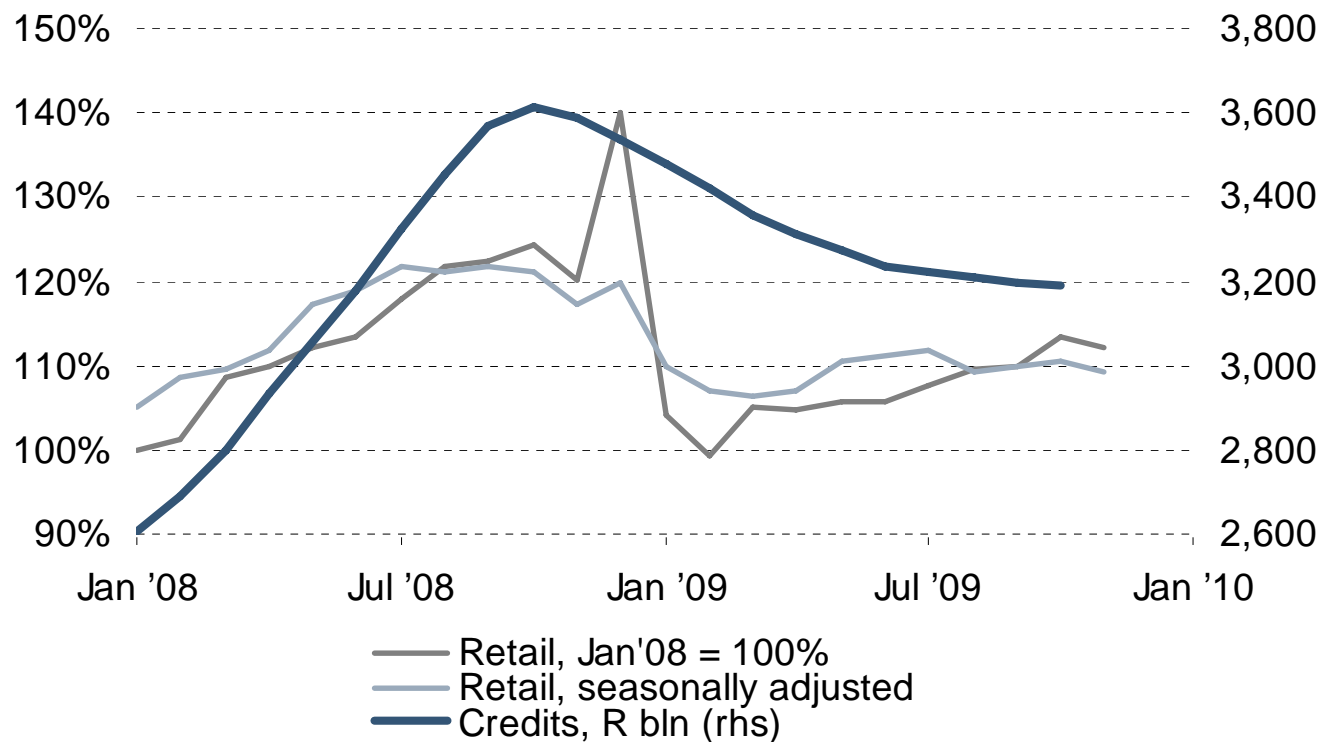
Source: Central Bank

Retail was booming due to foreign borrowing



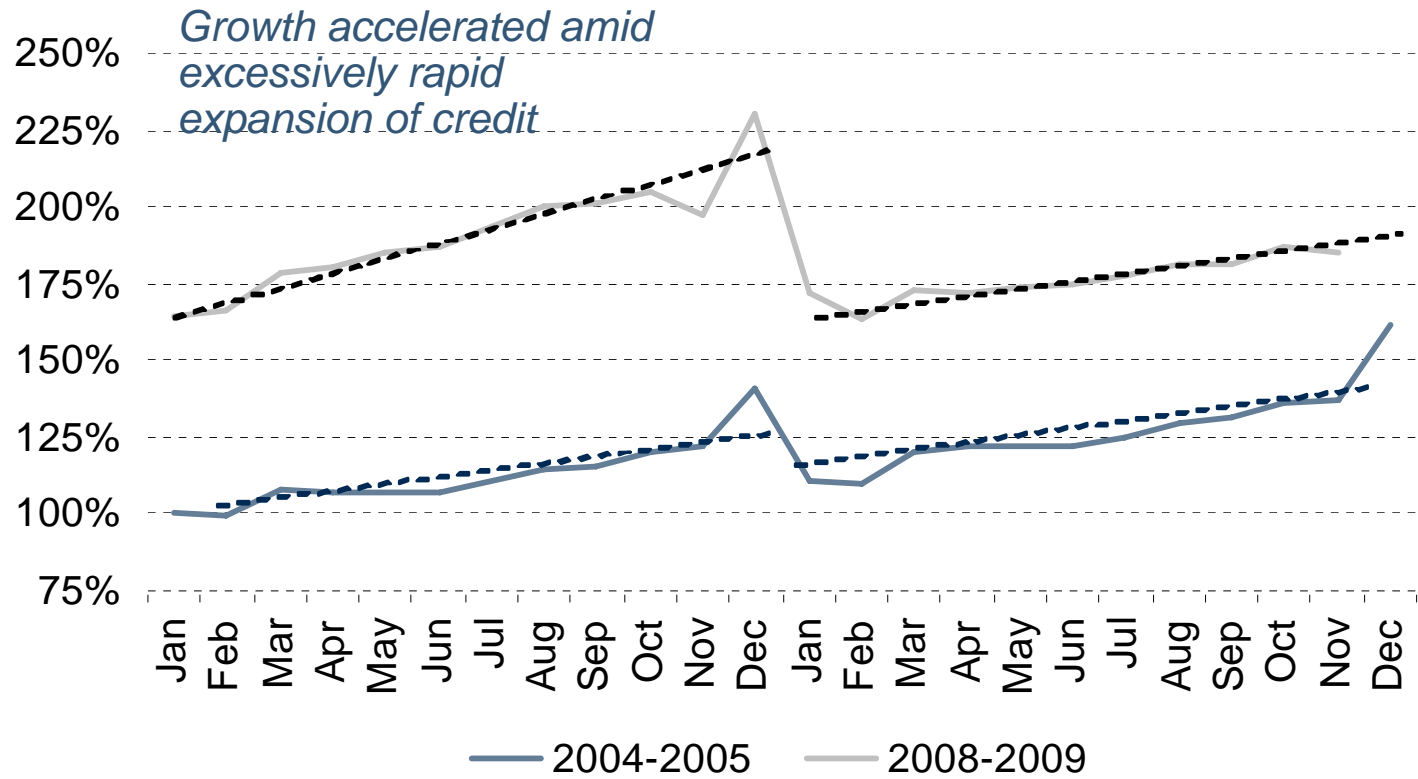
Source: State Statistics Service, Central Bank, Troika estimates

Consumption is steadily rising amid shrinking household debt



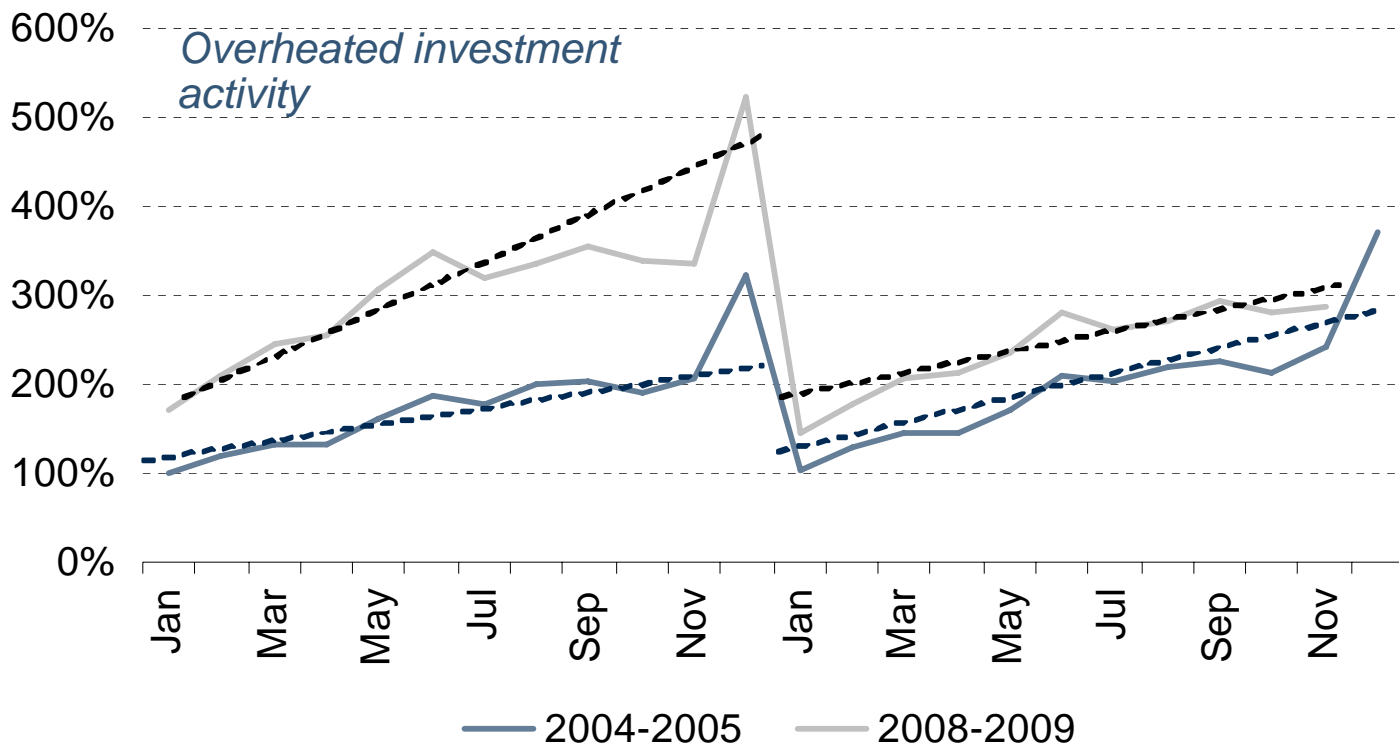
Source: State Statistics Service, Central Bank, Troika estimates

Retail growth moderated m-o-m amid a y-o-y contraction in 2009, Jan '04=100%



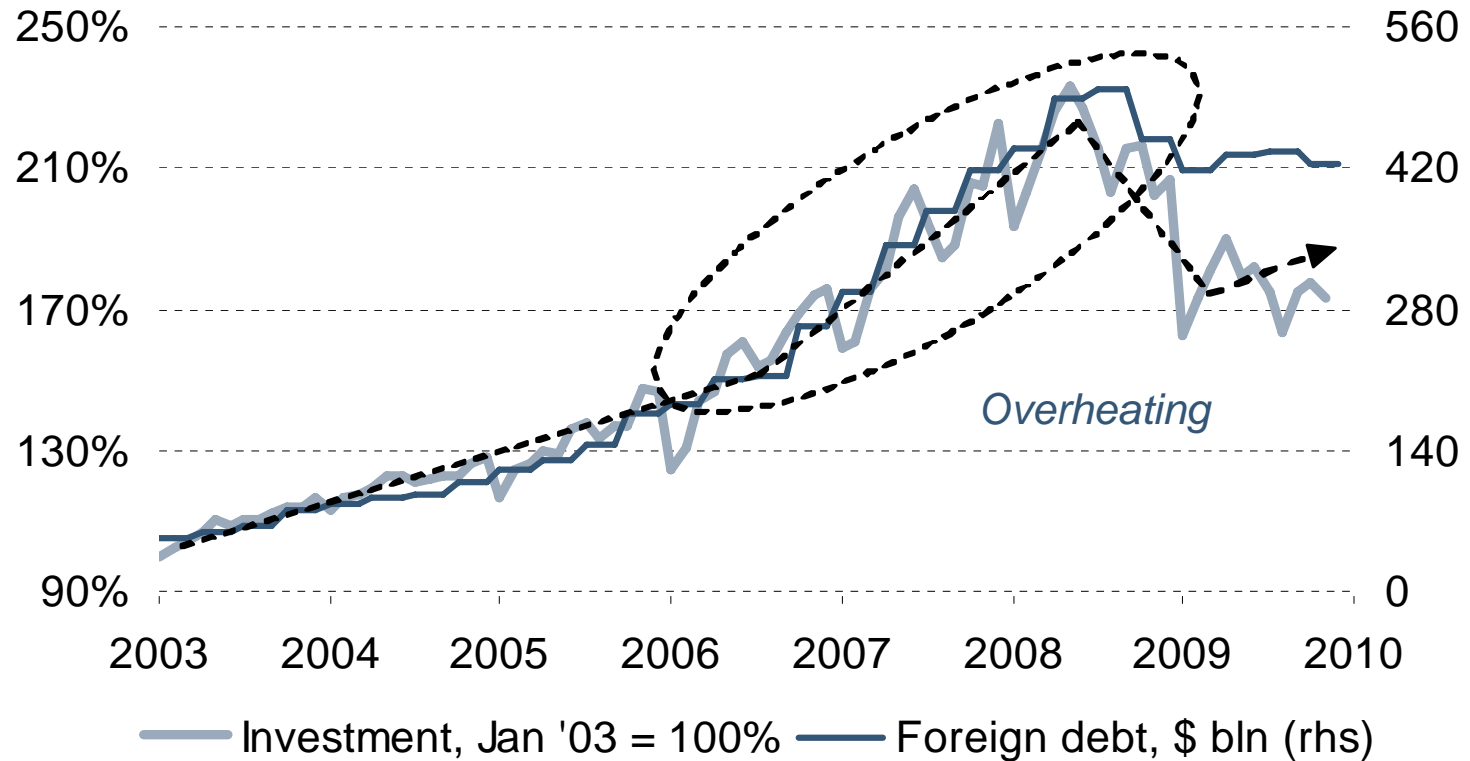
Source: State Statistics Service, Troika estimates

Investment is growing at a moderate pace m-o-m, as was the case several years ago, Jan '04=100%



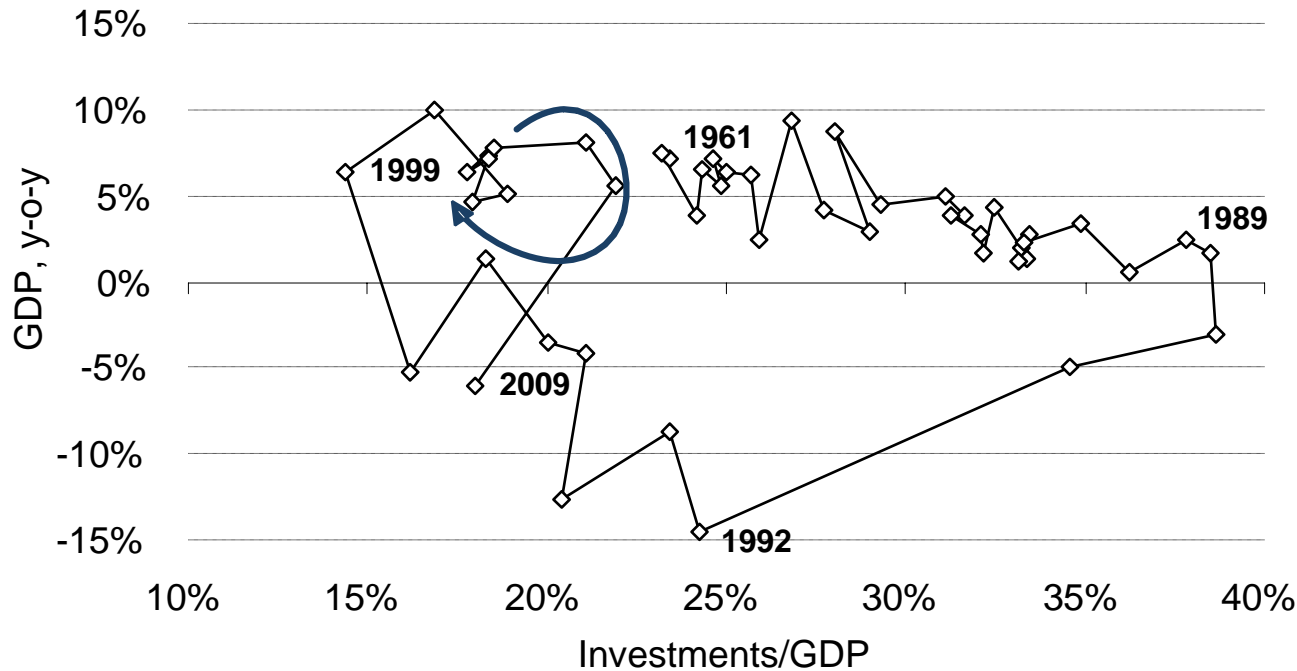
Source: State Statistics Service, Troika estimates

Investment overheating amid foreign borrowing



Source: State Statistics Service, Central Bank, Troika estimates

Russia is returning to more a balanced model of economic development after several years of overheating



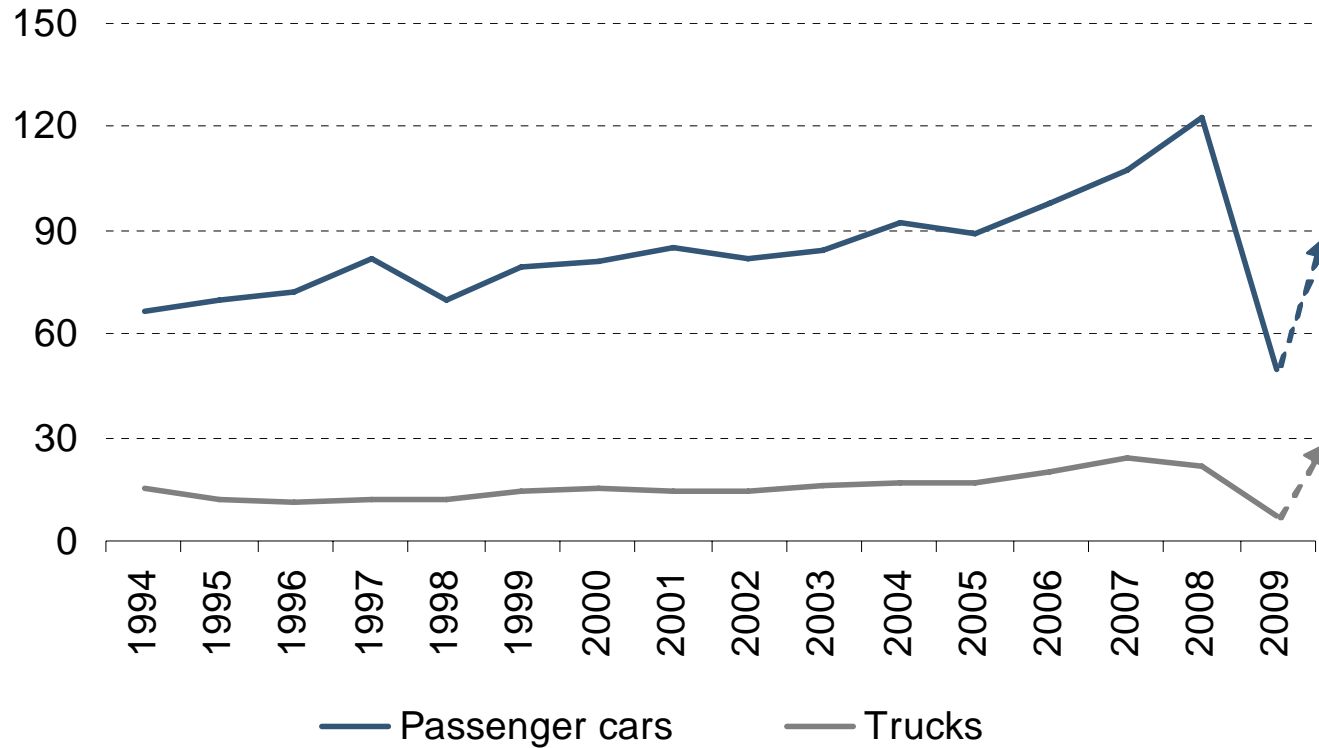
Source: State Statistics Service, Troika estimates

Russia is returning to growth in 2010, which will be more balanced in the years to come

- **In contrast to the overheated performance of previous years, growth and production volumes were abnormally low in early 2009 due to de-stocking.** The economy showed signs of recovery in 2H09. In 2010, Russia will deliver strong growth (at least 5%), due largely to the base effect.
- **In the medium term, growth should become more moderate and (hopefully) more balanced.** Growing government intervention, a “hands-on” approach which produced inefficiencies in recent years, is still a major risk for Russia’s future.
- **On the back of rapidly growing budget expenditures, inflation remained high in the preceding years, but it did not encourage economic growth.** Budget constraints, which all economic agents are facing, caused rapid disinflation in 2009 to 8.8%. Inflation in 2010 may be 4-6% or even less (if budget policy and monetary policy are coordinated). Interest rates will converge to this level.
- **Lower cost of borrowing is supposed to be a new platform for a more diversified growth.**

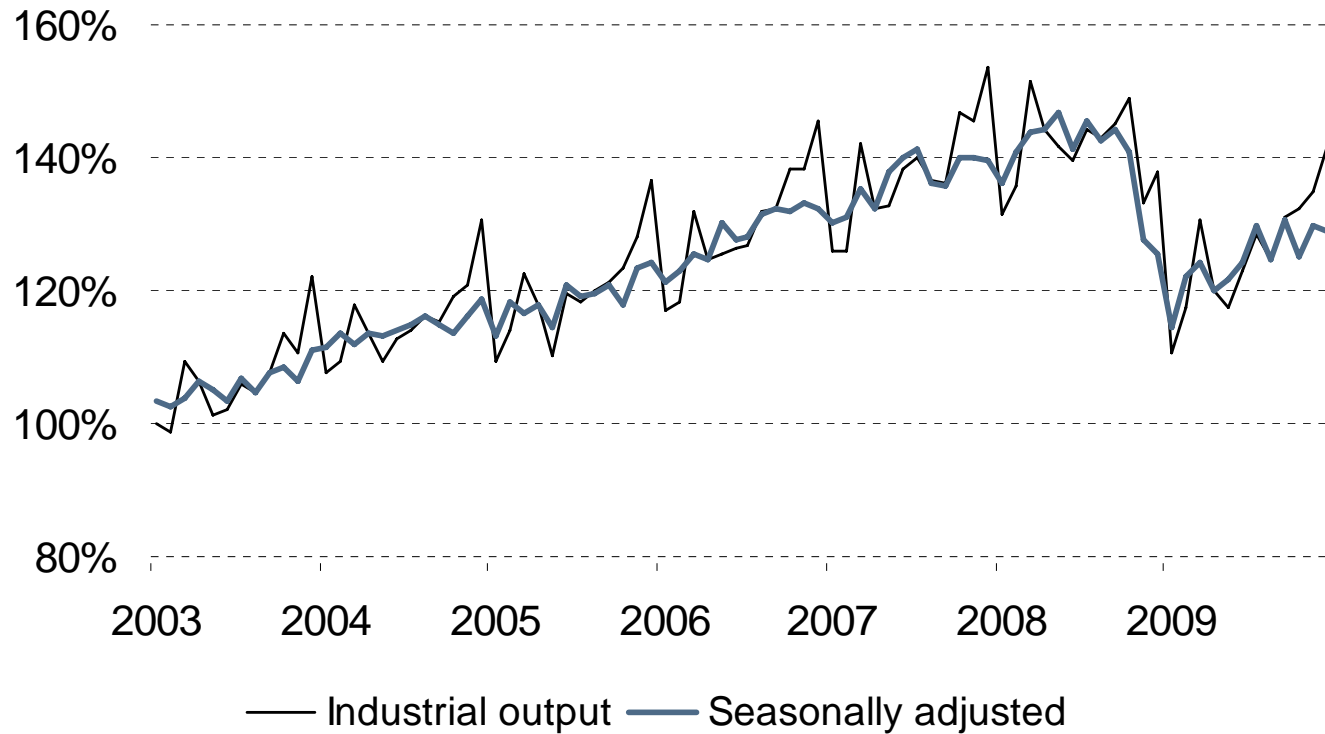
The decline in output was abnormal

Monthly average car production, '000 units



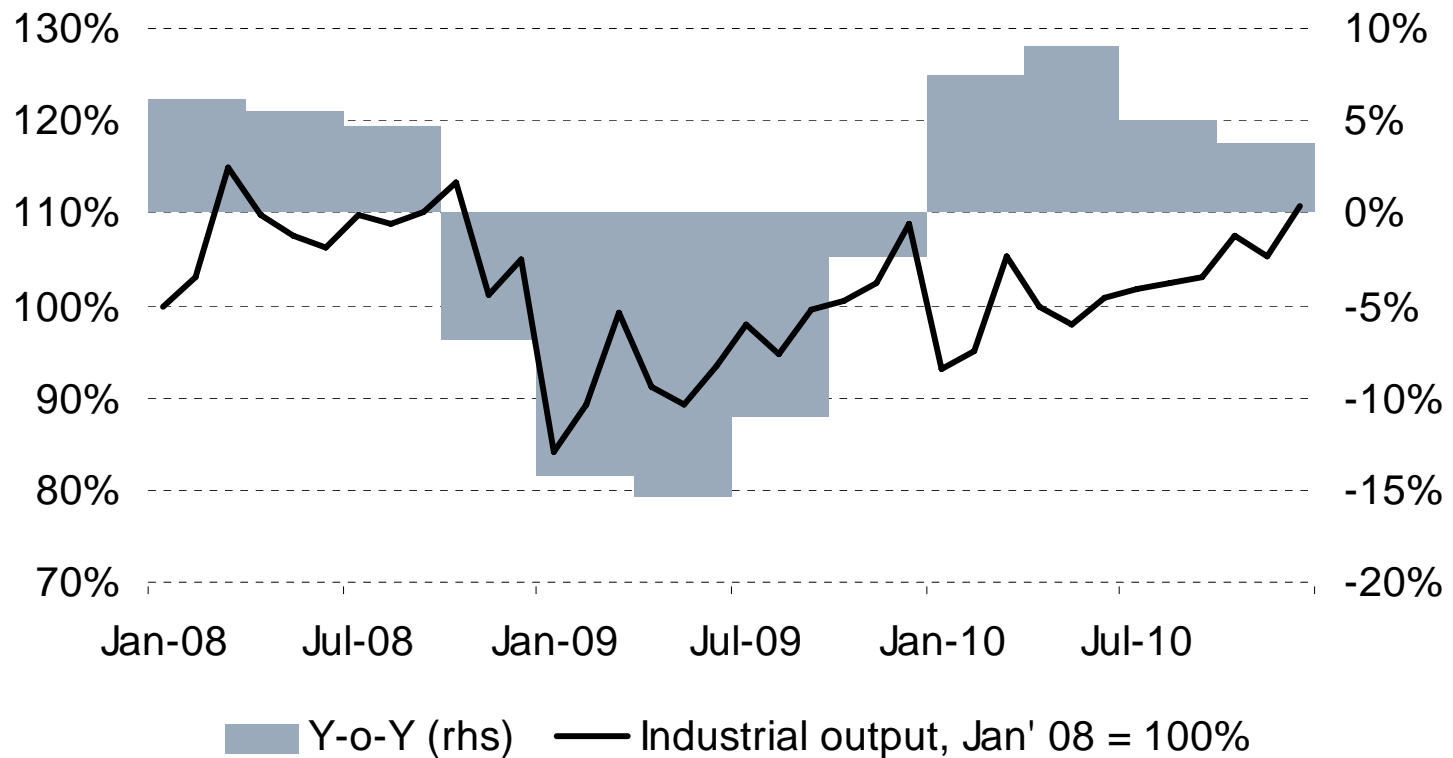
Source: State Statistics Service, Troika estimates

Industrial output has been recovering m-o-m since February 2009



Source: State Statistics Service, Troika estimates

Industrial output is expected to recover moderately in 2010, Jan'08 = 100%



Source: State Statistics Service, Troika estimates

Russia's economy will expand around 5% in 2010

	2008	1H09	2009	2010
GDP	5.6%	-10.4%	-7.0%	5.2%
Consumption	8.9%	-3.3%	-3.2%	3.1%
Household consumption	11.3%	-5.2%	-5.0%	4.5%
Public sector consumption	2.5%	1.7%	2.0%	-1.0%
Consumption of other sectors	-1.4%	-1.4%	0.0%	0.0%
Gross investments	11.1%	-55.4%	-30.0%	18.0%
Fixed capital investments	10.0%	-19.5%	-17.0%	5.0%
Changes in stocks	18.4%	–	–	–
Net export of goods and services	-36.0%	33.0%	34.0%	-3.0%

Source: State Statistics Service, Troika estimates. – 2009, 2010

Note: The Statistical service reported that GDP contracted by 7.9% in 2009

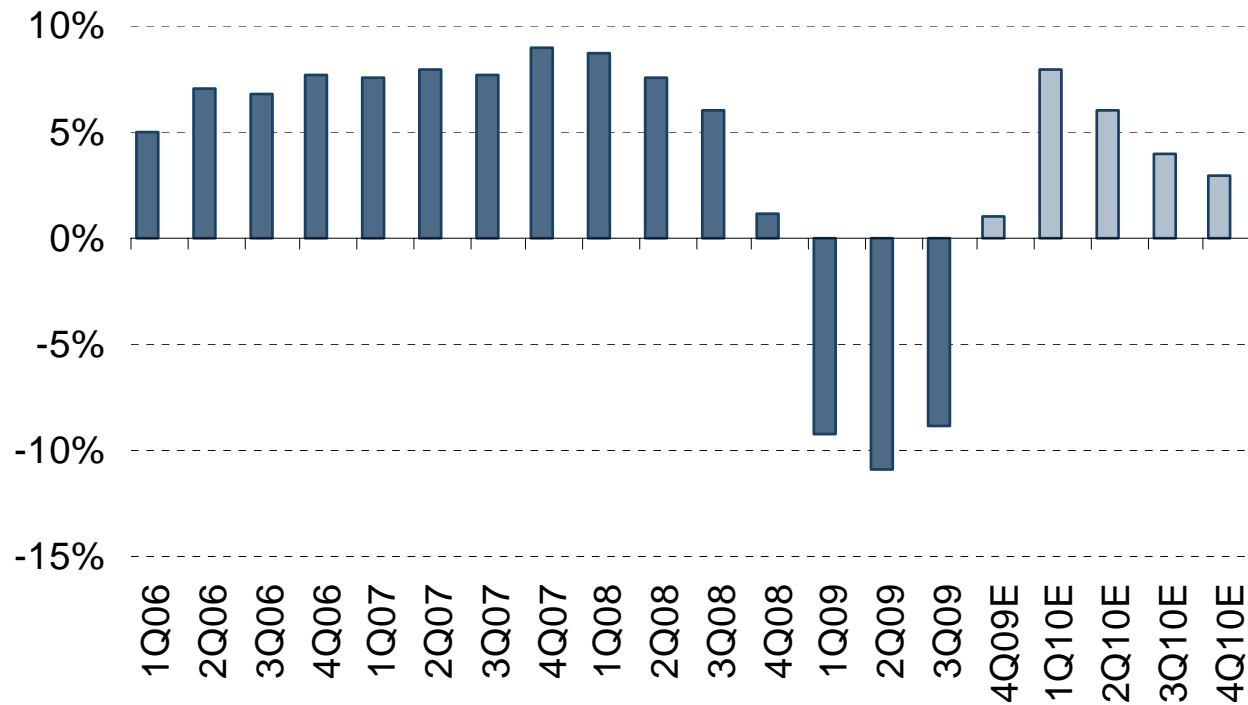
Deciphering Russian Statistics – Revisions Expected, y-o-y change

	Retail	Services	Household consumption	Real disposable incomes	Real wages
1Q08	17.2%	7.4%	12.2%	7.5%	13.4%
2Q08	14.9%	5.4%	13.4%	5.7%	12.5%
3Q09	15.0%	5.1%	12.2%	4.5%	12.2%
4Q08	8.7%	1.8%	8.0%	-6.9%	5.0%
2008	13.5%	4.8%	10.7%	1.9%	11.5%
1Q09	-0.1%	-0.9%	-3.2%	0.4%	-0.8%
2Q09	-5.6%	-4.7%	-7.0%	3.1%	-3.9%
3Q09	-9.2%	-6.4%	-11.6%	-2.9%	-5.2%
4Q09	-6.1%	-4.4%	-11.0%	7.0%	-1.0%
2009	-5.5%	-4.3%	-8.1%	1.9%	-2.8%

Note: 4Q09 numbers for services are Troika estimates based on 11m09 statistics, and 4Q09 household consumption growth is derived from the annual and 9m09 figures.

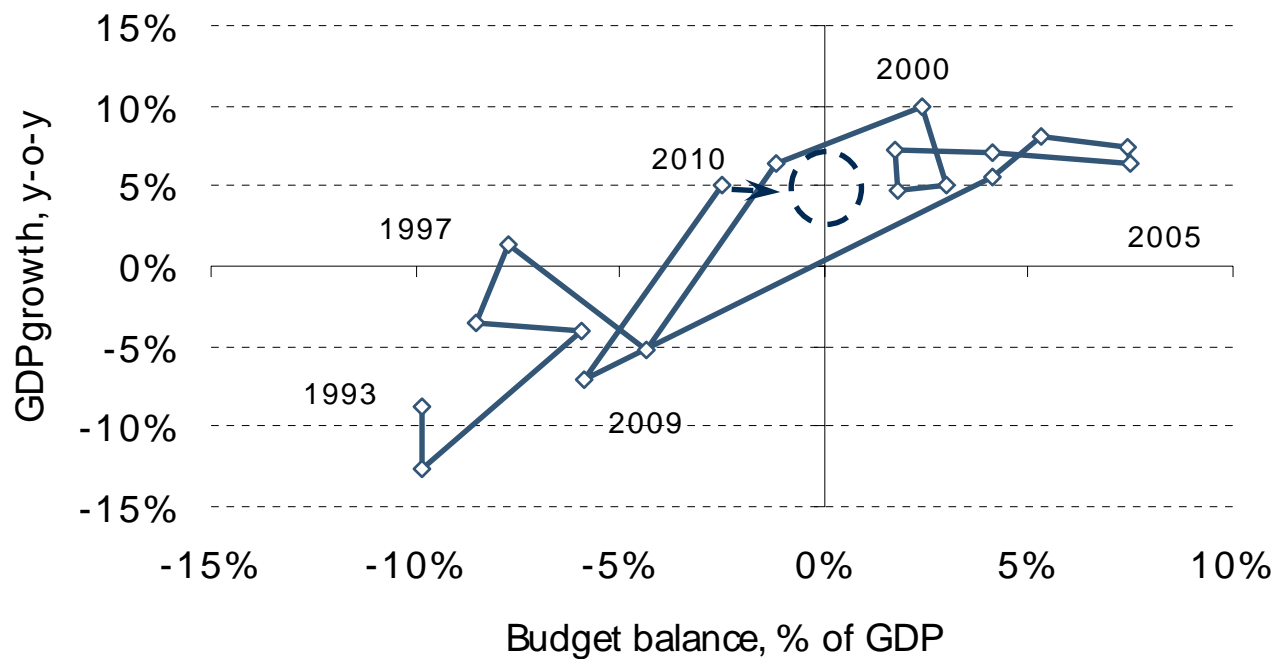
Source: State Statistics Service, Troika estimates

Due to low base effect, GDP growth (y-o-y) may be very strong in early 2010



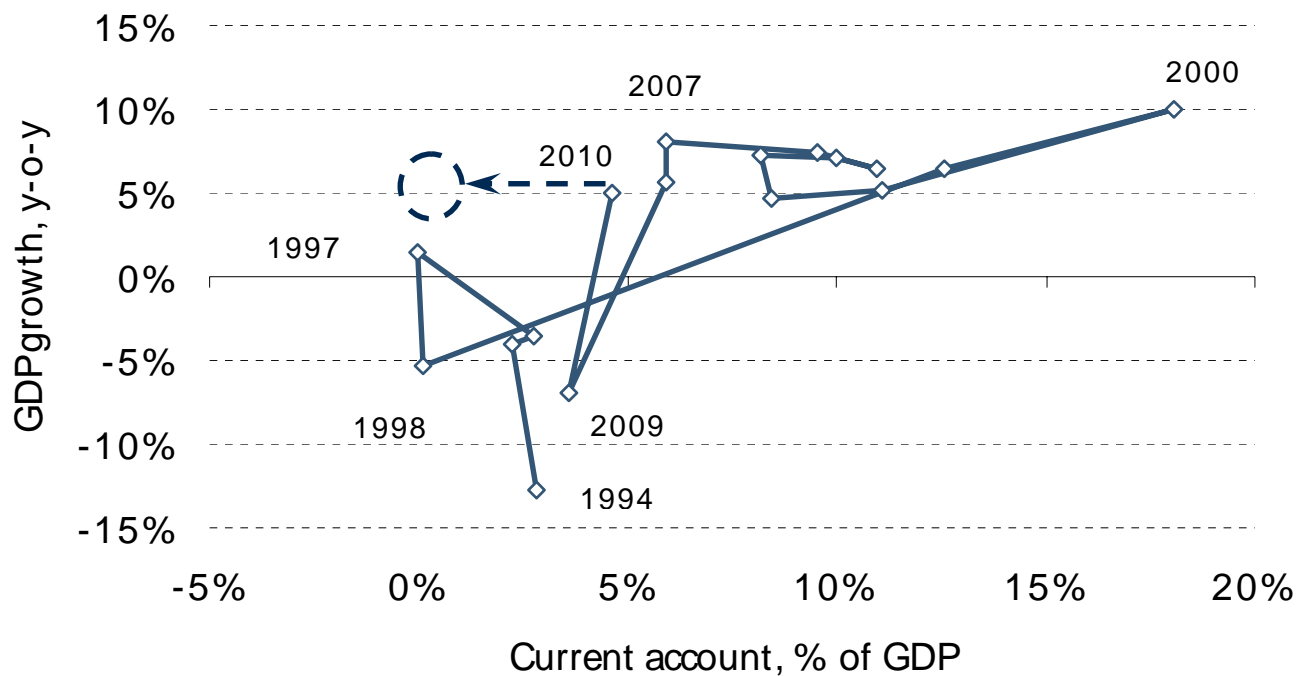
Source: State Statistics Service, Troika estimates

To guarantee economic growth, the budget should be balanced...



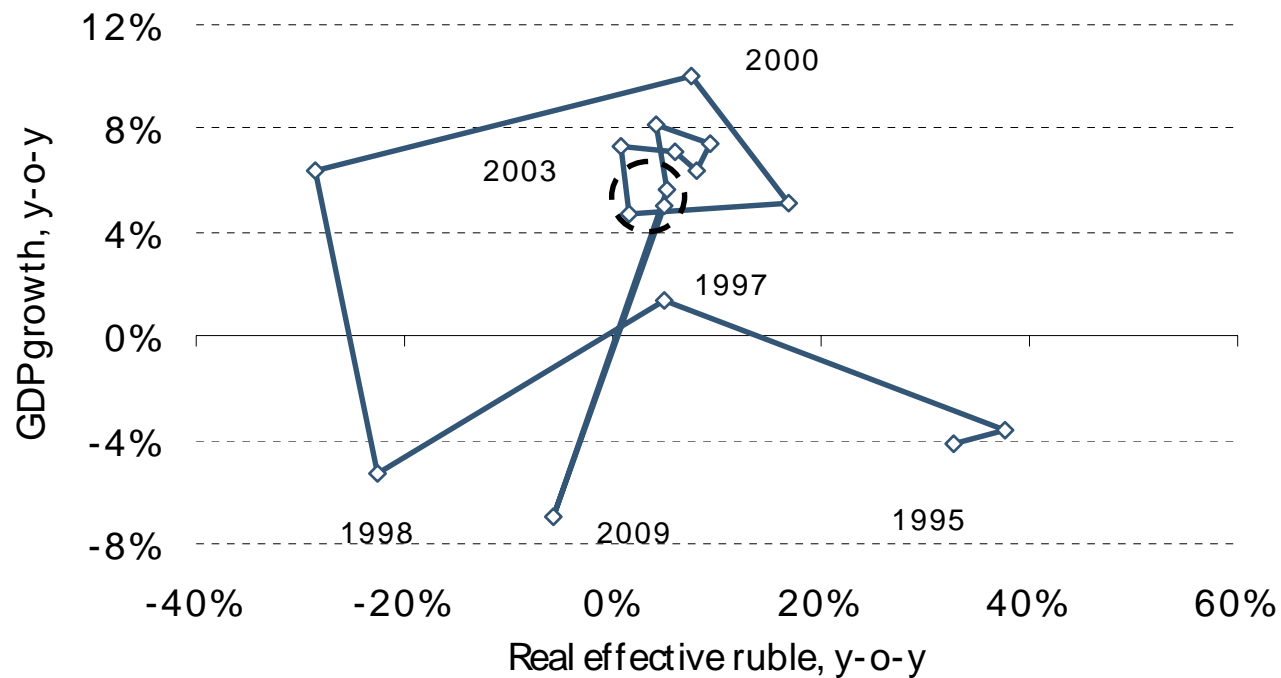
Source: State Statistics Service, Finance Ministry, Troika estimates

...the current account should remain in surplus...



Source: State Statistics Service, Central Bank, Troika estimates

...and the ruble's appreciation should be moderate



Source: State Statistics Service, Central Bank, Troika estimates

In uncertain times, economic performance will depend on government policies more than ever before – both in Russia and worldwide

As the global economy is no longer “overheating”, Russia must adjust to the new environment. The country desperately needs to bring inflation down further, restore confidence in the ruble and get rid of the sort of currency board regime it has implicitly implemented since 1999. Money should become more “endogenous” and borrowing costs must decline.

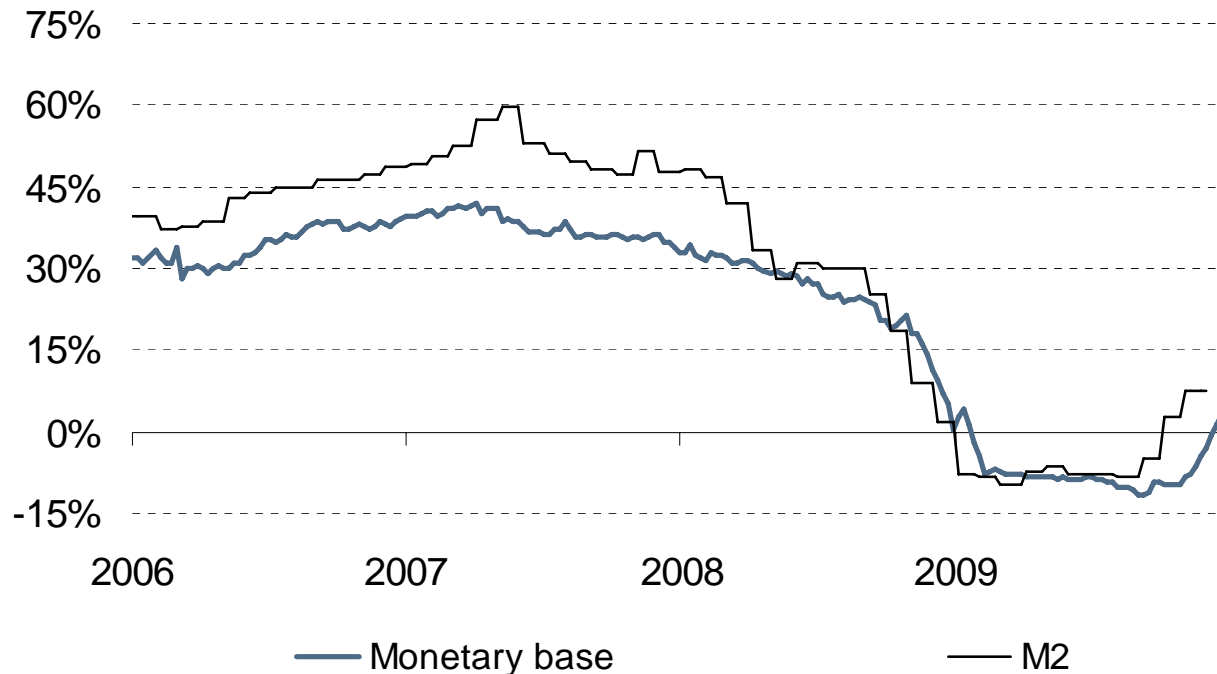
In contrast with monetary policy, which has improved significantly since the Central Bank abandoned exchange rate targeting last February, fiscal policy is expected to become less generous in 2010. Proposed budgets for 2010-12 require the need to finance huge budget deficits due to falling revenues. As a result, for the first time ever, expenditures are not expected to rise in 2010 and beyond – a major disinflationary factor. In a stable oil price environment there is no way out, apart from cutting wasteful expenditures. Budget policy will become more pragmatic, even though we expect significantly better performance on the revenues side, which will bring the deficit down.

M2 declined even in nominal terms, but started to rise since February 2009, a sign that the economy is recovering, R bln



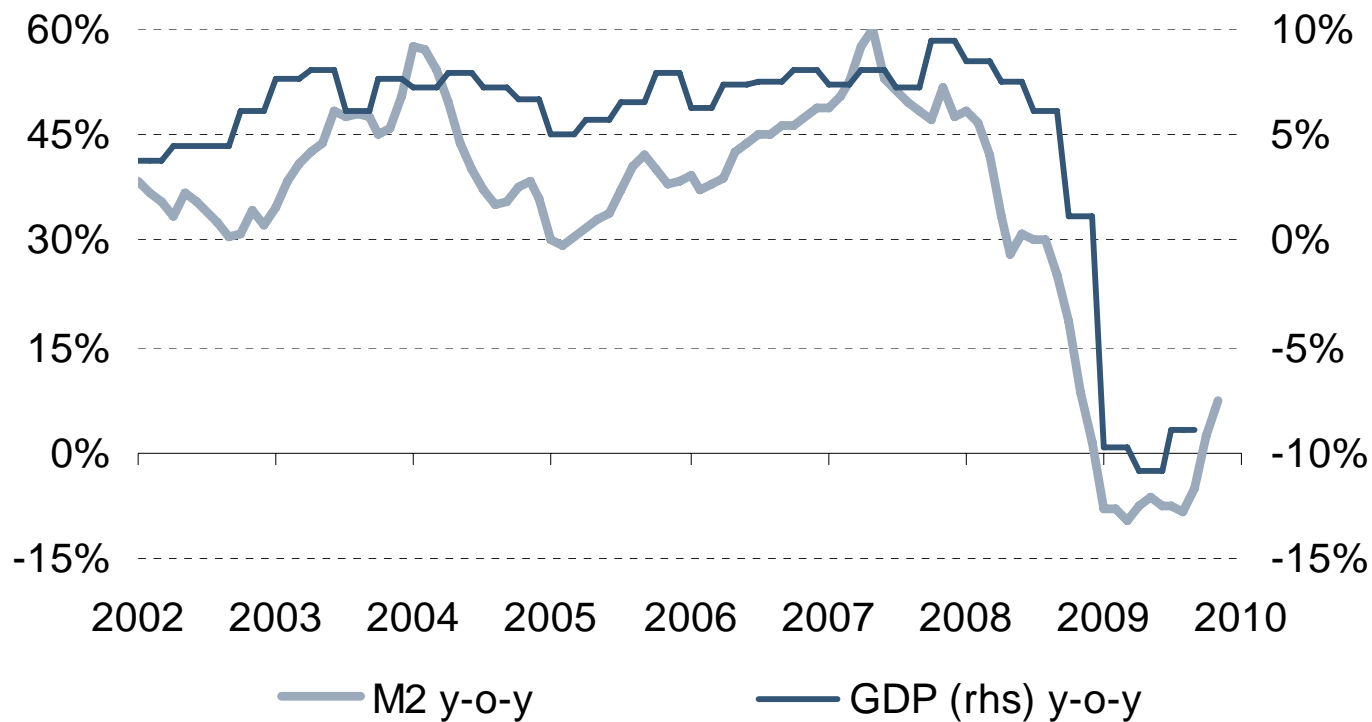
Source: Central Bank

The decline in economic activity in 2008-09 was accompanied by rapid demonetization of the economy (y-o-y)



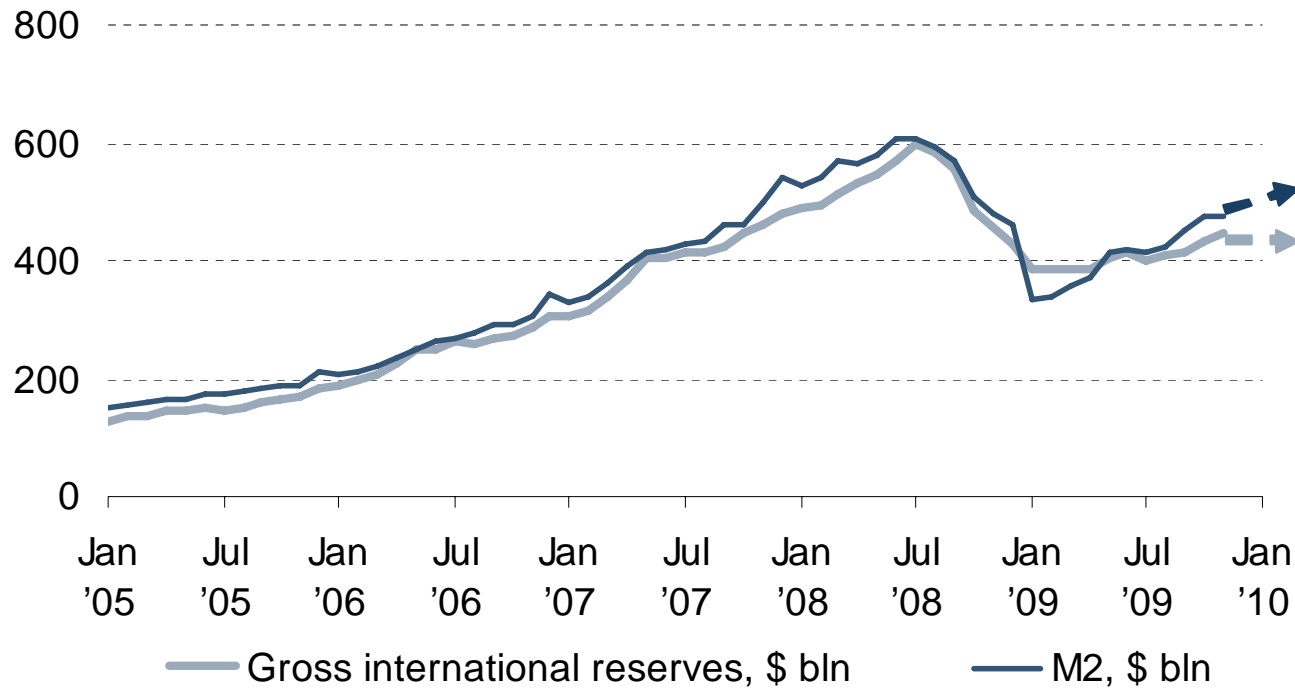
Source: Central Bank, Troika estimates

An upturn is occurring amid re-monetization of the economy



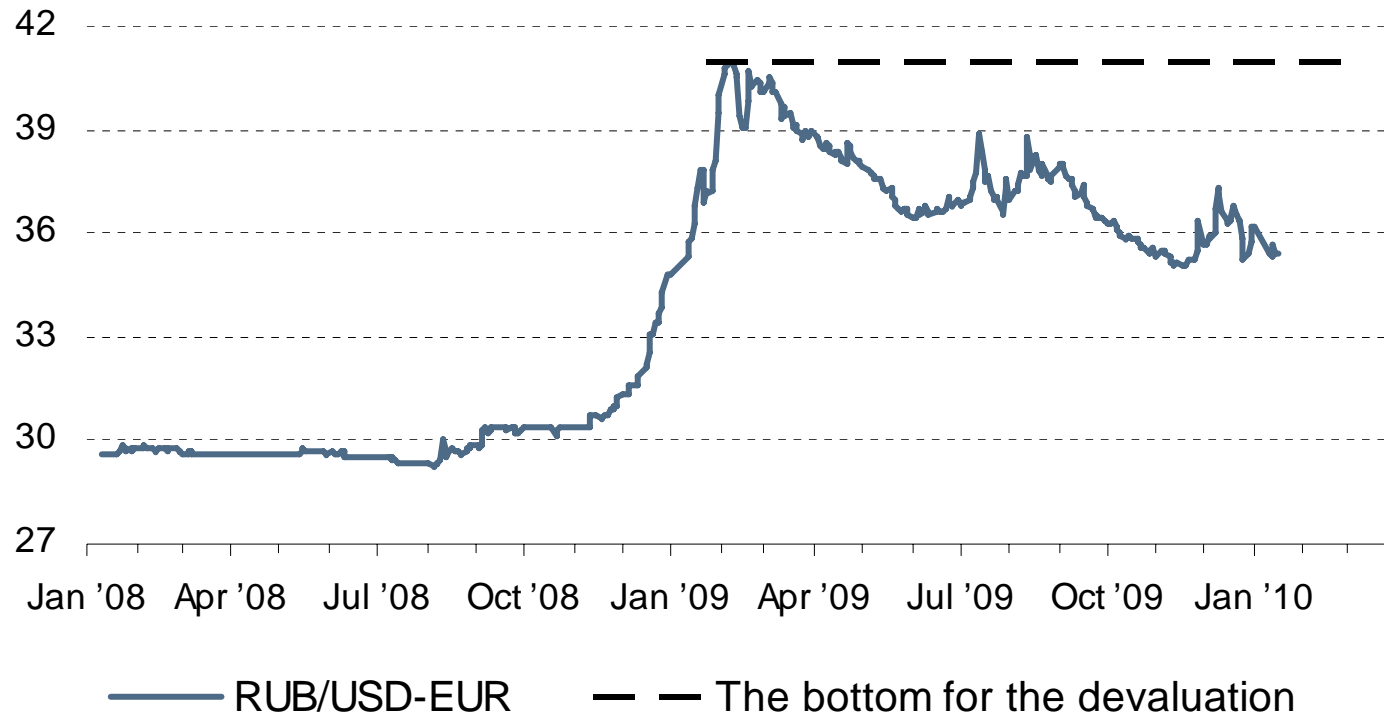
Source: Central Bank, State Statistics Service, Troika estimates

Still a sort of currency board: M2 follows the dynamics of gross international reserves, \$ bln



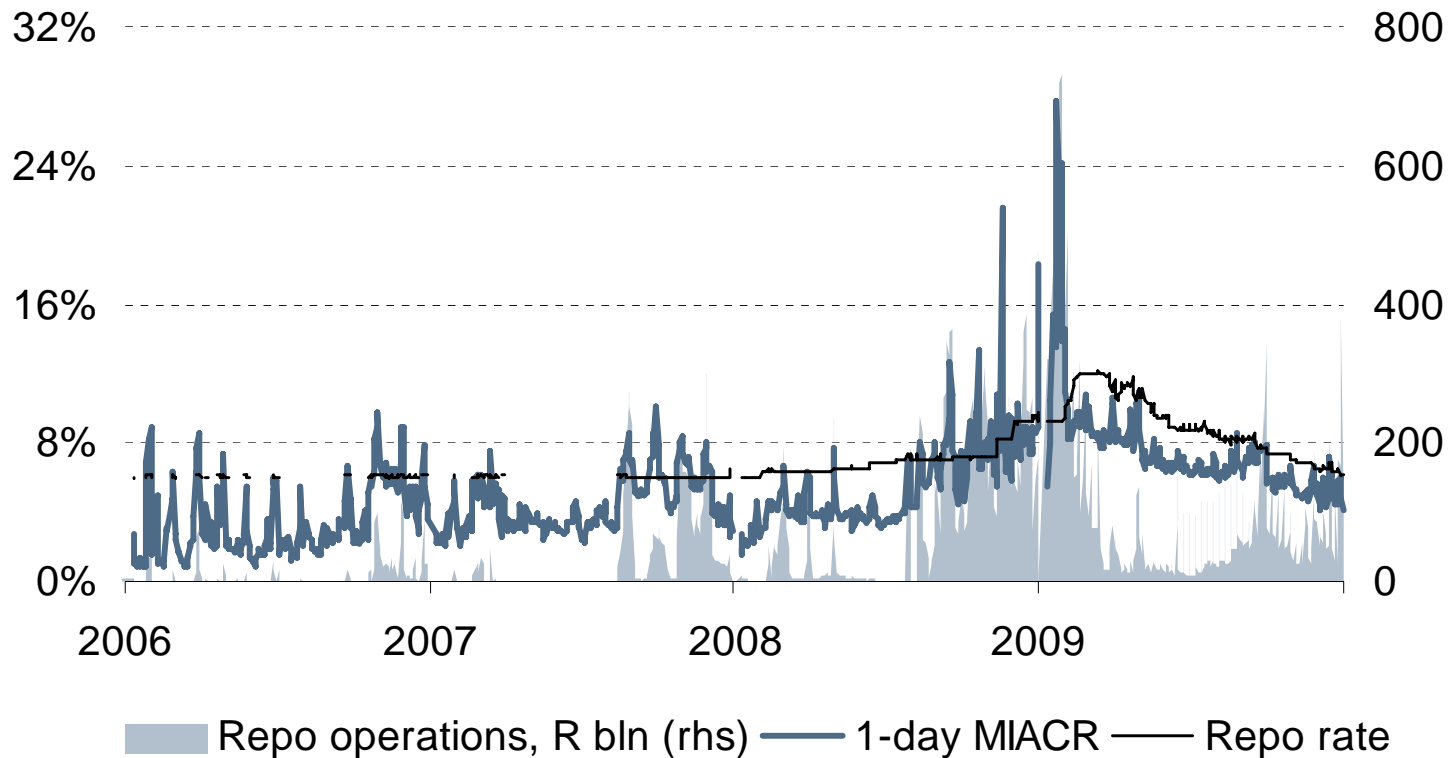
Source: Central Bank, Troika estimates

The ruble has appreciated since February (due to rising demand for money), but remains volatile



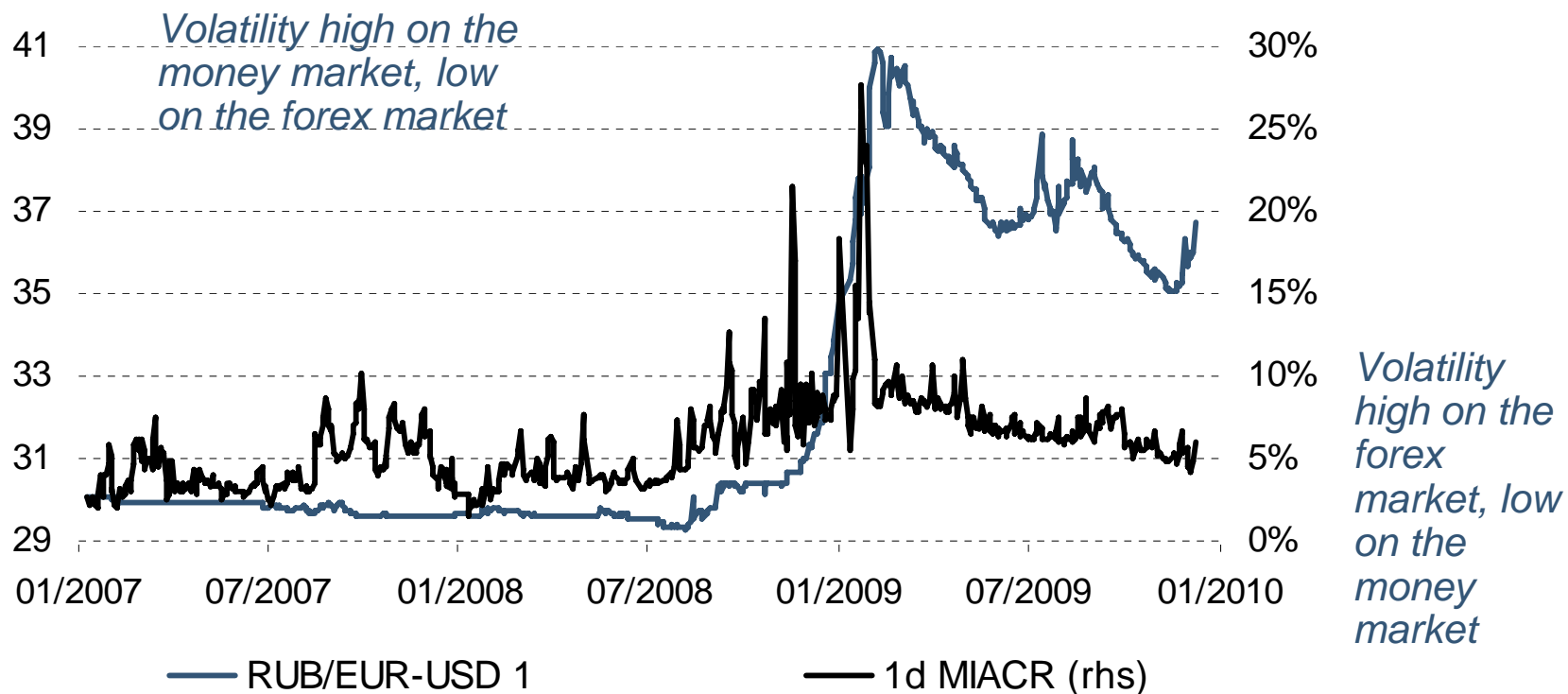
Source: Central Bank

The Central Bank's role as lender of last resort grew in importance during crisis periods



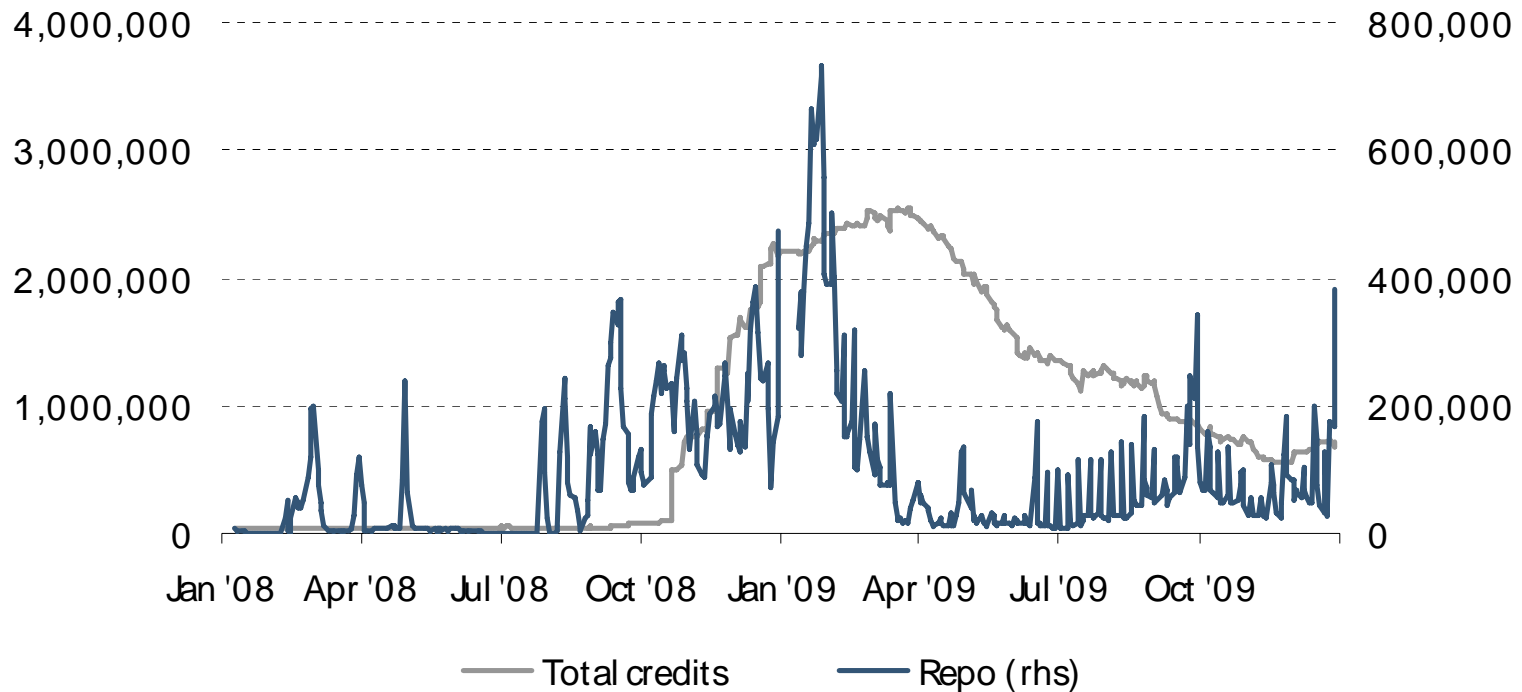
Source: Central Bank

Two regimes of targeting: currency first, money market second



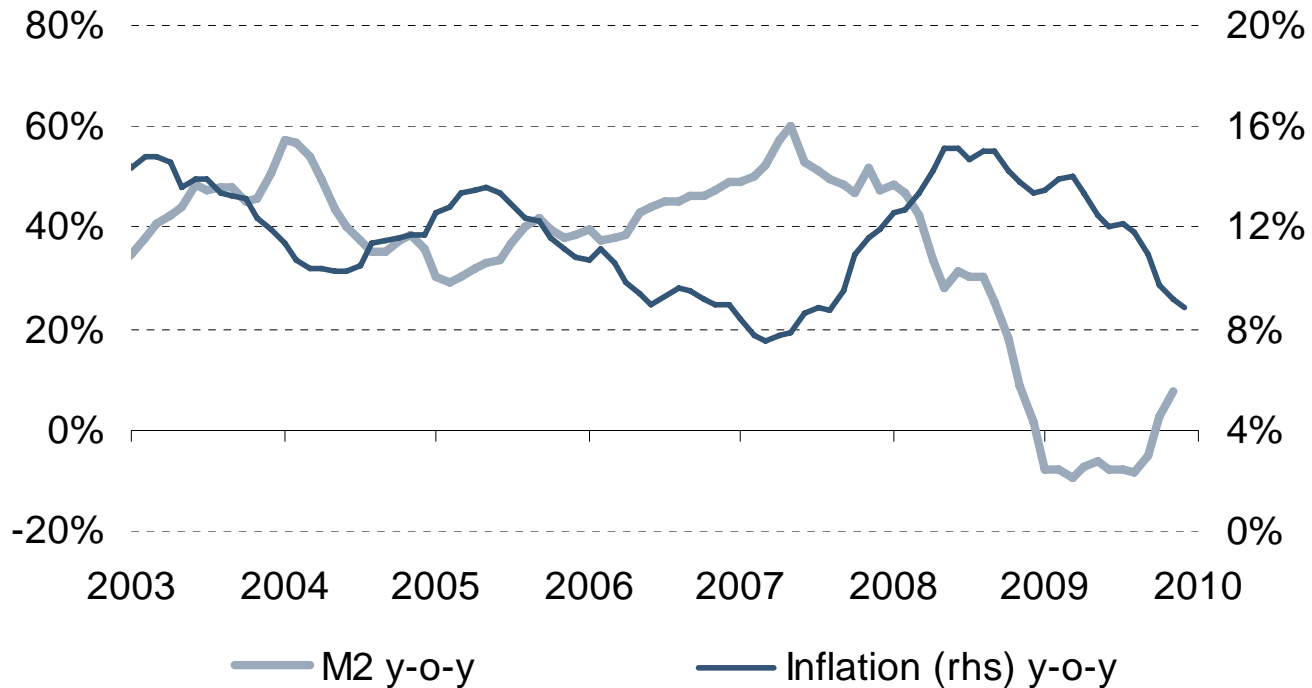
Source: Central Bank

Central Bank is absorbing previously extended loans, R mln



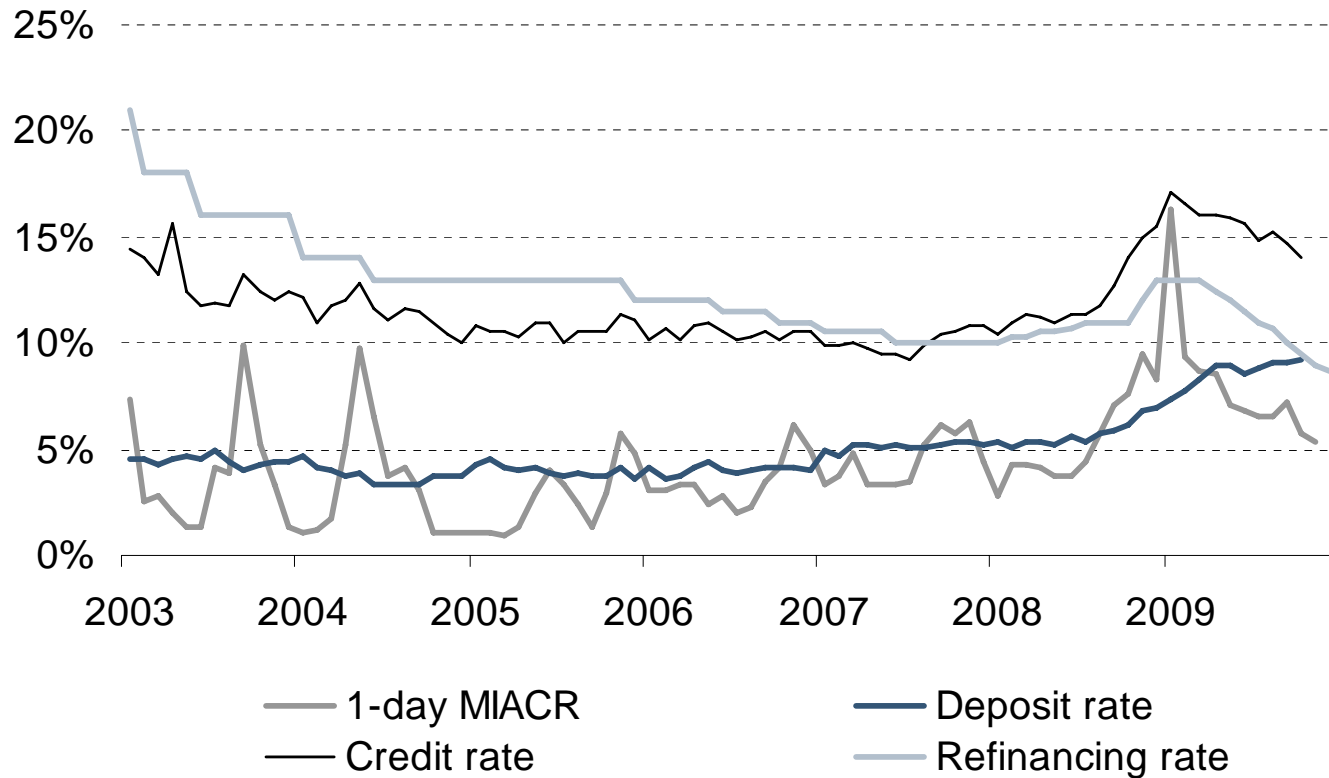
Source: Central Bank

Despite a budget deficit, inflation slowed in 2009, y-o-y



Source: Central Bank, State Statistics Service

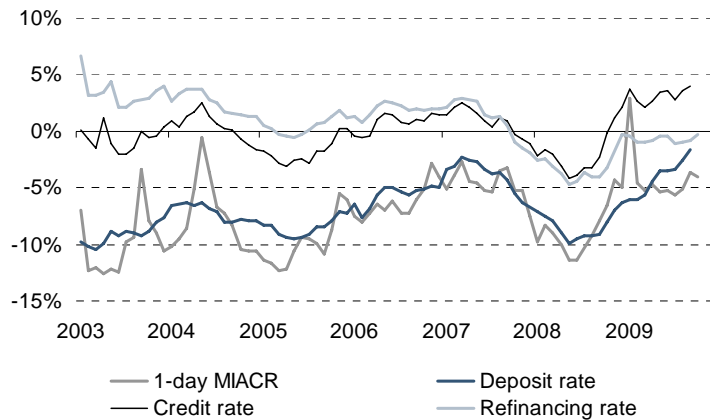
Nominal interest rates have started to decline...



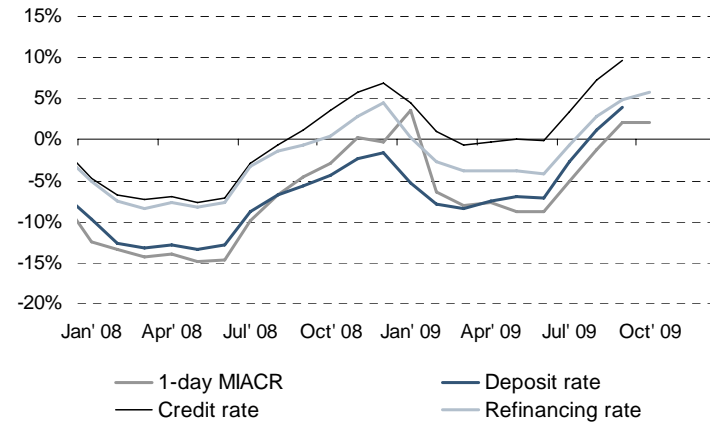
Source: Central Bank, State Statistics Service

... but real rates grew due to deceleration of inflation

Based on y-o-y inflation



Based on 6m moving average inflation



Source: Central Bank, State Statistics Service

The government expects budget revenues to fall, R bln...

	2005	2006	2007	2008	2009	10m09	2010	2011
Total revenues	5,127.2	6,276.3	7,779.1	9,274.1	7,336.0	5,787.6	6,950	7,456
Profit tax	377.6	509.9	641.3	761.1	-	158.9	-	-
Social tax	267.5	315.8	405.0	506.8	-	414.3	-	-
VAT	1,472.2	1,510.9	2,261.5	2,132.2	-	1,699.4	-	-
Excises	107.2	110.5	135.0	160.5	-	82.5	-	-
Raw materials extraction tax	854.5	1,094.3	1,122.9	1,604.7	-	773.6	-	-
Export duties	1,351.9	1,895.8	1,834.9	2,859.3	-	1,550.0	-	-
Import duties	270.9	341.6	488.0	625.6	-	375.2	-	-
Other	425.3	497.5	890.5	624.0	-	733.7	-	-

Note: The government initially expected revenues in 2009 at R6,713.8 bln .

Source: Finance Ministry

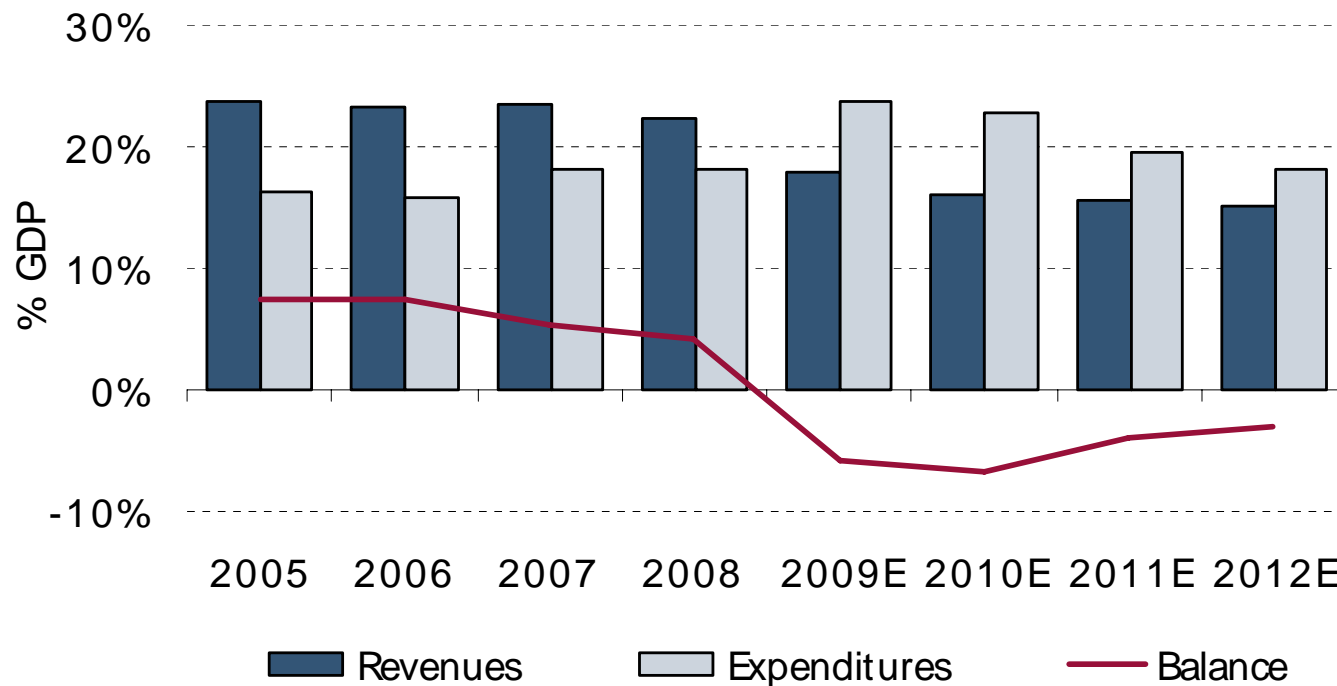
... but has not cut expenditures, R bln

	2005	2006	2007	2008	2009	10m09	2010	2011
Total expenditures	3,514.3	4,281.3	5,983.0	7,566.6	9,662.2	7,268.9	9,887.0	9,390.0
State administration	501.0	529.7	812.1	835.2	-	626.8	1,087.4	-
National defense	581.1	681.8	831.9	1,040.8	-	830.8	678.4	-
National security	450.1	550.2	667.0	835.6	-	756.4	726.8	-
National economy	248.7	345.0	692.6	1,025.0	-	1,190.1	1,366.1	-
Housing sector	6.9	52.7	294.9	129.5	-	84.5	103.0	-
Education	162.1	212.4	294.6	355.0	-	288.4	386.4	-
Medical care, sport	88.2	147.5	196.5	278.2	-	230.2	325.1	-
Social policy	178.3	201.2	214.0	293.6	-	237.9	328.8	-
Transfers	1,245.6	1,498.9	1,900.1	2,674.6	-	2,927.9	3,725.4	-
Other	52.3	61.9	79.2	99.0	-	96.0	1,159.7	-

Note: The government initially planned expenditures in 2009 at R9,845.2 bln.

Source: Finance Ministry

The government conservatively plans significant deficits in 2009-12, while reality may be brighter



Source: Finance Ministry

How the deficit is expected to be financed

Deficit financing, R bln

	2009	2010	2011
Deficit financing, total	2,326.1	2,937.0	1,934.0
Sovereign funds	2,032.2	2,246.0	762.0
External borrowing	-	430.0	515.0
Domestic borrowing	412.6	261.0	657.0

Note: The government initially expected budget deficit in 2009 at R3,131.4 bln.

Source: Finance Ministry

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**Chairman of Board of Directors and CEO,
Troika Dialog Group**

Ruben Vardanian

Chief Business Officer

Jacques Der Megreditchian

Chief Economist, Managing Director

Evgeny Gavrilenko

Research Department

+7 (495) 258 0511

Head of Research Paolo Zaniboni +7 (495) 787 2381

Strategy

Chief Strategist Kingsmill Bond, CFA +44 (207) 583 3257

Strategist Andrey Kuznetsov +7 (495) 933 9844

Oil and Gas

Senior Analyst Oleg Maximov +7 (495) 933 9830

Analyst Valery Nesterov +7 (495) 933 9832

Analyst Alex Fak +7 (495) 933 9829

Utilities

Senior Analyst Alexander Kotikov +7 (495) 933 9841

Analyst Igor Vasilyev +7 (495) 933 9842

Telecoms, Media and IT

Senior Analyst Evgeny Golossnoy +7 (495) 933 9834

Analyst Anna Lepetukhina +7 (495) 933 9835

Metals and Mining

Senior Analyst Sergey Donskoy, CFA +7 (495) 933 9840

Senior Analyst Mikhail Stiskin +7 (495) 933 9839

Analyst Irina Lapshina +7 (495) 933 9852

Manufacturing

Analyst Mikhail Ganelin +7 (495) 933 9851

Financials

Senior Analyst Andrew Keeley +7 (495) 933 9845

Analyst Olga Veselova +7 (495) 933 9846

Consumer

Senior Analyst Victoria Sokolova +7 (495) 933 9836

Analyst Mikhail Krasnoperov +7 (495) 933 9838

Assistant Analyst Vitaly Chakin +7 (495) 258 0511

Real Estate

Analyst Igor Vasilyev +7 (495) 933 9842

Chemicals

Senior Analyst Mikhail Stiskin +7 (495) 933 9839

Analyst Irina Lapshina +7 (495) 933 9852

Transport

Analyst Kirill Kazanli +7 (495) 933 9853

Small and Mid Cap

Analyst Mikhail Ganelin +7 (495) 933 9851

Market Analysis

Assistant Analyst Nadezhda Utenkova +7 (495) 933 9855

Economy

Senior Economist Anton Stroutchenevski +7 (495) 933 9843

Fixed Income

Head of FI Research Alexander Kudrin +7 (495) 933 9847

Senior Analyst Anton Tabakh, CFA +7 (495) 933 9857

Senior Analyst Alexey Bulgakov +7 (495) 933 9866

Analyst Ekaterina Sidorova +7 (495) 933 9849

Ukraine

Strategist Roman Zakharov +38 (044) 207 3780

Economist Iryna Piontkivska

Senior Analyst Yevhen Hrebeniuk

Senior Analyst Peter Keller

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Kazakhstan

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