



**ASSOCIATION OF EUROPEAN BUSINESSES
IN THE RUSSIAN FEDERATION**

Briefing by Chris Weafer

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Russia: Invest and Modernise or Stagnate

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Russia – Invest or Stagnate

February 2011



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➤ **Era of oil funded growth is ending**

.....*Russia earned approximately \$1.5 trillion from oil & gas exports since 2000*

.....*today, the budget needs over \$90 p/bbl to balance*

➤ **Investment will have to lead next decade's growth**

.....*\$90 p/bbl leaves little room for investment spending*

.....*Russia needs both foreign capital and, especially, foreign expertise to maintain growth*

➤ **Evolution is consistent with Putin's vision of development**

.....*Putin has been very consistent with his view that Russia should develop in stages*

.....*Putin's presidency focused on "preparation" – now its about "investment"*

➤ **Major obstacles, domestic and international, to be overcome**

.....*international investor perception of Russia is poor*

.....*Corruption, bureaucracy, poorly drafted legislation, demographics are major obstacles*

➤ **Period of crisis has created new sense of reality**

.....10 years of rising oil revenues led to complacency

.....and fostered the illusion that the economy had broken its dependency on oil

➤ **Priorities are infrastructure and rebuilding “lost” industries**

.....the August '09 Dam explosion provided the “wake up call”

.....reducing import dependency in food and medicines are now priority projects

➤ **Investment and expertise will have to be imported**

.....PPP Schemes and JV projects

.....Efforts to increase Russian investment abroad will also increase

.....Being admitted to WTO in 2011 is part of that process

➤ **Low investment = low growth = social instability = political risk**

.....people’s expectations are much higher today than in 2000

.....The March 2018 succession will be less predictable if economic growth remains low

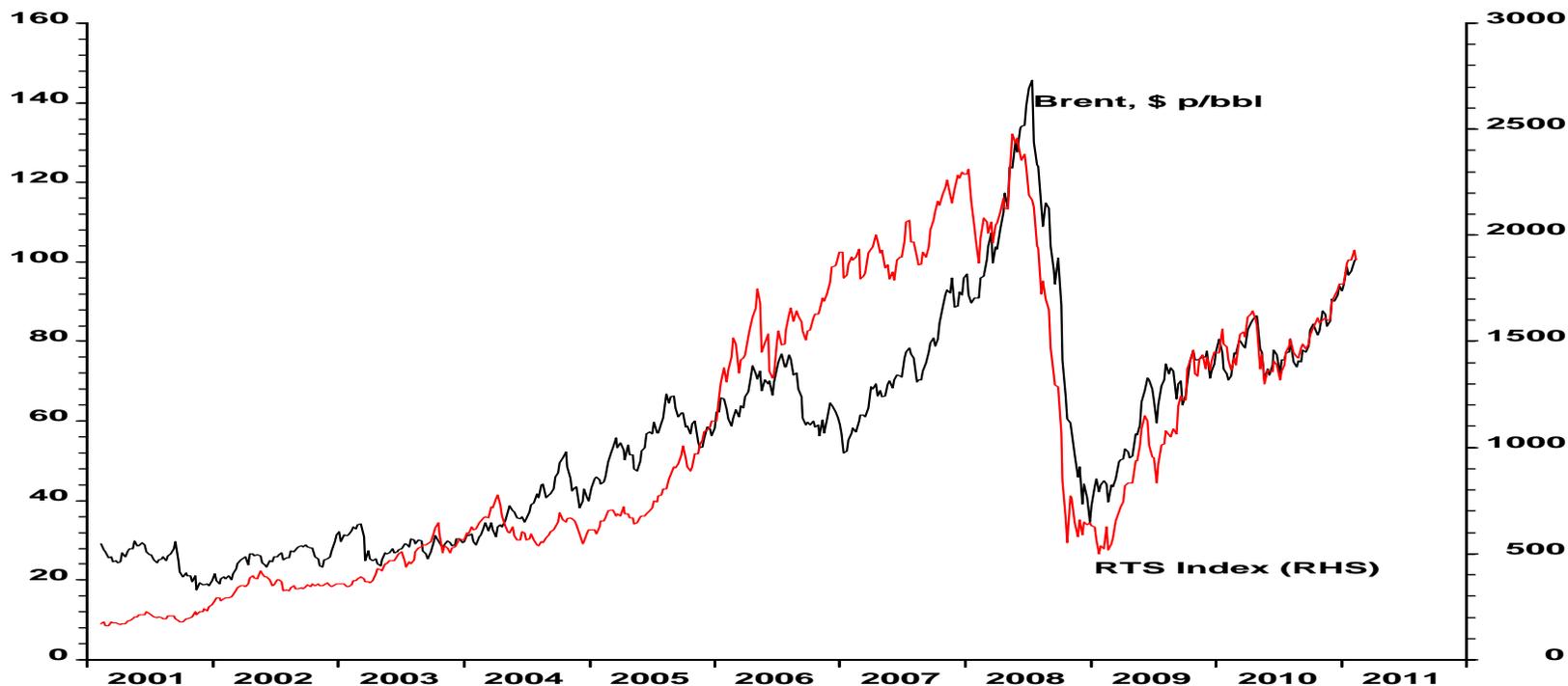
- **Average 3.0% annual growth without major new investment**
- **Demographic deterioration will have to be compensated with higher investment**

URALSIB long-term forecast, % YoY

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|-------------------------------|-------|------|------|------|------|------|------|------|------|------|------|
| GDP | 4.0 | 4.6 | 4.4 | 2.7 | 3.1 | 2.7 | 2.5 | 2.7 | 2.8 | 3.1 | 3.5 |
| Industrial production | 8.2 | 5.1 | 3.8 | 2.7 | 3.2 | 2.8 | 2.9 | 3.1 | 3.3 | 3.6 | 3.9 |
| Retail sales | 5.8 | 6.5 | 6.7 | 5.9 | 5.5 | 5.0 | 4.5 | 4.6 | 4.6 | 4.8 | 5.0 |
| Real incomes | 5.5 | 4.2 | 5.3 | 4.8 | 5.4 | 4.7 | 4.8 | 5.3 | 5.8 | 6.9 | 7.7 |
| CPI | 8.5 | 9.5 | 10.9 | 10.2 | 8.0 | 6.9 | 6.8 | 6.6 | 6.5 | 6.5 | 6.4 |
| Federal budget deficit, % GDP | (2.4) | 0.7 | 3.6 | 4.2 | 4.7 | 5.0 | 4.7 | 4.5 | 4.2 | 4.0 | 3.7 |
| RUB/\$ (average) | 29.9 | 29.4 | 29.5 | 30.3 | 31.1 | 32.2 | 33.4 | 34.7 | 36.0 | 37.3 | 38.5 |
| Urals (average), \$/bbl | 77.2 | 83.1 | 84.0 | 83.2 | 84.0 | 84.2 | 84.5 | 84.9 | 85.7 | 87.2 | 89.7 |

Source: URALSIB estimates

- **Economic growth and the price of assets have been very closely linked to the oil price since 2000**



Source: DATASTREAM

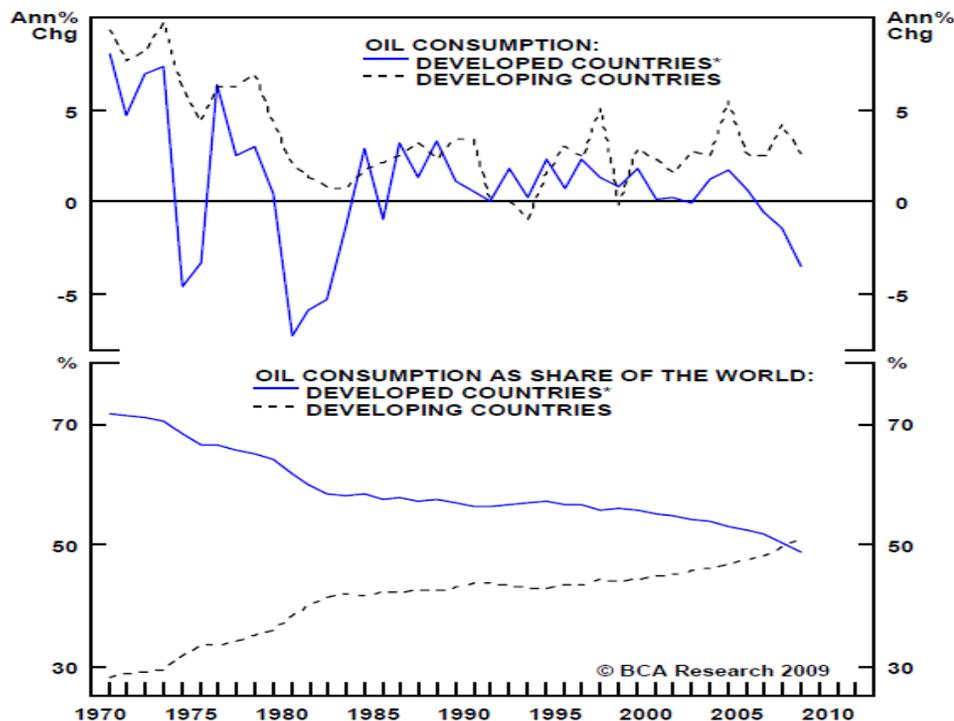
➤ Manufacturing, Consumer, Construction were drivers of growth

| | 2007 | 2008 | 2009 | 2010 |
|-------------------------|-------------|-------------|-------------|-------------|
| GDP | 8,5 | 5,2 | -7,9 | 4,0* |
| Manufacturing | 6,8 | 0,6 | -9,3 | 8,2 |
| Textiles | -0,5 | -5,4 | -16,2 | 12,1 |
| Wood processing | 7,9 | -0,1 | -20,7 | 11,4 |
| Machinery and equipment | 26,7 | -0,5 | -31,5 | 12,2 |
| Chemicals | 6,6 | -4,6 | -6,9 | 14,6 |
| Leather and shoes | 2,3 | -0,3 | -0,1 | 18,7 |
| Metallurgy | 4,5 | -2,2 | -14,7 | 12,4 |
| Food | 7,3 | 1,9 | -0,6 | 5,4 |
| Petrochemicals and coke | 2,8 | 2,8 | -0,6 | 5,0 |

*estimate

➤ Economic Growth is not Directly Oil linked – but Federal Budget Revenues are

Rising demand in developing economies provides long-term support

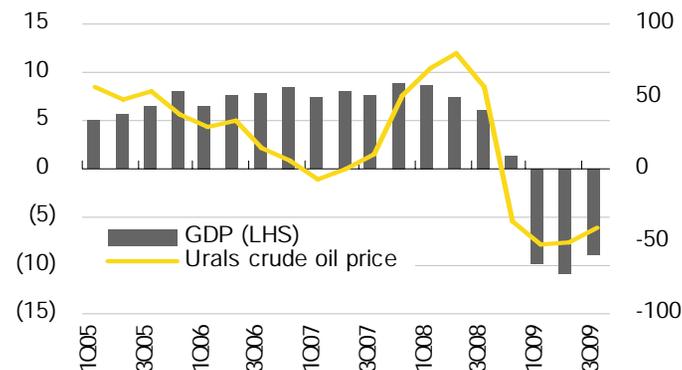


Oil & Gas in GDP = 25% in 2010 from 14% pre crisis.

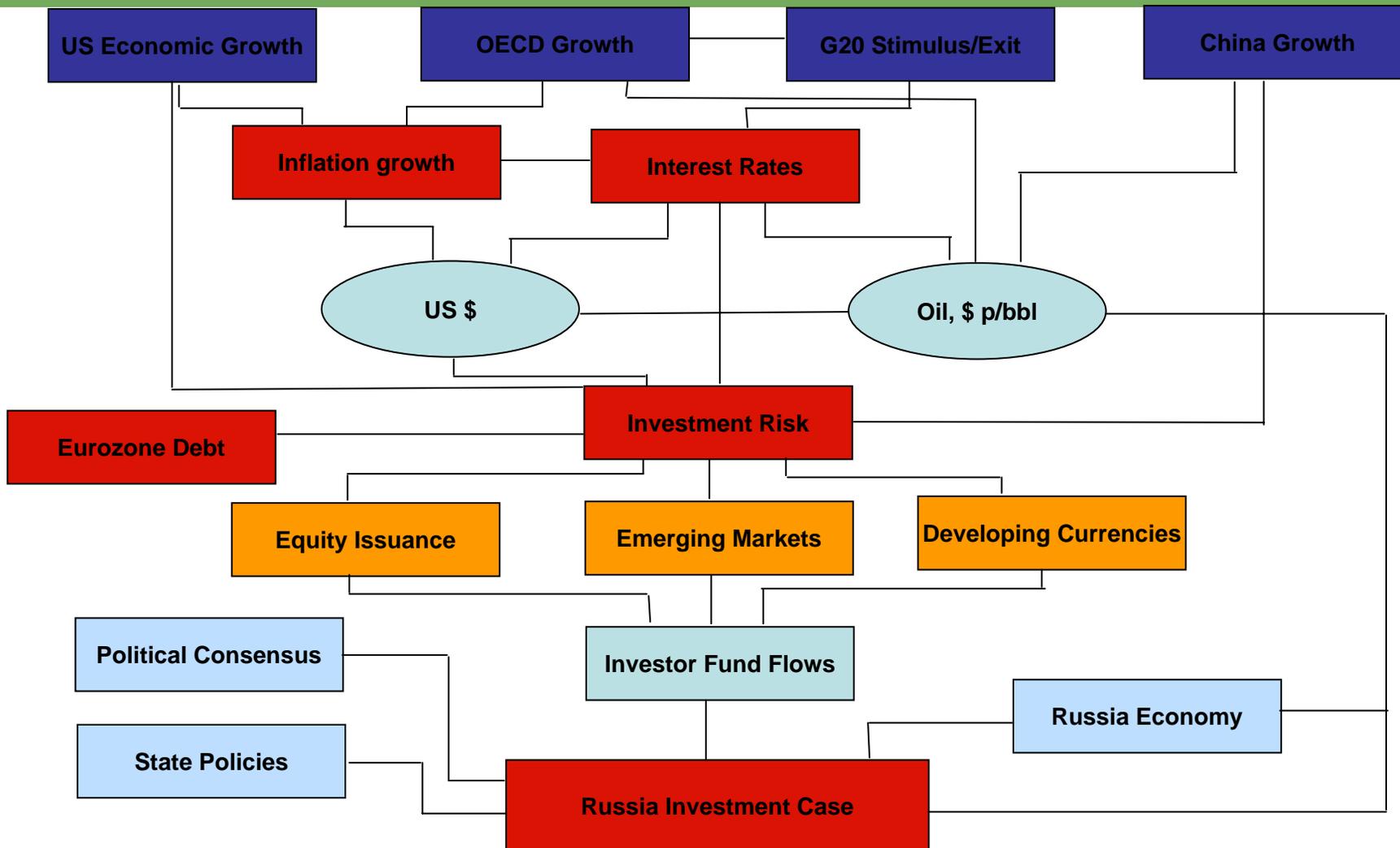
Oil & Gas in Budget = 40% in 2010 from 60% pre-crisis

Russia earns approx \$600 mln/d from oil exports....a total of \$1.5 trln since 2000

GDP and Urals Crude Price, \$ p/bbl



Russia is Vulnerable to External Shocks



➤ Revised Macro Forecasts

- **2010 growth lowered due to the effects of summer drought**
- **Fixed investment spending is expected to be much stronger in 2011 – driving GDP growth**
- **Inflation is the key domestic threat**
- **Budget deficit in 2011 will be half the government forecast and is forecast to be in surplus in 2012**

| | 2009 | 2010E: | 2011E: |
|-------------------------------|-------|--------|--------|
| GDP, YoY, % | -7,9 | 4,0* | 4,6 |
| Industrial production, YoY, % | -10,8 | 8,2 | 5,1 |
| Fixed investment, YoY, % | -17 | 6,0* | 11,7 |
| Retail sales, YoY, % | -5,5 | 4,4 | 6,5 |
| Real incomes, YoY, % | 2,3 | 4,3 | 4,2 |
| Employment, mln people | 69,4 | 69,8 | 70 |
| CPI, YoY, % | 8,8 | 8,8 | 9,5 |
| Exports, \$ bln | 303,7 | 398,0* | 407,4 |
| Imports, \$ bln | 191,8 | 248,8* | 287,1 |
| Current account, \$ bln | 49 | 72,6* | 52,2 |
| Federal budget deficit, % GDP | -5,9 | -3,9 | -1,5 |
| RUB/\$ (average) | 31,7 | 30,4 | 29,4 |
| Urals crude (average), \$/bbl | 61,3 | 78,2 | 83,1 |

* Estimate

➤ Finance Ministry is Deliberately Conservative

- **Finance Minister says that budget needs over \$90 p/bbl to balance. In fact, the budget balances just below \$80 p/bbl**
- **Finance Minister forecasts that the current Debt to GDP ratio of 10.5% will rise to 11.0% by year end and reach 16.3% by end 2013.**
- **That will depend on the average oil price and success in the privatization process**

Budget Deficit to Average 3% of GDP

| Main budget parameters | | | |
|------------------------|-------|-------|-------|
| | 2011E | 2012E | 2013E |
| Revenues, RUB tln | 8.8 | 9.5 | 10.4 |
| Spending, RUB tln | 10.7 | 11.2 | 12.2 |
| Deficit, RUB tln | 1.8 | 1.7 | 1.8 |
| GDP, RUB tln | 50.4 | 56.0 | 61.9 |
| Revenues, % of GDP | 17.6 | 17.0 | 16.8 |
| Spending, % of GDP | 21.2 | 20.1 | 19.7 |
| Deficit, % of GDP | 3.6 | 3.1 | 2.9 |
| Urals, \$/bbl | 75 | 78 | 79 |

Source: Finance Ministry

- **Stock Market investors have 'played' Russia as an oil proxy**
 -investor participation in Russia has been dictated by the price of oil*
 -but, when oil is "high enough" and reform optimism increases, the pool of investors increases*
- **Strategic investors have concentrated in extractive industries**
 -most of the headline deals have been in extractive industries*
 -BP raised its investment in Russia as Wal-Mart exited*
- **Bulk of F.D.I. is either Russian money or for extractive industries**
 -Cyprus is Russia's biggest FDI contributor*
 -core FDI is only about 1.5% of GDP*

➤ Russia weighting in GEM funds has halved in 30 months

.....GEM fund investors have preferred Brazil

.....Emerging Europe fund investors have preferred Turkey

| GEM Portfolio Investors Are Neutral | |
|---|--------------|
| Russia's Weight Still Lagging in GEM Funds | |
| Jan '06 | 6.63 |
| June '06 | 8.72 |
| Dec '06 | 9.99 |
| June '07 | 9.01 |
| Dec '07 | 10.80 |
| June '08 | 12.12 |
| Dec '08 | 5.63 |
| Jan '09 | 5.16 |
| June '09 | 6.63 |
| Dec '09 | 7.21 |
| June '10 | 6.59 |
| July '10 | 7.18 |
| Aug'10 | 6.67 |
| Sep '10 | 6.52 |
| Oct '10 | 6.48 |
| Nov '10 | 6.73 |
| Dec '10 | 6.84 |

Source: EPFR Global

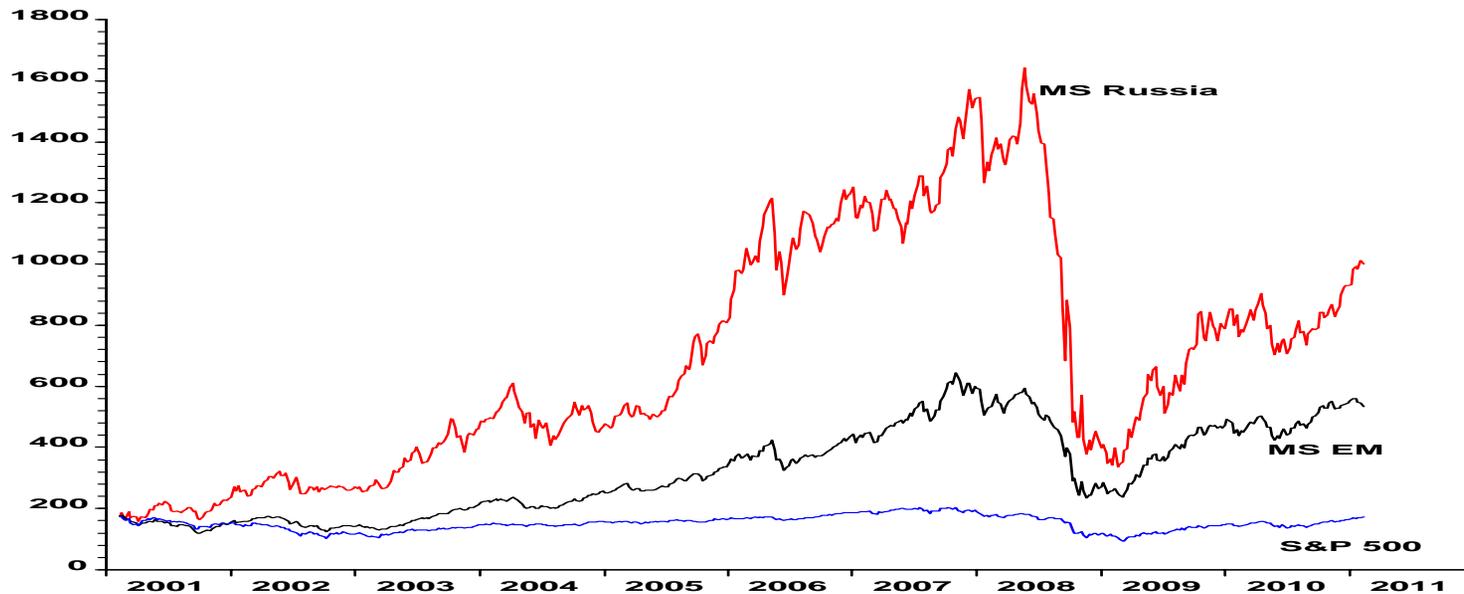
| Major Country Weights in Ave GEM Portfolio* | |
|--|-------|
| Russia was 3rd biggest in mid '08 | |
| Brazil | 15.9% |
| China | 14.5% |
| Korea | 11.7% |
| Taiwan | 8.9% |
| India | 8.1% |
| Russia | 6.8% |
| South Africa | 6.3% |
| Mexico | 5.0% |
| Source: EPFR Global | |
| * at December 31 '10 | |

➤ Russia's performance history makes investors nervous

.....highest event risk amongst the major emerging markets

.....that keeps the risk premium higher than the EM average

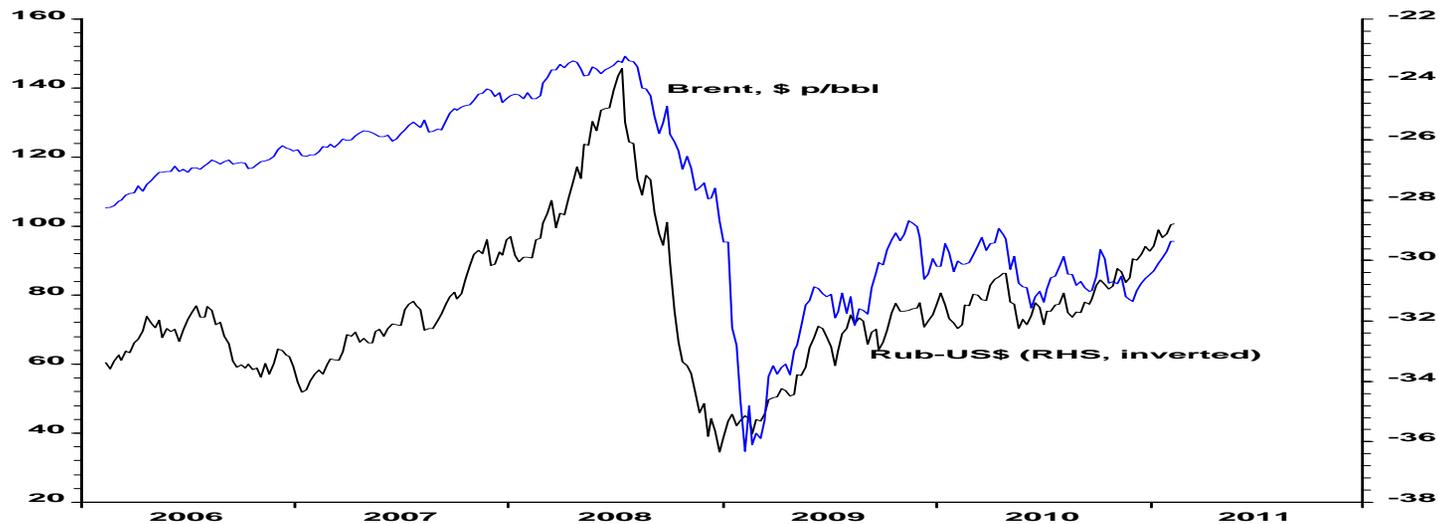
MSCI Russia, GEM, S&P – 10 yrs



Source: DATASTREAM

- Ruble is particularly sensitive to oil price volatility
- Higher economic risk perception in Russia has also held back Ruble performance

Oil and Ruble-US\$ Rate



Source: DATASTREAM

➤ **Crisis has led to greater urgency and pragmatism**

.....there were almost no mechanisms in place to support Medvedev's plan in 2008

.....only as a result of the long crisis – and its revelations – have attitudes changed

➤ **Government is more focused on efforts to attract investors**

.....much more aware of the PR disasters of the last decade

.....WTO entry is now a high priority

.....Russia needs foreign management expertise

➤ **Progress is slow but following a clearer path**

.....don't expect any major changes until after the next government is formed

.....legislation and bureaucracy still need to be changed

➤ ***For the next administration it should be a case of “one-step forward and two or three sideways”. Better than the “one-step forward and four or five sideways” of the last decade.***

➤ **Putin has been consistent about his vision for Russia**

Inherited a country in chaos

Believes in a step-by-step orderly development

recognises that Russia needs both international capital and expertise

➤ **Fix problems, then attract investors**

1st term priority was regaining political control

2nd term priority was establishing control over strategic industries and setting investment rules

Medvedev's presidency was to mark the start of the 'investment' phase

this step-by-step progress has slowed pace of change up to now

➤ **Legacy problems hard to shake off**

high profile negative publicity. YUKOS is far from over

investment concentration is still on oil & gas

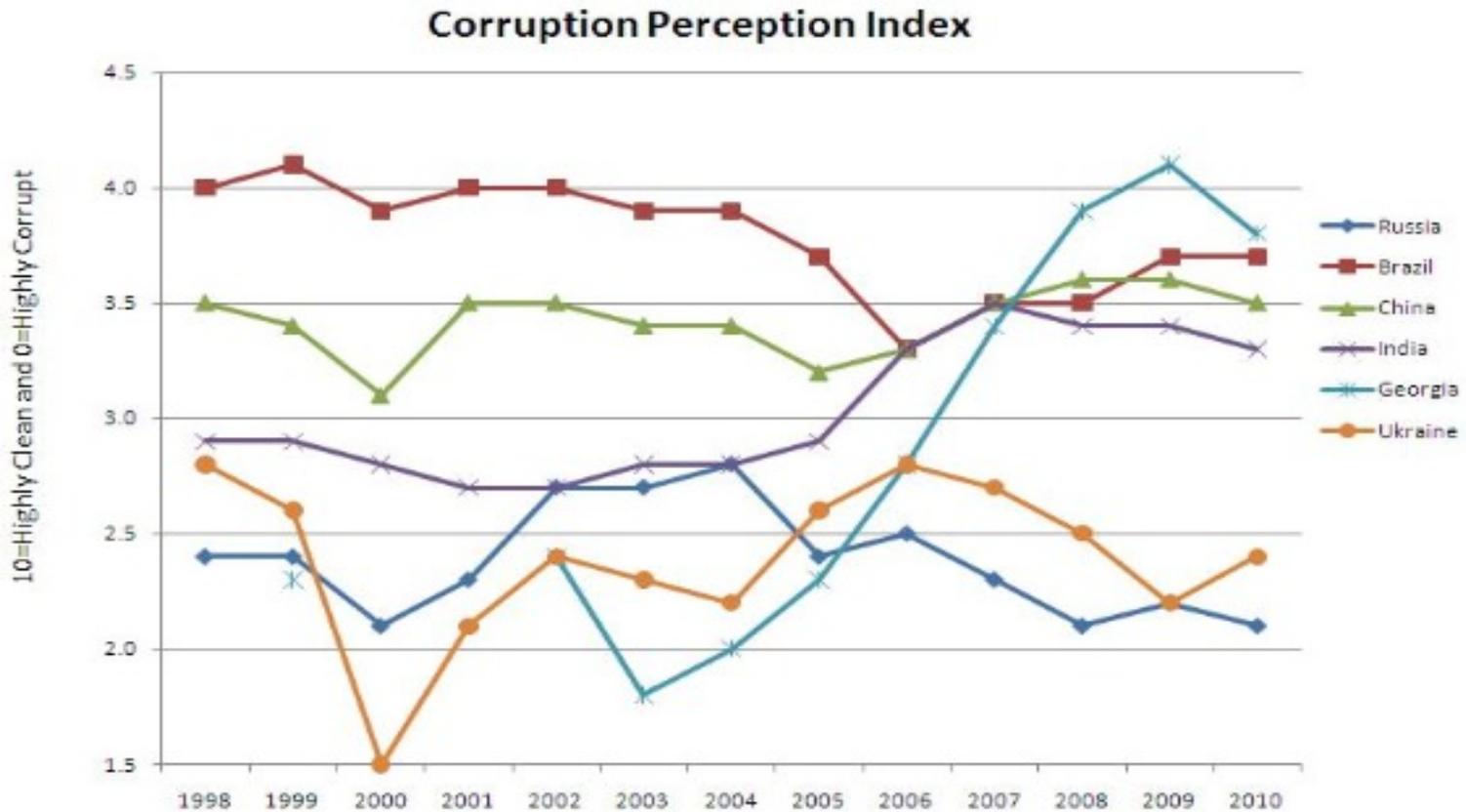
a lack of consensus at the top of government over key economic and investment priorities

➤ **Key investment priorities over the medium term include;**

- 1. *Moving up the value chain in raw material industries – refineries, petro-chemicals, LNG, smelters, timber processing plants, etc***
- 2. *Investment in basic infrastructure – electricity, gas, communications, transport***
- 3. *Event driven projects, e.g.***
 - 1. *Asean Forum - 2012***
 - 2. *Kazan University Games - 2013***
 - 3. *Sochi Winter Olympics and Grand Prix – 2014***
 - 4. *World Cup - 2018***
- 4. *Import substitution, e.g. agriculture, pharmaceuticals, food processing and basic technologies***
- 5. *Financial market/services***
- 6. *Health care and education***
- 7. *Leisure industries – including Sochi***

- **Corruption**
- **Cumbersome bureaucratic procedures**
- **Poor legal protection and redress**
- **Skilled workers have been lost and education standards have fallen**
- **Federal revenues are critically dependent on oil & gas**
- **Poor “PR” in western markets**
- **Deteriorating demographics**
- **Role of SMEs in economy is too small**
- **Middle class sector is increasing but still small**
- **Wealth gap remains very high**

Corruption is Getting Worse



Source: Transparency International Annual Corruption Index report

➤ **Economically active population keeps shrinking**

.....a more than 10% decline is expected in 2010-2010

.....*that can destroy between 1.0% and 1.5% of GDP in the 2013-2018 period*

➤ **Government can no longer afford to ignore demographics**

.....a likely increase in retirement age

.....a more flexible migration policy

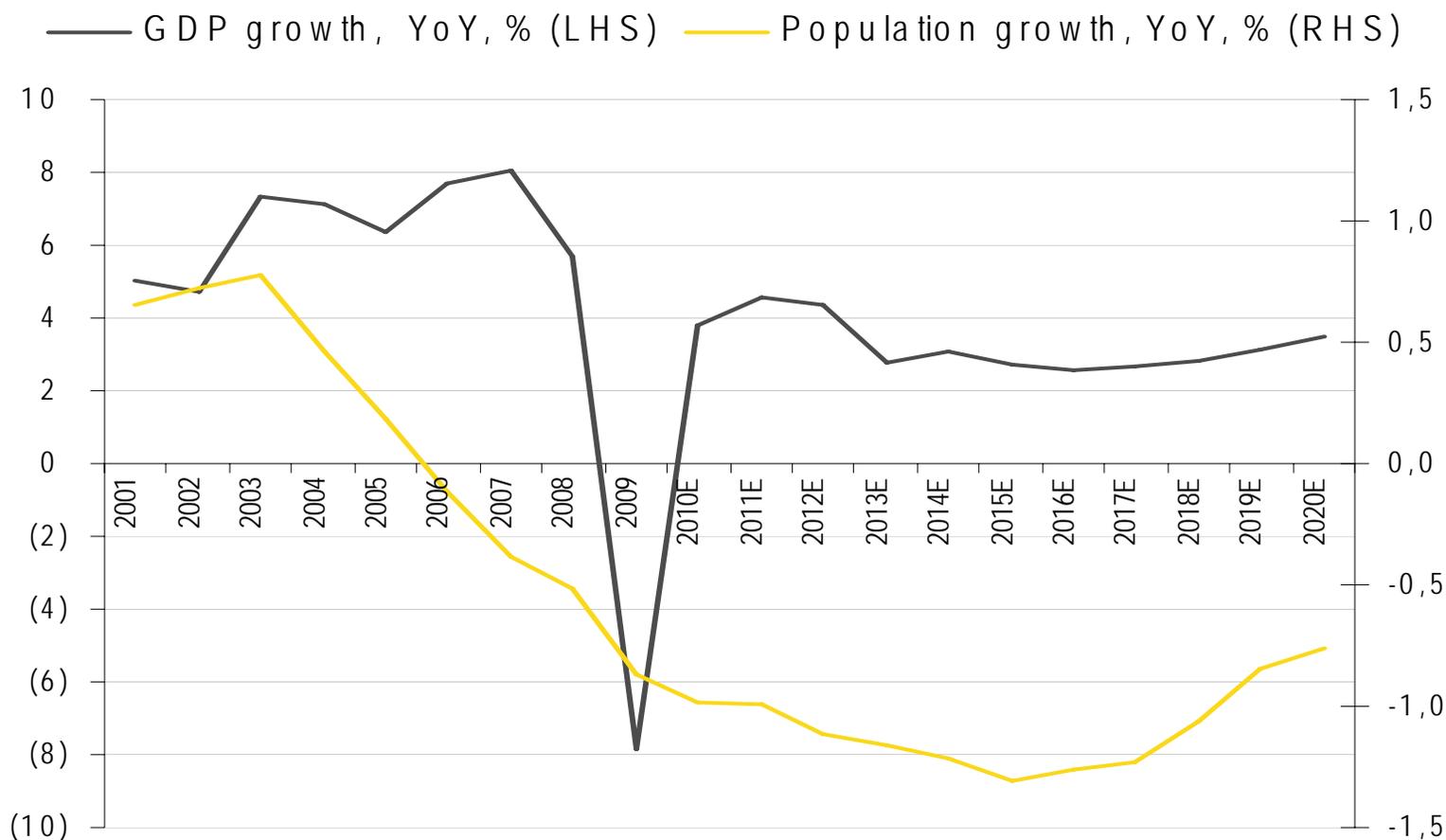
.....possible pension cuts

➤ **Next government will have to make unpopular decisions**

.....after the current election cycle and new government takes office

.....but very early in the life of the next government

Economically active population and growth dynamics



Macro Trends

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011F | |
|------------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|--------|-------|--------|---------|-------|
| | | | | | | | | | | | | UralSib | Govt |
| GDP \$ bln | 251 | 312 | 355 | 433 | 580 | 764 | 989 | 1,289 | 1,671 | 1,231 | 1,526 | | 1,729 |
| YoY, % | 10.0 | 5.1 | 4.7 | 7.3 | 7.1 | 6.4 | 7.4 | 8.1 | 5.6 | -7.9 | 4.0 | 4.6 | 4.2 |
| Federal budget Surp/Deft, % of GDP | 1.4 | 2.4 | 1.4 | 1.7 | 4.3 | 7.5 | 7.4 | 5.4 | 3.7 | -5.9 | -3.9 | -1.5 | 3.6 |
| Industrial prod. % YoY | 11.1 | 4.9 | 4.0 | 7.3 | 6.4 | 4.0 | 6.3 | 6.3 | 2.1 | -10.8 | 8.2 | 5.1 | 3.3 |
| Capital investment, % YoY | 17.7 | 8.7 | 2.6 | 12.5 | 11.7 | 10.7 | 13.5 | 21.1 | 9.1 | -17.0 | 6.5 | 11.7 | 8.8 |
| Current account, \$ bln | 46.3 | 34.8 | 29.8 | 35.8 | 60.0 | 84.2 | 94.5 | 76.6 | 98.9 | 49.0 | 72.6 | 52.2 | 25.0 |
| Trade balance, \$ bln | 60.7 | 49.6 | 46.6 | 60.4 | 87.0 | 118.0 | 139.2 | 146.4 | 180.2 | 114.2 | 149 | 120 | 107 |
| FDI, \$ bln | 4.4 | 4.0 | 4.0 | 6.8 | 9.4 | 13.1 | 13.7 | 27.8 | 27.0 | 15.9 | | | |
| Retails sales, % YoY | 9.0 | 11.0 | 9.3 | 8.8 | 13.3 | 12.8 | 13.0 | 15.2 | 13.0 | -5.5 | 5.8 | 6.5 | 4.5 |
| Ruble/\$1 rate, year-end | 28.1 | 30.1 | 31.8 | 29.5 | 27.7 | 28.1 | 26.3 | 24.55 | 29.39 | 30.19 | 28.1 | | |
| Ruble/\$1 rate, average | 28.1 | 29.2 | 31.4 | 30.7 | 28.8 | 28.3 | 27.2 | 25.58 | 24.85 | 31.7 | 30.4 | 28.3 | 29.4 |
| CPI, % change YoY | 20.2 | 18.6 | 15.0 | 12.0 | 11.7 | 11.0 | 9.0 | 11.9 | 13.3 | 8.8 | 8.8 | 7.0 | 9.5 |
| CBR reserves, \$ bln | 28.0 | 36.6 | 47.7 | 76.9 | 124.5 | 182.0 | 303.7 | 476 | 427 | 439 | | | |
| Foreign debt, \$ bln | 144 | 135 | 122 | 112 | 98 | 85 | 52 | 48.9 | 40.5 | 42.3 | | | |
| % of GDP | 57.1 | 43.4 | 34.4 | 25.9 | 16.9 | 11.1 | 5.3 | 3.8 | 2.4 | 3.4 | | | |
| Oil Price - Brent \$/bbl | 28.9 | 24.7 | 25.2 | 28.8 | 38.2 | 55.0 | 65.0 | 72.7 | 97.0 | 63.0 | | | |
| -Urals \$/bbl | 26.5 | 22.9 | 23.0 | 27.2 | 34.2 | 51.5 | 61.0 | 69.8 | 94.7 | 61.3 | 78.2 | 83.1 | 76.0 |
| -Population mln | 145.5 | 145.3 | 145.2 | 144.7 | 143.5 | 143.0 | 142.5 | 141.7 | 141.9 | 141.1 | 140.9 | 140.9 | |
| GDP per capita US\$ | 1,725 | 2,140 | 2,445 | 2,992 | 4,042 | 5,314 | 6,912 | 9,097 | 11,776 | 8,724 | 10,830 | 12,271 | |

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