Myths about Russian Economy

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19 September 2011

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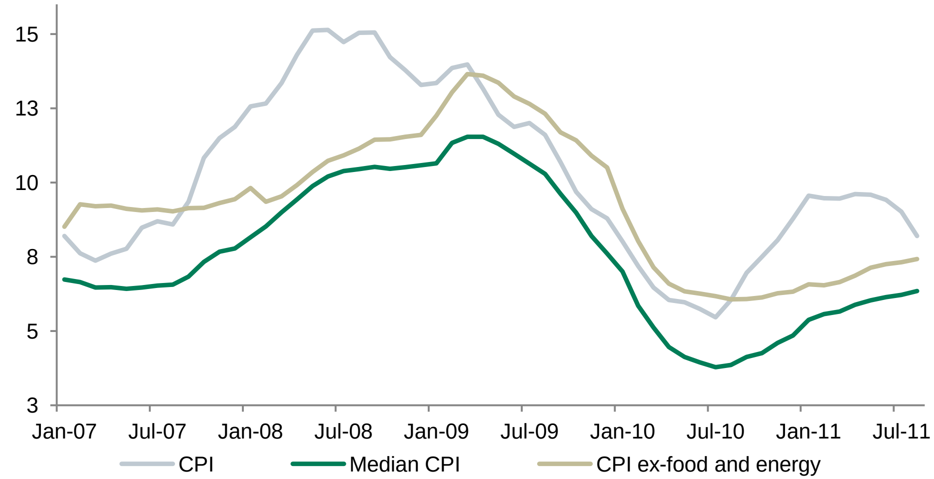
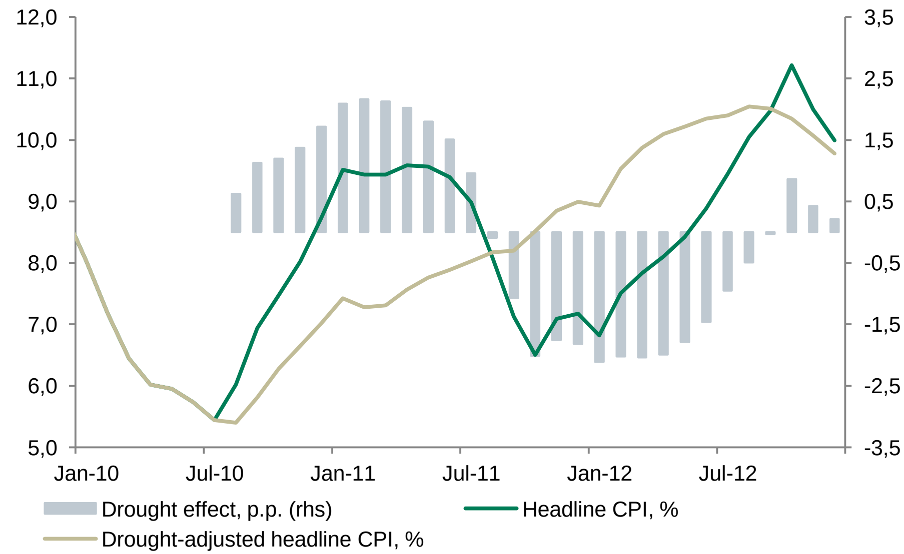
Inflation has started to abate – this is new trend for Russian economy

- Recent decline of headline CPI, which reached 8.2% by the end of August and will surely will decline much further in September-October, lead to a wave of optimism. Some believe that we entered a new sustained trend of disinflation.
- Current disinflation is driven only by the food prices (unlike disinflation of '09-H1'10), while every measure of core inflation is still on the upward trend.
- Extreme volatility of food prices is the result of severe drought. According to our estimates, drought-effect on CPI reached its maximum level of 2.2 percentage points in February'11, has declined to 0 in August'11 and will decline to -2 p.p. In Q1'12.
- Under our base case scenario we expect headline CPI to bottom in Q1'12 at below 7.0% and will come close to 10.0% level by the end of next year. RUB weakness will only add to CPI growth.
- Continuation of downward trend after Q1'12 can only be achieved with tremendous disinflation in core inflation trend. Ex-food and gasoline CPI should decelerate from end August level of 7.4% towards the level of 5.0% - all-time low.



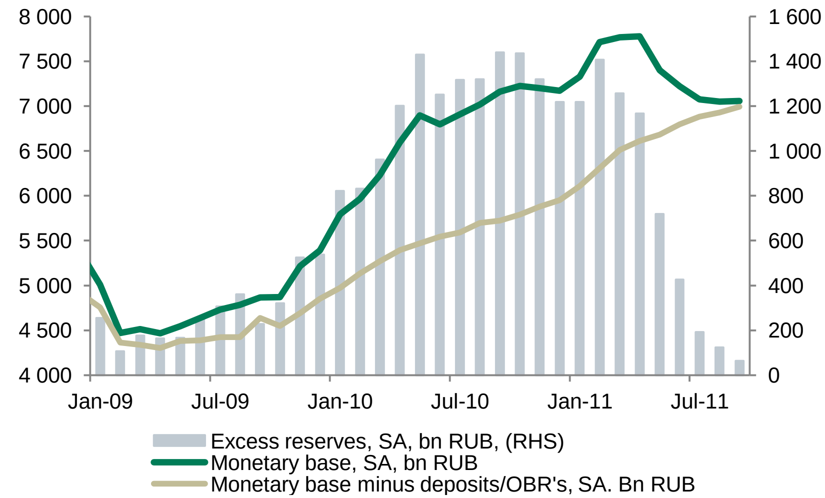


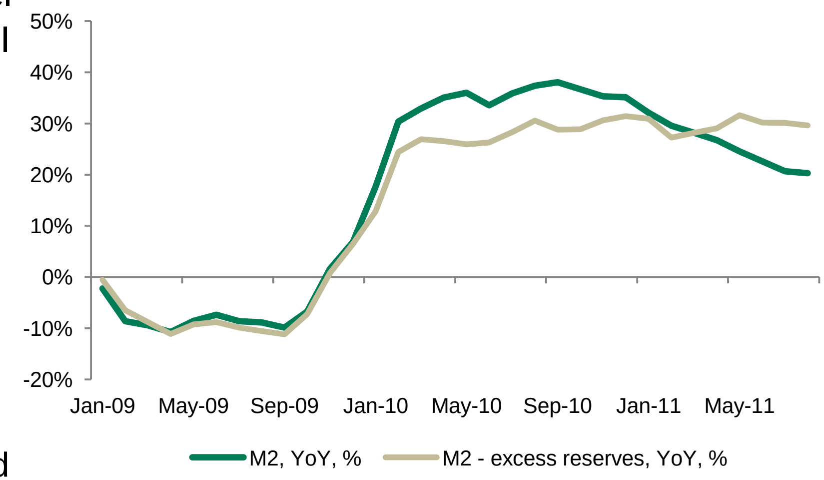
Source: CBR, Credit Agricole CIB

No disinflation, just food price volatility

Monetary aggregates' growth is slowing, it will eventually lead to lower inflation

- One of the ideas behind expectations of core prices disinflation is the slowdown of monetary aggregates growth. Monetary base growth already in negative area, and M2 growth at 20% level.
- As of now there are no signs of this monetary "tightening" having effect on economy: both internal demand and lending growth were only accelerating in recent months. The reason why this is happening is quite simple: part of the available funds were simply not working in the economy and were sitting idle in CBR's deposit facilities and in OBR's. And all slowdown of monetary aggregates just came from the decline of these excess reserves.
- We are at crucial point: with excess reserves declining towards 0 level further attempts to control monetary base or money supply growth will result in spike of short-term money market rates as the banks lacking needed liquidity will be forced to tap CBR REPO facility. There is no chance to see further slowdown of monetary aggregates growth without real tightening of monetary policy – increase of the level of real interest rates.
- There is possibility for further slowdown of monetary aggregates growth and subsequent disinflation in the Russian economy. But under this scenario bondholders will be very disappointed: it comes with much higher RUB interest rates on both short- and long-term end of the yield curve.



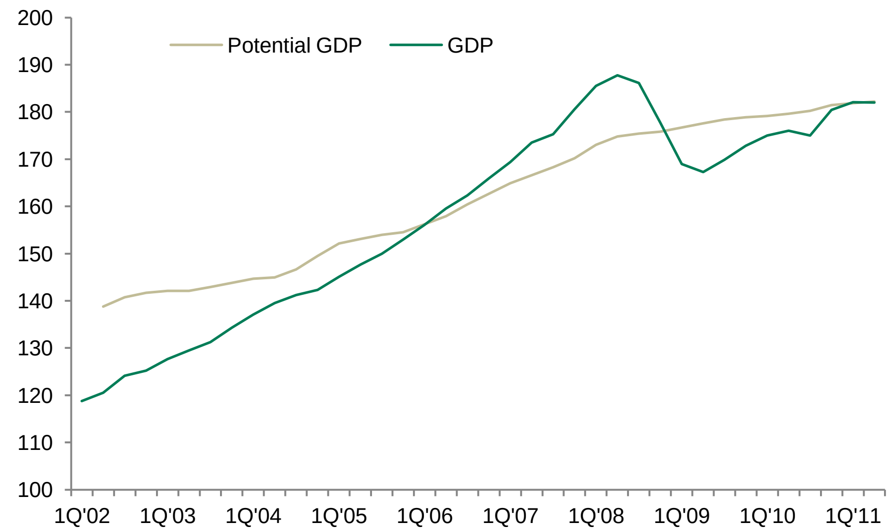


Source: CBR, Credit Agricole CIB

Real monetary policy tightening is still in front of us

4% growth is low, thus monetary policy should be accommodative

- Commentators also like to point out, that Russia is experiencing low growth rates and monetary policy should remain accommodative until we hit more "solid" 5.0% growth level.
- But even with current 3.7% GDP growth rate Russian economy is experiencing fast decline in unemployment rate, speed-up of nominal wage growth, increase of capacity utilization levels and fast import growth and acceleration of core inflation. This proves that economy is running at above and not below potential growth rate.
- Our estimates show that potential GDP growth rate is running below 2.0% level and is limited by:
  - Long-term demographic problem, which results in outright decline of labour force on a yearly basis since 2008.
  - Low level of productivity growth and low investments to GDP ratio, that can be attributed to not perfect investment climate and underinvestment in infrastructure.
  - Oil and gas production growing at a low pace.
- Current situation means that without implementation of proper supply-side policies monetary policy should be much more restrictive, and not accommodative to preserve macroeconomic stability in Russia.

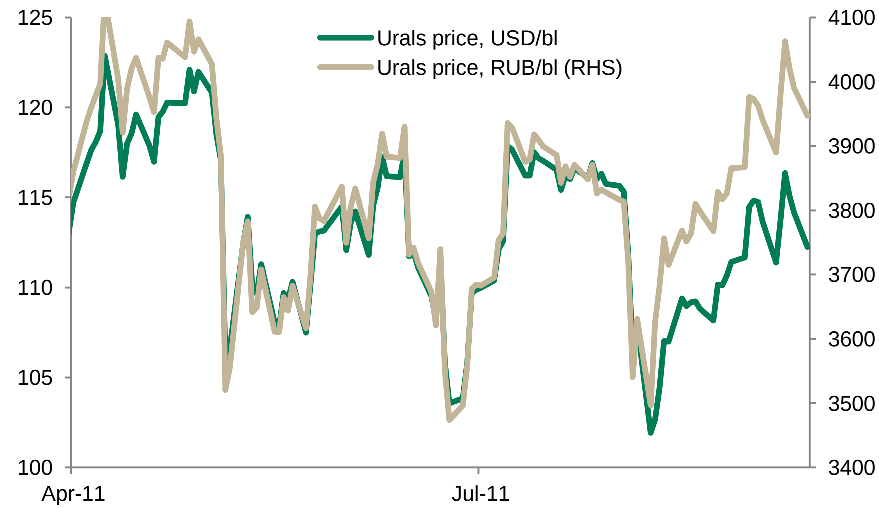


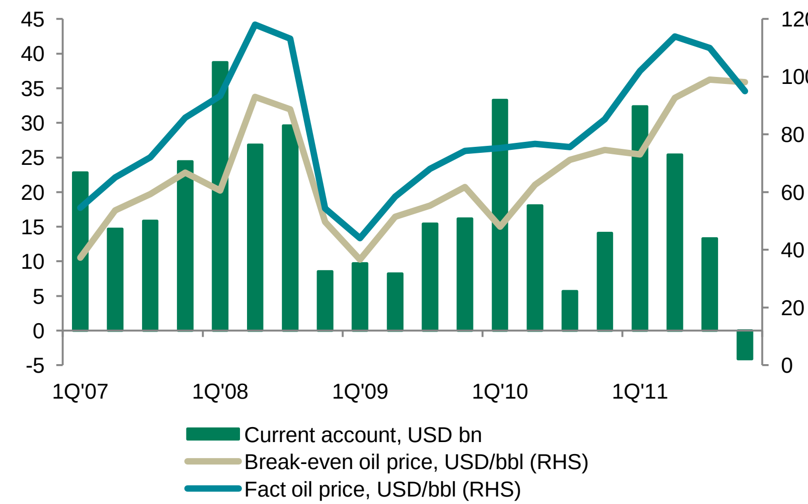
Source: FSSS, Credit Agricole CIB

Even 4% growth is not sustainable under current economic growth model

100 dollars a barrel is still high for Russia, so no big worries for RUB and economic situation

- Budget situation – long-term and not short-term issue. Spending is denominated in RUB, and now we are in the situation when decline in USD oil price to the large extent will be compensated by the RUB weakness. Moreover public debt in Russian economy is so small now, that this is really a second tier problem.
- The key thing here is the peculiarities of current model of economic growth in Russia: excessive stimulation of internal demand, GDP growth running above potential level and strong import growth. It is clear that this model is running smoothly only in situation when export level is enough to cover fast growing import.
- When oil price is coming closer to the current account breakeven price weakening external balances are triggering adjustment of the economy: weaker RUB, subsequent increase in inflation and higher interest rates are resulting in sharp end to fast growth of internal demand. And from whether this adjustment happens orderly or disorderly depends how deep GDP will plunge below potential level.
- This time critical oil price level is near USD100/bl – this means that we are just in a few steps in front of another adjustment.





Source: CBR, Credit Agricole CIB

We are once again very close to adjustment in Russian economy

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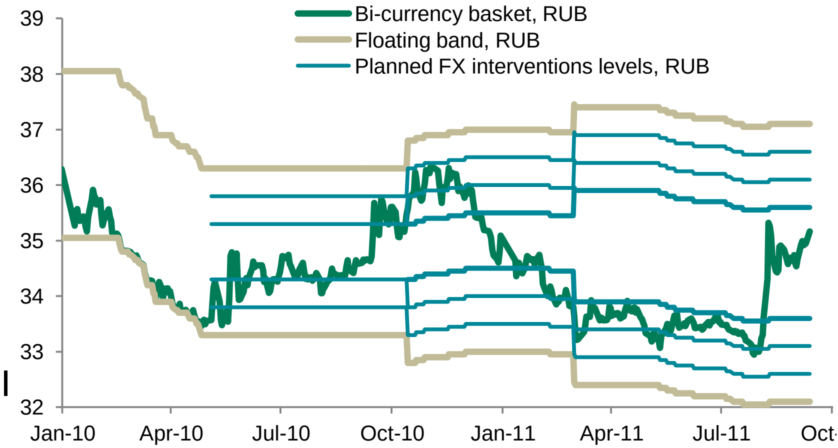
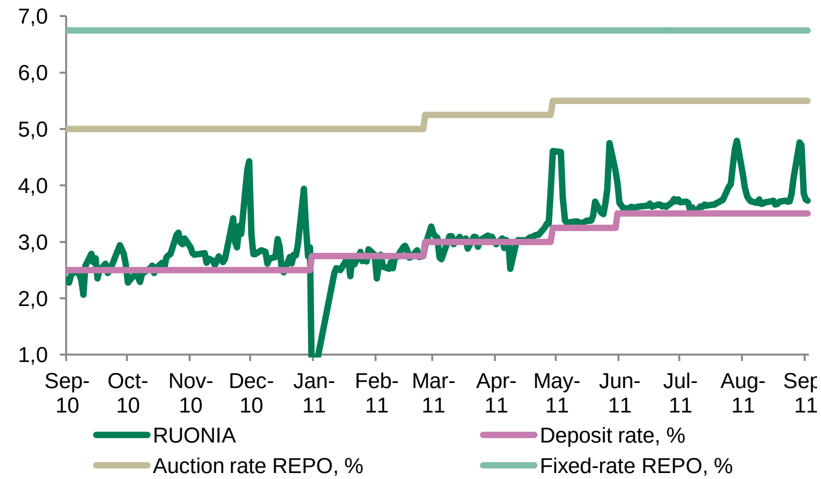
What should we expect from the Russian markets?

- Stabilization of URALS price below USD100/bl level is not compatible with basket price at RUB35, o/n money market rate at 4.0% and narrow credit spreads on RUB bond market.
- What form this adjustment will take this time? Both moves in FX and rates taken together should be bold enough to stop internal demand growth and lead to decline in import value. Taking into account characteristics of the current CBR policy on FX market we might expect bi-currency basket to reach initially RUB36 level and then continue to drift higher with resistance from CBR FX interventions; tighter liquidity will result in short-term rates jumping towards CBR REPO rate, further move in rates will depend on how much FX adjustment will be allowed by authorities.
- Weaker RUB and higher base rates will definitely result in another leg of negative correction. Credit spreads dynamics will also give no support for the market. Spreads on local market were much tighter than those on global even before big sell-down that was launched by some of the European banks, which created a lot of interesting opportunities for investors on global markets. And nowadays RUB bonds are looking extremely overvalued comparing with these opportunities.
- Under this scenario RUB bond market perspectives aren't good at all.





Source: CBR, Credit Agricole CIB

Correction of RUB, RUB yield curve and credit spreads on local market has just started

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