

# Macroeconomic Situation in Russia: Muddling Through, Successfully

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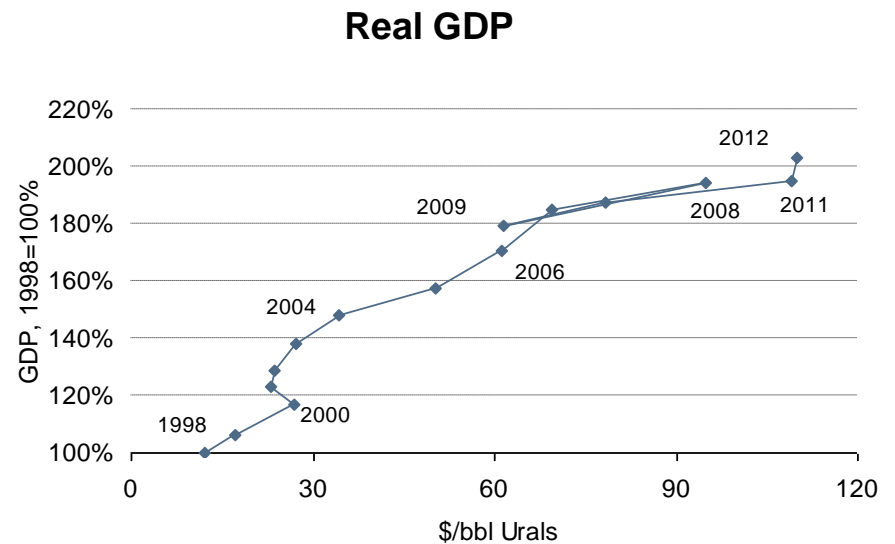
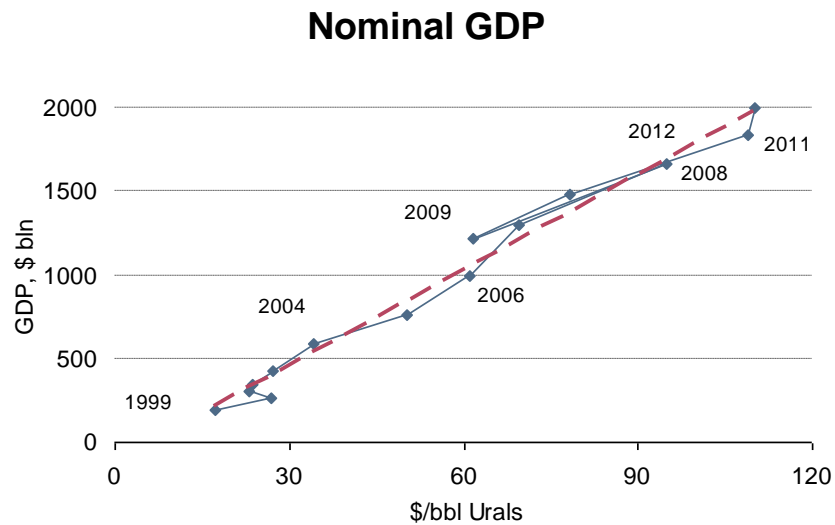
# The European debt crisis has not had a massive impact on Russia, which turned in a sustainable macroeconomic performance in 2011

- **Domestic demand robust.** In 2011, retail sales rose 7.2% and investment grew 8.3%, according to recently revised numbers. Investment activity was reportedly weak over 4m11 (0.1% y-o-y), which seems understated, as output of basic construction materials was more dynamic. Unsurprisingly, investment growth “statistically” accelerated later in the year, particularly in September-November (to almost 8-9%).
- **GDP growth understated.** Such robust performance of domestic demand does not match with the reported 4.3% GDP growth in 2011. We expect this figure to be revised upward, as with the 2010 national accounts.
- **Basic sector output expanded 5.1% in 2011, industrial output grew 5.0%, agriculture 22.1%.**
- **Peak inflation reached in January 2011 (9.6% y-o-y), CPI was 6.1% in 2011.** The key factors for the deceleration were high oil prices and the resulting budget surplus, as well as limited liquidity injections from the Central Bank. This year we expect inflation to decelerate further as y-o-y inflation has already decelerated to 3.6% (but may pick up slightly mid-year).
- **In 2011, Russia again became a twin-surplus economy (current account and federal budget).** The current account will post a strong surplus in 2012, while the fiscal surplus will evaporate.
- **Russian demographics look much better than earlier forecast.**

# Muddling Through, Successfully

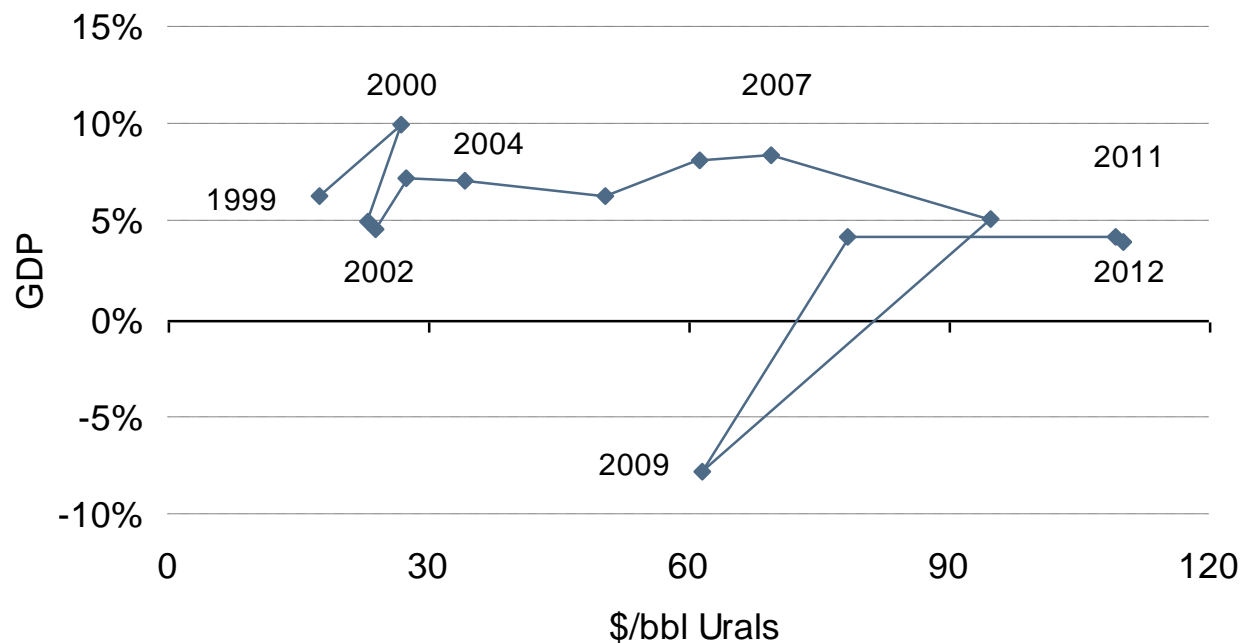
- **Basic sector output grew 5% y-o-y in 1Q12.** Domestic demand remained the major driver of economic growth, retail sales rising 7.5% y-o-y and investment increasing 11.2% in 1Q12.
- **Over 4m12, the CPI rose 1.8% compared with 4.2% a year earlier.** Annual inflation slowed slightly to 3.6% from 6.1% at end December. Although we expect y-o-y inflation to accelerate in July on the back of regulated tariff hikes, the annual figure will be around 4.5%.
- **Russia will continue muddling through successfully.** This is not a bad result amid global uncertainty. The government will eventually carry out some reforms, albeit very slowly and gradually, which will nonetheless enable the economy to maintain growth of around 3.0-3.5% in the years to come. Until the government indeed starts moving from talking the talk to walking the walk with respect to plans to downsize the public sector, we do not expect growth to accelerate.

# GDP correlates with oil price



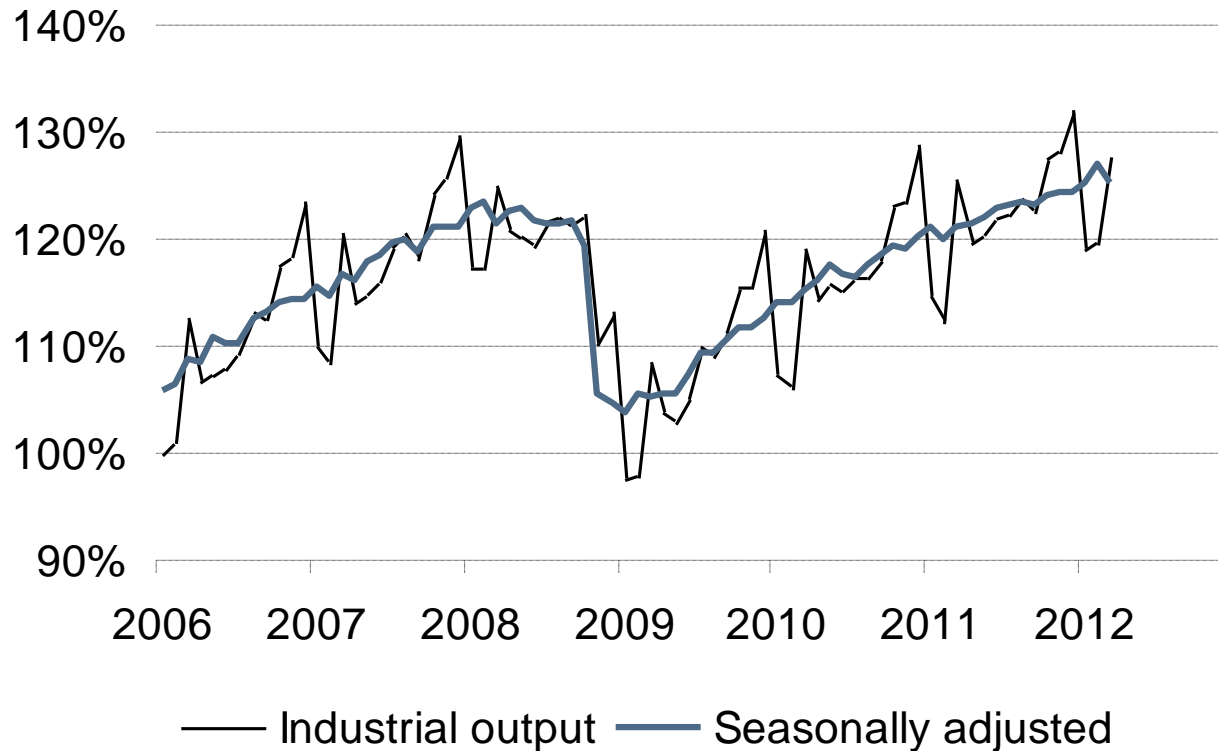
Source: State Statistics Service, Troika estimates

# Oil price inflation has not accelerated Russian economic growth



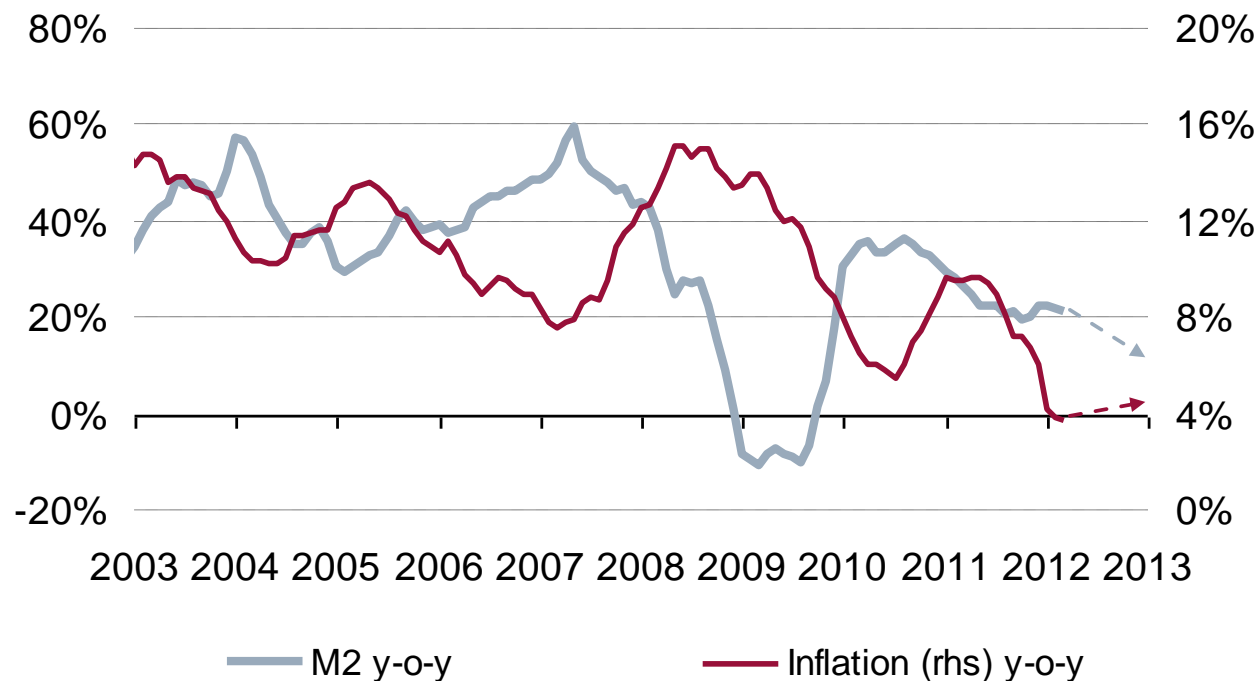
Source: State Statistics Service, Troika estimates

Industrial output has recovered since February 2009, the trend points to deceleration (albeit expected), Jan '06 = 100%



Source: State Statistics Service

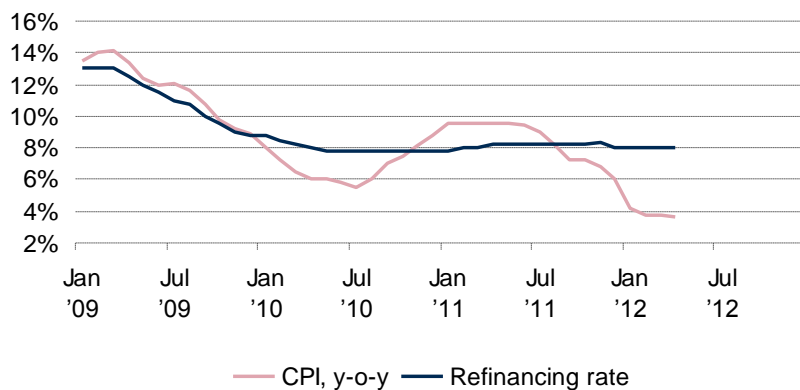
There has been a sort of inverse correlation between Russian money supply growth and inflation, which has stabilized



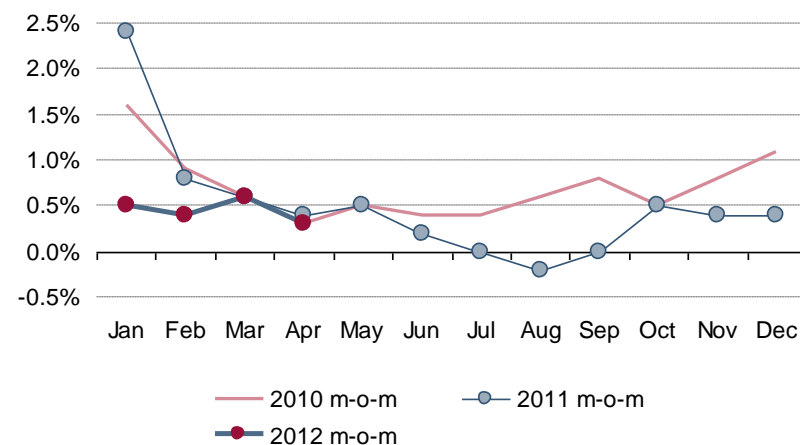
Source: Central Bank, State Statistics Service

# Annual inflation has been slowing more rapidly since August 2011 due to base effects

## Annual inflation vs refinancing rate



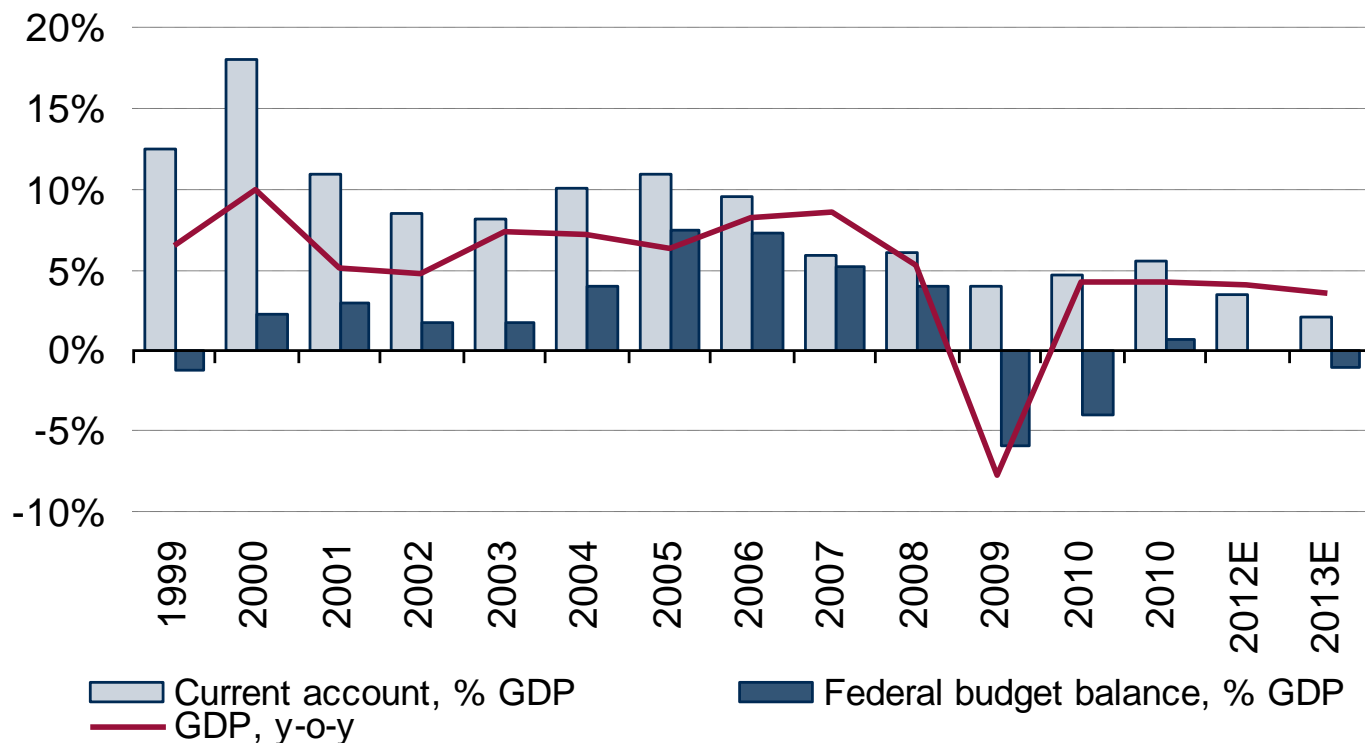
## Monthly inflation



Source: State Statistics Service, Central Bank

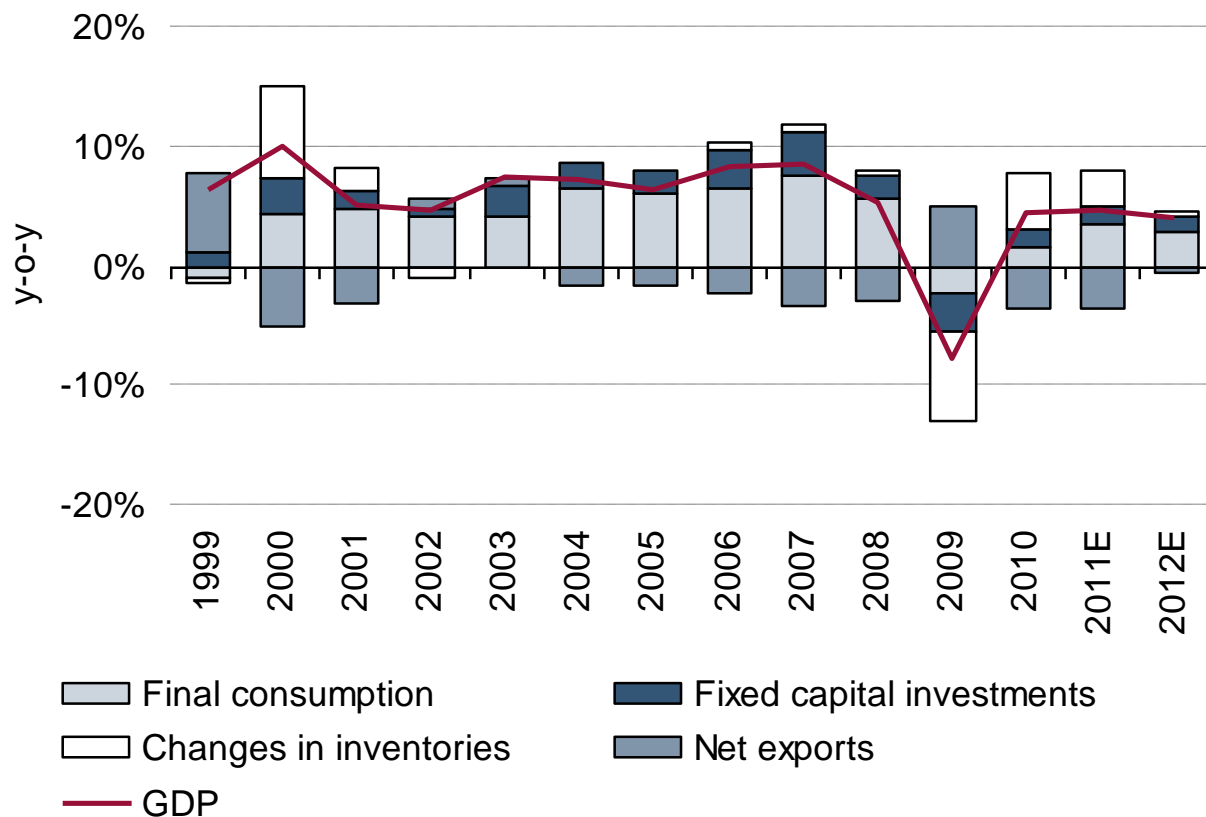


# Russia does not face the problem of serious external or internal imbalances



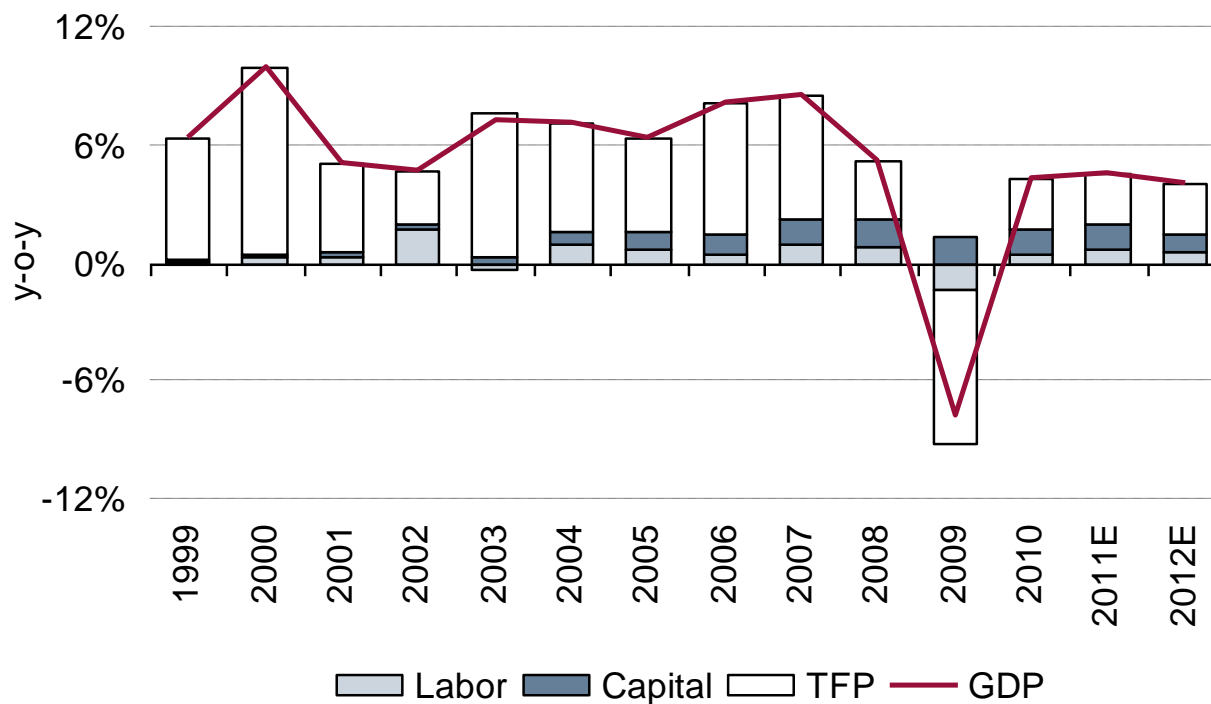
Source: State Statistics Service, Finance Ministry, Central Bank, Troika estimates

# GDP growth breakdown: domestic demand a key growth driver



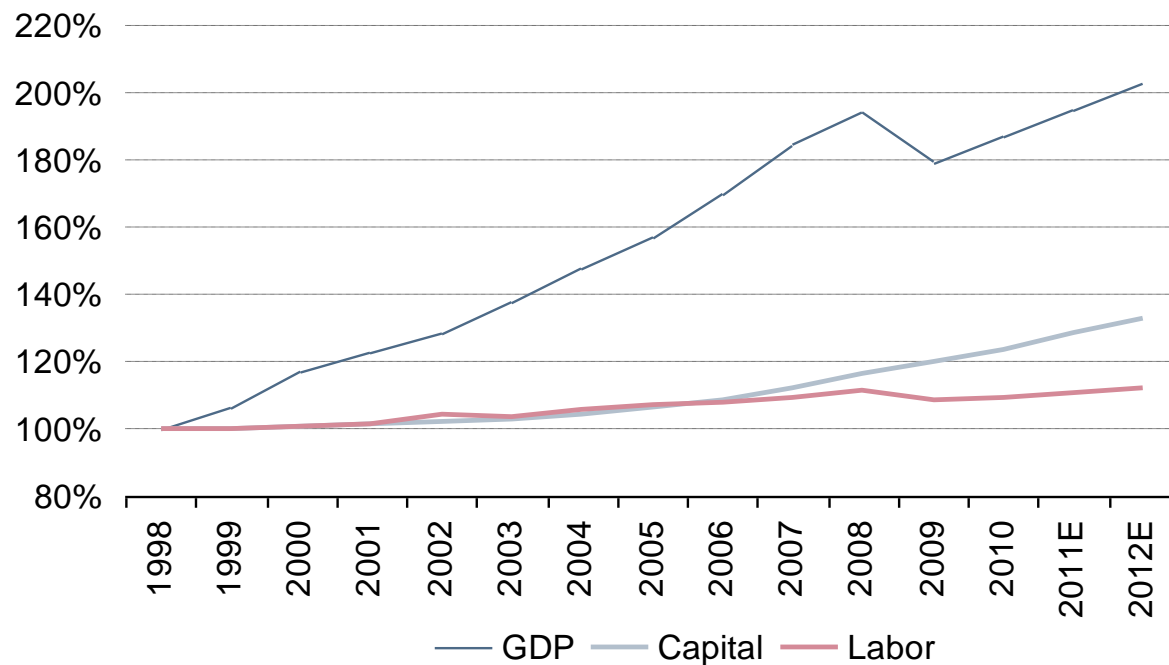
Source: State Statistics Service, Troika estimates

Since 1999, growth has largely been driven by rising total factor productivity (TFP)



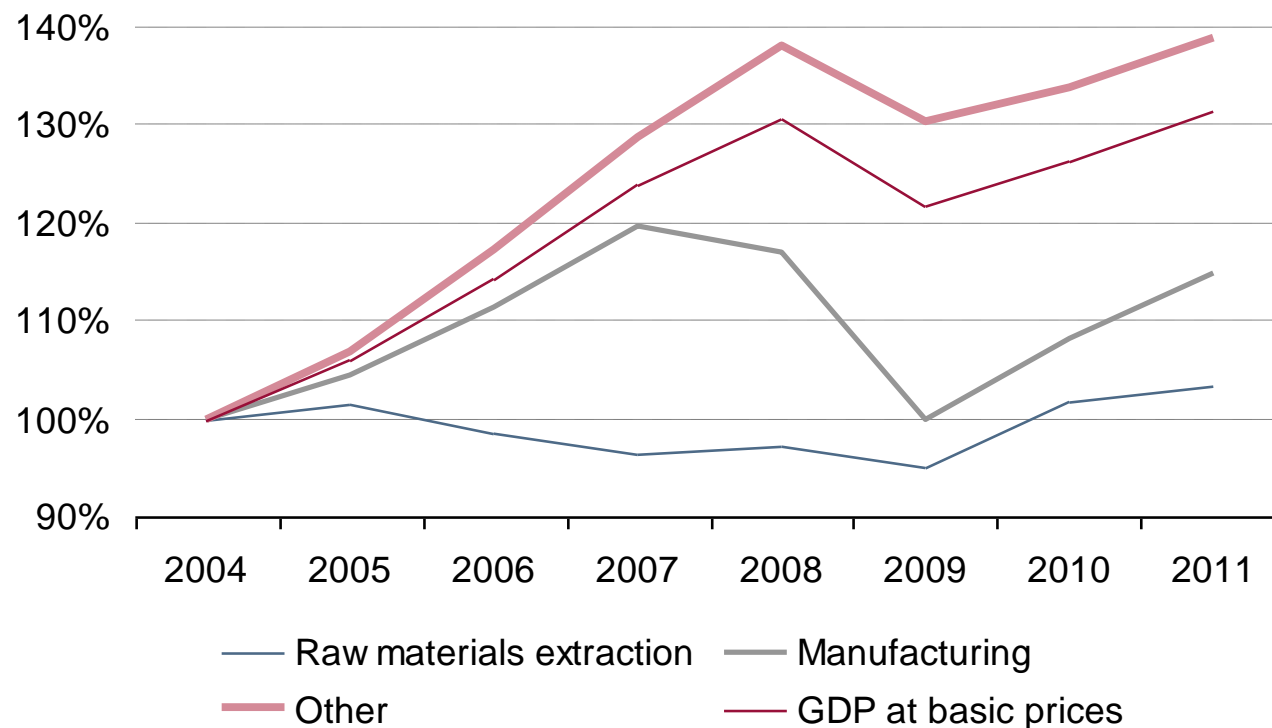
Source: State Statistics Service, Troika estimates

# Labor and capital productivity is growing, 1998=100%



Source: State Statistics Service, Troika estimates

## Value added growth (in real terms) in raw material extraction has been moderate, 2004=100%



Source: State Statistics Service, Troika estimates

# Breakdown of value added and employment by industry, 2011

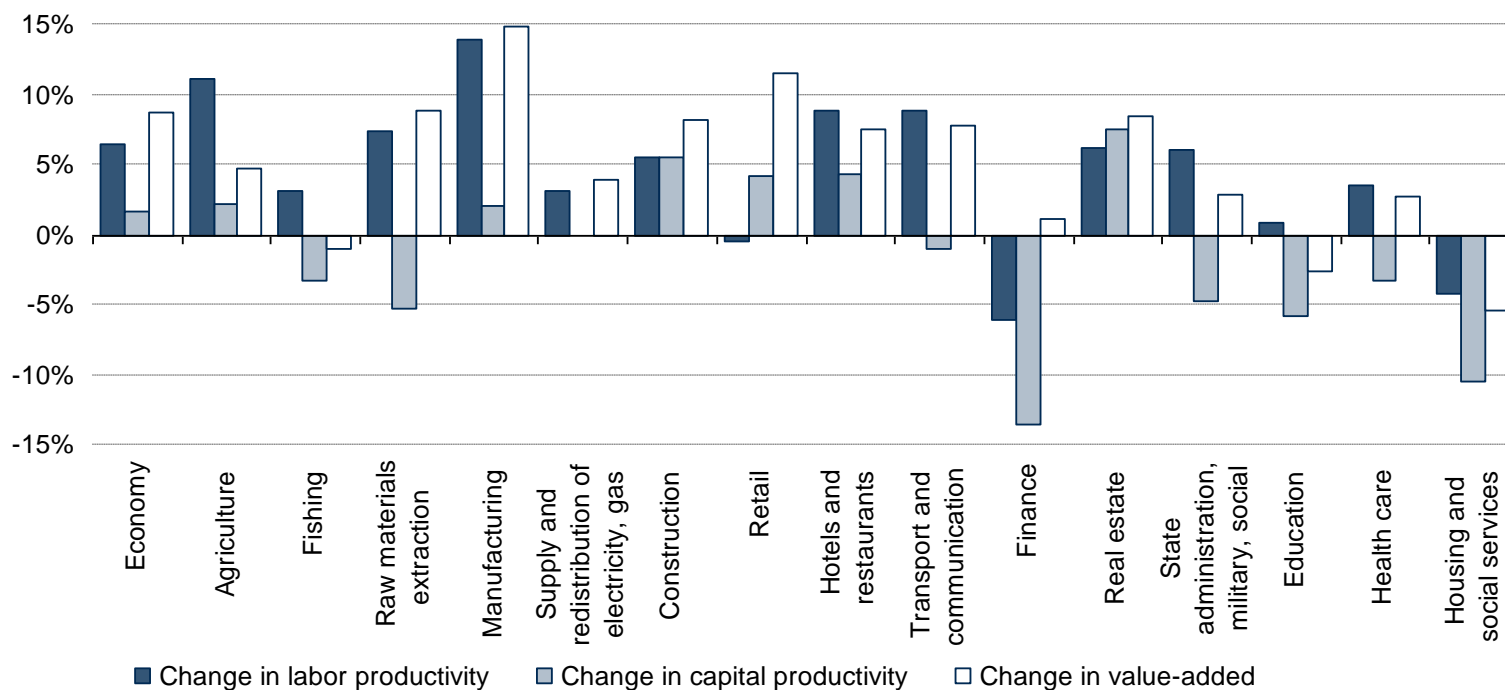
	Value added, \$ bln	Employment, mln	Value added per employee, \$ '000
Agriculture	63.7	6.4	9.9
Fishing	3.3	0.1	23.8
Raw materials extraction	167.8	1.0	160.3
Manufacturing	251.7	10.8	23.2
Supply and redistribution of electricity, gas and water	59.9	2.0	30.2
Construction	102.9	5.6	18.4
Retail	298.3	13.9	21.5
Hotels and restaurants	15.1	1.3	11.6
Transport and communication	140.0	5.5	25.3
Finance	65.1	1.2	53.1
Real estate	184.0	5.5	33.4
State administration, military, social services	90.3	3.8	23.7
Education	45.0	5.9	7.6
Health care	58.0	4.9	11.9
Housing and social services	22.8	2.7	8.5
Total	1567.8	70.8	22.1

\* value added is calculated at basic prices

Source: State Statistics Service, Troika estimates

# The manufacturing sector posted dynamic performance in 2009-11

Changes between 2011 and 2009



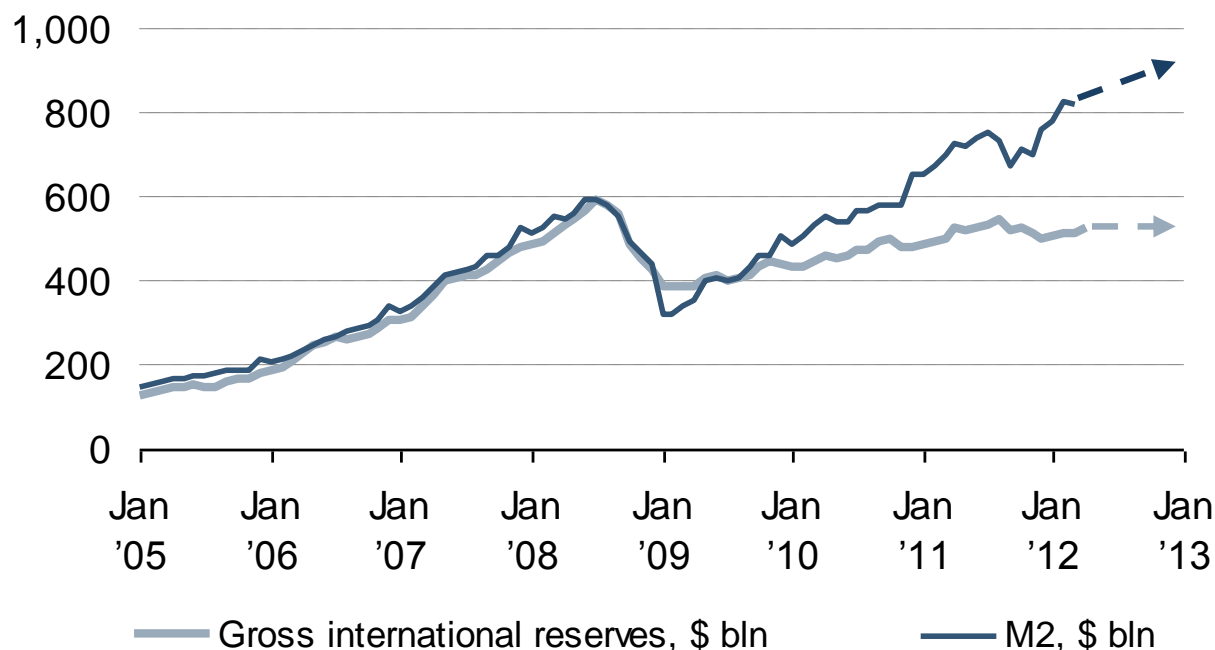
Source: State Statistics Service, Troika estimates

External risk should be associated not with the oil price alone (which affects the current account), but with sentiment and expectations affecting the capital account

- **Within a relatively short period, Russia has seemingly transitioned from a negative to positive real interest rate environment as inflation has subsided amid diminished Central Bank interventions on the forex market.** The key question now is how the Central Bank will strengthen the refinancing mechanism. The lack of collateral in the system makes it quite challenging for the Central Bank to become a lender of last resort. So far (at end 2011 and in early 2012) the Central Bank has demonstrated a strong ability to fully control the situation on the money markets.
- **As forex policy changed fundamentally in early 2009 and the exchange rate became almost floating (but not entirely), we have no concerns about the stability of the current account.** The major risk is now associated with the capital account, which sentiment and expectations (not necessarily always correct) may negatively impact. The effect on the financial system may be strong, as the current account may not always be able to act as a shock absorber in the short term.

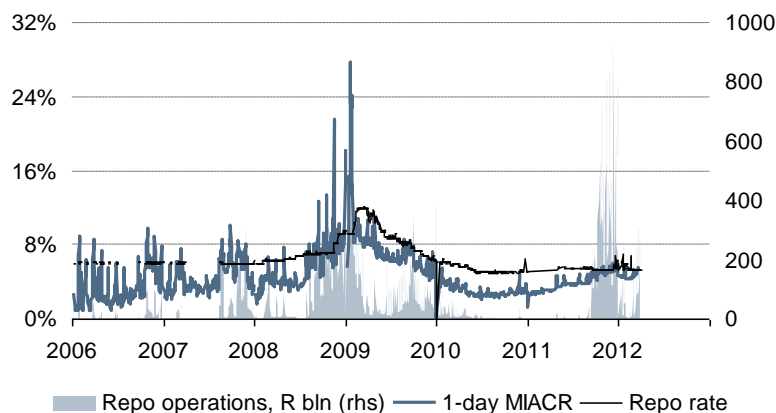


Russian M2 declined in nominal terms, but started to rise in February 2009, a sign that the economy is recovering (R bln); the sort of “currency board” regime is seemingly over: money is becoming endogenous



Source: Central Bank, Troika estimates

The ruble has appreciated since February 2009 after the Central Bank stopped targeting the exchange rate, which has become more volatile; the Central Bank's role as lender of last resort must grow in importance

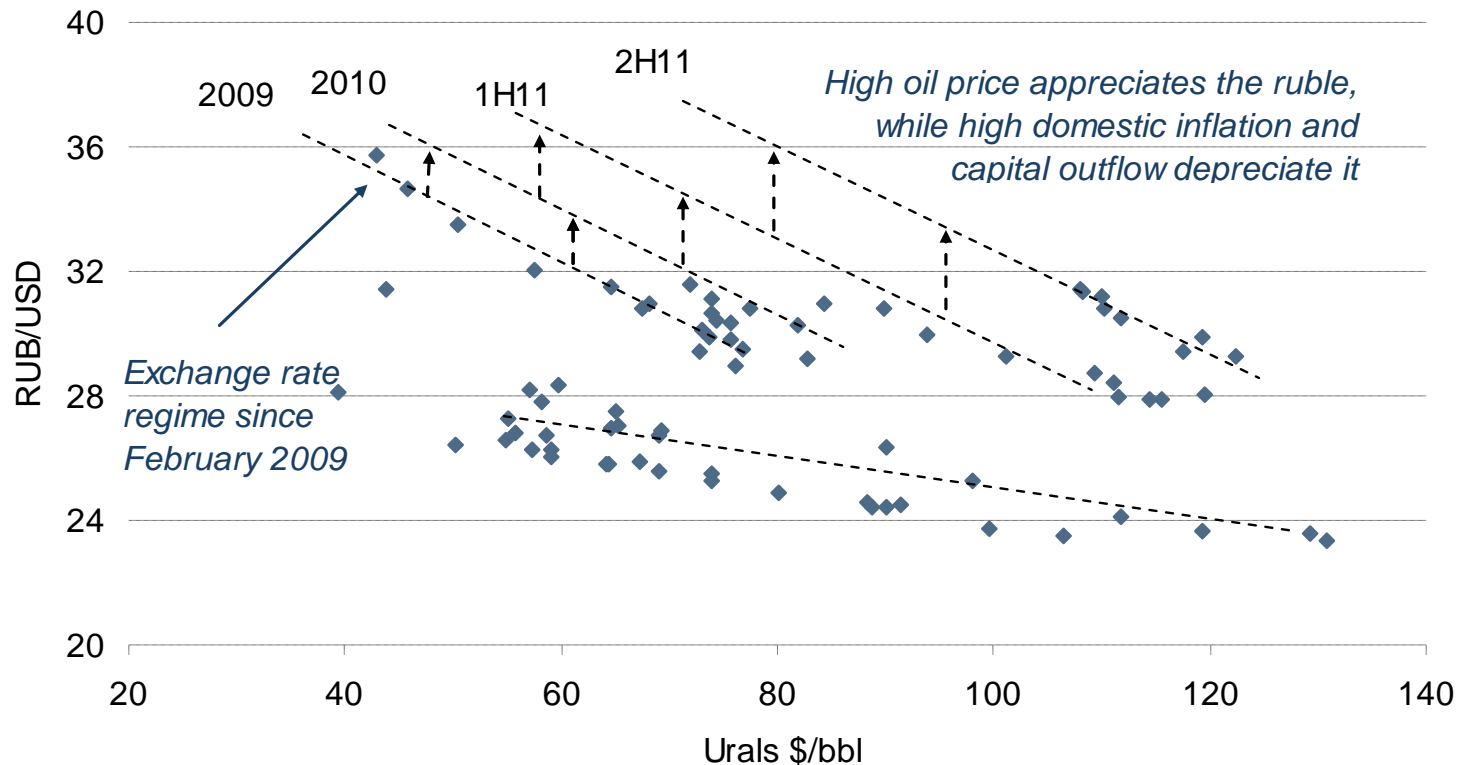


Source: Central Bank, Troika estimates



Source: Central Bank

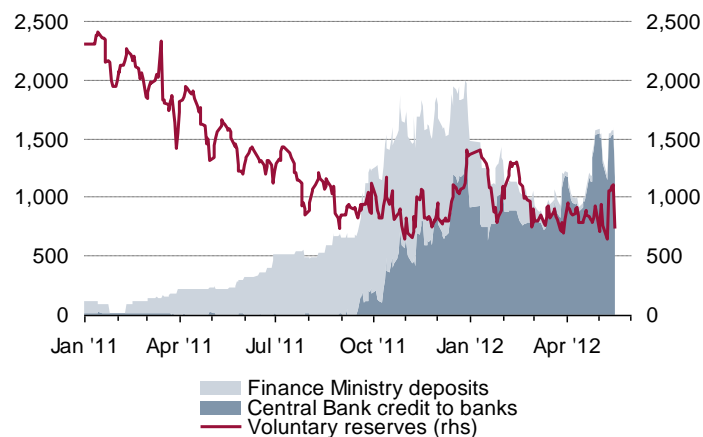
# Historical exchange rate and oil price: new regime emerges as Central Bank reduces interventions



Source: Central Bank, Bloomberg, Troika estimates

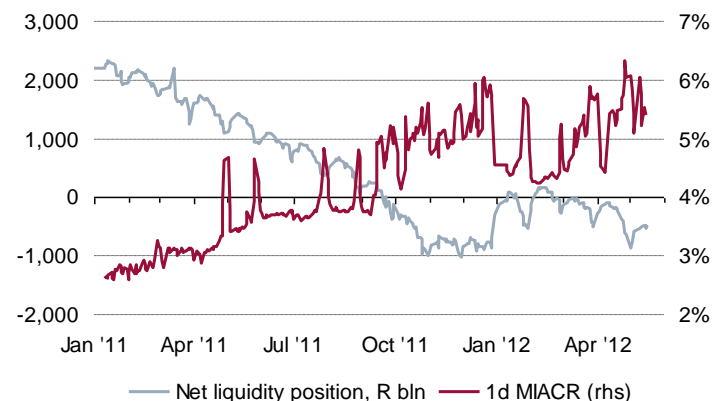
# The role of the monetary authorities as lender of last resort expanded substantially in late 2011

**Demand for refinancing is growing,  
R bln**



Source: Central Bank

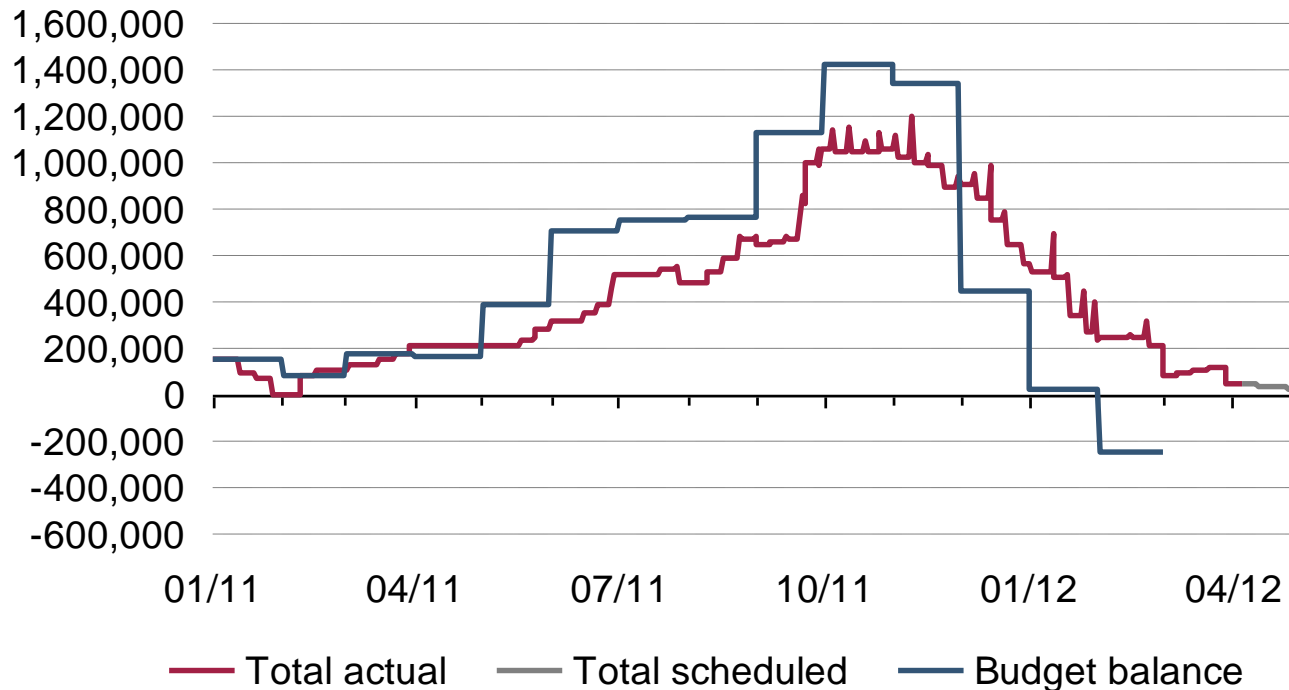
**Money market rates are on the rise amid  
tightening liquidity**



Note: Net liquidity position is calculated as the difference between voluntary reserves and crediting from the monetary authorities.

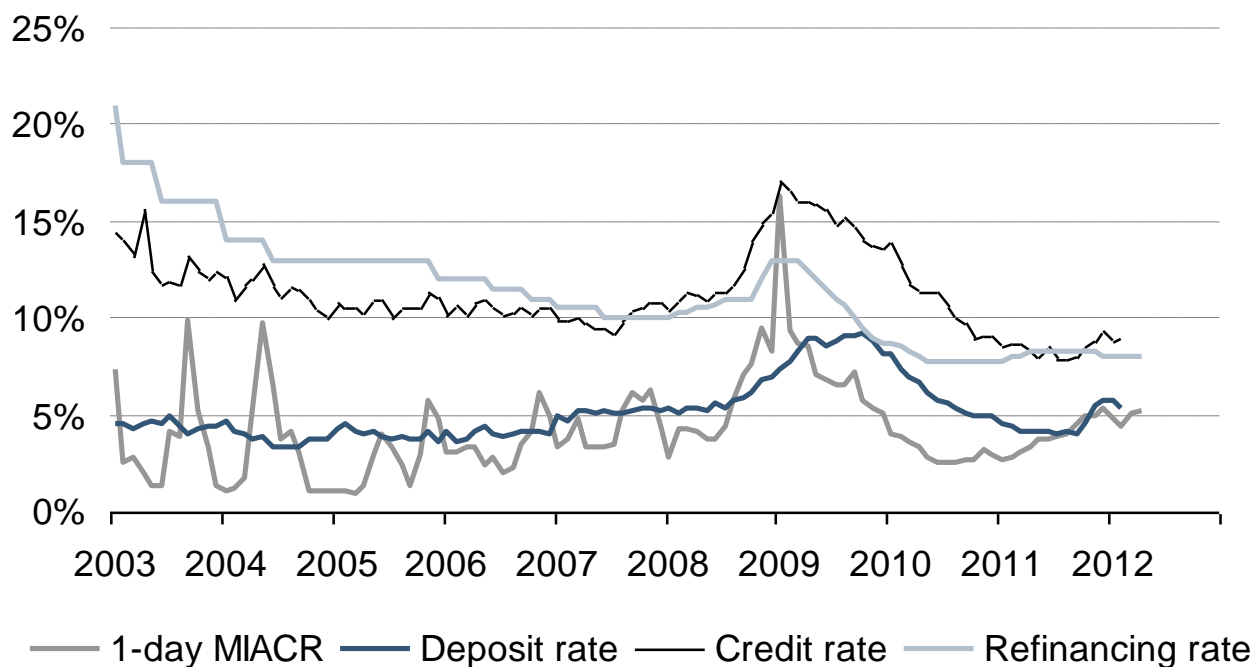
Source: Central Bank

The Finance Ministry provided liquidity by offering deposits to commercial banks, but is discontinuing this practice, R mln



Source: Central Bank

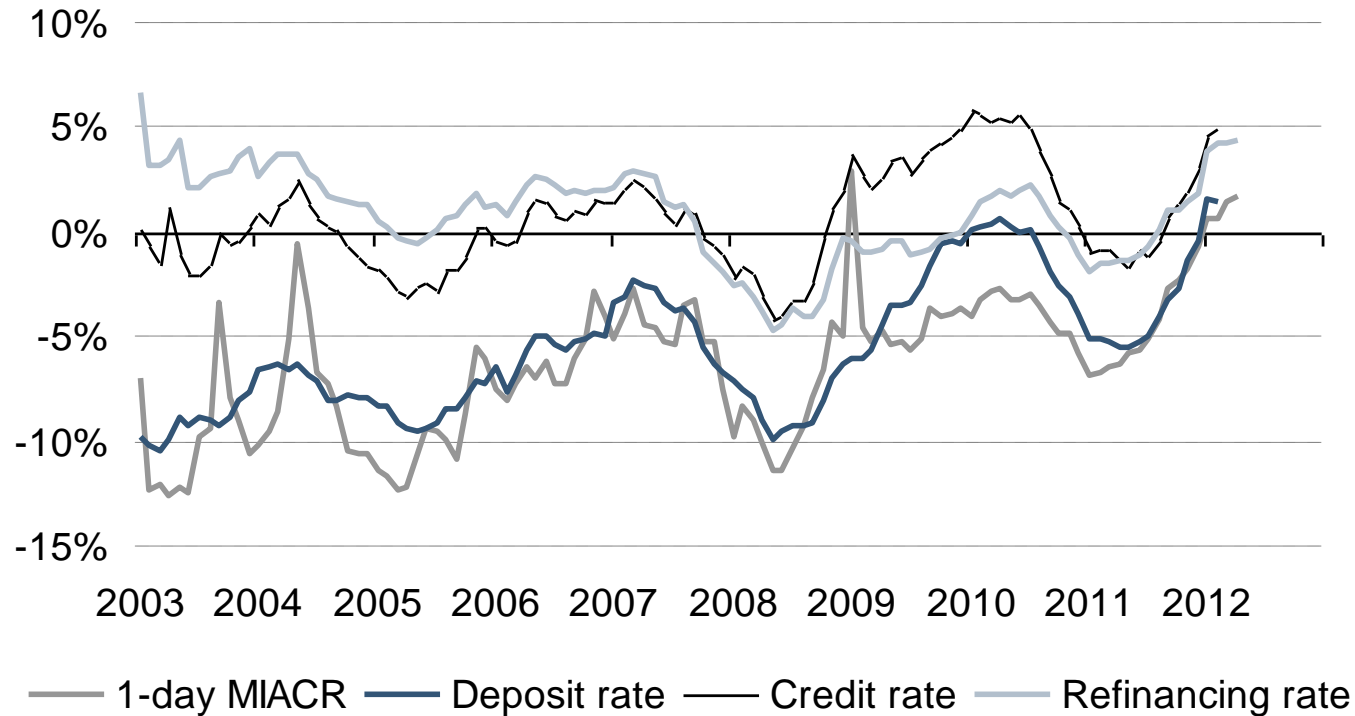
# The margin between banks' lending rates and their borrowing costs narrowed amid disinflation



Source: Central Bank

# Real interest rates are turning positive

Based on y-o-y inflation



Source: Central Bank, State Statistics Service, Troika estimates

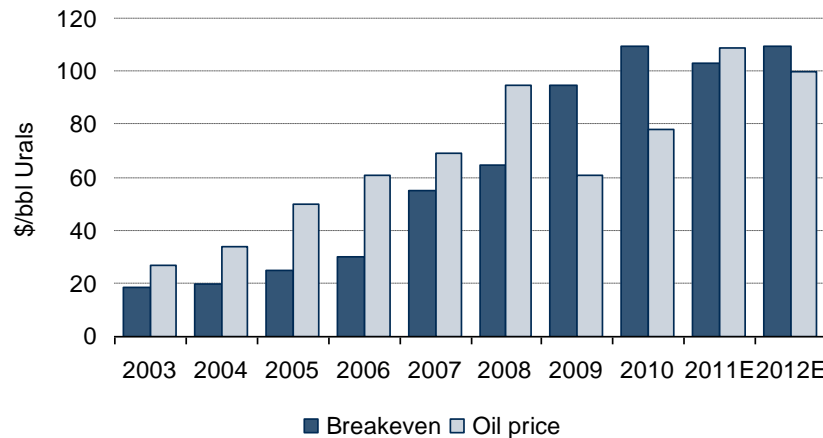
# One major internal risk is generous and inefficient budgetary spending

- **Aside from external risks, Russia's major internal risk is the budget's dependence on the oil price and excessive spending**, which was due to the regular practice of adopting amendments to the budget at mid-year.
- **At the same time, Russia's dependence on the oil price is no worse than the dependence of developed countries on printing money.**
- **Over 2011, the budget ran a surplus of R416.5 bln (\$16.4 bln), or 0.8% of GDP**; however, the government's adjusted expectations assumed zero balance and the original budget assumed a R1.8 trln deficit. Robust fiscal performance is a result of higher than expected oil prices, a weaker exchange rate and stronger than forecast economic growth.
- **The official breakeven oil price for 2011 was \$109/bbl and is envisioned at \$116/bbl this year.** These estimates are too high. Nevertheless, there is a risk that the government might boost spending this year, which means that the budget's dependence on the oil price will again increase.
- **At the same time, it is premature to judge by how much and when spending will be raised.** The additional impact on the budget from Vladimir Putin's election promises is hard to quantify accurately, as they were already budgeted. In any case, the government's spending will not help accelerate growth.

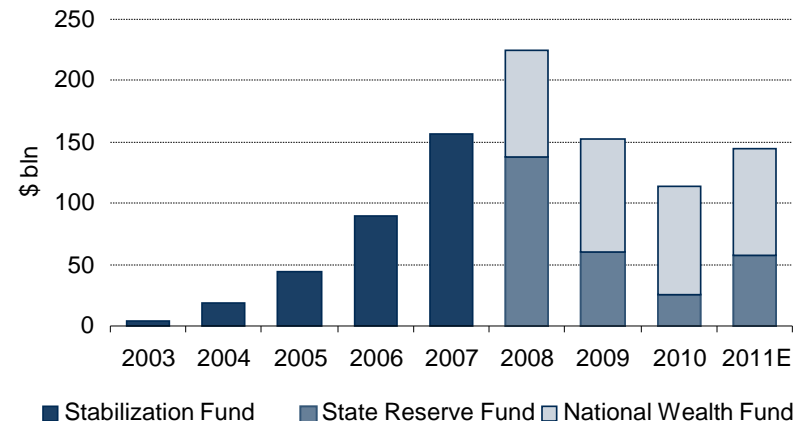


# Russia's breakeven oil price has grown substantially in recent years, but seems to have stabilized

**Budgetary policy was generous and the State Reserve Fund shrank in 2009-10, as the budget was in the red (chart on right)**

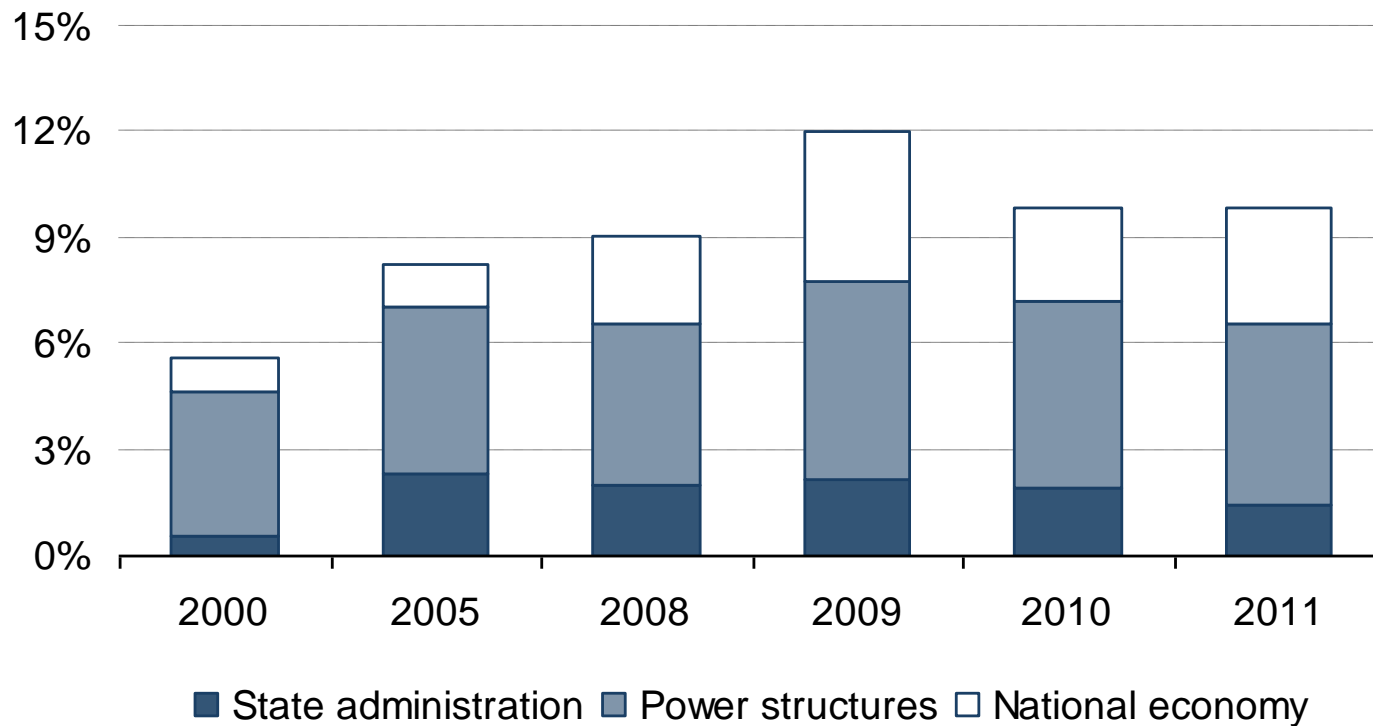


Source: Finance Ministry, Troika estimates



Source: Finance Ministry, Troika estimates

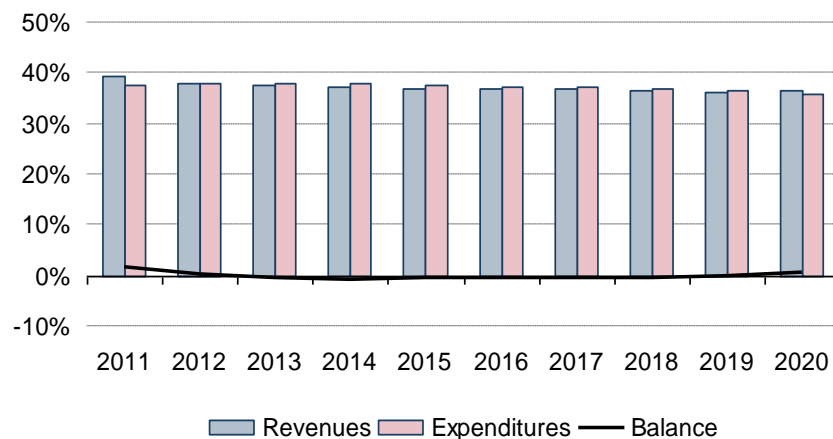
# Selected items in budget expenditures, % of GDP



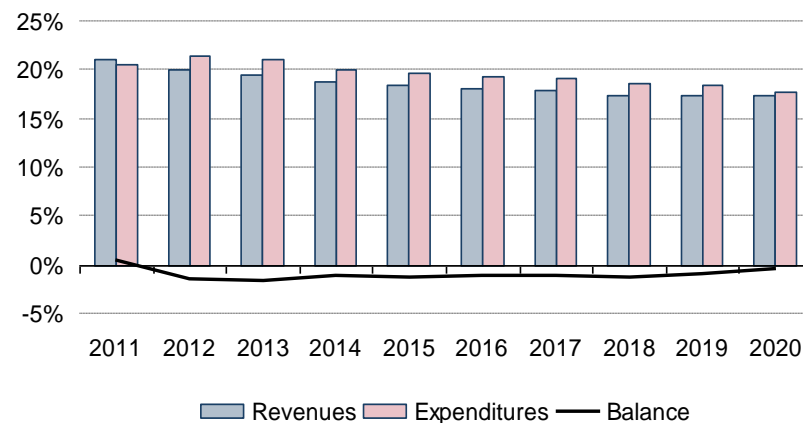
Source: Finance Ministry

# Expenditures/GDP ratio is expected to fall

## Consolidated budget

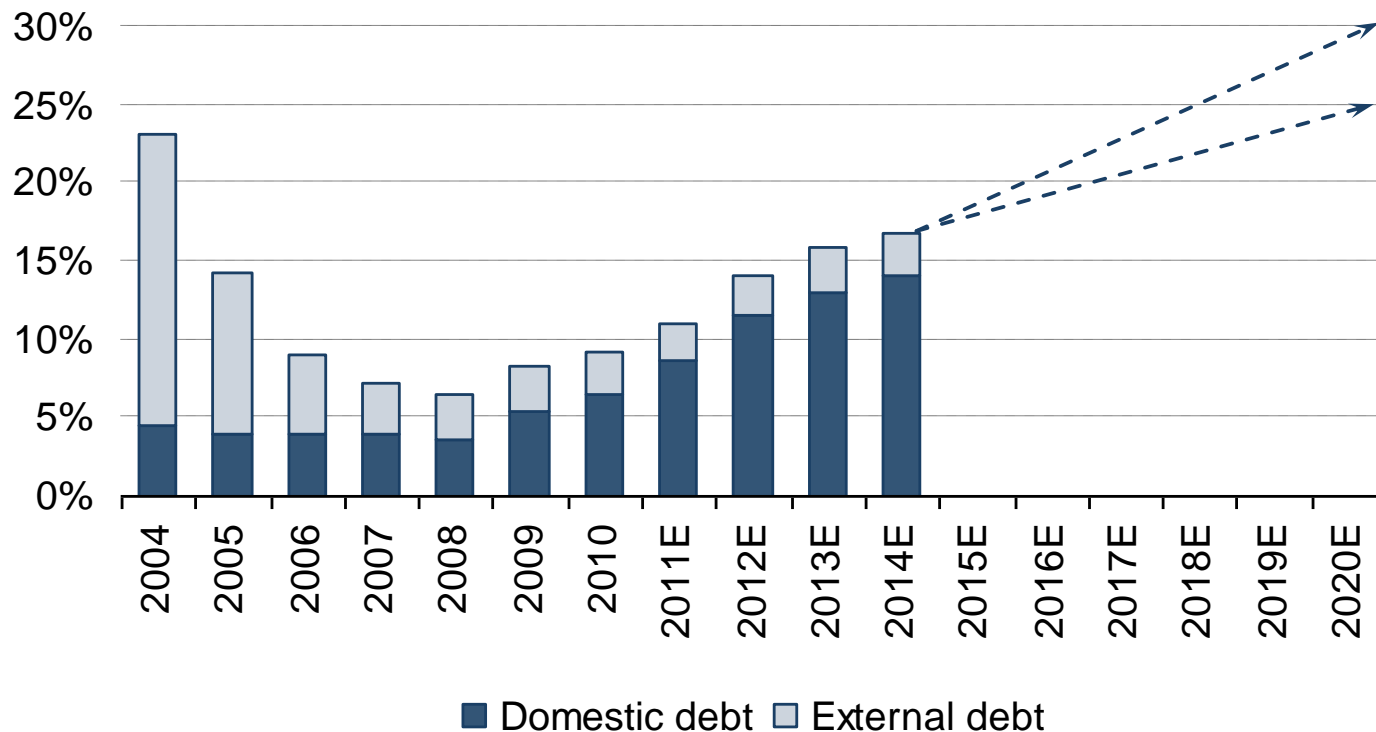


## Federal budget



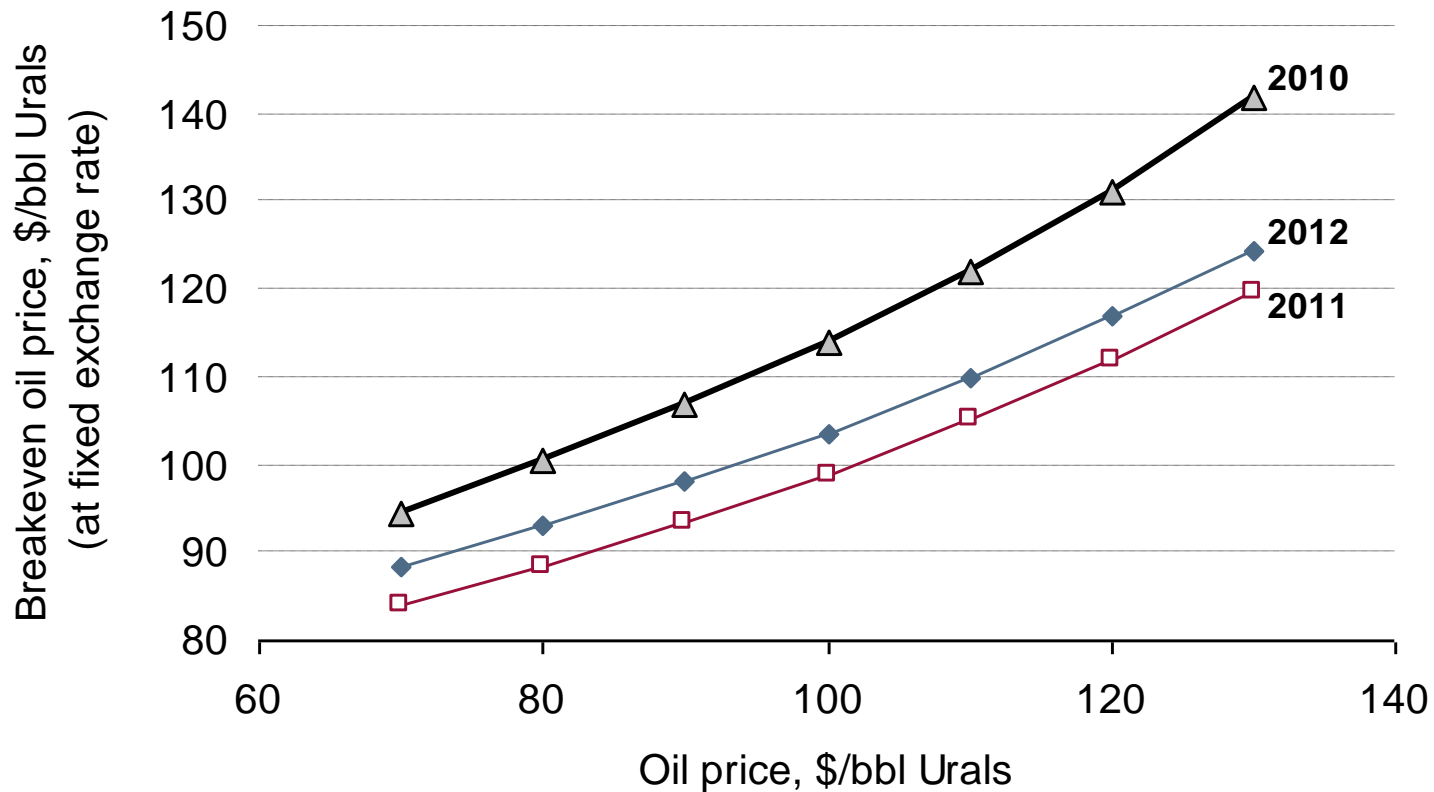
Source: Strategy 2020

# Debt/GDP ratio will not exceed 25-30% by 2020



Source: Strategy 2020

Breakeven oil price for budget is only a theoretical concept and is a function of actual price (not expenditures alone)

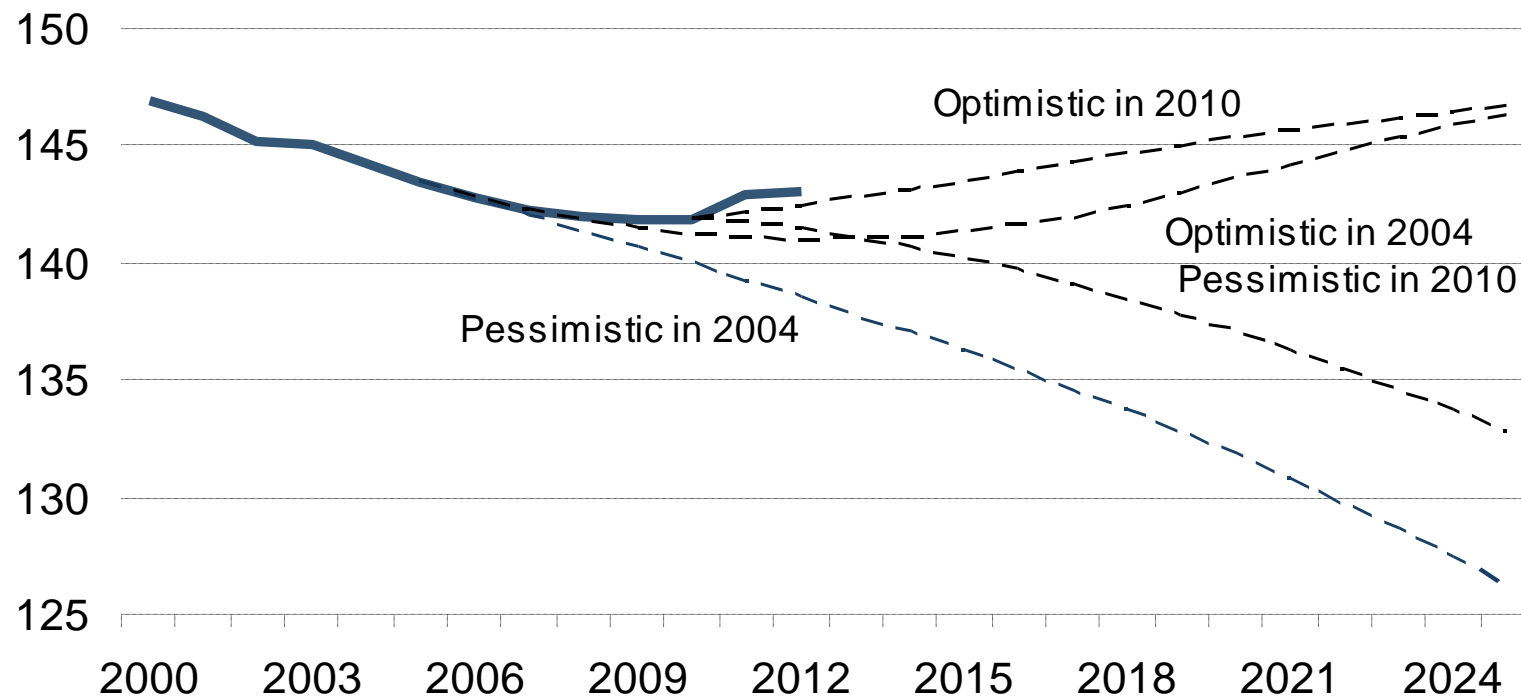


Source: Troika estimates

# Demographic situation is improving

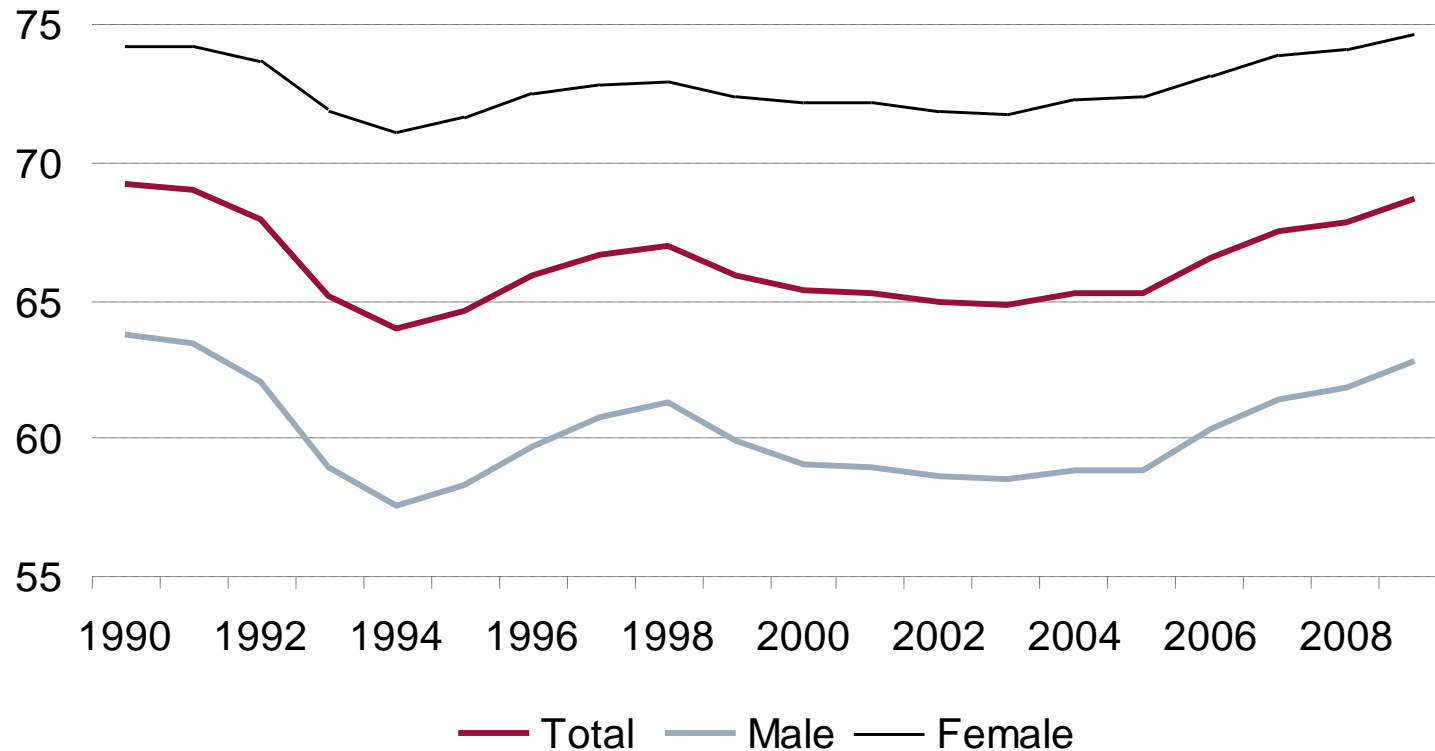
- **Population dynamics have outstripped the most optimistic scenario.**
- **Life expectancy is growing**
- **Though natural change in the population is still negative, the situation is obviously improving.**
- **Economically active population is growing, as is employment.**
- **Net migration with non-CIS countries is already positive.**

# Population dynamics are outstripping even the most optimistic scenario, mln



Source: State Statistics Service

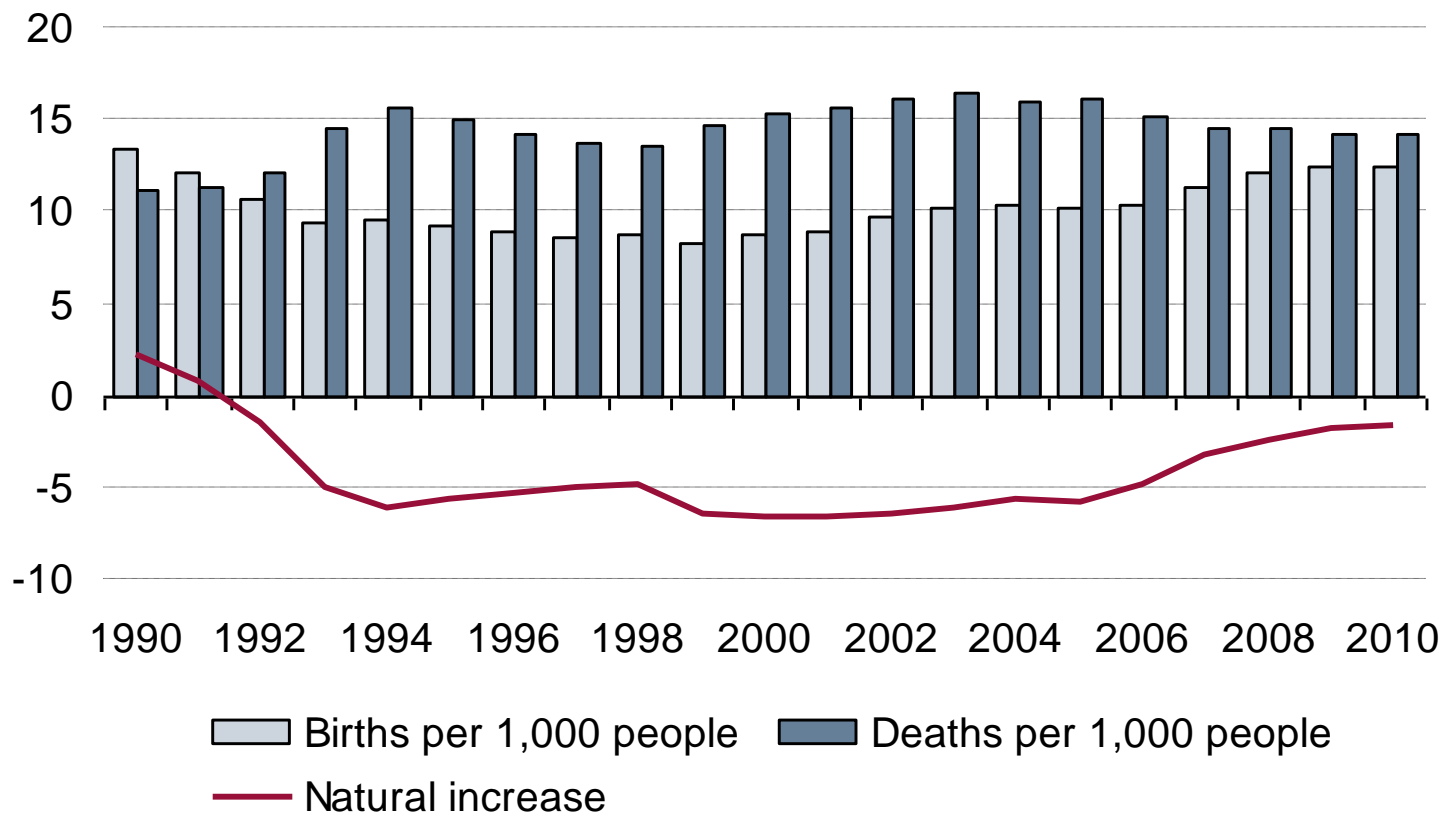
# Life expectancy is growing, years



Source: State Statistics Service

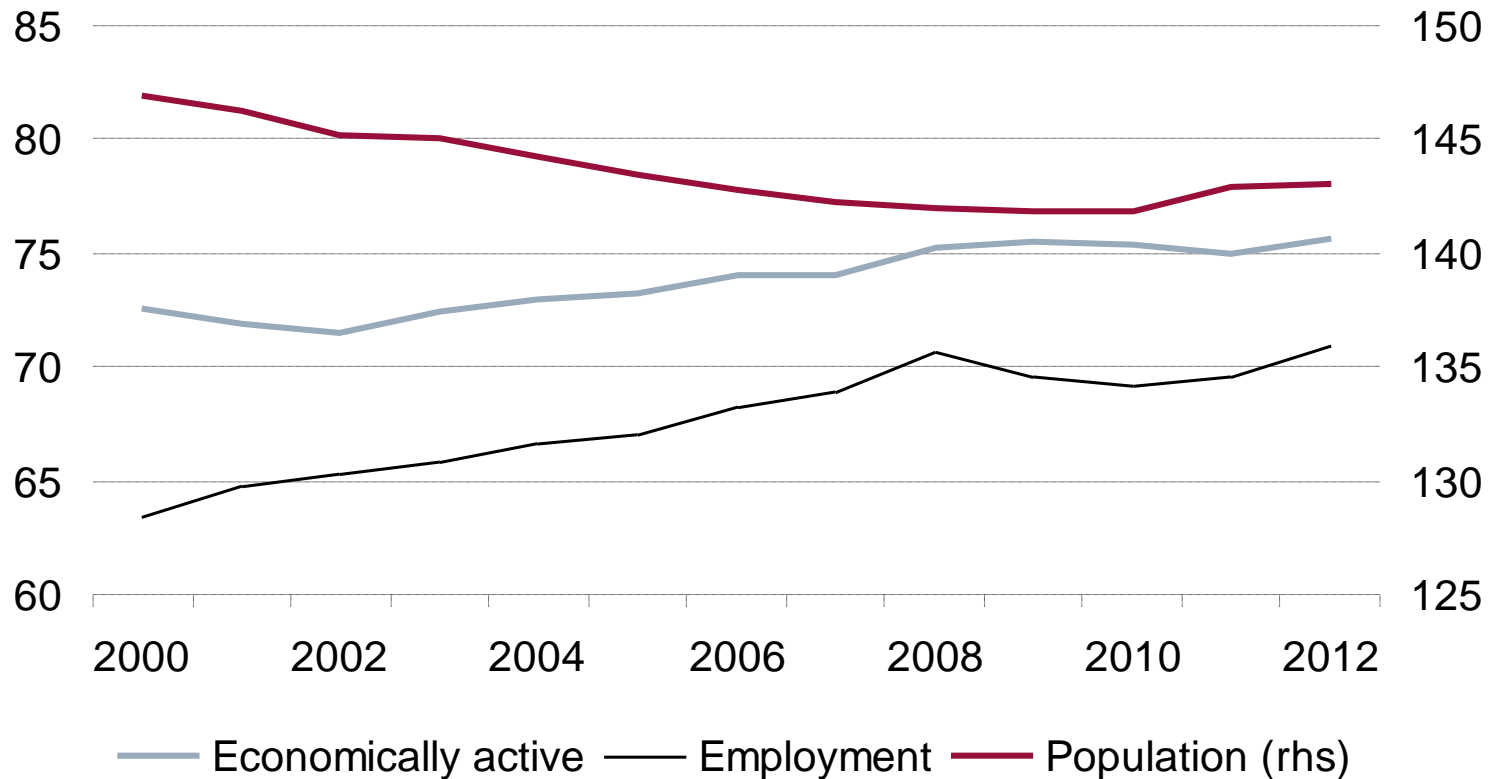


# Natural increase in population is turning positive



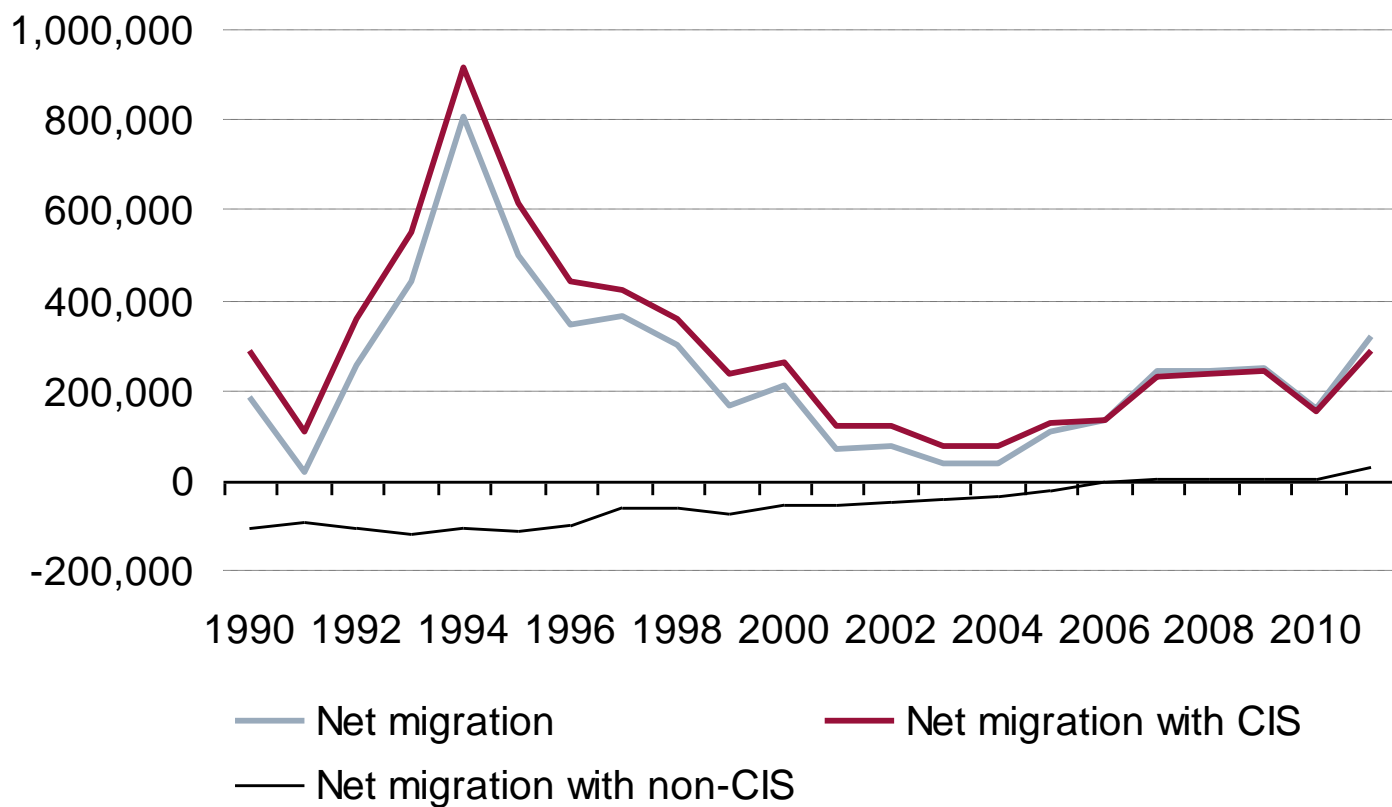
Source: State Statistics Service

## Despite earlier fears, the economically active population is growing, as is employment (as of January 1), mln



Source: State Statistics Service

# Net migration with non-CIS countries is already positive



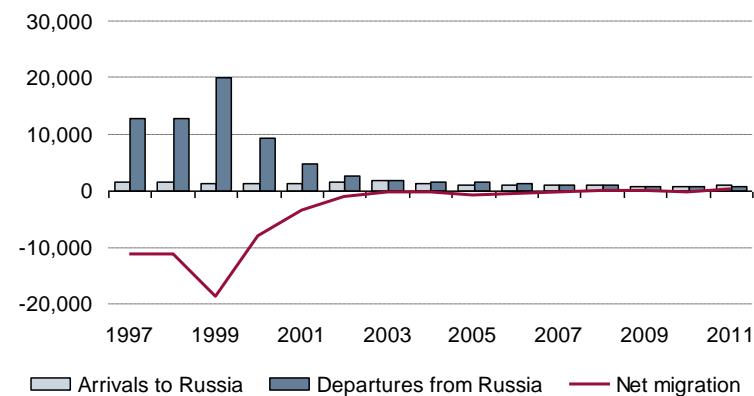
Source: State Statistics Service

# Net migration between Russia and select non-CIS countries such as...

...Germany



...Israel



Source: State Statistics Service

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