

# Russia: Growth Continues Amid Global Tumult

November 2011  
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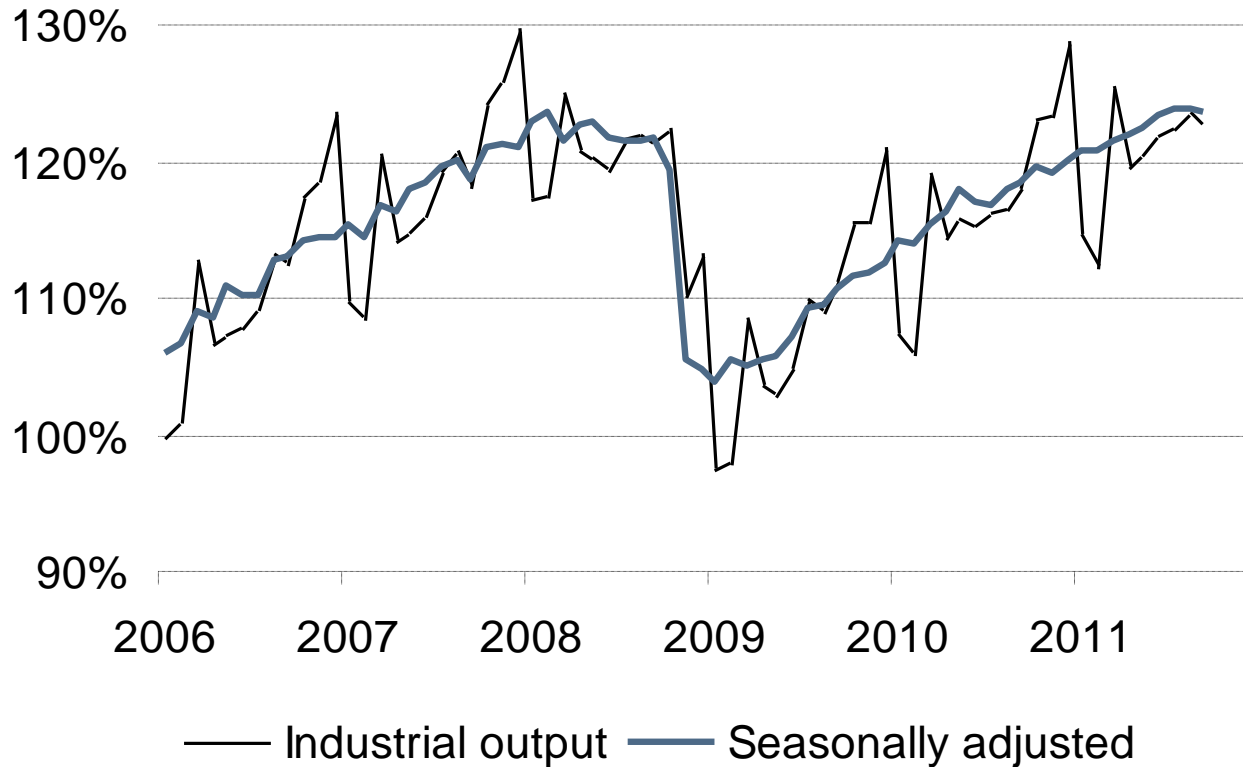


**Troika** Dialog

# Russia seems to be little affected by the global slowdown, delivering moderate but balanced growth in 2011

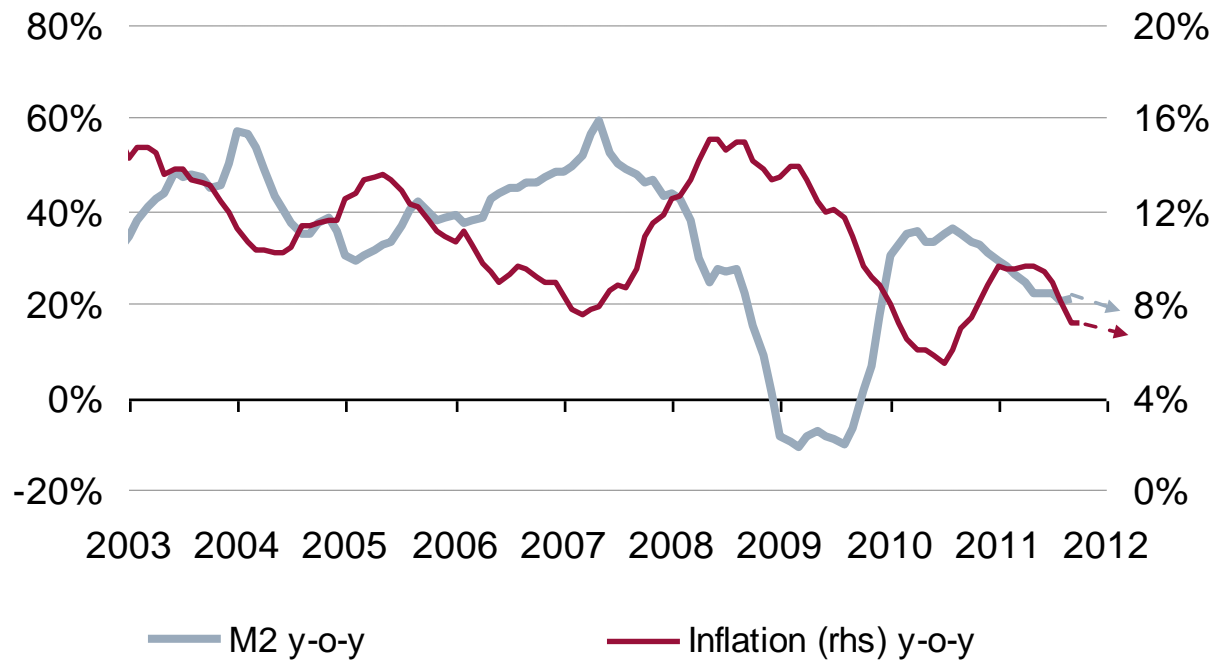
- **Monthly growth, which resumed in 2Q09, moderated relative to pre-crisis period, but looks healthier and more balanced, as the economy is no longer overheated.** In 2011, Russia may once again become a twin surplus economy.
- **Domestic demand is strong.** Investment was up slightly in 4m11 (up 0.1% y-o-y), but this number was not convincing, as output of major construction materials and other investment goods soared. Unsurprisingly, investment growth “accelerated” in mid-year and in September (8.5% y-o-y), which brought the 9m11 tally to 4.8% y-o-y; retail was up 9.2% in September and 6.2% y-o-y in 9m11.
- **Industrial output expanded 5.2% y-o-y in 9m11.**
- **Annual inflation peaked in January 2011 (9.6% y-o-y) and slowed to below 7.0% in October as high oil prices help run the budget at a surplus and limit liquidity injections.** By year end, inflation could be close to 6.0%.

# Industrial output has been recovering m-o-m since February 2009, Jan '06 = 100%



Source: State Statistics Service

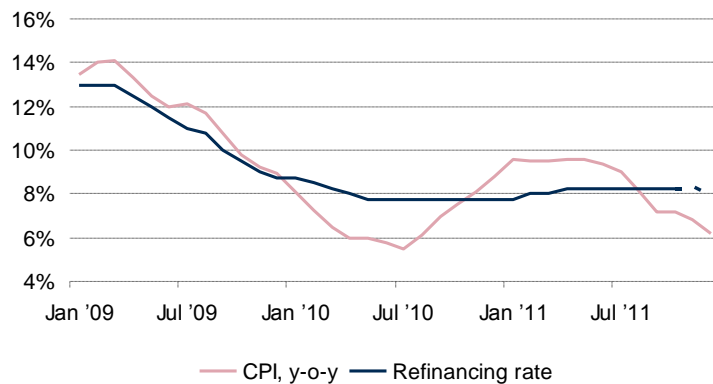
# There has been a sort of inverse correlation between money supply growth and inflation



Source: Central Bank, State Statistics Service

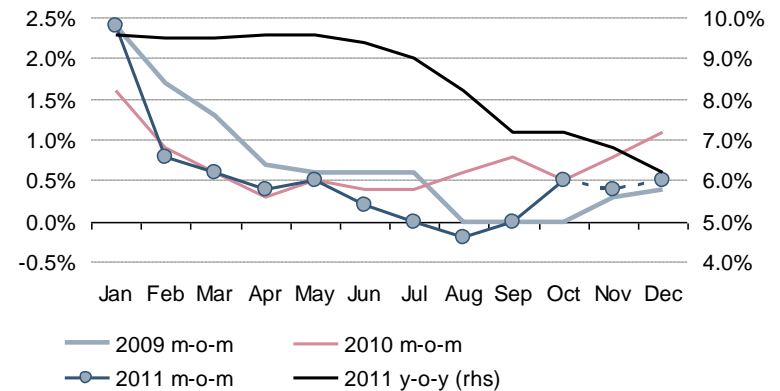
# Annual inflation has been slowing more rapidly but started to accelerate in August 2010

## Annual inflation versus refinancing rate



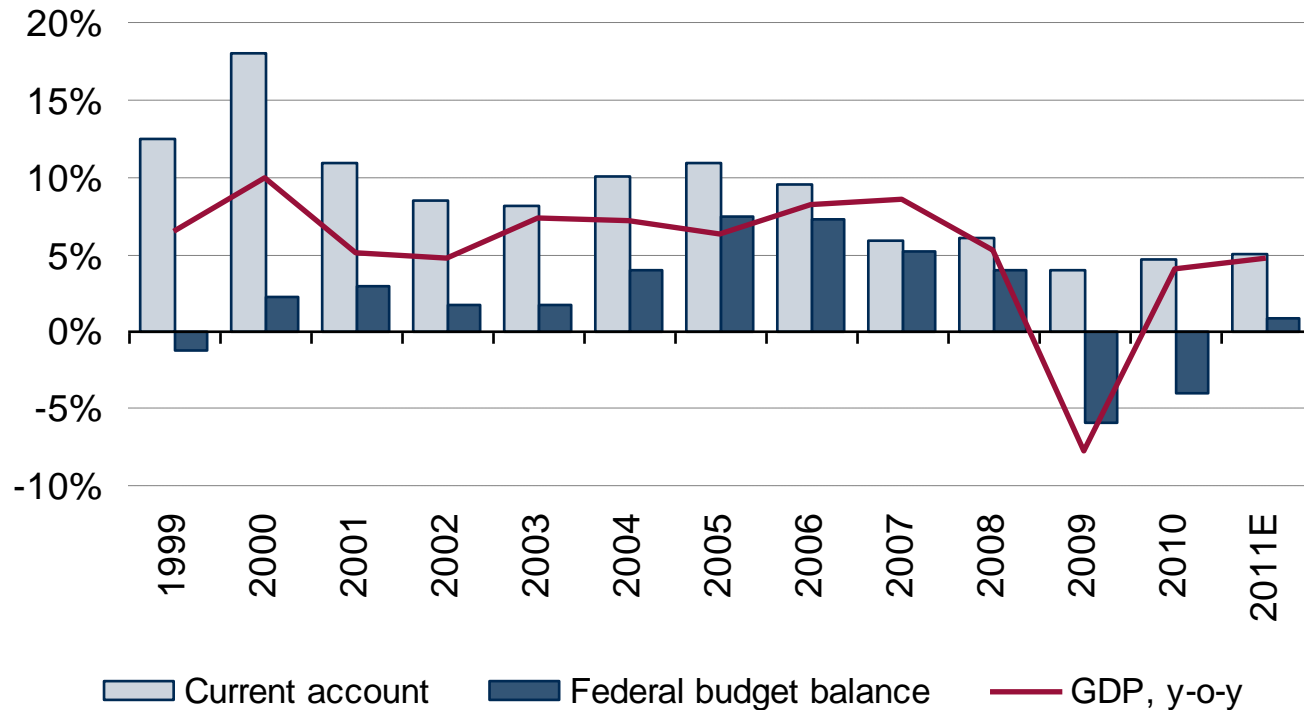
Source: State Statistics Service, Central Bank

## Monthly inflation



Source: State Statistics Service

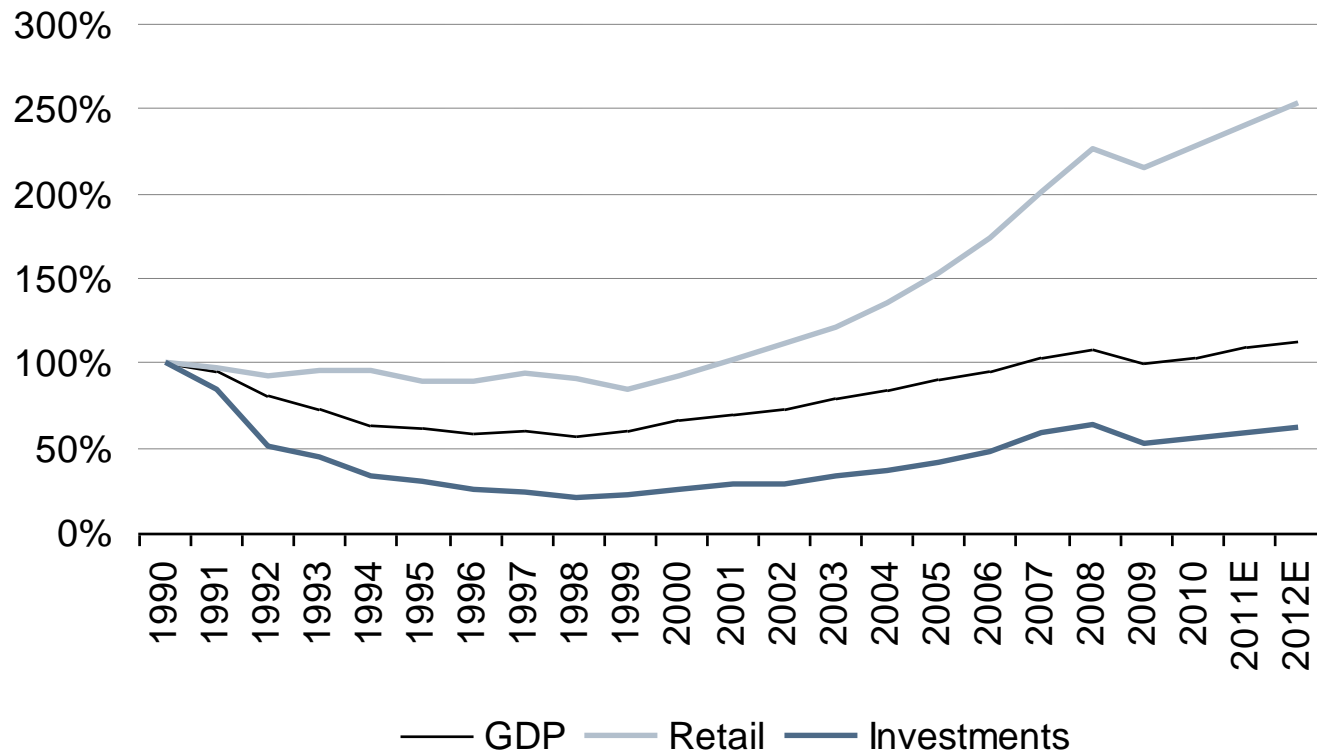
# In 2011 Russia will once again become a twin surplus economy (most likely temporary)



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

# Russia's GDP is already above Soviet era levels, but the structure has changed, 1990 = 100%

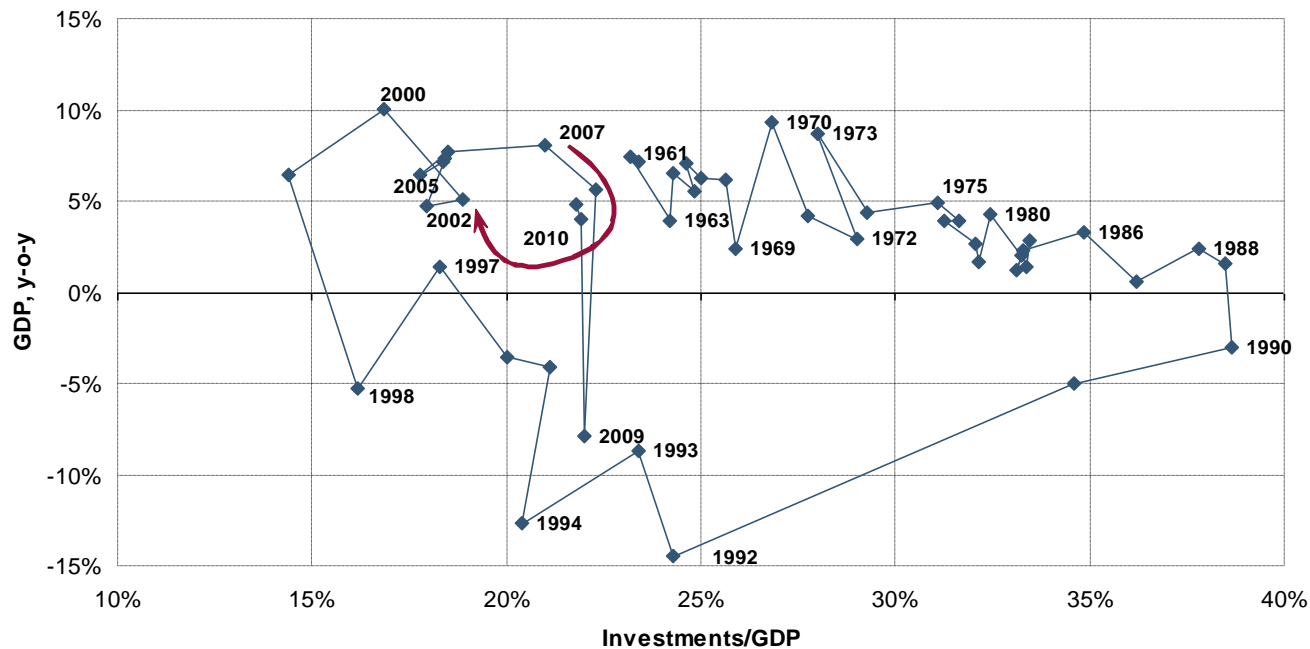
**Consumption more than doubled over 20 years, while investments are almost half the Soviet figure**



Source: State Statistics Service

# Russia is returning to a more balanced model of economic development after several years of overheating: searching for an equilibrium

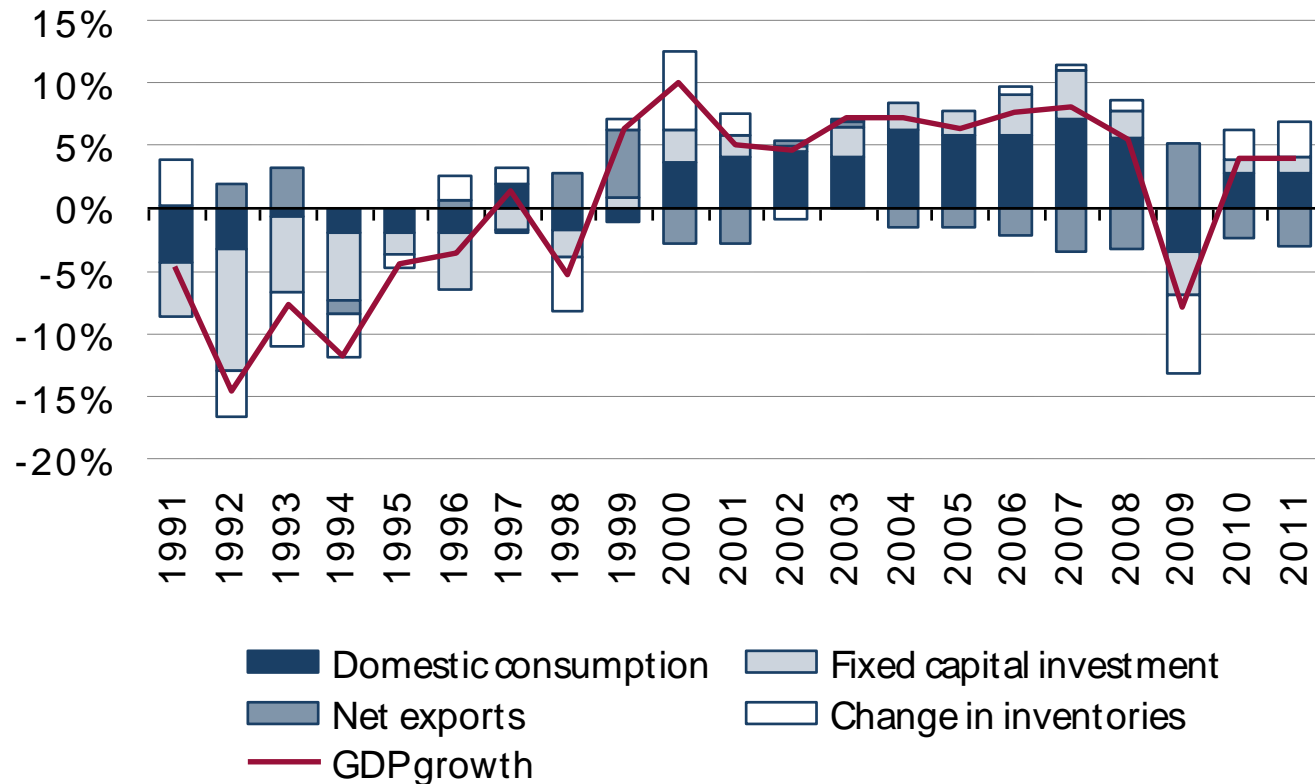
**The quality of investments is more important than the quantity: less is more**



Source: State Statistics Service, HSE, Troika estimates

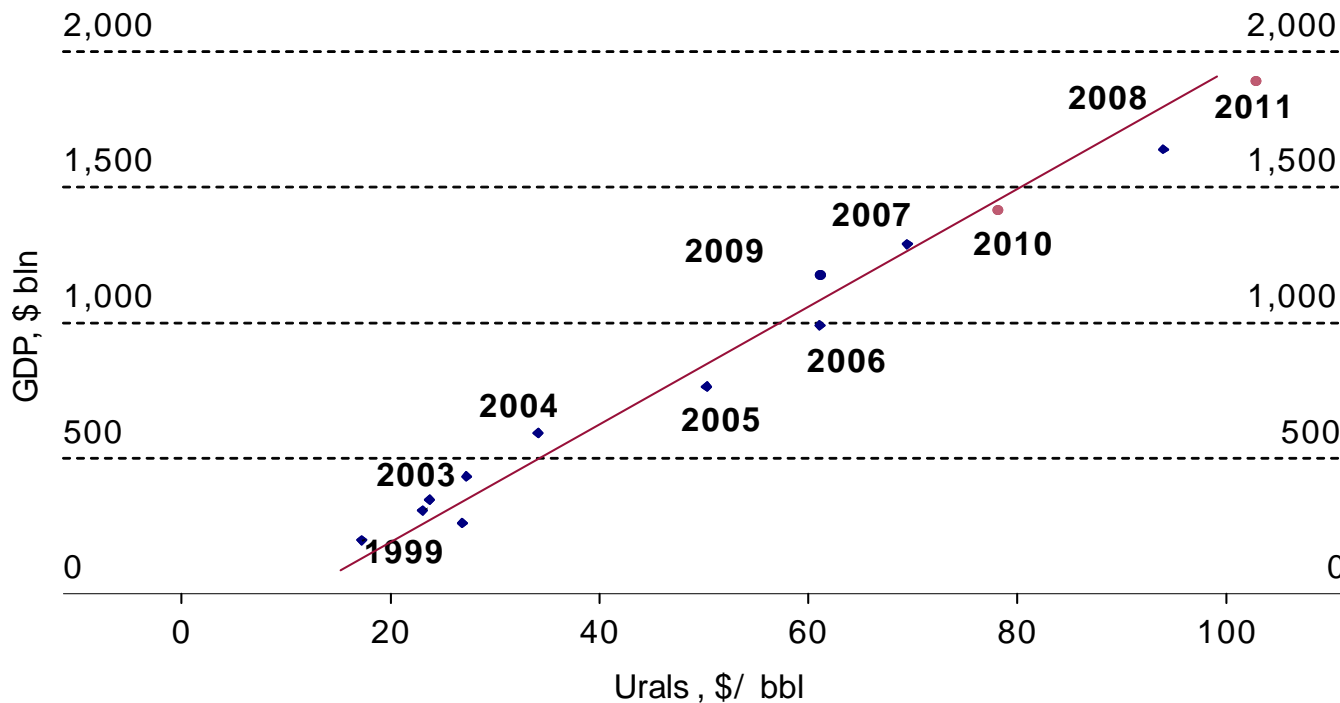


# GDP growth breakdown: domestic demand a key growth driver



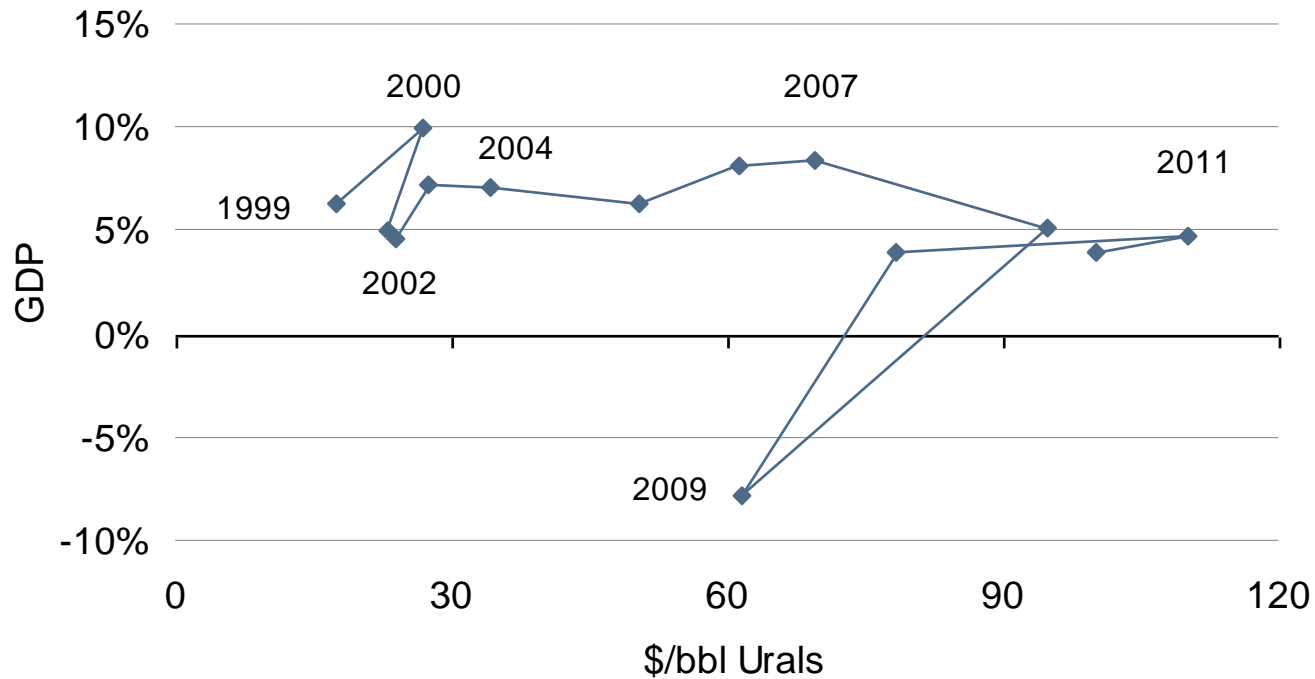
Source: State Statistics Service, Troika estimates

# Russia's nominal GDP (in dollar terms) correlates with the oil price



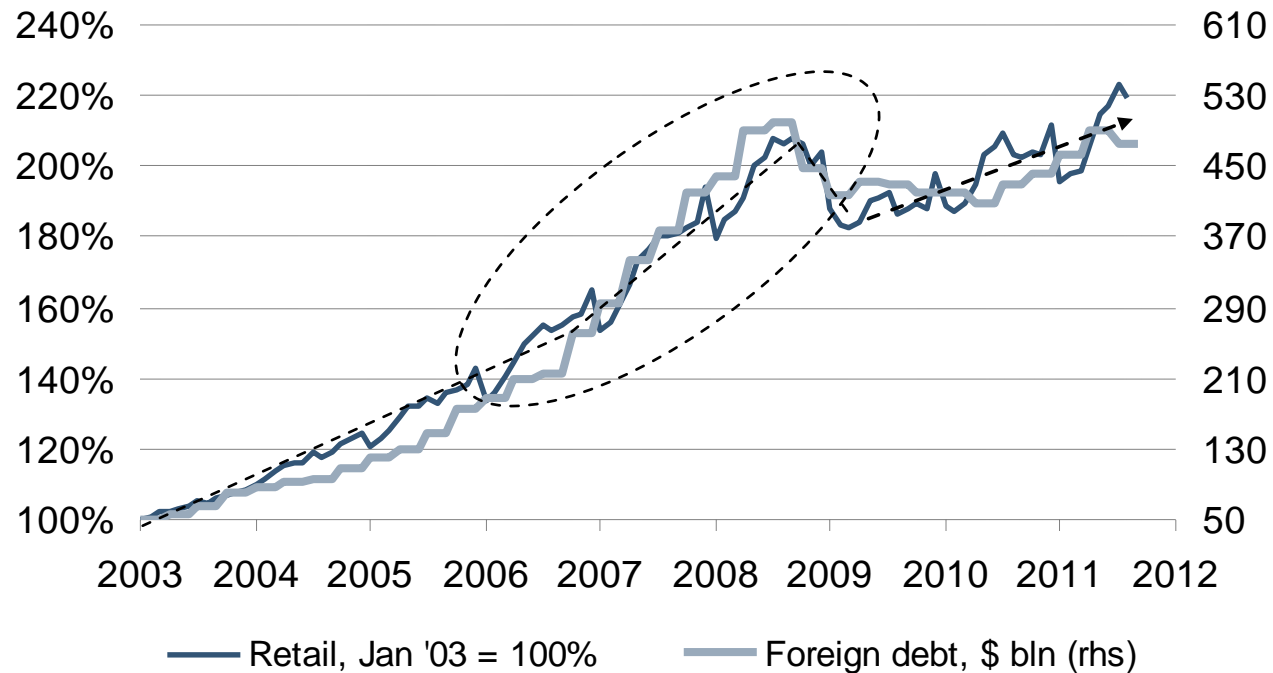
Source: State Statistics Service, Troika estimates

# Oil price inflation did not accelerate Russian economic growth



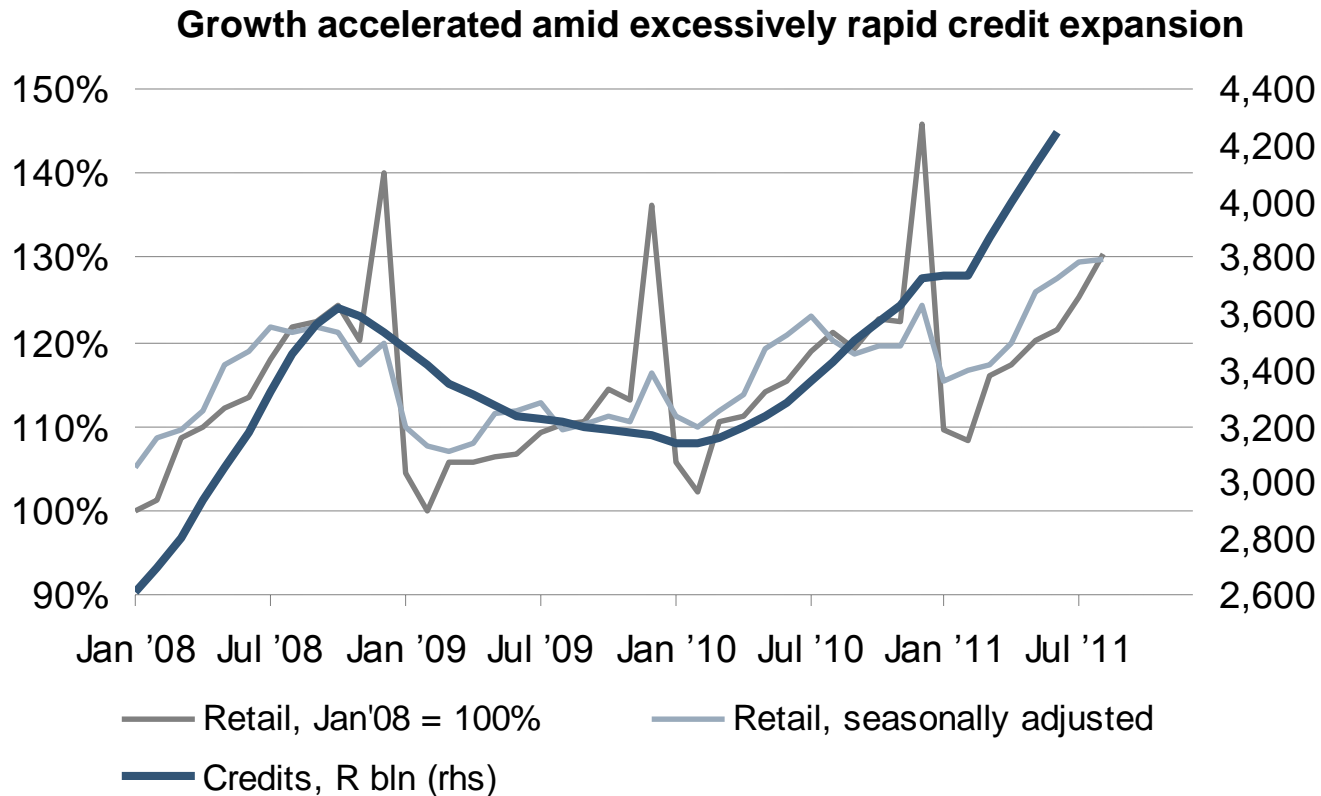
Source: State Statistics Service, Troika estimates

# Retail was booming due to foreign borrowing, which stimulated imports



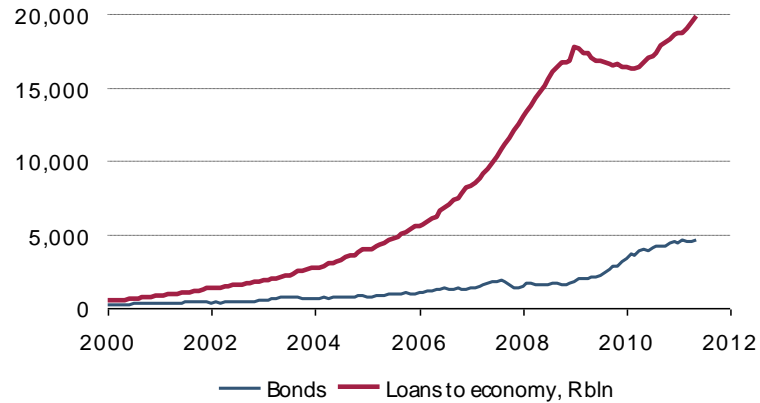
Source: State Statistics Service, Central Bank, Troika estimates

# Following the short correction in early 2009, consumption is rising steadily amid a resumption in consumer lending

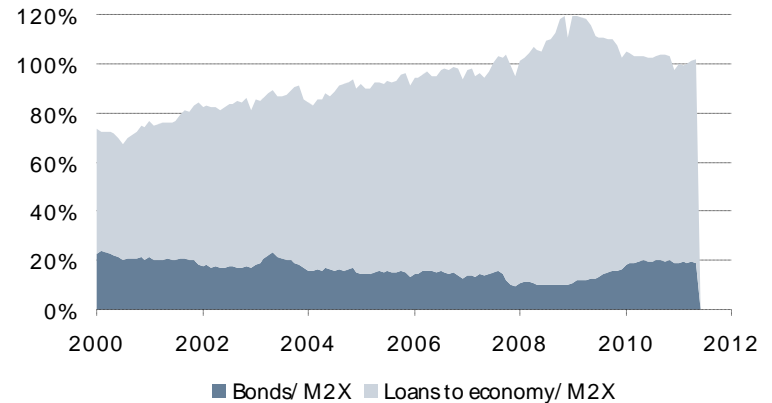


Source: State Statistics Service, Central Bank, Troika estimates

# Lending activity and bond purchases by banks



Source: Central Bank, State Statistics Service



Source: Central Bank, State Statistics Service

# Even though growth moderated after the 2008 crisis, the Russian economy looks healthier

- **Despite the fact that Russia's growth moderated in 2010 in the aftermath of the 2009 correction, growth was rather strong.** Official statistics suggest that GDP expanded 4%, which was the lower bound of our forecast from mid-2009.
- **Economic performance in 2009-10 was better than the State Statistics Service reported.** The same is true of 1H11. Monetary and financial indicators, which indirectly indicate where the economy is heading, have looked very encouraging since 2Q09. The statistics look unconvincing, as they are still affected by base effects (such as last year's drought) that will positively affect growth numbers in 2H11.
- **This year, actual growth may be over 4.5% and possibly higher,** i.e. to what we believe the economy delivered last year (close to 5%, the upper bound of our old forecast). The output of five basic sectors, a monthly proxy for GDP, expanded a respective 5.9% and 6.5% y-o-y in July and August 2011. Next year, growth will moderate to around 4%, partly due to the fact base effects will be completely eliminated.

# Statistical revisions were significant in the case of industrial output in 2010, but they have yet to come for GDP

## 2010 GDP growth breakdown, y-o-y

<b>GDP</b>	<b>4.0%</b>	<b>GDP</b>	<b>4.0%</b>
<b>Final consumption</b>	<b>2.5%</b>	Agriculture	-10.7%
Households	3.0%	Fishing	-3.9%
State	1.4%	Raw materials extraction	4.7%
Non-commercial organization, servicing households	-1.5%	Manufacturing	12.3%
<b>Gross capital formation</b>	<b>28.4%</b>	Supply and redistribution of electricity, gas and water	5.5%
Fixed capital	6.1%	Construction	-0.7%
Changes in inventories	-	Retail, wholesale trade	5.0%
<b>Net exports</b>	<b>-42.8%</b>	Hotels and restaurants	2.2%
Exports	7.1%	Transport and communication	7.7%
Imports	25.6%	Finance	-2.4%
		Real estate	-1.2%
		State administration, military, social services	3.9%
		Education	-1.9%
		Health care	1.3%
		Other housing and social services	-5.5%
		Net taxes on products	7.9%

Source: State Statistics Service

Source: State Statistics Service



# The State Statistics Service keeps revising elements of GDP, but has surprisingly refrained from revising aggregate numbers

	2010*	2010**	2009*	2009**	2009***	2009
<b>GDP</b>	<b>4.0%</b>	<b>4.0%</b>	<b>- 7.9%</b>	<b>- 7.9%</b>	<b>- 7.8%</b>	<b>- 7.0%</b>
<b>Consumption</b>	<b>2.1%</b>	<b>2.5%</b>	<b>- 5.4%</b>	<b>- 5.1%</b>	<b>- 3.7%</b>	<b>- 3.2%</b>
Household consumption	2.7%	3.0%	- 8.1%	- 7.7%	- 4.8%	- 5.0%
Public sector consumption	0.7%	1.4%	1.9%	2.0%	- 0.5%	2.0%
Consumption of other sectors	- 1.5%	- 1.5%	- 1.8%	- 1.4%	- 8.7%	0.0%
<b>Gross investment</b>	<b>24.3%</b>	<b>28.4%</b>	<b>- 37.6%</b>	<b>- 37.4%</b>	<b>- 41.0%</b>	<b>- 30.0%</b>
Fixed capital investments	3.5%	6.1%	- 18.2%	- 15.7%	- 14.4%	- 17.0%
Changes in stocks	—	—	—	—	—	—
<b>Net export of goods and services</b>	<b>- 27.3%</b>	<b>- 42.8%</b>	<b>58.0%</b>	<b>56.8%</b>	<b>56.7%</b>	<b>34.0%</b>

\* State Statistics Service (first estimate)

\*\* State Statistics Service (second estimate). In mid-April, the State Statistics Service revised statistics on retail sales upward for 2010 (from 4.4% to 6.3%) and 1Q11, which should have implied a respective upward revision of household consumption. However, this did not happen.

\*\*\* State Statistics Service (third estimate)

Note: Last column – Troika's old estimate.

Source: State Statistics Service, Troika estimates

# Consumption (SNA definition) seems to have been mis-estimated in 2010 and 2011

## y-o-y dynamics

	<b>Retail</b>	<b>Services</b>	<b>Household consumption</b>	<b>Troika estimate</b>
2006	14.1%	7.6%	12.2%	12.5%
2007	16.1%	7.7%	14.3%	14.0%
2008	13.5%	4.3%	10.6%	11.2%
2009	-4.9%	-2.5%	-4.8%	-4.3%
2010	6.3%	1.5%	3.0%	5.1%
1Q11	5.0%	2.9%	5.7%	4.5%
2Q11	5.6%	3.8%	6.1%	5.2%
3Q11	7.6%	3.0%	-	6.5%

Source: State Statistics Service

# Breakdown of Russian GDP growth

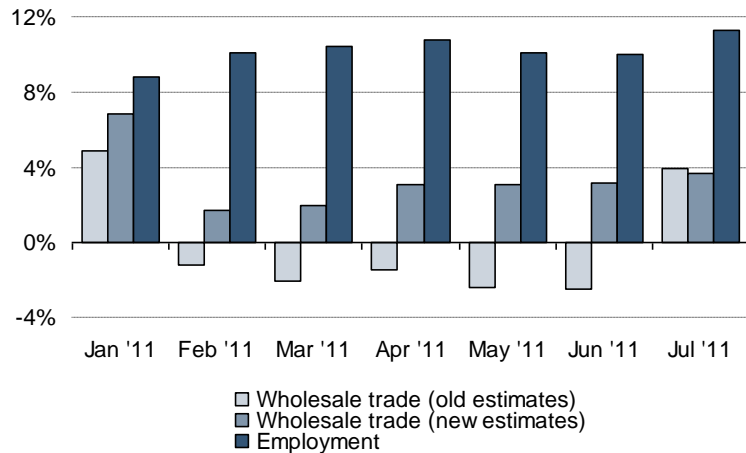
	1H11	1H10	Weight*
GDP in market prices	3.7%	4.3%	–
Agriculture, hunting and forestry	0.7%	1.3%	3.3%
Fishing	13.0%	-3.3%	0.2%
Mining	2.3%	5.7%	8.9%
Manufacturing	9.7%	13.5%	14.1%
Production and distribution of electricity, gas and water	0.7%	7.4%	3.6%
Construction	0.4%	-6.1%	4.9%
Wholesale and retail trade, repair of motor vehicles, motorcycles, household goods and personal items	1.8%	5.0%	15.7%
Hotels and restaurants	3.2%	1.1%	0.8%
Transport and communications	4.4%	9.5%	8.4%
Financial activity	2.2%	-5.6%	3.8%
Operations with real estate, renting and business activity	3.2%	-1.2%	9.8%
Public administration and defense; social insurance	-0.4%	5.0%	5.3%
Education	-2.0%	-1.2%	2.6%
Health and social services	-0.9%	1.3%	3.2%
Other community, social and personal services	5.2%	-11.0%	1.4%
Net taxes on products	7.3%	6.1%	–

\* data for 2010

Source: State Statistics Service

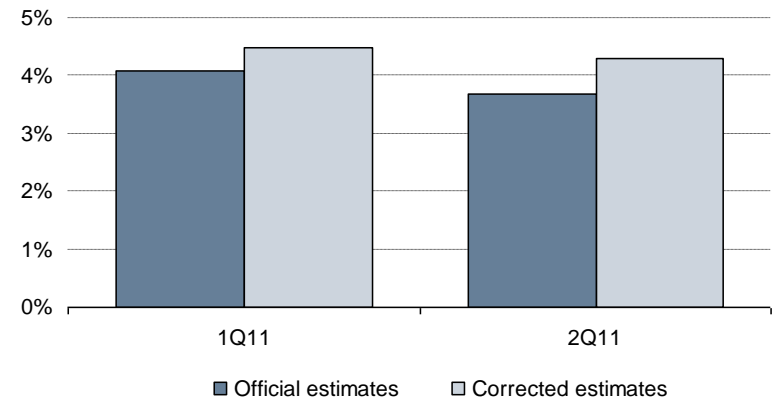
# Wholesale dynamics have been significantly revised, but not yet GDP

**y-o-y dynamics, real terms**



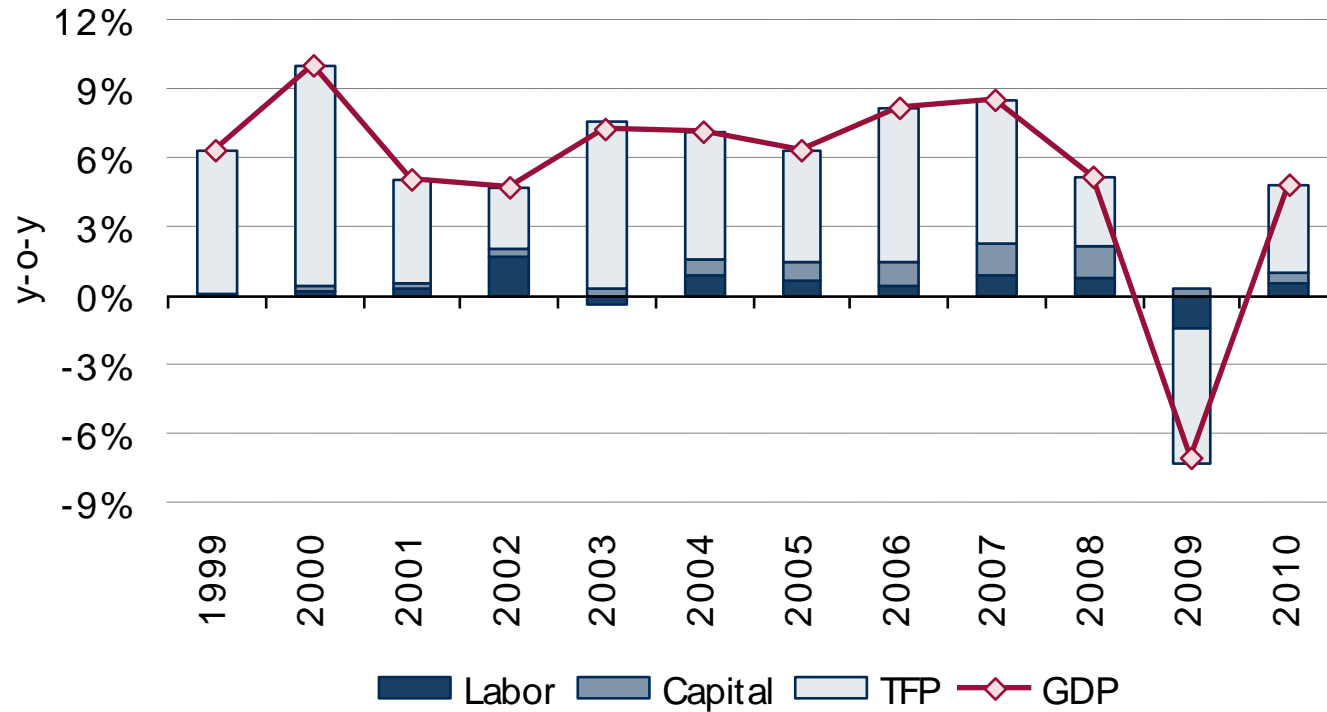
Source: State Statistics Service

**GDP seems to have grown faster, y-o-y**



Source: State Statistics Service, Troika estimates

# Since 1999, growth has largely been driven by rising TFP



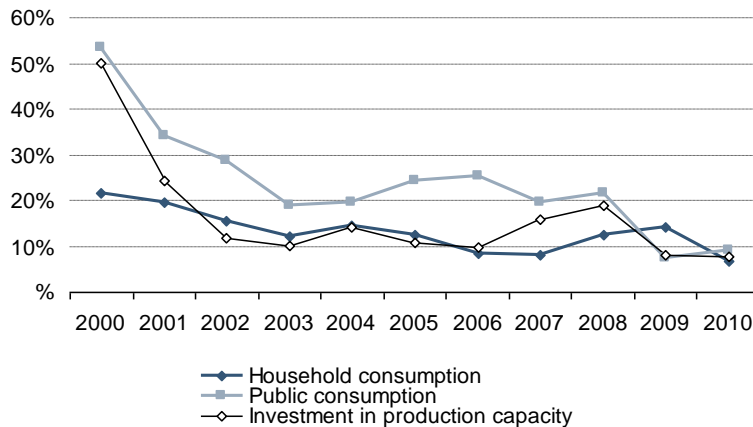
Source: State Statistics Service, Troika estimates

# Major risks stem from excessive budgetary spending

- **Aside from external risks, Russia's major internal risk is excessive budget dependence on the oil price and excessive spending.** The 2010 budget was amended amid an improved external environment and better performance of the domestic economy. As a result, Russia saw a rather toxic combination of sporadic Central Bank interventions on the forex market and a budget deficit.
- **Unsurprisingly, inflation accelerated in 2H10 and in early 2011, as the government allocated almost 18% of the annual budget in December 2010.** The budgets for 2011-12 still look generous, but the government seems lucky, as the oil price this year has been well above the \$75/bbl assumed in the budget. The budget was in surplus of around R1.1trln in 9m11. The government plans to balance the budget by year end, but we expect some surplus.
- **The breakeven oil price is currently officially estimated at around \$109/bbl for 2011 and \$116/bbl for 2012, while we think the figure will be lower – at least for this year.** However, the government may once again hike expenditures next year and thus, the 2012 budget's dependence on the oil price may increase.

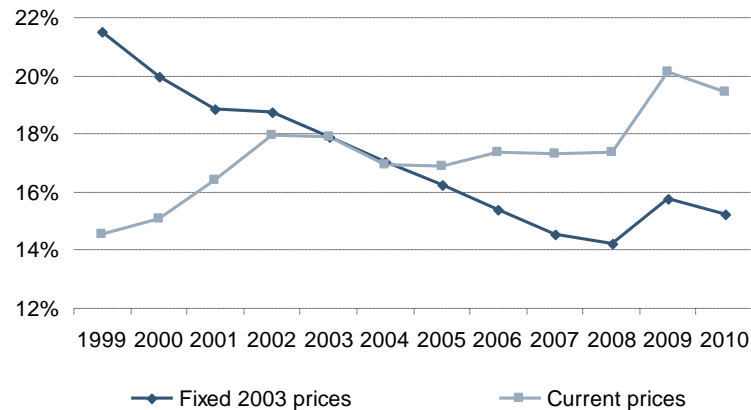
# Government interventions were inflationary: public consumption shrank in real terms

**Deflator for public consumption remained higher than for other elements of GDP**



Source: State Statistics Service

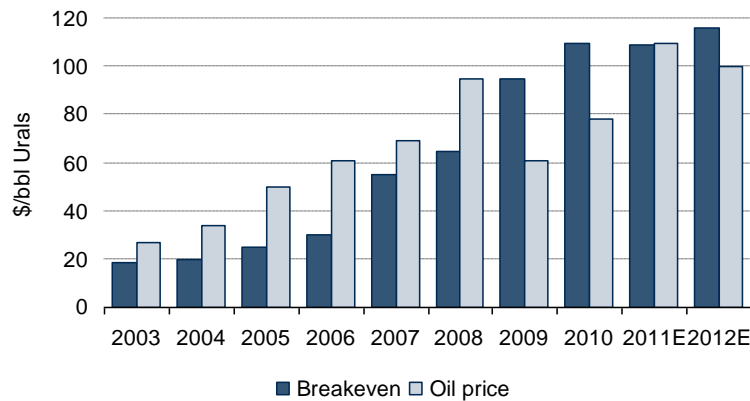
**Public consumption/GDP ratio shrank in real terms, its contribution to economic growth diminished**



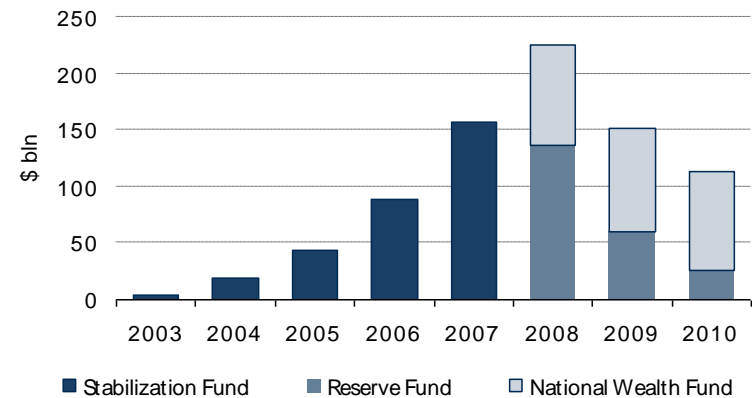
Source: State Statistics Service

# The breakeven oil price has grown substantially over recent years, increasing budgetary risks

**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



# Government budget forecasts have changed since August

## August 2011

	2010	2011E	2012E	2013E	2014E
Revenues, R bln	8,305.4	10,303.4	10,627.8	11,687.6	12,645.5
Expenditures, R bln	10,117.5	11,022.5	12,198.3	13,431.9	14,293.9
Balance, R bln	-1,812.1	-719.1	-1,570.5	-1,744.3	-1,648.4
Balance, % GDP	-4.0	-1.4	-2.7	-2.8	-2.3
Oil price, \$/ bbl Urals	78.2	105.0	93.0	95.0	97.0
Breakeven oil price, \$/ bbl Urals	109.3	118.3	124.6	125.2	125.7
GDP, R bln	44,939	53,274	57,532	63,436	70,409
GDP, y-o-y	4.0	4.2	3.5	4.2	4.6
RUB/ USD	30.4	28.4	27.9	27.9	28.0

## September 2011

	2011E	2012E	2013E	2014E
Revenues, R bln	11,008.0	11,789.1	12,715.0	14,101.1
Oil and gas revenues, R bln	5,431.0	5,575.0	5,646.0	6,127.0
Revenues, % GDP	–	20.1	19.6	19.4
Expenditures, R bln	11,008.0	12,658.3	13,719.9	14,579.5
Expenditures, % GDP	–	21.6	21.2	20.1
Balance, R bln	0.0	-869.3	-1,004.9	-478.4
Balance, % GDP	0.0	-1.5	-1.6	-0.7
Oil price, \$/bbl Urals, base scenario	108.0	100.0	97.0	101.0
Breakeven oil price, \$/bbl Urals	109.0	116.2	114.4	107.8

Source: Finance Ministry

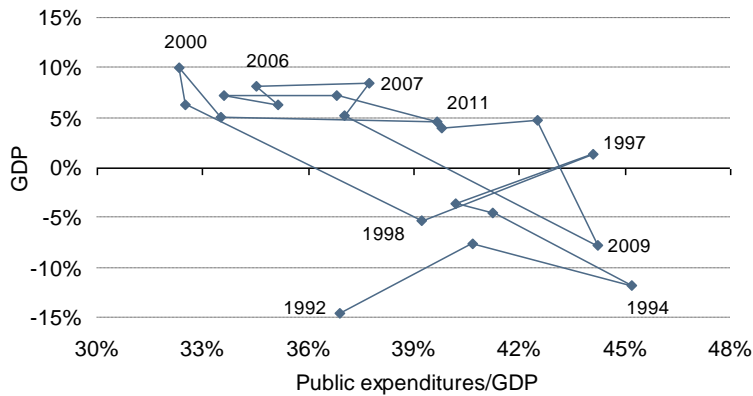
# Expenditures increased massively, R bln

	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
Total expenditures	3,514	4,281	5,983	7,567	9,660	10,116
State administration	501	530	812	835	829	885
National defense	581	682	832	1,041	1,188	1,276
National security	450	550	667	836	1,005	1,085
National economy	249	345	693	1,025	1,651	1,223
Housing sector	7	53	295	130	152	235
Education	162	212	295	355	418	443
Medical care, sport	88	148	197	278	352	347
Social policy	178	201	214	294	324	345
Transfers	1,246	1,499	1,900	2,675	3,594	4,135
Other	52	62	79	99	147	142

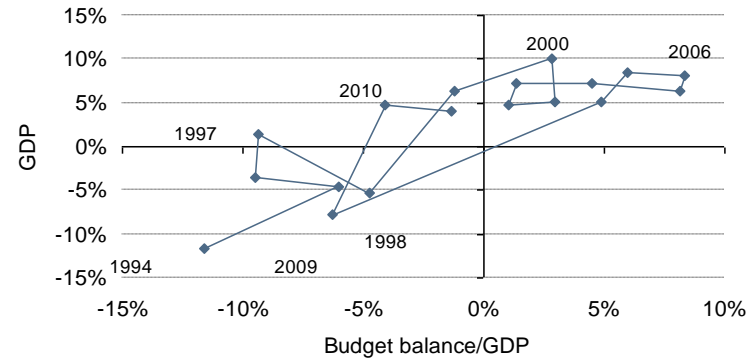
Note: The government initially projected expenditures in 2009 at R9,845.2 bln.

Source: Finance Ministry

# Higher government expenditures and an increased budget deficit in Russia usually translate to worse economic performance

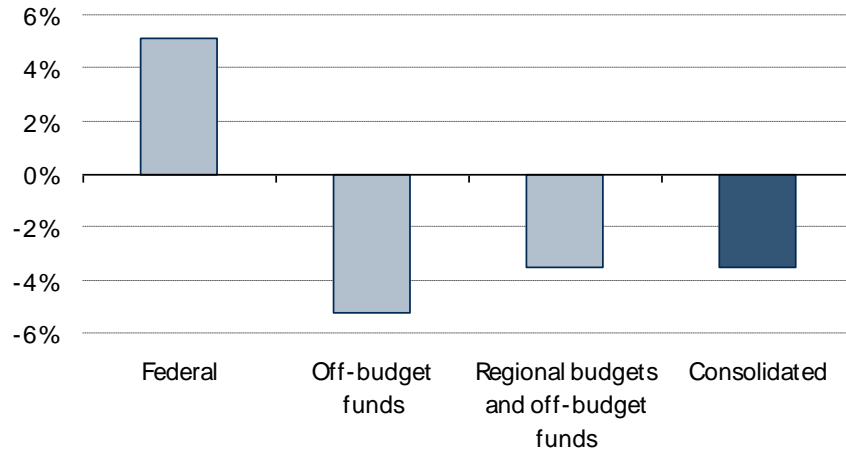


Source: State Statistics Service, Finance Ministry, Troika estimates



Source: State Statistics Service, Finance Ministry, Troika estimates

# Where are the biggest gaps in Russia's budget?



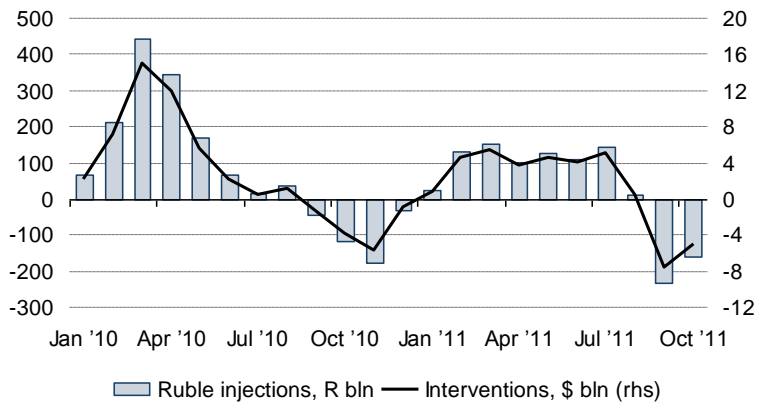
Source: Troika estimates

	Federal	Off-budget funds	Regional budgets and off-budget funds	Consolidated
Revenues	8,304	4,861	7,112	15,716
Of which net transfers	-4,136	2,672	1,578	114
Expenditures	10,116	4,535	7,211	17,301
Balance	-1,812	326	-99	-1,585
Balance adjusted for net mutual transfers	2,324	-2,346	-1,563	-1,585

Source: Troika estimates

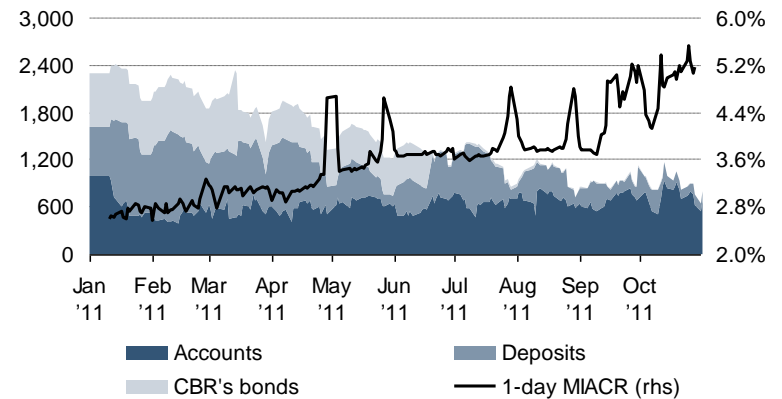
# Banks' voluntary reserves have shrunk in 2011 as Central Bank interventions have subsided and the budget has run a surplus

**Central Bank interventions have subsided**



Source: Central Bank

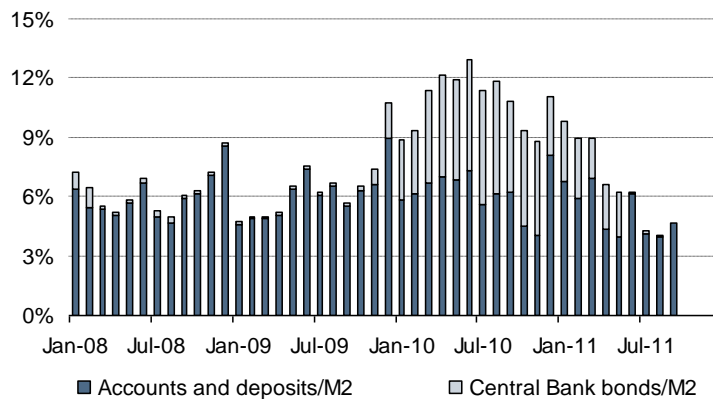
**Overnight rates are climbing amid reduced voluntary reserves, R bln**



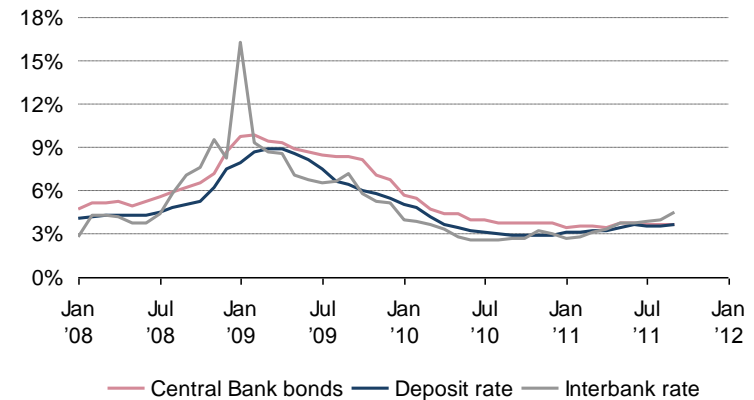
Source: Central Bank

# Banks' voluntary reserves increased in 1H10, as the Central Bank offered an attractive risk-free rate

**Voluntary reserves increased sharply in 1H10**



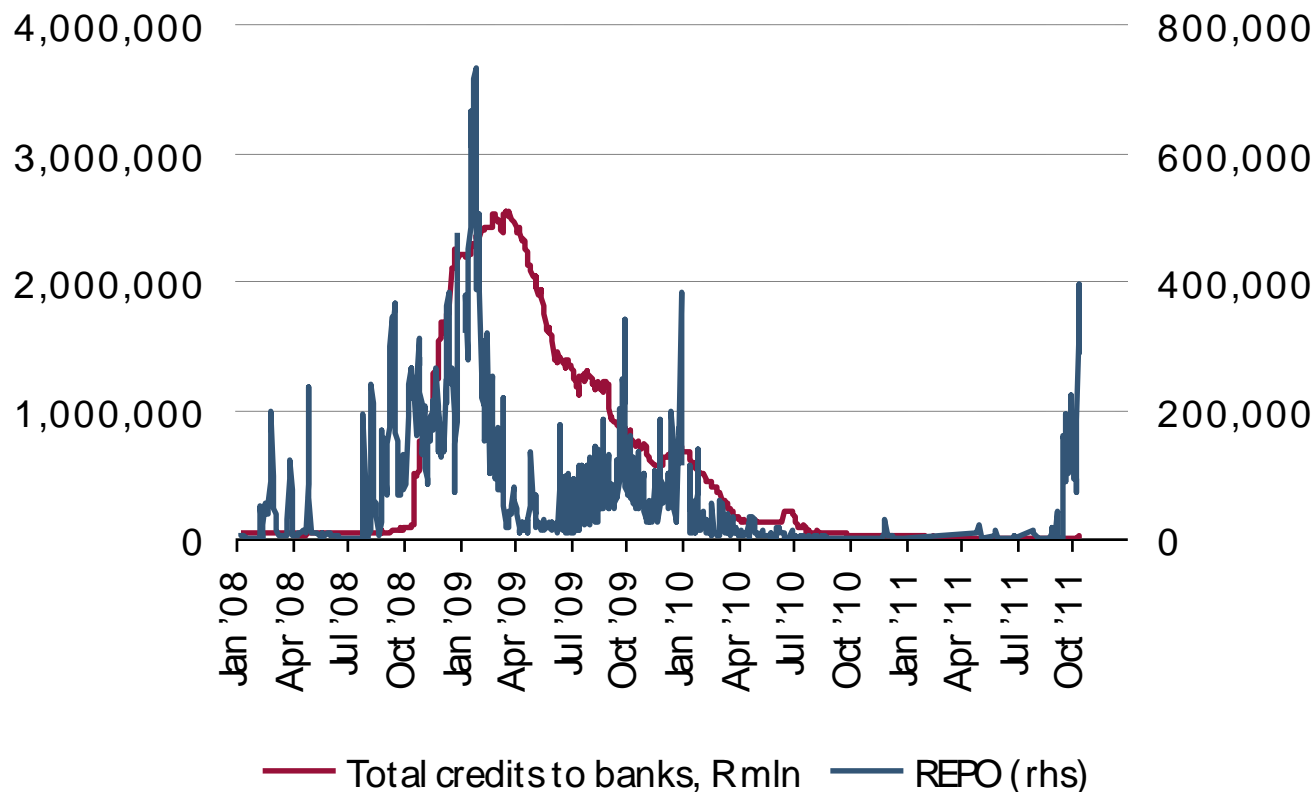
**Central Bank deposit and bond rates**



Source: Central Bank, Troika estimates

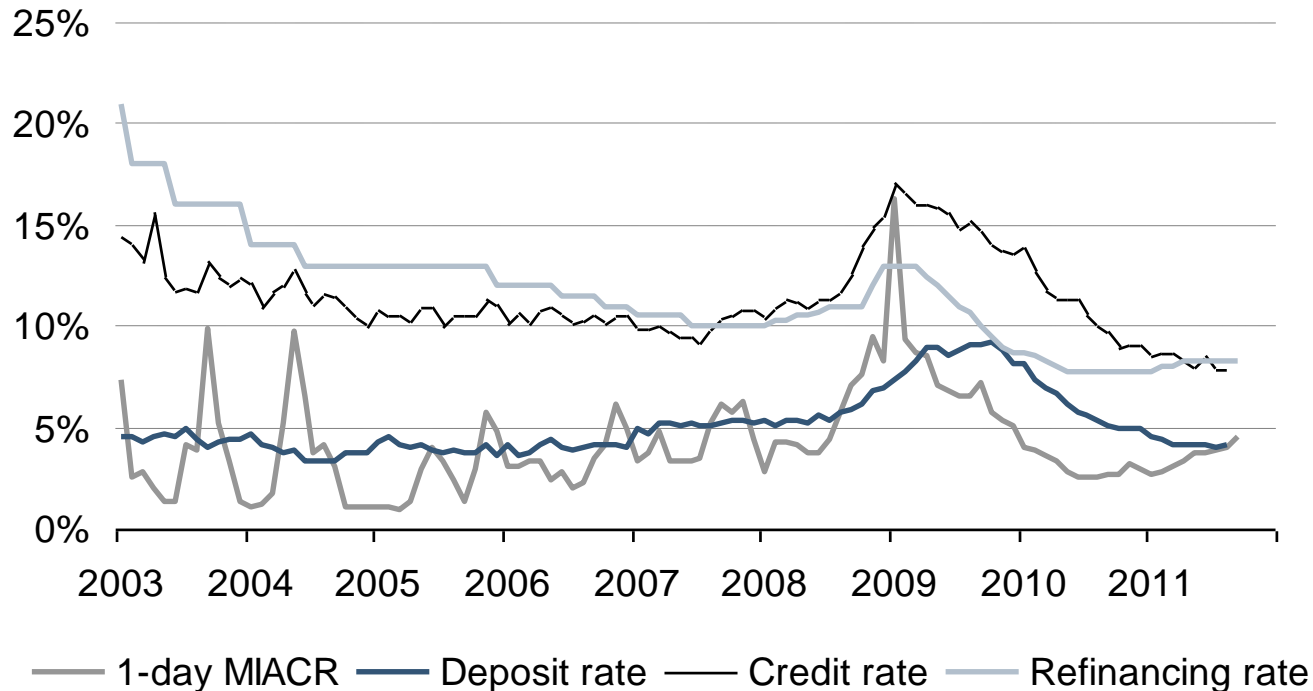
Source: Central Bank

# The Central Bank has absorbed previously extended emergency loans, R mln



Source: Central Bank

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

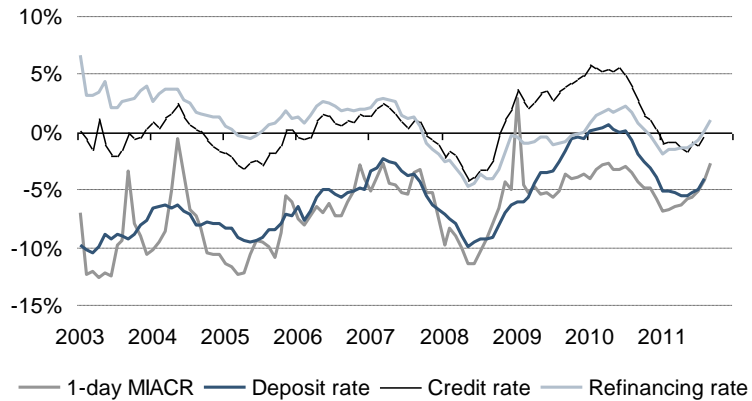


Source: Central Bank

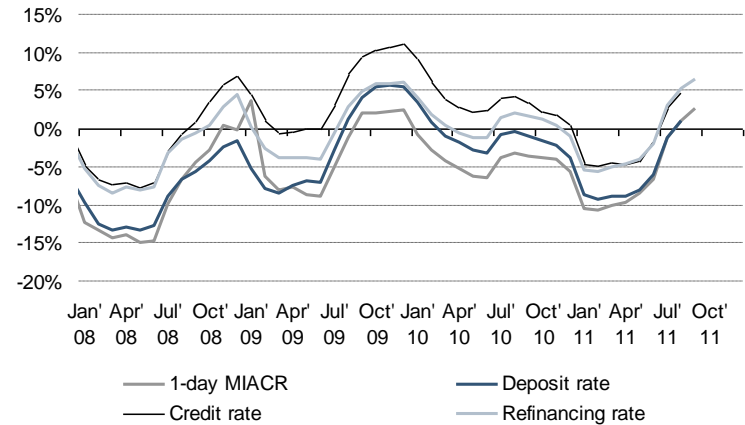


# Real interest rates are turning positive

## Based on y-o-y inflation

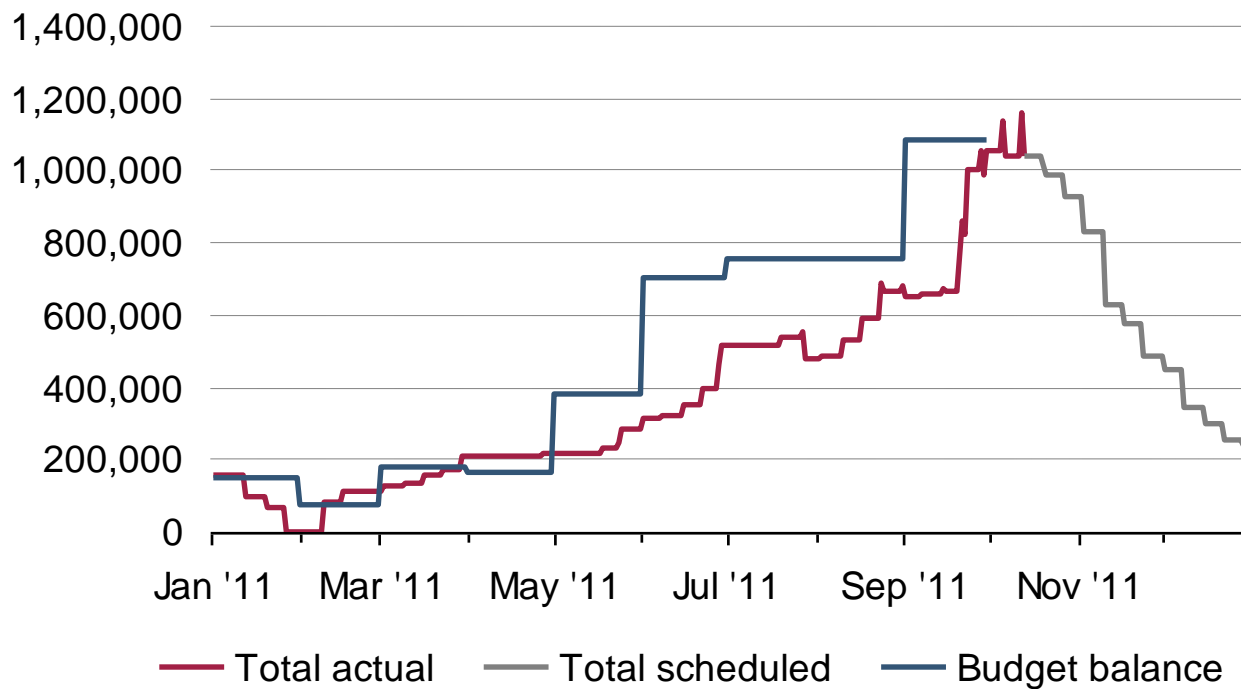


## Based on 6m moving average inflation



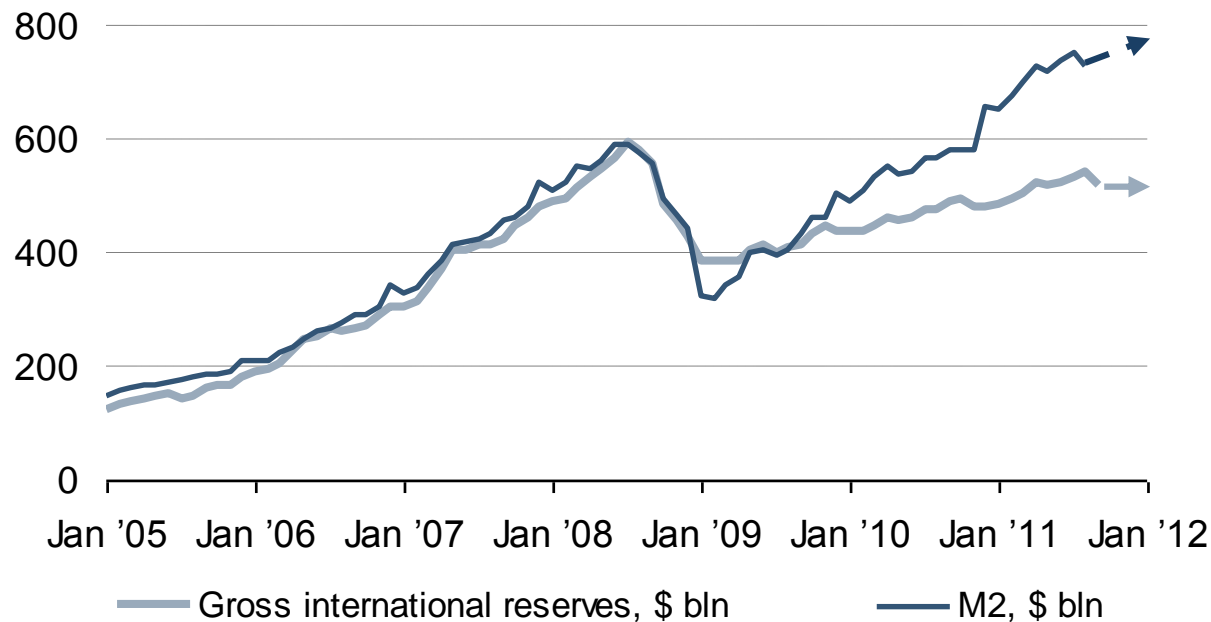
Source: Central Bank, State Statistics Service, Troika estimates

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



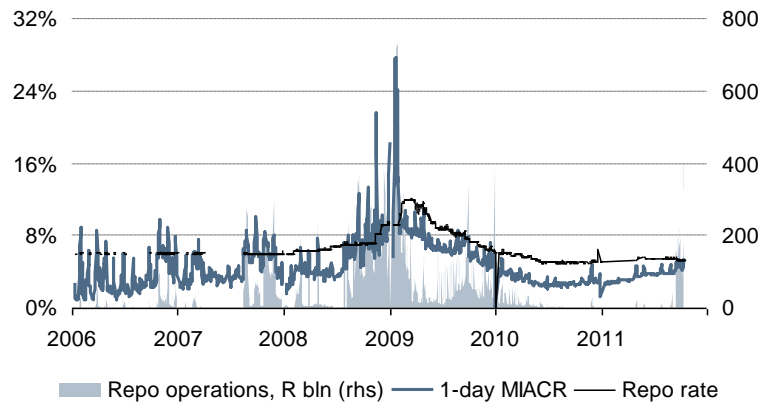
Source: Central Bank

M2 started to rise again 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 became more volatile; the Central Bank's role as lender of last resort has to grow in importance

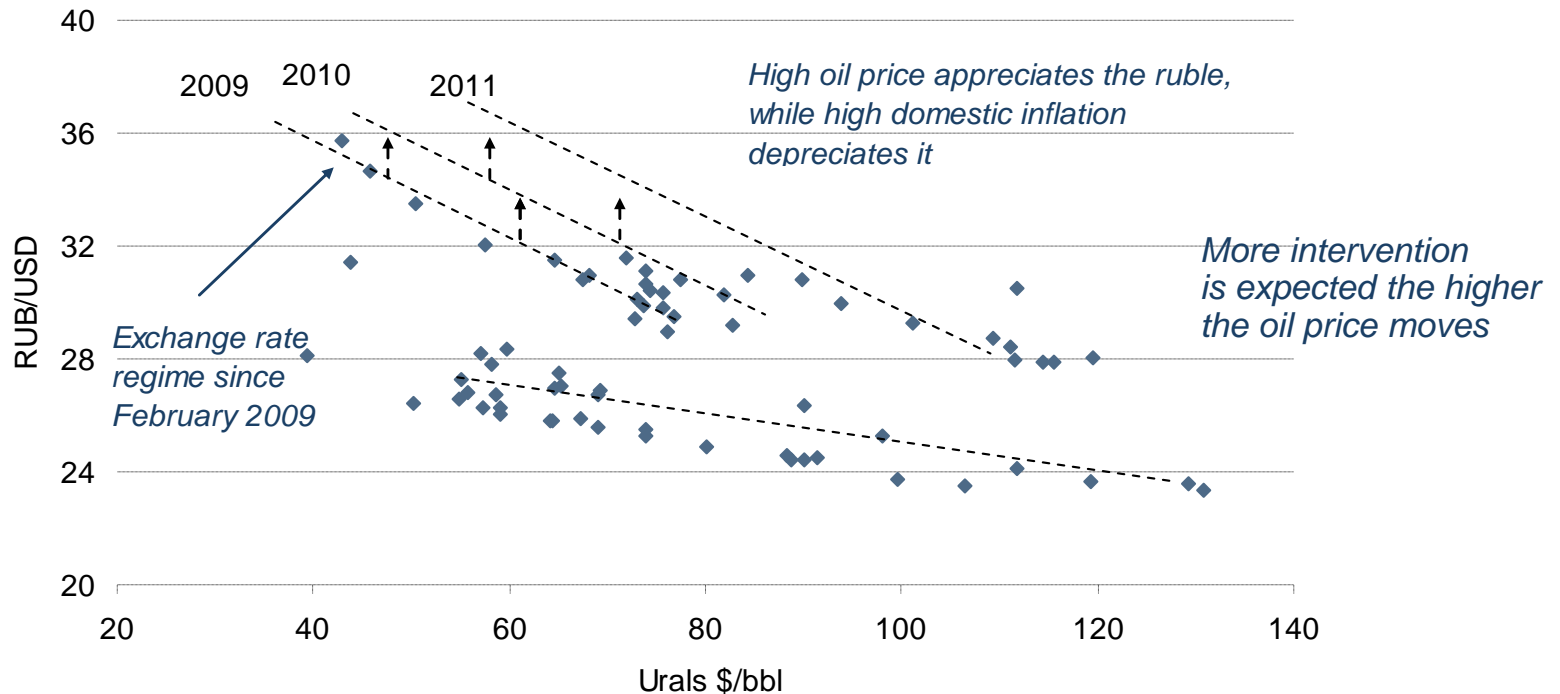


Source: Central Bank, Troika estimates



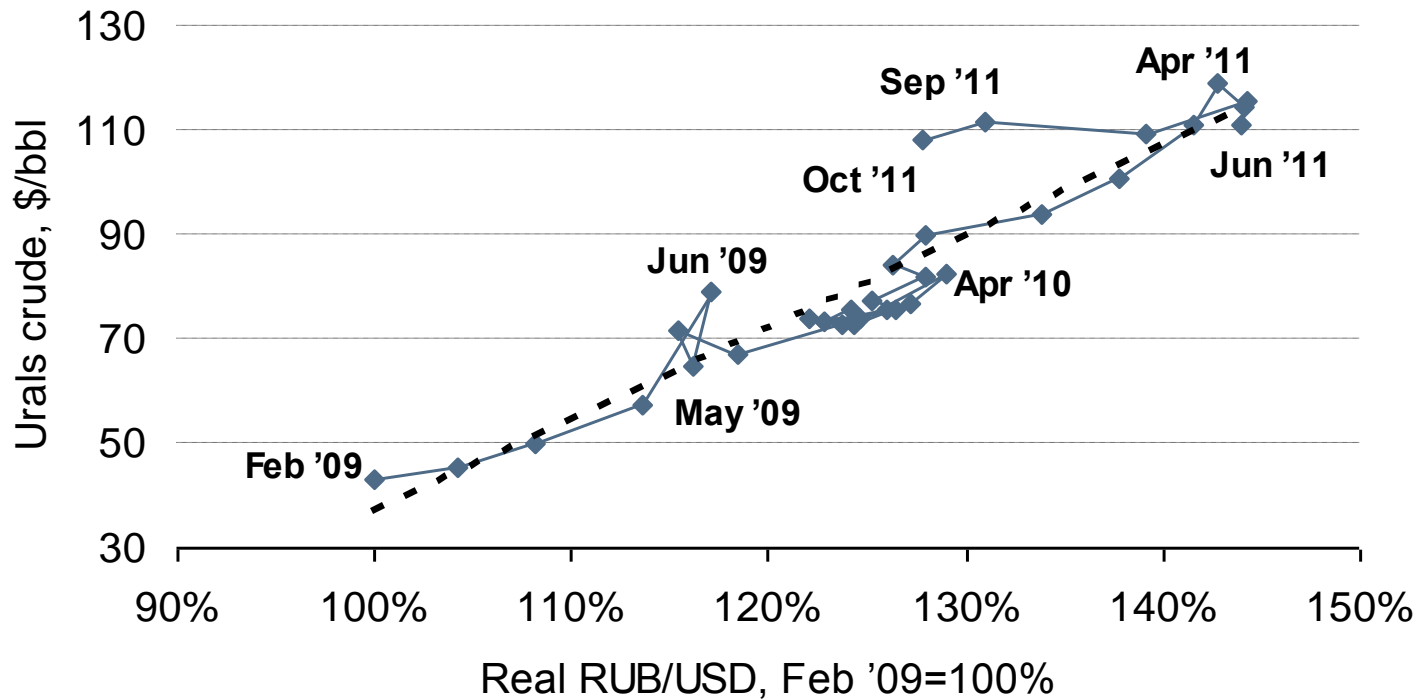
Source: Central Bank

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



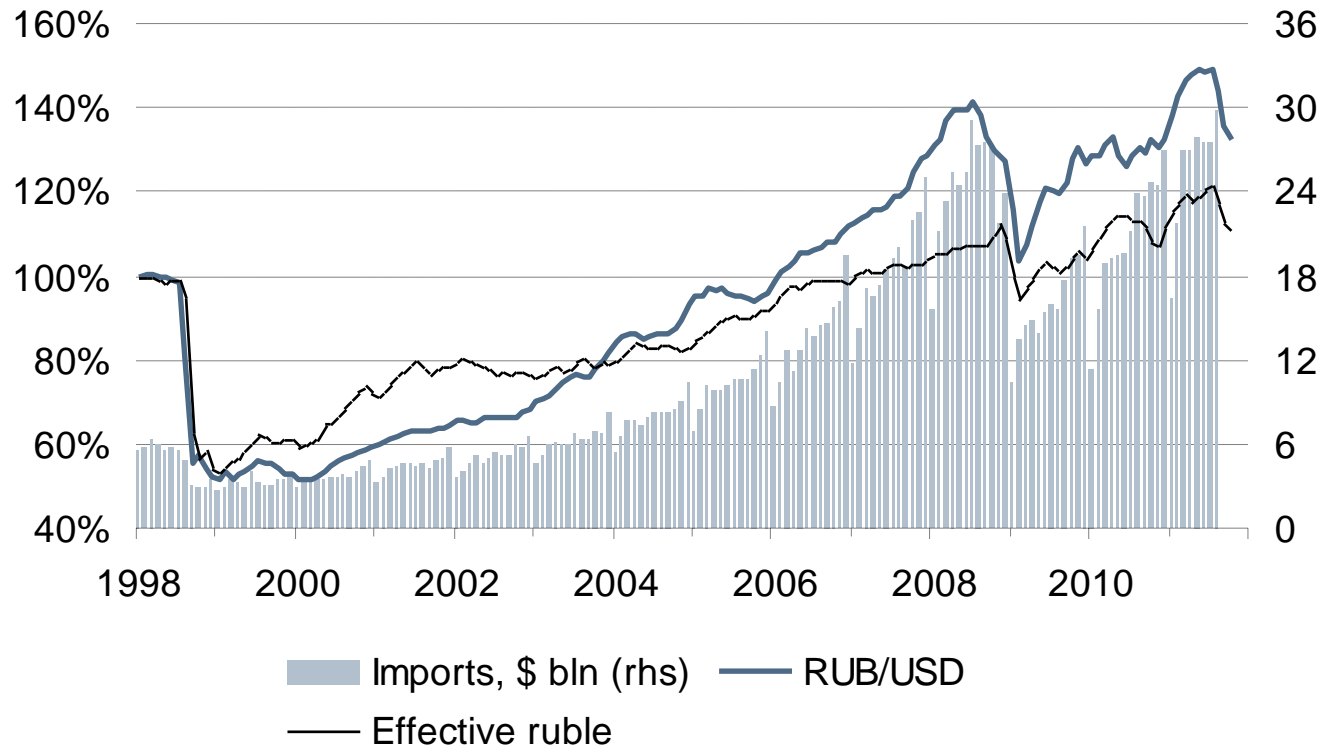
Source: Central Bank, Bloomberg, Troika estimates

# The real ruble generally moves in line with the oil price, albeit some overshooting cannot be ruled out



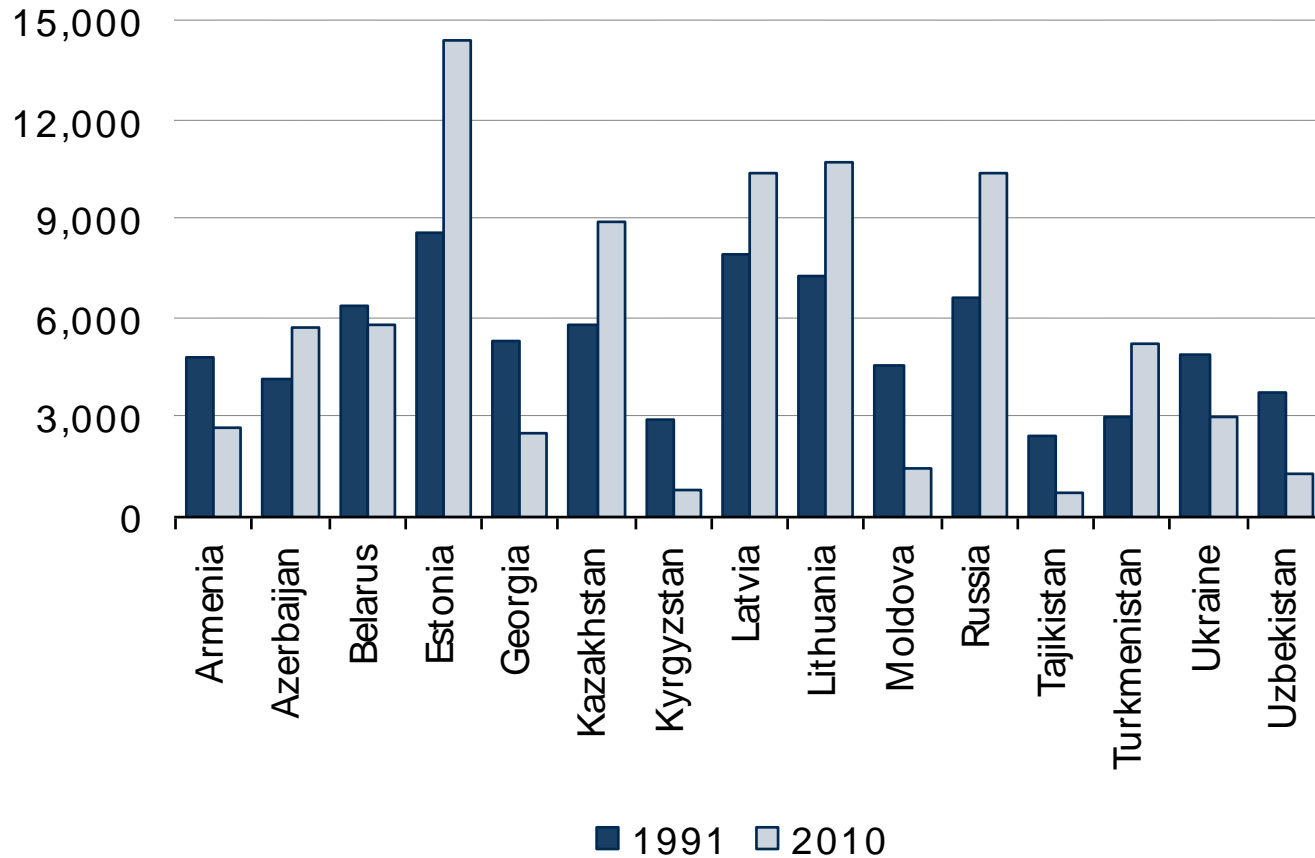
Source: Central Bank, Bloomberg, Troika estimates

# The real ruble tends to appreciate while imports are growing



Source: Central Bank

# GDP per capita FSU, 1991 and 2010, \$

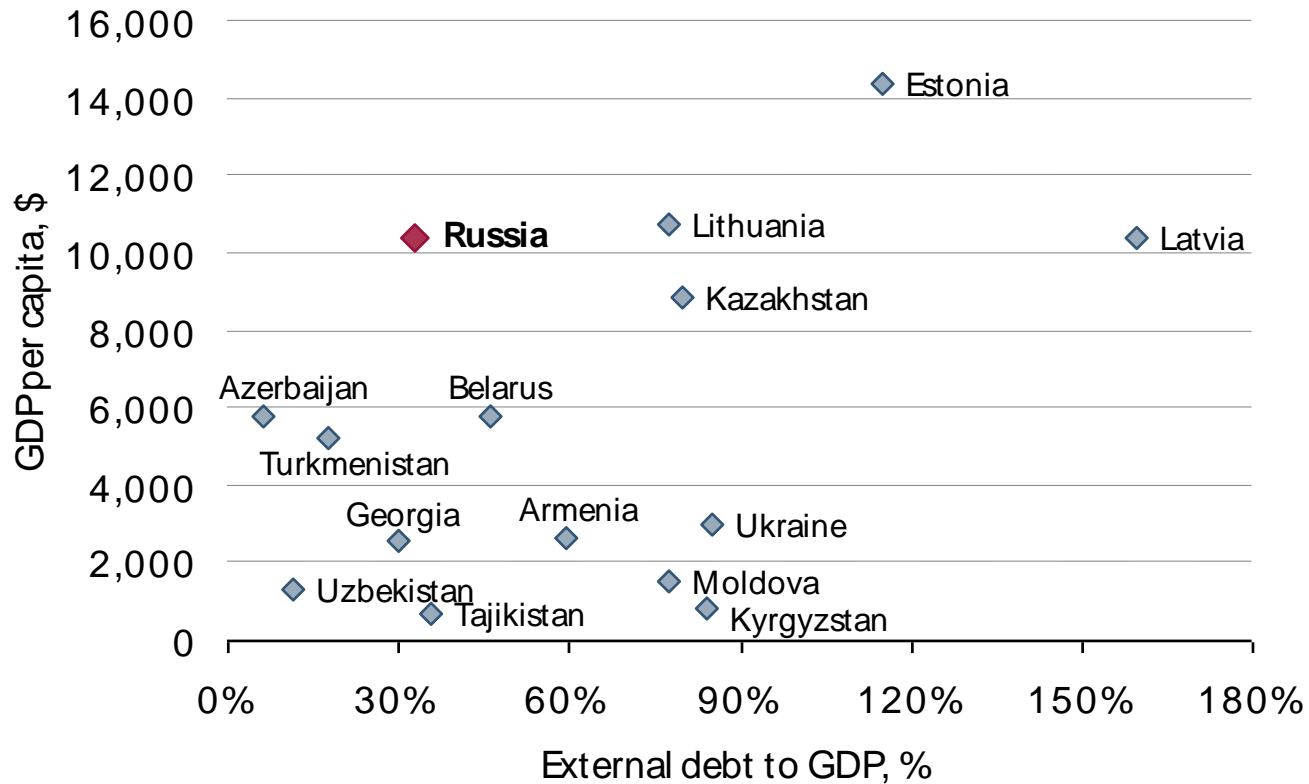


Source: IMF



# GDP per capita in FSU in 2010 and external borrowing

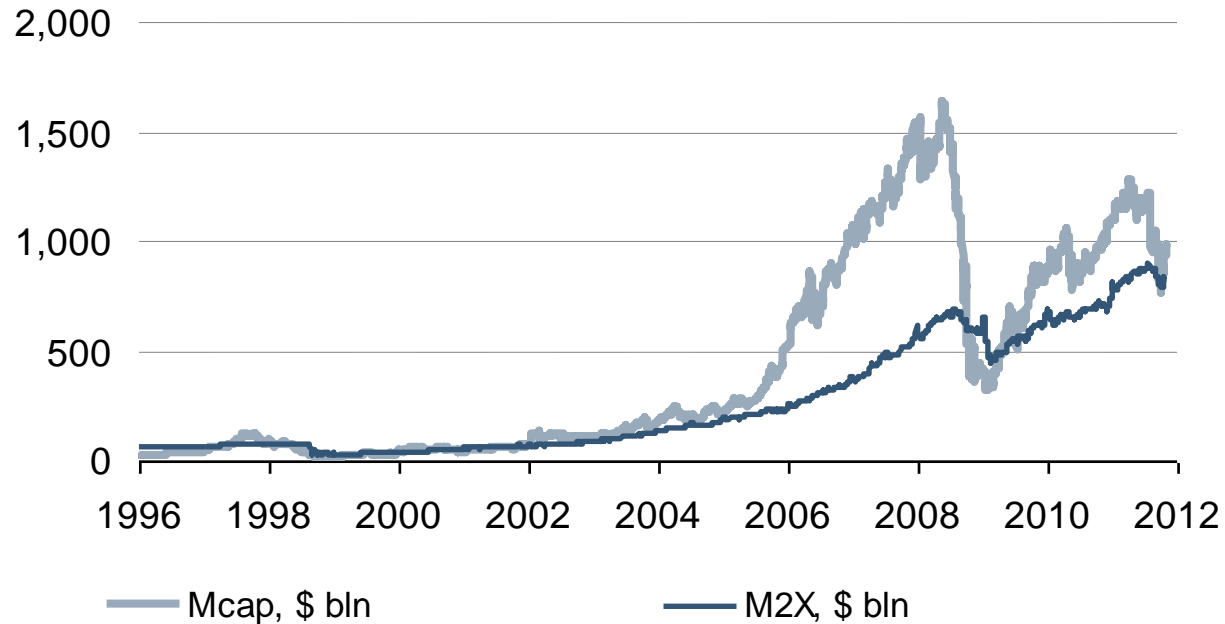
## Russia has not borrowed a lot



Note: Data for 2010.

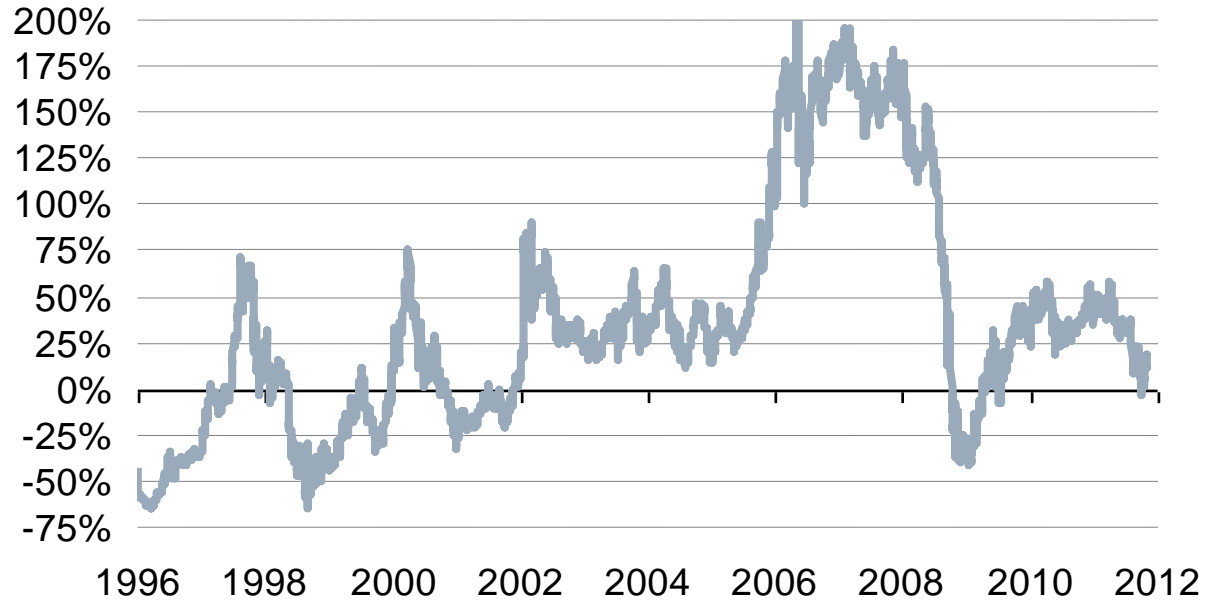
Source: IMF, CIA, national banks

# MCap and money supply move together



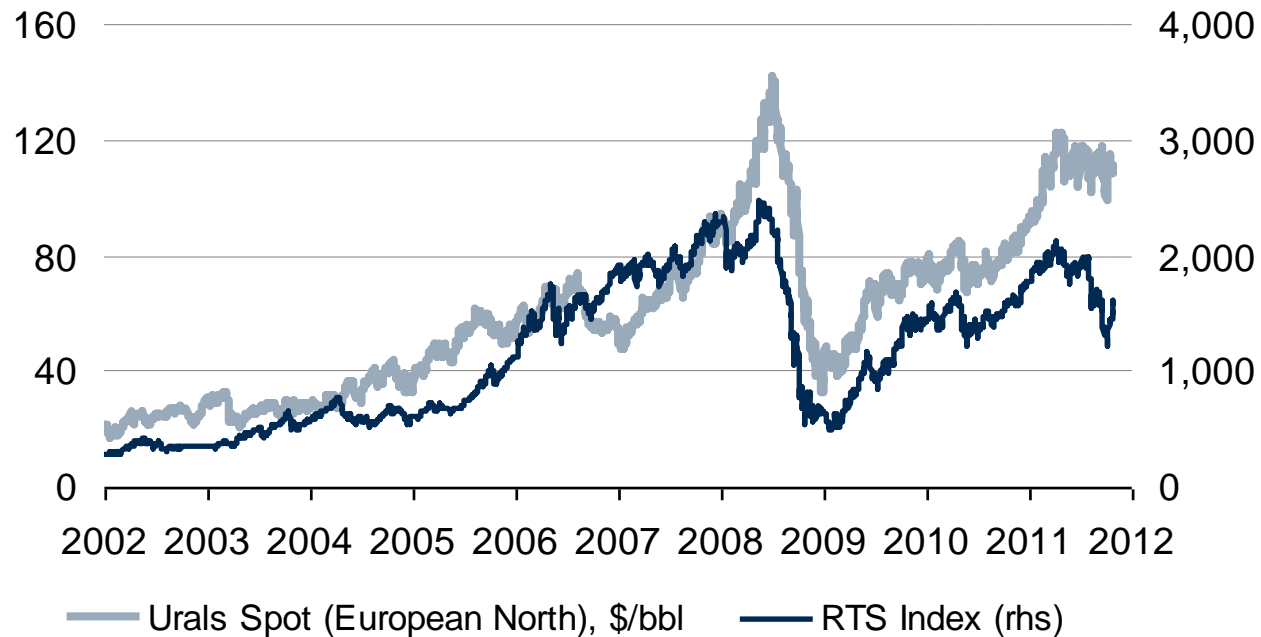
Source: Bloomberg, Central Bank, Troika estimates

# MCap normalized to money, or Bubble Metric Index



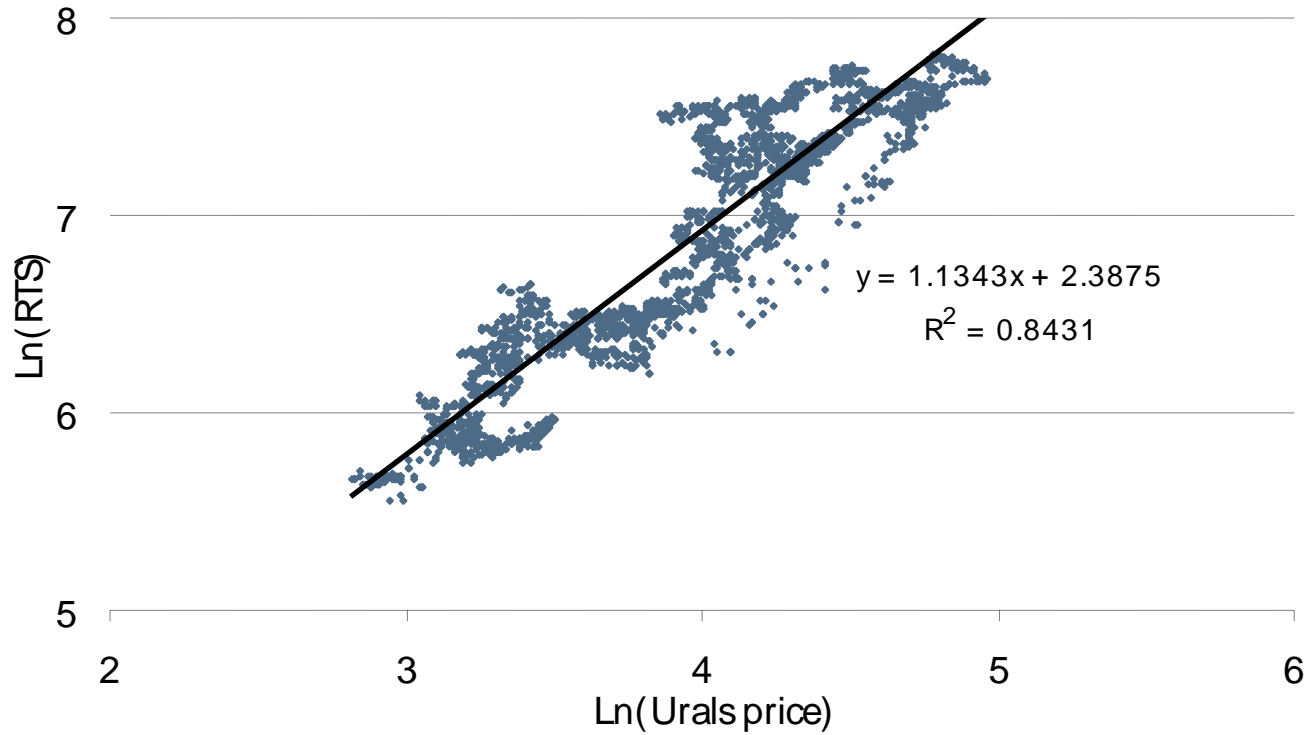
Source: Bloomberg, Central Bank, Troika estimates

# High correlation between the oil price and the RTS Index



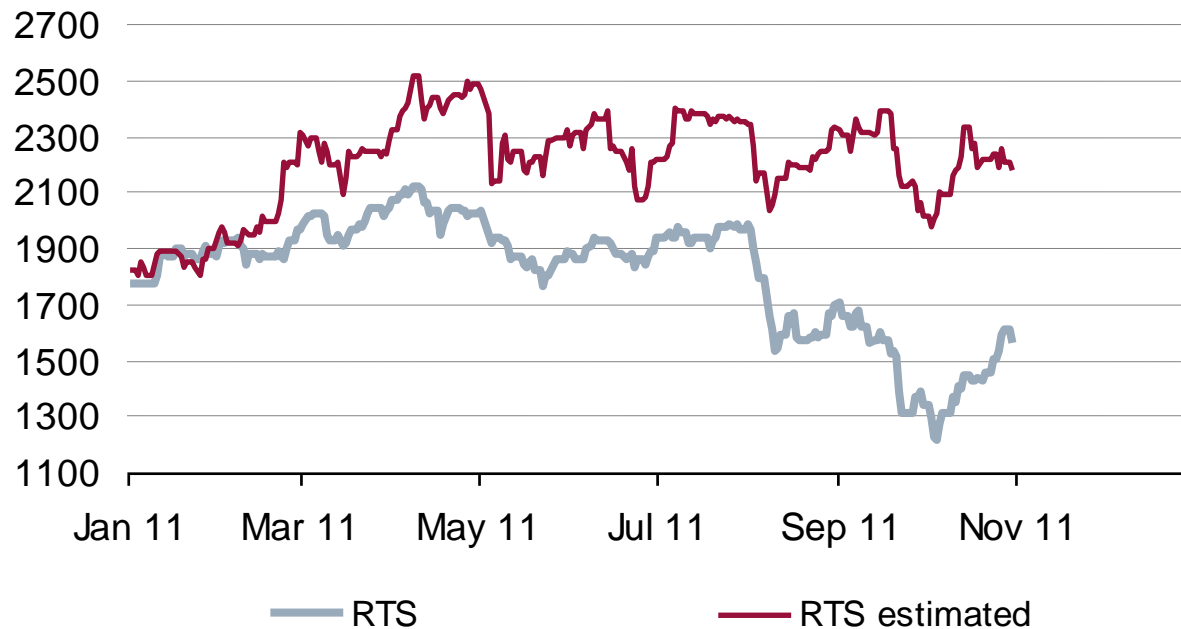
Source: Bloomberg, Troika estimates

# This correlation can be modeled



Source: Bloomberg, Troika estimates

# The value of the Russian equity market looks underestimated this year



Source: Bloomberg, Troika estimates