

Moscow as a financial center

September 2011
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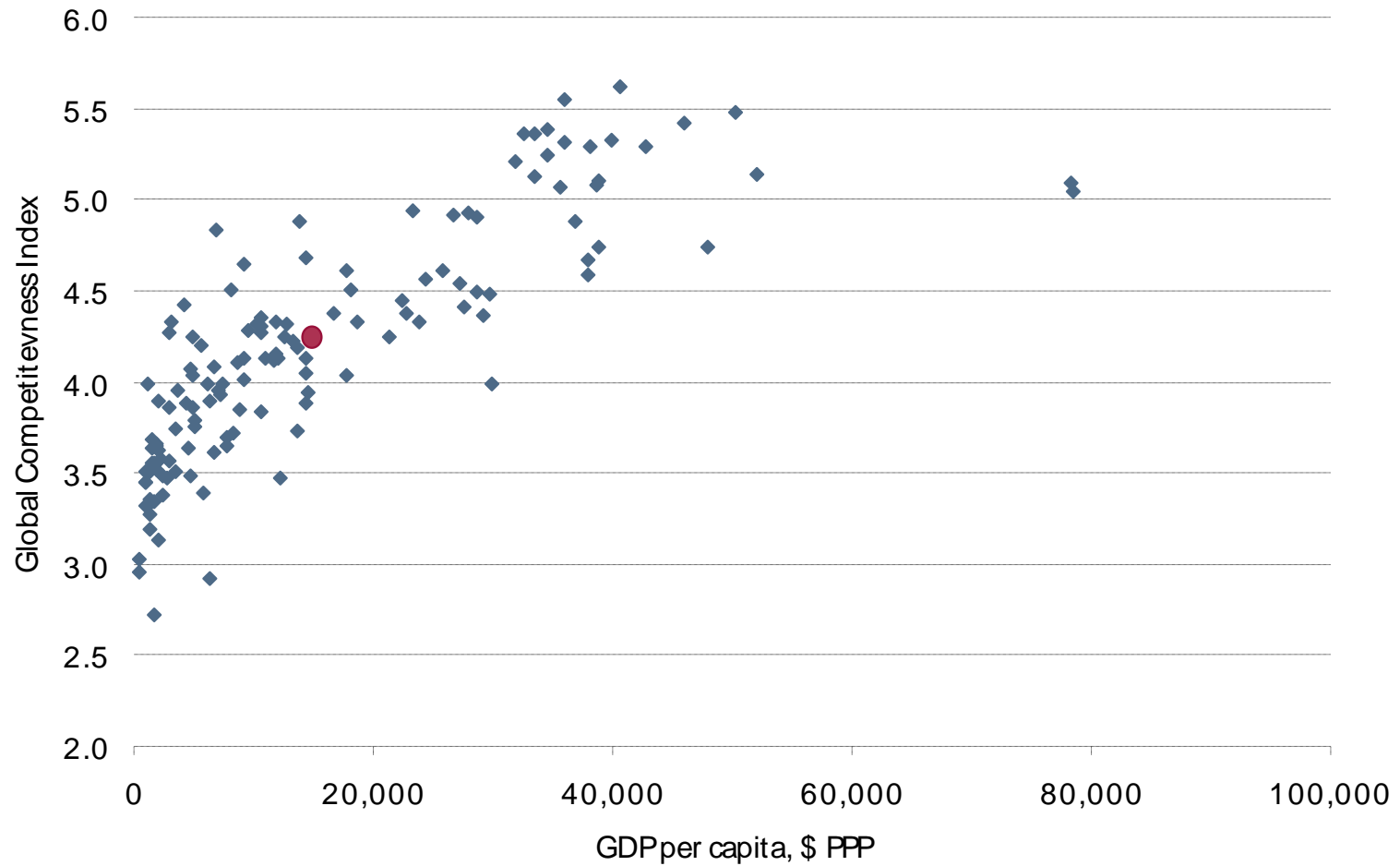


Troika Dialog

Apart from the need to solve well known institutional problems Russia still has to do a lot to improve its macroeconomic framework

- **Russia's growth moderated in 2010 in the aftermath of the correction in 2009.** Even though there is no clear dependence of economic growth on the oil price Russia's nominal dollar-denominated GDP very much depends on external environment.
- **Financial system is not deep enough, albeit monetization of the economy is rising in line with economic growth.** Equity market capitalization is low as well and is subject to oil price volatility. Bond market (government and corporate) is also small.
- **High and unstable inflation is another constraint as it causes real ruble appreciation and excessive forex market volatility.** Central bank policies change to a better in the past years, while budgetary policy has yet to improve.
- **The country needs to redesign key elements of its budgetary planning mechanism** and secure stable economic growth.

Global Competitiveness Index correlates with GDP per capita: this can highlight economies' weak points and advantages



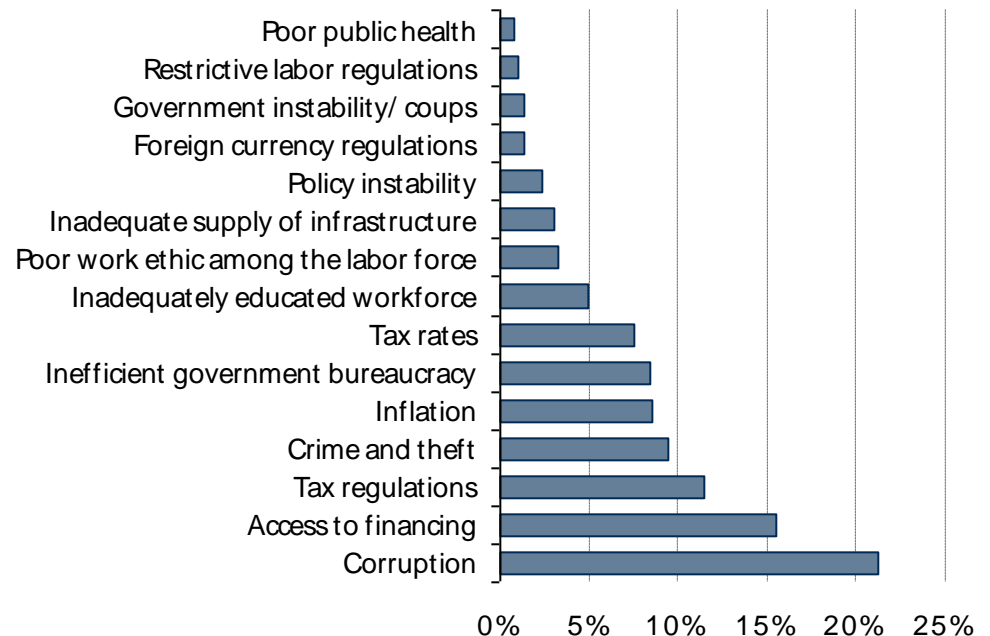
Source: IMF, World Economic Forum

Lower institutional quality and corruption are Russia's major Achilles heel

The breakdown of the GCI for Russia

	Rank out of 139
Global Competitiveness Index	63
Basic requirements	65
Institutions	118
Infrastructure	47
Macroeconomic environment	79
Health and primary education	53
Efficiency enhancers	53
Higher education and training	50
Goods market efficiency	123
Labor market efficiency	57
Financial market development	125
Technological readiness	69
Market size	8
Innovation and sophistication factors	80
Business sophistication	101
Innovation	57

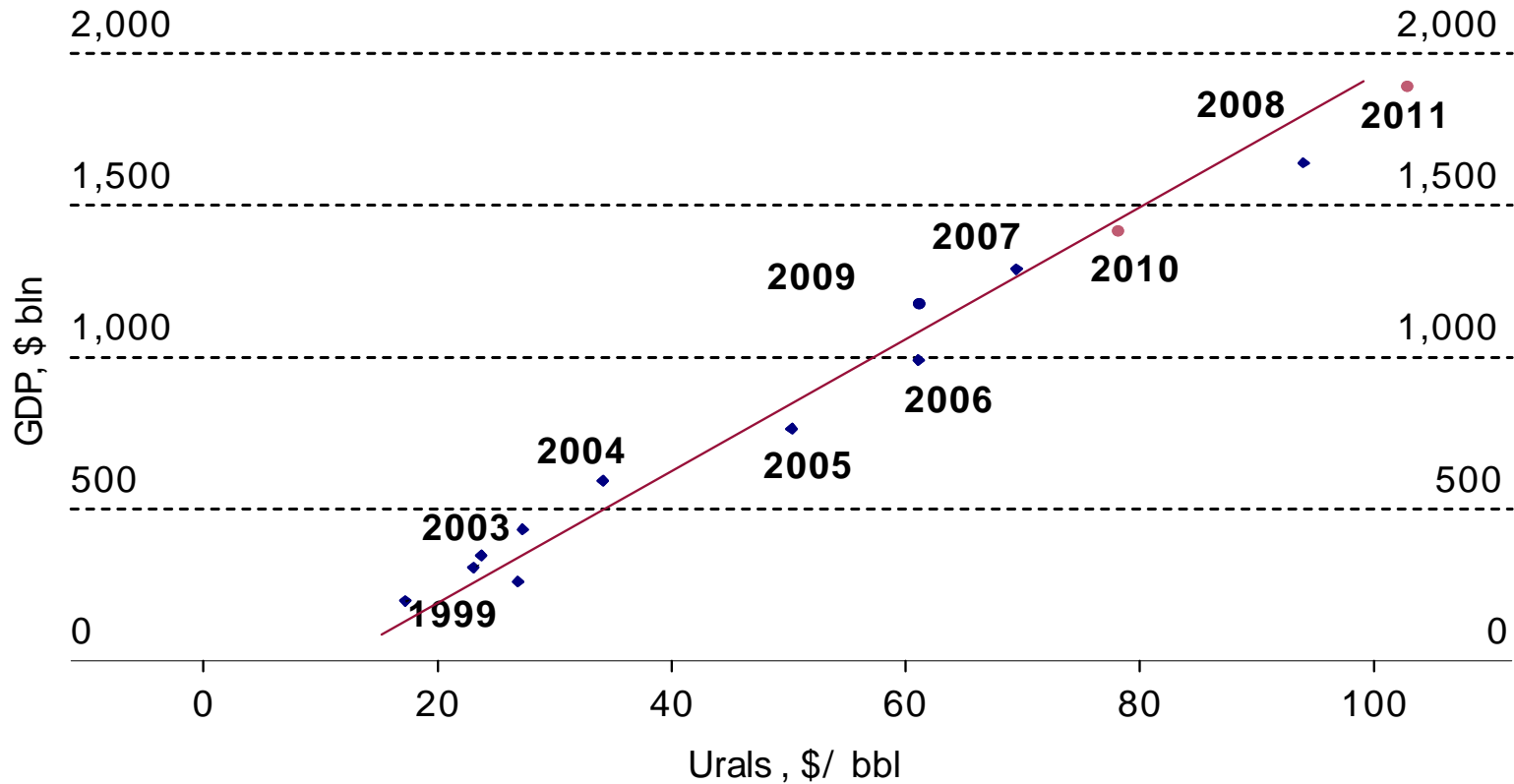
The biggest problems facing business in Russia



Source: World Economic Forum

From this list of 15 factors, respondents were asked to select the five most problematic for doing business in the country and to rank them between 1 (the most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

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



Source: State Statistics Service, Troika estimates

Consumption (SNA definition) seems misestimated in 2010 and 2011

y-o-y dynamics

	Retail	Services	Household consumption	Troika estimate	Wages
2006	14.1%	7.6%	12.2%	12.5%	13.3%
2007	16.1%	7.7%	14.3%	14.0%	17.2%
2008	13.5%	4.3%	10.6%	11.2%	11.5%
2009	-4.9%	-2.5%	-4.8%	-4.3%	-3.5%
2010	6.3%	1.5%	3.0%	5.1%	5.2%
1Q11	5.0%	2.9%	5.7%	4.5%	1.6%
2Q11	5.6%	2.9%	—	4.9%	2.7%

Source: State Statistics Service

“But actually, he thought as he re-adjusted the Ministry of Plenty’s figures, it was not even forgery. It was merely the substitution of one piece of nonsense for another” (George Orwell, Nineteen Eighty-Four)

	2010*	2010**	2009*	2009**	2009***	2009
GDP	4.0%	4.0%	- 7.9%	- 7.9%	- 7.8%	- 7.0%
Consumption	2.1%	2.5%	- 5.4%	- 5.1%	- 3.7%	- 3.2%
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%
Gross investment	24.3%	28.4%	- 37.6%	- 37.4%	- 41.0%	- 30.0%
Fixed capital investments	3.5%	6.1%	- 18.2%	- 15.7%	- 14.4%	- 17.0%
Changes in stocks	—	—	—	—	—	—
Net export of goods and services	- 27.3%	- 42.8%	58.0%	56.8%	56.7%	34.0%

* State Statistics Service (first estimate)

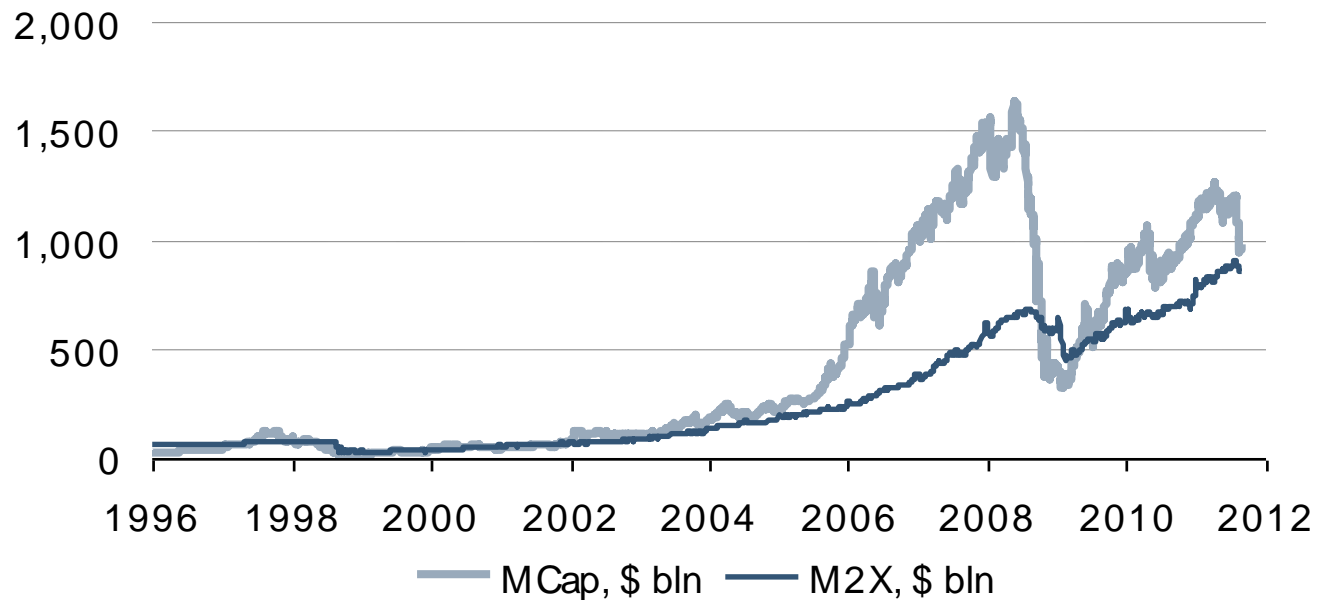
** State Statistics Service (second estimate). In mid-April, the State Statistics Service revised statistics on retail sales upward for 2010 (from 4.4% to 6.3%) and 1Q11, which should have implied respective upward revision of household consumption. However, this did not happen.

*** State Statistics Service (third estimate)

Note: Last column – Troika’s old estimate.

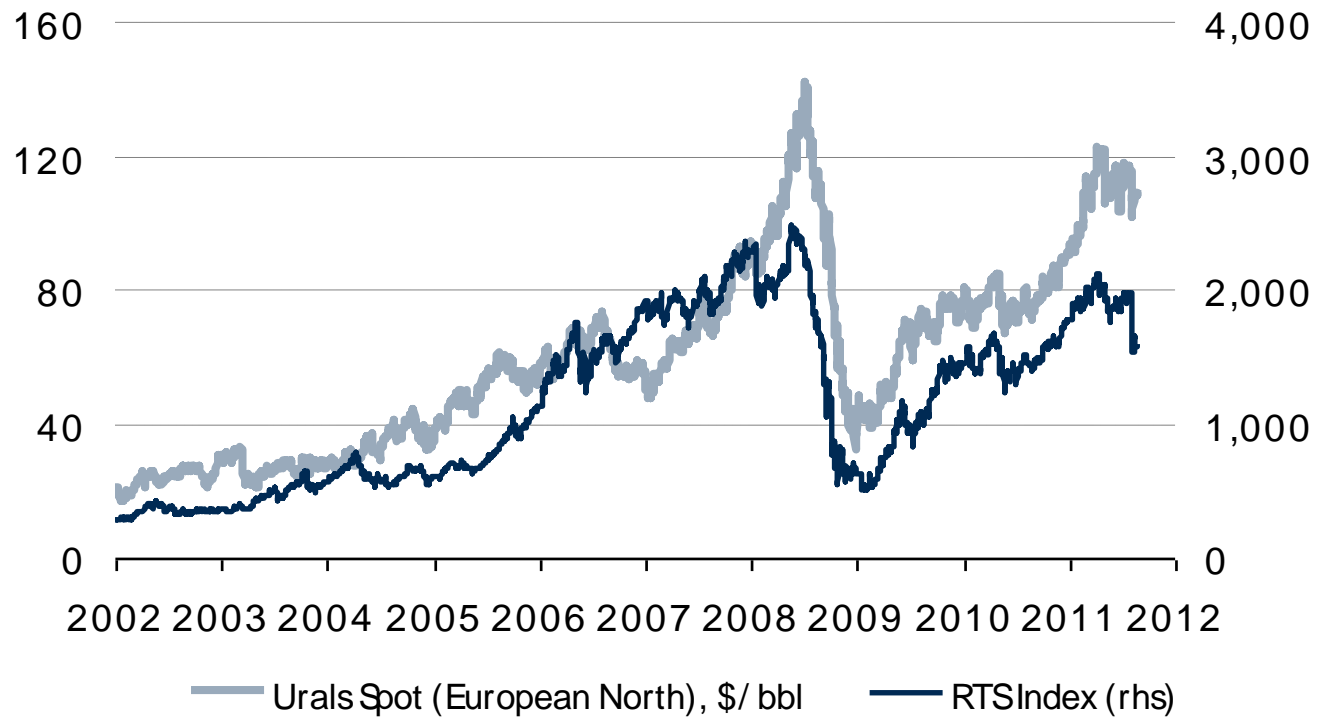
Source: State Statistics Service, Troika estimates

MCap and money supply move together



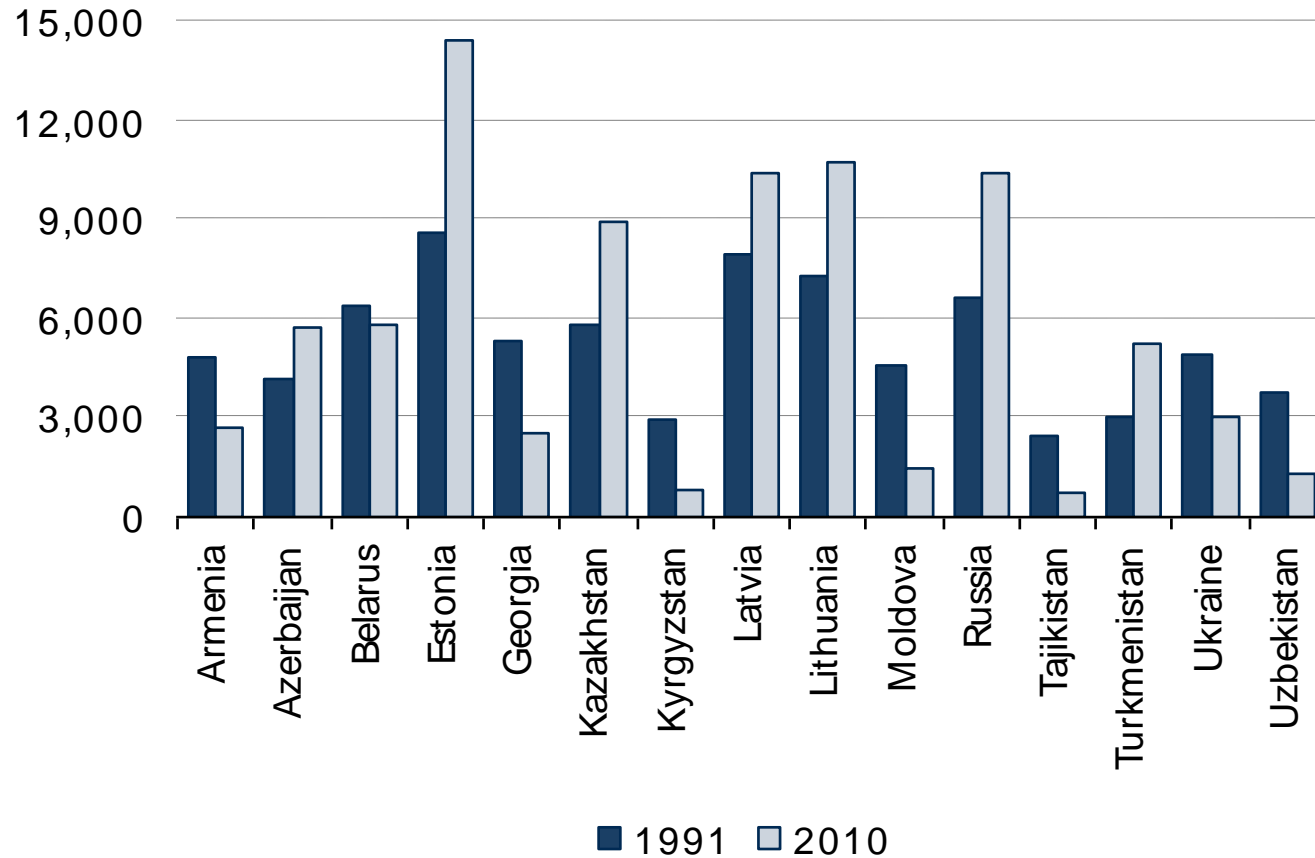
Source: Bloomberg, Central Bank, Troika estimates

High correlation between the oil price and the RTS Index



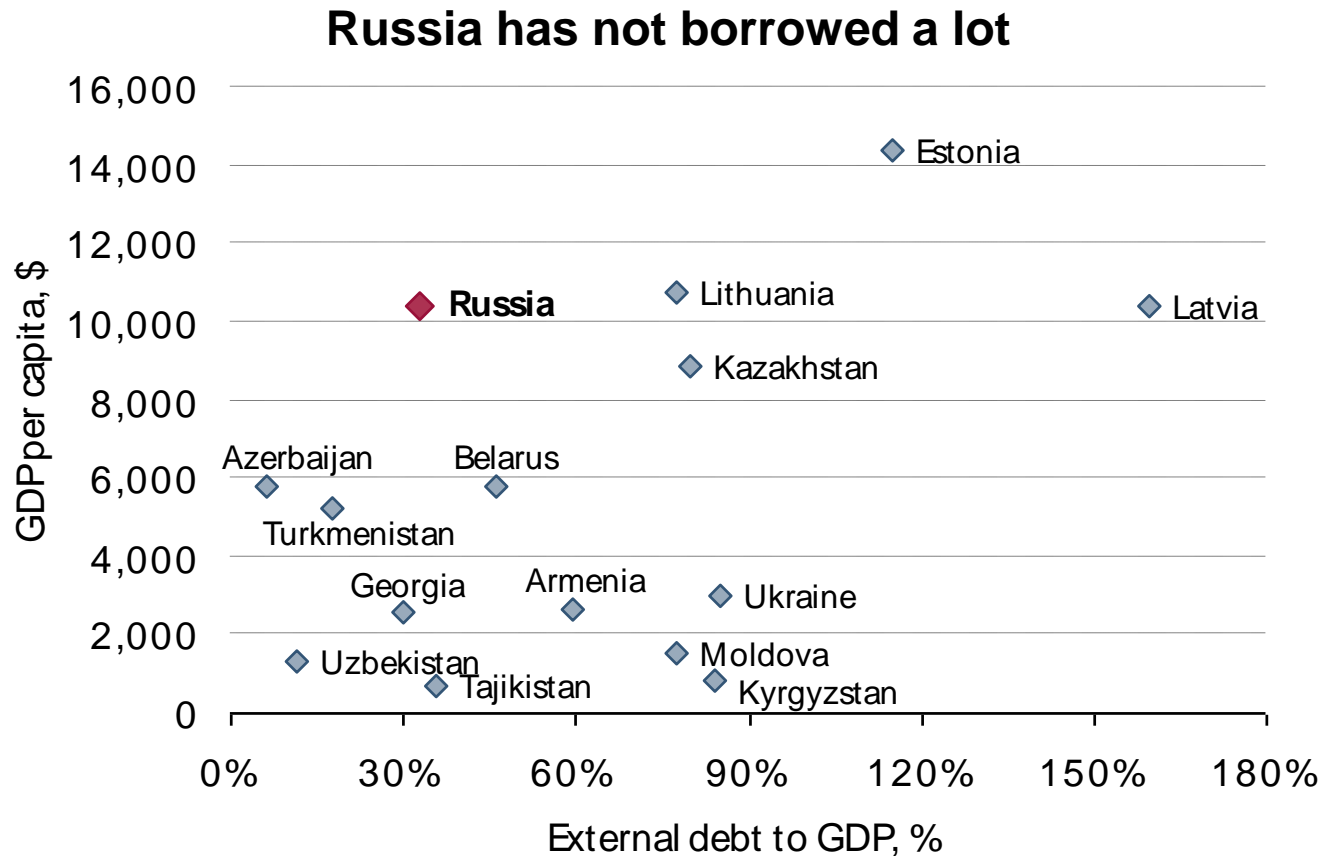
Source: Bloomberg, Troika estimates

GDP per capita FSU, 1991 and 2010, \$



Source: IMF

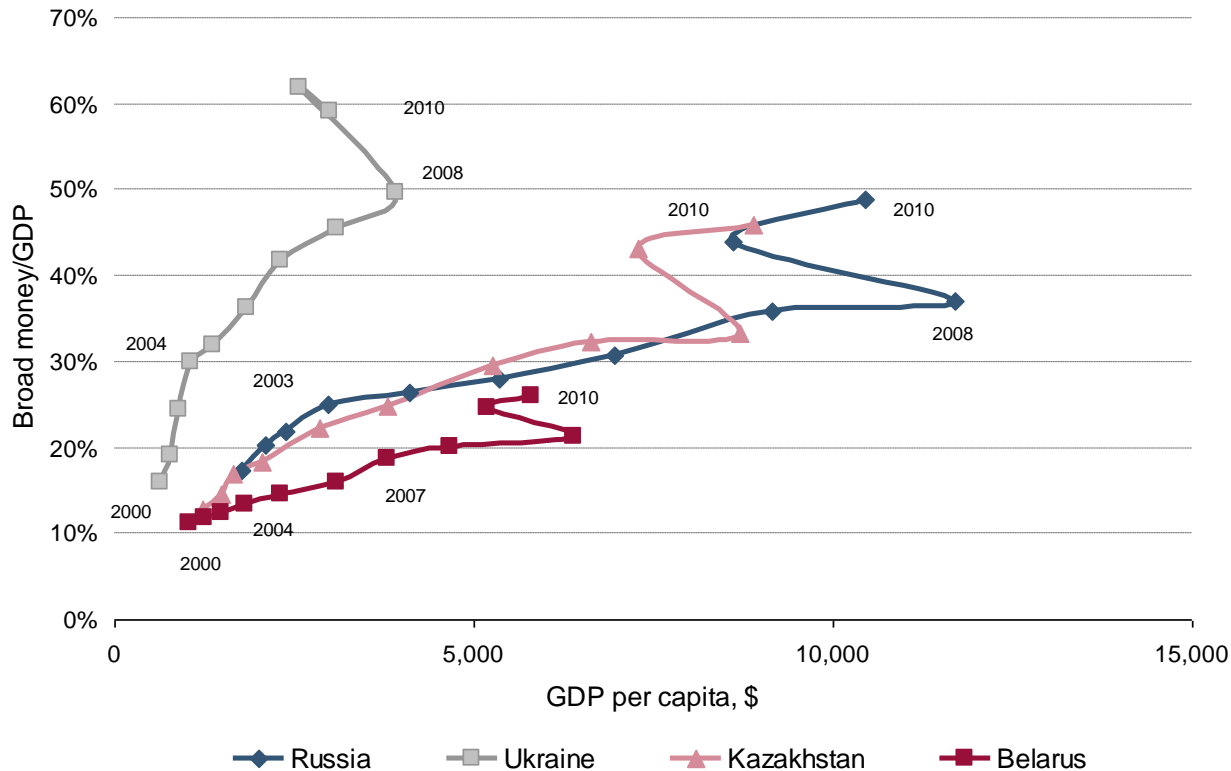
GDP per capita in FSU in 2010 and external borrowing



Note: Data for 2010.

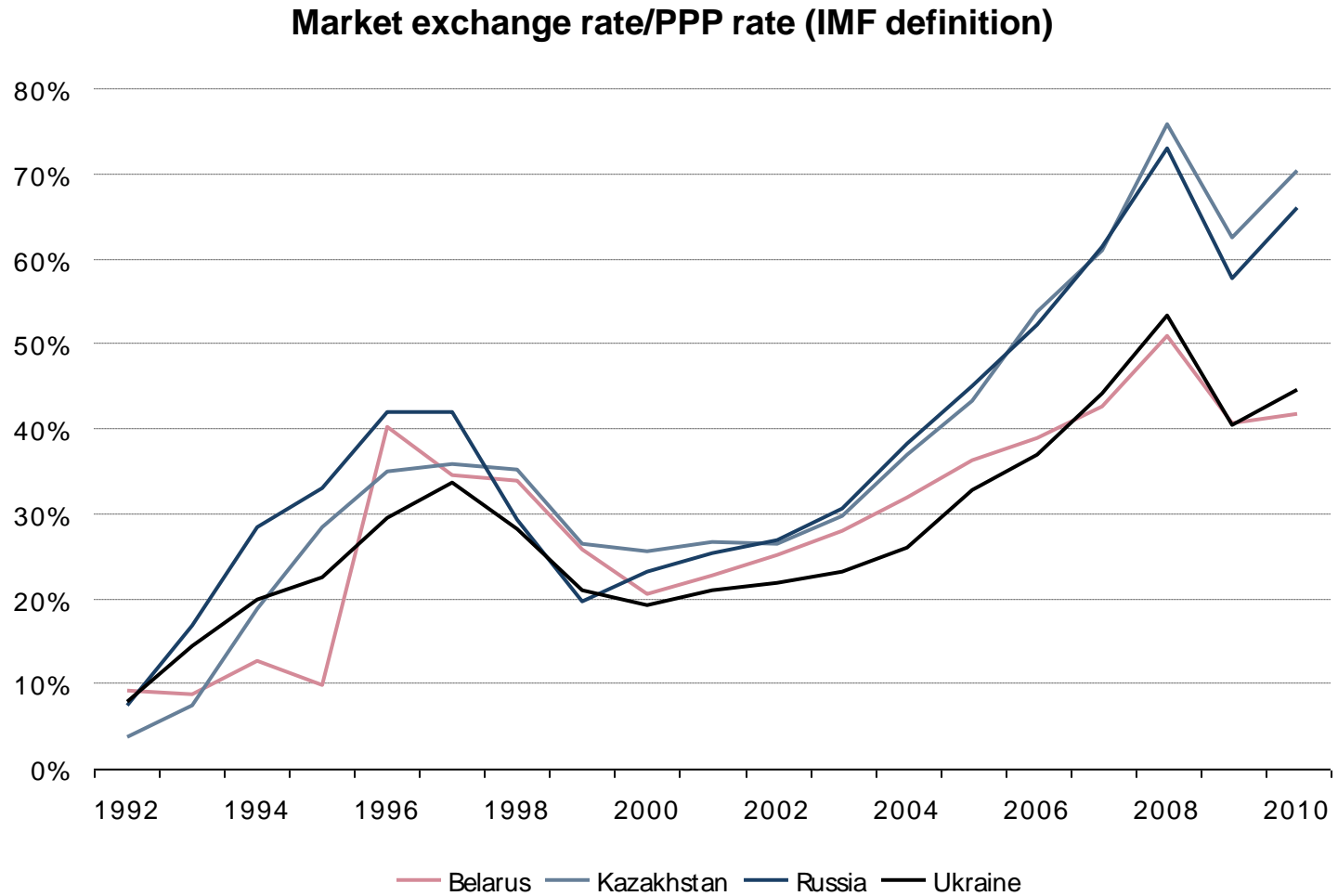
Source: IMF, CIA, national banks

Monetization of economies rises with economic growth

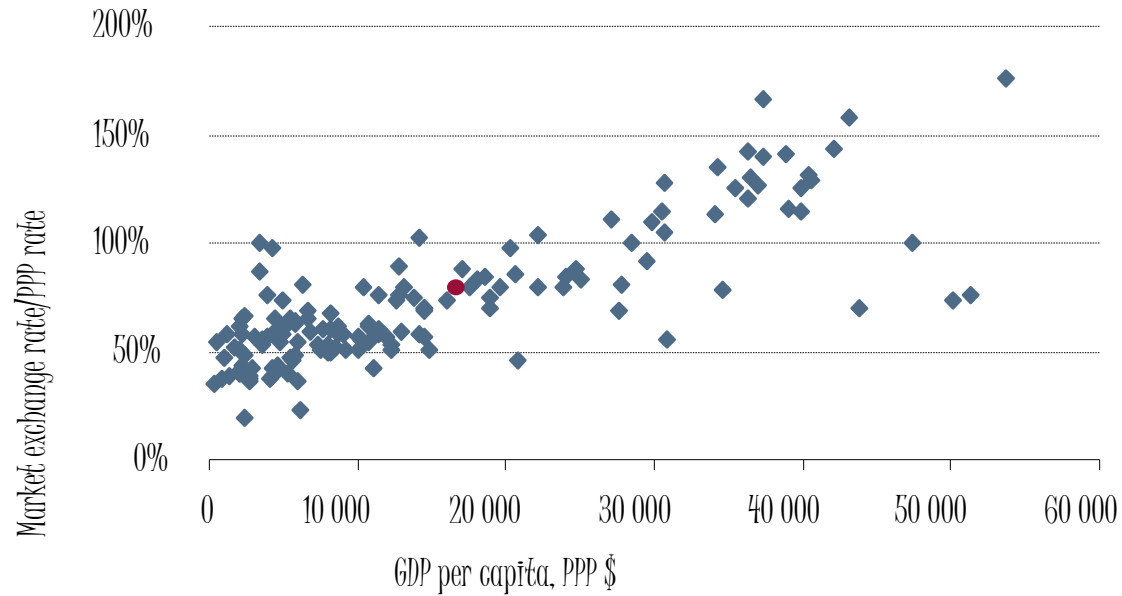


Source: State statistics services, Troika estimates

Real appreciation of national currencies



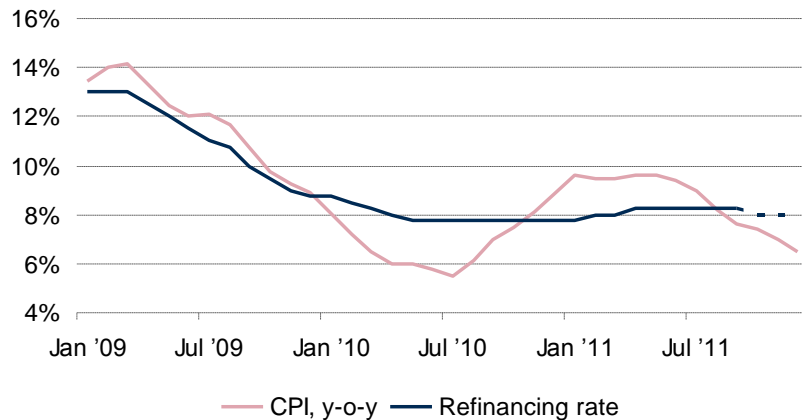
Economic growth will be accompanied by the appreciation of the real ruble



Source: IMF, Troika estimates

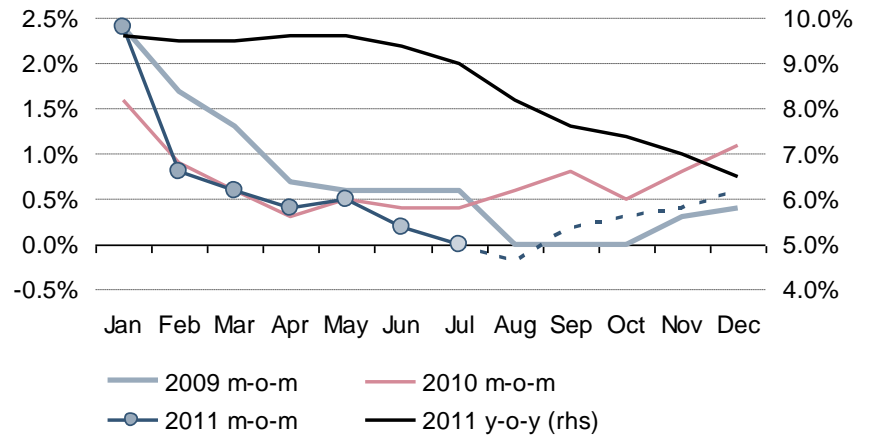
Annual inflation has been slowing more rapidly, but started to accelerate in August 2010

Annual inflation versus refinancing rate



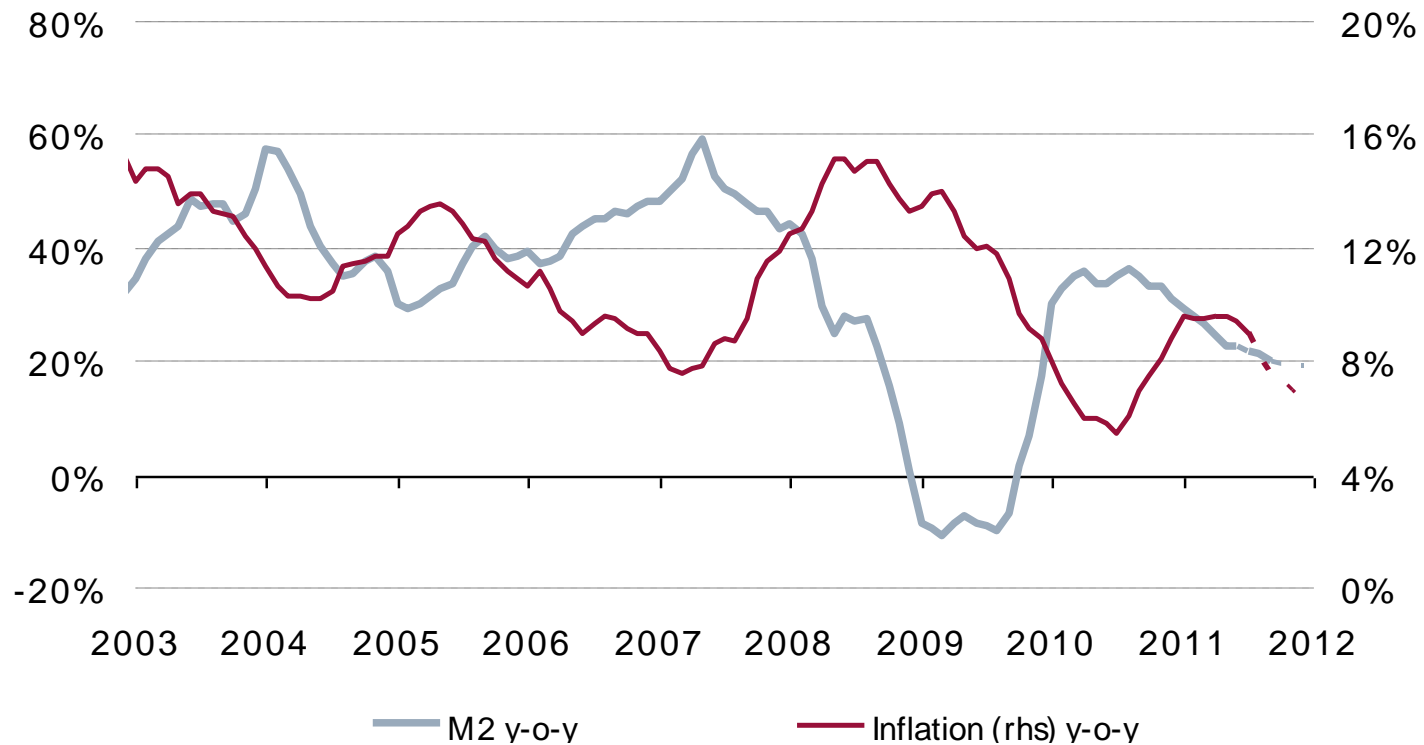
Source: State Statistics Service, Central Bank

Monthly inflation



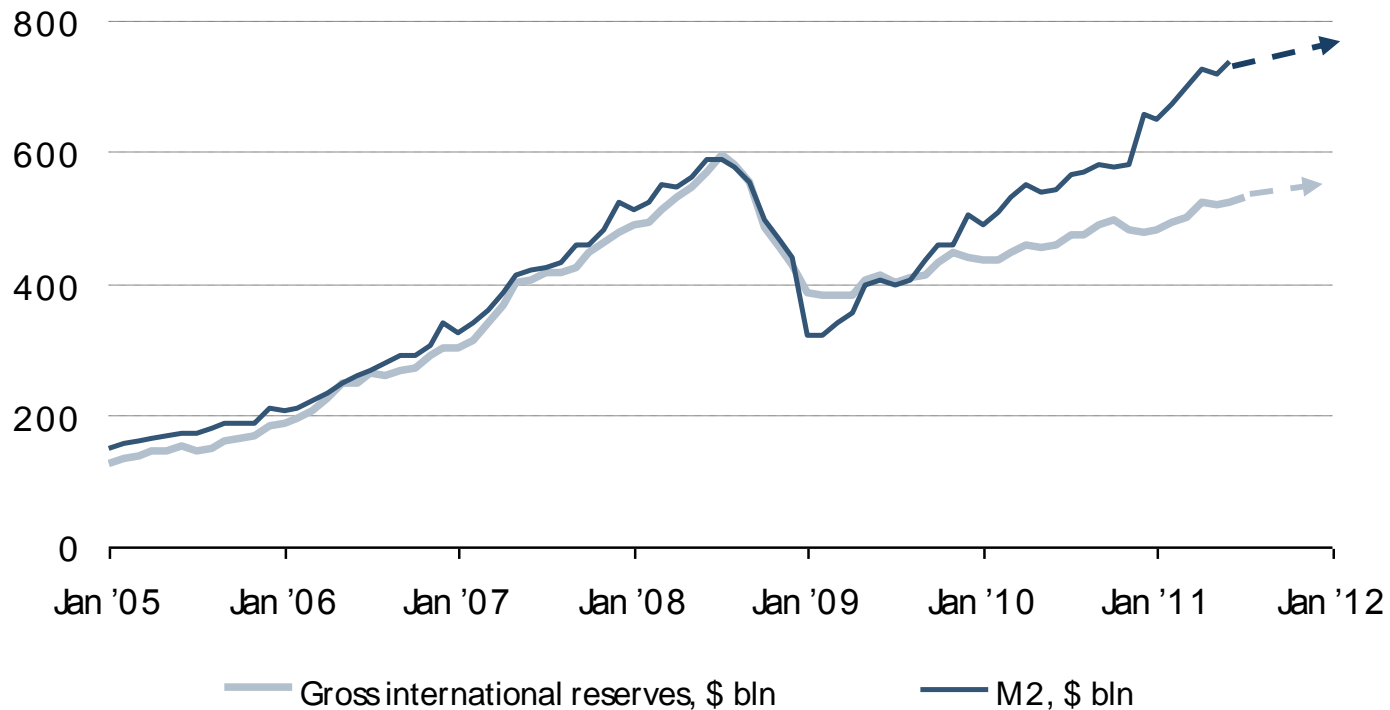
Source: State Statistics Service

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



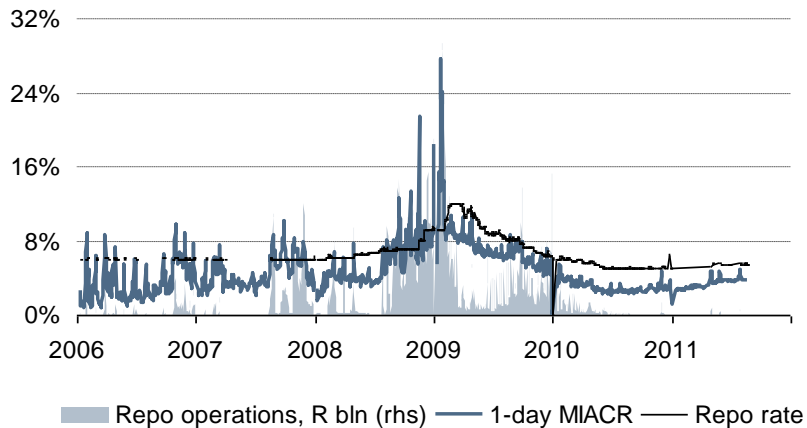
Source: Central Bank, State Statistics Service

M2 declined in nominal terms at end 2008, but started to rise in February 2009, a sign that the economy is recovering (R bln); the sort of unannounced “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 should grow in importance

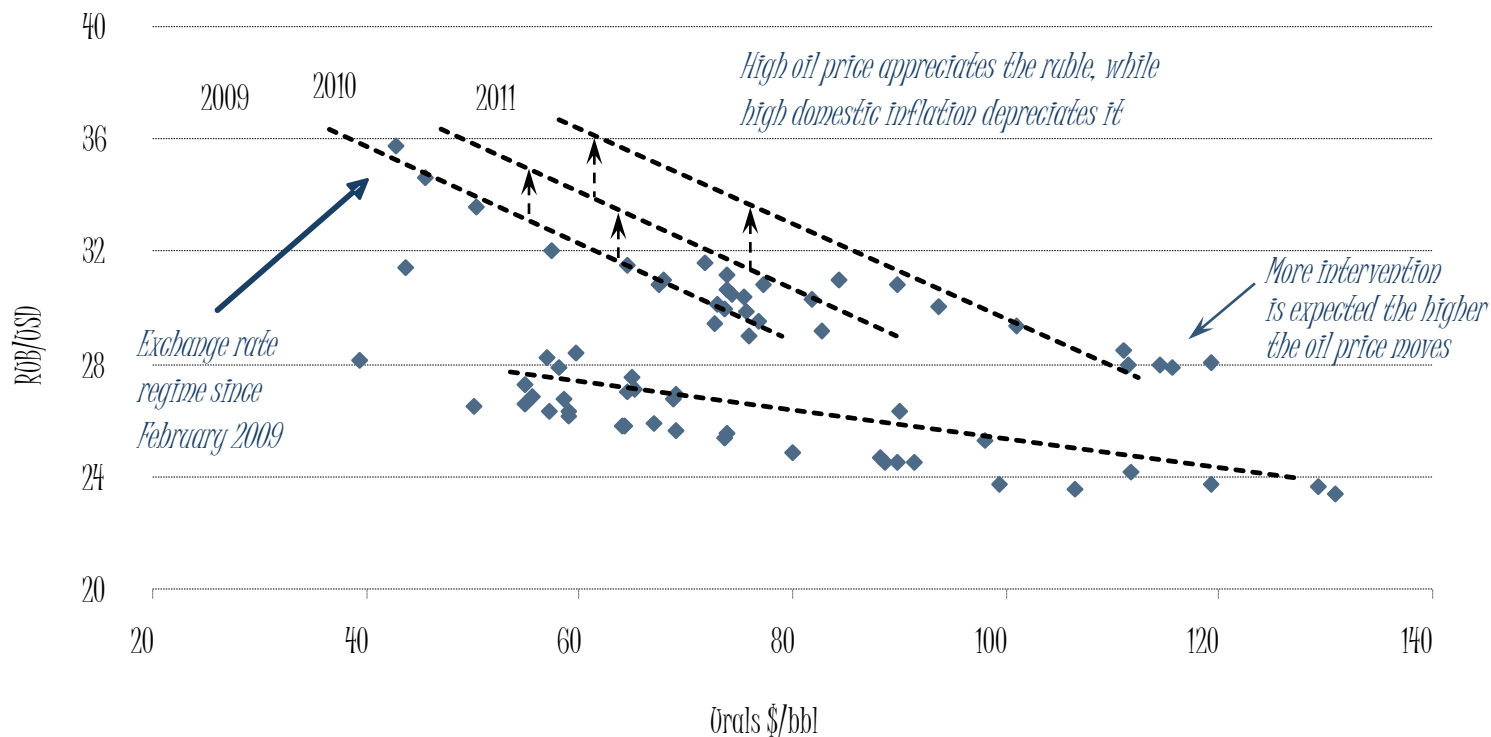


Source: Central Bank, Troika estimates



Source: Central Bank

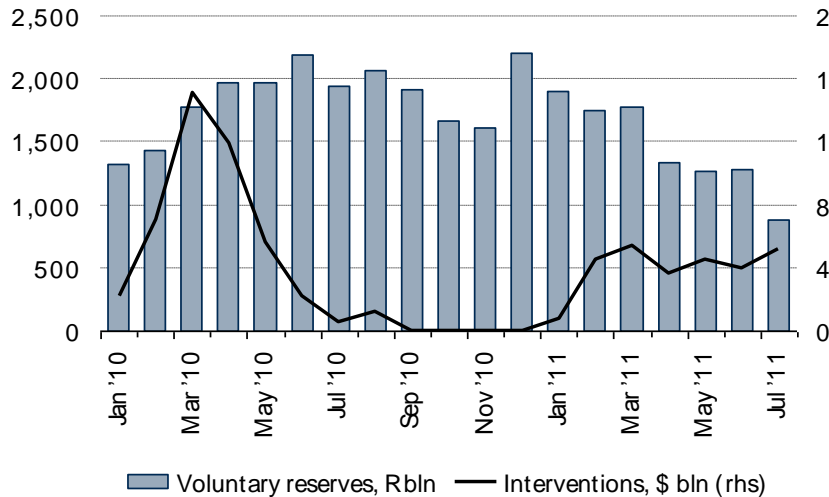
Historical exchange rate and oil price: new regime emerges as the Central Bank reduces interventions



Source: Central Bank, Bloomberg, Troika estimates

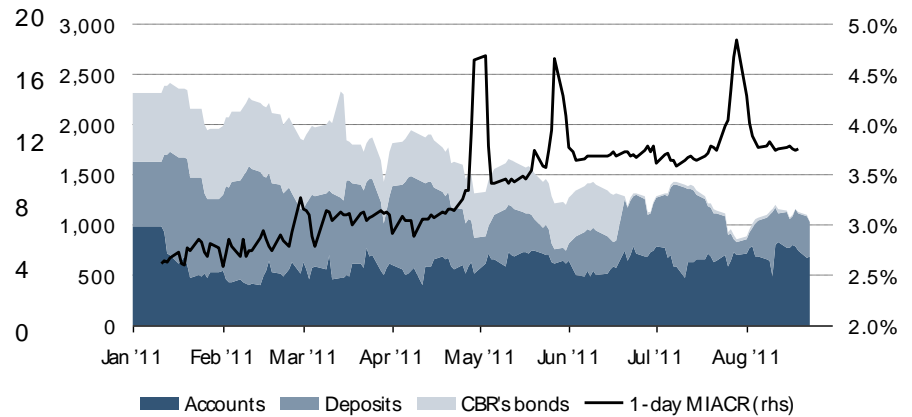
Voluntary reserves shrank in 2011 as Central Bank interventions subsided and budget was in surplus

Central Bank interventions subsided



Source: Central Bank

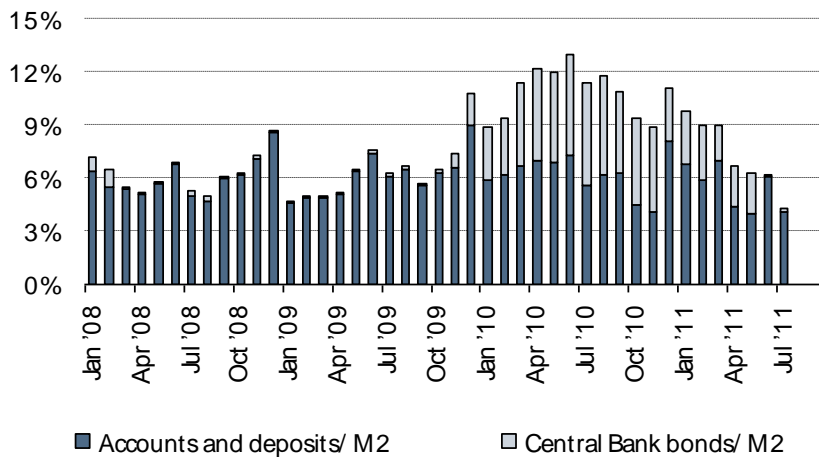
Overnight rates climb amid reduced voluntary reserves, R bln



Source: Central Bank

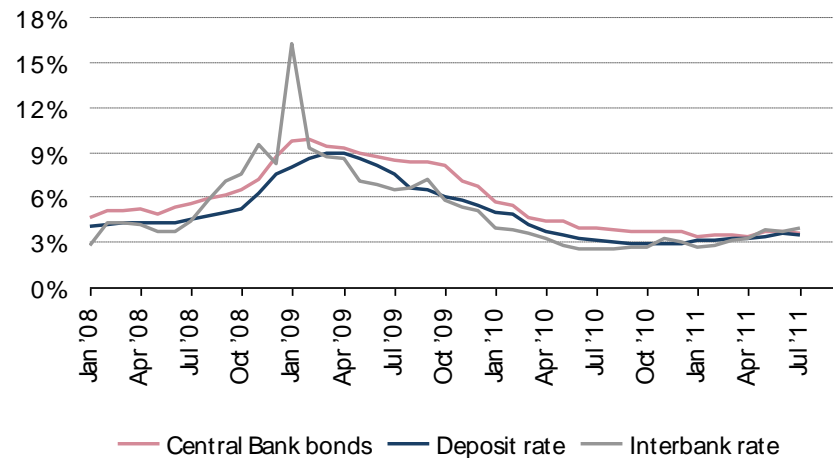
Voluntary reserves increased in 1H10 as the Central Bank offered an attractive risk-free rate

Voluntary reserves increased sharply in 1H10



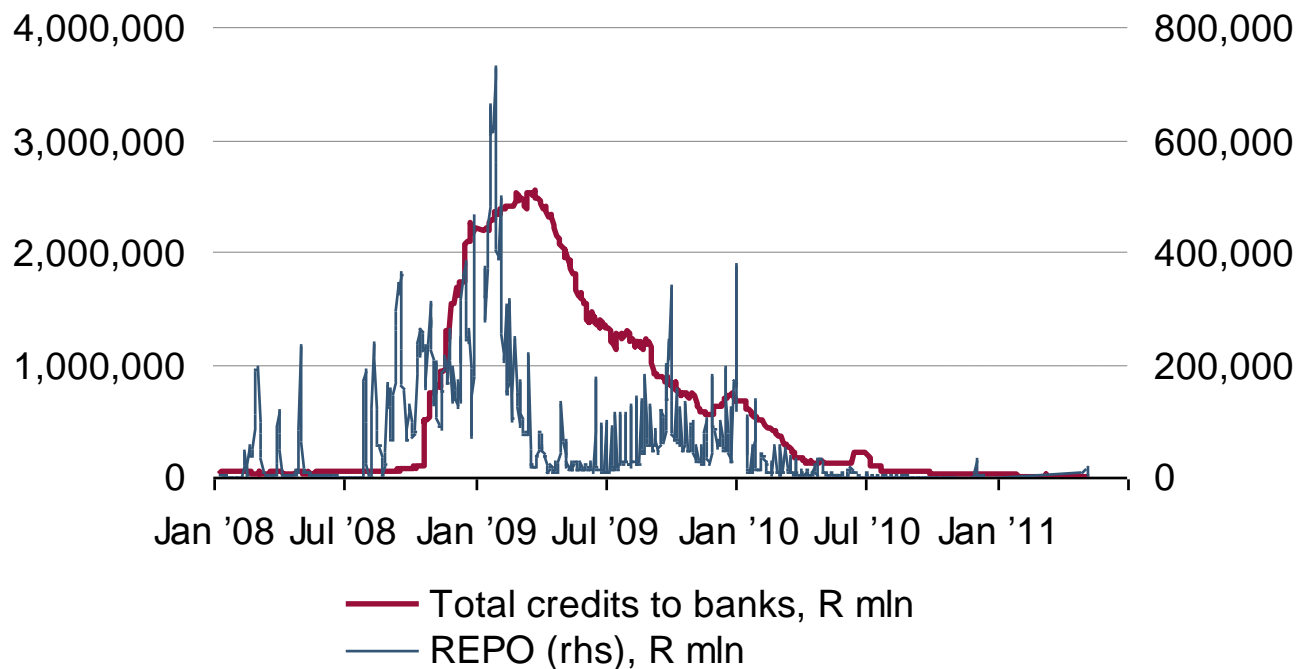
Source: Central Bank, Troika estimates

Central Bank deposit and bond rates



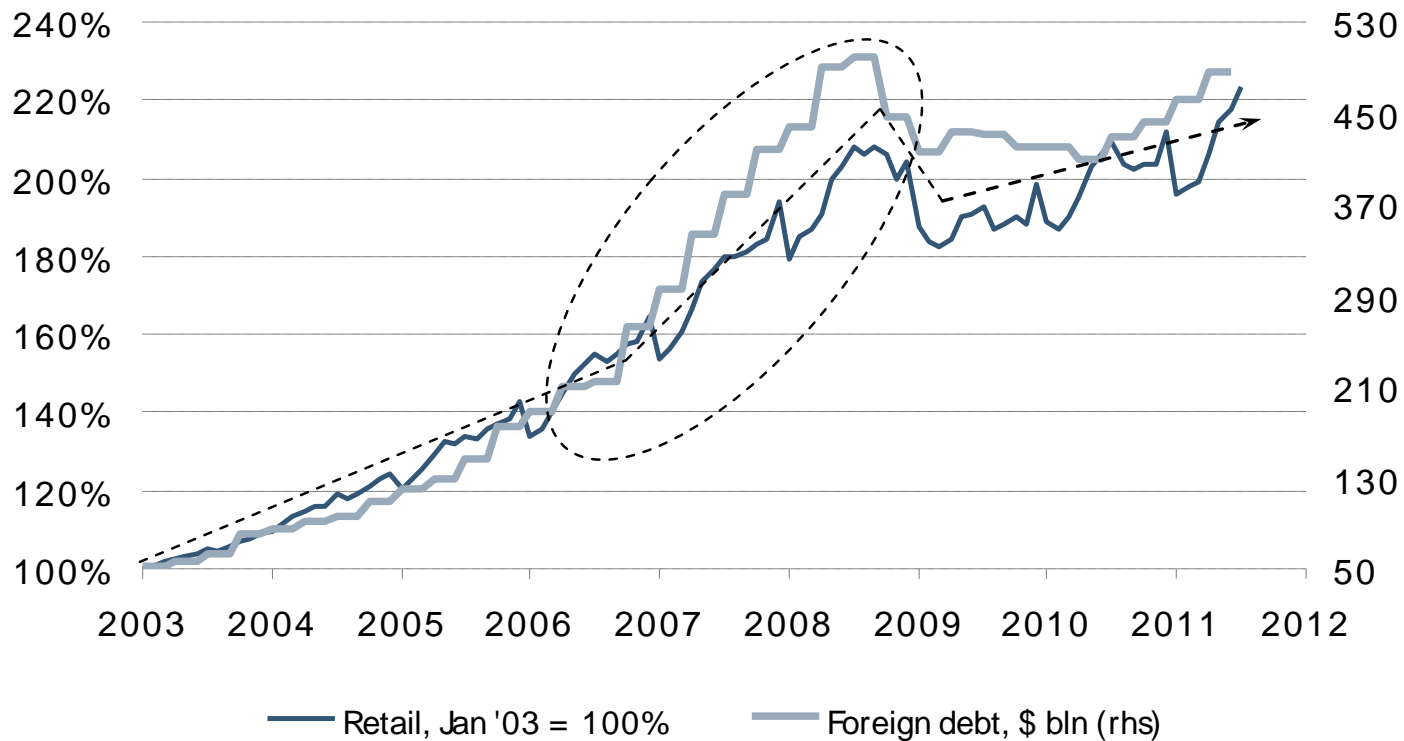
Source: Central Bank

Central Bank has absorbed previously extended loans, R mln



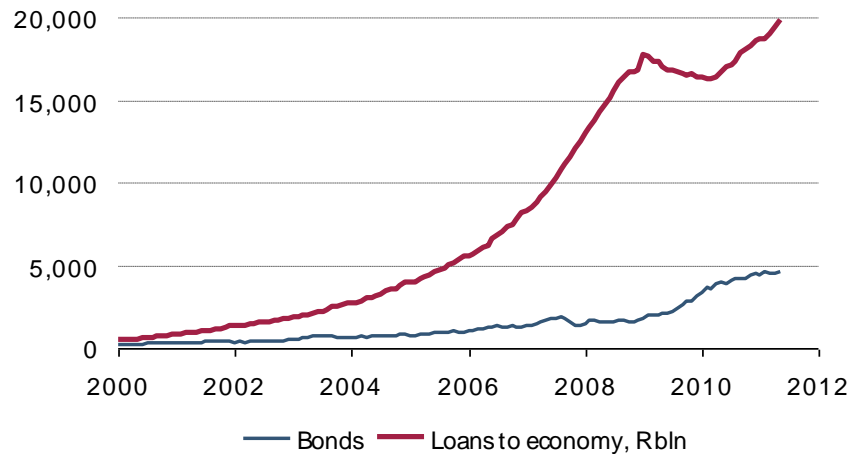
Source: Central Bank

Retail was booming due to foreign borrowing, which stimulated imports

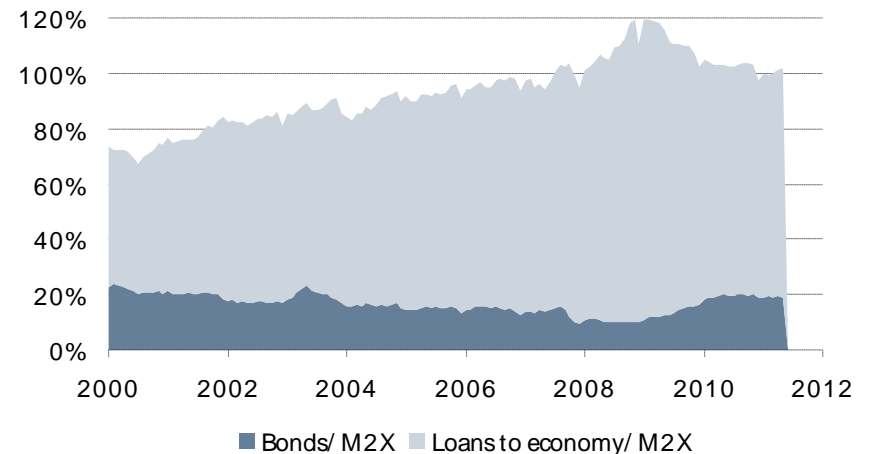


Source: State Statistics Service, Central Bank, Troika estimates

Lending activity and bond purchases by banks



Source: Central Bank, State Statistics Service



Source: Central Bank, State Statistics Service

Major risk stems 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 R759 in 8m11. By year end the government plans to balance the budget, albeit a small surplus may remain.
- **The breakeven oil price is currently estimated at \$109/bbl for 2011 and \$116/bbl for 2012.** However, the government may increase expenditures next year once again and thus the dependence of the 2012 budget on the oil price may increase.

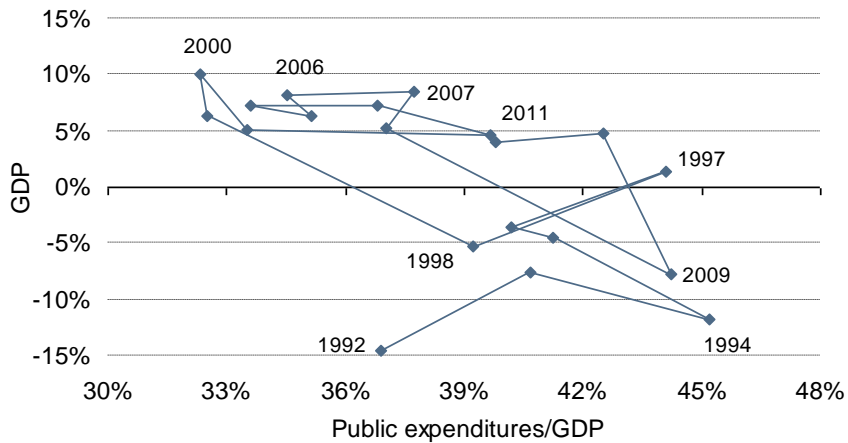
Expenditures increased massively, R bln

	2005	2006	2007	2008	2009	2010E
Total expenditures	3,514	4,281	5,983	7,567	9,660	10,212
State administration	501	530	812	835	829	839
National defense	581	682	832	1,041	1,188	1,264
National security	450	550	667	836	1,005	1,096
National economy	249	345	693	1,025	1,651	1,583
Housing sector	7	53	295	130	152	198
Education	162	212	295	355	418	433
Medical care, sport	88	148	197	278	352	341
Social policy	178	201	214	294	324	329
Transfers	1,246	1,499	1,900	2,675	3,594	3,633
Other	52	62	79	99	147	496

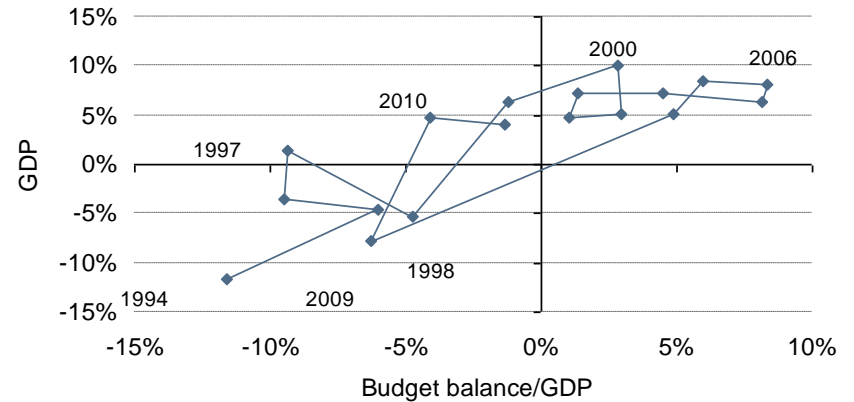
Note: The government initially planned expenditures in 2009 at R9,845.2 bln.

Source: Finance Ministry

Larger government expenditures and an increased budget deficit in Russia usually mean worse economic performance



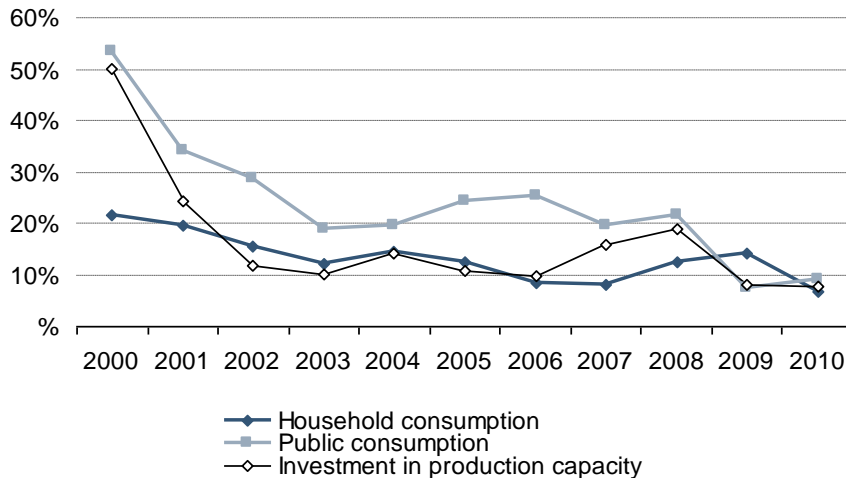
Source: State Statistics Service, Finance Ministry, Troika estimates



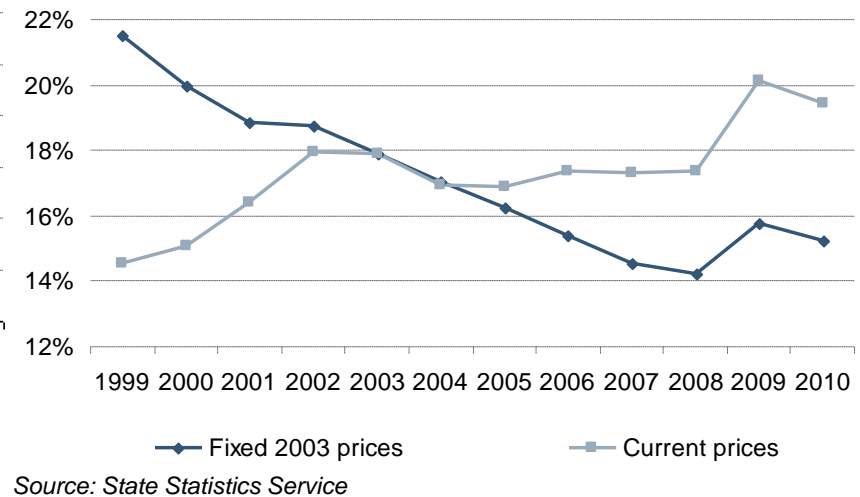
Source: State Statistics Service, Finance Ministry, Troika estimates

Government interventions were inflationary: public consumption shrank in real terms

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

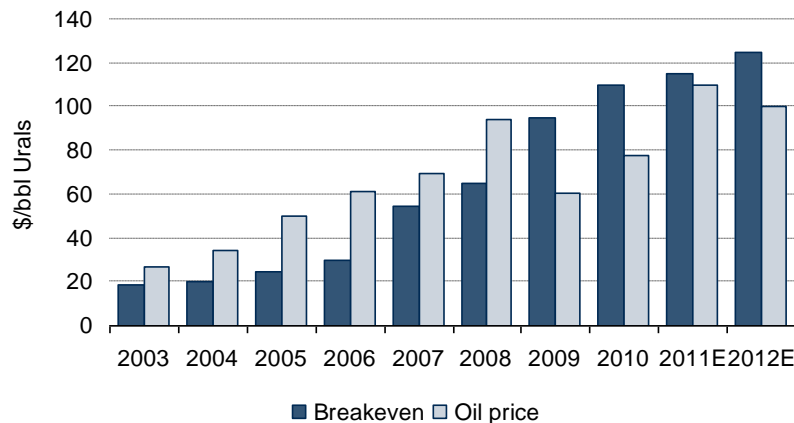


Public consumption/GDP ratio shrank in real terms, its contribution to economic growth diminished

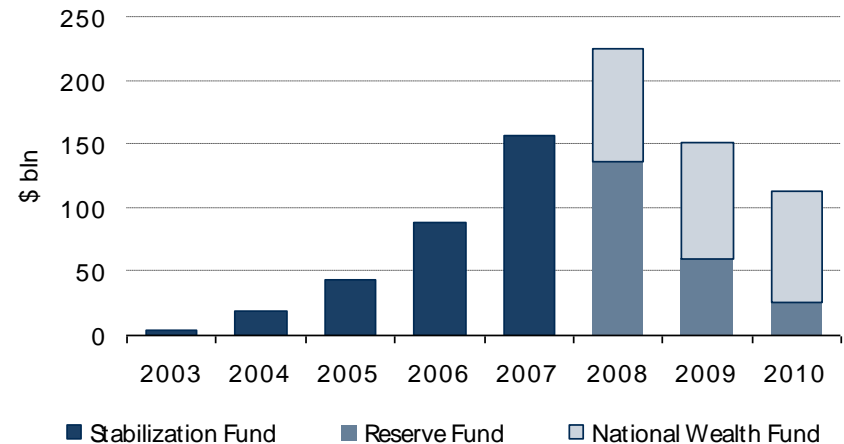


Breakeven oil price has grown substantially over recent years, increasing budgetary risks

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

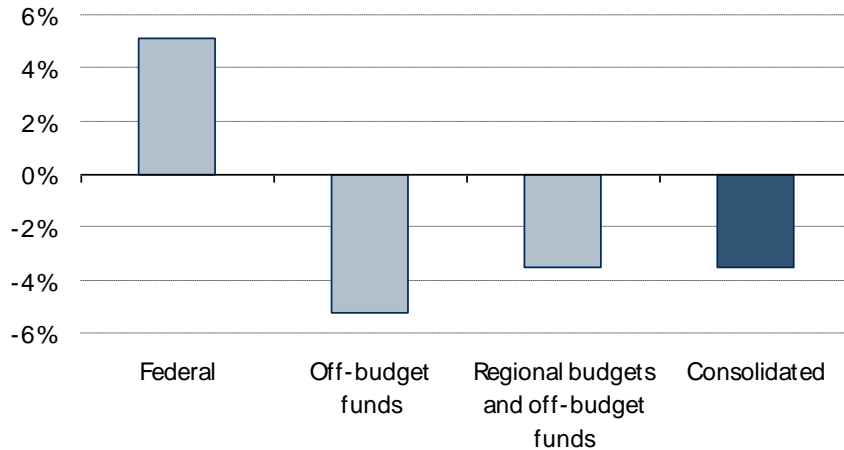


Source: Finance Ministry, Troika estimates



Source: Finance Ministry, Troika estimates

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

Sources of deficit financing as planned at end 2010, R bln

	2011	2012	2013
Budget deficit financing	1,814.0 (3.6% GDP)	1,734.5 (3.1% GDP)	1,795.7 (2.9% GDP)
Reserve Fund	284.4	0.0	0.0
National Wealth Fund	5.0	7.5	10.0
Net foreign borrowing	45.7 (\$1.5 bln)	82.9 (\$2.7 bln)	83.5 (\$2.7 bln)
Net domestic borrowing	1,180.9	1,368.0	1,392.8
Privatization receipts	298.0	276.1	309.4

Source: Finance Ministry

Government budget forecasts have changed since August

August 2011

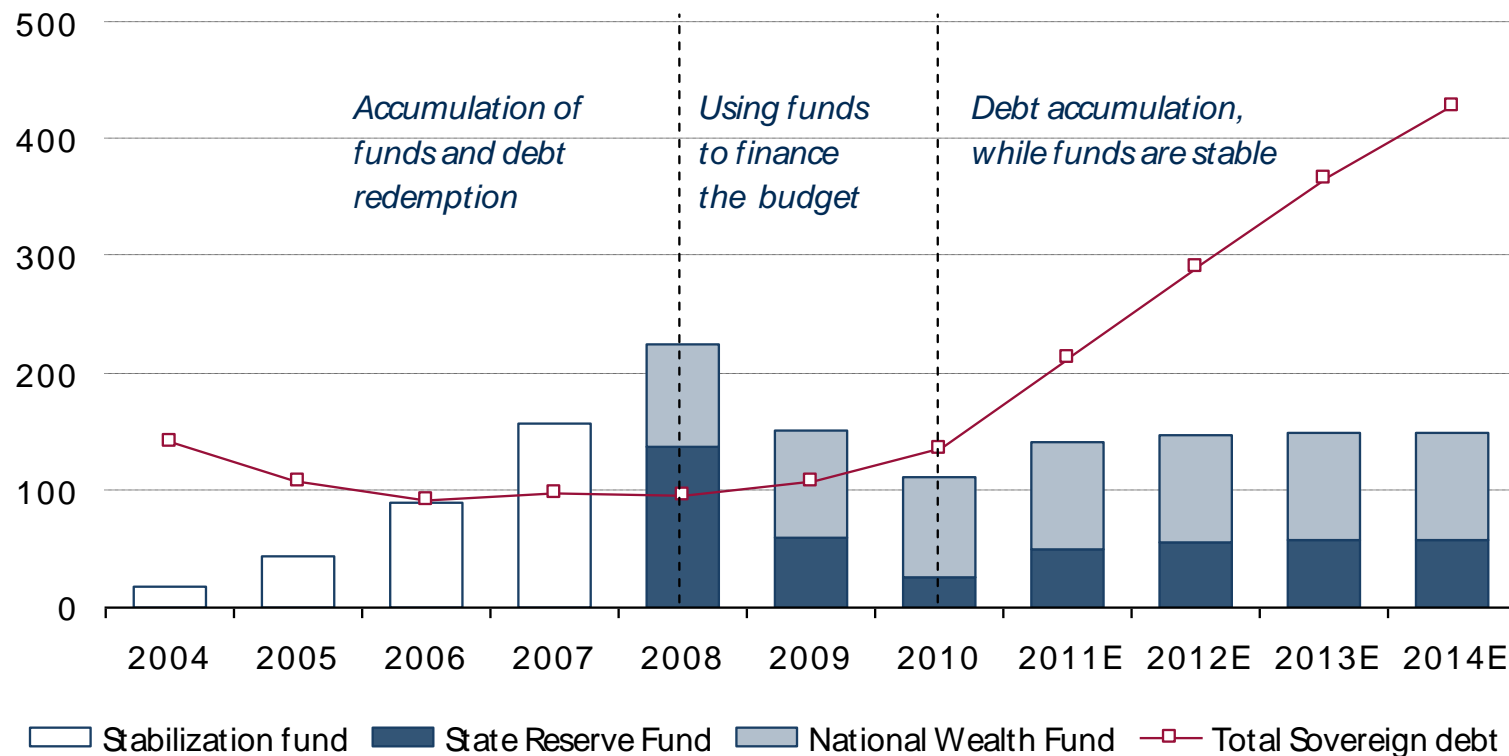
	2010	2011E	2012E	2013E	2014E
Revenues, R bln	8,305.4	10,303.4	10,627.8	11,687.6	12,645.5
Expenditures, R bln	10,117.5	11,022.5	12,198.3	13,431.9	14,293.9
Balance, R bln	-1,812.1	-719.1	-1,570.5	-1,744.3	-1,648.4
Balance, % GDP	-4.0	-1.4	-2.7	-2.8	-2.3
Oil price, \$/ bbl Urals	78.2	105.0	93.0	95.0	97.0
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	11,779.0	12,728.0	14,116.0
Oil and gas revenues, R bln	5,431.0	5,575.0	5,646.0	6,127.0
Revenues, % GDP	–	20.1	19.6	19.5
Expenditures, R bln	11,008.0	12,670.0	13,766.0	14,631.0
Expenditures, % GDP	–	21.6	21.2	20.2
Balance, R bln	0.0	-890.7	-1,037.0	-514.3
Balance, % GDP	1.3	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

Three stages of budgetary policy, \$ bln



Source: Finance Ministry