Russian Market Overview

Russia has been famously described as a riddle, wrapped in a mystery, inside an enigma – the riddle is deciphering the opportunities, the mystery is finding the right structure, the enigma is unlocking the vast potential.

November 2010

Policy

The authorities are pursuing an accommodative policy stance, designed to stimulate recovery in economic performance. The weakening of output in the third quarter can be expected to concentrate government attention on fostering stronger performance, particularly given the approach of Duma and Presidential elections in late 2011 and early 2012 respectively. The reduction of disposable income and the increase in poverty levels could undermine the government's re-election prospects given that its popularity has been largely derived from its ability to deliver economic growth and associated increases in per capita income. The difficulty for opposition groups is that they remain associated either with the discredited Yeltsin reforms or the stagnation of the last years of the Soviet period. Thus whilst speculation may intensify over whether the next Presidential candidate will be the current incumbent President Dmitry Medvedev or the previous incumbent, the current Prime Minister, Vladimir Putin, the current government is expected to be re-elected. The degree to which democracy is permitted under the system of guided democracy is likely to be closely linked to the rate of economic growth and the price of oil.

General Economy

With the notable exception of 2009, real GDP growth has been robust over the past decade. While this growth was in part fuelled by the surge in oil prices over the same period, this is only part of the story. Growth was recorded across the economy, with manufacturing and services sectors expanding dynamically, contributing to significant improvements in real per capita incomes. Although the downturn in 2009 was more severe than that recorded in the 1998 financial debacle, the economy proved much more resilient, reflecting the institutional strength of the market framework that has embedded itself since 1998. Furthermore, while the 1998 crises was largely the result of domestic fiscal and financial mismanagement within the context of fragile economic infrastructure, the 2009 recession was principally the result of external shocks associated with the 2007-2008 G7 financial crisis. Both banks and corporates came under severe pressure, with the fiscal balance deteriorating considerably. However, prudent economic management, notably the build up of large reserves in Sovereign Wealth Funds prior to crisis, enabled the authorities to support institutions and deploy a counter-cyclical policy to stabilise performance. As a result, boosted by firming oil prices, the recovery in the first half of this year was strong.

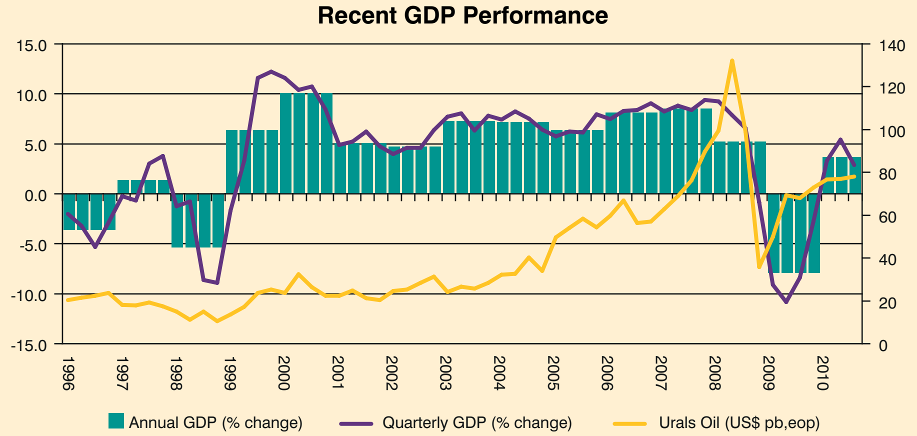
Third quarter output performance was however disappointing, with production constrained by the impact of the summer drought and fires on both agriculture and the wider economy, reflecting the continued paucity of public infrastructure and the need for further reform in this sector. Preliminary data from the Federal Statistics Service, indicate that GDP increased by 2.7% y-o-y, compared to the more vibrant growth of 5.2% y-o-y recorded in the second quarter. Despite vying with Saudi Arabia as the world's largest energy exporter and the revival in oil prices, the authorities estimated that the drought and associated fires shaved almost 1% off growth. Retails sales in September dropped 1.9% m-o-m, the first easing since February, and weaker consumer demand was a factor behind the Central Bank of Russia (CBR) maintaining its accommodative policy stance. The increase in food prices, attributed to the drought, has led to the poverty rate temporarily deteriorating to 13.6% according to latest World Bank data, while overall real disposable income fell 0.2% m-o-m in September.

Not only was growth weaker than market expectations, but more subdued than other comparable economies. Although the BRIC's classification is a misleading analytic for assessing emerging market potential, growth in China for the third quarter was 9.6% y-o-y and in India 8.8% y-o-y. Growth is expected to be stronger in the final quarter, due to firming oil prices, revived consumer demand and intensifying investment, however most forecasts of GDP growth for the year have been revised downwards below 4% with the Economics Ministry now projecting 3.6% for 2010.

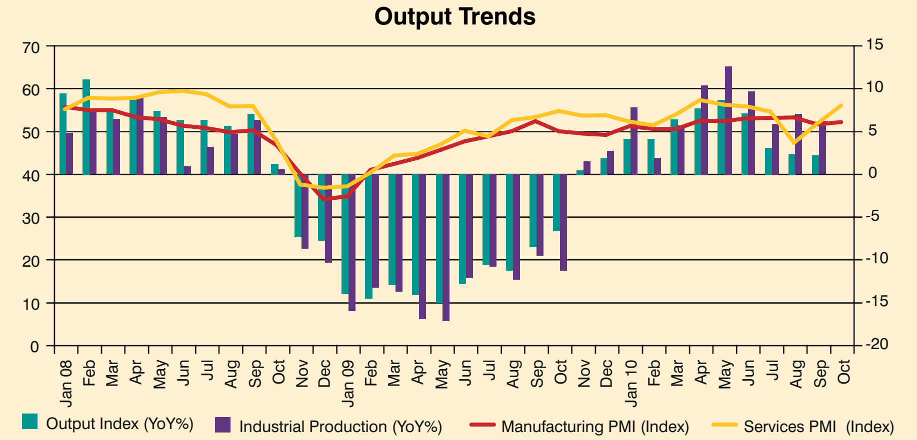
Manufacturing production was particularly compromised by the adverse climatic conditions of the summer, with industrial production growth slowing to 6.2% y-o-y in September, from 7% y-o-y in the month previous. This trend was reflected in recent data from the HSBC manufacturing PMI, with production growth easing for the fourth consecutive month. The manufacturing PMI for October was 51.8 (a reading below 50 indicating contraction), which although slightly stronger than the 51.2 recorded in September, was due to increased employment and increased suppliers' delivery times, whereas output and new orders indicators eased. On the positive side this represents 15 months of continuous expansion, albeit at a rate that has been decelerating since July. With the extended New Year holiday period, coupled with the onset of winter, demand as reflected in new orders may remain muted. Input prices continue to firm, with agriculture-related product prices in particular rising, although commodity prices generally were recorded as strengthening. The upward track of inflationary pressures is likely to be sustained, as suppliers' delivery times are increasing sharply.

In contrast, the latest HSBC Services sector PMI recorded an improvement in business conditions, in October. At 55.6 the pace of increase was the strongest since June, following on from output increases recorded in September. This was attributed to overall activity and new businesses coupled with improving employment market conditions. This marks a strong recovery from August, when as a result of the drought, the PMI fell to 47. A further factor signalling improving business conditions was the deceleration of input cost inflation, which remained weaker than the long-run trend. The capacity of service providers to set prices was itself constrained by the moderation in economic conditions. Overall, sentiment in the services sector was optimistic regarding future economic prospects.

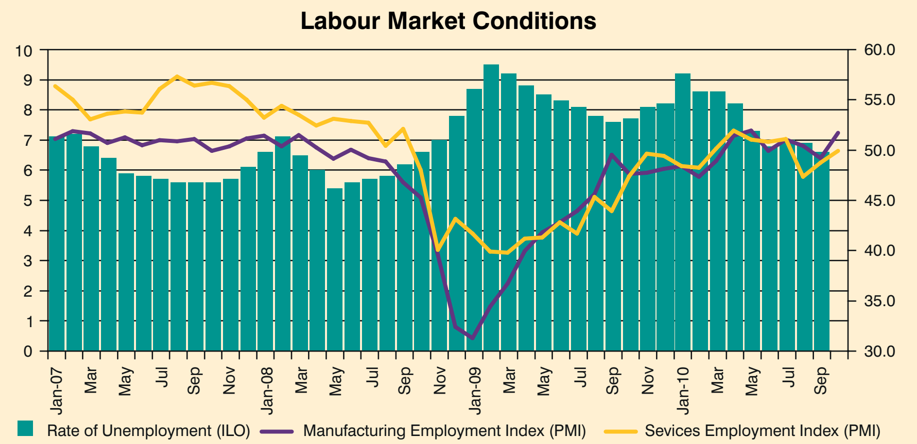
The firmness of labour markets, with the recorded level of unemployment falling to 6.6% in September, has raised concern about what is the structural level of full employment and the implications for wage-related inflation. However although some indicators, such as reducing corporate profits, increased wage rates and input costs, suggest that full employment is nearing, overall GDP performance is subdued and below trend, while at current levels more than 60% regions have higher unemployment rates than 2008. More recent PMI data records that manufacturers increased labour recruitment, over three of the last four months, with the rate of job creation in October the most rapid since May. The labour market in the services sector was more mixed, and the sector continued to undertake workforce reduction, albeit it at more marginal pace in October.



Source: *Federal Statistical Service*



Source: *Federal Statistical Service & HSBC Russian PMIs*



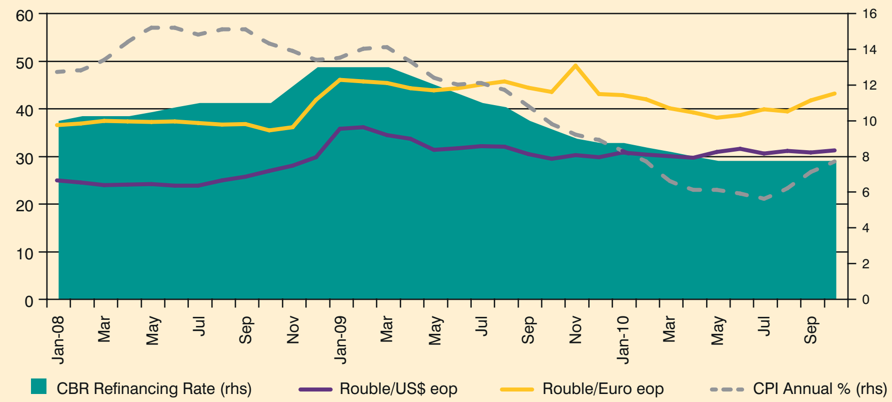
Source: *Federal Statistical Service & HSBC Russian PMIs*

Inflation, Monetary & Foreign Exchange Policy

Despite firming prices, the CBR has chosen to pursue an accommodative interest rate policy as part of its efforts to support output performance, keeping the refinancing rate at 7.75%. At the same time the CBR has been attempting to subdue demand for the Rouble and Rouble-denominated bonds. As part of this strategy, the CBR has been discreetly adjusting its foreign exchange rate policy. Since 2005, the CBR has been managing the currency against a basket of the US dollar (55% of the basket) and the Euro (45%), the CBR has expanded the so-called floating corridor it allows the Rouble to trade freely within versus the basket twice last month as part of a strategy to end intervention by 2012. In effect, the authorities have effectively moved its focus from the basket, to a policy holding the currency to between 30 and 31 against the US dollar. While market forecasts had tended to anticipate the currency strengthening below 30 over the course of this year, the CBR's foreign exchange interventions were equivalent to US$ 5.1 billion in October to keep the currency in its preferred range. Thus although the CBR argues the trading range of the currency is market determined, its progressive interventions to support the Rouble over the past year, have unsettled market perception as to the future direction of the currency. This has deterred carry trades and speculative flows.

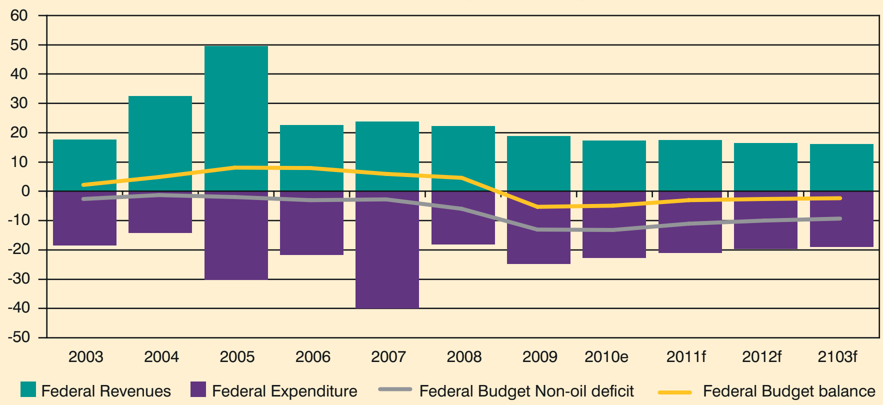
With firming oil and commodity prices, inflationary pressures can be expected to tighten into next year. Consumer price inflation is expected to exceed 8% by the year-end, although this is in part due to the one-off impact of the drought on agricultural production and prices. Money supply growth and the scale of the fiscal deficit will nevertheless sustain price pressures through the course of 2011, and as a result inflation is not anticipated to fall substantially below 8% until the late in 2012.

Interest Rate Conditions



Source: *CBR & Federal Statistical Service*

Fiscal Trends (% of GDP)



Source: *Ministry of Finance*

Fiscal Performance

Although the oil sector is only one factor driving economic growth, public expenditure is heavily dependent on oil revenue receipts. The equivalent of US$ 1.5 trillion has been generated from oil exports, since Putin was first elected President, allowing the state to establish internationally competitive personal and corporate tax rates. This has helped foster robust output performance, but has ensured that fiscal outturns are vulnerable to price volatility in global oil markets. Thus whilst oil sector provided the impetus for 14% of overall growth in 2007 (rising to about a quarter this year as a result of the downturn), the sector provided over 40% of total government revenues (rising to 60% in 2010). Currently favourable oil prices indicate that the fiscal deficit for 2011 is likely to be below 3% of GDP, rather than the forecast deficit of 5%.

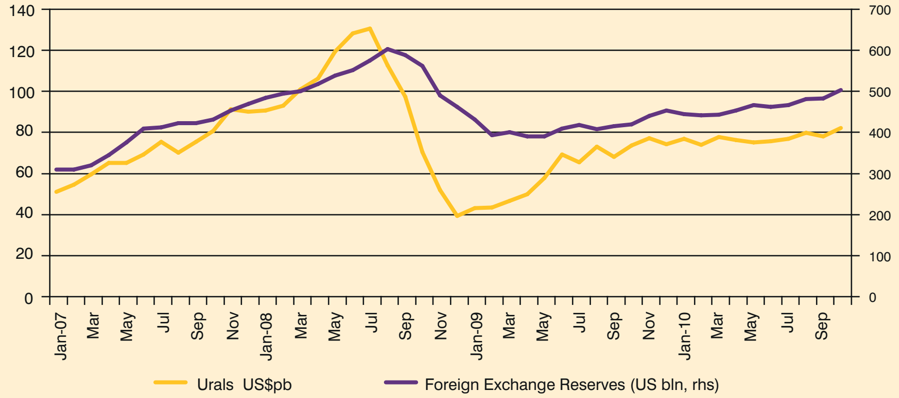
In contrast to earlier pre-crisis fiscal years, when windfall revenues (revenues derived from above budget forecast oil prices) from the oil sector were directed toward Sovereign Wealth Funds, the revised 2010-2013 medium-term fiscal strategy largely directs any surplus revenues toward consumption. While the Ministry of Finance continues to suggest it is pursuing a restrictive fiscal strategy, the new programme is expansionary, designed to stimulate the wider economy, particularly given the fact that the Presidential election is approaching. The revised programme is based on an oil price forecast range of US$ 75-80 pb over the programme period. This strategy includes a substantial deepening of the non-oil deficit, which could potentially reach the equivalent of 13% of GDP, and even with the forecast favourable oil prices, the overall fiscal deficit is expected to remain above 3% of GDP at least until 2013.

Financing the deficit is expected to be achieved largely through recourse to domestic debt issues, with limited tapping of external financial markets. Drawdowns from the Reserve Fund (one of two Sovereign Wealth Funds, the other being the National Welfare Fund) will also be utilised to support the budget into next year, although by 2012 the programme envisages that the deficit will be financed domestically. Privatisation of government assets, including bank shareholdings, should also raise funds equivalent to 0.5% of GDP.

External Balances

Imports rose strongly as a result of lost production, both agricultural and non-agricultural, due to the drought. The pressure on external balances have been exacerbated by the decision to impose an export ban on grain exports, in August, to protect domestic stocks. The export ban is in place until at least the end of June 2011, and was in response to the forecast domestic grain harvest falling by over a third, to 62 million tonnes. However, despite the export ban potentially making available an additional 12 million tonnes, with domestic consumption at 78 million tonnes, Russia is likely to become a net importer of grains. This contributed to the deterioration of the current account, on the balance of payments, in the third quarter. following stronger performance in the first half of the year on the back of firming oil prices and compressed import demand. Nevertheless, the latest available CBR data indicates that for the first three quarters the current account surplus was equivalent to US$ 61 billion, nearly double the US$ 33 billion recorded in the year previous. However over the third quarter itself, the merchandise trade surplus eroded to US$ 9 billion, in contrast to surpluses of US$ 35 billion and US$ 19 billion recorded in the first two quarters respectively. It is anticipated that the current account will come under further pressure in the final quarter, and as a result accumulation of foreign exchange reserves could ease..

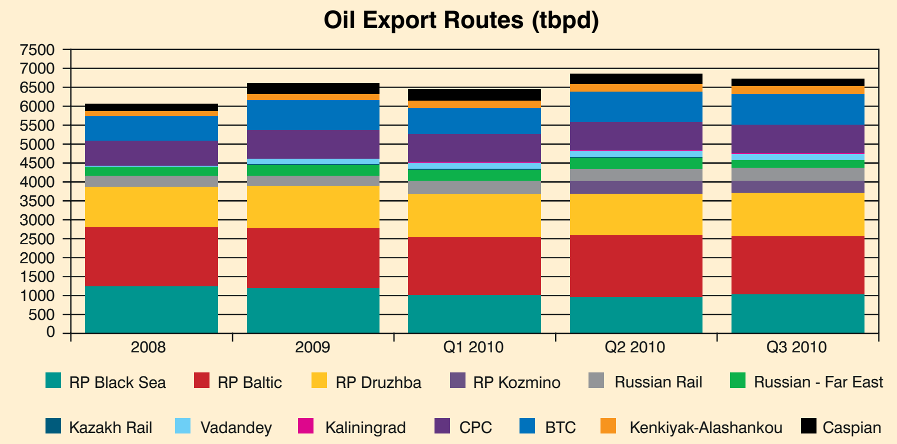
Foreign Exchange Reserves



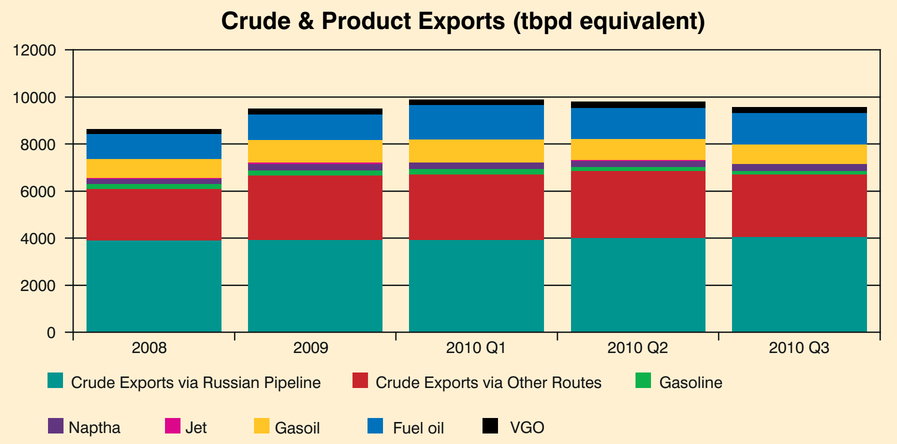
Source: *CBR*

Oil Sector

According to preliminary OPEC data, October saw Russia achieving a new record production level, increasing by a further 100,000 bpd over the month previous to 10.28 mbpd. It is apparent that this is a sustained increased in production, with monthly output setting fresh records six times this year, and OPEC projecting average growth for 2010 of 180,000 bpd, ensuring that average production will be 10.1 mbpd. This increase was due to new fields coming on-stream, such as Ravninnoye, and existing fields starting to move toward production peaks, including those at Vankor, Uvat, and Odoptu. In the context of overall oil exports from the FSU region, Russia remains the predominant exporter. Despite the enhanced levels of production, overall FSU exports fell to 6.36 mbpd in October, the weakest performance since late 2008. This was due to a combination of lower Transneft (Russian) pipeline traffic as a result of increased export duties and the halt of Tengiz (Kazakh) loadings at Odessa (Ukraine). For the year up until October, however exports averaged 7.57 mbpd, some 14% up on the equivalent period last year. This was due to producers using the bulk of their export quota before increased duties came into effect in September, as a result September Transneft exports fell to 3.79 mbpd. The significant decline in Urals crude exports contributed to record high price differentials in the Mediterranean and 14-year highs in Northwest Europe. However, crude exports through the Druzhba (Russian) pipeline increased considerably, partially offsetting the decline in Urals exports. Output from the Tengiz field slumped due to maintenance, although larger volumes were directed toward the CPC (non-Russian) pipeline. While, larger volumes of Tengiz went into the CPC Blend, although overall CPC exports were reduced exports as where BTC (non-Russian) pipeline exports.



Source: *OPEC*



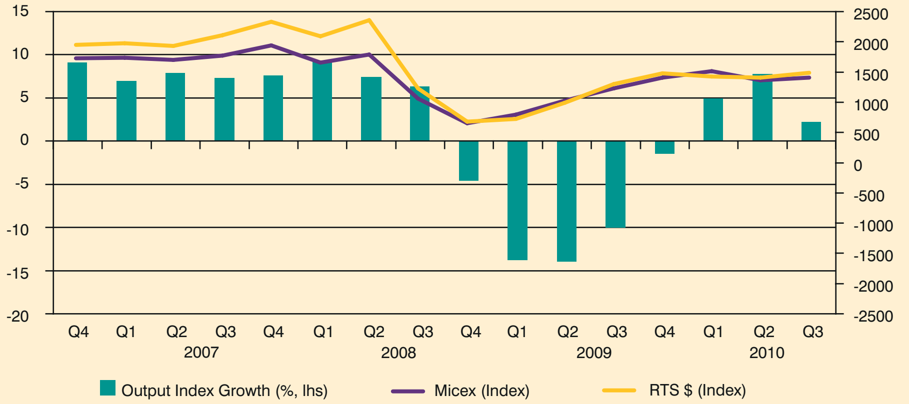
Source: *OPEC*

Similarly product exports declined to the equivalent of 2.68 mbpd in September, a fall of over 5% m-o-m. The decline was however due to refinery maintenance and product hoarding by producers awaiting the phasing in of reductions in export product duty in October. The shift in emphasis in export duty regimes favouring product exporters over crude, should be ultimately reflected in a shift in the export structure. Currently, in October increases were recorded only in gasoline and vacuum gasoil (VGO), with naphtha product at similar levels and other products declining. Adverse weather conditions in the Gulf of Finland (storms) and reduced water-levels (due to drought) in the main inland waterways constrained supply. Significantly, fuel oil exports dropped by 8.3% to 1.27 mbpd, due to higher domestic demand, and utilities are starting to stock-up ahead of the heating season. Gasoil and diesel exports declined in September to the lowest level in two years. Diesel and gasoil exports through the Transnefteprodukt (TNP) pipeline are expected to increase during October. During the first nine months of the year, product exports from the FSU averaged 2.85 mbpd, a decrease of 1.2% compared to the same period last year.

Stock Market

Consistent with global trends, which remain as great an influence as domestic factors, investor sentiment has been unsettled by concerns over future economic prospects. The third quarter downturn has unsettled market sentiment, but stronger final quarter performance is likely to bolster confidence. With 2011 GDP growth anticipated to be more muted, stock market performance can be expected to mirror this, although stronger oil prices could contribute to more positive trends. More significant is the weakness of the fiscal position, which will ensure that the government has to improve the attractiveness of Russia to foreign investors as it is proposing to raise close to US$ 15 billion via privatizations next year and close US$ 50 billion over the course of the medium-term fiscal strategy. As part of this process, the authorities can be expected to seriously pursue WTO membership to a conclusion. In addition, the wider needs of the economy, to enhance value-added production and government aspirations to move away from simple commodity production, is likely facilitate a more investor friendly environment.

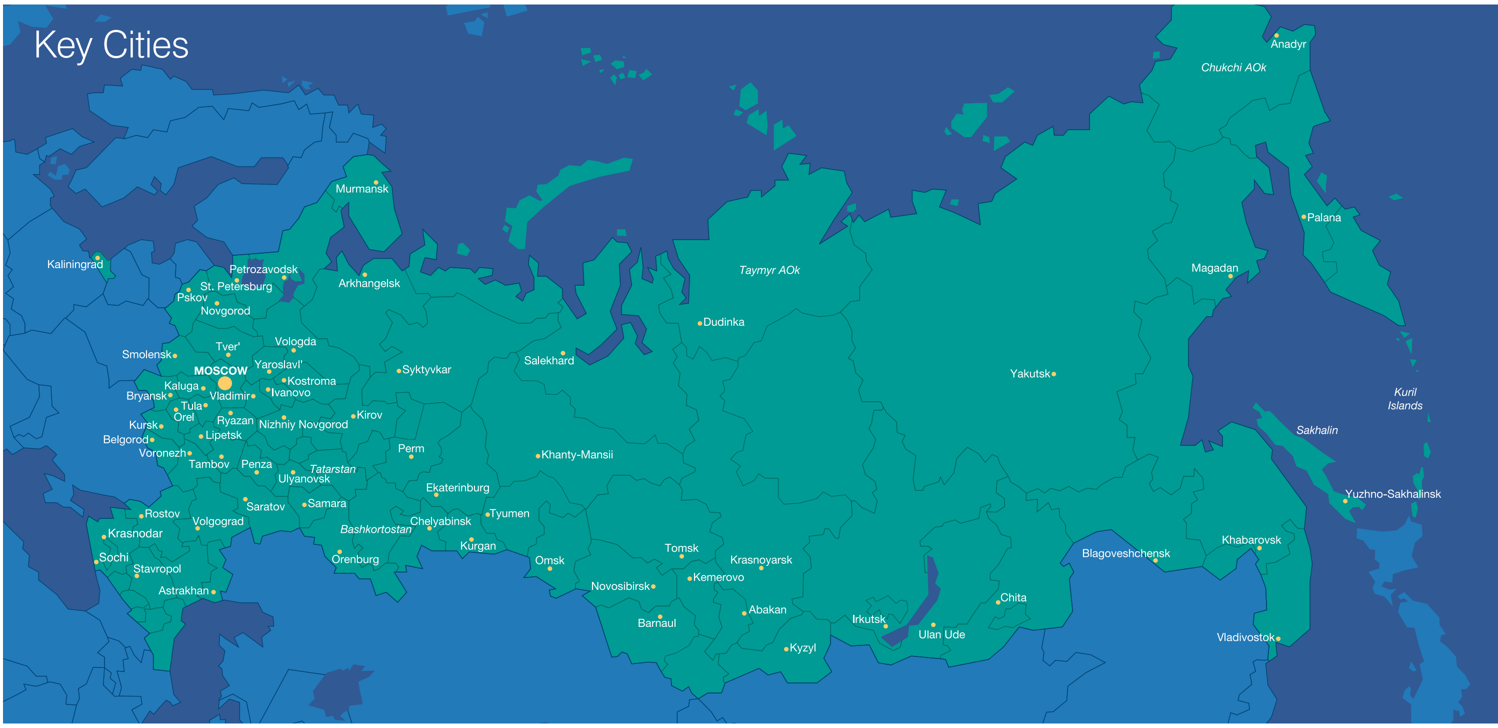
Stock Market Performance



Source: *Federal Statistical Service & Bloomberg*

Some Anecdotes

Russian Federation only emerged as an independent entity in 1991, and the political & economic structure is still evolving after 20 years
Construction of a viable market economy achieved in less time than it took to build Wembley
Export flight of high technology and processes in early 1990s fuelled some cynicism with regard to IP
Raw capitalism of the first years has mutated into a more formal, intelligible business culture but it is not the UK
There are 15 cities with populations close to or over 1 million
Industrial enclave development of the economy: in 1995 there were 11 internationally competitive corporates, now there are over 200, but outside the enclaves infrastructure provision and productivity are largely weak
In 1989 there was one centre of power, in 2010 there are probably over 70
Russia has an historic legacy of Imperial over-reach & Soviet rigidity, but the central problem of transforming the economy from a primary commodity exporter to a value-added producer, has been a focus of successive regimes since the Witte reforms of the 1890s and remains an issue



Basic Facts

Land area:	17,075,400 sq kms (largest globally)
Population:	141.8 (rate of change – 0.1%, 9th largest globally)
Ethnic mix:	Russian 80%, Tatars 4%, Ukrainians 2%, Bashkirs 1%, Chuvashes 1%, Chechens 1%, Armenians 1%, Others 10%
Life expectancy at birth:	74.2 years (female) 61.8 years (male)
Constitution:	Presidential Republic, with bicameral legislature, the Duma
Regions:	83 federal subjects (constitutionally defined areas) comprising 46 oblasts (provinces); 21 republics; 9 krais (territories); 4 autonomous okrugs (districts); 1 autonomous oblast & 2 Federal Cities. In addition, for planning & administration there are 8 Federal okrugs, largely congruent with the main geographic regions.
Next elections:	Duma – December 2011; Presidential – March 2012
Climate zones:	Range from Arctic to sub-tropical
Times zones	9
GDP:	US$ 1.23 billion (UK – US$ 2.18 billion)
GDP per capita:	US$ 8,681 (UK – US$ 35,257)
Structure:	Agriculture 5%; Industry 35%; Services 60% (2009 est.)
Oil reserves:	74.2 billion barrels (13% of global production, 2009)
Gas reserves:	44.3 billion cubic metres (18% of global production, 2009)
Coal reserves:	157010 million tonnes (4% of global production, 2009)
Internet use density	32 (per 100 people)
Time to start business	30 days (according to World Bank)

FORREST RESEARCH

8 Beaufort Way
Aldridge WS9 0HJ
Tel: 01922 457336
Mobile: 07738 324517
mail@forrestresearch.co.uk

www.forrestresearch.co.uk

Forrest Research supports the Snow Leopard Trust
info@snowleopard.org

Snow Leopard Trust