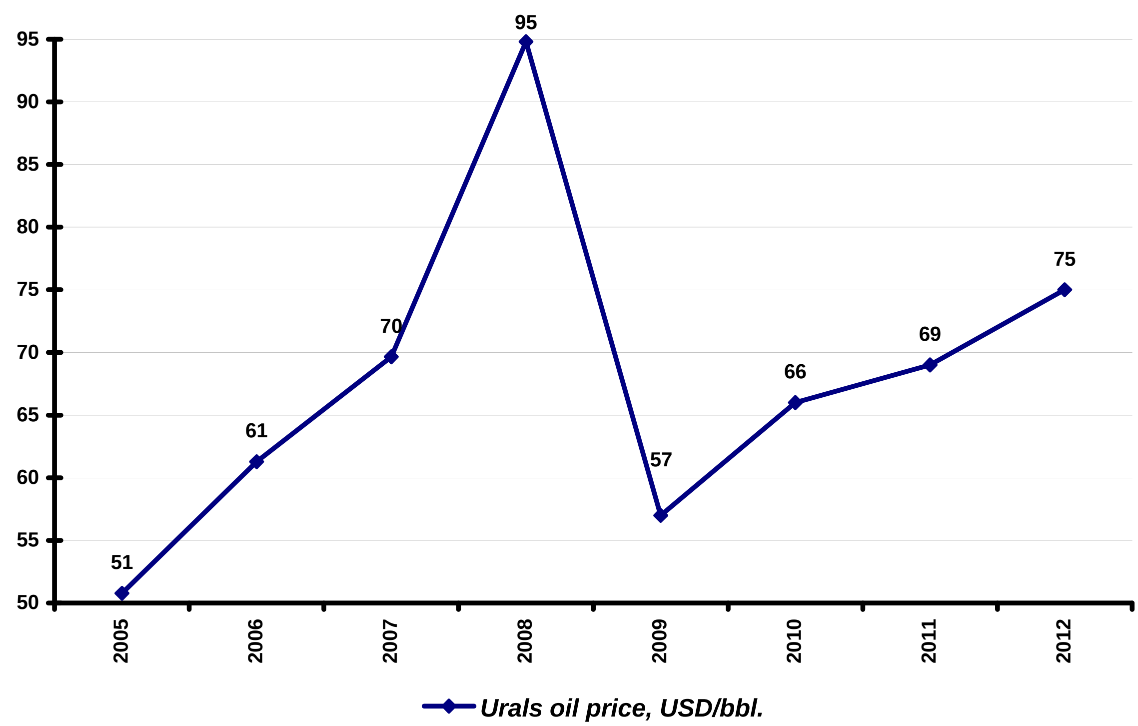
On the development of the Russian economy in 2009 and forecast for 2010-2012

The Russian economy dynamics in 2009 and the medium-term macroeconomic perspective were determined by the processes outlined below:

- reaction of the economy to changes in external conditions, namely, first and foremost to the drop in the world commodity prices at the end of 2008 and beginning of 2009, followed by their partial recovery by mid-2009 (which was, naturally, far from complete); average annual world prices for crude oil declined from $96 per barrel in 2008 to $56-58 per barrel in 2009; the price is expected to further recover to $70-80 per barrel);

Chart 1. Dynamics of world oil prices Urals
(US dollars per barrel)



- correction of the overheated labor, loan and real estate markets;
- overcoming the consequences of the destabilization of the balance of payments at the end of 2008 and in early 2009.

Over the course of the year, the Russian economy went through several stages of development, distinguished by the nature of the problems that arose. In total, three can be distinguished: the first, occurring in January and February - a continuation of the crisis processes carrying over from 2008; the second, covering March through May - a period of financial stabilization; the third, June through September - the stabilization of industrial production.

1. January - February 2009: crisis inertia

The balance of trade crisis at the end of 2008 and increasing capital flight rate (stimulated both by negative expectations and by the actions of the Central Bank, which was maintaining the liquidity of the banking system, thus creating a resource for purchase of foreign exchange by both banks and companies) led to rapid growth in foreign exchange purchases and devaluation of the Ruble.

Net capital outflow from the non-government sector in January-February 2009 reached 26 billion USD (total since August 2008 was 194 billion USD). The exchange rate dropped from 29.38 Rub/USD at the end of December 2008 (compare to 24.58 Rub/USD at the end of August 2008, preceding the crisis) to 35.72 Rub/USD at the end of February 2009.

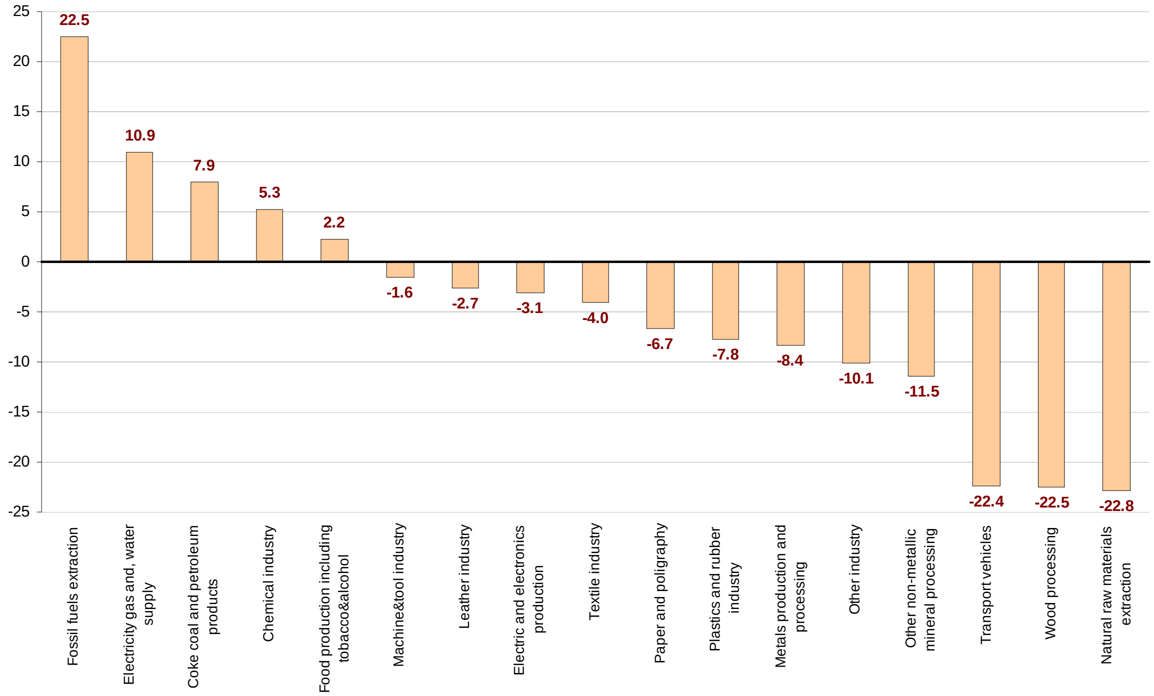
At the same time, adverse processes occurred in the real sector of the economy. Prices changes in international and domestic markets concurrent with growing wages in real terms (and under the conditions of increases in regulated prices for gas, tariffs on electricity and railroad cargo transportation), led to plummeting incomes in practically all major sectors.

A significant factor that exacerbated the financial plight of enterprises was the increase in "non-sale expenditures" related to revaluation of foreign exchange liabilities during times when the Ruble was devalued[1].

[1] It is important to note that due to devaluations in Russia's trade partner countries (including CIS countries), the positive effect of the Ruble devaluation was quite limited, ending up about 30% weaker than expected.

On the whole, for the process industry sector the loss ratio (the ratio of the net financial results to costs) in the first quarter amounted to 2.8%; specifically, for metallurgy it reached 8.4%, and for machinery and equipment manufacturing, 11.5%.

Chart 2. Profit rate by sector in the first quarter 2009

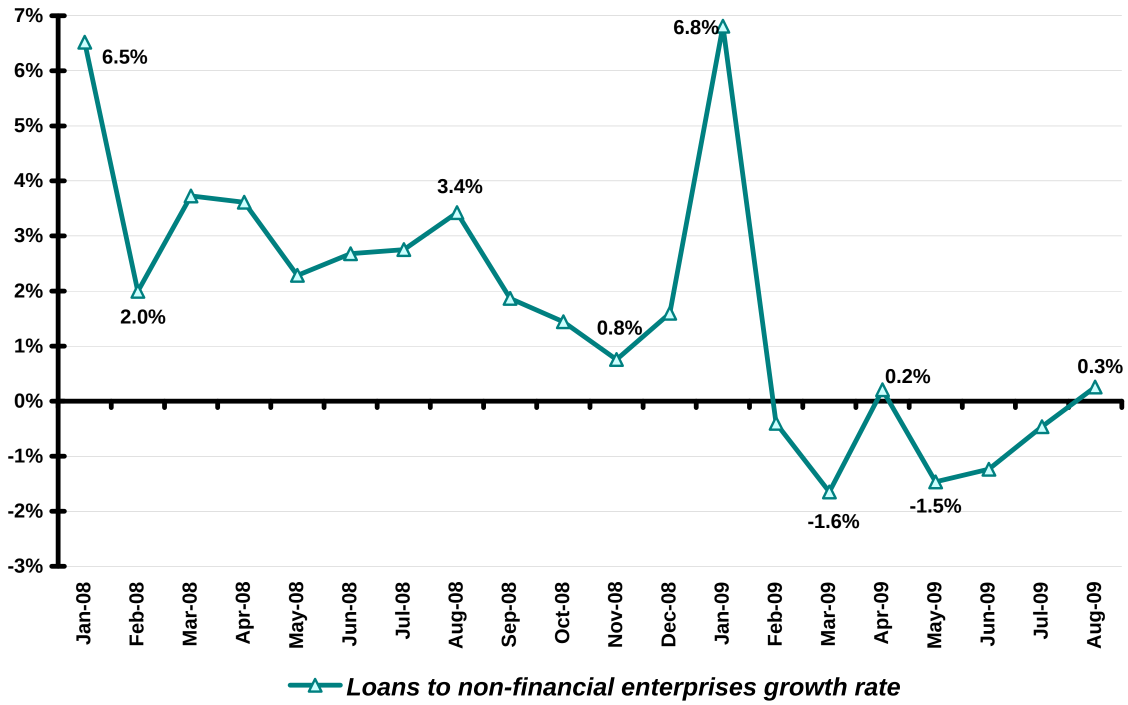


Given rapidly intensifying risks in the loan sector (the share of arrears on loans to enterprises in February reached 3.8%, compared to 2.4% in December, and just 1.1% in August, excluding Sberbank) and contracting capital inflow from abroad, investments in fixed capital started to decline rapidly. In February their decrease compared to February of the previous year reached 14.8%, with a steady trend to continuing decline.

At the same time, a crisis in short-term lending was developing. While in January - February 2008 the volume of short-term loans to enterprises and individuals grew by 6.5%, in January - February 2009 it dropped by 3.7%.

Chart 3. Loans to non-financial enterprises

(rate of growth as % of the previous month's value)



The logical result from the reduction in lending was a crisis in the working capital of companies that affected practically all sectors of the Russian economy.

That, in turn, brought about a decline in production in a broad range of sectors of the Russian economy. While at the time the crisis began (at the end of 2008) the decline could be clearly tied to the sectors primarily affected by the investment and export-oriented industries, now the decline practically grew into a frontal offence, having spread into all major industries, including the consumer sectors.

In the end, the industrial decline as of the results for January-February reached 14.6% compared to the corresponding period of last year.

At the same time, the potential for stabilization of the situation could already be seen during that period. That pertained first of all to the foreign exchange markets and the financial system.

At the end of 2008 and the beginning of 2009, monetary authorities working to stabilize the exchange and financial system were able, in general, to ensure a successful balance in resolving several conflicting tasks:

- reducing the incentive for capital outflow from Russia by devaluing the Ruble and finding a new level of balanced exchange rate corresponding to the changed situation in the global markets;
- reducing the pressure on gold and foreign exchange reserves by limiting the money supply dynamics ("expensive money" policy);
- supporting the financial stability of the banking system via deposit insurance agencies, through the system of state-run banks and by introducing various means of market distribution of resources (unsecured loans, etc.).

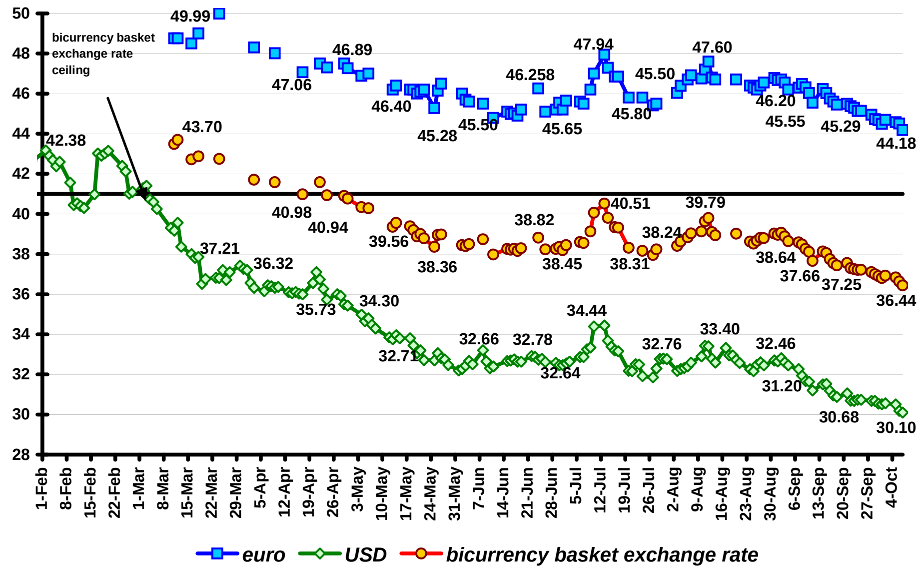
As a result, conditions became suitable for ending the period of Ruble devaluation and establishing, starting in February, a fixed level for the upper limit of exchange rate fluctuation (41 Rub to a "euro-dollar" bi-currency basket which was, at the time, equivalent to about 36 Rubles per US dollar).

2. March - May 2009: stabilization in the monetary and financial system

Ending the period of devaluation of the Ruble along with an "expensive money" policy (average rate on the loans placed by the Bank of Russia was 15.5% in March and 13.5% in May) led to a qualitative change in the economic situation.

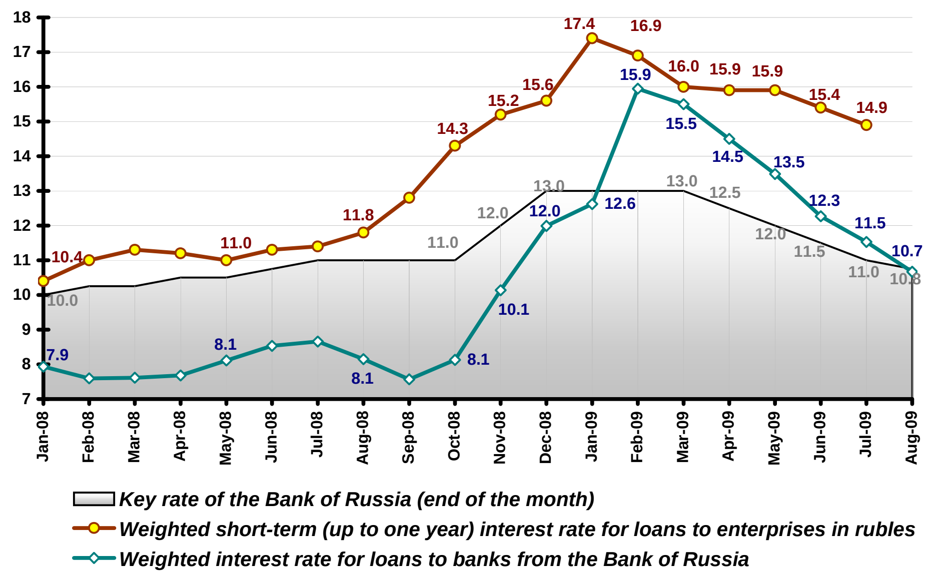
On the one hand, the pressure on the foreign exchange market eased considerably. The market accepted the new level of the exchange rate: over subsequent months the actual exchange rate never even came close to the set limit. Following a brief period of fluctuation, the futures contracts market also remained within the foreign exchange rate ceiling.

Chart 4. Futures contracts for exchange rates of currencies against the Ruble for December 2009 (rates shown at the prices as of the latest transactions of the main FORTS session, in Rubles)



On the other hand, the "expensive money" policy was continued in order to reduce the pressure of the foreign exchange market. The cost of loans received by companies from commercial banks reached 15.9% in May (reflecting the heightened risk levels).

Chart 5. Credit interest rates (% per annum)



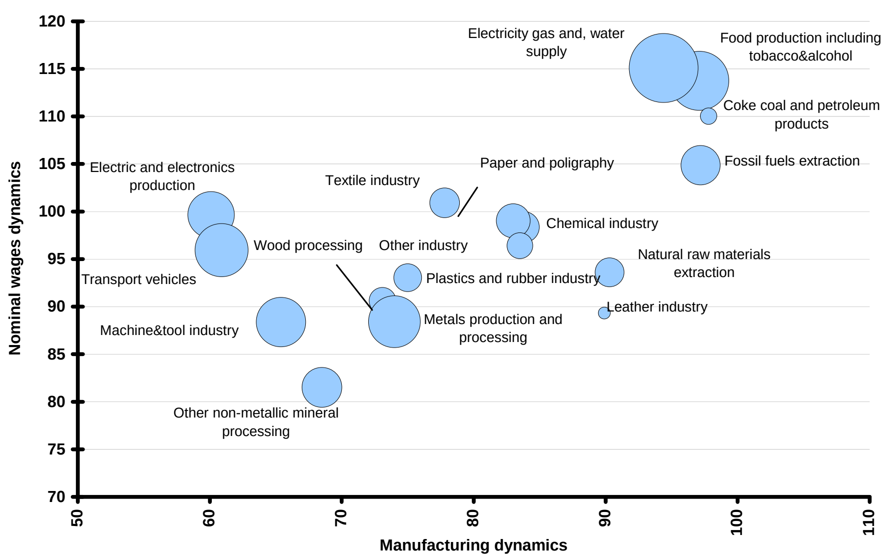
This situation, which triggered the appropriate adaptation processes, had a number of systemic effects at the level of companies, the public and the financial markets.

For **companies in the non-banking sector,** the new situation meant a need to transition to financial self-sufficiency, both in terms of investments and of working capital, while in the state of declining levels of business profitability.

This resulted in probably the most notable of the crisis processes, which was the internal adaptation of the companies in the real sector to the changed conditions of development. According to the available estimates, these changes affected nearly 90% of Russian companies. In addition to purely organizational changes aimed at optimizing the business processes, one could see the elimination of the core imbalance lying in excessive labor costs as compared to productivity. Thus in 2008, in dollar terms, wages approached levels observed in Eastern European countries: the Czech Republic, Slovakia, and Poland.

Given the constraints present in the regions for releasing the labor force, the most important instrument of the adaptation lay in stopping the growth in real wages. Moreover, in the majority of processing industries it even started dropping.

Chart 6. Manufacturing and nominal wages dynamics by industry (half-year 2009 to half-year 2008)



In combination with the labor release that still intensified, it resulted in declining wage pressure on the financial resources of companies. Given that prices on primary commodities increased at about the same time, practically all industries were within the profitability range by mid-2009 (refers to the raw materials sector to a more significant extent))[2].

For the banking system. the new situation meant, on the other hand, the need to function while relying on expensive funds it had to attract (public deposits, the interest rates on which reached 12.6% by the end of May, and funds obtained from the Bank of Russia), and on the other hand in the situation of growing credit risks. This was indicated by an increase in late payments on bank loans of up to 6% by the end of May, and according to estimates including the masked portion - 14% (a level of 10% is considered critical). In addition, these developments coincided with a deterioration in the collateral quality on the loans; this process was driven by a decline in real estate prices.

The natural results were a reduction of the lending activities of the banks and stricter demands for the financial stability of borrowers.

In general, primarily large (mostly state-run) banks were the ones that remained in the loan market. They had additional capacity to work with the borrowers (well-developed networks of branches in the regions, mass-market standardized lending products, well-established systems for working with corporate borrowers, etc.)[3].

On the whole, however, with respect to the main ranks of commercial banks and their borrowers, a negative self-reinforcing loop started to form:

growth of arrears on loans to companies and the public – increasing the level of reserves against problem loans – reduction in credit resources – decline in the volume of lending to companies – difficulties in raising working capital – growth of arrears

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[2] In addition, the companies received a certain amount of "non-sales" revenue due to initial signs of the strengthening of the Ruble and revaluation of their foreign exchange liabilities.

[3] Besides that, it is important to bear in mind that the state-run banks were tasked with increasing their lending volume (2% per month in nominal terms).

For the banks the new situation may be described as "functioning under conditions of expensive credit resources".

On the one hand, the funds borrowed by the banks from the Bank of Russia became more expensive (in the end, the high price led to a reduction in this type of lending). On the other hand, persistent high inflation and the decreasing propensity of the public to save gave rise to an increase in interest rates on public deposits.

As a result of this situation (taking into account high risks of lending to the real sector and exhausted opportunities for risk-free play on the growing exchange rate), liquidity was being crowded out into the stock exchange markets. Accordingly, rapid growth of the stock indices started: RTS grew from 545 points in the end of February to 1088 points by the end of May)[4].

3. June - August 2009: beginning of stabilization or a respite in decline?

The middle of the year was marked by the establishment of a complex balance of positive and negative factors. That makes it difficult to offer a simple interpretation of the current situation.

On the one hand, for the first time since the end of 2008 we could see a slowing of the decline in the rate of production. As far back as May some signs of revival could be seen in the industrial sector (+0.3% over the previous month, corrected for seasonal factors); it peaked in June and July (at 2.1% each month). As a result, in July the depth of the recession in the industrial sector decreased to 10.8% compared to July 2008, against 15.4% on average for the second quarter.

The developing stabilization was based on three factors. On the one hand, the companies were adapting to the need to become self-sufficient financially, and that

[4] This growth was additionally driven by an influx of foreign capital into the financial market due to the reduction in the rate-related risks of the Russian market.

brought results[5]: the level of investments in fixed assets has stabilized (+5.8% in June, +2.9% in July, change against the previous month, corrected for seasonal factors). To a significant extent, investment activities were concentrated in medium-sized businesses (while larger and the largest companies - for example, Gazprom - are reducing their investment programs)[6].

Secondly, the effect of the world market growth of prices of natural resources - especially oil - has reached Russia (with the inevitable lags associated with the timeframe of returning export proceeds into the Russian economy). While in the beginning of the year serious discussions were held (at the level of preparing official forecasts by the Ministry of Economic Development of Russia) on the possibility of oil prices "sinking" to 40 USD per barrel (Urals), it became clear by the middle of the year that the new price fluctuation range is around 60-70 USD per barrel.

Finally there were some signs of easing access of companies to loans, which was indicated by surveys taken among heads of enterprises. Therefore, this enabled the latter to break the cycle of "reduced access to credit for enterprise - growth of arrears" which had predicated a risk of significant deterioration in the situation, both in the banking sector and in the real sector (see above). Improved access by Russian companies (primarily the large ones) to refinancing in the external markets served as an additional factor.

At the same time it seems that the very mechanism of the enterprises' adaptation to the new conditions harbored the basis for future difficulties.

The key point here, as confirmed by the results of the surveys among the companies, was the reduction in the employment level and real (and sometimes even nominal) wages as an instrument for adapting to the reduced profitability of business activities. Consequently, the growth of real wages during that period had stopped, and real income

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[5] An additional positive factor noted from surveys of the companies lay in the normalization of the situation with inventories. In particular, that referred to exhaustion of excess stocks of resources and raw materials that were laid down back in 2008.

[6] According to the available survey-based estimate (*Russian Economic Barometer*), 33% percent of Russian enterprises are ready to start "major investments" (50% at mid-2008)

and private consumption began to decline (an added powerful factor for public consumption was the growth of payments due on the consumer loans taken out by the public at an earlier time).

Accordingly, the potential for economic stabilization was determined by the resultant force from the two opposing trends: revival of exports and (to a certain extent) internal demand for investments along with shrinking consumer demand.

Given that the latter factor is likely to have come into play in earnest and for the long haul, one has to state that economic growth was not and could not have been sustainable. Already in August the rate of growth in the industrial sector dropped again down to 0.4% (seasonalities excluded) and further slowing is quite likely.

There is an additional adverse factor - namely an emerging trend toward a decline in world market oil prices (dropping down to 67 USD per barrel by the beginning of October from the peak level of 75 USD per barrel at the beginning of August 2009).

4. Forecast for 2010-2012

The key question at the moment is whether there will be a second wave of economic recession, or could one expect that the reduction in consumer spending will slow down and the initial growth will acquire the necessary sustainability.

Fiscal policy

The basic idea of fiscal policy for 2010-2012 is aimed at gradual movement towards a balanced budget, along with a gradual closure of anti-crisis budgetary programs.

Depletion of the reserve funds within the federal budget (according to the draft federal budget, the Reserve fund will be depleted already in 2010, and by the end of 2012 the National Wellbeing Fund will be reduced by two and a half times compared to its current level) naturally leads, even with inclusion of possible borrowing, to a reduction in the capacity to finance a federal budget deficit.

It is expected to drop from 8.3% of GDP in 2009 to 6.8%[7] in 2010, to 5% in 2011 and 3% in 2012.

Given that in accordance with the draft federal budget budget revenue will decrease from 17.2% of GDP to 15.0% of GDP, a significant reduction in budget expenditures can be expected. Even in nominal terms (in current prices), in 2012 they will end up at somewhat below the level of 2009, which is naturally to a great extent related to the extraordinary anti-crisis expenditures that were accepted for the current year.

However, all of the next three years will be noted as years when federal budget expenditures will shrink in real terms for the first time since 1998 (in 2010: -9.5%, in 2011: -12.1%, in 2012: -3.6%). Therefore, the contribution of federal budget spending to economic growth is becoming negative – again, for the first time in recent years.

Exchange rate

Dynamics of the exchange rate during the period reviewed will be determined by the effects of two diametrically opposing factors:

On the one hand, the exchange rate of the Ruble will be supported, due to the sufficiently favorable situation in external markets and (quite likely) a continuing inflow of speculative capital into the Russian market.

On the other hand, an excessive strengthening of the Ruble leads to the reduced competitive advantage of Russian goods. This is likely to cause both an acceleration in import growth and actions of the monetary authorities to slow the strengthening of the Ruble.

In view of this, one can expect in 2010 a continuation of the current trend toward moderate strengthening of the Ruble both against the US dollar and (to a lesser extent) against the dual currency basket. In the future some weakening of the Ruble can be expected, to a level somewhat below average for 2009.

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[7] Which is above earlier projections (5-5.5% of GDP), which indicates there is a desire to preserve fiscal stimulus for the economy.

Chart 7. Dynamics of the Ruble exchange rate (Rubles)

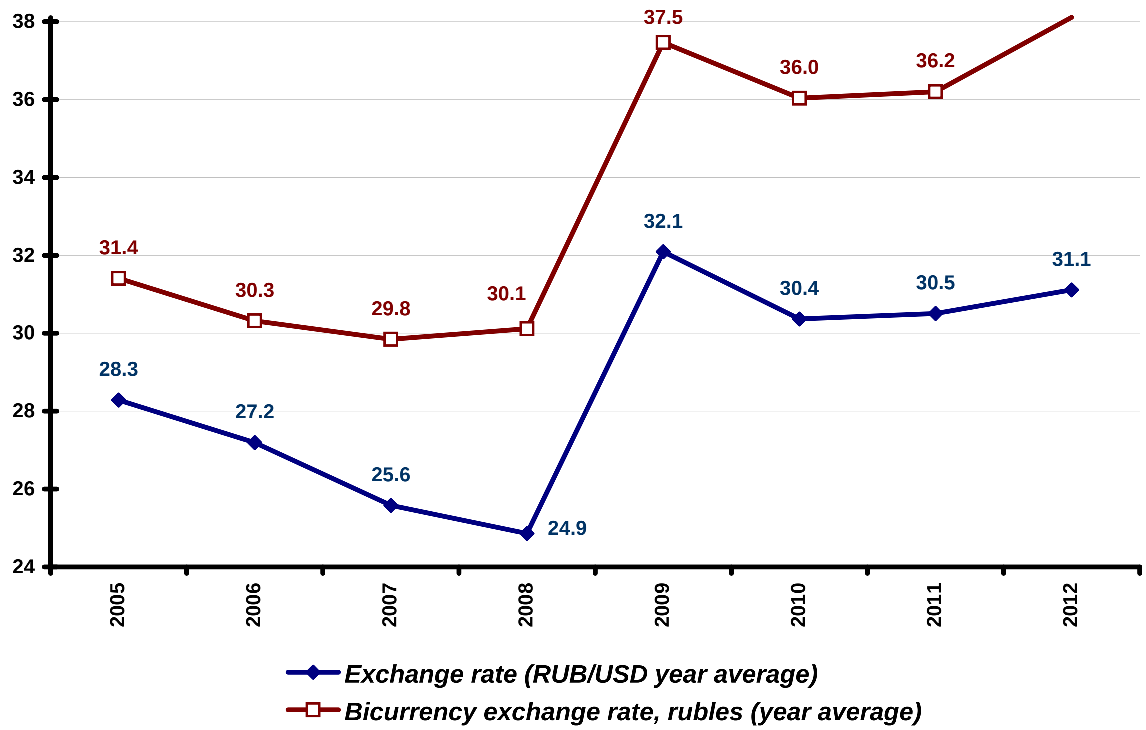
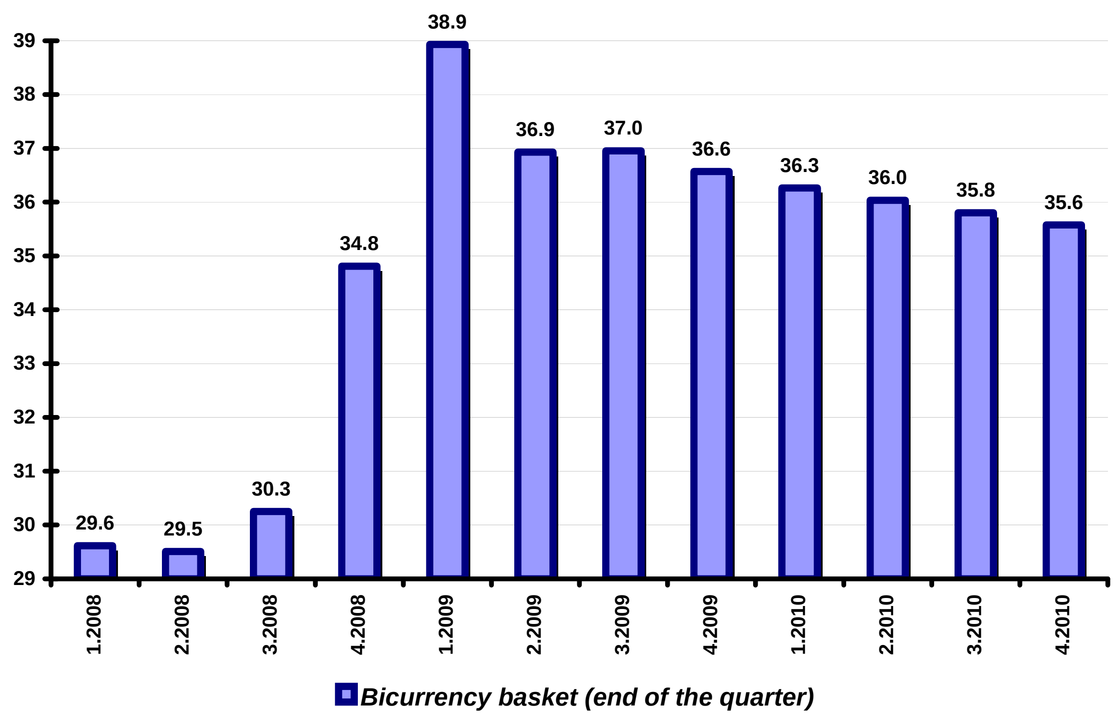


Chart 8. Dynamics of the Ruble exchange rate against bicurrency basket (at quarter end, Rubles)



GDP Dynamics

A moderately optimistic scenario for the development of the Russian economy is expected. This year the first signs of economic growth will emerge and manifest themselves as a reduction in decline as compared to the previous year: from 9.8% in the first quarter to 5.1-5.2% in the fourth one. Next year, 2010 will become (as it will be for the global economy as a whole) the year for macroeconomic stabilization. The rate of economic growth of GDP will not exceed near-stagnation levels at 1.5-1.6%. It will only be by the end of 2012 that the accumulated growth in the Russian economy will make it possible to overcome the consequences of the economic recession of 2009. Throughout this period of time economic growth will be considerably slower than the 5% which is necessary, according to the estimates, for long-term stability of the Russian economy, social sector and national defense.

At the same time it is necessary to point out that throughout the entire period of the forecast, the rate of growth of the Russian economy will exceed the general global level (even though not by as much as in 2005-2008).

Chart 9. Dynamics of GDP

(growth rate compared to the respective quarter of the previous year, %)

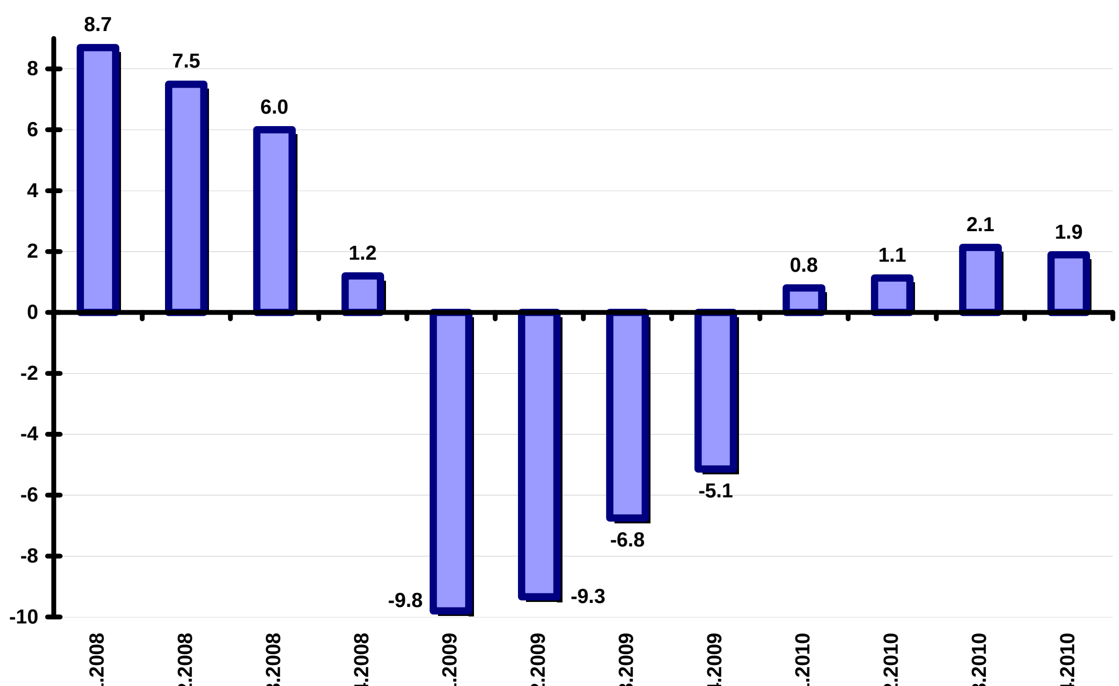
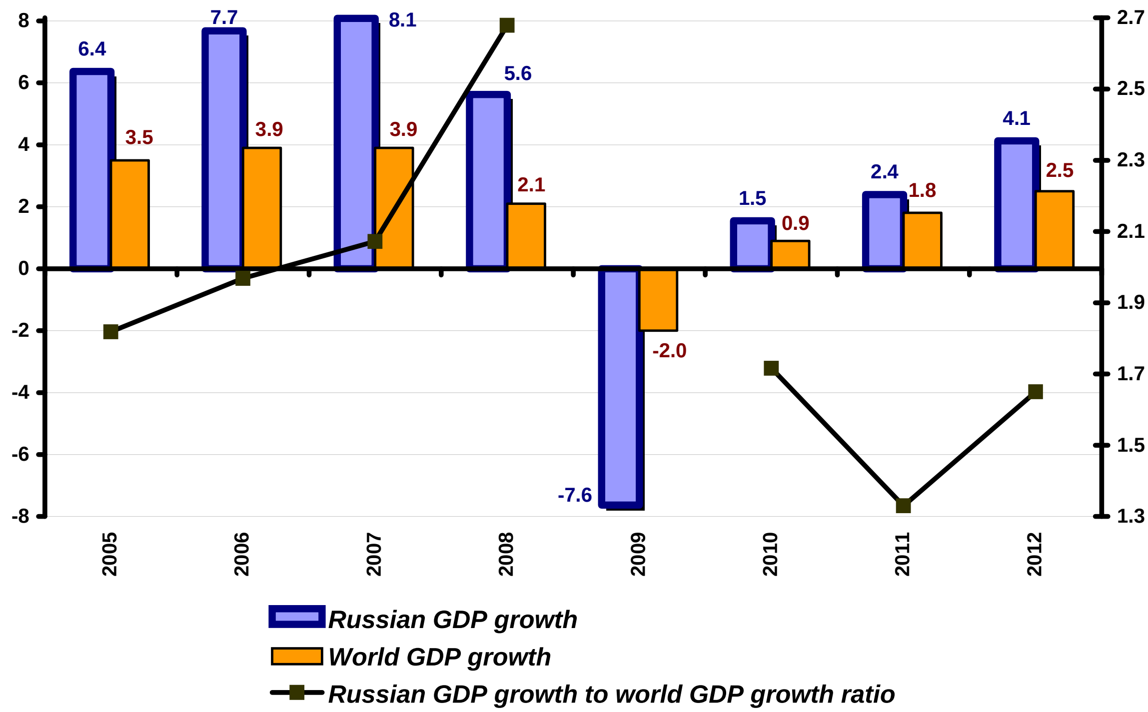


Chart 10. Dynamics of Russian and global GDP (growth rate, %)



Fixed capital investments

Investments in fixed assets shall remain the most important driver for economic growth. However, their dynamics are going to stay at a much lower level than during the period preceding the crisis (at a maximum of 7.5-8% in 2012) whereas prior to the crisis investment rates stayed in the double digits for a long time.

At least in the early stages (2010-2011), the key role in the investment process will likely be played by mid-sized companies at the regional level, along with foreign investments. At the same time, one can expect a reduction in the scale of government investments (see above) and in investments from government-run companies, which have announced a reduction in investment programs.

Further on (in 2012 and subsequent years) investments by state-run companies (Gasprom, first and foremost), are likely to resume intensive growth, specifically as they are implementing a number of large-scale projects in the extraction and transportation of energy products (Shtokman Gas Field, Nord Stream, etc.).

Chart 11. Quarterly dynamics of fixed capital investment (growth rate compared to the respective quarter of the previous year, %)

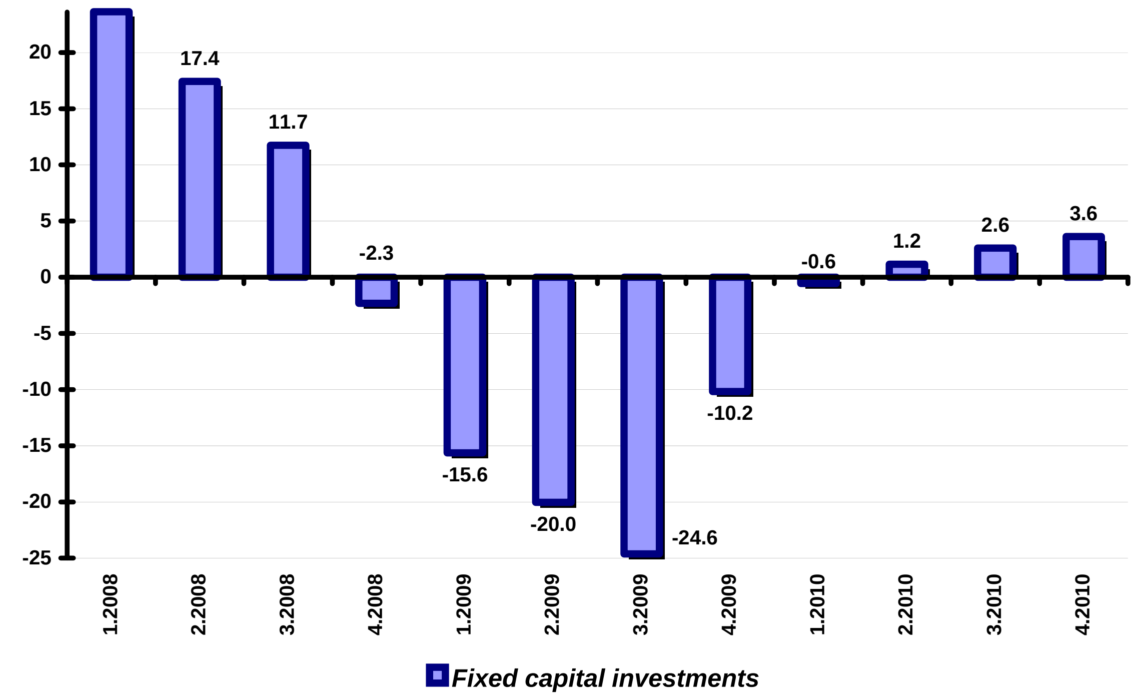
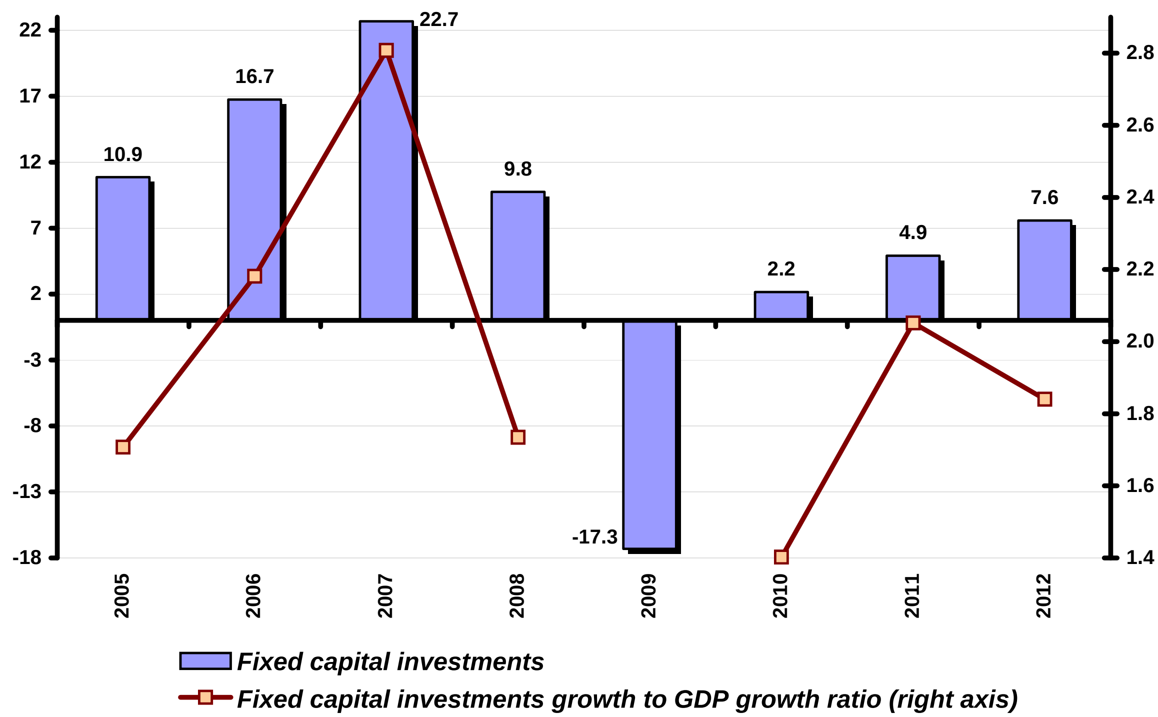


Chart 12. Dynamics of fixed capital investment (growth rate, %)



Household revenue and consumption

The contribution of retail sales to economic growth will gradually decline. It is expected that further down the road retail sales dynamics will be less and less ahead of general economic growth: by 2012 the relation between the rates of growth of the retail trade and GDP will drop to an unprecedentedly low level of about 1.3 (in 2005-2008 it was, and in 2010 it will be at about 2).

Household consumer spending will be affected by two diametrically opposing trends. On the one hand, it will be constrained by the slowing dynamics of real wages as part of the enterprises' trend to improve the health of their financial status by bringing it closer to the growth rates in productivity. On the other hand, it will be supported by the propensity of the population to spend related to the reduction in household savings in the form of financial assets.

Chart 13. Quarterly dynamics of real wages and retail sales volume (growth rate, as compared to the respective quarter of the previous year, %)

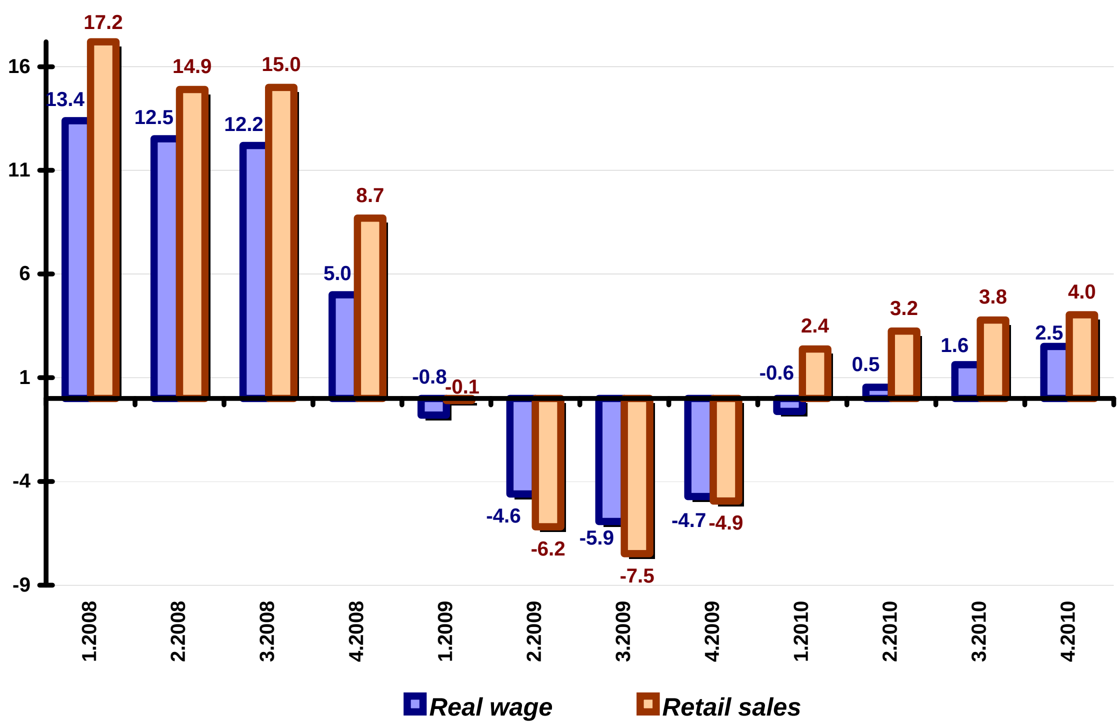
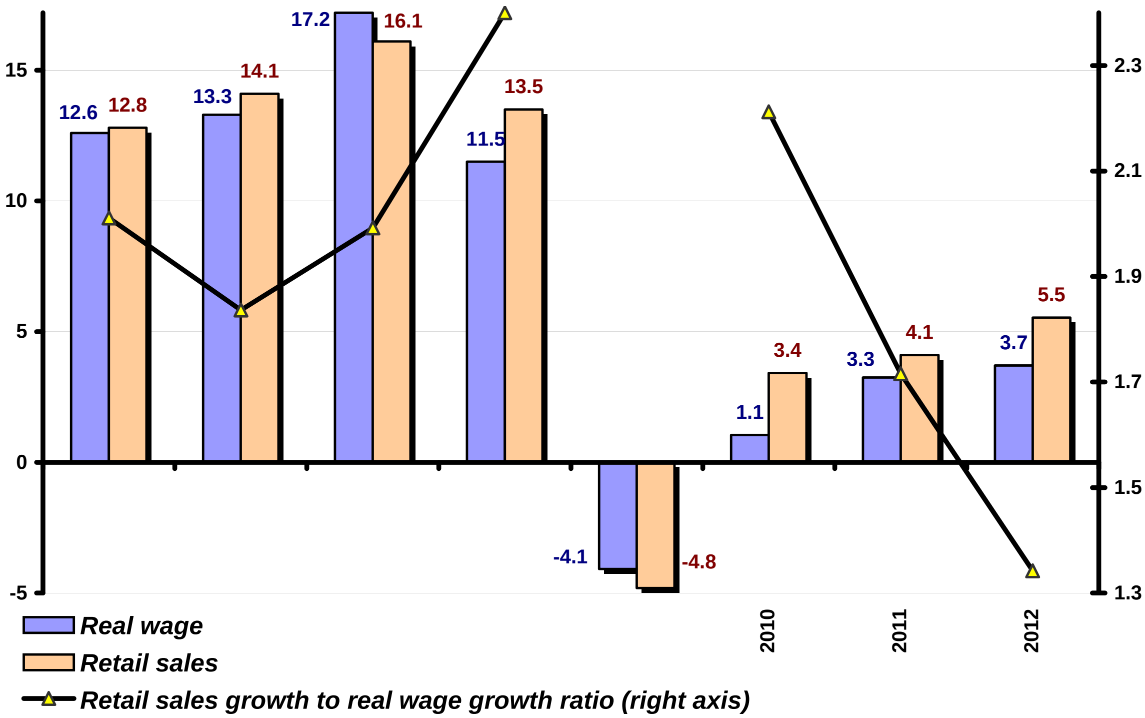


Chart 14. Dynamics of real wages and retail sales volume (rate of growth, %)



Export and import of goods. Balance of trade

Recovery in external trade turnover volume is expected in the future. It is expected that both exports and imports will grow at very high rates, ahead of the general trends in the economy.

A stable balance of trade surplus is expected to continue (in this scenario - partially due to the transition, starting in 2011, to a mild weakening of the Ruble relative to the US dollar and the Euro - see above).

It is notable that exports are expected to grow, not primarily due to the increase in oil exports (oil extraction and piping rates will be constrained, due to depletion of the existing oil fields and the high costs of developing new ones), but due to other types of products.

It is probable that a significant role here will be played (naturally, in case the necessary infrastructure is successfully developed) by exports of gas, which is expected to return to the pre-crisis volume of about 190 bln m^3 in 2012 (in terms of physical volume).

Chart 15. Quarterly dynamics of the main foreign trade indicators (bln USD)

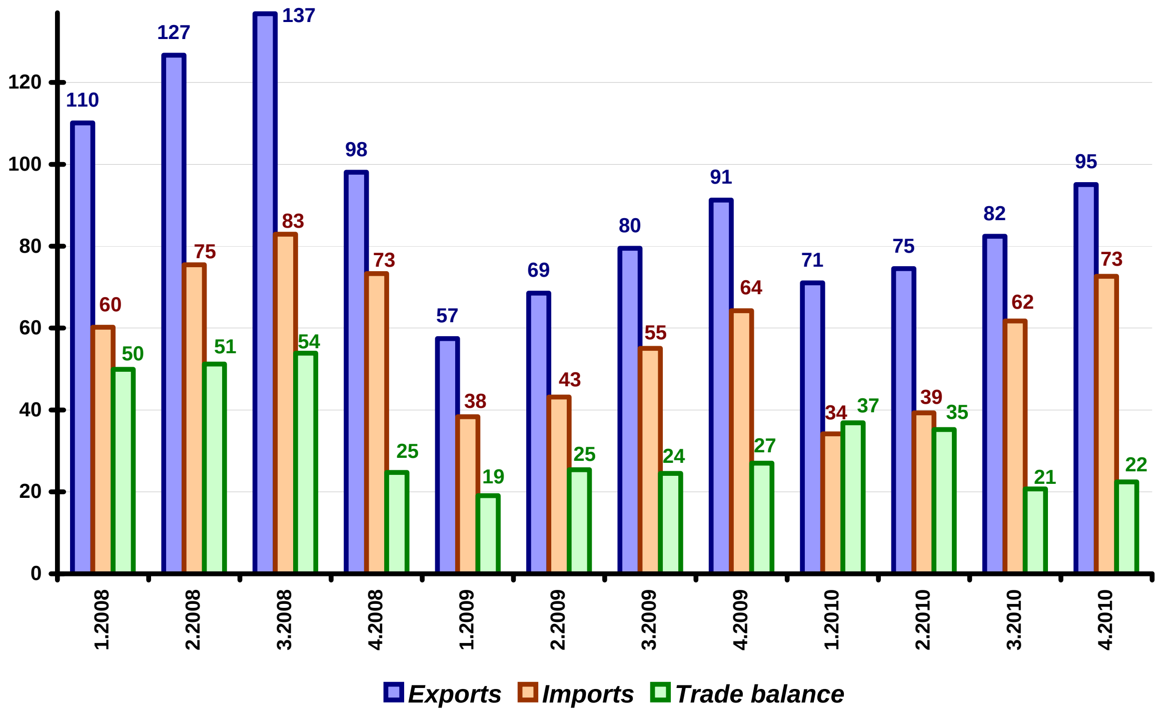


Chart 16. Dynamics of the main foreign trade indicators (bln USD)

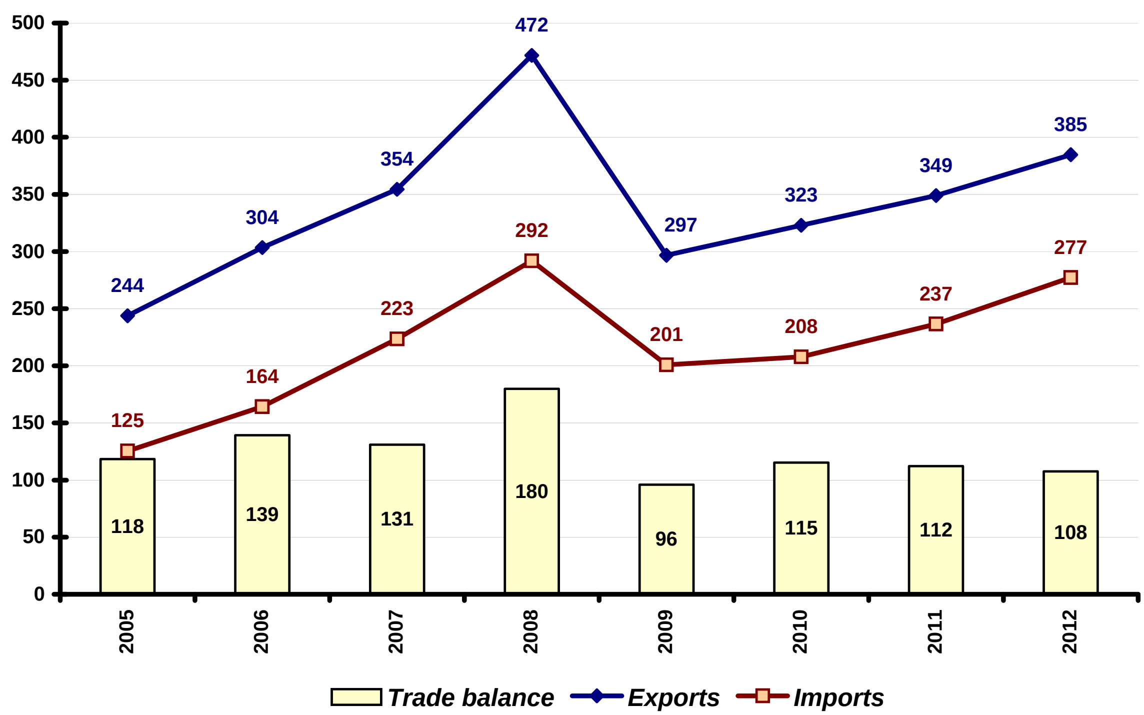


Chart 17. Dynamics of exports of hydrocarbons

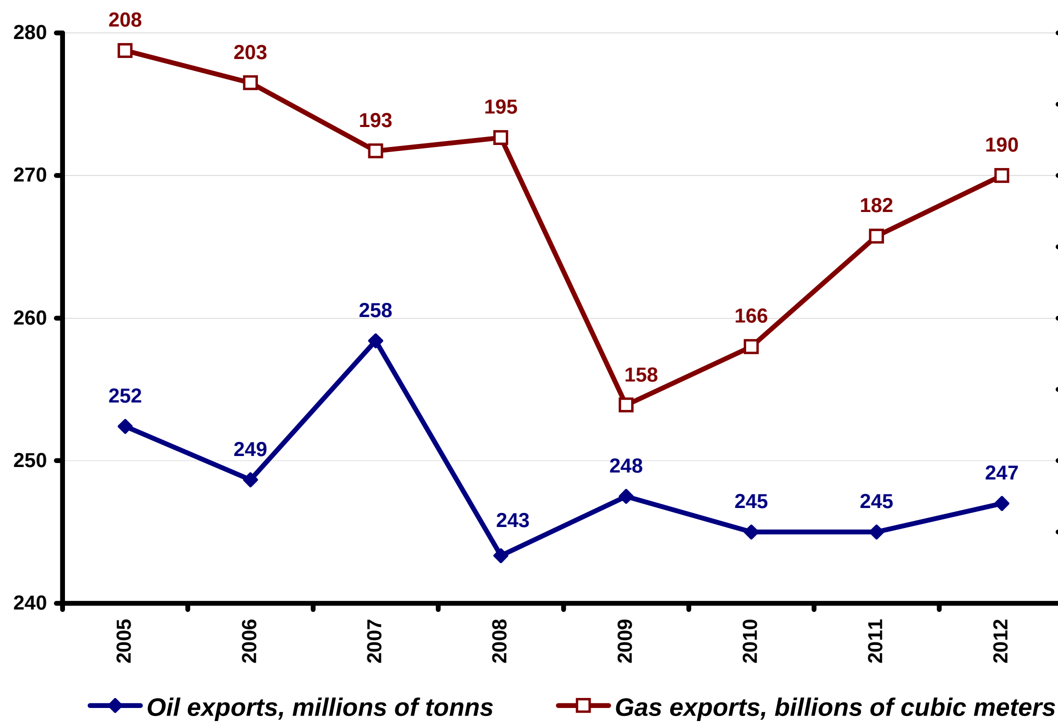
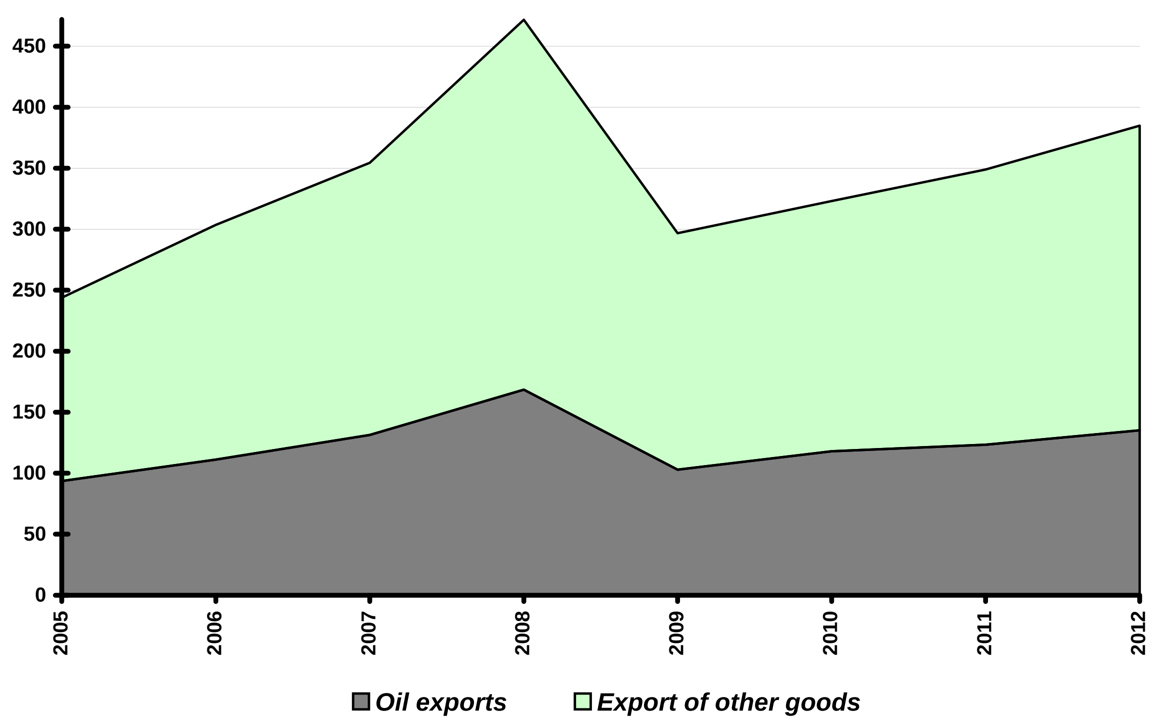


Chart 18. Structure of commodities exports (bln USD)



Inflation

Completion of reforms in the area of natural monopolies and a moderate inflow of foreign exchange through foreign trade channels will lead to a decline in the level of inflation. Starting as early as 2010 it may drop into single digits (9% in 2010, which corresponds to the best pre-crisis results). By 2012 it may decrease to 6.5-7%.

Chart 19. Dynamics of inflation

(consumer price index, growth rate, %)