RUSSIA

Economic

Credit Agency Ratings
Moody's: Baa1
S&P: BBB
Fitch: BBB

Nominal GDP (2009)
USD 1.23 trillion

Population (2009):
141 million

Total Trade / GDP:
48%

Currency:
Russian rouble

Exchange Regime:
Managed float

Merchandise Imports from Canada (2009):
CAD 798 million

Main Sources of Foreign Exchange (excl. FDI):
Foreign borrowing, energy exports

Largest Trading Partners:
Netherlands, Germany, Italy China, Ukraine

Main Imports:
M&E, motor vehicles, steel products, medicine, and communications equipment

Sources: IMF, EIU & Statistics Canada

Risks to the Outlook:

Rising commodity prices sustainable renewal of lending growth

Relapse in global risk appetite and growth Failure to deepen economic, fiscal reform

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Market Spotlight: Curbed access to foreign capital, coupled with the slump in global demand for commodities and industrial goods, took its toll on the Russian economy last year. While growth bottomed in mid-2009 and oil prices have been supportive in the last year, a weak credit climate and labour market continue to constrain Russia's scope for a swift recovery. This patchy trajectory is further reinforced by inconsistent dynamics in the external environment, especially as they affect trade, capital flows, and asset prices.

Real Economy: While the economic downturn has run its course, robust and sustainable recovery remains a distant prospect; borrowing costs are high with interest rates now in positive territory, credit growth – stagnant, and structural weaknesses – more prominent than in the pre-crisis era. The Russian economy grew by 3% y/y in Q1 in spite of a strong base effect, posting a contraction on a quarter-over-quarter basis. Manufacturing activity has been benefiting from improved external demand, the state's car-scrap scheme, and the population's rising real incomes. Financial services, retail trade, construction, and real estate, meanwhile, remain depressed. The turn in the inventory cycle should continue to offer a lift to growth this year, with household consumption drawing further strength from pension and public sector wage increases. We expect domestic demand to be subdued into 2011, however, particularly as investment activity will remain very limited.

Fiscal policy: Russia's fiscal position has outperformed expectations so far this year, owing largely to a supportive oil price environment. This has allowed the government to scale back its planned borrowing program and should enable it to bridge more of its financing gap using the Reserve Fund. The medium-term fiscal program targets a narrowing of the budget deficit substantially by 2012, though our expectation of weak GDP growth, limited oil price and volume growth, and the challenges of reining in social spending ahead of elections through 2012, lead us to anticipate still substantial red-ink spill beyond 2010. The government's highly successful Eurobond placement in H1 – the first in over a decade – meanwhile, attests to the health of its market access.

Monetary & Exchange Rate Policy: With domestic demand soft and little new lending taking place, consumer price growth is at a 10-year low (+6% y/y in June). The central bank, which has cut policy rates by a cumulative 5.25 percentage points since April 2009 is, meanwhile, unlikely to maintain a loose monetary stance moving forward; not only does the monetization of the fiscal deficit signal inflationary pressures, but so does the recent run-up in grain prices. The *rouble* continues to benefit from historically high oil prices, though given the limited upside we see to these and growth beyond 2010, significant further appreciation is unlikely. Russia's exchange rate policy has grown increasingly flexible through the crisis, and central bank interventions appear likely to continue to focus on limiting the currency's volatility.

External Accounts: Assuming oil prices average $75/bbl this year and next, the current account should maintain a comfortable surplus while net flows of capital reverse, albeit modestly, from last year's USD 52bn outflow. With the real effective exchange rate approaching pre-crisis levels and the rebound in manufacturing raising demand for intermediate goods, imports have edged up in recent months. It will, however, take time for imports of capital goods to recover given the slump in domestic investment. Rollover rates on corporate and bank debt have held up well, though Russia registered a net capital outflow in Q1-10 in contrast to the net inflow recorded in Q4-09. Volatility is likely to remain considerable into 2011 in light of the lingering uncertainties in the global economy.

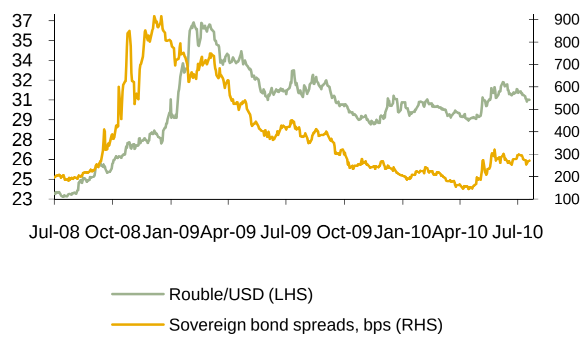
Outlook: *Unlike after the crisis of 1998/1999, Russia's road to recovery stands to be protracted and uneven. Base effects, coupled with restocking and support from consumer demand, will boost growth this year. With banks, however, working off pre-crisis excesses and businesses reluctant to invest, we expect growth to fall back in 2011 and underperform over the MT. The rouble will remain vulnerable to commodity price fluctuations and interest rate differentials. Key to the country's MLT potential will be progress in addressing long-standing structural economic weaknesses.*

ECONOMIC INDICATORS

	04-08 avg.	2009	2010f	2011f
GDP (% growth, real)	7.0	-7.9	**4.4**	**3.8**
Inflation (%chg, pa avg.)	11.3	11.7	**7.7**	**6.7**
Fiscal Balance (% of GDP)	5.7	-6.0	**-4.4**	**-4.0**
Exports (%, comp. annual growth)	28.2	-35.7	**24.8**	**5.5**
Imports (%, comp. annual growth)	30.9	-34.0	**19.5**	**8.6**
Current Account (% of GDP)	8.5	3.9	**5.4**	**4.8**
Reserves (months current debits)	11.4	14.9	**13.4**	**13.2**
External Debt (% of GDP)	32.9	37.4	**31.4**	**30.4**
Debt Service due, to Curr. Acct. Rcpts	15.2	20.7	**18.1**	**17.4**
Exchange Rate (RUB to USD; eoy)	27.4	30.2	**31.0**	**31.8**

Sources: EIU, IIF, IMF, EDC Economics

Bond Spreads & the Exchange Rate



Source: Haver Analytics

RUSSIA

Political

Political Structure
Federal Republic

President
Dmitry Medvedev

Prime Minister
Vladimir Putin

National Legislative Bodies
- Lower House: State Duma (directly elected)
- Upper House: Federation Council (indirectly elected; comprised of regional officials)

Major Parties (seats in assembly)
- United Russia: 315
- Communist Party: 57
- Liberal Democratic Party of Russia (Zhirinovsky): 40
- A Just Russia: 38

Last Elections
- Duma: December 2007
- Presidential: March 2008

Next Elections
- Duma: December 2011
- Presidential: March 2012

Press Freedom Survey:
- 2009 Score: 80 (Not Free) (0: Free; 100: Not Free) freedomhouse.org

Control of Corruption Index:
- 2008 Score: -0.98. (-2.5: Worst; +2.5: Best) worldbank.org

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General Political Environment: Political power in Russia is highly centralized in the President and the Presidential Administration within the Kremlin which exert their influence over all aspects of domestic and foreign policy. Following the election of former President Vladimir Putin in early 2000, political stability gradually increased in Russia and the development of policy became more predictable. President Dmitry Medvedev, Mr. Putin's protegé was elected with 70% of the popular vote in the March 2008 presidential election. Mr. Medvedev's election and his close partnership with Mr. Putin ensures policy stability and predictability for the long-term.

Mr. Medvedev benefited tremendously from being Mr. Putin's anointed successor and endorsement by the pro-Kremlin governing party, United Russia, as its candidate. The 2008 election cannot be considered fair by accepted democratic standards: opposition candidates were banned from standing and the broadcast and much of the print media, which are effectively under the Kremlin's control, favoured Mr. Medvedev's candidacy. Despite the lack of fairness, the few western observers present for the elections conceded that Mr. Medvedev's victory was assured given the genuine and overwhelming popularity of his predecessor; both the President and PM consistently enjoy between 60 and 70% approval ratings in polling. Speeches by President Medvedev indicate that he has chosen to focus on legal, constitutional and governance reform, as well fighting corruption, as his key priority areas. Although ostensibly responsible for domestic policy as PM, Mr. Putin continues to play a leading role in foreign policy as evidenced by his involvement in Ukrainian-Russian bilateral relations and Russia's strained relations with Georgia.

The State *Duma* is a body that is loyal to the Kremlin and thus has little autonomy. Given the dominance of United Russia in the *Duma* (in the December 2007 legislative elections United Russia received 64.3% of the vote and in October 2009 regional elections it garnered 80% of seats contested) and Mr. Putin's position as PM, the legislative and executive branches are for all intents and purposes now fused. There is little effective opposition with only the Communist Party opposing the Kremlin within the *Duma*; pro-Kremlin parties hold 393 of the 450 seats. In January 2009 President Medvedev signed into law a constitutional reform that extends the presidential term from 4 to 6 years; it comes into effect after the next election in 2012. This reform would benefit Mr. Putin should he decide to return to the Presidency in 2012, conceivably giving him another 12 years in power under current conditions.

Investment Environment: Trade and investment matters are strategic areas of both domestic and foreign policy. The Kremlin and associated political elites involve themselves directly and actively in commercial dealings. There have been numerous cases in which the government has intervened in sectors deemed to be strategic to Russia's foreign & security or commercial policies, such as oil and gas, minerals, defence and aerospace. Under Mr. Putin the state passed extensive new legislation and took other measures that increased state involvement in the economy, notably in the oil and gas sector under the state-owned champions Gazprom and Rosneft. There is now greater clarity as to the role of the state in the economy.

The global financial crisis in the second half of 2008 hit Russian oligarchs particularly hard. The Russian state took on increased stakes in key companies formerly oligarch jewels, such as Norilsk Nickel. However, President Medvedev recently signaled that the state plans to reduce its holdings in several key commercial enterprises.

Changes to the natural resources investment laws have effectively limited foreigners from owning majority stakes in strategic sectors. On 7 May 2008, a new Strategic Sectors Law came into effect defining foreign investment limits in 42 sectors. Foreign firms will only be allowed to invest in these areas beyond a certain percentage with government approval.

Political Violence: Politically-motivated violence is generally limited to isolated incidents, with the exception of chronic instability in the north Caucasus (Chechnya and Ingushetia). To date, neither foreign nor domestic economic interests have been targets of political violence.

Political Outlook
The Putin-Medvedev tandem will continue to maintain a unified approach to governing. Stability is assured in the long-term. Mr. Putin will continue to play a dominant role in Russian politics and the coterie of governing elites associated with him will remain in power exercising influence through the Kremlin and state-owned companies. Increasing corruption and weak rule of law will continue to pose challenges to foreign investment.