

Economic

Credit Agency Ratings

Moody's: Baa1
S&P: BBB
Fitch: BBB

Nominal GDP (2008)

USD 1.65 trillion

Population (2008):

142 million

Total Trade / GDP:

48%

Currency:

Russian rouble

Exchange Regime:

Managed float

Merchandise Imports from Canada (2008):

CAD 1.41 billion

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:



Strong rebound in commodity prices
Credit unfreezes, filters down to companies



External demand & credit tighten again
Loss of confidence in the banking system

January 2010

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Market Spotlight: Curbed access to foreign capital, coupled with the slump in global demand for commodities and industrial goods, has taken its toll on the Russian economy. Financial markets have calmed since the turbulence of Q4-08 and Q1-09; equities have gained, bond spreads have narrowed to pre-crisis levels, and the rouble has firmed. The new steady state, however, is fragile. Much of the apparent rebound is being fueled by an untenable rally in oil prices and related inflows of speculative capital. In the absence of bank sector recovery and, more broadly, fundamental changes to the economic model, Russia runs the risk of staging but a cosmetic recovery leaving it vulnerable to shifts in the external environment.

Real Economy: In 2009, Russia's economy saw a reversal from brisk average growth of 7% p.a. to deep contraction. The recession appears to have bottomed out in the third quarter, with GDP edging up by 1.1% q/q. Beneath this figure are marked divergences between expenditure categories; net exports posted solid gains, while the drop in household consumption slid into double-digit territory. Recent indications of improving labour market sentiment signal a possible turnaround in households' spending behaviours in the coming quarters, yet the unemployment rate remains stubborn, consumer credit – scarce. Credit and demand conditions for companies are also poor, though these increasingly report improving access to credit and less difficulty servicing debt.

Fiscal policy: The shrunken economy and weaker export revenues have eaten into public sector revenues. The government, however – taking advantage of its strong balance sheet and fiscal buffers – introduced a substantial stimulus package in 2009 aimed at shoring up real sector activity. Spending priorities were shifted from capital to social spending, from direct support to banks to support contingent on lending to the real sector, and from company bailouts to more systemic, sector-specific stimulus. We expect the red-ink spill on fiscal accounts to again amount to under 8% of GDP this year. The deficit is to be financed via depletion of the state's oil-boom savings, which will not soon be replenished, with the bulk of further shortfalls to be covered via foreign borrowing.

Monetary & Exchange Rate Policy: Having conducted 21 step-wise devaluations since Nov-08, the central bank announced a "soft trading limit" for the rouble in late Jan-09, pledging to resume large-scale currency interventions in the event that the oil price fell sustainably below USD 30/bbl. Stabilization of the rouble since then, whose value is currently down by 23% from its pre-crisis level, has had much to do with the rebound in oil prices. After tightening monetary policy at the year's outset, the central bank has, meanwhile, been cutting rates since late April (a cumulative 425 bps) in a so far minimally effective effort to lower borrowing costs for businesses. Inflation, which receded to 9% y/y in October, remains a headache for the Russian economy.

External Accounts: Russia's current account position has deteriorated since the onset of the global economic crisis, yet it remains in surplus. Assuming oil prices average \$65, we expect the current account to post a surplus of over 3% of GDP in 2010; there is upside to this forecast, yet we do not see export prices being sustained at current levels. On the financial front, the repatriation of capital by resident businesses should yield a net inflow of capital for the country, though FDI prospects are unlikely to brighten materially until further into the medium-term. While the foreign reserve position has strengthened in recent months, a relapse in global commodity prices and risk appetite could again swiftly place heavy demands on this war chest.

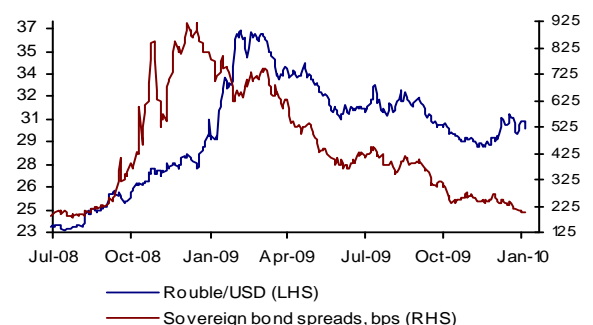
Outlook: Unlike in 1998-1999, Russia's road to economic recovery stands to be protracted and uneven. On current trends, there is a risk of a bubble re-emerging as macroeconomics dynamics are buoyed by favourable terms-of-trade – and of the perceived urgency for reform fading from the policy agenda. We expect the feedback loop from the real sector into the financial system to leave banks hesitant to lend well into 2011 in spite of authorities' best efforts. The rouble, meanwhile, will remain tied at the hip to commodity prices, and we expect the central bank to maintain tolerance for depreciation in the interests of the export sector. Russia's medium-long term potential will, unequivocally, remain intimately tied to the progress of diversification and institutional reform.

ECONOMIC INDICATORS

	03-07 avg.	2008 ^e	2009 ^e	2010 ^f
GDP (% growth, real)	7.3	5.6	-8.1	2.9
Inflation (%chg, pa avg.)	11.2	14.1	11.7	9.0
Fiscal Balance (% of GDP)	5.5	3.6	-7.6	-7.7
Exports (% comp. annual growth)	27.1	32.3	-35.1	11.2
Imports (% comp. annual growth)	29.7	30.9	-39.4	12.4
Current Account (% of GDP)	8.9	5.9	3.8	3.1
Reserves (months current debits)	10.8	10.4	15.2	13.2
External Debt (% of GDP)	31.4	28.8	37.6	33.3
Debt Service due, to Curr. Acct. Rcpts	9.1	11.2	20.7	15.5
Exchange Rate (RUB to USD; eoy)	27.4	29.4	30.3	32.9

Sources: EIU, IIF, IMF, Bloomberg, EDC Economics

Russia: Bond Spreads & Exchange Rate



Sources: Haver Analytics, EDC Economics

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 protégé 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 in Russia are for all intents and purposes now fused. There is little effective opposition in Russia 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: In Russia, 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. The financial crisis has provided increased opportunity for the state to assert its role in the economy, but short of outright nationalisation of industrial sectors. President Medvedev has recently signaled that the state plans to reduce its holdings in these 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. It is not clear yet how the law will be implemented.

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. The economic downturn has led to some sporadic, small and relatively peaceful protests against the government.

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)

This represents a ↓ trend.
freedomhouse.org

Control of Corruption Index:

- 2008 Score: -0.98. (-2.5: Worst; +2.5: Best)

worldbank.org

December 2009

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Political Outlook

The Putin-Medvedev tandem will continue to maintain a unified approach to governing, with perhaps some shifts in emphasis as a result of the economic downturn. 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. Russia is expected to join the WTO early in 2010. Increasing corruption and weak rule of law will continue to pose challenges to foreign investment. Russia will aim to exert greater influence over its neighbours Georgia, Ukraine, Belarus and Central Asian states such as Kazakhstan and Kyrgyzstan through economic and strategic cooperation.