Russian Economy: Macroeconomic Trends and Medium-Term Forecast

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Russian economy recovery compared with other countries (CIS, BRIC and developed ones)

The Russian economy recovers after decade-largest recession, albeit too slowly. GDP has grown for three quarters but the rate is modest – slightly less than 1% per quarter on average or around 4% annualized. We forecast 3.8-4% GDP growth in 2010.

Since the GDP trough of January 2009 Russian economy has grown[1] 5%. This is faster than either in seven largest developed countries (almost zero) or Eastern Europe (less than 1%). However, Russian GDP is still almost 8% behind the GDP level at the inception of the crisis (fall 2008), while both Eastern European and developed countries' have less than 2% to catch up, supposing the crisis started in early 2008 for them.

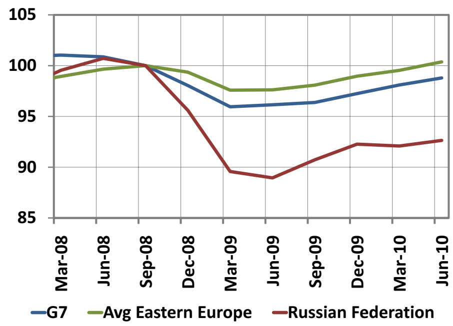
Compared to 2009 results in Brazil (-0.2%), India (5.6%) and China (8.7%), Russia (-7.9%) is a slow-grower and is much closer to Eastern Europe (-3.6%) or G7 (-3.4%). Due to a deep downturn in manufacturing recession in Russia was sharper and concurrent recovery slower than overall in CIS (-6.6%).

So far (three quarters of 2010) the proportions remain the same. 2010 recovery in Russia is expected to be around 4% – faster than in G7 or CEE countries and closer to that of Brazil, but, due to a lower basis, farther from pre-crisis levels of production.

Russian industry has kept pace with the developed countries, while severely underperforming Chinese and Indian industry. Manufacturing took most of the slump and is recovering at half the pace, as car utilization program has only started in March 2010.

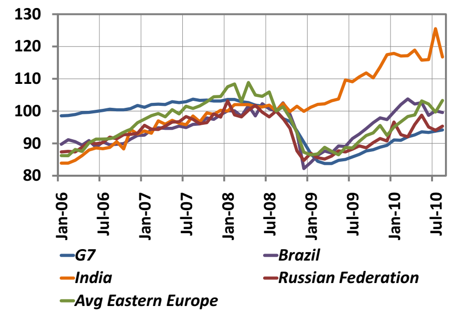
On the other hand, the surge in unemployment compared both to G7 and CEE countries was limited, as both administrative pressure on factory managers and government part-time employment subsidy program have clinched imminent mass layoffs in the beginning of 2009. Since 2009, Minzdrav reports the reduction of part-time employment of over 50%, and over two quarters of rehires at companies.

Figure 1. GDP index, 3Q08 = 100.



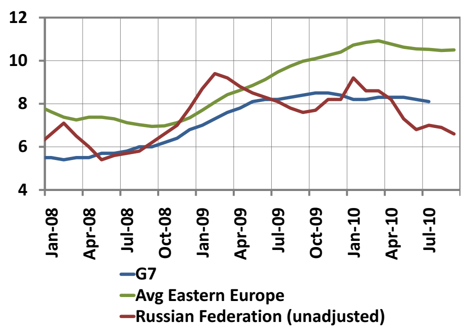
Source: OECD, Federal State Statistic service, CMASF calculations.

Figure 2. Industrial production index, Aug 2008=100.



Source: OECD, Federal State Statistic service, MinEc estimates, CMASF calculations.

Figure 3. Unemployment in Russia, Eastern Europe and developed countries, % of labour force.



Source: OECD, Federal State Statistic service, CMASF calculations.

This contrasts with labour market situation in G7 or CEE countries, where easing has just begun and 2008 unemployment levels are still 3-5 percentage points away.

Overall, present economic dynamics in Russia suggest a slow recovery, albeit faster than G7 or CEE countries. Russian economy seriously underperforms that of Brazil, China or India, and grows slower than other CIS economies due to problems in its large manufacturing sector.

Current macroeconomic situation and main drivers of the economic growth

Although 2009 was marked by deep production decline (GDP dropped by 7.9 percent), the national economy actually went through a period of recovery. Taking into account this year's gains in the leading macroeconomic indicators (for example, GDP growth is estimated to reach 3.8 to 4 percent), these trends mean that major macroeconomic indicators will reach its pre-crisis (2007) levels in 2011, and the rest (including capital investments) in 2012.

Despite positive movements of macroeconomic indicators that clearly suggest that the Russian economy is "firmly following the path of recovery", a very complex set of problems remain. It is still too early to make any suggestions about the creation of the stable engine of economic growth.

Post-crisis re-emergence of the foreign markets contributed to explosive recovery of export operations in 2009. However, at the beginning of the year, decline of the export markets halted the growth of export-oriented industries. According to some estimates, loss export growth potential might mean a 1 to 1.5 percent drop in the rate of economic growth. An entire segment of the export-oriented industries returned to the pre-crisis levels of output (energy, chemistry and petrochemicals).

Opportunity for renewed growth is related to the environment conducive to the creation of the closed cycle of "growth of output, income growth, demand growth and growth of output".

[1] *Rosstat seasonally-adjusted estimates for 1H2010.*

Overall, the Russian economy has no reason not to grow. In general, after a short slowdown in June and July, Russia is experiencing a new wave of economic development.

Figure 4. Private demand for Russian-manufactured goods[2] (excluding investments in stock) and the manufacturing output in primary sectors[3] (% of the respective quarter of previous year)

World oil prices have stabilized at a relatively high level (US $75 to $80 per barrel), which is higher than 2007 levels, for example.

Growth of manufacturing industries is still there: In August the rates were +0.4 percent (according to the estimates of the Center for Macro-Economic Analysis and Short-Term Forecasting, seasonally adjusted), in September, the growth rates were +0.7 percent. This is a sign that Russia is overcoming the stagnation of industrial manufacturing.

This growth is driven primarily by increased capital investments in fixed assets. Despite of all expectations, and in spite of adverse natural and ecological environment in August, the country recovered from July's decline, and the growth continued throughout September (July: -3.7 percent, August: +9.7 percent and September: +4.7 percent, seasonally adjusted). The industries which experienced most significant inflows were machine building and construction (August: +4.8 percent and September: +2.0 percent).

This data perfectly aligns with the analysis of the capital construction projects conducted by *Expert* weekly[4]. Their analysis shows that starting mid-year the country is experiencing a real boom in capital construction although this explosion is driven primarily by foreign investors actively entering Russian markets. If this surge of investment activity actually takes place, it might imply that Russia is recovering from the crisis under the so-called Schumpeter's model –that the crisis creates an environment for investment and innovation activity of individual companies, thus contributing to the increase of competitiveness overall.

Lending increase by commercial banks over the past six months, covering a wide spectrum of transactions and types of borrowers, became an additional factor contributing to the overall positive trends. Also, drop in inflation rates which followed a spike in the August to September time frame facilitated credit availability to the borrowers and promoted a higher level of business activity.

In addition, the increased manufacturer's confidence levels (as shown by IEP polls[5]) also indicate that the Russian manufacturing sector is clearly on the way to recovery.

In connection with other indicators (primarily, declining unemployment[6], and high confidence in consumer demand) this combination suggests that the Russian economy is recovering from the recession.

However, several negative factors suggest that the economy has not yet recovered. The main factor is the decline of the retail sales (August: -1.0 percent and September: -.14 percent, seasonally adjusted), caused primarily by the decline in food sales. On one hand, this was caused by the zero, or negative growth rates of real wages (July -0.0 percent, August -1.2 percent and September -0.6 percent). On another hand, adverse weather conditions led to drop in sales at the farmer's markets[7]. In many cases sales volumes already reached their pre-crisis levels. Subsequent sales growth would be caused by another "consumer revolution" (that is, increased sales of premium items, including food items with higher content of proteins and vitamins, and changing standards on the non-food group markets), or increased activity at the consumer credit market.

The last few months were noted with relatively high levels and positive growth rates of domestic cars sales (AvtoVAZ). However, almost 40 percent of these sales fall under the "Cash for Clunkers" sales, thus, any statements to the effect of overcoming the crisis in this industry are somewhat premature.

If in the past we observed certain degree of demand overheating (creating favorable conditions for subsequent increase of supply, but at the same time creating the risks related to import expansion), the first half of 2010 brought "supply surplus" (meaning a possibility for the companies to increase their revenues and pull the demand to match the increased output vs. the risk of entering a corrective decline). At present we have reasons to believe that Russian economy entered the phase of stagnation. Demand for Russian-made goods and production growth rates have leveled out, and unfortunately, there was almost no increase in those compared to the similar period of the previous year.

Therefore, new growth acceleration potential is tied to ensuring conditions for the rise of a closed loop cycle of "production growth – earnings growth – demand expansion – production growth." Furthermore, latest data (for June 2010 and the second quarter as a whole) lead to the conclusion that the situation is generally improving.

First of all, a significant investment growth is emerging, which compensates for their fall in April-May. Households' spending has also increased and expanded.

Combined with other signals (continued recovery manufacturing output growth[8], unemployment drop[9], companies' high level of satisfaction with the state of demand[10], the expansion of bank lending to the economy) – all probably means that Russian economic recession is coming to a close.

[2] *Total investments in fixed assets, retail sales and exports minus imports*
[3] *GDP volume from industrial, agricultural and construction sectors*
[4] *http://www.expert.ru/printissues/expert/2010/38/dengi_est_uma_ne_hvataet/*
[5] *Based on the poll conducted among manufacturing companies (IEP), more than 50% of respondents were satisfied with their sales. IEP - Gaidar Institute for Economic Policy.*
[6] *June unemployment levels equaled 6.8% of work force. Total number of unemployed (5.2 million people) was 17.7% lower than in June of 2009. According to IEP polls, for the past three months the number of people hired by manufacturers exceeded the number of laid-off.*
[7] *It is worth mentioning that despite of the unchanged sales volumes of the non-food products, their output is increasing.*
[8] *According to the Center for Macroeconomic Analysis and Short-Term Forecasting estimates, average monthly growth of industrial output (seasonally adjusted) over the second quarter was 1.0% – versus 0.4% in the first one. Growth occurred primarily in machine building*
[9] *In June, unemployment level was just 6.8% of the economically active population. Total number of unemployed (5.2 million people) was 17.7% lower than that in June of 2009. According to the IEP polls, hiring has been exceeding layoff in industrial sector companies for the past three years.*
[10] *According to industrial sector company survey data (IEP), the proportion of companies satisfied with sales volume exceeds 50%*

Figure 5. World Economy Trends (growth rates, %)

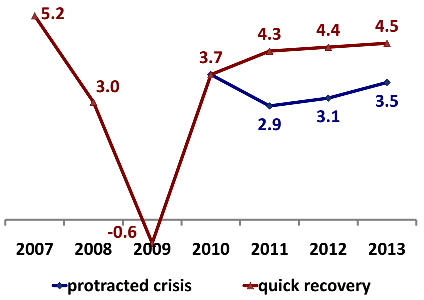


Figure 8. Gross Domestic Product Trends (growth rates, %)

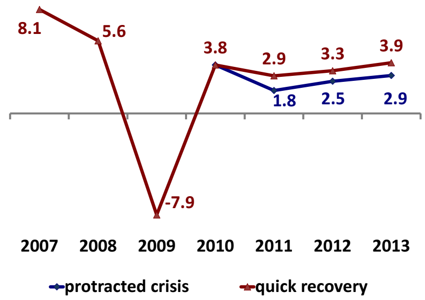


Figure 11. Investments in fixed assets (growth rates, %)

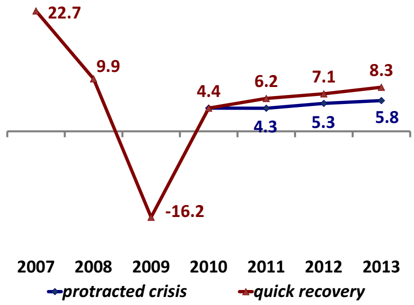


Figure 6. World Oil Prices (in dollars per barrel, Urals)

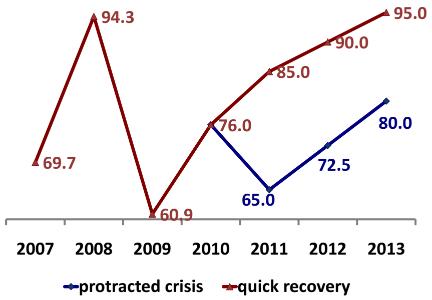


Figure 9. Real Wages (growth rates, %)

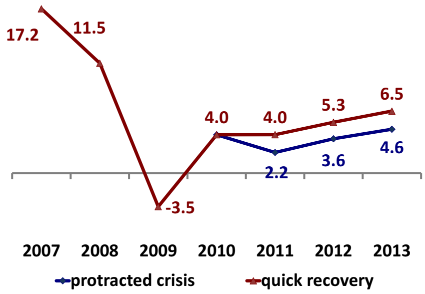


Figure 12. Elasticity of investments in fixed assets, by GDP

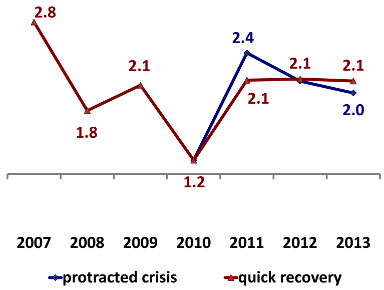


Figure 7. Real Wage Elasticity in Terms of Labour Productivity

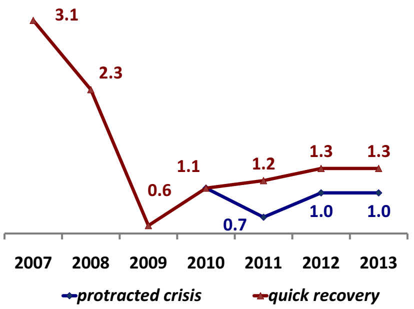


Figure 10. Retail Sales (growth rates, %)

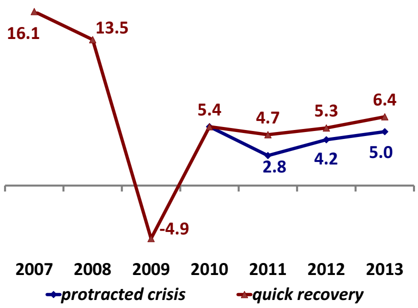
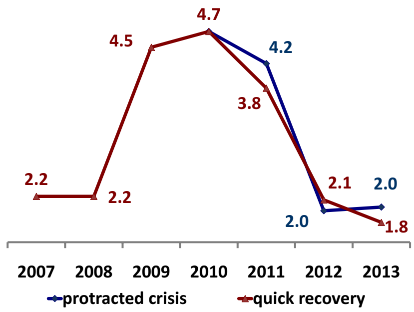


Figure 13. Import Elasticity in Terms of Final Domestic Demand



Sector Structure of Recovery Growth

Manufacturing output has been experiencing recovery for over year now (starting in the second quarter of 2009, with short pause in the third quarter of 2010). Current Manufacturing manufacturing output is 5-6% below the before pre-crisis maximum by the middle of 2010 (seasonally adjusted).

The sector structure of decline/recovery is very clearly delineated. Two For large sectors had virtually no decrease in output (compared with pre-crisis year): first, oil production extraction and refiningprocessing, and second, food industry, chemical industry, electrical and optical equipment. The next segment is as follows: the majority of export oriented raw material industries where the crisis decline (by 10-15%) has now been overcome (with the exception of metallurgy where output is 10% lower than the pre-crisis levels). The segment that has suffered the most is the one oriented towards investment demand and the production of durable consumer goods. Output initially contracted almost two-fold here, and now is 20% below pre-crisis levels.

It is interesting that output has significantly exceeded pre-crisis levels for a large number of sectors, such as: shoe production (+21% against the pre-crisis level), paper and cardboard goods (+6%), household chemicals (+25%), pharmaceuticals (+6%), agricultural machinery (+9%), electric motors, generators and transformers (+26%). As a rule, the growth is driven by import substitution supported by investment projects begun back in the pre-crisis period.

Effectiveness of the anti-crisis measures taken by the Government

A large-scale anti-crisis package of measures totaling 1.2 trillion rubles or 3.1% of GDP, targeting primarily the following areas:

- Supporting the economy's most vulnerable areas – the banking system and industrial sector;
- Compensating for the smaller wages with transfer payments;
- Using government demand as primary instrument for sustaining final domestic demand.

The banking system was rendered the largest amount of support, its primary goal being to prevent bank panic and to preserve normal operation of the payment system by avoiding the spread of the crisis along payment flows.

Banking system stabilization measures were carried out rather successfully: overall, its liquidity was successfully maintained. Also, measures aimed at capitalizing the banking system were successful. At the beginning of the crisis, the level of banks' capital had significantly suffered due to the higher proportion of "bad debt." However, subordinated loans provided by the Bank for Development and Foreign Economic Affairs and the Bank of Russia helped stop the banking system decapitalization process. It is true, however, that primary aid recipients were government-owned banks which received 90% of the total loans.

Credit stimulus measures (providing government guarantees, applying pressure on banks which used subordinated credits), conversely, did not yield the necessary effect. The volume of credit portfolio over 2009 nominally decreased by 2.7%.

Anti-crisis measures of 2009 aimed at supporting the industrial sector primarily consisted of targeted support of some major companies (by providing government guarantees, subsidies and contributions to capital stock). These measures prevented snowballing growth of bankruptcies, though they did not have a significant impact on restoring the industrial sector. Import tariff increase measures had a more significant impact on the gradual resumption of industrial output growth, in particular in sectors most in need of support, i.e., machine building and agriculture.

Population's social protection measures (increasing pensions and unemployment payments, ensuring employment, etc.) helped maintain social stability during the crisis and avoid a sharp drop in the population's income (end of year figures show the population's real disposable income to have grow 1.9% over the year, primary due to transfer payment rise).

The primary measure for supporting economic growth was the stimulation of final demand through government expenditures, including government defense procurement. Year-end figures of the government-managed final consumption sector growth rate were 102.0%.

However, the primary purpose of government procurement growth, i.e., supporting domestic demand, was not fully achieved, internal final demand fell by 9.9% (primarily due to a fall in investments) according to year-end figures.

Strengths, weaknesses and alternative ways of stimulating economic growth

The lag in adoption of growth stimulation policies during crisis in Russia seems main policy The lag in adoption of growth stimulation policies during crisis in Russia seems main policy drawback, in sharp contrast with timely and adequate financial sector support policies of fall 2008.

Old-2009 budget process took time till November 2008, and emergency budget correction procedures were not in place till December. While new-2009 budget was passed quickly, by April, the delay in budget funds' flow was almost six months. This proved to be a serious problem for government purchase-dependent factories – first of all, defense producers.

The anti-crisis measures themselves were timely mostly for the non-discretionary part – government responded with tax and tariff rate change package in November. The discretionary anti-crisis package measures were delayed – drastic industrial production fall (started October-November 2008) was responded to with some government plan only in March 2009.

Government guarantees to the selected corporate creditors were another example of emergency measure with a delay in correction. First edition of March 2009 was offering compensation only on after-liquidation basis, which effectively delayed the payout for years. The guarantee was not accepted by a single creditor until the correction in July. Unfortunately, nearly four months for credit stabilization support were lost.

Another problem of emergency government reaction was preference of direct subsidies to the corporations instead of final consumption support. Direct subsidies were spent just to keep companies afloat. The second round of subsidies (fall 2009) was provided in exchange for restructuring plans and so far companies stick to the plans to raise labour productivity and lower costs.

As car utilization programs were fueling demand in Europe, troubled automakers in Russia (GAZ and AVTOVAZ) were directly subsidized either through state banks or through budget. Analogous program was adopted in Russia only in 2010, and caused swift recovery of production in budget vehicle sector while each car bought brings back tax amount more than compensating the subsidy.

Anti-crisis measures for the labour market, however, were efficient both economically and socially. Subsidies to workers employed part-time because of the crisis (so-called "public works") helped financially troubled companies to keep personnel through lightening the cost burden in low-demand environment. At the same time, less drop in wages during part-time employment helped keep social stability under control and stabilized consumer demand. Another important piece of consumer growth stimulus package was sharp increase in pensions.

Mentioning foreign experience that could have been adopted, it is important to turn to infrastructural construction which was the backbone of Chinese anti-crisis package and constituted significant part of ARRA (or "Obama plan"). Unfortunately, transport infrastructure expenditures were cut down during the crisis both on federal and regional levels, partly being transferred to the social security programs (such as a raise in unemployment benefit size or part-time employment subsidies). On the other hand, state-funded transport infrastructure construction in Russia did not prove to be particularly cost-efficient (in comparison with North European countries). Also, mass employment of industrial workers in construction could not be viewed as desirable in light of industrial personnel scarceness in strategic labour market perspective.

Balancing Russia's Budget by 2015: Increasing Taxes and Cutting Spending

The economic crisis of 2009 became the tipping point for the Russian budget system: there was a sudden switch from stable surplus, observed in Russia over the past several years, to a large budget deficit. In 2009, federal budget deficit was 5.9% of GDP, in 2010 various estimates place it at 4.3-4.8% of GDP.

In case moderate or unfavorable international economic environment continues long term, Russia will find itself in a difficult situation. Medium term, budget deficit can be financed with the saved oil and gas funds, and partially, by accumulating government debt, on domestic and international levels. After exhausting sources of financing, an urgent need to create a balanced budget system will arise. Therefore, Russia is currently faced with a strategic goal of gradually reducing the size of the budget deficit in order to return to non-deficit budget by 2015.

Partially, the issue of Russian budget deficit will be resolved by increasing the tax burden on raw material sectors – the 2011-2013 budget includes a significantly increased natural resource tax levied on oil and gas extraction, as well as petrol and diesel fuel excise tax, in addition to an increase in export tariffs on oil-based products, nickel and copper. Moreover, a higher excise tax on tobacco products, which is currently lower than in many developed countries, is also expected. Overall, tax innovations included in medium term budget will yield approximately 1.1 trillion rubles of additional income over 2011-2013, or approximately 0.7% of GDP per year.

A more significant increase of the tax burden is currently not feasible – it will have extremely negative consequences not just for developing the Russian business and increasing the competitiveness of domestic production on the world market, but also for attracting foreign direct investments to Russia.

The privatization of the non-controlling interest of a number of large government-owned companies will be an additional source of financing the 2011-2013 budget deficit, with potential annual privatization income to reach approximately 0.5% of GDP.

Further reduction of the budget deficit must be done by reducing expenses, which, however, is not easy due to the high proportion of social commitments in current expense structure that cannot be reduced (including transfers for covering the constantly growing Pension Fund deficit), as well as due to Russian economy's need for government investments in infrastructure upgrades and development.

Financial Sector: Banking lending is Restoring

Beginning in March of 2010, Russia's banking sector started experiencing an increase in credit issuing to non-financial companies and households for the first time since the crisis had started. Outside of the impact of currency re-evaluation, in March-September 2010 monthly increase in corporate loans (excluding Sberbank) was approximately 1,9% per month and for retail (excluding UralSib and Sberbank) - approximately 1,5% per month.

Credit portfolio growth was fueled by factors on the credit demand side from businesses and households, as well as factors on credit supply side. The readiness to issue credit is mainly due to the fact that banks are completing the process of adjusting acceptable risk levels (credit, currency, and liquidity risks):

- Stabilizing overdue debt volume and its ratio in the overall bank portfolio (7-8% in 2010 excluding Sberbank and the VTB).
- The return of credit-to-deposit ratio to the 1.0 level characteristic of 2003-2004, i.e., before the credit market "overheated."
- The existence of a "margin of safety" of capital – capital adequacy ratio (1) reaching a record high level of the last 4-5 year (approximately 18-19%)
- Banks accumulating excess liquidity (over 1.5 trillion rubles placed in low-yielding instruments of the Bank of Russia)
- A decreased level of banks' foreign assets (currency position of the banking system fell between January and September by approximately 8 billion dollars), due to lower risk of the ruble depreciation.

Credit demand accelerates due to credit interest rate decrease to reach levels existing before the crisis. In the corporate sector, credit demand increase is assisted by a gradual return to profitability of businesses and a reevaluation by a number of major companies of their investment plans with a view to increasing investments (in oil and gas production, energy utilities, railroad and motor vehicles.) Significant investment growth was noted in August and September after a period of stagnation since the beginning of 2010 and decline in July, demonstrating an improvement in expectations of companies.

Corporate sector credit demand growth is shown again by the IEP polls, which indicate that over the period between January and September there was a sharp jump in companies' positive outlook of their ability to attract credit.

A growth of retail loan issuance is due to a return of household expenses to before crisis levels and an improved employment situation: according to IEP polls, the number of new hires has been exceeding layoffs since March. Furthermore, the observed noticeable consumption increase (retail sales is forecasted to grow by 5.4% in 2010) also accelerates the demand for bank credits.

Medium Term Macroeconomic Forecast

Environment

The development of the world economy experiences an uncertainty related to the rate with which the world's largest economies overcome the crisis processes.

Two primary scenarios of the development of the world economy are possible, "a quick recovery" or "a protracted crisis".

Within the framework of the first of those, in light of the emerging recovery of the US economy and the continued high rates of growth of the Chinese and Indian economies, it can be expected that a noticeable growth of the global economy will start as early as the second half of the current year. Consequently, the global economy can be expected to reach growth rates of approximately 4% per year starting in 2010.

The growth of demand for energy products (including relatively power-hungry Chinese economy) and the expansion of financial markets will stimulate the growth of oil prices – from 75-78 dollars for a barrel in 2010 to approximately 95 dollars per barrel in 2013.

The alternative is the "protracted crisis" scenario.

Within its framework, the spread of the European financial crisis outside of the group of "poorly disciplined" countries (to the United Kingdom, first and foremost), will lead to an increase in investor risk perception. Taking into account the uncertainty of the future of post-crisis development of the US economy and possibly, out of habit, keeping earlier decisions about the "cooling" of the Chinese economy, may lead to moderate growth rates of the global economy starting this year, by approximately 3%.

Taking into account the stabilization of demand for energy products, the low investor expectations and the stabilization of the dollar relative to euro due to the softening of financial policy in the European Union, the price of oil will virtually stabilize at the 65-75 dollar per barrel level.

In Russia, the uncertainty is primarily due to the potential for a higher rate of the growth of domestic final demand in the second half of 2010 and at the beginning of 2011.

Simultaneous increase in real wages and unemployment rates in the corporate sector would be the key "signal" that the crisis is over. On the one hand, increased rates of salary growth will become the basis for an expanded consumer demand, on the other – will be a signal that real sector of the economy is stabilizing, which, in turn, will stimulate expanded investments.

Therefore, the following two scenarios are basic in terms of starting conditions: a "high" scenario, combining a rapid end of the global economic crisis (with primary global markets starting to grow, world raw material prices gradually rising, as well as foreign direct investments) and the stabilization of real wages in companies – and the "low" one, involving low rates of world economic growth in the current year, and, simultaneously, absence of expansion of final demand for Russian products in 2010.

Forecast

Taking into account the recovery growth in the second half of 2009, the "arithmetic" result of the economic development this year should not be at a level lower than 3% of GDP growth – even if stabilized at the levels equal to those at the end of last year.

Therefore, end-of-year results can predict GDP growth of approximately 3.8%. In subsequent years, taking into account the higher base, the growth will formally, start slowing down. Within the framework of the "high scenario", after reaching the minimum in 2011, (approximately 3% of GDP growth), economic growth rate can be expected to increase. Within the framework of the "low" scenario, the growth will experience a 1 percentage point a year slowdown due to the moderate demand expansion and the simultaneous and faster import expansion.

The following will become primary features of medium term economic development:
1. The leading role of investments in fixed capital as the source of economic growth; switching from a "consumer-oriented" to "investment-oriented" growth. The previous wave of economic growth was largely based on high rates of consumer demand. At this point, however, there are no real opportunities for a continued development along this path in the future.

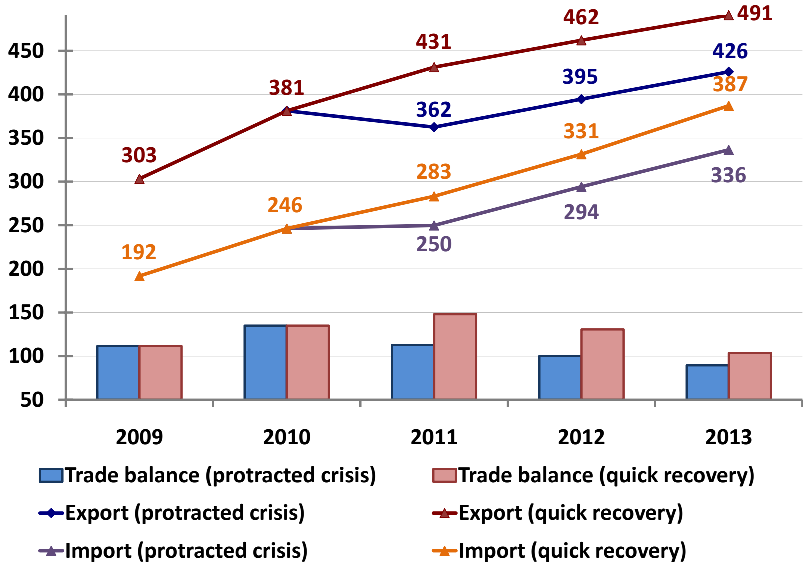
On the one hand, there is no reason to expect an increased growth of wages, which in previous years exceeded labor productivity increases by a factor of two to three[11]. On the other hand, we are unable to see the conditions for a resumption of "consumer credit boom", which used to drive the decoupling of sales growth from the population's wage growth.

Under these conditions, investments in capital assets will probably become the primary contributors to economic growth. In particular, their behavioral trends will be maintained by an increased competition on domestic markets, requiring technical refurnishing of manufacturing, partially – by the need to replace depreciated equipment[12], partially, by the actions of the government to develop infrastructure, the social sector, etc. It is expected that the growth rate of investments, starting in 2011, will be twice that of the general rates of economic growth. Consequently, in 2010, investments will rise by approximately 4% in the subsequent years, within the framework of the "high" scenario, by 6-8.5% per year within the framework of the "low" scenario, and by 4-6% per year taking into account the deficit of company incomes. Therefore, investment expansion will be approximately twice the rate of general economic growth.

2. Faster import trends. The insufficiently competitive domestic goods may lead to an expectation that in medium term, import of goods will be expanding faster than the domestic market, thus reproducing the situation which existed during the pre-crisis period, to a certain extent: the growth of domestic production will occur to the extent where the expansion of domestic markets will not be taken over by import increases.
Figure 13. Import Elasticity in Terms of Final Domestic Demand

Taking into account the faster import expansion rates (relative to the slow expansion of the export of goods [13]), a gradual decrease of the trade balance can be expected, from 135 billion dollars in 2010 to 90 billion dollars in 2013 according to the low "scenario".
Figure 14. Primary Foreign Trade Indicators (in billions of dollars)
3. A weakened ruble as current account balancing instrument.

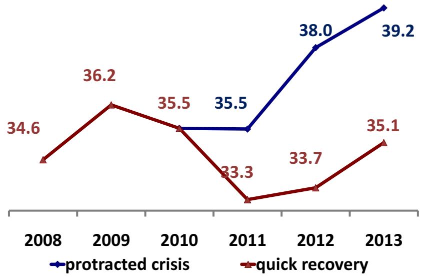
Figure 14. Primary Foreign Trade Indicators (USD billion)



Under the conditions of a fast growth of the import of goods, for both scenarios, especially the "low" one, stabilizing current account balance is only possible with a weakened ruble.

In the "high" scenario, the weakening of the ruble needed to restore the current account balance is moderate and gradual (almost linear, to 35 rubles according to the bi-currency basket by the end of 2013). The "low" scenario will necessitate a significantly weakened ruble in 2012 (by 2.5 rubles.), with 39-39.5 ruble level reached in 2013.

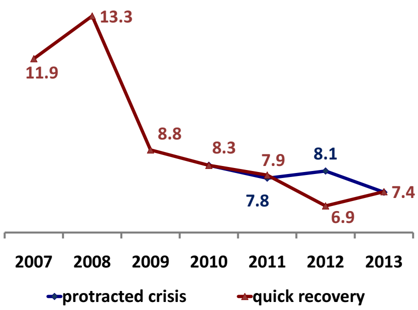
Figure 15. Ruble to bi-currency basket exchange rate (by the end of the year, rubles)



4. Inflation Stabilization
The current year is expected to become the year of lowest historical level of inflation. According to CMASF estimates, in 2010 it will be 8-8.3%. Change of the ruble exchange rate from increase to a decrease together with this year's drought in Russia caused inflation acceleration in the second half of 2010[14].

Analysis shows that a 1% weaker ruble will lead to a 0.5 point consumer price increase as soon as next month. Therefore, taking into account the forecasted increase in natural monopoly tariffs, in the "high" scenario, inflation will stabilize at 7-7.5% per year over the entire period. In the "low" scenario, taking into account how much the ruble is weakened, it will be in the 7.5-8% range in 2011-2013.

Figure 16. Consumer Price Index (growth rates, %)



[11] Determined earlier by the inflow into the Russian economy of foreign income and, on the other hand, by market deficit of labor supply.
[12] Taking into account the extended service life of equipment in a number of sectors, a jump in the decommissioning of this equipment may be expected even in the next several years.
[13] Determined by the expansion of foreign markets, taking into account the competition presented by alternative suppliers (including shale gas, Iraqi oil, etc.), energy effectiveness trends in consumer countries, etc.
[14] Let us note that food price growth due to this year's drought will, according to estimates, cause additional consumer price growth by approximately 1 percentage points in 2010 and by approximately 0.2 percentage points in 2011.