

**CENTER FOR MACROECONOMIC ANALYSIS
AND SHORT-TERM FORECASTING**

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On the economic results of the development of the Russian economy in 2007 and the forecast for 2008–2010

2007-2008: trends turn

The last year and a half turned out to be the most significant, while at the same time being the most problem fraught for the Russian economics over the decade that passed since the 1998 crisis.

On the one hand, 2007 was the most successful year for the Russian economy.

The combination of the “investment boom” and the very intensive growth of consumer credit lead to record-high economic growth rates, 8.1%, which is twice as high as for world economy as a whole. At the same time, the two-year rapid growth of investment in process branches of the economy resulted in an increase of their competitiveness, and, consequently, in a rather intensive production growth.

A number of signs point to a strengthening of favorable structural shifts which started back in 2006. 2007 was marked by a jump in production in a group of process branches of the industry, first and foremost in investment machine-building, where growth was virtually widespread. Domestically oriented branches “were marked” by high-rate investment activity as well. This is partly the result of the implementation of national projects, partly – the development of infrastructure projects (transportation, energy), partly – the upgrades in a number of the most investment oriented industries.

The outcome of mobilizing “oil” income (which has been experiencing a stable profit in recent years) was rapidly forming federal budget’s reserve funds. The size of the Stabilization Fund (which since the beginning of the year has been split into two – the Future Generations Fund and the National Wellbeing Fund) totaled 3849 billion rubles by the end of the year (\$157 billion). Gold and currency reserves reached \$ 478 billion.

The growth of the country’s financial capacity allows for an increased expansion of the financing of expenditures, which ensure long-term development of the Russian economy. Significant investments have been made in infrastructure development as well as in capitalizing development institutions (see below).

Overall, there was a range of reasons to discuss the overheating of the Russian economy (caused by a combination of intensive economic growth and high inflation, the growth of high-risk bank crediting and a number of other trends).

Insert. On the Emergence of the Signs of Overheating in the Russian Economy

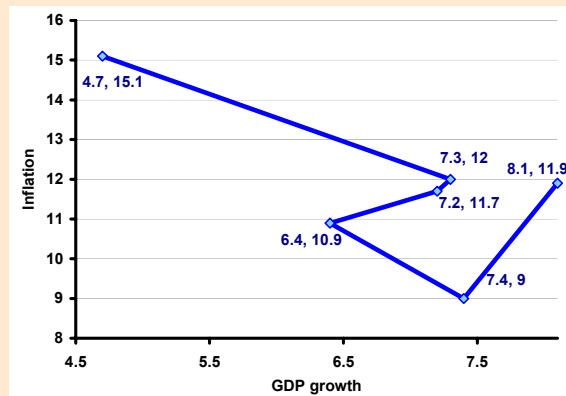
2007 was marked by the emergence of clear signs of overheating in the economy. A classic indicator is the combination of high inflation and intensive economic growth (graph 1.4).

In addition, there are obvious signs of overheating in the credit market. Over the last three years, the basis of the credit portfolio of commercial banks, which are also growing at a fast pace, is credit provided to companies in sectors with high level of credit risk (which becomes clear from the rates of debt delinquency, etc.).

Finally, consumer market is also overheated due to the increased rate of salary growth (which has not been following labor productivity for the past four years) and the continued “consumer credit boom” (see below).

This situation means that the outlook for economic development through primary subjects of the economy (the business sector, first and foremost, including financial structures, and, partially, the population). The problem is that any glitch in economic development, even rather random, for example, caused by a crisis on some of the world markets, may lead to a sudden slowdown of the economic activity to “normal” level or to a level that is even lower, due, in turn, to overly pessimistic analysis of the situation.

**GDP and Inflation Behavior
(rate of increase, %)**



At the same time, the most important factor driving the high rate of investments in capital goods, in addition to the economic growth of 2006-2007, was the globalization of the Russian economy, i.e. actively attracted direct foreign investments, as well as the involvement by Russian financial companies, of large real sector companies.

Insert. On the Influence of Globalization Processes on the Russian Economy in 2007

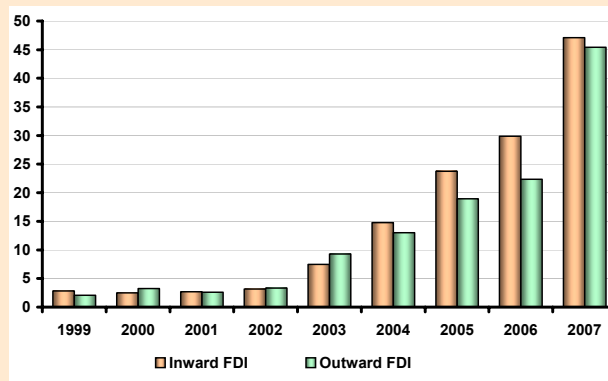
This was the year when the Russian economy became a real participant in global processes. A range of trends developing over the past year are a direct reflection of the processes that were occurring on the global markets

First of them is, of course, inflation. The jump experienced by Russian inflation is primary due to the situation on world agricultural markets. In May, the first upswing in inflation was a direct reaction to the growth of worldwide prices for wheat/зерно (which, in turn, was due to fundamental factors as well as current market factors¹). In August-October, the second jump was due to the European increase in food prices (first of all, mil product prices). And the final outcome was the emergence of a deficit of some of the types of food and the increased inflation.

The other global factor that had a significant impact on the situation was the financial crisis, which was “triggered” by the events on the US mortgage market. Having attained significant proportions, the consequences of this crisis affected all money markets to at least some extent. The result of bad conditions for providing credit to Russian borrowers, which caused problems with liquidity in the Russian financial system and even to a short “halt” in investments at the end of the third-beginning of the third quarter.

And finally, obvious changes occurred in the investment process during this year. In the previous year, the unprecedented growth of direct foreign investment in real sector projects was accompanied by equally large-scale investments by the Russian companies abroad (see graph).

**Direct investments in Russia
and abroad in the non-financial sector (in billions of dollars)**



This means that Russian business is becoming a part of the global production/industrial chains – and not just as investment recipient (which leads to an entry onto new markets, access to modern technologies, etc), but also as an investor acquiring assets to ensure access to sources of raw materials, to chains ensuring product promotion, to brands positioned on the markets, and to potential future sources of income.

Russian company and bank debts to foreign creditors acquired utmost significance (partially due to the world financial crisis). The fast-paced growth of loans taken by Russian companies and financial structures created non-government sector debt, which reaches 29% of the GDP, according to the RF Finance Minister.

¹ Fundamental factors – increased consumption of wheat due to biofuel production, as well as due to the urbanisation in China and a number of other countries, which all lead to an increased wheat consumption for food and feed needs as food demand structure becomes more “refined”. The draught in South-East Europe is a market factor.

In conclusion, we can say that 2007 became a stage at which solving the issue of competitiveness entered its application stage (and which probably started yielding initial results.) All of the major positions of last year's "agenda" points to that, such as: quantitatively higher level of integration into global economy (which also means assuming its risks); the depletion of easily accessible resources (first and foremost – the workforce), leading to understandable need for improving effectiveness; the shift in growth to competitive areas (investment machine-building, and, to a significant extent, consumer sectors).

On the other hand, the biggest problems started emerging in as early as the middle of 2008, which curbed the established model of economic development. The crisis on the overheated housing market in Moscow and St. Petersburg (which started in April-May of 2008) caused a noticeable decreased in the pace of investments in capital goods. The outflow of capital from Russian economy which resulted from the intensifying crisis on world financial markets (beginning in August) and, a virtual suspension of banks providing credit to non-financial companies (due to the outflow of liquidity, starting in September) caused at least a temporary leveling out of investment.

At the same time, July-September (with seasonal impact factored out) saw a leveling out of industrial output². This is the first time that this type of industrial output stabilization has been observed since 1999.

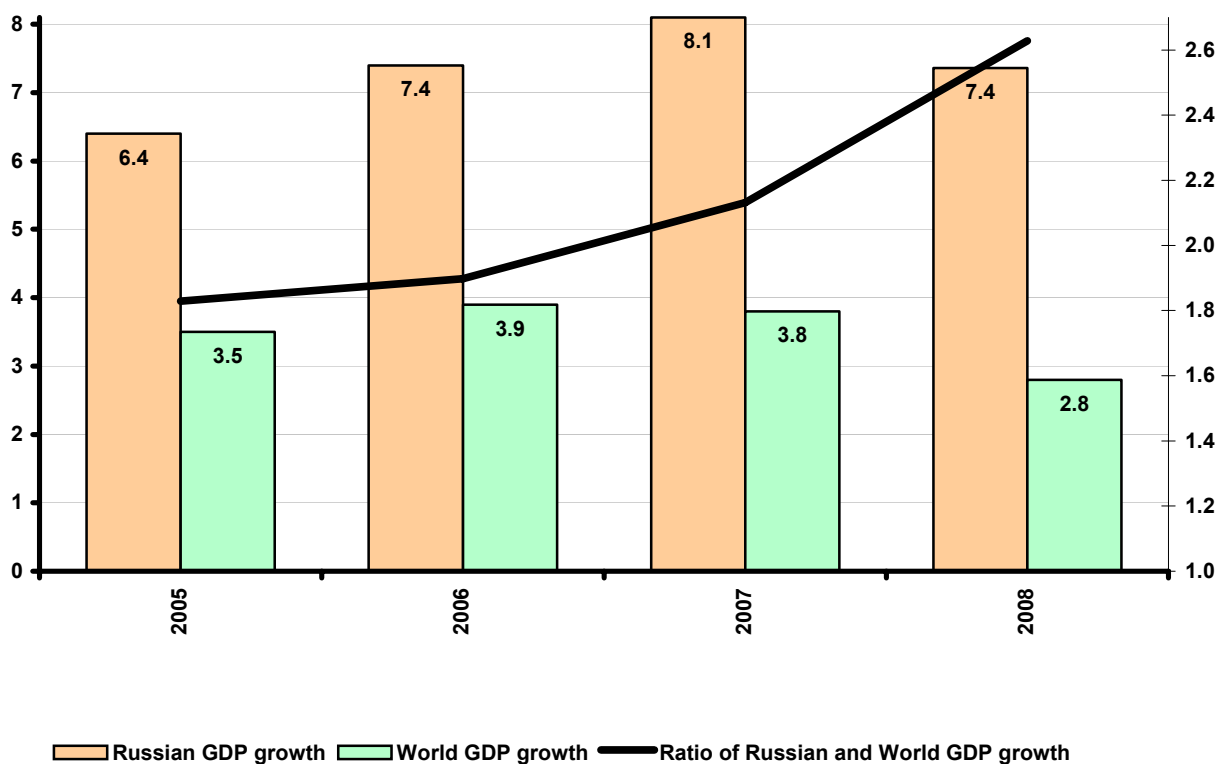
Therefore, Russian economy's weakest links are precisely the ones that most hopes were pinned on for increasing the stability and quality of economic growth: the banking system and financial markets that were hit due to the outflow of liquidity from the Russian market; the rapidly growing construction sector in large cities; the processing (primarily investment oriented) industries.

Major Macroeconomic Indicators in 2005-2008 (growth rates, %)

	2004	2005	2006	2007	2008 (оценка)
Inflation, YoY	11.7	10.9	9.0	11.9	12.5
GDP	7.2	6.4	7.4	8.1	7.4
Industrial production	8.0	5.1	6.3	6.3	5.7
Agricultural production	3.0	2.3	3.6	3.3	3.8
Real household incomes	10.4	12.4	13.5	10.7	9.3
Retail sales	13.3	12.8	14.1	16.1	13.2
Gross fixed capital investment	13.7	10.9	16.7	21.1	13.2
World Urals oil price, USD/bbl.	34.4	50.6	61.1	69.3	106
Export, goods, USD bn	183.2	243.8	303.6	354.4	508
as % of GDP	31.0	31.9	30.7	27.5	28.0
In real terms	11.5	5.4	5.8	5.5	3.0
Import, goods, USD bn	97.4	125.4	164.3	223.5	296
as % of GDP	16.5	16.4	16.6	17.3	16.4
In real terms	23.3	19.6	23.8	30.2	24.0
Trade balance, USD bn	85.8	118.4	139.3	130.9	212

² Also, in July (with seasonal impact factored out) there was a drop in industrial production

World and Russian GDP Behavior (growth rates, %)



Budget and Tax Policy

Budget and tax policy in 2007 and 2008 was very contradictory. The state is trying to use it to resolve simultaneously a whole range of contradictory issues – both of anti-crisis nature, and those aimed at forming long-term development potential:

1. Containing inflation.

As gold and currency reserves are being expanded, the expansion of the Government's reserve assets became key method for limiting the growth of money supply. Over 2007, Stabilization Fund grew by 1502 billion rubles, which ensured, all else being equal, an decrease in inflation level by approximately 5 percentage points;

2. Stimulating technological modernization of the economy.

In 2007, a number of development institutions were created and capitalized by the budget. Six-hundred forty billion rubles were allocated to capitalize them. Of those, Housing and Public Utilities Fund received 240 billion rubles, National Development Fund -- 180 billion rubles, Russian Nanotechnology Corporation -- 130 billion rubles, and Investfund -- 90 billion rubles.

Additional incentives for investing in high-tech equipment have been introduced within the framework of shock-absorption policy. Tax rates for mineral (oil) production have been lowered. VAT decrease is in the works. (see below).

3. Ensuring long-term stability of the tax-budget system.

Long-term forecast calculations of social and economic development and the long-term financial planning show that starting in the middle of the next decade, the Russian financial system will find itself in a difficult situation due to a combination of negative demographic trends (an increase in retirement burden on the employed population) and the continuing low

collection rates of the Uniform Social Tax (UST), it being the primary source of income for the Pension Fund. This is true in case retirement benefits are indexed to the level which would ensure a replacement coefficient of at least 40%, which would mean massive deficit for the Pension Fund. The government would then have two options – either to stop indexing pensions paying 40% of average salary, or to make a large transfer to the Pension Fund from the federal budget, which would ultimately lead to a deficit of the latter even if ensuring maximum savings on other budget line items (by 2020 it would be at least 1-1.1% of the GDP).

Consequently, the Government has recently made a decision to switch from the UST, of which 26% is going to the payment of insurance premiums to the Pension Fund, which would equal 26%. Payments to other funds (8%) would still remain. The above would effectively preserve the rate that existed before the 2004 UST reform (when the lowering of the UST from 35.6% to 26% was not accompanied by a corresponding increase in the rate of tax collection).

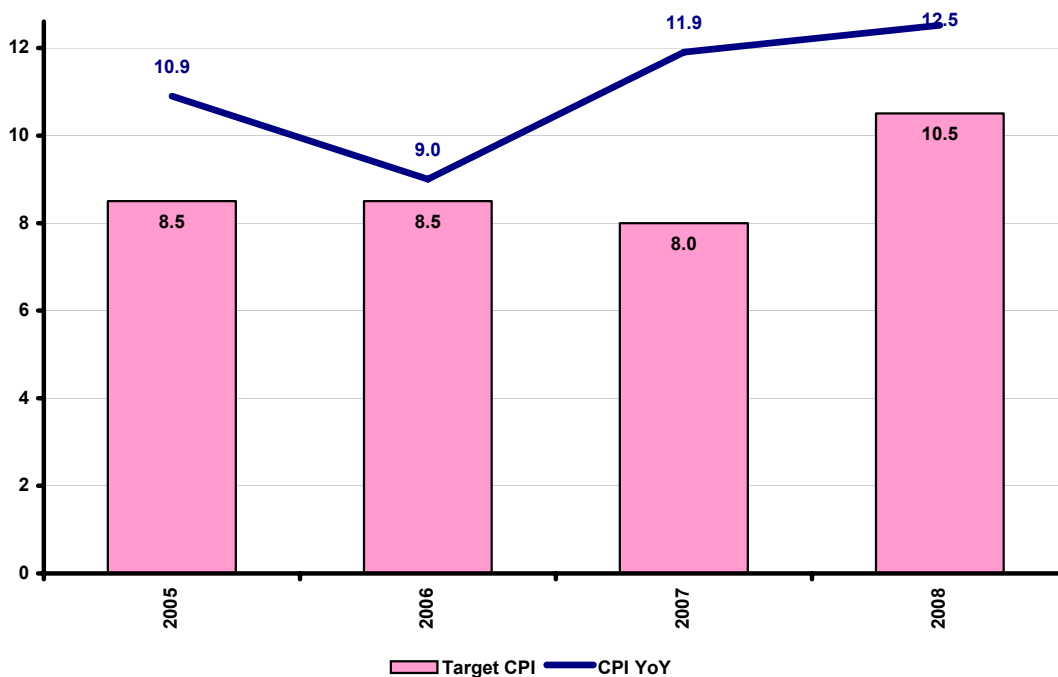
4. Increase in the income of the employees of the budgetary system and retirees

Over the entire 2007-2008 period (and in the future, as it is expected), increasing payments to employees paid out of the government budget and to retirees became the most important aspect of budgetary policy.

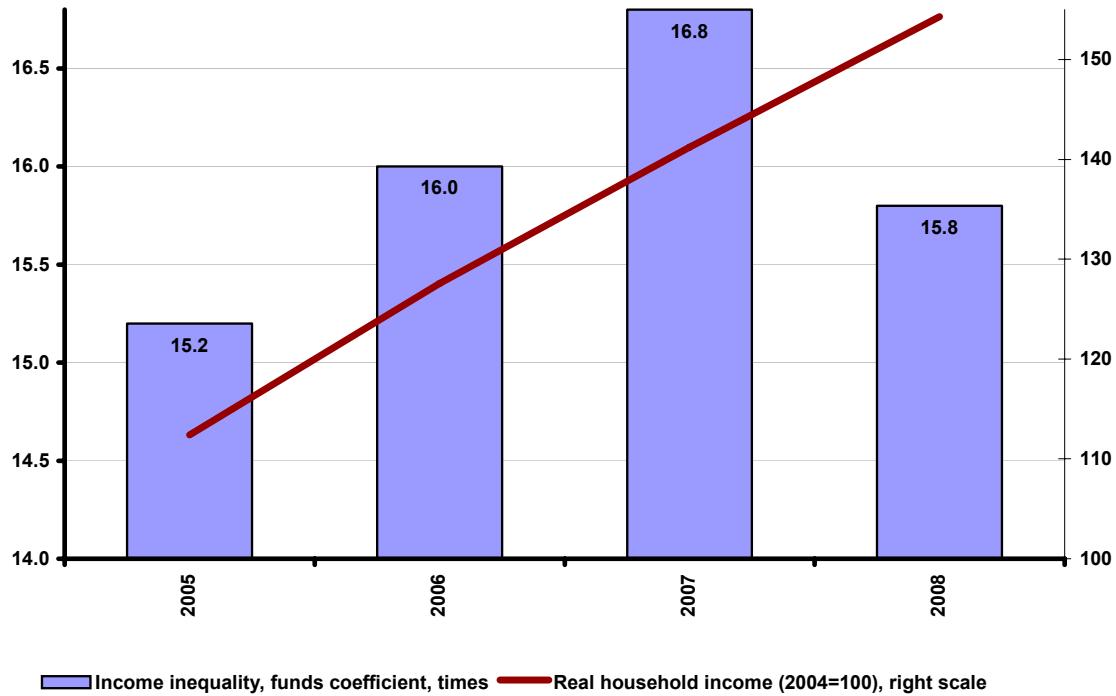
Simultaneously, a trend toward population differentiation by income continued. Fund coefficient grew again to 16.8 (see graph). This was helped along by a decrease in real retirement benefits to a record low level of 103.8%.

One of the factors which in 2007 lead to deteriorating quality of life for the low-income population was a sharp increase in inflation among some food groups. Year-end results show that nominal income growth rate per capita was ahead of the minimum food basket price by as little as 0.3% (in previous years it was 10-15%).

Inflation level in 2005-2008 (CPI growth rates, %)



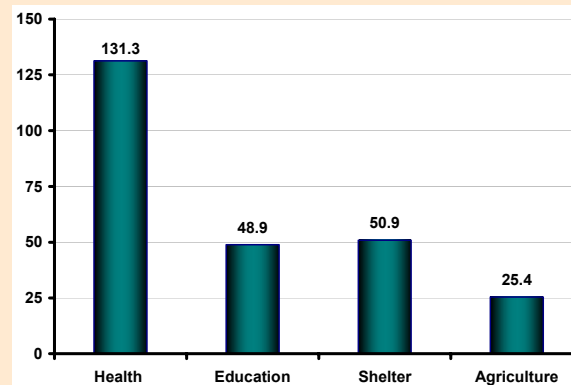
Growth of real disposable income and fund coefficient



On the Implementation of National Projects in 2007

In 2007, the implementation of four priority national projects in healthcare, education, better access to housing and the agriculture and industrial agricultural complex development started.

National Project Financing Volume in 2007 (in billions of rubles)



Healthcare national project was the recipient of the largest amount of financing. The total allocated to implementing it in 2007 is comparable to the 13.6% of the value added of the entire healthcare sector. Within the framework of the national project, measures were taken to develop emergency medical aid and to provide the population with high-tech medical care.

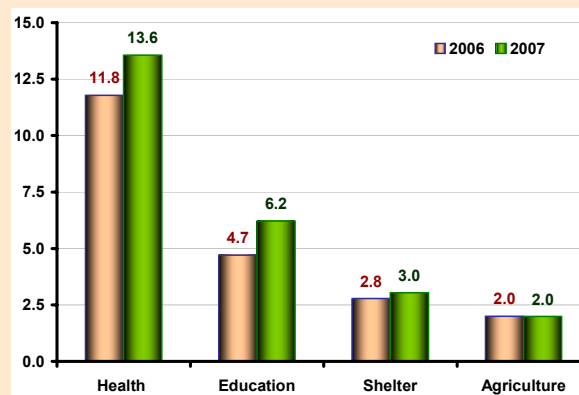
Education national project saw an equivalent of 6.2% of the value added of the education sector allocated for its implementation in 2007 from the federal budget. Financing was primarily aimed at maintaining and developing the best examples of Russian educational system, the introduction of new technologies, the creation of federal universities and business schools.

This year, the **Affordable and Comfortable Housing for Russian Citizens** national project was allocated financing total equaling 3% of the total value added of the entire construction sector over 2007. The project is primarily aimed at increasing the volume of housing construction, the development of the mortgage sector and the improvement of the population's living conditions.

This year, the **Industrial Agricultural Complex Development** project was allocated money from the budget corresponding to 2.0% of total value added of the agricultural sector. The project's mission is to develop animal husbandry, promote the development of farms and provide housing to young specialists in rural areas.

Overall, in 2007, financing of national projects has experienced significant growth by comparison with the previous year. The amount of money allocated to Healthcare and Education national projects has grown to the biggest extent.

**2006-2007 Financing of National Projects
(in % of value added of the relevant sector)**



On the Impact of Financial Crisis on the Economy

Current year has had a significant impact on the economy. Market cooldown, signs of growth slowdown in entire industries, final domestic demand structure change – all indicate the end of the period of economic growth, both overall and "cheap" – with different meanings of the word.

Insert. On the impact of the banking crisis on the real sector company activity

The primary negative factor which is already having an effect is the **growth of costs which is the result of bank credit interest rates**. Estimates show that a 1 percentage point increase is equivalent to a 0.26 percentage point increase of total costs for the economy and in the processing industries, which is equivalent to an annual profit decrease of 1,9-2,0%. Therefore, it can be stated that rate growth according to 2008 year-end results will lead to an additional cost increase for the companies of at least 1.6%, equivalent to a profit fall of 11%.

Companies in the final product processing sector are especially vulnerable to company cost growth. These are the companies competing with import sector and having low profit margins (clothes and shoe production), or active recipients of credit (the timber industry). In these sectors, cost increase will reach 2-3%, while profits may experience a two-fold fall. In addition, transportation vehicle manufacturers are very sensitive, as well as those of food products where profit decrease may reach a quarter or a third of its total volume (see table).

Table 1. Short-term sensitivity of production and profit cost changes to bank credit interest rate changes (per 1% of interest rate change)

Сектор экономики	на 1 % удорожания кредитов		на 6% удорожания кредитов (оценка для 2008)	
	% роста издержек	% снижения прибыли	% роста издержек	% снижения прибыли
В целом по экономике	0,26	1,9	1,6	11
Промышленность	0,25	1,6	1,5	9
Добыча полезных ископаемых	0,30	1,1	1,8	6
Обрабатывающие производства	0,26	2,0	1,6	12
производство пищевых продуктов, включая напитки, и табака	0,27	4,4	1,6	27
текстильное и швейное производство	0,30	7,1	1,8	42
производство кожи, изделий из кожи и производство обуви	0,39	7,9	2,4	47
обработка древесины и производство изделий из дерева	0,52	7,5	3,1	45
целлюлозно-бумажное производство; издательская и полиграфическая деятельность	0,26	3,3	1,6	20
химическое производство	0,32	1,2	1,9	7
производство резиновых и пластмассовых изделий	0,24	3,4	1,5	21
производство прочих неметаллических минеральных продуктов	0,32	1,7	1,9	10
металлургическое производство и производство готовых металлических изделий	0,25	1,0	1,5	6
производство машин и оборудования	0,18	2,8	1,1	17
производство электрооборудования, электронного и оптического оборудования	0,17	2,7	1,0	16
производство транспортных средств и оборудования	0,25	5,7	1,5	34
прочие производства	0,22	4,5	1,3	27
Производство и распределение электроэнергии, газа и воды	0,14	2,7	0,8	16
Сельское хозяйство, охота и лесное хозяйство	0,75	5,2	4,5	31
Строительство	0,16	3,6	1,0	22
Оптовая и розничная торговля; ремонт автотранспортных средств, мотоциклов, бытовых изделий и предметов личного пользования	0,21	2,3	1,2	14
Гостиницы и рестораны	0,18	1,7	1,1	10
Транспорт и связь	0,32	1,9	1,9	12
Финансовая деятельность	0,30	1,8	1,8	11
Операции с недвижимым имуществом, аренда и предоставление услуг	0,46	1,7	2,8	10
Государственное управление и обеспечение военной безопасности; обязательное социальное обеспечение	0,12	2,3	0,7	14
Образование	0,04	0,6	0,3	3
Здравоохранение и предоставление социальных услуг	0,14	2,0	0,8	12
Предоставление прочих коммунальных, социальных и персональных услуг	0,14	0,6	0,8	4

Second negative factor is the decrease in volume of credit offers for commodity producers.³ As a result, the opportunities for companies to obtain financing for working capital to expand production are already contracting. In the future, the need to stop the issue of credit may arise.

³ Banks have recently significantly limited the issue of new credit (especially for borrowers without privileges) to improve current liquidity levels.

Estimates show that the slowdown of the growth of the issuing of bank credits due to the financial crisis is evaluated at 11-13 percentage points of growth in 2008 and at 8-10 percentage points in 2009. This has the potential to slow down goods and services manufacture by more than 2 percentage points in 2008-2009 for the economy as a whole and by 1.6-1.8 percentage points -- for the industrial sector. (see table). At the same time, real slowing down of the issue, will apparently be lower, as it will be compensated by the increase in borrower debt and remuneration, as well as prompt measures taken to increase production effectiveness (optimizing the number of the employed, stock, etc.).

Table 2. Estimating the Potential for Changes in Production Due to Bank Credit Slowdown (in percentage points of issue growth)*

<i>Сектор экономики</i>	<i>sensitivity to 1% credit growth in 2006-2007</i>	<i>in 2008</i>	<i>in 2009</i>
<i>Overall</i>	0,26	2,3	2,1
<i>Fossil fuels extraction</i>	0,31	1,8	1,6
<i>Natural raw materials extraction</i>	0,25	0,2	0,2
<i>Food production including tobacco&alcohol</i>	0,33	2,2	1,7
<i>Textile industry</i>	0,24	0,9	0,7
<i>Leather industry</i>	0,45	5,4	4,1
<i>Wood processing</i>	0,25	1,8	1,4
<i>Paper and poligraphy</i>	0,51	1,8	1,4
<i>Coke coal and petroleum products</i>	0,43	1,7	1,3
<i>Chemical industry</i>	0,30	1,4	1,0
<i>Plastics and rubber industry</i>	0,27	6,5	5,0
<i>Other non-metallic mineral processing</i>	0,52	2,2	1,7
<i>Metals production and processing</i>	0,29	2,0	1,6
<i>Machine&tool industry (civil)</i>	0,38	3,6	2,7
<i>Electric and electronics production</i>	0,40	0,5	0,4
<i>Transport vehicles</i>	0,29	4,3	3,3
<i>Other industry</i>	0,37	5,6	4,3
<i>Production&distribution of gas, electricity and water</i>	0,06	0,9	0,5

At the same time, for current situation in Russia, there is an overlap of two causes of the crisis – one internal, tied to overheating correction in some sectors of the Russian economy (housing construction being a classical example), and the second one – external, tied to the outflow of financial capital from the Russian market.

Now, primary damage from the crisis was sustained specifically by the most successful sectors of the Russian economics – which are most integrated in global markets of goods and capital and/or have benefited the most from the markets heating up in 2006-2007.

The above involves the investment sector (both in the area of savings and financing of the investment process, as well as in the area of housing construction and investment equipment production); the banking sector and the financial markets which depend on trans-border capital flows; manufacturing in export and investment-oriented sectors of the fuel industry, of metallurgy and investment machine-building.

On the other hand, the trends in population's income and consumption, and, consequently, the consumer-oriented sectors (excluding some sectors, like car manufacture, which are significantly impacted by consumer credit crisis) has not experienced any noticeable impact of the unfolding crisis

so far. Trends in population's salary, real income and consumption currently remain high, equal roughly to the pre-crisis level.

Therefore, the perspectives for the Russian economy emerging from the financial crisis are currently predicated upon the following factors:

- How deep (accounting for active measures taken recently in support of the banking and financial sectors) would financial institution crisis will turn out to be – as the banking sector is currently largely oriented toward foreign sources of loans;
- Will it be possible, by taking measures in support of the banking sector and the national financial markets (supplying government subordinated credits to capitalize the banking system, to create government market maker on the domestic corporate securities⁴ market, to create mechanisms to have the ability to quickly deal with debt policies of government companies-the largest foreign borrowers⁵, etc.) in order to benefit from the crisis situation to reform the Russian financial system by improving its system stability and by ensuring support through domestic sources of long-term credit, as opposed to foreign ones as it stands now.
- Will the crisis spread to the consumer market, will there be massive unemployment and/or a decrease in real salary trends, with subsequent decrease of the population's real income;
- Will the Russian manufacturers be able to, in a deteriorating global economy situation maintain or improve their positions on the foreign (raw materials, some types of cars and equipment) and domestic markets. The last factor is key: the economy which will be able to preserve or even improve, to the largest extent, its position on the markets, will in the future become the most attractive sector for investments and for building global cooperative chains. Therefore, Russia is faced with a unique choice today: either become a new “star” – a center for attracting investments and technologies once the world economy emerges from the crisis, or rather quickly become submerged in protracted stagnation, which is not conducive to implementing priority issues in the area of economic and social development;
- Will an inflation jump occur as a result of pouring economy large sums of money into the economy tied to supporting financial markets – or would the world market cooling result in “inflation import”, which would balance out the consequences of pumping in money.

In what concerns the impact of the world financial crisis on Russian domestic situation, different sectors have been influenced in different ways.

First of all, even before the world financial crisis started, **investment activity** experienced a decrease. The initial cause was the fall in housing construction investments. Then, the contraction of long-term credit became an additional factor limiting the growth of investments, as investment growth (values adjusted for seasonality) virtually came to a halt. While in January-April, the average monthly investment increase was 0.5% (versus the previous month, values adjusted for seasonality), in the subsequent four months it decreased to 0.1%. Therefore, investments in housing construction and the number of houses placed on the market started falling⁶.

⁴ It is expected that Foreign Trade Bank will begin providing assistance to Russian corporate securities markets, and acting as investment operator on these markets for some of the National Well-being Fund moneys

⁵ Foreign Trade Bank (Vnesheconombank) will refinance large foreign credits of Russian companies that were obtained for investment projects and for acquiring assets in Russia. One of the possible conditions for providing this type of refinancing would be making Foreign Trade Bank representatives part of the borrower's management and accepting conditions for limiting new foreign borrowing.

⁶ Case in point: in August, investments in housing construction fell by 1.5%, introduction of new housing – by 1.8% (values adjusted for seasonality). A similar situation was observed in previous months.

Economic growth. The slowdown in investment activity, the contraction of consumer credit sector, the general deterioration of the economic situation have logically lead to a slowdown of economic growth. Overall, economic losses in 2008 are evaluated at 0.3-0.4 percentage points (before the crisis, economic growth in 2008 was estimated to be 7.8%, and currently it stands at 7.3%).

Employment. The slowdown of economic growth will probably lead to a massive loss of employment. For example, Delovaya Rossiya business association, as well as Russian Union of Manufacturers and Entrepreneurs have announced that reducing excess workforce will be inevitable.

Lowering the job market burden (in 2007, unemployment rate fell from 7.2% to 6.1% of the active population) could be potentially viewed as positive outcome. However, due to existing conditions, i.e. the low territorial (due to expensive housing) and professional (poor continuous education/additional education system), these newly unemployed will probably lead not to an increase in the number of jobs in the most effective sectors of the economy, but to an increase in the burden on social institutions.

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Money markets. The last phase of the global financial crisis on the developed markets has become an ultimate challenge for the financial system model that emerged in Russia over the past several years. "Pumping out" liquidity to federal budget accounts which ensured the sterility of the money offer, produced a liquidity deficit on Russian domestic market. Taking into account the intensive growth of demand for money from fast-growing Russian companies and population, this situation has logically lead to a decreased liquidity of the Russian banking system. Banks and large Russian companies have found a solution by obtaining more loans on the world markets. The other basis for the stability of the Russian financial system was the intensive influx of capital onto Russian financial markets.

The outflow of capital lead to a fast decrease of the banking system's liquidity, to partial disorganization of the interbank credit market. The monetary authorities have promised over 3 trillion rubles (over \$ 130 billion, excluding measures to support the fund market and bank recapitalization) to maintain banking sector liquidity and to refinance foreign corporate debt.

Fund market. One of the outcomes of the "money vacuum" sucking out liquidity from the Russian fund market, was the rapid fall of major fund indices. The RTS Index, which was approaching 2500 points in May, fell to less than 800 points by the beginning of October. This development stopped virtually any possibility for the Russian companies of obtaining resources on the open markets (through IPO's or other mechanisms).

The crisis is having a contradictory impact on the crisis as it reflects the remaining influence of pro-and anti-inflationary factors. On the one hand, the pouring into the economy of significant financial resources aimed at supporting the money market, undoubtedly has the capacity for producing inflationary consequences. On the other hand, the "cooling" of world markets (food and oil product markets first of all), is capable of lowering "structural inflation", to which the Russian economy turned out to be very sensitive (it is estimated that approximately 1-1.5 percentage points of consumer price growth can be assigned to it), which partially compensates the impact of the monetary factor. An additional factor is the potential for a growing cost inflation due to companies transferring the growing costs to the consumer.

In light of the possible actions taken by the companies to increase prices, the acceleration of inflation on the consumer market could be at least 0.2-0.3 percentage points.

GDP Growth Factors

The most important aspect of the 2007 economic growth, and in fact, one which ensured record rates of economic growth, was the emergence of a new “hotbed of growth ” in processing industries. Here, value added growth rate increased from 2.9% in 2006 to 7.4%. In fact, growth was observed for a wide range of processing industries, primarily those manufacturing cars and equipment. Consequently, car and equipment production growth rate took first place among primary groups of processing industries.

Intensive growth in areas, which used to be economic development leaders, i.e. sales and construction, maintained their intensive growth rate last year. For the former, the value added increase was 12.9% (14.6% in 2006), and 16.4% for the latter (therefore, 11.6%).

We must note that growth had clear signs of overheating in both sectors. For construction it was based, to a significant extent, on expanding investments in housing construction in large cities where obvious market overheating was observed. In sales, on the one hand, real salary was approximately twice as large as labor productivity, and on the other – a boom in consumer credit.

The 2008 financial crisis has brought with it significant changes in the structure of economic growth.

In the spring (April-May) the number of houses introduced on the market started falling – primarily, through overheated markets of Moscow and St. Petersburg. After the issue of long-terms credits was suspended due to the financial crisis (and due to the outflow of liquidity from the Russian market), construction numbers continued to fall.

Then, in the third quarter of 2008, output rates in the processing sectors slowed down significantly. It is still unclear, however, how stable this trend will be, although a number of areas are highly to be affected by the unfolding crisis. The cement industry representatives have already announced that they are experiencing problems with increasing output (construction slowdown in large cities; JSC Evrotsement announced that it would decrease cement output by 30%); the metallurgy industry (for housing structure manufacture, probably, the metal for metal-intensive sectors of car manufacturing, and possibly – for export supplies); car industry (the result of the credit expansion by the Russian banks -- for consumer credit, as well as for truck purchase loans); possibly the manufacture of cars and equipment (scale and duration of problems will be determined by the rate at which banks will resume issuing credit).

As a result, the industrial output level has stabilized over recent months. In July, industrial production fall was observed for the first time in recent years (0.2% as compared to June, values adjusted for seasonal and calendar factors), August increase did not compensate for this decrease (0.3% as compared to July, values adjusted for seasonal and calendar factors).

Value Added Trends for Primary Types of Economic Activities (%)

	2006	2007
Валовой внутренний продукт	7.4	8.1
Processing industry	2.9	7.4
Agriculture	3.6	3.1
Construction	11.6	16.4
Wholesale&retail trade	14.6	12.9
Transport&communication	9.6	7.7

It is important to note that in the past, and definitely this year, the trend in export lagging behind economic growth has become entrenched. In fact, under existing conditions (when raw material export represents the bulk of product export), opportunities for growing physical volume of export are rather limited – due to the limitations imposed by the raw materials, transport infrastructure, resources, the policies of large companies, etc. Overall, in recent years product export growth has been experiencing a stable lag behind overall GDP behavior. Under 2008 conditions, external market contraction and breaks in issuing credit became additional factors, which slowed down of goods even further, all while economic growth still continued (through fast sales growth, for example).

In the meantime, import, which was being stimulated by an intensive expansion of domestic markets, has been growing approximately twice as fast as they were.

As a result, last year, the faster growth of import became one of the most significant factors slowing down economic growth. It caused a “loss” of approximately 4 GDP increase percentage points.

Gross Domestic Product and Product Export Behavior (increase rates, %)

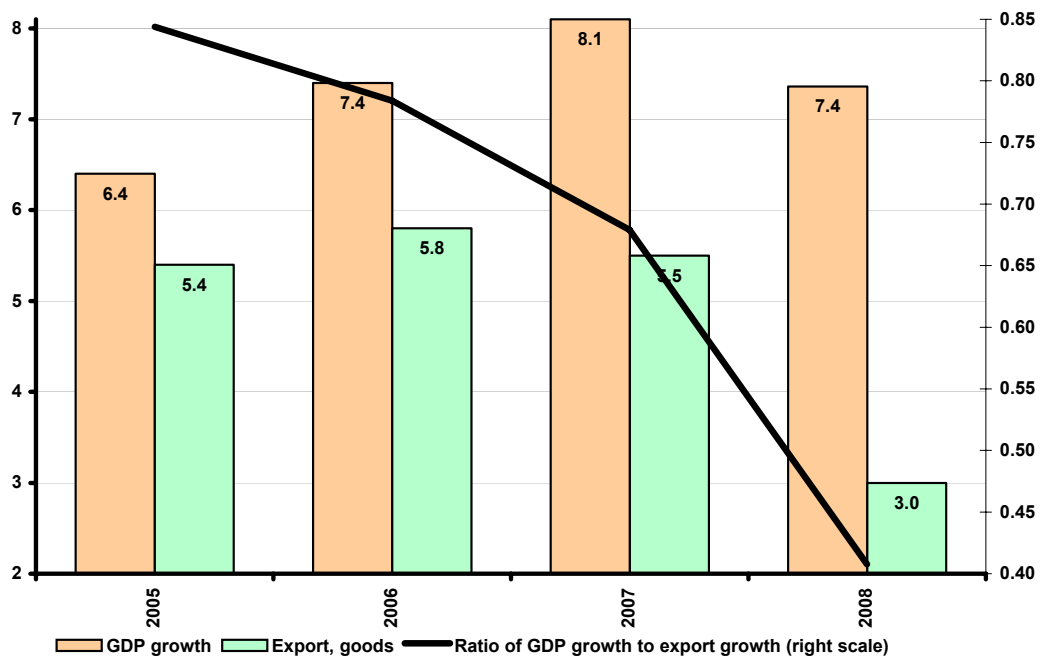


Table 1.2. Economic Growth Factors in 2006-2007

	2006	2007	Growth factors	
GDP	7.4	8.1	8.1	100
including:				
Final consumption	8.9	10.6	7.1	87
households	11.2	12.8	6.3	77
government	2.5	5.0	0.8	10
Not-for-profit	-0.2	-0.7	0.0	0
Gross savings	18.3	22.6	4.8	59
Gross fixed capital formation	17.7	20.8	3.8	47
Inventory stocks change	22.9	34.0	1.0	12
Net export	-15.6	-28.1	-3.9	-48

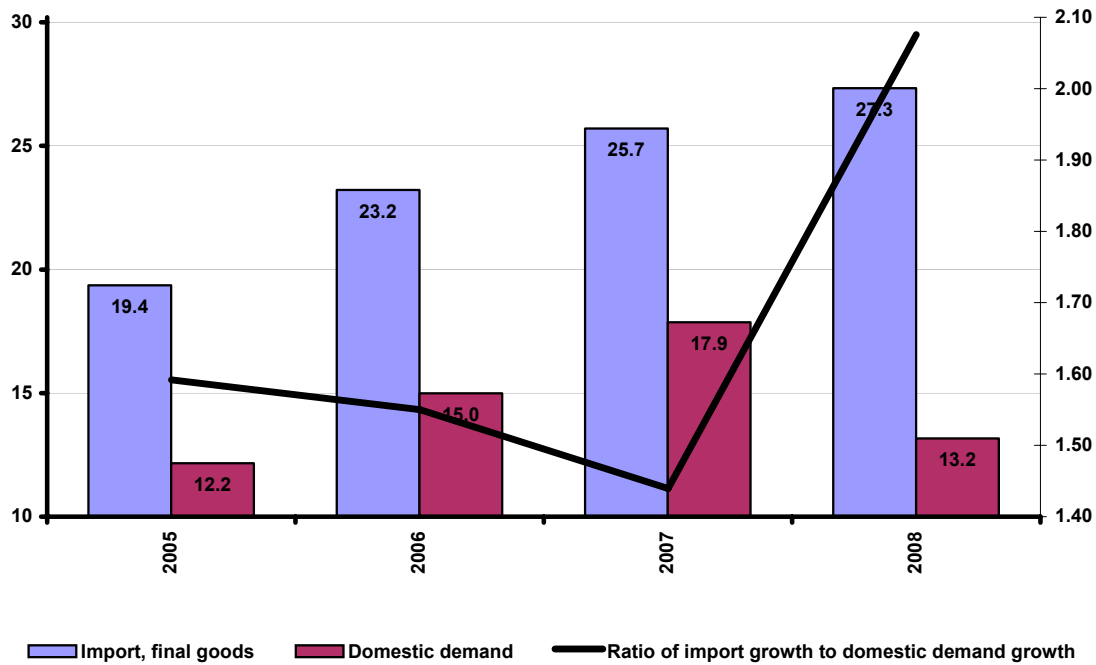
In theory, the faster growth of imports has been observed against the background of an accelerated market growth rate (which significantly contradicts the situation in, say, 2006). Thus, in

2008, import growth was almost twice as high as the expansion of domestic final (investment and consumer) demand.

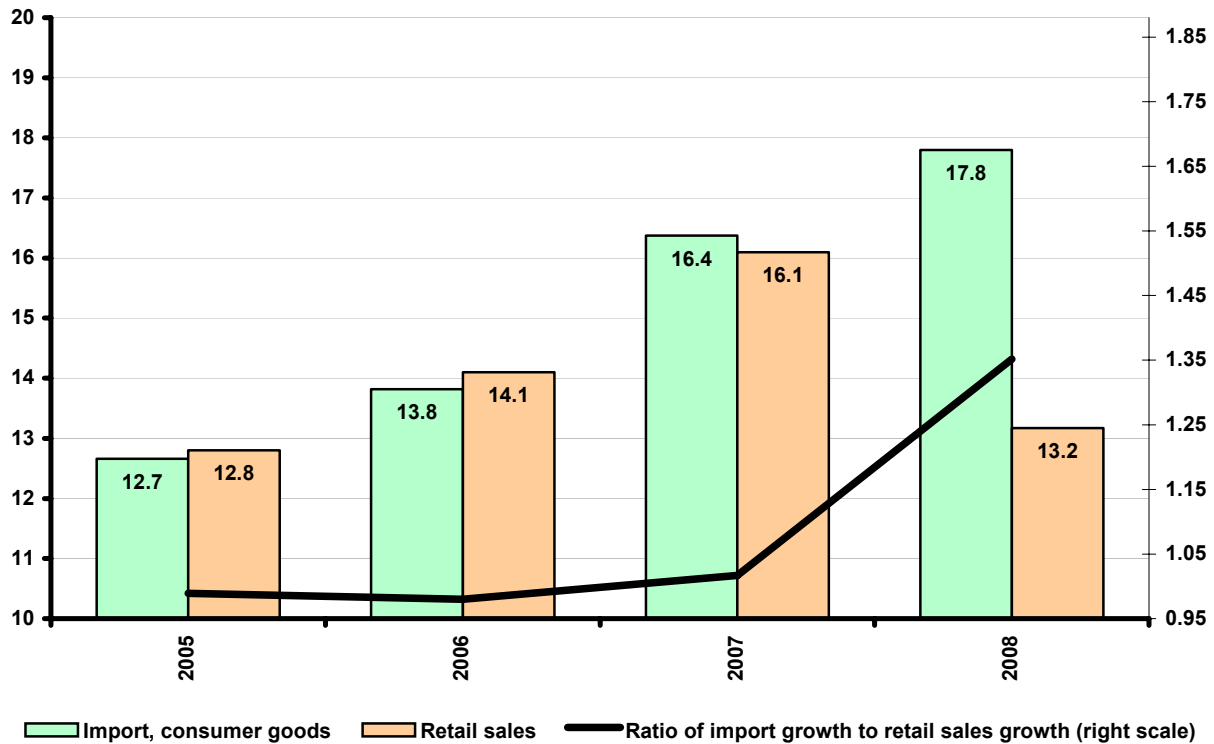
However, for the situation that existed over the past two years, the dynamics of import in and of itself is not indicative. For example, the dynamic growth of import observed last year, is to a large extent tied to the expansion of investment import which stimulated the decision to cancel customs duties levied on a wide range of investment equipment.

At the same time, a trend change has been taking shape on the consumer market, which proves that the competitiveness of Russian products is growing – and which is in turn evidenced by a certain improvement of the ratio of the growth of consumer import to consumer market.

**Domestic Final Demand and Import of Final Products
(increase rates, %)**



Consumer Import and Retail Sales (increase rates, %)



GDP Consumption Dynamics

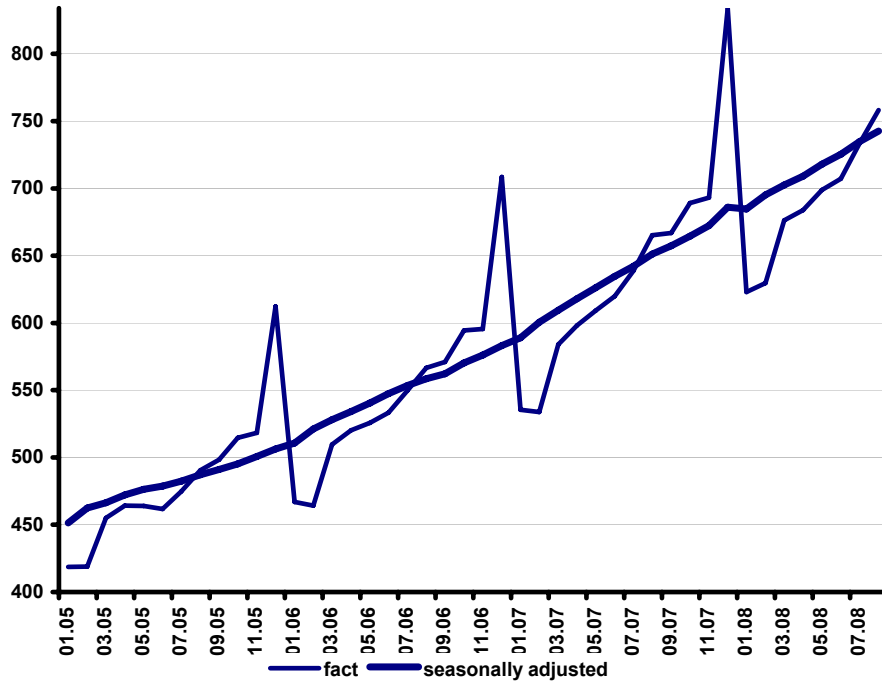
Retail Sales Volume

“Consumer boom” period continued in 2007. Product consumption increase even accelerated and reached a record 15.2%. On the other hand, the expansion of fee-based services provided to the population somewhat slowed down to 7.1%.

Primary Consumer Market Development Indicators in 2003-2006 (increase rates, %)

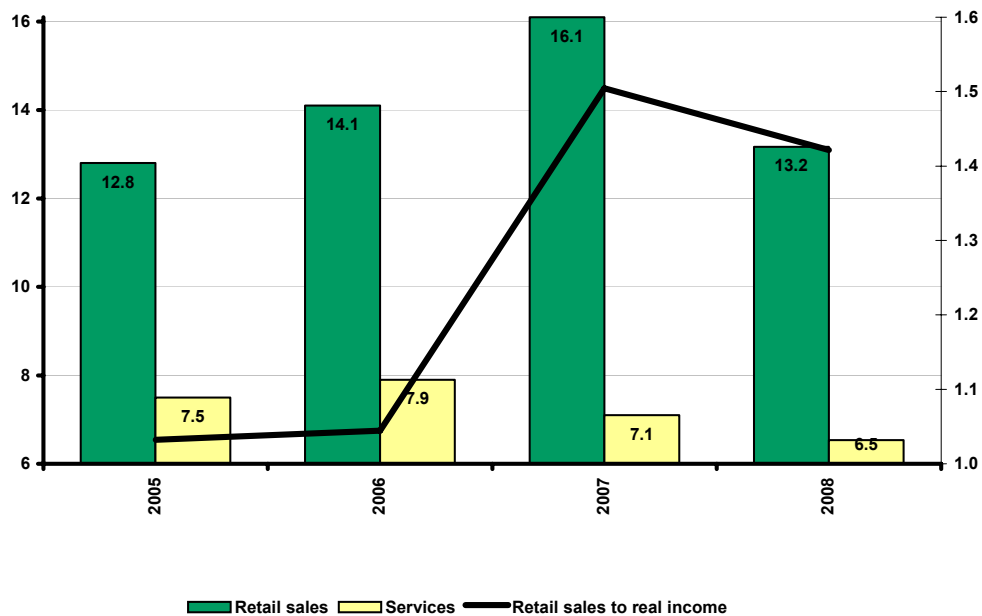
	2005	2006	2007	2008 (оценка)
Retail sales	12.8	14.1	16.1	13.2
Food	10.5	11.0	12.4	н.д.
Nonfoods	15.1	16.8	19.2	н.д.
Services	7.5	7.9	7.1	6.5

Retail Sales Volume (in billions of rubles in 2003 prices)



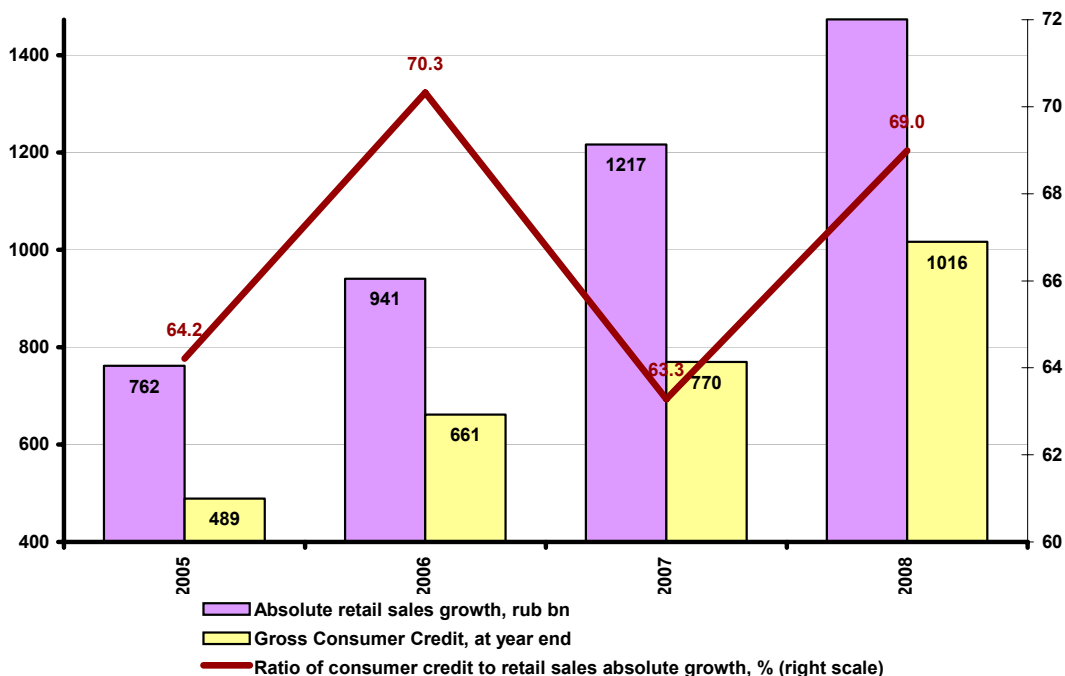
Explosive growth of sales volume was stimulated by the continued fast-paced growth of population's income. However, in 2007, the ratio of retail sales volume growth to real disposable income grew significantly and reached 1.5 (see graph). This shows that other factors also contributed to the expansion of sales, such as increased tendency on the part of the population to consume, and consumer credit.

Consumer Market Behavior (increase rates, %)



Consumer credit still remained an important factor influencing the expansion of non-food item sales. However, for the first time in recent years, the weight of this factor did not increase, but even decreased to an extent (see graph).

Contribution of Consumer Credits to Non-food Item Volume Growth (%).



The deteriorating conditions in which the Russian economy was developing has so far been translated into retail sales volume slowdown only to a limited extent (due to the consumer credit crisis). It is caused by the continued the high real income of the population and the increased tendency of the population for consumption.

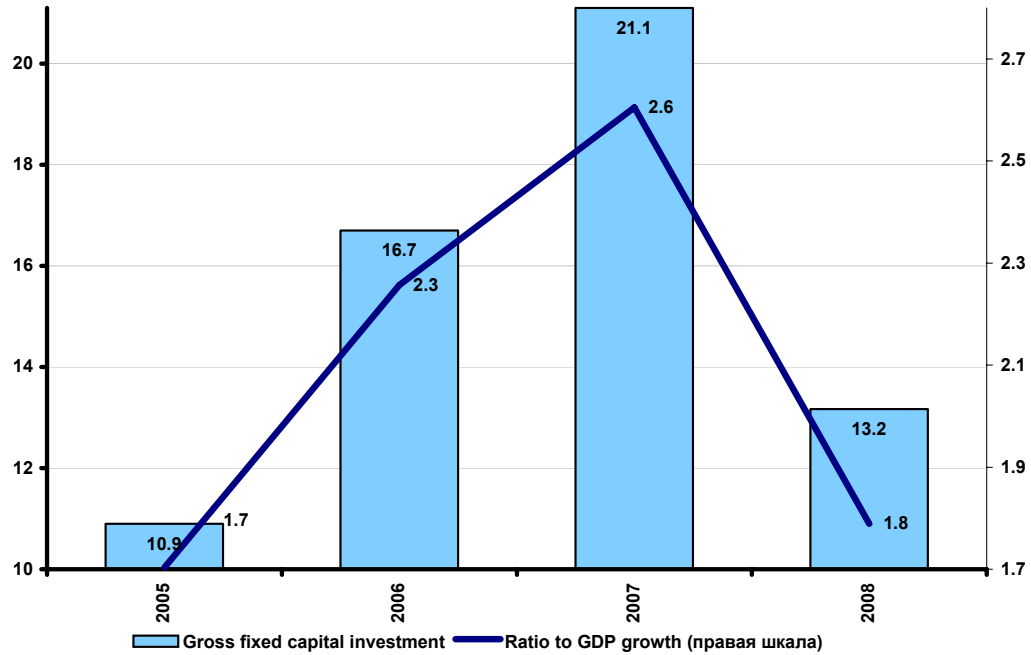
Generally, turnover growth in the current year is estimated to be at 13.2%, which is just 2.9 percentage points lower than a year ago. This is so far in line with the general and rather natural “cooling” of the overheated Russian economy.

Investments in Capital Goods

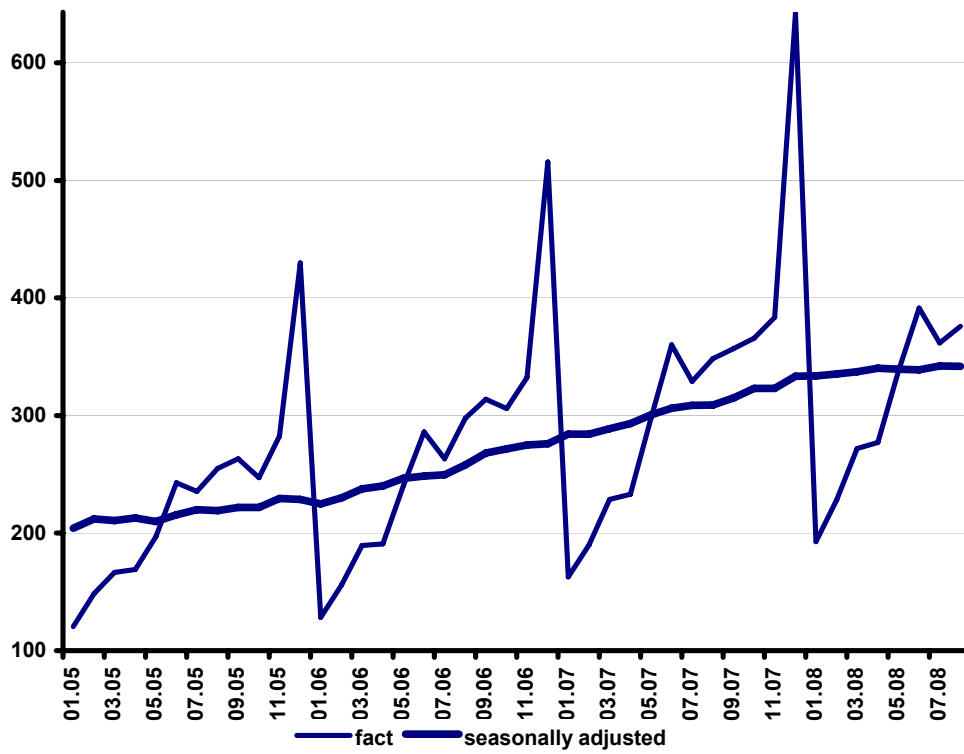
Last year, as has already been repeated many times, was marked by a fast growth of investments. They jumped 21.1%, which is significantly higher than in recent years.⁷ (see graph).

⁷ Elasticity (ratio of growth rates) of GDP investments reach a historic maximum last year

Investments in Capital Goods (increase rates, %)



Volume of Investments in Capital Goods (in 2003 prices, billions of rubles)



In 2007, capital investments reflected the unfolding of the following very significant trends.

Stepped up efforts by companies and the government aimed at lifting limitations imposed by infrastructure. This trend expressed itself in a massive increase in capital investment in heat and electrical power generation (almost by a factor of 1.5), as well as ground transportation (by a quarter as compared to the 2006 level). For the production and distribution of electrical energy, the growth of investments was primarily the result RAO "UES of Russia" starting to implement its investment program for 2006-2010⁸.

- For transportation, the growth of capital investments was due to the implementation of RAO Russian Railways investment program, as well the growth of investment activities of passenger car and urban electrically-powered transportation.
- ***Preserving investment boom in agriculture***, which is also supported, inter alia, by the implementation of the "Industrial Agricultural Complex Development" priority national project. Investments in animal husbandry have also experienced a significant increase.⁹ At the same time, the attractiveness of investment in agriculture¹⁰ ensured entry into the sector not just of traditional investors (i.e. large Russian manufacturers of food products interested in supplying raw production materials), but also of "external" companies which previously were not involved in the agricultural sector.
- ***The growth of investments in social capital and housing infrastructure*** was ensured by two macro factors. First, a stable and fast growth of population's income over the past years stimulated development of the social sector which was catching up with it and which had been chronically underinvested in the 90-ies and at the beginning of the 2000-s. Second, the implementation of the "Education", "Health" and "Affordable and Comfortable Housing for Russian Citizens" priority national projects clearly had a role to play.¹¹ The above factors impacted 2006-2007 by increased investments: in education – by 27% per year, in healthcare –

⁸ RAO "UES of Russia " Investment program for 2006-2010 was approved by the Holding's Board on January 29, 2007. According to the program, capital goods investments were to be increased to 502 billion rubles in 2007 from 180 billion rubles in 2006. Among the largest projects completed in 2007 most notable were the 450 megawatt power generation plant (for electrical energy) at the TPP-27 of JSC "Mosenergo", and the 330 kilowatt "Rzhevskaya" substation. Plants were also put online in Belgorod, Novgorod, Yaroslavl' and a number of other cities. It is worth noting that the 2007 investment increase also reflected the start of a significant number of projects that are expected to be completed by bringing online new plants in the subsequent year.

⁹ Growth by 59% in 2006 and by 27% in 2007 (although capital investment growth rates in crop raising area also rather significant: 35% and 21%, respectively).

¹⁰ Let us note that the increase in agricultural product prices in 2007 helps manufacturers by enabling them to get a faster return on investment and by making the sector even more attractive for investments.

¹¹ For example, the "Health" project planned for the construction of 15 federal centers of high-tech medical centers, which saw 19.4 billion rubles allocated to it in 2007. Construction work started in 2006. The proportion of the national project in total investment increase in healthcare is estimated to be at least 40%.

In accordance with the "Education" project for the 2006-2007 period, on the order of 5.5 billion rubles have been allocated to develop the technical basis for contemporary information educational technologies, and 4.6 billion rubles – for equipping schools with educational and visual aid equipment. Over two years, over 7 thousand school buses were delivered to the regions. National project's share of total investment increase in education is evaluated to be at least 25%.

The "Housing" project for the 2006-2007 period also saw approximately 10 billion rubles earmarked for upgrading utilities infrastructure.

by 19%, in organizations for providing other utility, social and personal services, as well as operations in real estate, lease and services¹² – by 20% and 13%, respectively (see table.).

- ***Overcoming the deteriorating conditions of hydrocarbon mining.***¹³ For over two years, the level of investments in oil production has been growing by an annual average of 27%. However, in recent years, production volumes have been experiencing very insignificant growth (with no significant future increases expected), which means that investment growth reflects an increase of the production's¹⁴ capital intensity as a consequence of the gradual exhaustion of relatively easily accessible deposits with highly productive wells.¹⁵ Investment growth acceleration has been recorded in gas production area– from 11% in 2006 to 36% in 2007.

The concentration of investments in fuel and raw materials sector is tied to the impact of several systematic factors, of which primary ones are the following:

- A sharp change in profitability (due to high fuel and metal prices worldwide) between the fuel and raw materials sector and processing industries, which complicates the creation of financial investment resources in them both through companies' own means and through loans (relatively high-risk loans);
- The existence in the fuel and energy industry and the raw materials sector of large companies capable of signing contracts with foreign investors and having the ability to accumulate significant volumes of resources.¹⁶;
- The implementation in natural monopoly sectors of capital-intensive investment projects, including those financed through budgetary resources.

There is qualitative inequality that emerged in terms of the possibilities for creating investment resources between various sectors of Russian economy. This inequality further consolidates the multi-faceted nature (which has assumed

its virtually final shape) of the Russian economy, whereas its different sectors find themselves in diametrically different circumstances of economic circumstances in terms of access to development resources and institutional order.

¹² By increasing the amounts of capital investments in organizations belonging to the housing and utilities sector. Same can be said for manufacturing and distribution of electrical energy, gas and water.

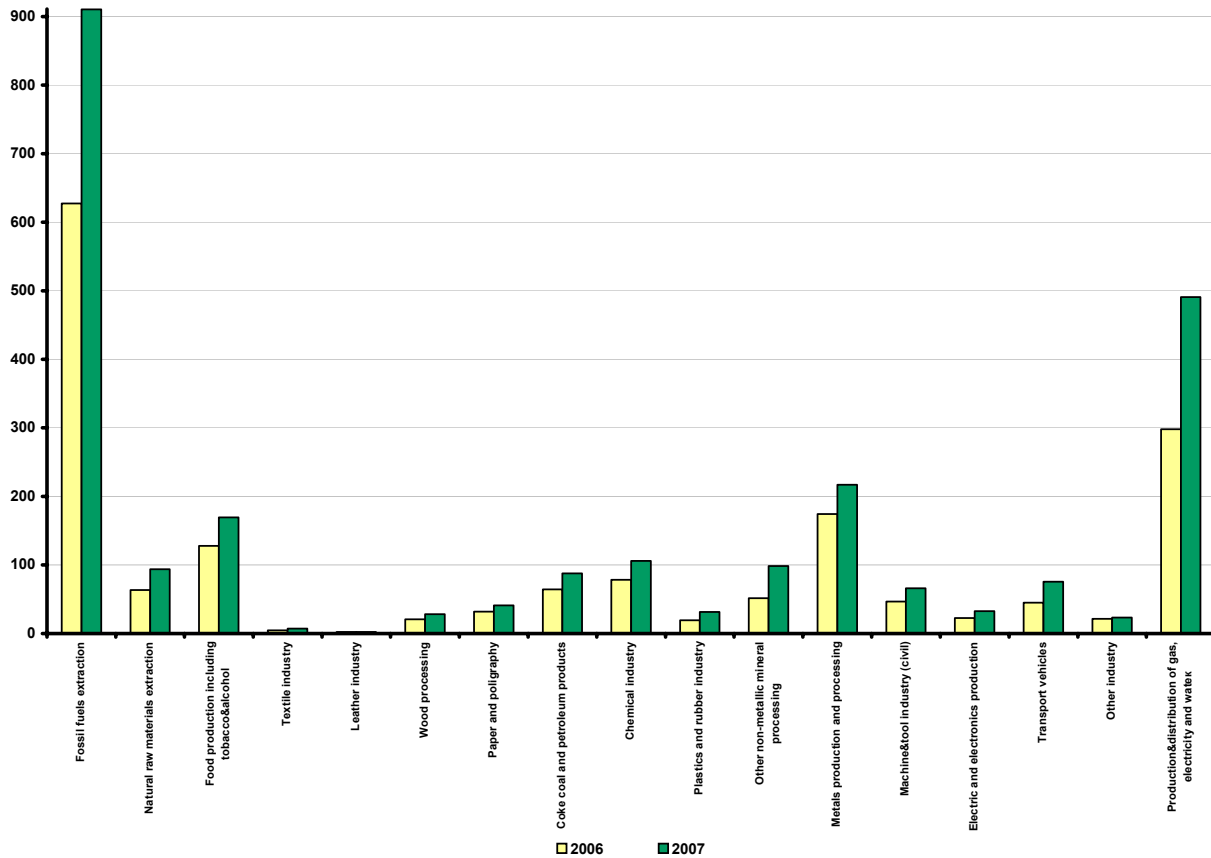
¹³ Trends in the growth of capital intensity have recently become more urgent for other mining sectors also, but in oil production it is probably most obvious.

¹⁴ The fast-paced growth of oil prices only partially covers the growing capital expenditures of the sector. Over the past five years, oil prices have grown three-fold (with the production volume growing by 29%), while investments have grown 4.2 times (in dollars). Currently, further capital investment is required just to maintain current levels.

¹⁵ It must be stated that the growth of oil production that many remember from the first half of the 2000's, was largely a restoration of production levels following its fall in the 90-ies. (in 2007, oil production level was 15% lower than the Soviet-era maximum level)

¹⁶ Let us also note that the loan boom on the fund market by the fuel and energy, metallurgy and sales companies

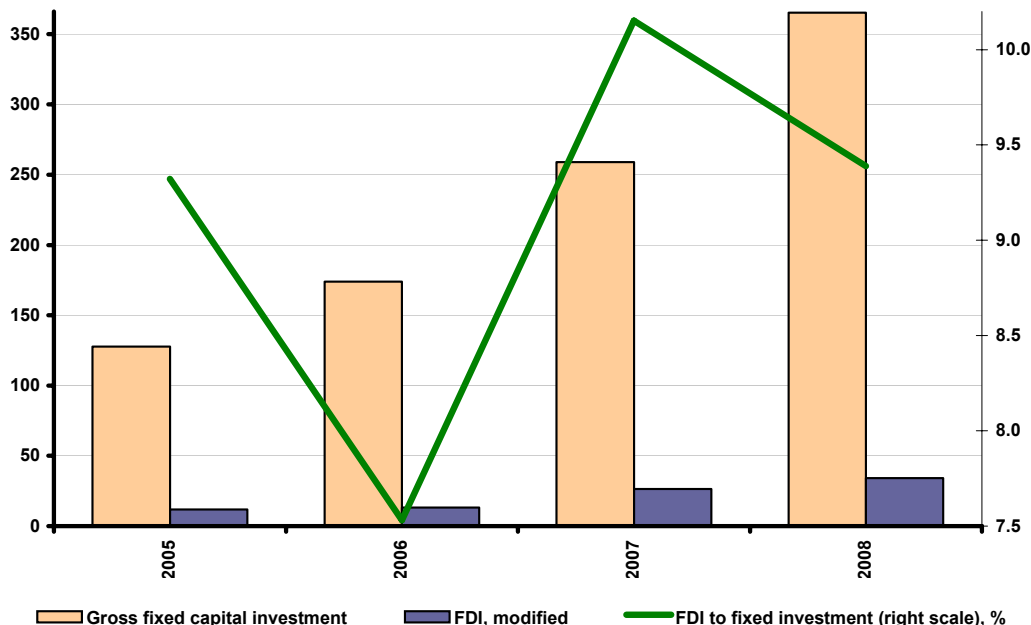
Volume of Investment in Capital Goods in Major Industries (in billions of rubles)



Past year was marked by a significant increase in the participation of foreign investors in Russia's investment process.

This includes not just the 1.5-fold expansion of the influx of direct foreign investments in the real sector of the Russian economy (from 30 to 47 billion dollars). The more important fact is that foreign investors are implementing projects inside Russia, often in the processing industry, and aimed at real construction of industrial sites and production of products for the domestic and foreign markets (the best examples are the automobile industry and the production of household goods, food products, and building materials).

Investments in Capital Goods and Direct Foreign Investments (in billions of dollars)



The financial crisis has significantly damaged the investment process in the Russian economy. The leveling out of the level investments in the middle of the year has slowed it down in 2008 to 13.2% (as a reminder, in 2007 the value stood at 21.1%); for 2009, an increase of as little as 11.9% is expected.

In addition, the current situation is special because the crisis happened at the same stage for an entire range of productions – the stage of intensive unfolding of investment projects aimed at continuing the intensive growth of domestic and foreign demand. These projects were started in oil processing, paper and timber industry, the automobile industry, power generation and others. In a situation where there several projects are in the early stages of development simultaneously, the vulnerability of Russian companies to the financial crisis definitely becomes is much higher¹⁷.

On the Impact of the Banking Crisis on Investment Activity in the Economy

In recent years, banking system's credit resources have become the most significant source of capital goods investment financing. By the middle of 2008, the proportion of bank credits in capital goods reached 12% for the industry and 18% – for processing sectors. At the same time, in tamper processing, light industry, construction material production, almost a third of investments is now financed through bank credits.

In light of reviewing investment plans for companies as risk and profitability of potential projects are reevaluated, if credit conditions continue to be bad, they may slow down investments in capital goods for economy as a whole, by approximately 3 percentage points, and by [sic] percentage points for processing sectors (and even more for some of the sectors, see table).

¹⁷ Foreign Trade Bank (Vneshekonombank), which has recently been granted significant additional government support, can be expected to provide anti-crisis support to companies like this.

Table 3. The proportion of bank resources obtained of the total amount of financing of investments in capital goods and the evaluation of the slowdown in investment activity in 2009.

	<i>Bank credit share, %</i>	<i>Potential investment growth slowdown, % points</i>
Overall	10,5	3,1
Industry	12,2	3,7
<i>Fossil fuels extraction</i>	<i>7,1</i>	<i>2,1</i>
<i>Natural raw materials extraction</i>	<i>19,0</i>	<i>5,7</i>
<i>Food production including tobacco&alcohol</i>	<i>18,3</i>	<i>5,5</i>
<i>Textile industry</i>	<i>31,4</i>	<i>9,4</i>
<i>Leather industry</i>	<i>3,7</i>	<i>1,1</i>
<i>Wood processing</i>	<i>31,3</i>	<i>9,3</i>
<i>Paper and poligraphy</i>	<i>39,5</i>	<i>11,8</i>
<i>Coke coal and petroleum products</i>	<i>25,2</i>	<i>7,5</i>
<i>Chemical industry</i>	<i>10,8</i>	<i>3,2</i>
<i>Plastics and rubber industry</i>	<i>30,1</i>	<i>9,0</i>
<i>Other non-metallic mineral processing</i>	<i>12,3</i>	<i>3,7</i>
<i>Metals production and processing</i>	<i>10,4</i>	<i>3,1</i>
<i>Machine&tool industry (civil)</i>	<i>8,7</i>	<i>2,6</i>
<i>Electric and electronics production</i>	<i>17,4</i>	<i>5,2</i>
<i>Transport vehicles</i>	<i>33,8</i>	<i>10,1</i>
<i>Other industry</i>	<i>13,9</i>	<i>4,2</i>
<i>Agriculture</i>	<i>42,1</i>	<i>12,6</i>
<i>Construction</i>	<i>7,0</i>	<i>2,1</i>
<i>Retail trade</i>	<i>14,6</i>	<i>4,3</i>
<i>Hotels and recreation</i>	<i>9,7</i>	<i>2,9</i>
<i>Transport and communication</i>	<i>4,7</i>	<i>1,4</i>
<i>Financial activities</i>	<i>11,9</i>	<i>3,5</i>
<i>Real estate operations</i>	<i>6,5</i>	<i>1,9</i>
<i>Government services and defence</i>	<i>0,0</i>	<i>0,0</i>
<i>Education</i>	<i>0,2</i>	<i>0,1</i>
<i>Health and social services</i>	<i>1,1</i>	<i>0,3</i>
<i>Other utility and social services</i>	<i>2,9</i>	<i>0,9</i>

Balance of Payments

In 2007, the balance of payments was influenced by two key trends:

1. The lowering of the active foreign trade balance and other current account operations that was taking shape;
2. Sudden expansion of the influx of foreign currency for capital account operations, which to a large extent lead to a smaller influx for current account operations.

Over the entire period after the 1998 crisis, the active current account operation balance served as the basis for the strong, stable ruble. However, in as early as the end of 2006, the trend to a decrease of this balance started taking shape. In 2007, it developed further: as compared to 2006, the balance fell by 1/5 – from \$94 billion to \$76 billion.

This trend is based on a vibrant growth of the import of goods and services, which is significantly ahead of the export levels. However, at some points, this difference may occur even in a world market situation that is extremely favorable to the Russian manufacturers – during intensive growth of the price of oil and other key products of the Russian export. This is exactly what was observed in 2007.

Major Elements of the Balance of Payments (in billions of dollars).

	2005	2006	2007
Current account	83.8	94.3	76.2
Trade balance	118.4	139.3	130.9
Export, goods	243.8	303.6	354.4
Import, goods	-125.4	-164.3	-223.5
Service trade balance	-14.8	-13.7	-19.8
Investment income balance ¹	0.5	7.8	16.0
Balance, other private sector operations	-20.1	-39.0	-50.9
Capital account²	-22.4	13.1	72.7
Government operations balance ^{1,3}	-20.3	-28.9	-0.2
Net private sector inflow ² («-» - отток, «+» - приток)	0.6	41.8	83.1
Balance, other operations	-2.8	0.2	-10.2
Currency reserves growth («-» - growth, «+» - decrease)	-61.5	-107.5	-148.9

¹ Including Bank of Russia

² including errors&omissions

³ not including operations with reserve assets (like third countries debt' writedown)

The growth of capital inflow in the private sector was also observed over an extended period. However, in 2007, the rate at which this process was occurring experienced a sharp increase: the influx reached \$83 billion, which represented a two-fold increase against the previous year¹⁸.

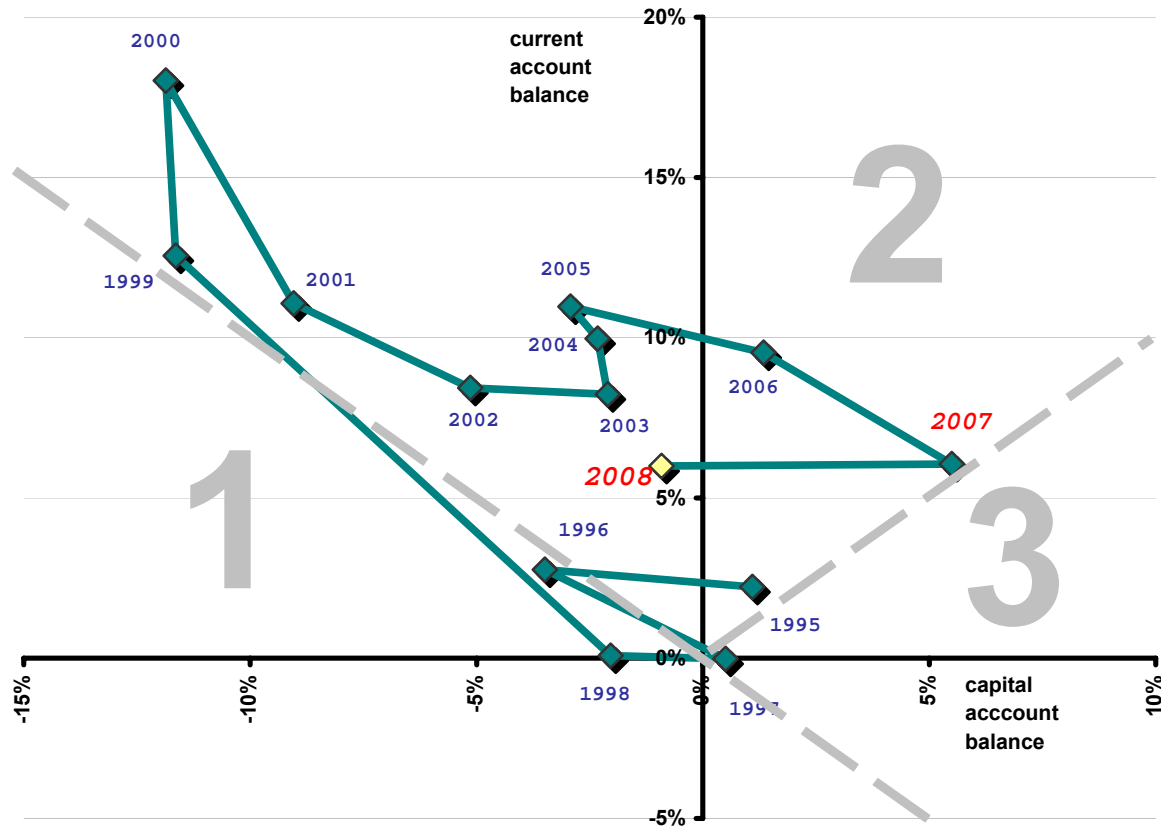
As a result, the amount of incoming foreign currency ensured by capital operations has become virtually equal to the income from foreign trade and other current operations. This was the first time that it happened in a ten-year period. (see graph)

A massive influx of capital led to an unprecedented growth of official foreign currency reserves (+\$149 billion over 2007 versus +\$108 billion over 2006)¹⁹. This influx created an increase in the surplus of the supply of foreign currency, versus demand, on the market. To prevent the ruble from becoming excessively strong, the Bank of Russia was forced to expand net purchases of foreign currency for its reserves.

¹⁸ The large-scale influx of capital in 2007 partially occurred thanks to several mega-deals, which attracted a significant (over \$30 billion) amount of money from abroad. This involves the SPO of Sberbank, the IPO of VTB, as well as loan resources obtained by Rosneft' oil company to buy YUKOS oil company assets.

¹⁹ Without taking into account changes that arise when different foreign currencies are reevaluated in relation to the dollar.

Key Elements of Russia's Balance of Payments, in % of GDP



Обозначения:

1 – weak BoP

2 – strong BoP, positive current account

3 – strong BoP, positive capital account

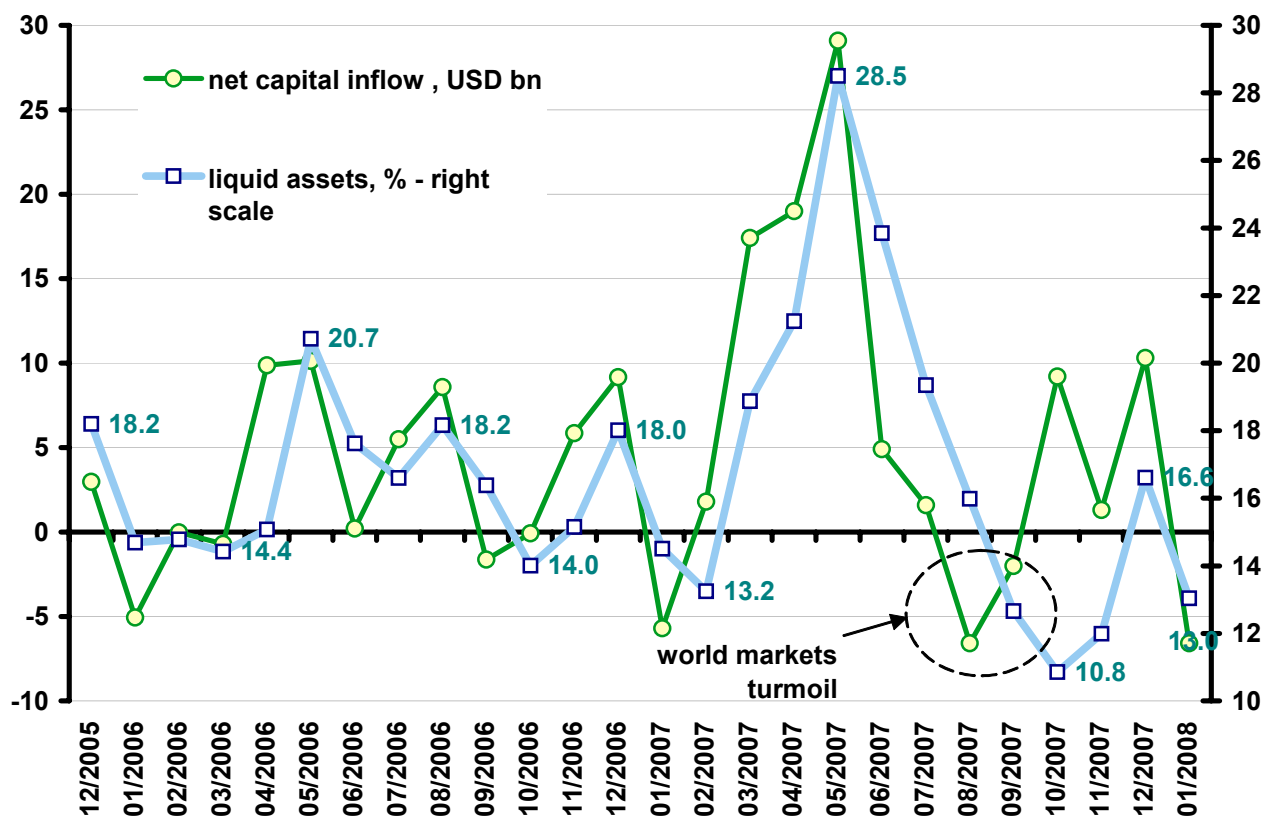
Under these conditions, the state of the Russian foreign currency market started to depend on the stability of trans-border capital flows to a very large extent. In light of the sensitivity of these flows to the changes in foreign exchange rates of key currencies, the situation on the markets of raw materials, and the risks on international financial markets, this definitely meant that the economy would become more vulnerable to external shocks.

Then as early as 2007, some aspects of the impact of the shock of capital flows on the monetary sector of the economy and on the economy started to be felt.

The first aspect: the fluctuations of money supply and of banking system liquidity caused by the shifts in capital flows.

In 2007, this situation was observed in the third quarter when issues experienced some of the segments of American financial markets have grown into a full-blown crisis. This occurrence caused a massive “salvo” outflow of private capital from the Russian economy. As a consequence, the banking system liquidity fell sharply, to minimum, 1998, levels (see graph).

Correlation between the Liquidity of the Banking System¹ and the Net Capital Influx in Non-government Sector



¹ Correlation of a bank’s absolutely liquid assets (cash in cash registers, balances on correspondent accounts and депозитax in the RF Central Bank, the Bank of Russia bonds, etc.) and bank obligations for rubles accounts and deposits

Second aspect: more difficult refinancing of companies’ accumulated debt (including foreign debt).

The intensive growth of foreign corporate debt observed over recent years (see insert) has significantly increased interest and principal payments. Thus, in 2007, these payments by non-financial

companies totaled over \$60 billion – without accounting for payments of short-term loans taken out for a period of under one year.

Until 2007, the increase in payment of foreign corporate debt was compensated that fact that companies obtained new foreign loans at an accelerated rate. However, as world financial markets entered the period of instability as early as the second half of 2007, this mechanism started experiencing problems.

Insert. The Growth of Foreign Debt of Non-financial Companies and Banks

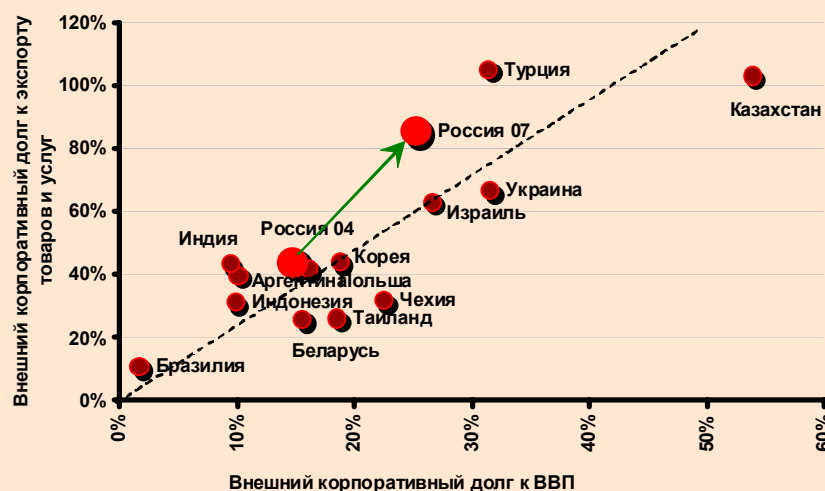
Over the past few years, intensive growth of foreign private debt is being observed against the background of contracting foreign government debt (in 2005-2007, by an average of 57% per year, including 56% in 2007).

As corporate debt grew faster than export volume, the correlation between currency income and currency debt of the Russian corporate sector is gradually deteriorating. If foreign debt continues to grow at the same highly intensive rate, and if the ruble becomes weaker, which is possible in the middle term, this may create problems for some corporate borrowers.

Nevertheless, so far, in terms of the debt burden Russia is still in a position which is far from critical. For example, the ratio of corporate debt in Russia is twice as small as in Kazakhstan, which in 2007 was faced with foreign debt crisis. Russia also has much better figures than Turkey and many of the CEE countries.

At the same time, in terms of debt burden, Russia is already ahead of many countries with developing markets, such as Brazil, India, Indonesia, Korea, and Poland (see graph).

Figures for Foreign debt Private Debt for Countries with Developing Markets ¹

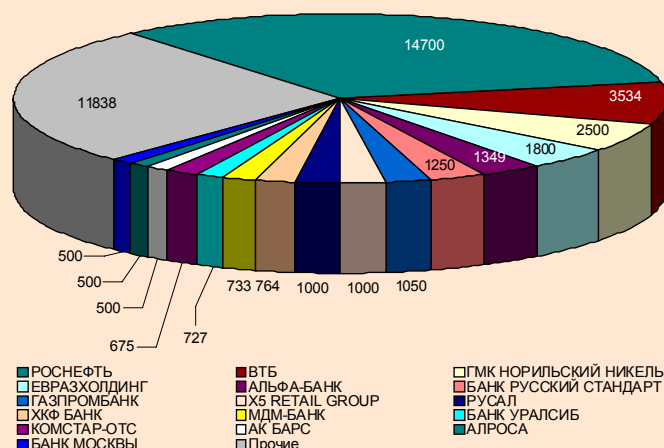


¹ Based on IMF data. Debt figures do not take into account the cost of bank and company bonds. Aside from Russia, these are data for 2006

A significant share (1/3) of Russia's corporate debt comes from large companies and banks under direct or indirect government control. In particular, these companies have the significant share of the total debt of the private sector which was paid out in 2008: 43% - for euro-bonds and syndicated credits (including Rosneft' – 33% , VTB – 8%, Gazprombank– 2%, see graph). These borrowers have reasonably good options for obtaining new loans on foreign markets to refinance debt. Also, as the events of 2008 showed, these companies can count on some financial support from the government.

Under the conditions of high turbulence on debt markets, this debt structure can be considered to be a stabilizing factor.

Payments of Foreign Syndicated Credits and Euro-bond Loans in 2008, in millions of dollars



Ultimately, due to the 2007 changes in the balance of payments, a turnaround happened in the development of the monetary sector: the mechanism that ensured a quick and mutually interconnected expansion of domestic credit and financial markets, an increased capital influx and dedollarisation of the economy became broken.

The 2008 situation was a logical consequence of the trends and factors that took shape in 2007.

- 1) The difficult situation that emerged on developed financial markets, in combination with a massive pouring of liquidity into developed economies caused another wave of capital influx in countries with developing markets, including Russia, in the first half of 2008;
- 2) The same factors stimulated the influx of speculative capitals on the markets of raw materials, which in turn caused a stable increase in prices of key products exported from Russia and intensive short-term growth of the active balance of current account operations;
- 3) The attempt by the Russian monetary authorities to suppress the deepening inflation by strengthening national currency has provided an additional stimulus for the influx of hot capitals on the Russian markets in the first half of 2008;
- 4) The powerful foreign economy shock that happened in the middle of the year and that was due to the transition of the global financial crisis to a new stage (the bankruptcy of a number of the largest American financial institutions), lead to a massive exit of short-term hot capitals from developing markets and the simultaneous fall of prices of raw materials.

Economic Policies

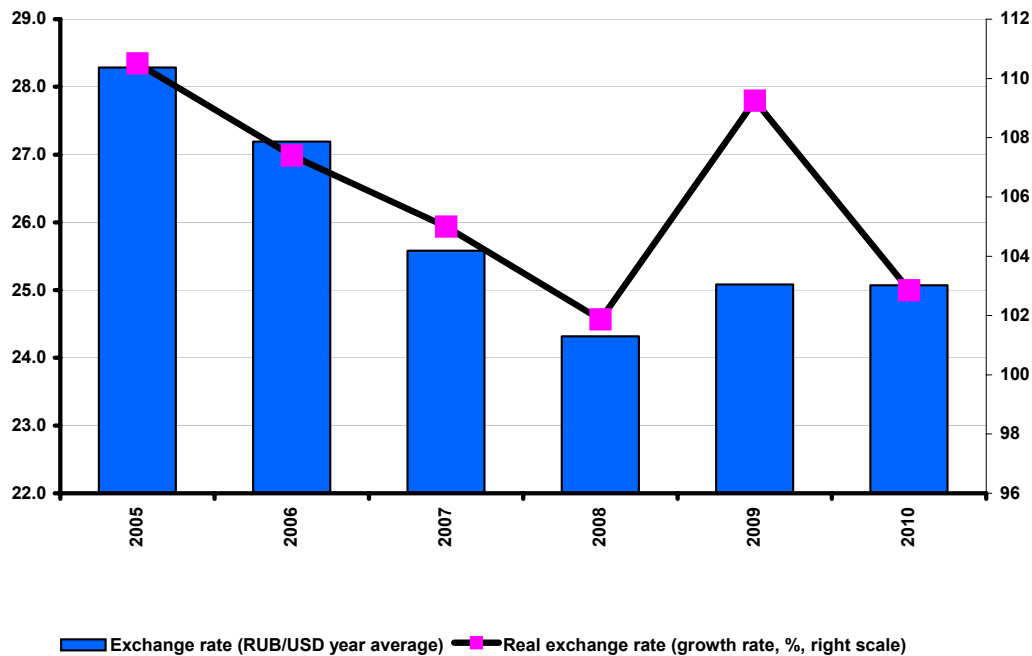
Exchange Rates

In the mid-term, the US dollar exchange rate to the ruble should be expected to stop its fall. (see graph). It can be expected that in 2009-2010, the rate would be above 25 rubles/dollar, which exceeds the average annual rate of 2008. To compare: over 2003-2008, this rate was falling by an annual average 4.2%.

The real effective ruble exchange rate will also experience significant changes. After short-term fluctuations to occur in 2009 due to the expected market changes of the exchange rates of major world currencies, the rate of increase of the real effective exchange rate will reach significantly lower levels than those of the past six years – not exceeding 2-3% a year versus 6.3% on average in 2003-2008.

The key factor causing the suspension of the process of the strengthening of the nominal and real value of the ruble, will be the expected increase in the tension experienced by the balance of payments. This concerns the expected reduction of the active balance on current account operations, as well as of the net capital influx fall to a level that is significantly lower than that of previous years. The reduction of the balance of current account operations (for 2010 -- four-fold as compared to 2007 level) will be tied to the fall of export income against the background of a stable import growth.

Ruble's Exchange Rate



The Prices of Natural Monopolies

The need for a significant expansion of investments in production and transportation of natural gas (while taking into account the per unit cost of raw material production at new deposits) and the expansion of power generation plants requires significant acceleration of the growth of regulated gas and electricity prices. For example, in accordance with the price schedule approved by the Government, in some years, gas prices will grow by 20-40% (in 2009: 19.9%, in 2010– 28%, in 211 [sic] – 40%).

Electricity prices will grow, respectively, by 18-26% (a maximum of 26% in 2009).

Budget Policy

In the nearest coming years, the conditions under which budget policy will be implemented may experience a significant change.

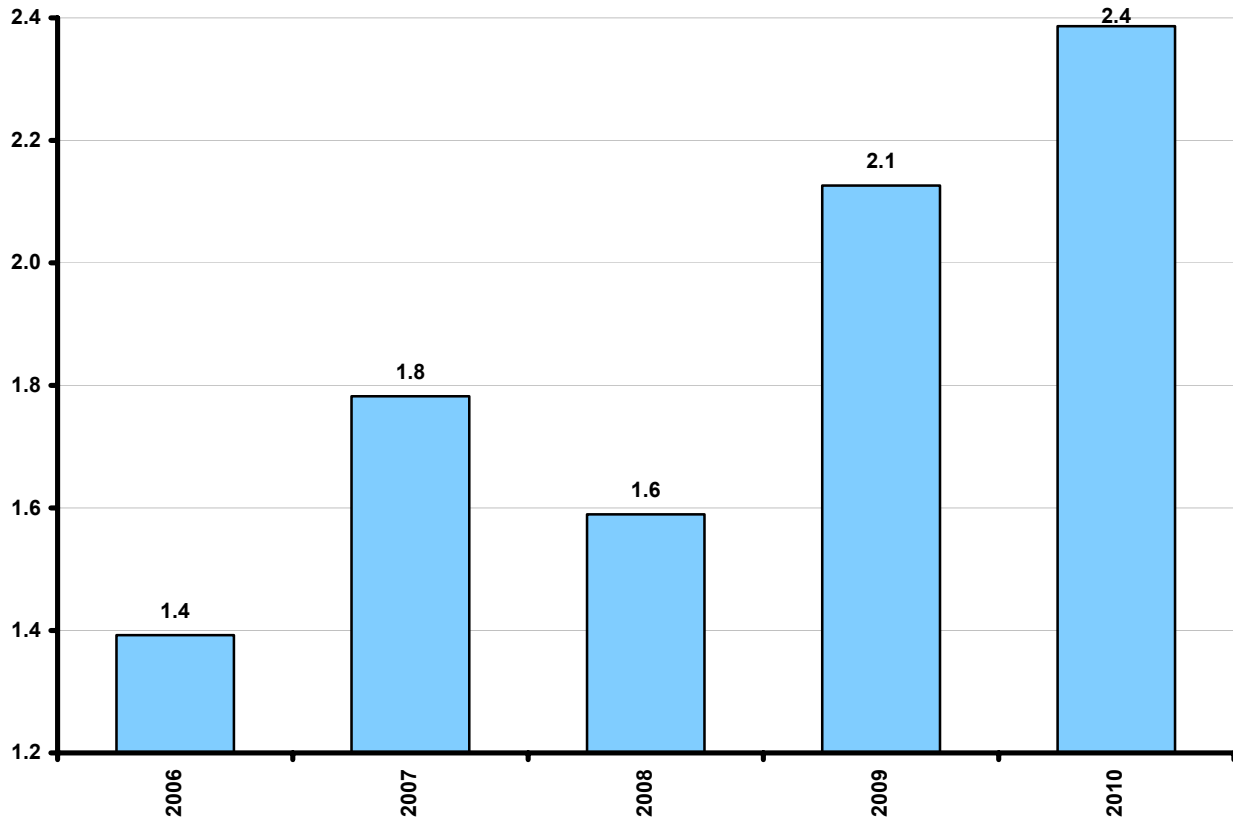
First. Halting active expansion of gold and currency reserves will mean a slowdown of the expansion of money supply, which will, in turn, decrease the need for sterilizing it by increasing the balance of the Reserve fund (which will be accumulating oil and gas profits invested in *высоконадежные?* securities of foreign governments) and the Future Generations Fund.

Second. The growing deficit of the Pension Fund will be having an increasing influence on the stability of Russia's budget system (over the entire period– 1-1.5% of the GDP). Its growth is due to the ageing population and to the increase of pension burden on the employed, as well as to the gradual transition of new age groups of citizens to the accumulation pension system (2008), which will be accompanied by a contraction of the resources for current pension payments.

Third. The need to implement a number of massive scale investment projects (primarily in the area of transportation infrastructure development) assumes the need to accelerate expansion of investment out of consolidated budget. In terms of percentage of the GDP, they will increase from 2.6% currently to 3.3% in 2007. (see graph).

Fourth. Under these conditions, the tax burden on non-raw material sector, which was falling over the past several years, can be expected to stop temporarily. An increase (first one in post-crisis period) of the UST rate from 26 to 34% (the date has not been announced). A discussion of a compensating decrease in VAT rate is underway (it is currently at 18% and 10% for the preferential items; a switch to 15%/10% rate system or to a universal 13% rate is expected starting in 2010 or 2011).

Government Investments (consolidated budget, % of the GDP)



Institutional Policy

The main thrust of the actions undertaken in the near future is the creation of the institutes of development aimed at providing (different forms of) credit for investment and innovation activities of Russian companies (primarily of the processing sectors, the high tech sector, as well as the agricultural sector), and also – in light of WTO requirements – the promoting their products on the world markets. Of these, the most important institutions ones are the Foreign Trade Bank (VneshEkonomBank), the Russian Venture Company and the Russian Nanotechnology Corporation.

Moreover, a government holding structure, Government Corporation “Rostekhnologii” was created to manage high-tech assets.

In the interests of improving the quality of the policy affecting technology, national technological Форсайты work is under way.

Massive scale measures aimed at supporting the national financial sector, and undertaken by Russian financial authorities could prove to be the starting point for creating a radically new model of

the financial sector in the country, a model which would be characterized by a significantly higher level of concentration and which would be supported by the preferred use of resources from domestic markets.

In particular, the proposed idea of providing government subordinated credit to Russian banks with the purpose to expand their own capital (totaling over \$35 billion) has the potential to suspend the process of the decrease of capital owned by the Russian banking system. Let us note that anti-crisis measures in the Russian banking system are rather liberal in nature, and that nationalizing Russian banks is not even being discussed.

These measures can help form the “core” of large banks capable of giving leading Russian companies massive-scale long-term credits.

Economic Development Forecast for 2007-2010

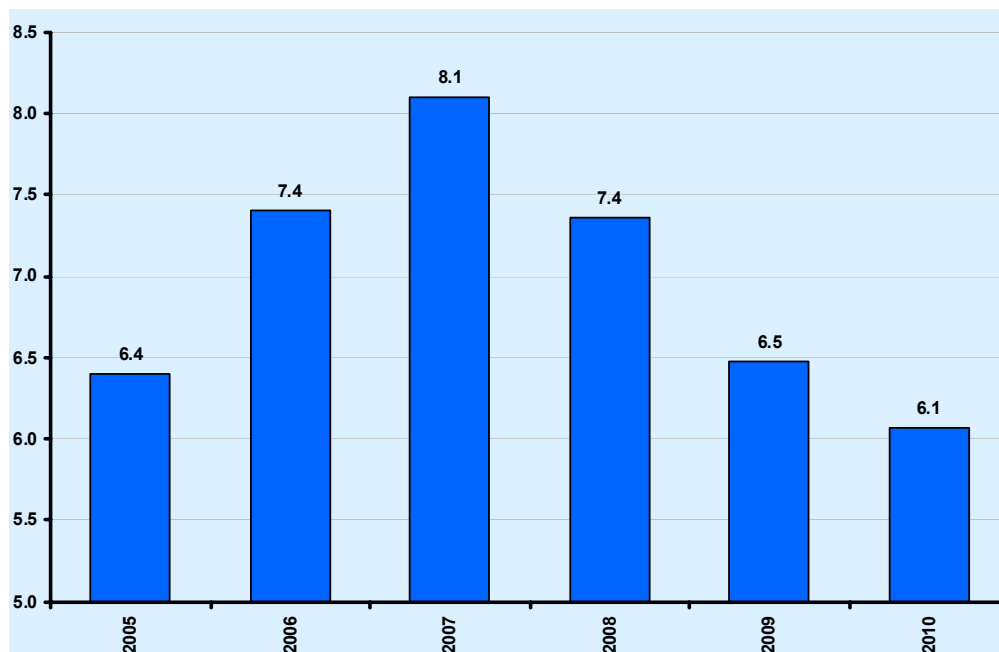
Economic Growth

A slowdown awaits Russian economic growth. Economic growth slowdown is expected due to the fall in manufacturer demand for equipment, including imported equipment, as well as construction production slowdown, including housing construction. At the same time, the fall of ruble’s exchange rate, the refusal to fulfill previous WTO agreements, as well as the outsourcing of production of a number of imported products (primarily in the automobile industry) to Russia will improve trade balance.

In 2008-2010, consumption will also grow at a slower pace: the slowdown of the rate of growth of the population’s income will be complemented by more strict rules for issuing consumer credit due to the continuing financial crisis.

Overall, a significant decrease in the rate of economic growth is expected – up to 6.0-6.2% a year in the future (see graph).

GDP (increase rate, %)



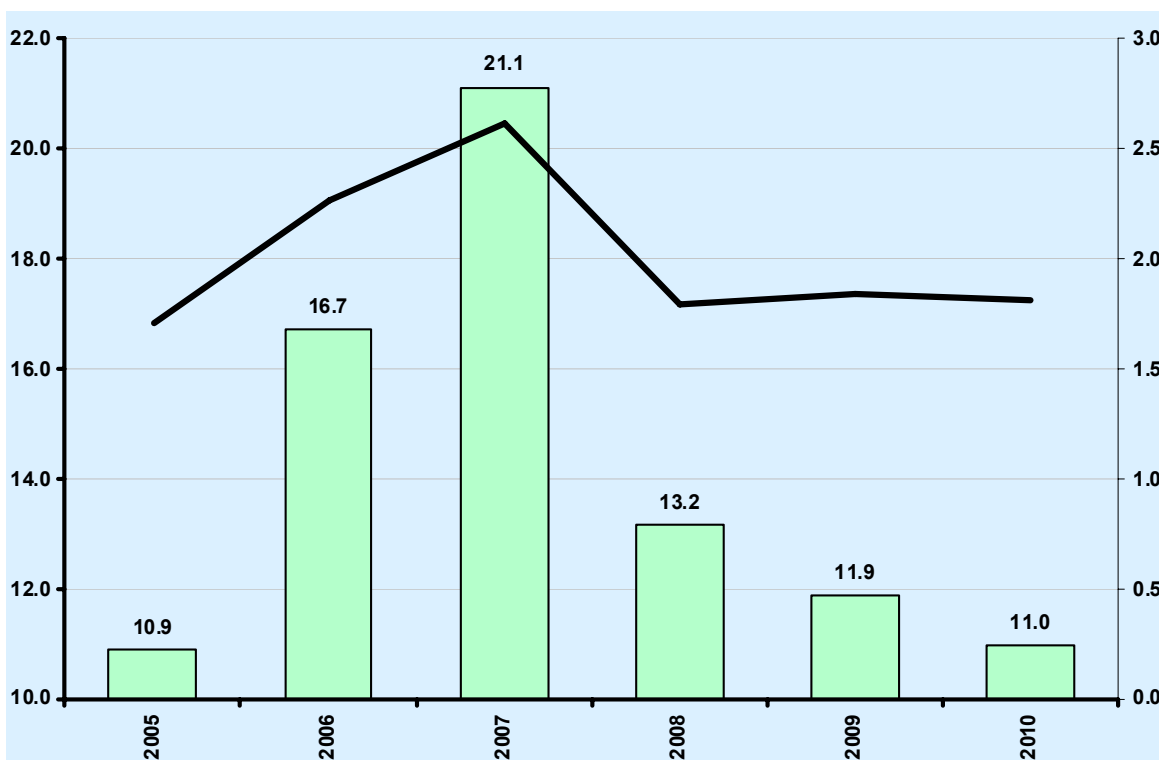
Investments in Capital Goods

Under the conditions of insufficient liquidity and expensive credit, investment contraction is to be expected in real sector investment programs as well as in production construction with long investment cycles.

Despite these complications, it can be expected that investments in capital goods will be large – growth rates (11-13% annually) will be almost two times higher than the overall economy growth rate (see graph). In particular, this is due to ongoing long-term projects aimed at technological upgrading of high-tech sectors of the Russian economy, including those within the framework of government-private sector partnership.

Expansion of investments in capital goods will increasingly stimulate economic growth in the longer future. Here, investments in raw materials and infrastructure sectors (due to the growth of capital-intensive of production and transportation of the resources and the need for infrastructure upgrades), in addition to an entire range of processing sectors, judging by the already announced investment projects.

Investments in Capital Goods
(increase rates, %)



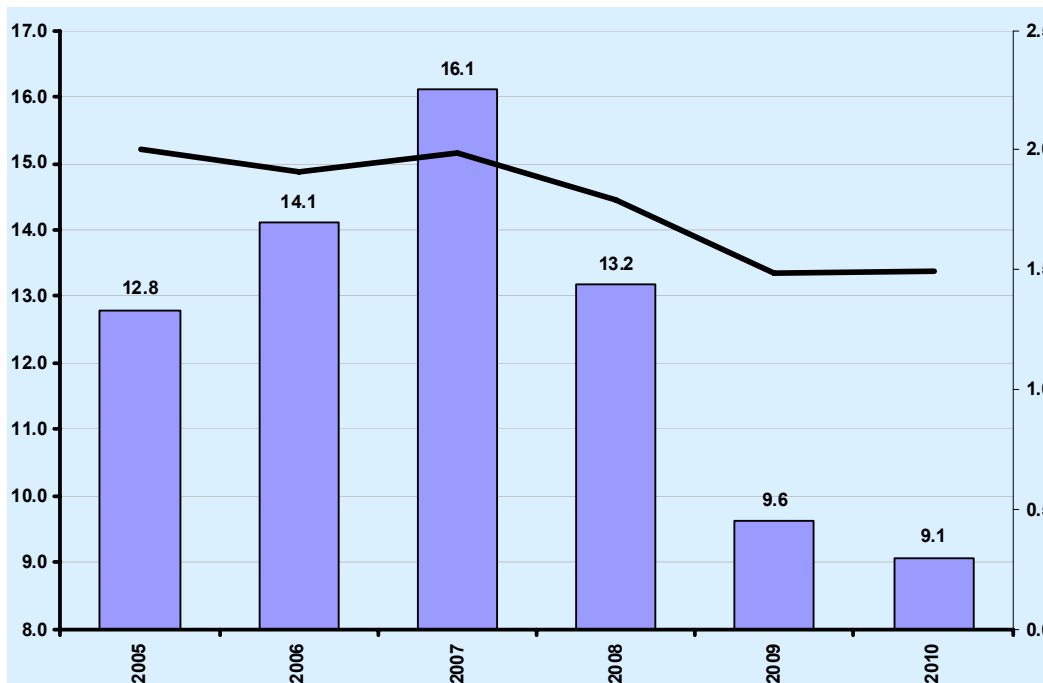
Consumer Markets

Consumer market performance will be gradually falling – from 16.1% in 2007 to 9.1% in 2010 (see graph).

This may be due to two sets of circumstances. On the one hand, if oil prices start to stabilize, there will be a slowing down of the influx of “oil income” into the Russian economy. As a result, the main component of the population’s income – salary – will start nearing labor productivity growth rates (the latter is forecasted to grow at 6-6.5% annually). This will cause a general slowdown of the growth rate of the population’s real disposable income as well as of the consumption.

On the other hand, if liquidity is insufficient, starting in approximately 2009, “consumer credit boom” will become exhausted. This will in turn slow down the growth of consumer goods sales (primarily, food items) and will ensure that their growth rates will near the growth of the population’s real disposable income.

**Retail Sales Returns
(increase rates, %)**



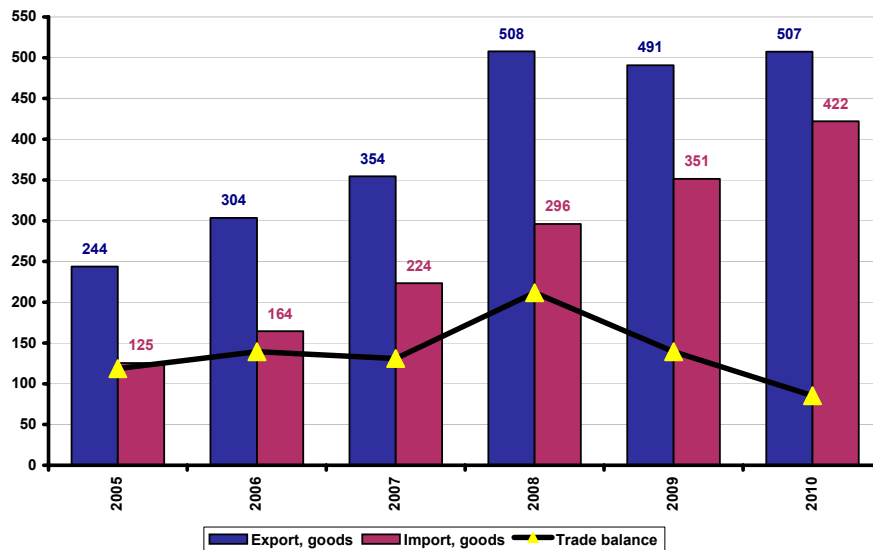
Foreign Trade

In the future, as already mentioned, cost values of the Russian exports can expect to stabilize. The above will happen because the volume of exports of the most important Russian raw materials (oil and gas) will stabilize and because their worldwide prices are expected to stop growing.

At the same time, there will be a progressive increase in imports stimulated by a fast expansion of domestic markets. Some slowdown of this growth will occur if investment demand decreases, and if Russian ruble’s exchange rate falls.

Accordingly, by 2010 trade balance may reach approximately 85 billion dollars (for comparison– 2007: 131 billion dollars, see graph)

Primary indicators of foreign trade (billions of dollars)



Economic Development Risks

The following will probably become the main risks for economic development in the middle term:

1. The possibility that an inflation/devaluation spiraling will occur in light of a worldwide fall of demand for energy sources.

Russia's trade balance is expected to deteriorate significantly in the future. Some decrease of investment imports resulting from the corporate sector's financial problems and the impact on imports of a weakened ruble may be compensated by the continuing double-digit growth rates of consumer imports due to the insufficient competitiveness of Russian products.

At the same time, exports will contract due to the fall of energy source prices and the stable levels of their production. A significant outflow of capital from developing markets, resulting from the global financial crisis, and in light of the situation with the Russian balance of payments, may require significant weakening of the ruble's exchange rate by as early as 2009.

The increased inflationary pressure due to the growth of prices and tariffs may lead to a growth of the overall level of inflation and to the emergence of "inflation-devaluation spiraling", accompanied by non-residents removing money from financial markets. In light of the possible future contraction of the combined demand due to investment contraction, the possibility that this risk will play out can be estimated to be *moderate*.

2. The risk that economy will stagnate and that there will be massive rise of unemployment due the fall of worldwide oil prices.

Experts say that the level below which oil (Urals) prices must fall to create very significant problems for the Russian economy (due to market growth slowdown, problems with the balance of payments and the exchange rate, the lower attractiveness for investment of financial assets as well as for projects in the real sector of the economy) from the standpoint of the balance of payments, the exchange rate and inflation, as well as production, is estimated to be at 70-80 dollars a barrel over the course of one full. In the latter case, it is possible that if foreign trade income influx in the Russian economy contracts, domestic final demand will also contract (consumer and investment). If import

growth is still ahead and if opportunities for taking out loans on foreign and domestic markets continues, companies may need to choose one of the three options: either stop investing while maintaining high rate of real salary increases (if there is a labor resource deficit); or limit salary growth; or opt for massive unemployment. All of the above options lead to a sharp slowdown of the economy and/or to increased burden on social institutions.

The possibility that this risk will play out can be estimated to be *moderate*.

3. The possibility that the financial collapses.

The 2007-2008 world financial crises has made it more difficult for Russian borrowers to access money on the foreign markets. Under these conditions, a significant share of foreign loans within the structure of the liabilities of the Russian financial sector assumes a sudden worsening of financial stability. This risk also emerges if Russian banks' credit, deposit and loan deadlines are unbalanced, since in 2009-2010 it will be significantly more difficult to obtain the required refinancing of short term liabilities.

However, government is pursuing active stabilization policy: The Bank of Russia is increasing credit volume and is expanding the number of potential recipients, while the government is planning to take off "bad debt" from the balances of the financial system and possibly to support funds market during the high volatility period. Moreover, placing the money of government corporations and the balance of the budget extends banking system's liabilities and its liquidity.

The risk group is first and foremost composed of financial organizations involved in the securities market (investment banks), since during the reaction to the crisis, stock market value of traded assets fell by over 60%. The threat of a crisis also exists for a wide range of small commercial banks which use population's deposits: if the situation on the financial markets deteriorates further, it can cause a run on the banks. Meanwhile, measures aimed at ensuring financial stability of these banks have yet to be developed. The result may be a series of group bankruptcies of commercial banks working with individuals may occur (as it happened during the local banking crisis of 2004).

In light of the "resistance margin" accumulated in the Russian financial system, the chance that this risk will play out can be estimated to be *low*.

4. Decreased liquidity of the banking system resulting from a slowdown of money supply growth.

If the stemmed growth of gold and currency reserves, which today are the primary source of money supply expansion, is not compensated by the emergence of new sources for it, then, in light of an increased demand for money in the economy, the threat that the banking system's liquidity level will experience a significantly fall will emerge. The result may be a series of group bankruptcies of commercial banks working with individuals may occur (as it happened during the local banking crisis of 2004).

In light of the fact that this problem is long being discussed by experts, the banking community and the monetary authorities, the possibility that this risk will play out on full scale may be estimated to be *moderate*.

5. Reduction of investments due to more rigid constraints imposed by companies.

In liquidity crisis situation, a significant reduction of the cost of the assets of Russian companies imposes rigid constraints on their investment policy. As the cost of potential security deposit decreases in a situation of insufficient liquidity and growth potentially experiences a slowdown, companies are forced to reduce expenditures which first and foremost leads to canceling investment programs and to a slowdown of economic growth.

The reduction of investments will not, of course, affect government investments, but the investment programs of government corporations, as well as those companies that assumed investment obligations (such as power generation companies), may be reduced.

Taking into account the fact that cost reduction programs have already started in several dozens of medium-sized businesses, the possibility that the above will occur can be estimated to be *high*.

6. Massive unemployment.

In the near future, Russian companies will be faced with the need to significantly improve their labor productivity, which may be accompanied by layoffs of excessive workforce. However, in light of low professional (due to inadequate worker retraining programs) and territorial mobility of the workforce (due to a dearth of cheap housing which would be satisfactory in terms of the standard of living, as well as due to logistical shortcomings, bad awareness of the labor markets in other regions), unemployment may be accompanied by an increased burden on the social infrastructure in a number of Russia's regions and by the emergence of additional territorial enclaves of acute social problems.

The possibility that this risk will play out is estimated to be *moderate*.