

# WORLD FINANCE REVIEW™

May 2008

Special Edition



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inflationary tendencies

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## Performance of Russian Economy in 2007

By Evsey Gurchich, Head of Economic Expert Group (Moscow)

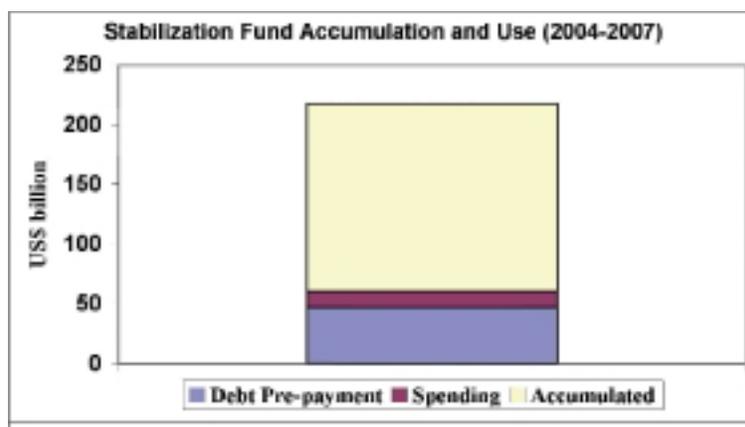
Russian economy exhibited impressive performance in 2007. GDP volume grew 8.1% - which is more than in the previous year (7.4%) and significantly more than expected (the Federal Budget Law envisaged growth by 6.2%). Fixed investment hiked by 21.1% in real terms — as compared to 16.7% a year before.

Worth noting is marked further increase in capital inflow (almost two-fold as compared to the previous year). Net inflow in the private sector reached US\$81 billion (equivalent of 6.3% of GDP). This is a great progress as compared to earlier period — say, in 2005 net inflow was close to zero, and before that Russian economy experienced net outflow of private capital. Foreign direct investment are also booming: they increased more than 4 times over the last two years, to reach US\$ 3 billion (equivalent to 4.1% of GDP). Russia outperformed thus China by proportion of FDI to GDP (in China it amounted to 2.6% in 2006).

Recent developments do not support a broadly debated idea that Russian economy is suffering from the Dutch disease. Despite further appreciation of the Ruble (its real effective exchange rate grew by 5.0% in 2007) output in the manufacturing sector is continuing rapid growth (9.5%).

Still the year 2007 saw also some adverse changes in economic performance. First of all, inflation not only exceeded the target level, but accelerated as compared to the previous year — for the first time after 1999. This could negatively affect inflation expectations, all the more so that consumer prices continued rapid growth in the Q1 2008. Inflation was partly attributed to increased prices in the world food markets. Still even if we make adjustment for this factor, most likely inflation would go beyond the target.

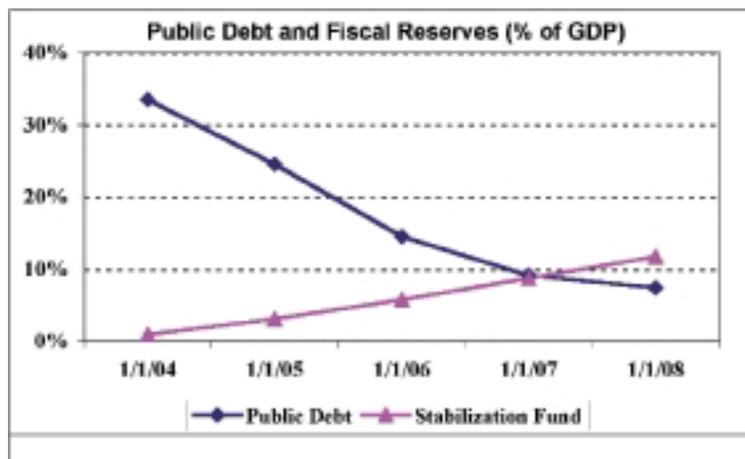
It looks like inflation evidences some overheating of Russian economy. The latter was fueled with both rapid credit expansion and substantial increase in fiscal spending. General government budget expenditures grew by 2.1% of GDP in 2007. It should be noted though that part of allocations were one-off contributions by the government to the charter capital of the newly established development institutes (first of all Bank for Development).



Stabilisation Fund Accumulation and Use (2004-2007)

|                  |              |
|------------------|--------------|
| Receipts         | \$217 .9 bln |
| Debt Pre-payment | \$47 .4 bln  |
| Spending         | \$13 .3 bln  |
| Accumulated      | \$157 .2 bln |

Public Debt and Fiscal Reserves (% of GDP)



|                    | 1/1/04 | 1/1/05 | 1/1/06 | 1/1/07 | 1/1/08 |
|--------------------|--------|--------|--------|--------|--------|
| Public Debt        | 33.5%  | 24.5%  | 14.5%  | 9.1%   | 7.4%   |
| Stabilisation Fund | 0.9%   | 3.1%   | 5.7%   | 8.7%   | 11.7%  |

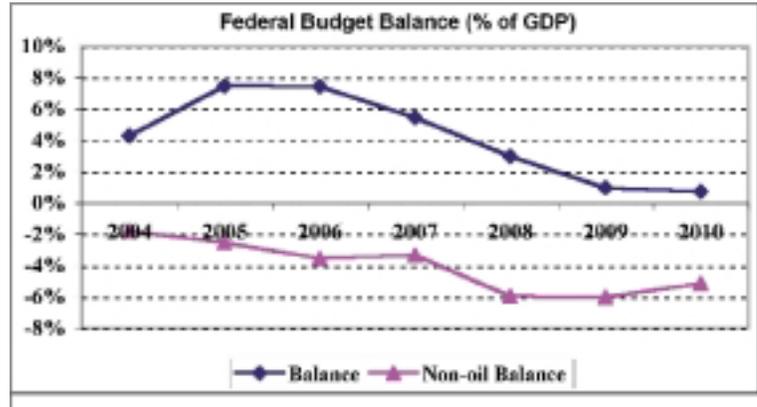
Russian banks are not exposed to risks generated in the sub-prime mortgage market.

Possibility of further loosening fiscal policy will be restrained with a reform of the Stabilisation Fund and amendments to the Budget Code. In four years since establishment Stabilisation Fund accumulated US\$ 157 billion (12% of GDP in 2007). Overall receipts of the Stabilisation Fund (including return and capital gains) amounted to US\$218 billion, of which US\$47 billion (22%) were used to pre-pay public debt to the Paris Club and IMF, and US\$ 13 billion (6%) were spent.

Starting 2008 all proceeds to the federal budget that can be treated as taking natural rent from hydrocarbon sector are managed in a special regime. These include mineral extraction tax and export duties paid by oil and gas sectors, that amounted to 11.0% and 8.7% of GDP in 2006 and 2007 respectively. The necessity of using special regime is explained with their volatile and unpredictable size, and second with their exhaustibility. The new version of the Budget Code sets fiscal rules in terms of non-oil deficit, limiting its size with 4.7% of GDP (ceiling for the transitional period 2008-2010 is somewhat higher). Non-oil deficit may be financed with oil transfer and borrowing (its size cannot exceed 1% of GDP).

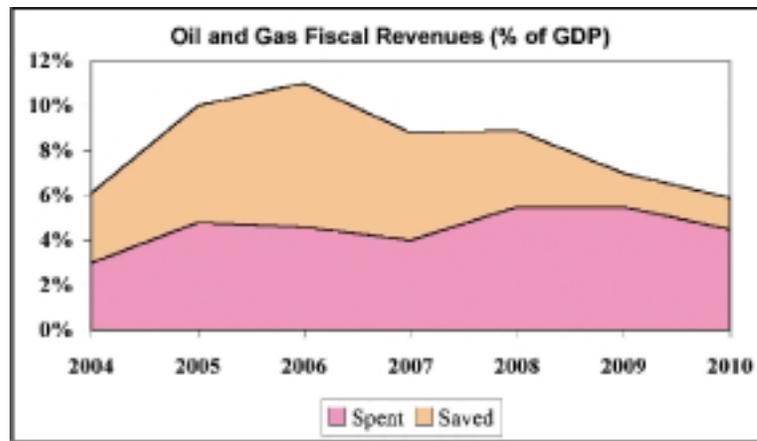
Medium-term prospects of Russian economic development critically depend on the ability to increase investment rate. Fixed investment grew to 21 % of GDP in 2007, but still is remaining relatively low for the rapidly growing economy. An important role here can be played with foreign capital. Turmoil in the international capital markets may temporarily lower its inflow. It is unlikely though that this turmoil heavily affects Russian economy.

First, Russian banks are not exposed to risks generated in the sub-prime mortgage market. Second, despite slow-down of the world economy, most experts do not expect sharp decline in oil prices. Third, the government and the Central Bank have accumulated large amount of fiscal and foreign exchange reserves (the latter exceeds US\$ 500). In particular any shocks in the terms of trade will be fully absorbed by the Reserve and National Prosperity Funds.



Federal Budget (% GDP)

|                        | 2004  | 2005  | 2006  | 2007  | 2008  | 2009  | 2010  |
|------------------------|-------|-------|-------|-------|-------|-------|-------|
| <b>Balance</b>         | 4.3%  | 7.5%  | 7.4%  | 5.4%  | 3.0%  | 0.9%  | 0.7%  |
| <b>Non-oil Balance</b> | -1.8% | -2.5% | -3.5% | -3.3% | -5.9% | -6.0% | -5.2% |



Oil and Gas Fiscal Revenues (% GDP)

|                               | 2004 | 2005  | 2006  | 2007 | 2008 | 2009 | 2010 |
|-------------------------------|------|-------|-------|------|------|------|------|
| <b>Oil &amp; Gas Revenues</b> | 6.1% | 10.0% | 11.0% | 8.8% | 8.9% | 7.0% | 5.9% |
| <b>Spent</b>                  | 3.0% | 4.8%  | 4.6%  | 4.0% | 5.5% | 5.5% | 4.5% |
| <b>Saved</b>                  | 3.1% | 5.2%  | 6.4%  | 4.8% | 3.4% | 1.5% | 1.4% |