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Russia and the CIS:
Adjusting to a New
World View

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The world we knew in the 2nd half of the 20th century:

A. -- First, Second, Third Worlds

- ~ Prominence of the US
- ~ The cold war
- ~ Second and Third Worlds marginal to global economy

B. -- Regional integration

C. -- Liberalism and globalization

7 years into the 21st century:

- 'A' already now longer holds
- How the World reacts will affect directly the continuation of 'B' and 'C'.

Today's focus is on the rapid changes in Russia and the CIS as one of the key changes where our perceptions are lagging dangerously behind.

The Collapse of the Soviet Empire

Almost overnight, Post Soviet Russia lost:

- its economic system of state ownership and state-controlled management,
- its political system with the omnipotent Communist party for an initial period declared illegal,
- over one third of the territory and population of the FSU (engendering chaos in production and distribution, and creating new Russian minorities in neighboring territories),
- control of its currency which was being printed by new central banks in the new neighboring states,
- the trading system, orchestrated by Moscow, under the Council of Mutual Economic Cooperation (COMECON) with its satellites in Eastern Europe and elsewhere, and
- the Warsaw Pact.

The 1990s – Russia's « Lost Decade »

WHY?

- Total Collapse of effective decision-making and policy chaos
- Lack of managerial experience, incompetence, and greed

SO WHAT?

- Passivity
- Role of Western finance, advice, imitation
- Russia and CIS integration with West
- The 1990s were not normal

Vladimir Putin – Lucky or the right man at the right time?

- First, an overview of the Economy
- Then, a summary of domestic politics

Russian economy

- **Recent performance and growth drivers**
- **Weaknesses**
- **The importance of oil and gas**
- **Global backdrop**
- **The fundamental potential**

Recent performance

Russian economy delivered consistently strong results since 2000.

	2000	2001	2002	2003	2004	2005	2006	2007E
GDP, real growth	10.0	5.1	4.7	7.3	7.2	6.4	6.7	5.8
GDP per capita, \$	1,795	2,128	2,378	2,984	4,060	5,365	6,894	8,838
Nominal monthly wage, USD	79.1	111.0	139.0	179.2	234.0	302.3	395.1	497.0
Industrial production, real growth	11.9	4.9	3.7	7.0	7.3	4.0	3.9	5.5
Investments, real growth	17.4	10.0	2.8	12.5	10.9	10.5	13.5	9.0
CPI, YoY	20.2	18.6	15.1	12.0	11.7	10.9	9.0	7.4
M2, YoY	61.5	39.7	32.4	50.5	35.8	38.6	48.8	32.0
RUB/USD, eop	28.2	30.5	31.8	29.5	27.7	28.8	26.3	25.0
Real RUB appreciation	10.6	7.8	7.9	18.6	14.8	3.4	15.1	9.7
Current account, USD bn	46.8	33.9	29.1	35.4	58.6	83.2	91.4	72.9
FDI, USD bn	2.7	2.7	3.5	8.0	15.4	15.2	15.0	25.0

Recent performance

Russian GDP grew by 6.7% per annum on average...
... to just short of \$1trn in 2006



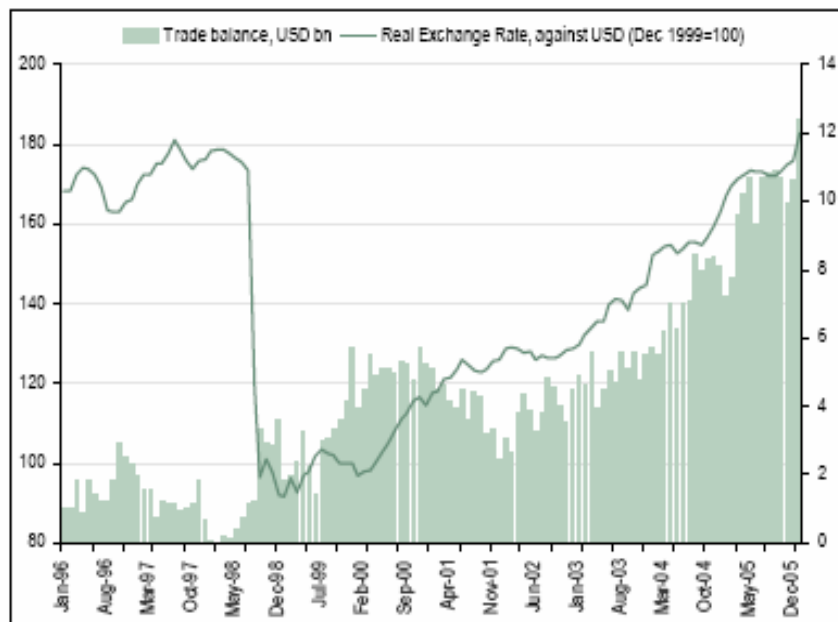
Source: Rosstat

Recent performance

Russia has had one of the largest current account surpluses globally over the last few years...

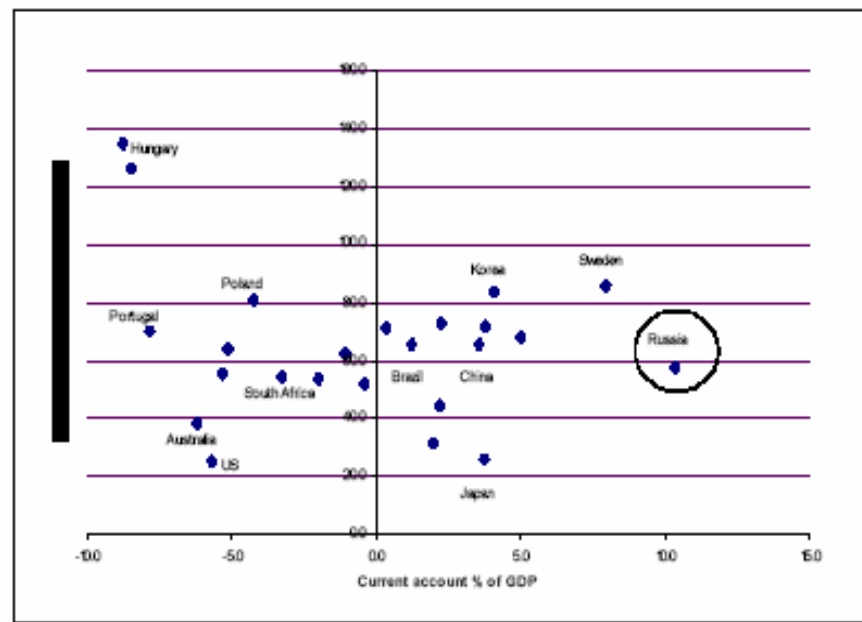
...particularly for the size of the overall economy

Real Appreciation Against Trade Surplus



Source: CBR

Current Account Against Foreign Trade Turnover



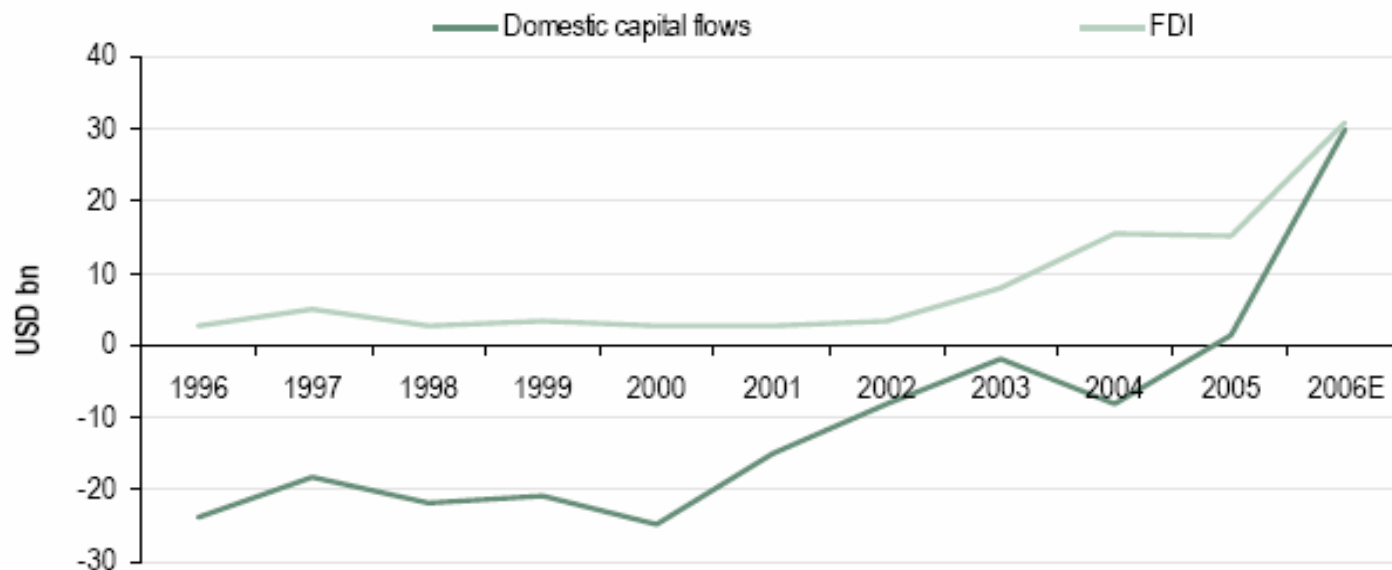
Source: CBR

Recent performance

More recently, it has been the capital account which has been improving the most...

- Capital outflow has been replaced by capital inflow.
- FDI has been rising rapidly.

FDI, Domestic Capital Inflow



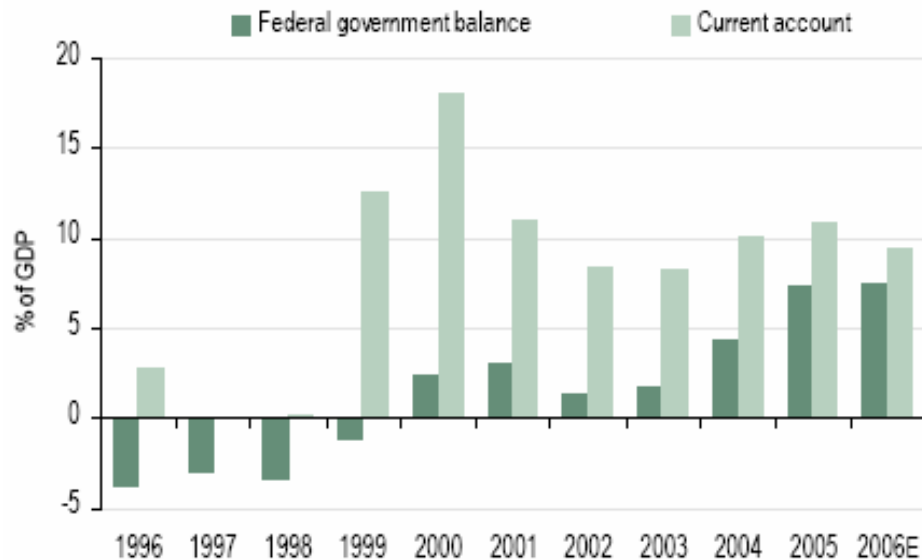
Source: CBR, Rosstat

Recent performance

Large budget surpluses have been traditionally the primary mechanism to sterilise monetary increases...

...but the government has been recently beefing up public sector investments.

Current Account Vs Federal Budget Surplus



Source: CBR, Ministry of Finance

Signs of fiscal loosening...

- Increasing social and military spending will see expenditure rise from USD120 bn in 2005 to USD223 bn in 2007
- The Economy Ministry has an Investment Fund of RUB70 bn (USD2.5 bn) for infrastructure projects
- A 'Hi-Tec' fund has been launched, although so far its size is unclear

Recent performance

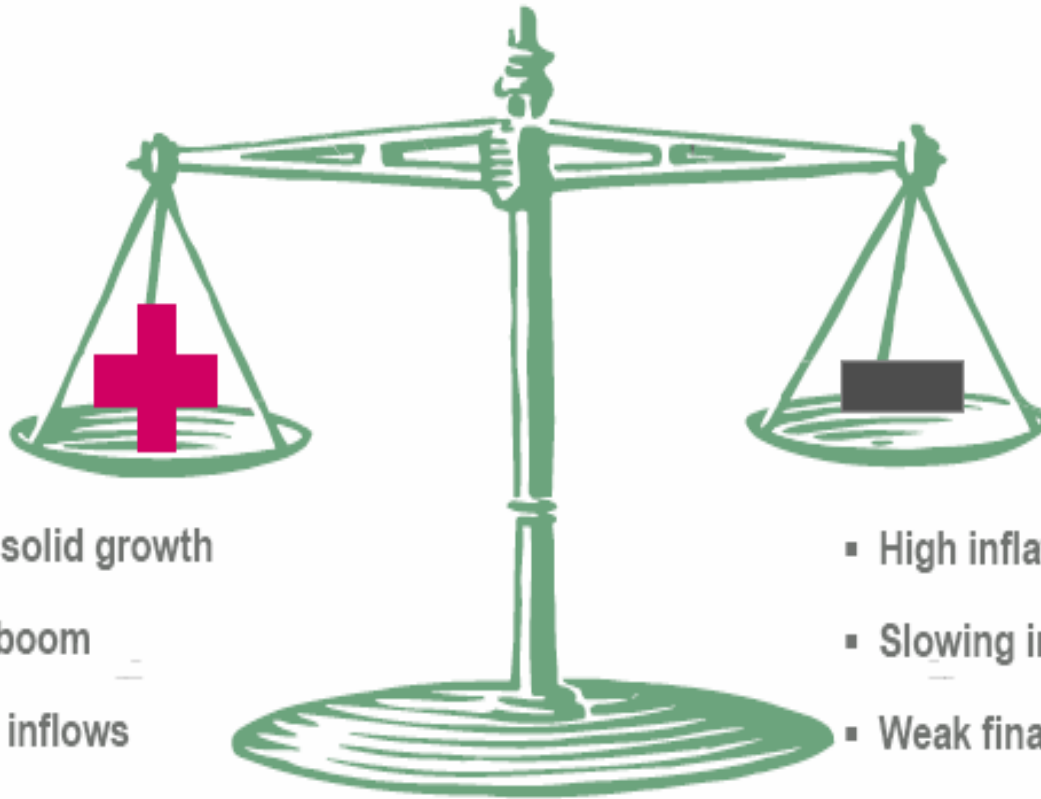
- Between 1999 and 2002, growth was primarily driven by industry recovery supported by a cheap rouble and ample unused capacity.
- Between 2002 and 2006, growth has been driven by an expanding net exports and booming consumption.
- Going forward, net exports are likely to fall quite sharply.
- Growth, instead, will be driven by further consumption and booming investment.

Growth Drivers for 2007

Consumption Drivers	Investment Drivers
Dollar incomes rising by 25%	Private infrastructure projects
Access to consumer credit (growth - 80%)	Public infrastructure projects
Government transfers (pensions, public wages)	FDI
Rising house prices (average increase USD 8k)	Access to financial markets

Weaknesses

However, there are several weak spots remaining.



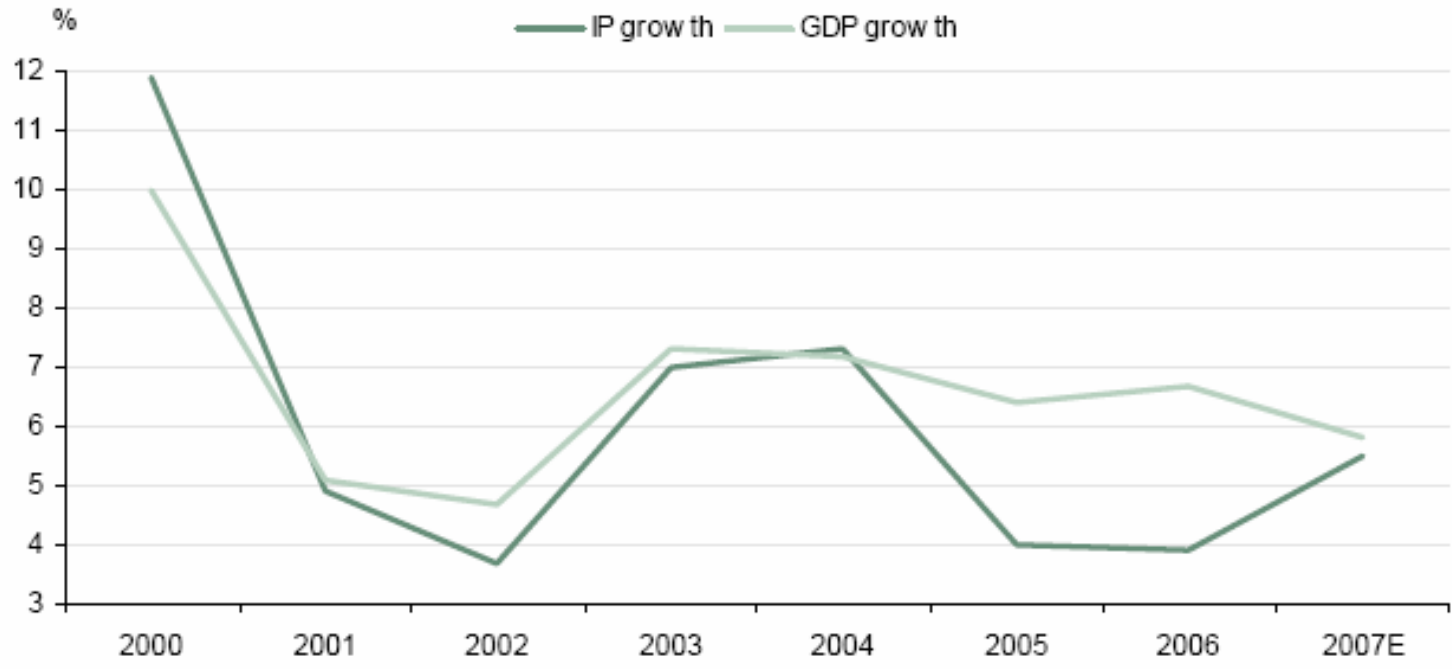
- Consistent solid growth
- Consumer boom
- FDI, capital inflows
- Strong fiscal performance
- Active debt repayment

- High inflation / money supply
- Slowing industry / low investments
- Weak financial sector
- Bleak demographics

Weaknesses – Industry and investments

Despite double-digit growth year after year, the share of investments in GDP lingers at around 18%. This is insufficient for maintaining satisfactory growth rates.

Industrial performance has recently been well below the other parts of the economy. In fact, extraction sectors have performed the worst.



Source: Rosstat

The importance of oil and gas

Share of oil and gas (2005)

GDP – official	9.6%
GDP – fully accounted	c. 20%
Exports	47.6%
Budget revenues	51.9%
RTS Index	65.0%

Source: Rosstat, CBR, Ministry of Finance, RTS, Renaissance Capital

The importance of oil and gas

Clearly, the oil price has major influence over Russia's economic fundamentals...

...however, success at paying down debt together with sizeable inflow on the capital side has made the impact of oil much less than in the past.

Oil price sensitivity

	\$1 change of oil price effect	Non-inflationary or zero-balance oil price (\$)
Exports	\$3.5 - 3.7 bn	---
Trade balance	\$2.7 bn	15
Current account	\$1.8 bn	19
Federal Budget Revenues	\$1.7 bn	27.4
Stabilisation Fund	\$0.7 bn	27
GDP growth	0.018 - 0.048 ppt	---
CPI	0.07 - 0.17 ppt	37.6 - 45.2

Source: Renaissance Capital Estimates

The importance of oil and gas

Even at considerably lower oil prices, Russia's fundamentals still hold up.

Indeed, arguably from a macro-perspective, Russia looks better at lower oil prices.

Major economic variables sensitivity to oil price for 2007

	Oil price	International reserves	Budget revenues	Budget expenditures	Budget surplus	Budget surplus	Current account	Exports	Imports	Trade balance	M2	CPI	GDP	Real GDP growth
	\$/bbl	year-end, \$bn	\$bn	\$bn	\$bn	% of GDP	\$bn	\$bn	\$bn	\$bn	\$bn	%	\$bn	%
2004	34.2	124.5	119.0	93.7	25.3	4.4	58.6	183.2	97.4	85.8	157.2	11.7	582.5	7.2
2005	50.46	182.2	181.2	124.2	57.0	7.4	83.2	245.3	125.1	120.1	210.0	10.9	765.6	6.4
2006(E)	61.32	303.7	227.1	163.1	64.0	6.5	93.6	305.6	161.6	144.0	333.2	9.0	989.9	6.6
	30	274.4	227.2	212.9	14.4	1.2	29.6	208.4	152.6	55.8	308.7	5.8	1,246.1	4.9
	35	295.2	235.6	212.9	22.8	1.8	38.0	225.7	157.3	68.4	338.0	6.2	1,248.4	5.1
	40	316.0	244.0	212.9	31.1	2.5	46.3	243.0	161.9	81.1	367.4	6.6	1,250.8	5.3
2007 scenarios	45	336.8	252.4	212.9	39.5	3.2	54.6	260.3	166.5	93.8	396.7	7.0	1,253.2	5.4
	50	357.6	260.8	212.9	47.9	3.8	63.0	277.6	171.1	106.5	426.1	7.5	1,255.5	5.6
	55	378.4	269.2	212.9	56.3	4.5	71.3	294.9	175.8	119.1	455.4	7.9	1,257.9	5.8
	60	399.2	277.5	212.9	64.7	5.1	79.6	312.2	180.4	131.8	484.7	8.3	1,260.2	5.9
	65	420.0	285.9	212.9	73.0	5.8	88.0	329.5	185.0	144.5	514.1	8.7	1,262.6	6.1
	70	440.7	294.3	212.9	81.4	6.4	96.3	346.8	189.6	157.2	543.4	9.2	1,264.9	6.2
2007(E)	56.33	383.9	271.4	212.9	58.5	4.6	73.5	299.5	177.0	122.5	463.2	8.0	1258.5	5.8
2008(E)	51.95	415.0	357.6	274.7	82.8	5.4	58.2	292.0	195.0	97.0	590.8	7.2	1526.9	5.4

Source: Renaissance Capital estimates

Global backdrop – Commodity prices

The short-term outlook for commodity prices might be uncertain...

...but the longer-term demand dynamics look remarkably strong.

A major question facing commodity markets is how much speculative money is currently in the market...

...but arguably the speculative money is simply bringing forward future demand.

Global Consumption Of Selected Natural Resources

	Oil (barrels per person)	Copper (pounds per person)	Aluminium (kg per person)
US	25.6	15.4	23.1
Japan	15.5	19.3	16.3
Korea	16.4	35.3	24.3
China	1.8	5.6	5.4
India	0.9	0.7	0.8

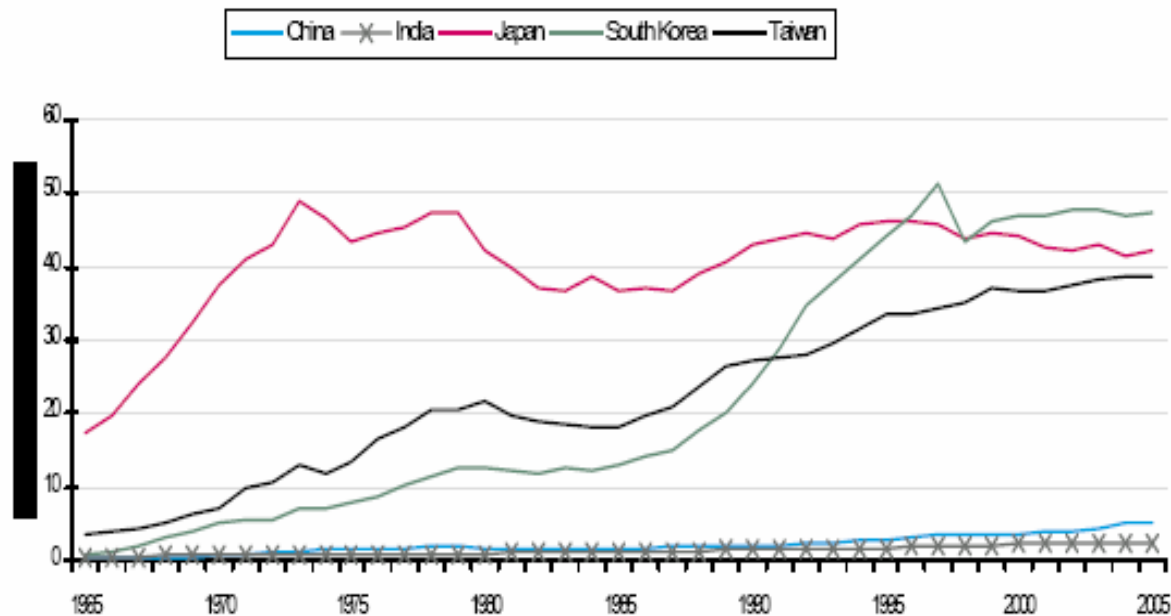
Source: World Bank

Global backdrop – Support for natural resources

The history of oil consumption is perhaps instructive for the future development of some of the larger emerging markets...

...the upside potential is truly remarkable

History Of Oil Consumption

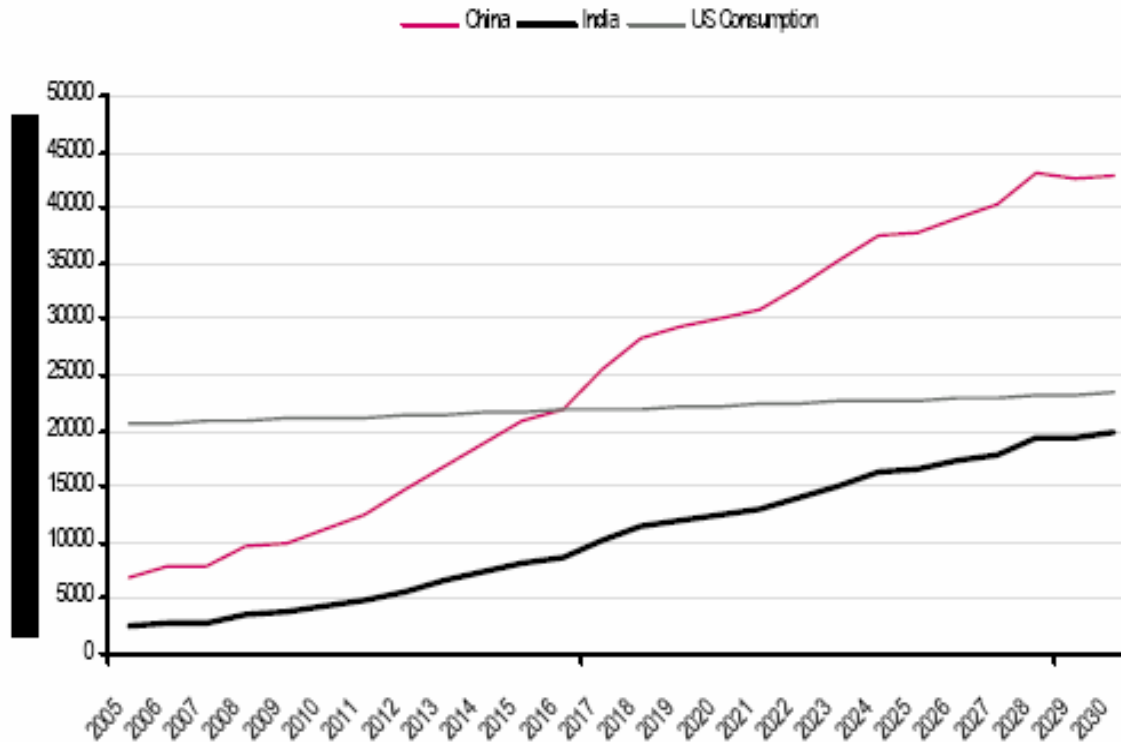


Source: World Bank

Global backdrop – Support for natural resources

Assuming that China and India go through the same consumption dynamics as Japan and Korea...
...then China will reach US consumption levels in a decade, and India will approach those levels in another 20 years.

Potential Future Oil Consumption, thsd barrels per day, relative to US



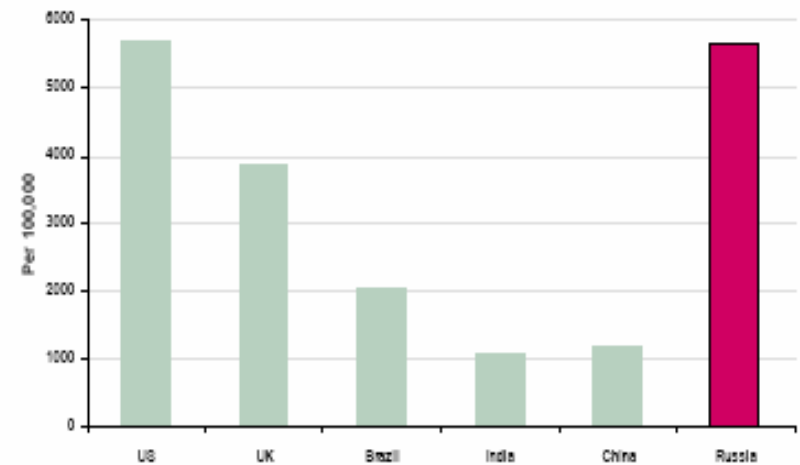
Source: World Bank

Russia – The fundamental potential

The positive story for Russia is one of potential and progress....

- **Natural resources, domestic liquidity and global enthusiasm makes Russia an enormously exciting opportunity**
- **Its one missing resource is capital, making returns on the scarce resource superb over the last eight years**
- **And since 2000, the basic economics show that the potential is being realised.**

Graduates from Tertiary Education



Source: Rosstat

Russia's Natural Advantage

	Production		Reserves	
	Russia	% of Global	Russia	% of Global
Oil (bpd mn)	8.8	12%	60 thd	5%
Gas (bcfd)	56	20%	1680 thd	30%
Nickel (refined tonnes)	256	30%	38800	24%
Platinum (ounces)	980	16%	82137	12%
Palladium (ounces)	2668	41%	308991	44%
Gold (ounces)	5682	7%	482000	15%
Pulp and Paper (mn m3)	1100	7%	875 mn hectares	25%
Fresh water (bn m3)	n.a.	n.a.	4262	15%
Land mass (thnd km)	n.a.	n.a.	17075	11%

Politics

- **Current situation**
- **Parliamentary elections – December 2007**
- **Presidential elections – March 2008**
- **Where will Mr Putin go?**

Current situation – Mr. Putin in control

Over the last six years, Vladimir Putin has centralised control of pretty much every institution under the Kremlin umbrella.

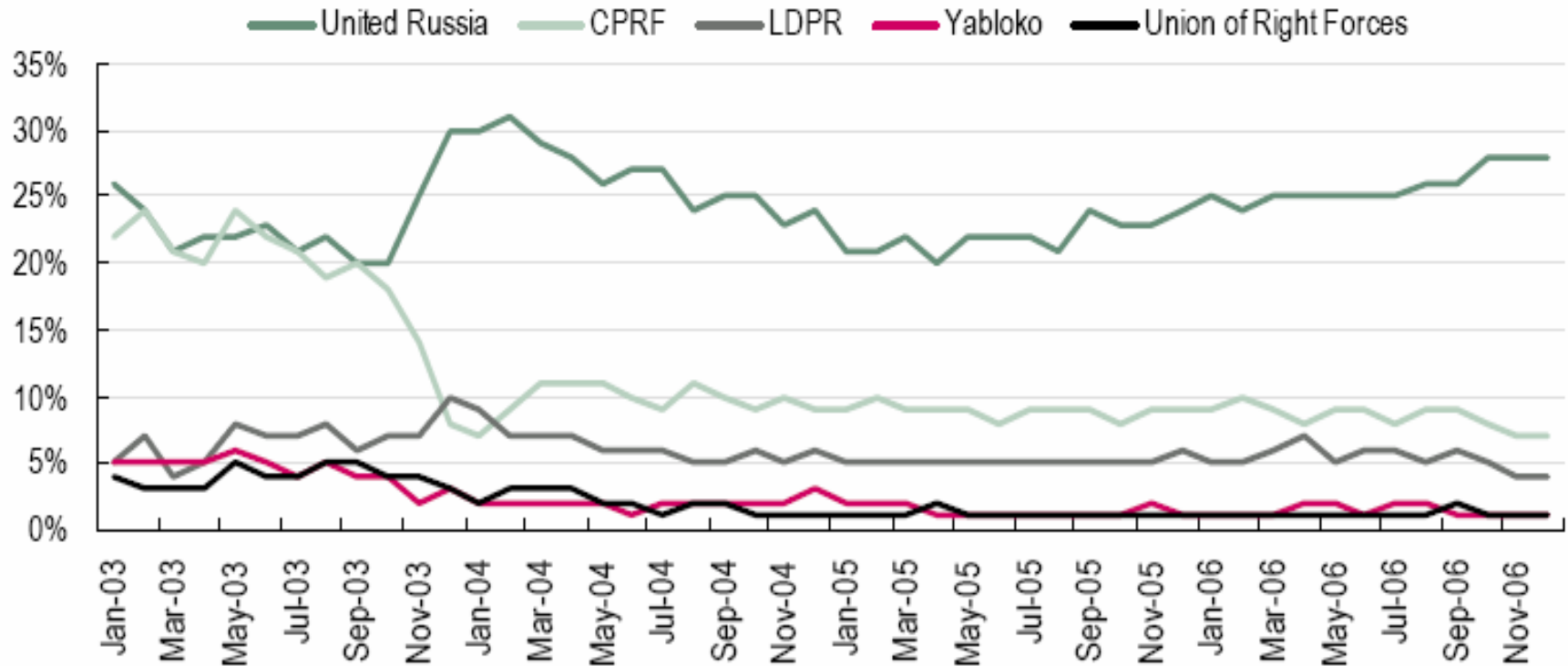
The Kremlin controls...

- The government
- The Duma
- The Federation Council
- The judiciary
- Regional government
- The media
- The 'commanding heights' of the economy
- The oligarchs
- The army
- The Central Bank
- The nationalists
- The centrists

Meanwhile the communists and the liberals have been marginalized.

Current situation – Party popularity

President Putin has also managed to lend his own popularity to that of his party, United Russia, which is by far the dominant party in the country



Source: FOM

Parliamentary elections (December 2007)

The Parliamentary elections lost the feature of determining which party wins. The questions it will answer are:

- How strong will be the dominance of the pro-Kremlin United Russia and Fair Russia parties
- What other parties would qualify to the Duma

This time, the hurdles for independent parties are higher.

- Only candidates from party lists are elected (vs. 50% independents previously)
- Party qualification minimum has been raised from 5% to 7% of the total vote

Parliamentary elections (December 2007)

The Kremlin has had the majority of parliamentary seats under its control in the last two elections.

Further gains are likely this year, as the new pro-government party (Fair Russia) will likely attract votes from electorate of alternatives (LDPR, Communist Party)

Duma election results

	1999	2003
Pro-government parties	52.6	66.7
Communist Party	28.2	11.6
Liberal Democrats (LDPR)	3.7	8.0
Rodina (Motherland)	na	8.0
Unaffiliated deputies	4.3	3.6
Other parties	10.5	1.6

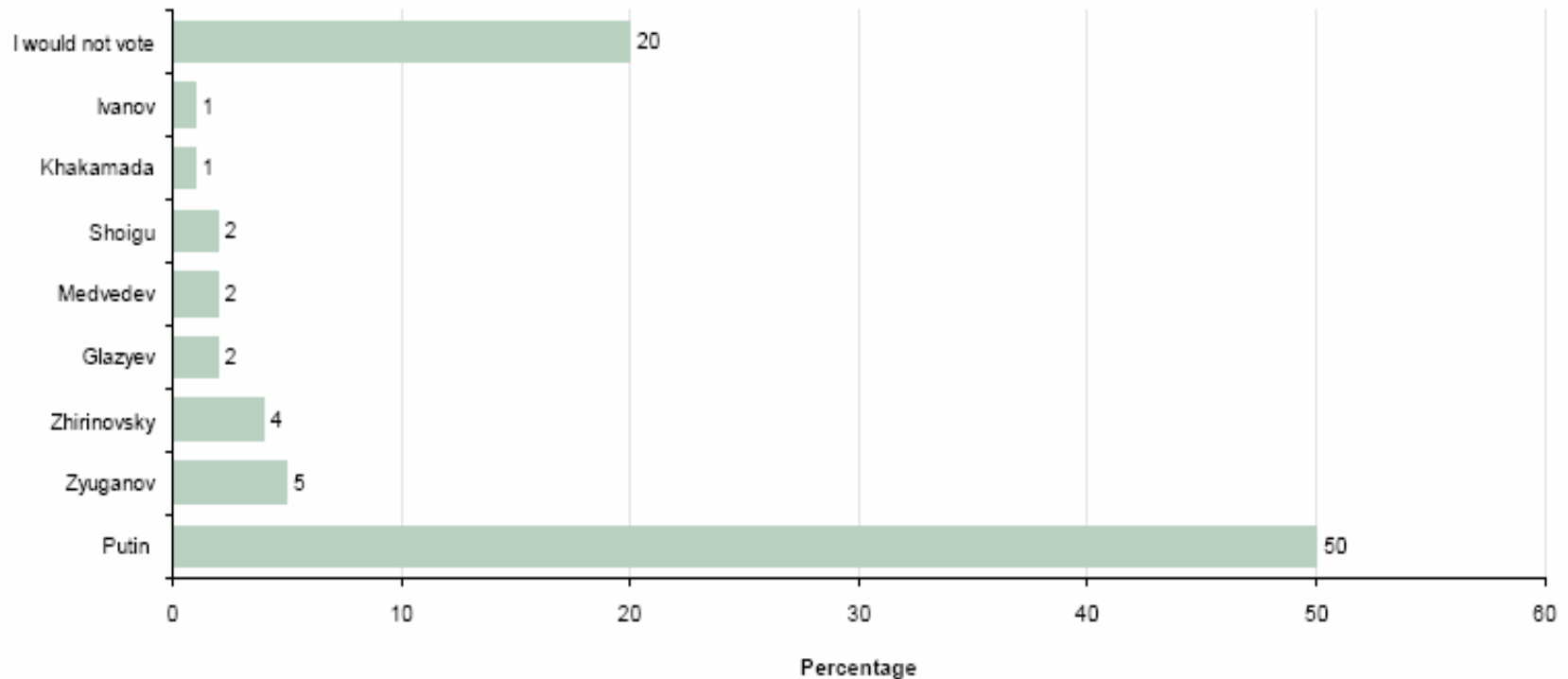
Source: Election Committee

Mr. Putin's replacement – The field is wide open

While there is much talk of who may be the successor to Putin, as things stand, there is no competition...

...none of the alternatives have even a tenth of Putin's popularity

Imagine that Presidential Elections are going to be held this Sunday. Which of the following candidates would you vote for?



Source: FOM

Putin's replacement – The front runners

Mr Medvedev and Mr Ivanov currently appear to be the lead contenders for the Presidential spot.



Dmitry Medvedev- First Deputy PM. Former Head of Presidential Executive Office. Responsible for social programs, including 'Priority National Projects'



Sergei Ivanov- First Deputy PM and Former Minister of Defense. Responsible for the real sector of economy and for diversification away from oil and gas


However, the result is far from certain, and other candidates may resurface as the election day approaches.

Where will Mr. Putin go?

One of the main reasons for the continued silence on the matter of what President Putin decides to do in the build up to the March 2008 presidential elections, must be the hope of keeping his many options open. Here are some of them

Change the Russian Constitution to allow a third term- 340 seat United Russia Duma Majority, popular referendum

- Step aside in 2008 only to return in (or before) 2012 - totally acceptable under the constitution
- Take a senior job in government - Prime Minister, Natural Resources Minister
- Take a senior job in state-controlled company - Chairman Rosneft/ Gazprom
- Take a senior job in a pro-government United Russia party



Could have a combination of all these three or could pic'n'mix any two

People in the Kremlin are extremely tight-lipped about personnel changes. Putin's own rise was never foreseen. It is possible if Putin is trying to maintain some power after he leaves the Kremlin that an unknown candidate will come into the Presidency.

Major risk

- Despite Putin's popularity and the centralised control that the Kremlin enjoys, the struggle for the Kremlin remains Russia's biggest medium-term risk...
- The centralised control means that the prize is commensurably large
- While there are few important pressure groups outside of the Kremlin...
- ...there are several important factions inside.
- The big question is how to guarantee the positions and authority of those currently in power under the next President – particularly given the Precedent set by Putin
 - The best solution for all sides is that Putin remains in place – moreover, he has motive and opportunity
 - However, the timing for this is getting reasonably tight, and it remains unlikely.
 - More likely is that the current incumbents create enough centres of power outside of the Kremlin that they are able to influence their chosen successor
 - Nonetheless, the struggle to nominate a successor will be intense and potentially destabilising...
 - ...expect a lot more populism between now and the elections

The CIS – a similar pattern

- **Strong economies**
- **Political stagnation even with “color” revolutions**

Can we change our World view?

Not just Russia – China, India, Brazil and others

- Trade
- Investment
- Finance – new reserve currencies

The US, Europe, Japan – how will they react?

Let's not repeat the mistake of 1907