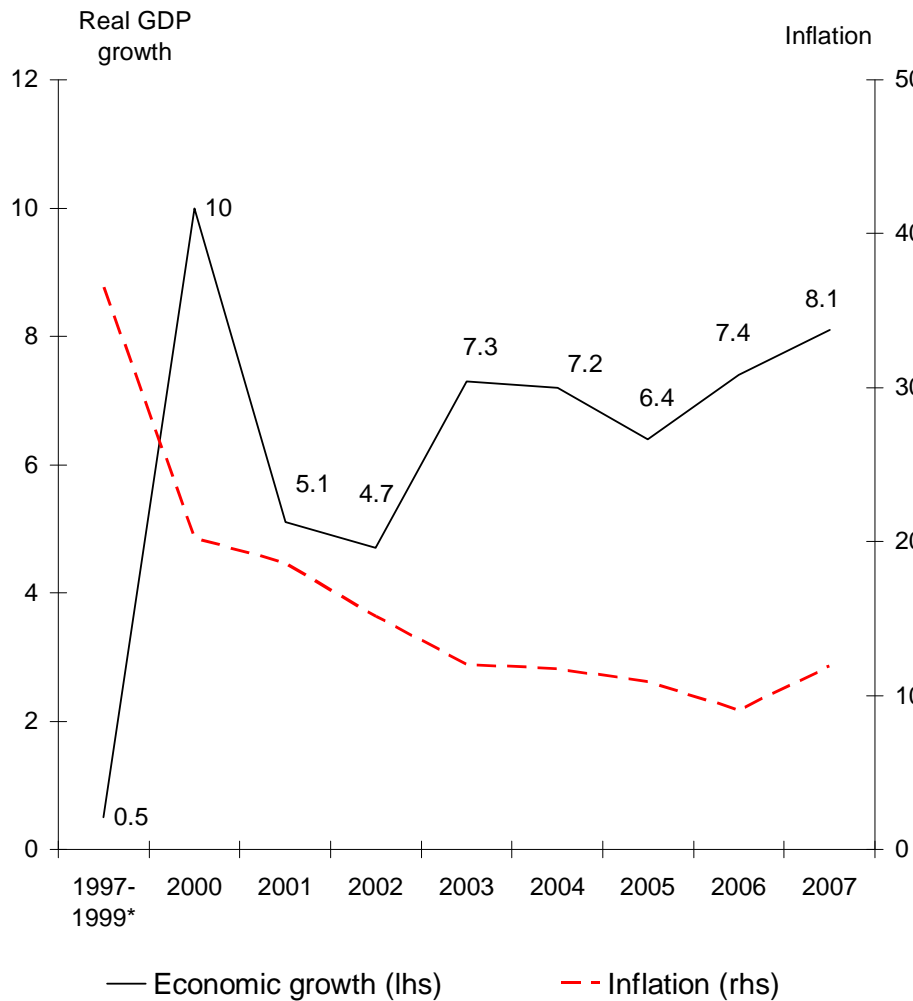


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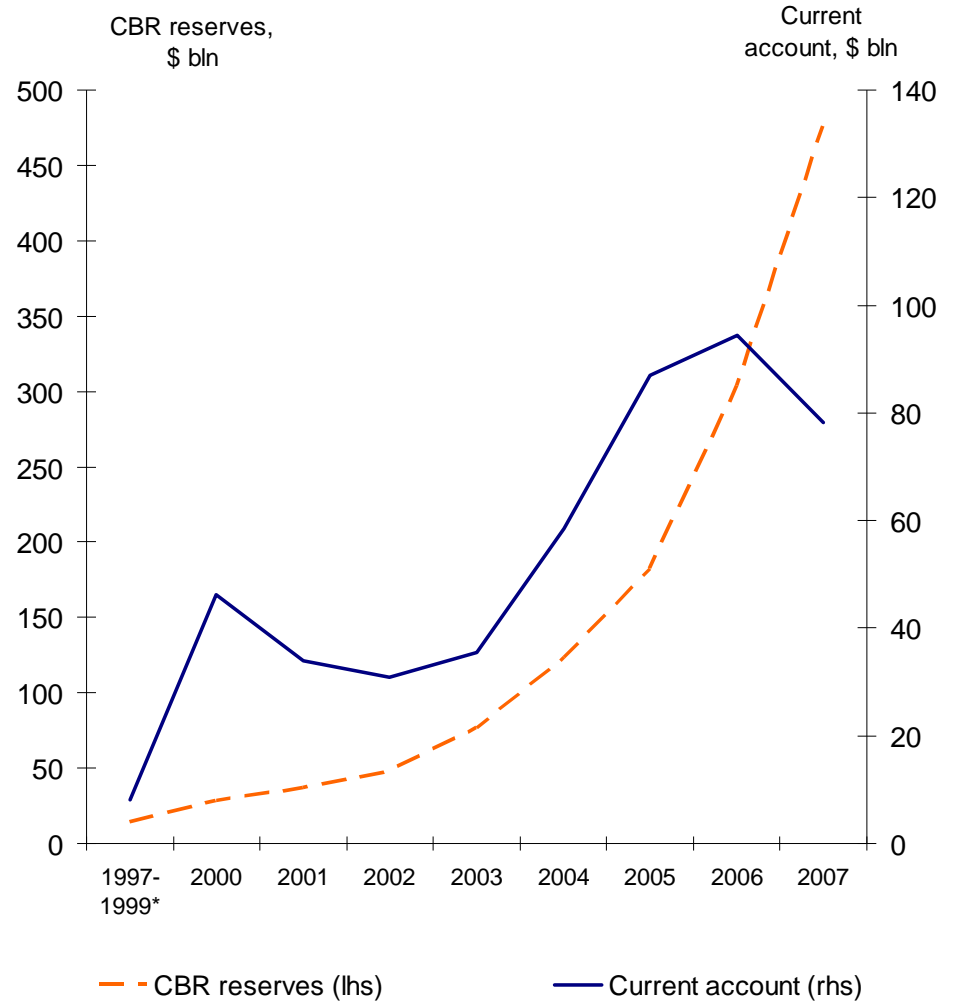
# Russia's 2000-2007 Economic Success: Pros and Cons

Petr Aven  
Alfa Bank President

# Economic trends remain favorable



Source: Rosstat

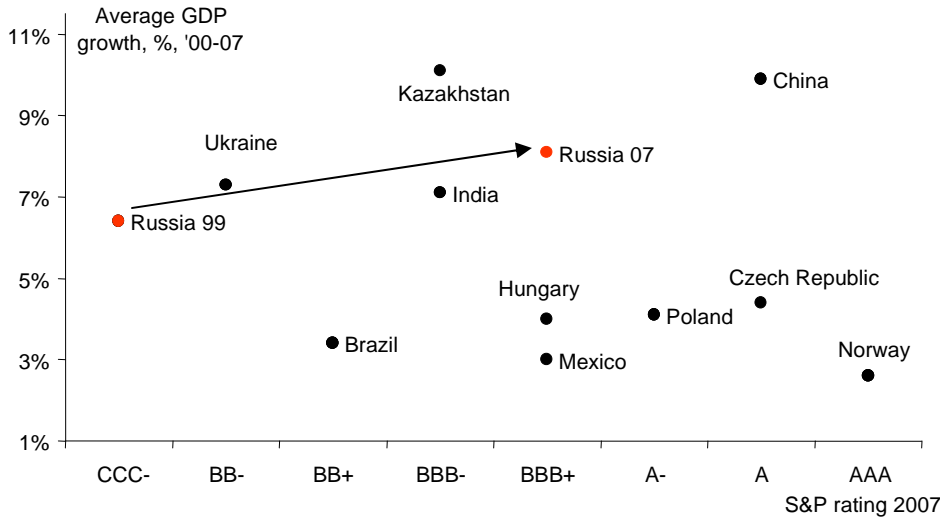


Source: CBR

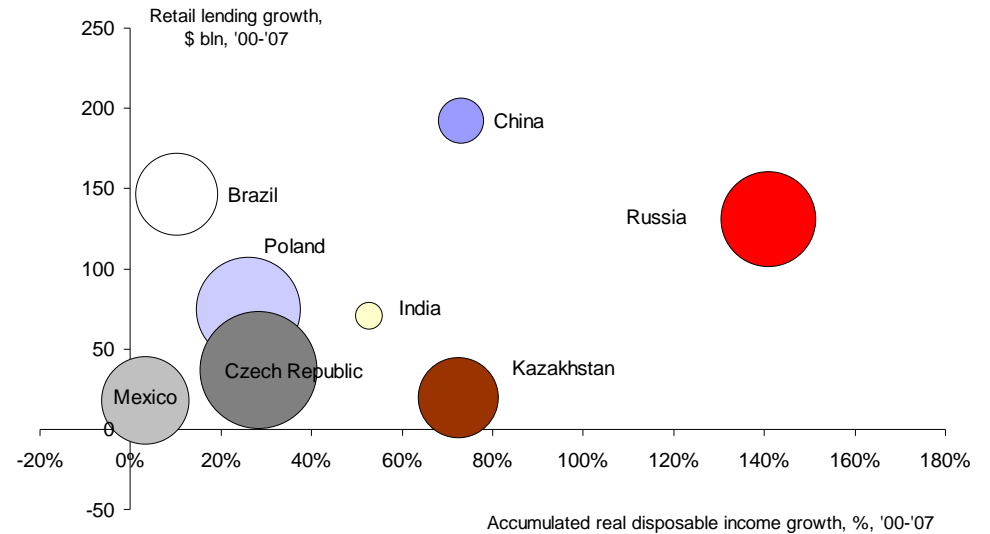


# Russia 2000-2007: A Success Story?

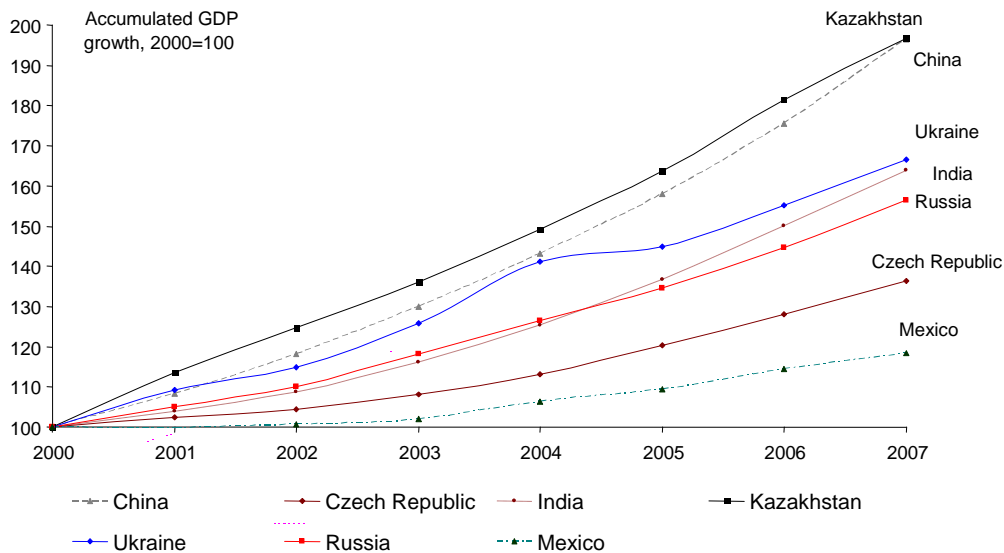
Higher rating positively affected growth



Private wealth in Russia increased faster than in peers \*



GDP growth index 2000-2007, %



- In the previous seven years Russia became an investment-grade country, access to foreign capital helped accelerate the growth rate
- Disposable income up 140% in 2000-2007, Russians have access to \$115 bln in retail loans
- Though strong, 2000-2007 accumulated growth was below that of some peers

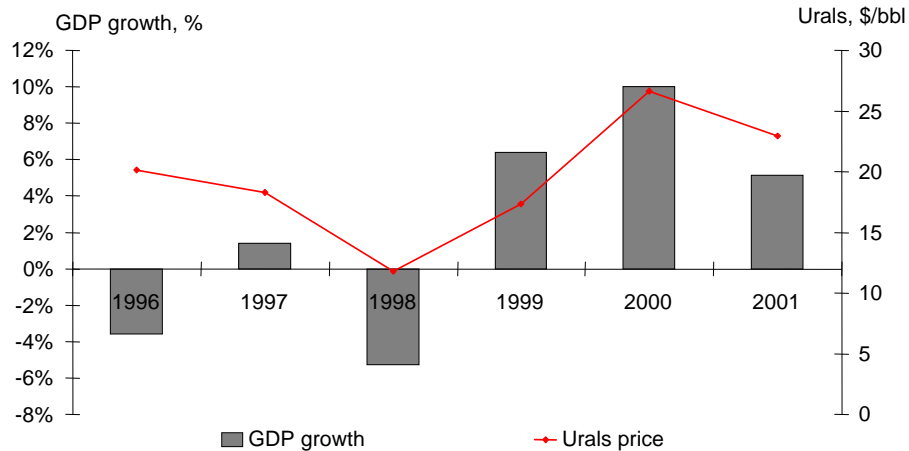
Sources: World Bank, S&P, CBR

\*Note: Size of bubble reflects GDP per capita 2007



# Russia 2000: Weak economy, poor macro story

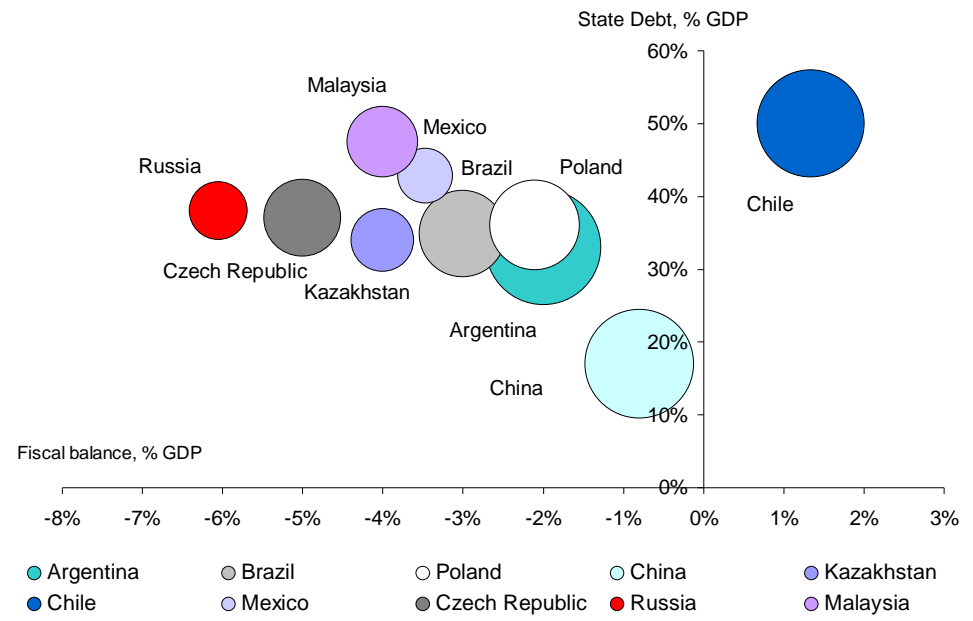
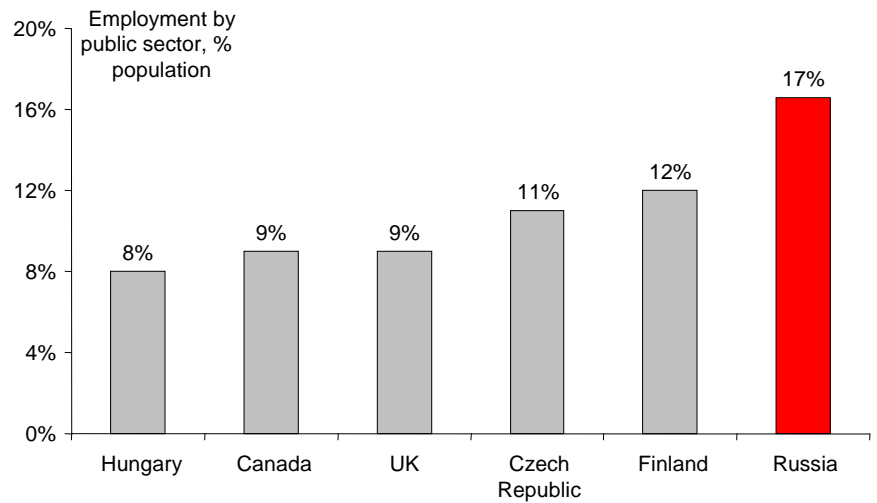
GDP growth correlation with oil prices was high



- Russia's GDP growth trend was highly correlated with oil prices
- Public sector employed 17% of population in 2000
- In '95-00 Russia had one of the world's highest fiscal deficits, a debt burden equal to 40% of GDP and low import coverage by reserves

In '95-00 Russia had a high fiscal deficit, high debt burden, low reserves \*

Public sector employment is high at 17% of population

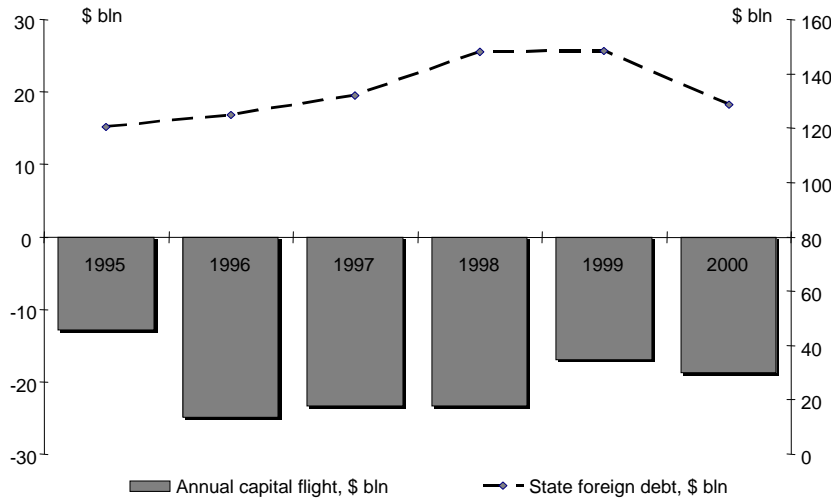


\*Note: Size of bubble reflects ratio of Central Bank reserves to imports



# Russia 2000: Capital flight, low FDI

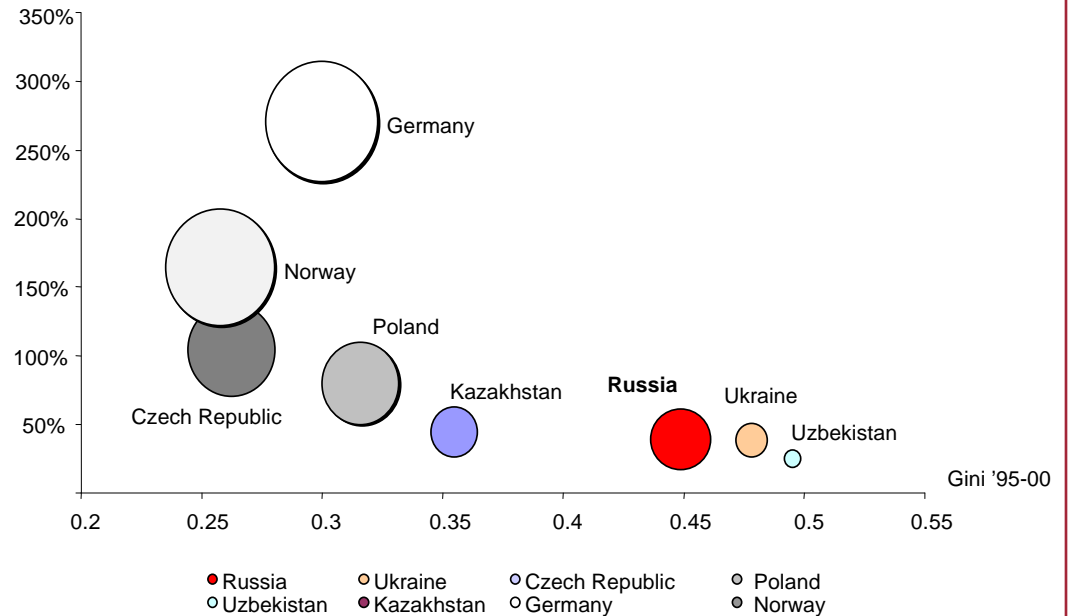
Capital flight was offset by state borrowing



- Capital flight of \$10-20 bln a year in 1995-2000 was offset by state foreign borrowing
- Russia failed to attract FDI despite low average monthly salary of \$79
- Banking assets penetration was as low as 34% of GDP

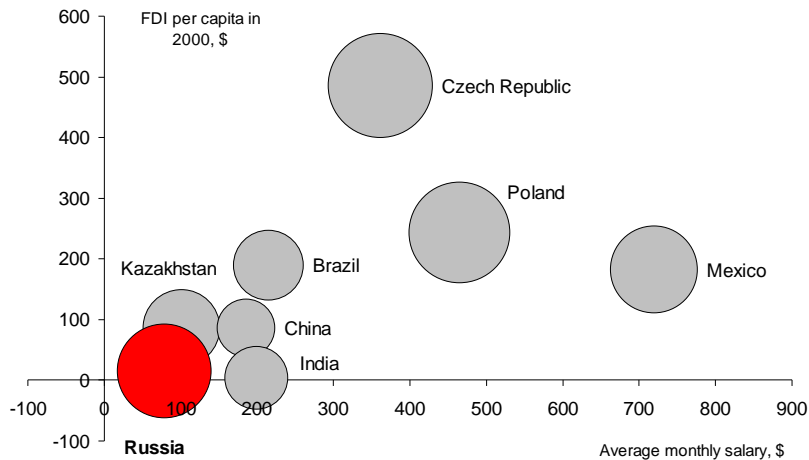
Banking penetration remained low

Banking assets/GDP



Note: Size of bubble reflects private consumption per capita in 2000 prices (figures for Norway and Germany are scaled down by a factor of three)

Russia failed to attract FDI



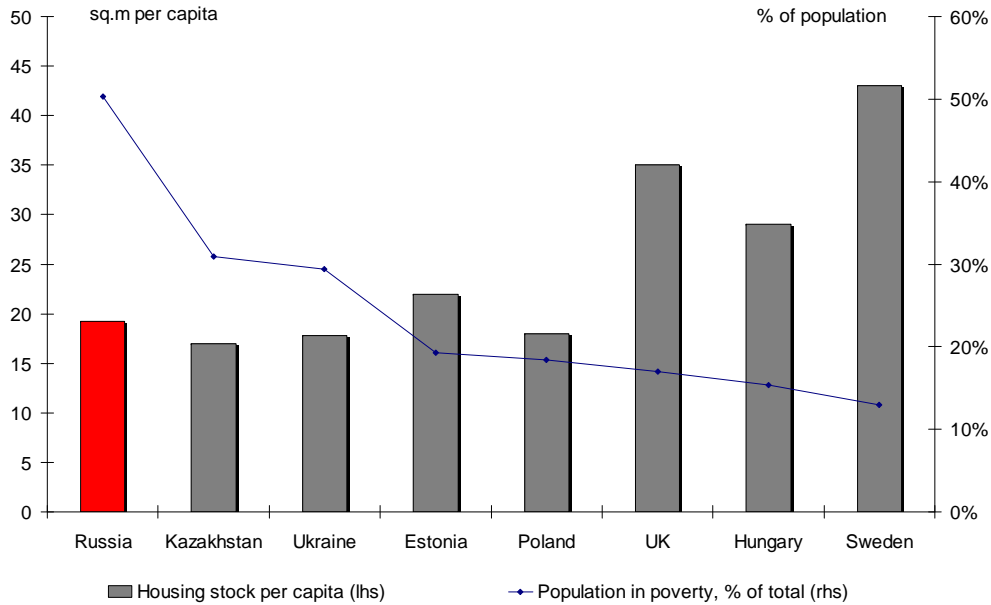
Note: Size of bubble reflects enlarged budget spending, % GDP

Sources: Rosstat, CBR, World Bank, Alfa Bank Research

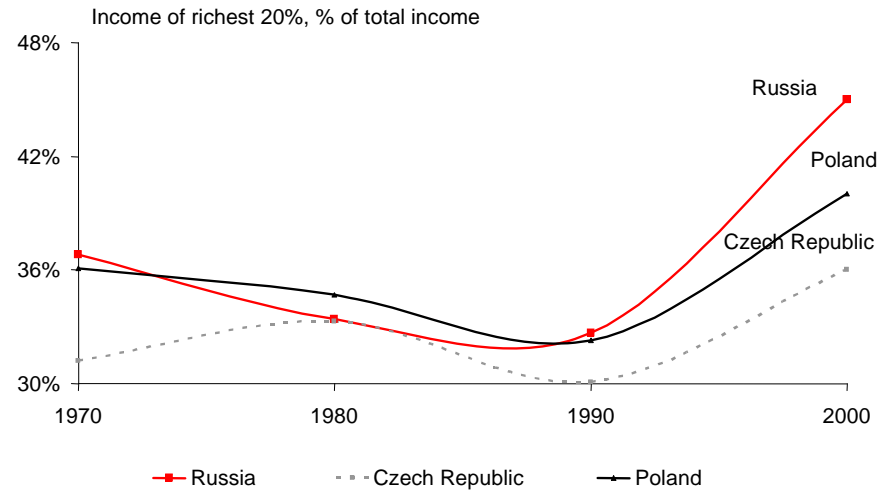


# Poor population, rising inequality

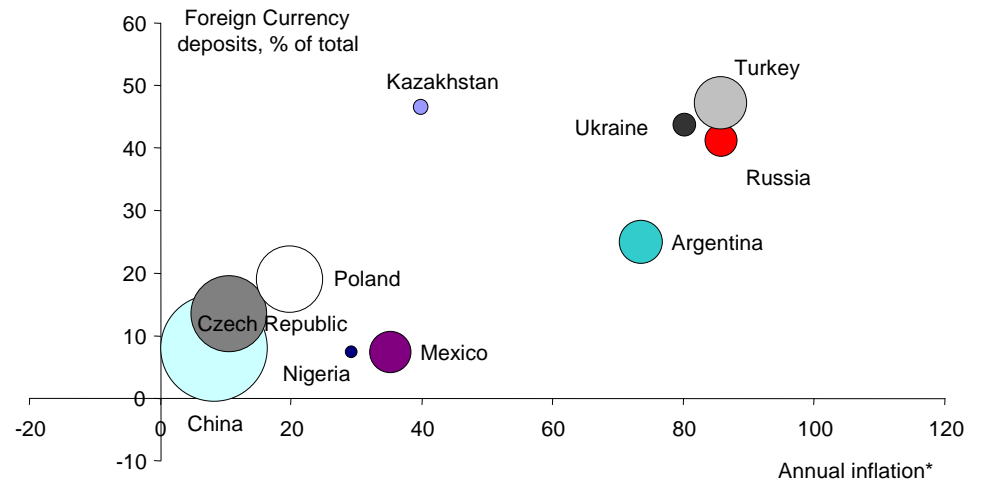
In 1999 living standards in Russia were very low



Income inequality worsened dramatically



High inflation ruined savings, boosted dollarization



- In Russia 50% of the population was living below \$4 PPP/day in 1999, housing stock per capita was modest at 20 sq m
- Income inequality widened after 1990, with 47% of wealth in the hands of the richest 20% of the population in 2000
- Persistently high inflation destroyed savings, fuelled dollarization and lowered the deposits-to-GDP ratio to 10%

Note: \* Maximum annual inflation level during 1996-1999  
Size of bubble reflects retail deposits, % GDP

# List of reforms 2000: Restructuring the economy

## Financial infrastructure

### Fiscal reform

Creation of stabilization fund  
Total budget expenditures to be cut from 35% of GDP

### Tax reform

Cutting profit tax, personal income tax, payrolls

### Pension reform

Introduction of defined contribution system  
Defined contributions invested in financial markets

### Banking reform

Introduction of deposit insurance  
Foreign access to banking sector to be liberalized  
Privatization of state banks on the agenda

## Industrial development

### Liberalization

SMEs in Russia accounted for only ~10% of GDP vs.  
50% in Europe  
SMEs employed only 15% of the labor force in Russia vs.  
49% in the UK and 54% in the US

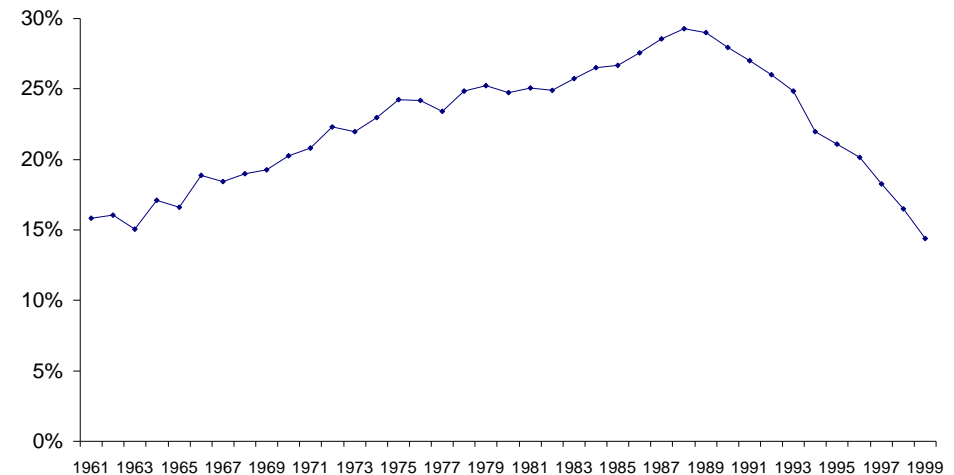
### Reform of natural monopolies

Cross-subsidization by UES, Gazprom as high as 5% of GDP  
Number of accidents in communal housing sector had increased by five times since 1990

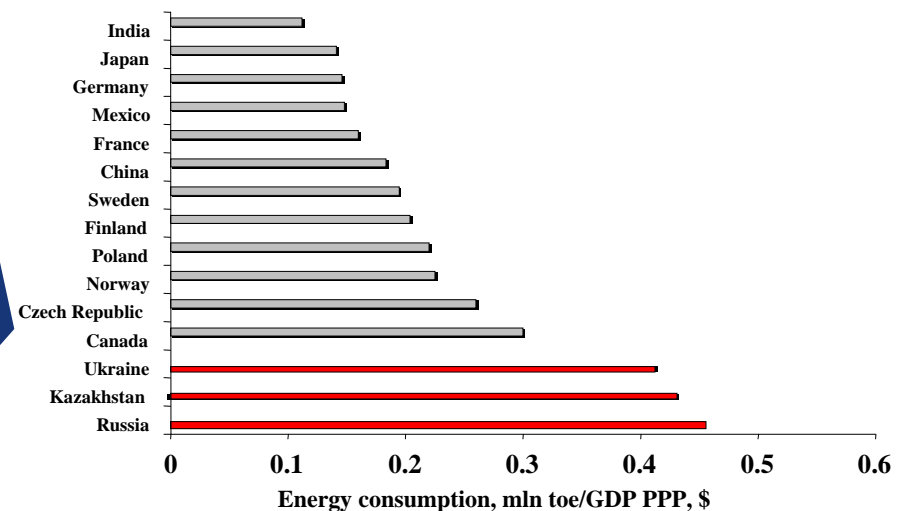
### Administrative reform

Reducing and streamlining responsibilities of state authorities

Fixed Investments, % of GDP, 1961-1999



Energy efficiency had to be improved



## 2000-2007: Macro stability achieved

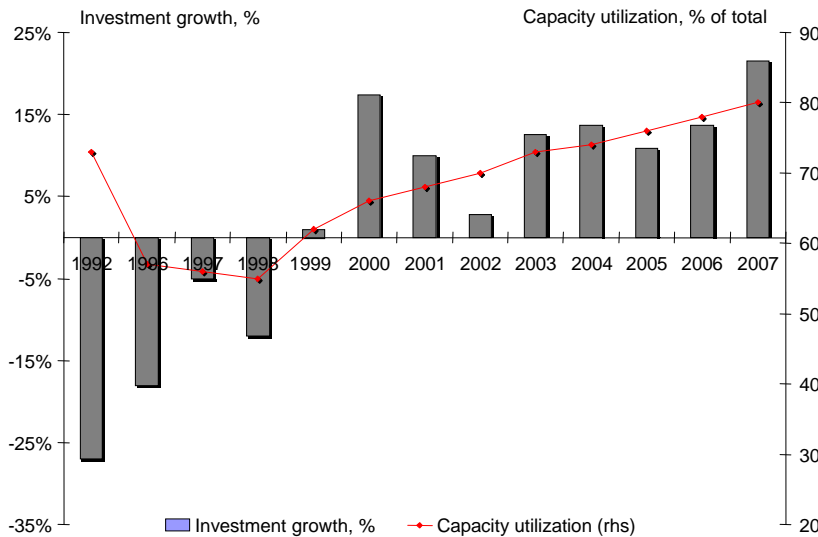
	Russia 2000	Russia 2007
Federal budget surplus, % GDP	1.5%	5.5%
CBR reserves, \$ bln	\$28 bln	\$476 bln
Months of imports	8.0	25.0
% total foreign debt	18%	103%
Net capital flows	-\$24.8 bln	\$81.2 bln
Foreign currency retail deposits, % total	32.5%	13.0%
State foreign debt, \$ bln	128.6	46.4
% of GDP	51.2%	3.6%
S&P rating	CCC-	BBB+

Sources: CBR, Minfin, S&P, Alfa Bank Research



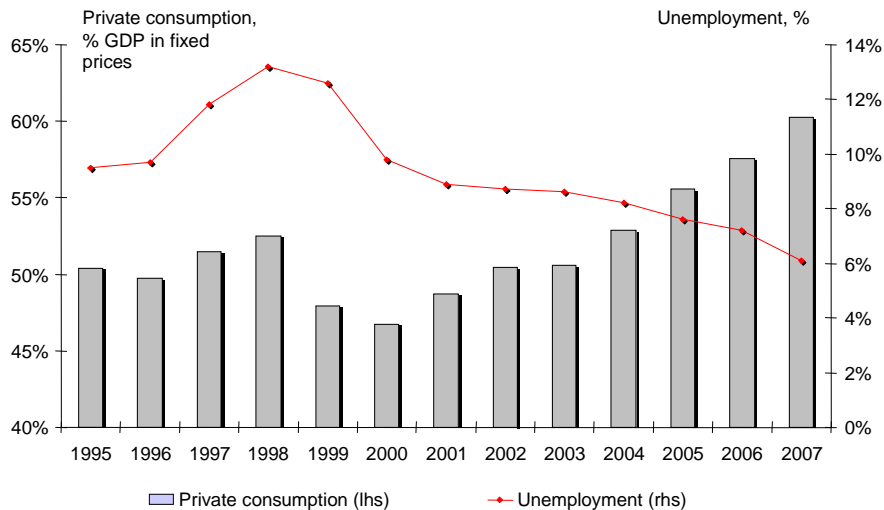
# Russia 2007: Very strong macro picture

## Investment growth exceeded 20% in 2007

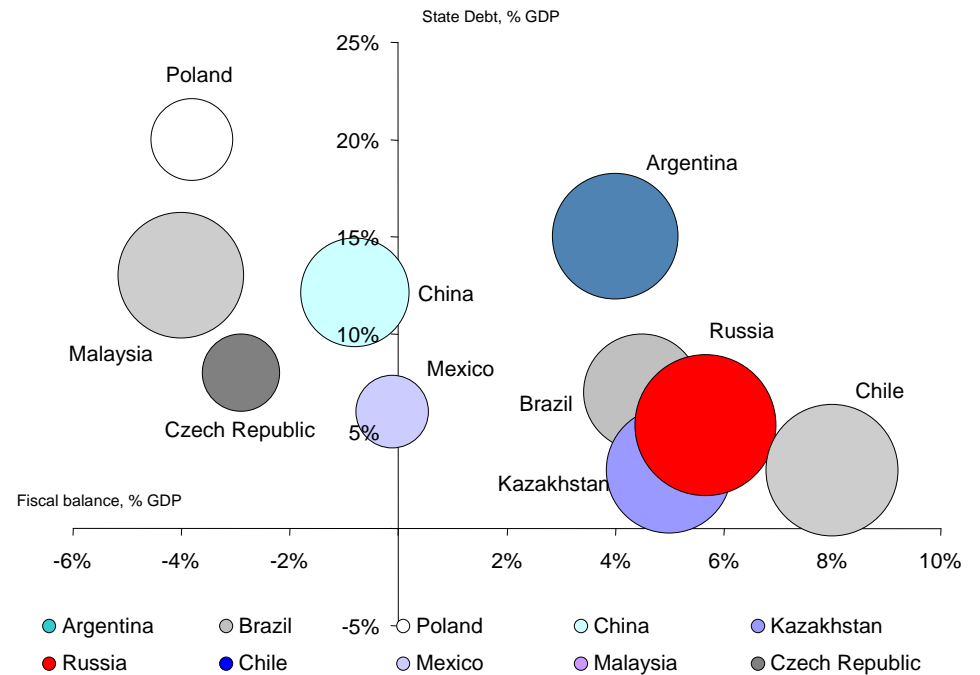


- Macro stability helped to accelerate consumption growth, private consumption rose to 60% of GDP
- Investment growth accelerated to 21% y-o-y in 2007, the highest since 1992, capacity utilization rate went up to 80%
- In 2007 Russia had one of the world's lowest state debts (3.6% of GDP), one of highest fiscal surplus and held the world's third-largest reserves

## Lower unemployment supports consumption



## Countries by budget deficit, reserves and debt in 2007



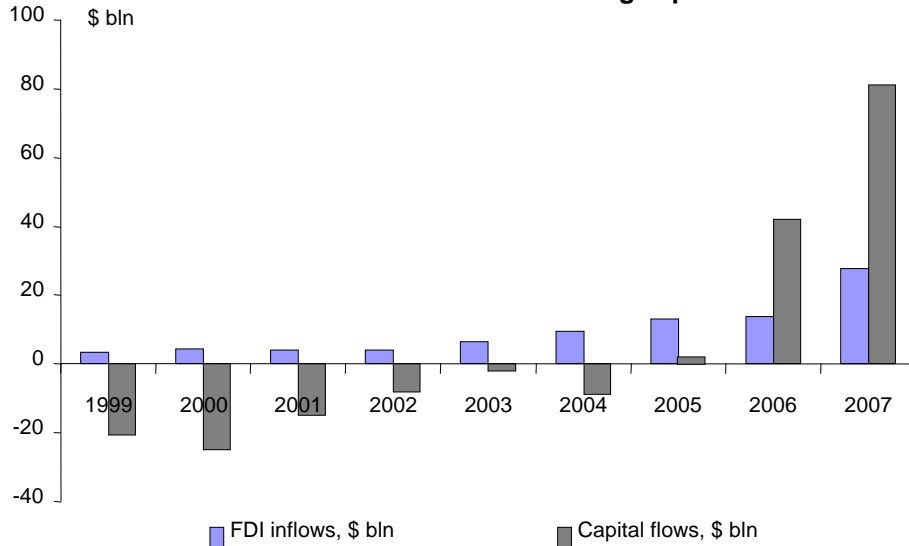
Sources: Rosstat, CBR, World Bank, Alfa Bank Research

\* Size of bubble reflects Central Bank reserves to import ratio



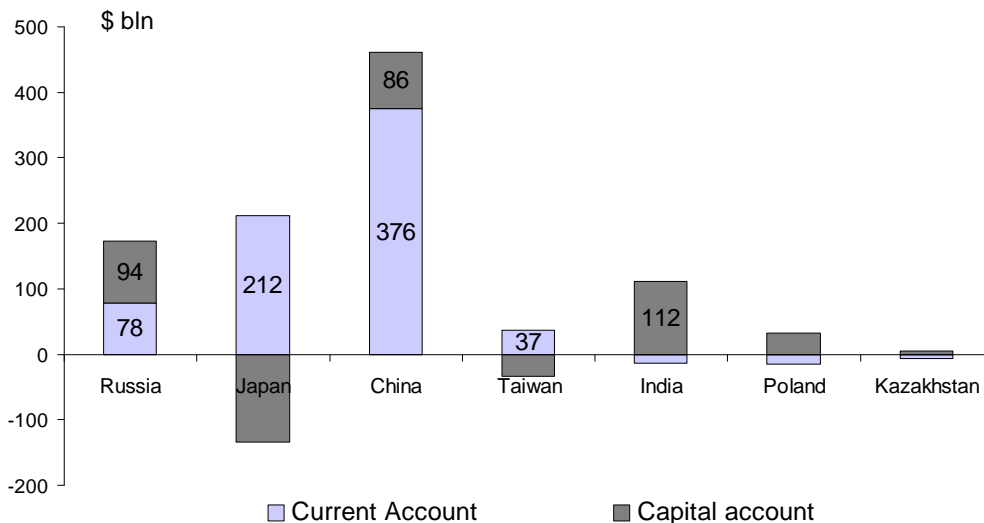
# Russia 2007: Stabilization fund at \$158 bln

Since 2005 Russia has seen a strong capital inflow

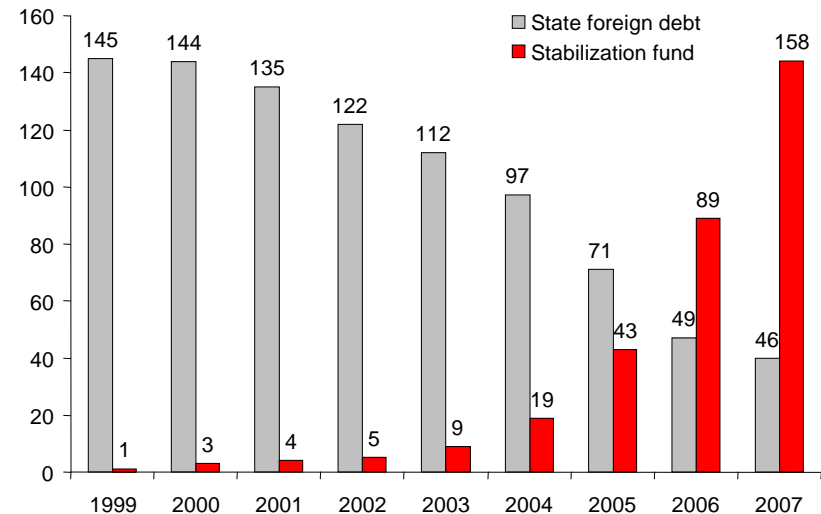


- After receiving investment-grade rating in 2003, Russia benefited from capital inflows (\$81.2 bln in 2007) and increase in FDI (\$27.8 bln in 2007)
- Unlike the other largest reserves holders, Russia is running both a capital and current account surplus
- Russia has used high commodity prices to resolve its debt problem

Russia benefited from current and capital account surplus in 2007



Russia's stabilization fund and state foreign debt, \$ bln

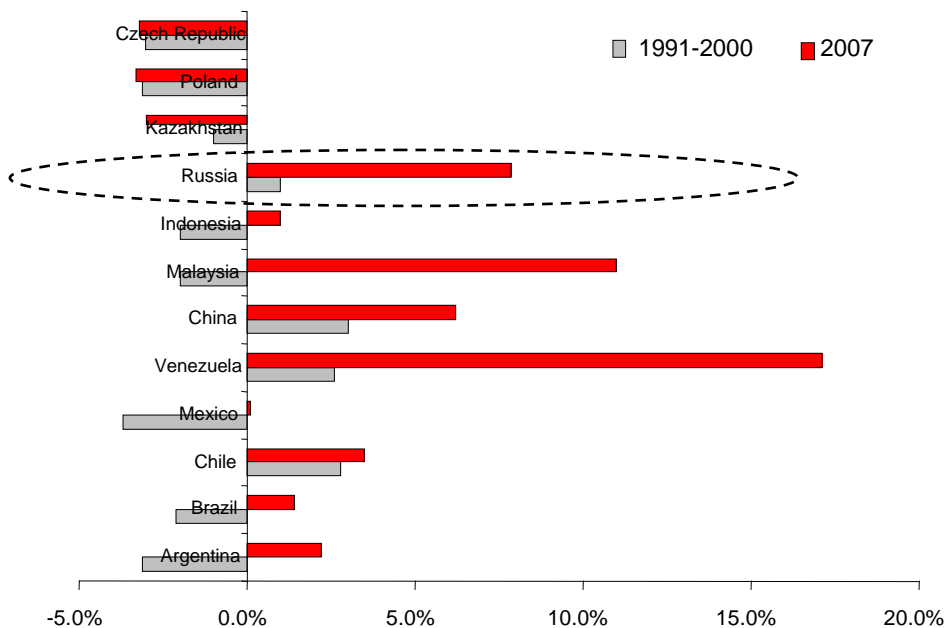


Sources: Rosstat, CBR, Bloomberg, Alfa Bank Research

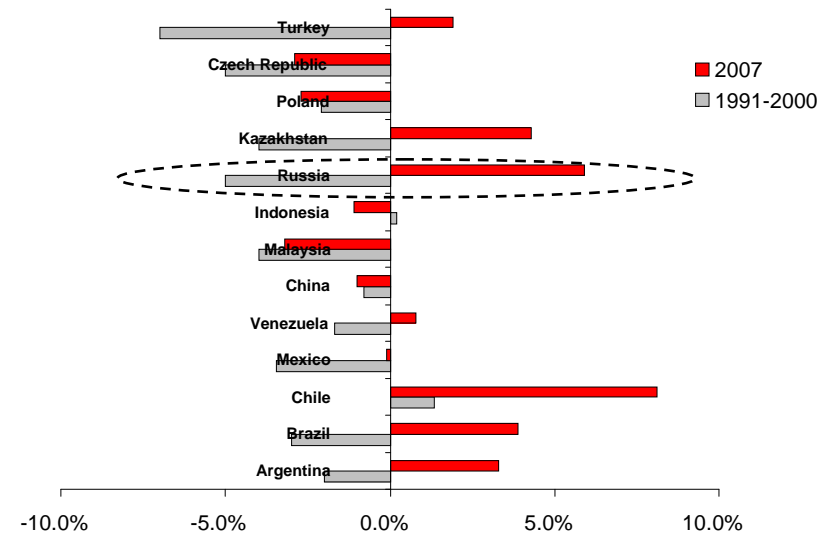


# Emerging markets have become more stable

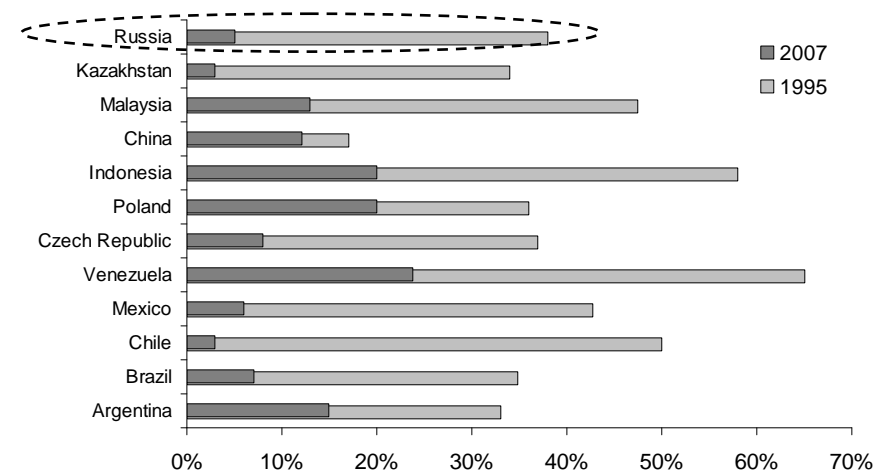
Current account, % GDP



Fiscal position, % GDP



State Debt, % GDP

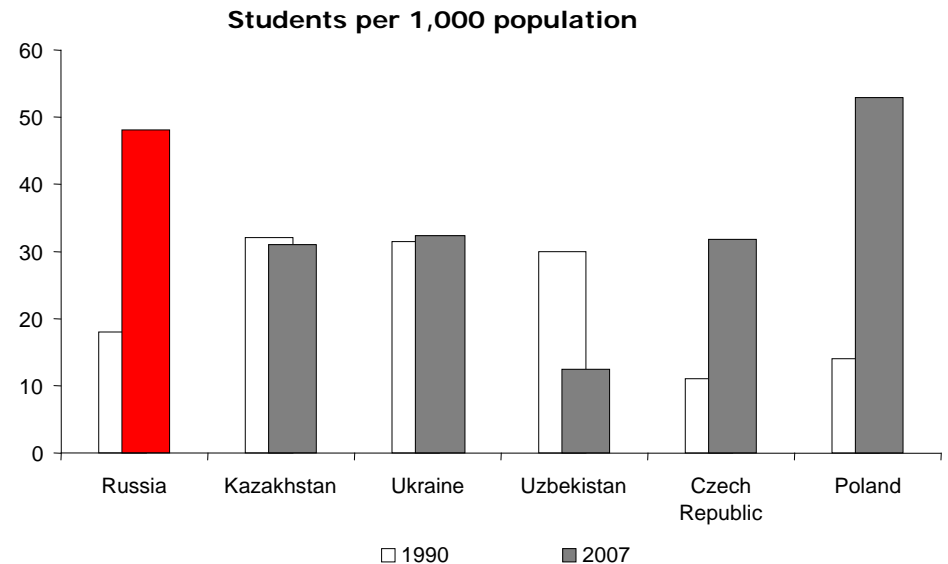
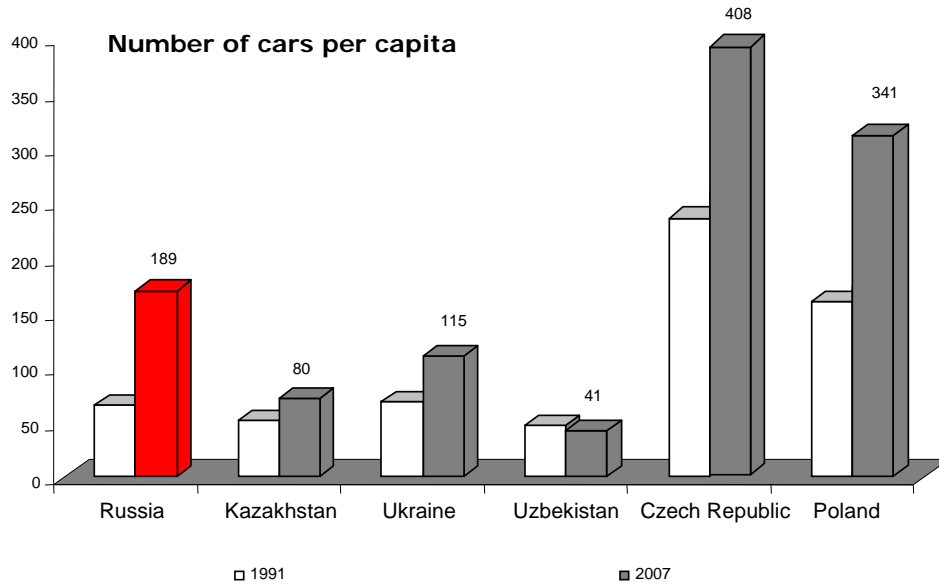


Emerging market countries now have a current account surplus of \$1,445 bln versus a \$170 bln deficit in 1990-1993

All emerging market countries have managed to reduce state foreign debt since 1995

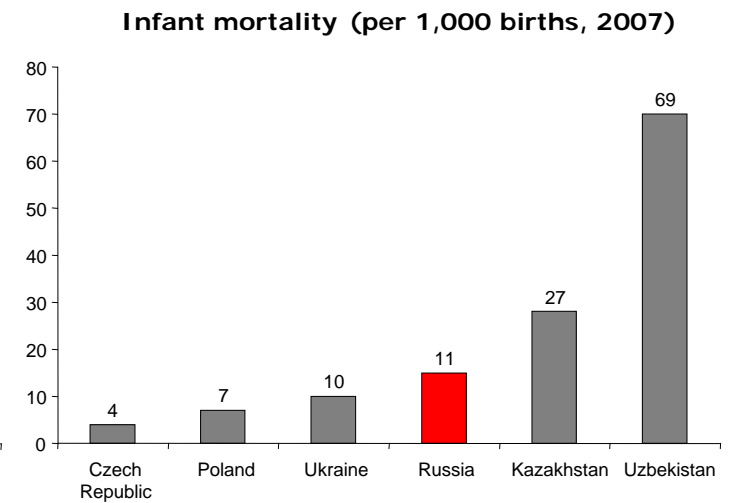
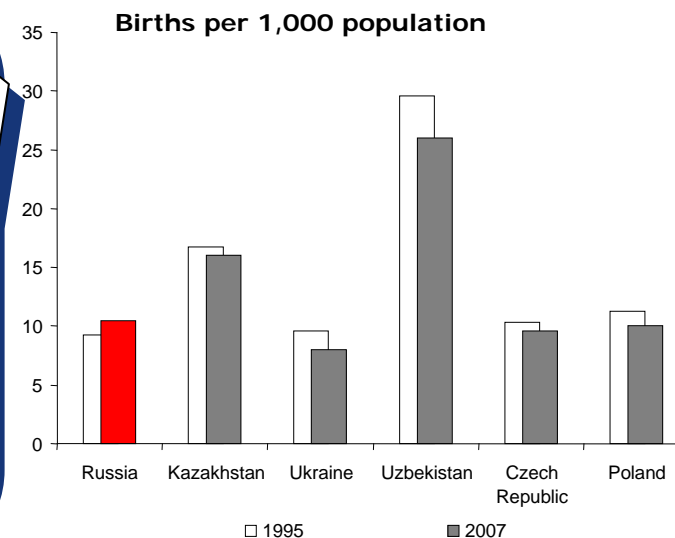
Russia has one of the world's largest fiscal surpluses, at 5.5% of GDP, and one of lowest state foreign debt levels, at 3.6% of GDP

# Social issues: Living standards improved



**Middle class is gradually emerging**

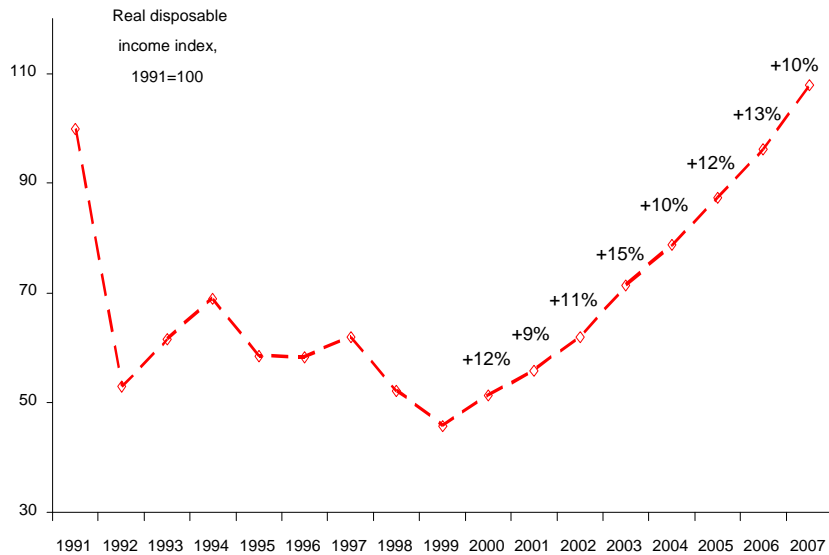
- Number of cars per capita tripled from 1991
- Over 10 mln Russians travel abroad annually
- Number of students has more than doubled over the past 10 years
- Birth rate has increased compared to 1995, infant mortality dropped from 15 to 11 per thousand



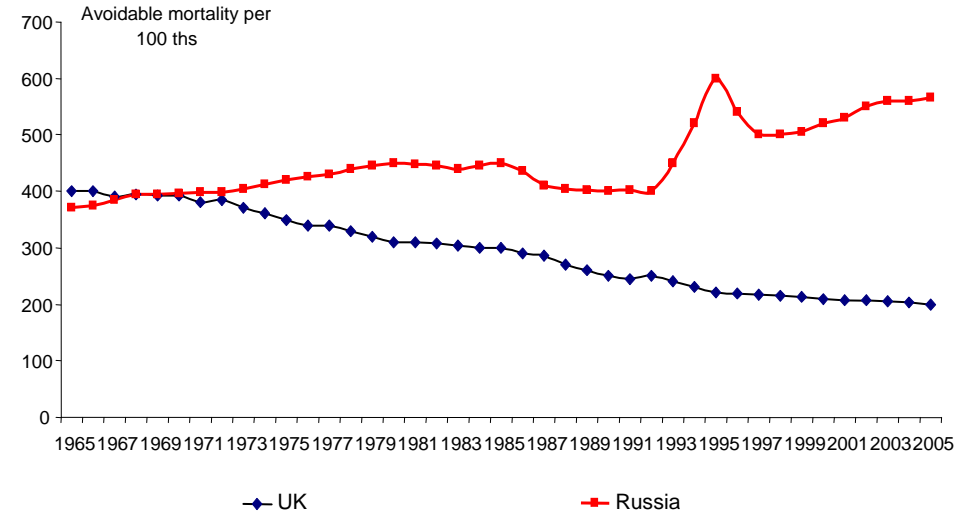
Sources: Rosstat, CIA World Factbook 2007, World Resources Institute

# Quality of life up, but should be better

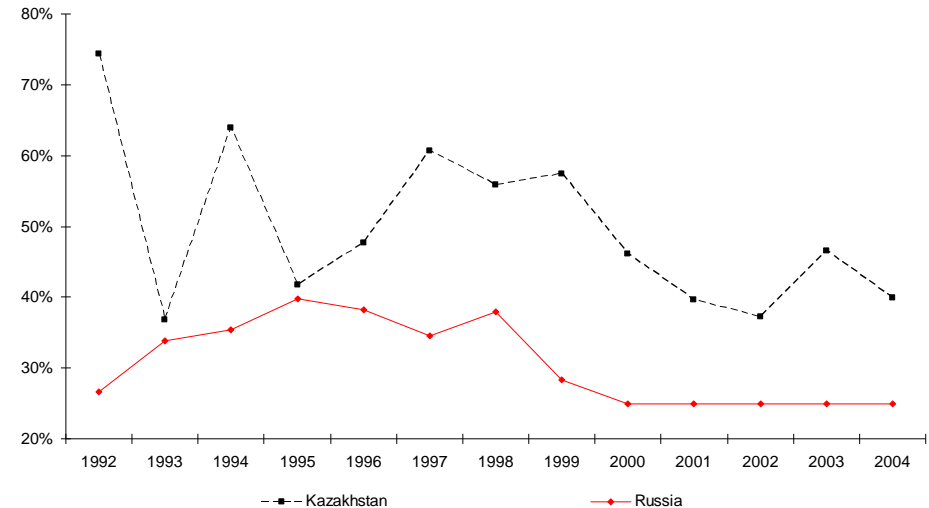
Real disposable income trend



Poor health care responsible for high avoidable mortality rate



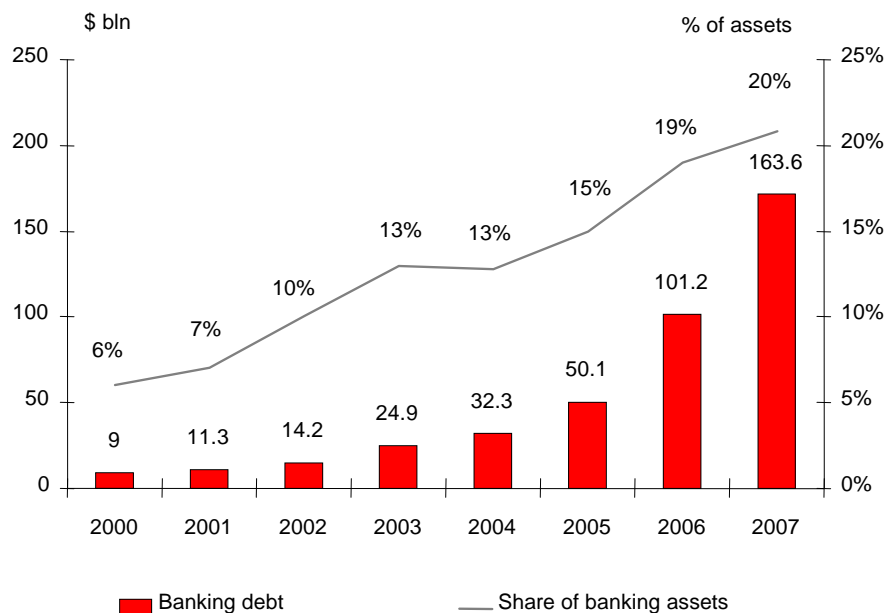
Pensions-to-average salary, %, in Russia and Kazakhstan



- Russia saw very strong growth in real disposable incomes, which has been in the double digits in the past several years
- State spends only 3.2% of GDP on health, while the avoidable mortality rate continues to increase
- Pension-to-salary ratio staying flat at a modest 26%, down from 40% in 1998

# Banking risks low, but penetration still weak

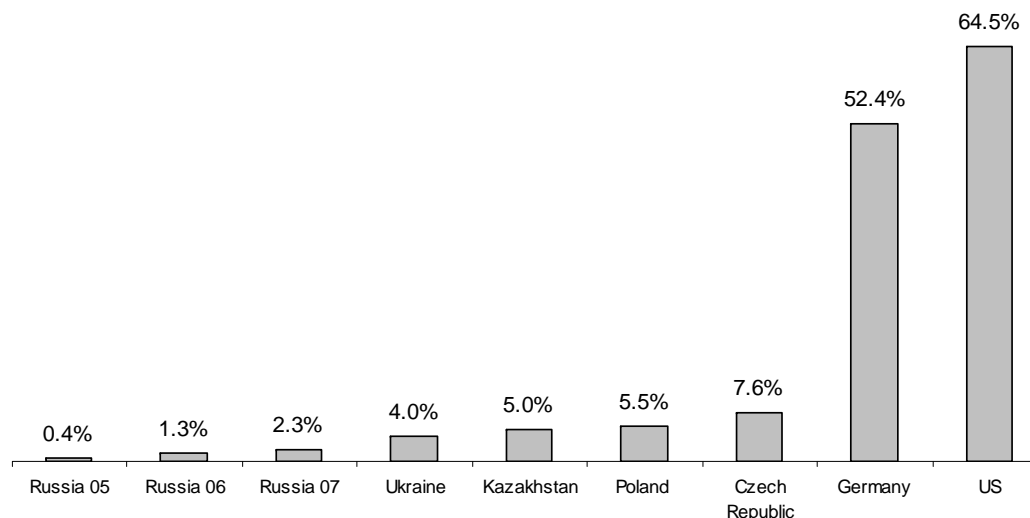
Dependence on foreign debt is not crucial



Banks finance only 11% of investments, maturity still short

	2000	2005	2006	2007
Assets, % GDP	34%	44%	54%	63%
Loans, % investments	3%	8%	9%	11%
Loans >3 years, % total	12%	15%	19%	24%

Mortgage market totaled only 2.3% of GDP in 2007



- Russian banks are not highly dependent on foreign borrowing, with only 20% of assets funded from abroad
- Banking penetration still weak, assets-to-GDP was 63% in 2007 versus 95% in Kazakhstan and 84% in Ukraine
- Russian banks have just started to penetrate the mortgage market, mortgages-per-capita only \$211

# Restructuring should remain on the agenda

## Financial infrastructure

### Budget policy

Russia will face the need to increase state social expenditures, including a likely increase in pension payments of some 3% of GDP

### Pension reform

Only 2% of population has transferred pension savings to private management, \$15 bln of defined contribution is managed by the State Pension Fund

### Banking reform

Number of banks still exceeds 1,000  
Foreign banks' penetration in Russia is low

## Industrial development

### Liberalization

The role of SMEs remains modest, estimated at 17% of GDP

### Reform of natural monopolies

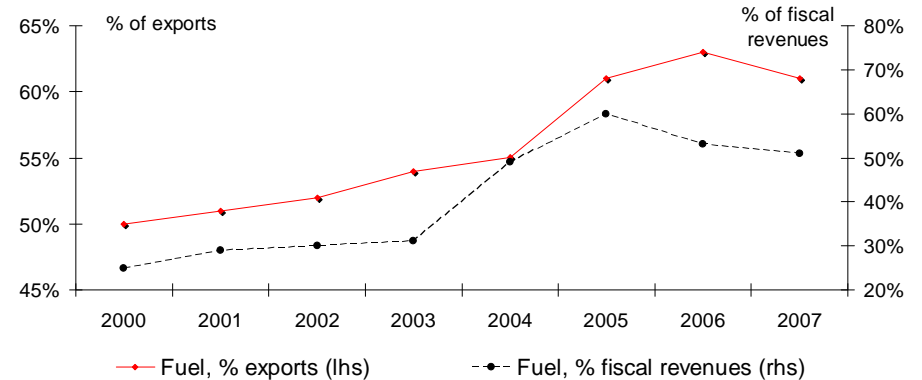
Cross-subsidization by UES, Gazprom still as high as 3% of GDP

### Administrative reform

The state still has to reinforce its role as a regulator

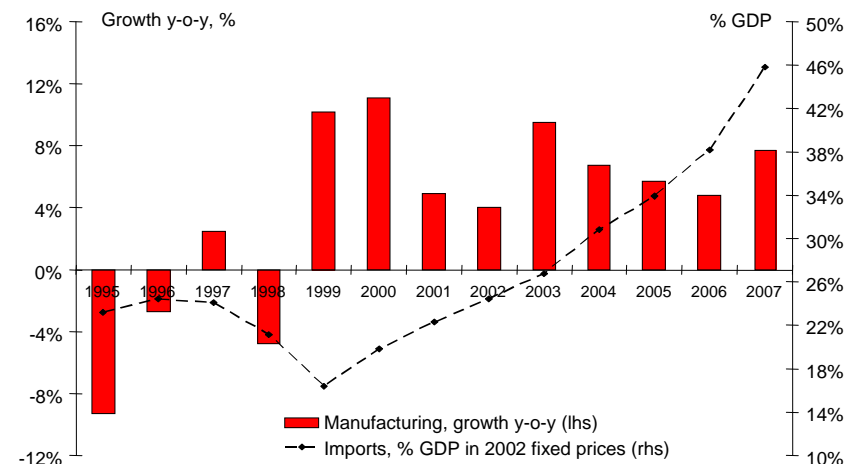
Public sector still employs 16% of population, number of state bureaucrats increased at least 25% since 2000

Fuel , % of exports and % of federal budget revenues



Share of oil in Russia's exports is increasing; some 61% of revenues in 2007 came from fuel exports versus 37% in 1995

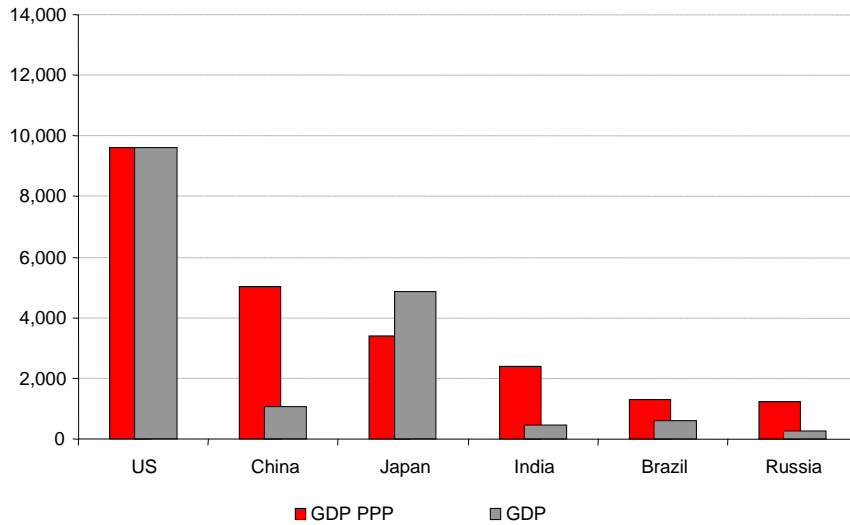
Rise in imports is limiting growth potential



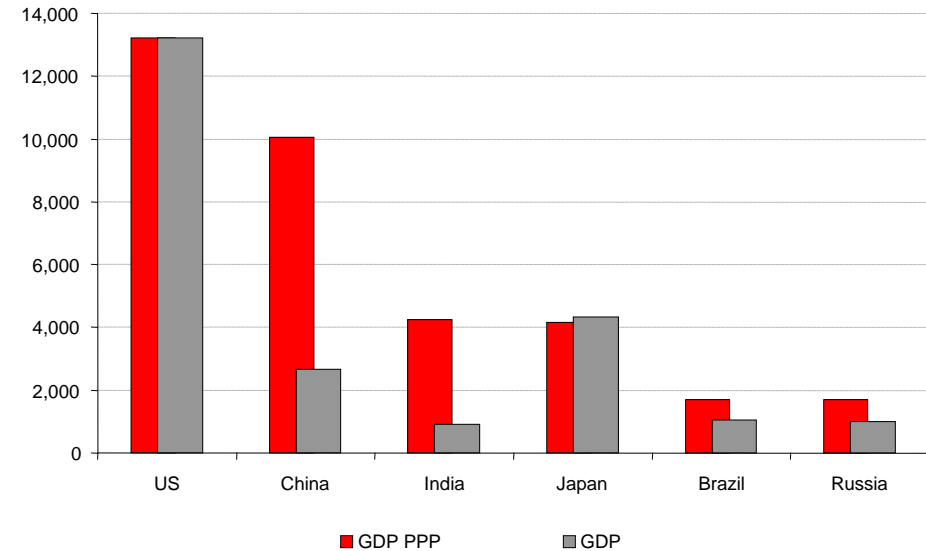
Sources: Minfin, Rosstat, Alfa Bank Research

# Russia's challenges

Russia's role in the world, 2000



Russia's role in the world, 2006



- The gap between Russia and Brazil on the one hand and China and India on the other has widened in the past several years
- Russia has a low SMEs-to-GDP ratio, and with 12% of the population over 65, the economy is not flexible enough
- Demographic situation suggests the need to increase state social expenditures in coming years

Small SMEs sector, old population

