

# Country Report

Economic Research Department

August 2008



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Closing date: August 13, 2008

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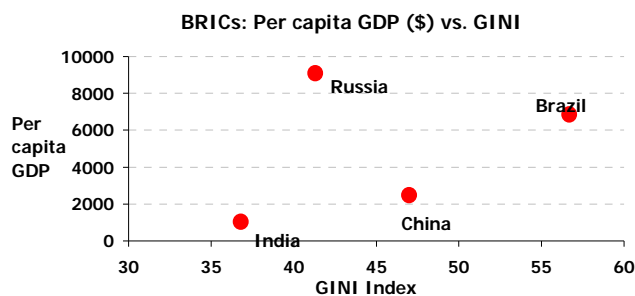


# Economy

## ECONOMIC STRUCTURE

With 17 million square kilometres and 142 million inhabitants, Russia is geographically the largest country and the seventh in demographical terms. However, in relation to income per inhabitant, Russia is a middle income country, with close to US\$ 10,000 income per capita in 2007 (US\$ 14,000 in ppp).

The country has featured an intense growth since the beginning of this decade. This reason, as well as its military power, makes Russia as a major hallmark among emerging economies. Bearing in mind the rest of the BRIC, the size of the Russian economy can be compared to that of Brazil or India. In terms of economic development measured by per capita income, Russia reaches levels similar to Brazil and well above those shown by China or India. Even though its income gap has increased in the last few years, it is still more balanced than those countries' average.



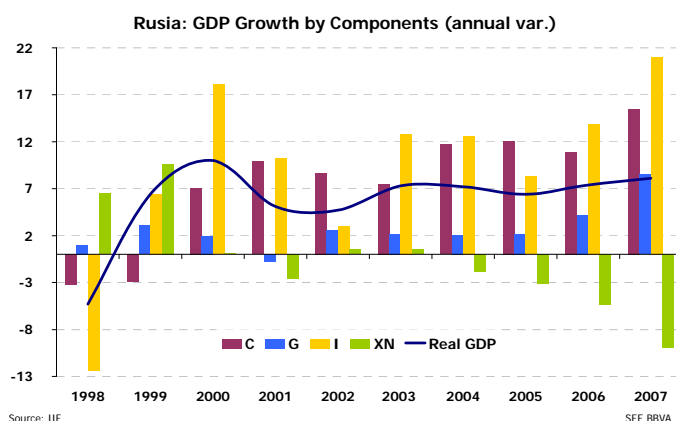
Sources: IIF, CIA World Fact Book

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### A long expansion cycle with different driving forces

In 2007 Russia recorded intense growth for the ninth consecutive year, with a mean GDP change of approximately 7% per annum during 1999-2007. This growth rate has been supported by many factors, whose significance has varied throughout time. Initially, the collapse of the centralized planning socialist system triggered the massive underutilization of both workers and productive facilities. This, together with the introduction of private property, free prices and incipient market institutions, allowed for the relocation of production factors towards the most productive sectors. After the serious depreciation of the rouble after the 1998 crisis, the heavy fall of real salaries and further

responsiveness to Direct Foreign Investment, Russian companies' competitiveness increased markedly. As time went by, the end of the productive factors relocation process, the recovery of real salaries, and the real appreciation of the rouble eased the significance of the initial driving forces of growth in Russia. But especially since 2003, the bullish cycle of commodity prices has triggered a major increase of export revenues and a strong boost of fiscal revenues. A process that has facilitated consumption and investment growth, resulting in an extraordinary upsurge of imports.



Source: IIF

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### Challenges to ensure long-term growth

In short, the rapid income growth experienced during this decade largely responds to the restructuring process faced by the Russian economy during the 90's, which facilitated an increase of total factor productivity (TFP) sparing major investment commitments, thanks to a large idle capacity in place. Productivity has continued to show positive growth; however, everything seems to indicate that the sustainability of the current growth is necessarily linked to further accumulation of factors. Russia is undoubtedly growing at rates above its potential growth, which according to several estimations is around 6% (IMF, 2006). Given the state of production factors, this situation poses several future challenges to bear in mind. With regards to labour, the predictable Russian demographic evolution generates concerns as to its capacity to contribute to future growth (see section on demographics). In fact, especially in those industries and areas of the country with higher growth, bottlenecks in the labour market have already emerged, and are being translated into upsurges both in the utilisation rate of this

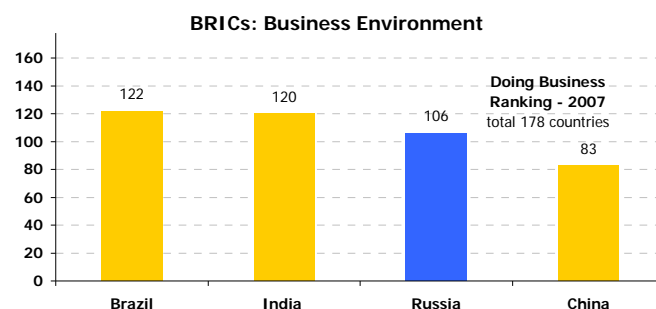
factor and in real salaries. Another labour market mismatch, which will worsen in the future, is tied to the relative shortage of qualified labour. The high education standard has experienced a decline since the end of the Soviet era, mainly due to the chronic infra-allocation of resources, to an extent that, according to the Ministry of Education, only between 10 and 20% of higher education institutions still maintain the high levels recorded during the Soviet period.

As to the role of capital in future growth, investment ratios are still low (around 24% of GDP), especially compared to those recorded in the emerging Asian countries. Most of such investment does not represent increments to the productive capacity, as it will replace obsolete or seriously deteriorated facilities and equipment in the energy sector (see section on energy). This reduced level of investment is, first, the result of the long period of economic planning under Soviet protection, which eradicated private investment. Later, the entrance into the market economy was characterised by high economic volatility, which discouraged saving and domestic investment. Regulatory obstacles that have hindered the development of the business fabric should be added to the abovementioned factors.

Despite this background, however, the current period of macroeconomic stability is speeding up investments, with year-to-year increments of around 20% in late 2007. The current favourable macroeconomic situation has offered a more predictable framework for investment, which has boosted the return of an important portion of the crisis capital outflow. On the other hand, the public sector emerges as a crucial player to maintain the investment activity's growing path. Following this, last year the Kremlin presented an industrial policy program that includes the creation of several companies through public-private partnerships in industrial sectors considered crucial to future growth (nanotechnology, aeronautics, naval engineering, etc.). The public sector also fosters investment through injections in infrastructure, forecasted at 100 billion dollars for the upcoming years. The ultimate objective of these programs is to achieve further diversification of the economy, making it less dependent on the energy industry. All these positive elements for domestic investment have been partly offset by higher arbitrariness in dealing with foreign investors, especially in sectors considered essential to the government, such as oil and gas (see section on energy).

This investment program has a financing strategy based on a scenario of relatively conservative oil prices. As the most negative aspect, several analysts argue that higher public investment in selected infrastructures and industrial sectors would not be sufficient to reduce the energy sector's export or fiscal dependence. In order to achieve this objective, a number of complementary reforms are necessary, especially those aimed at improving the human capital or the business activity regulatory framework.

This last issue is paramount for any reform strategy to be successful. If guided by institutional indicators related to the business activity, and compared to the rest of BRIC, Russia has a clear disadvantage against China, though exceeding Brazil and India. Aspects such as applying for activity licenses or the management of cross-border trade are some of the activities facing greater obstacles from public institutions.



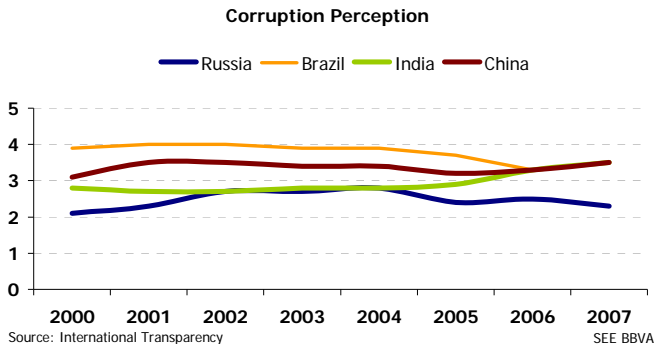
Source: World Bank. Highest values show worse business environment.

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Although closely linked to the abovementioned institutional aspects, the incidence of corruption in the country is even more worrisome. The corruption perception index<sup>1</sup> in Russia has shown virtually no change since 2000, slightly worsening in 2007. Thus, and compared to the other BRICs, the country is regularly reported as the economy with the highest levels of corruption in the group. The influence of government bureaucracy in business operations, unofficial barriers imposed by regional authorities and unpredictability in law enforcement are among businessmen's main complaints.

Regardless of the country's ranking in these indices, the truth is that building a more appropriate institutional environment for the development of the economic activity seems a priority for the new Russian government: President Medvedev has made several statements during the last few months on the need to strengthen the "rule of law" and to fight corruption. Last April, the first set of measures was approved to protect small and medium sized enterprises, the main victims of corruption in the business environment.

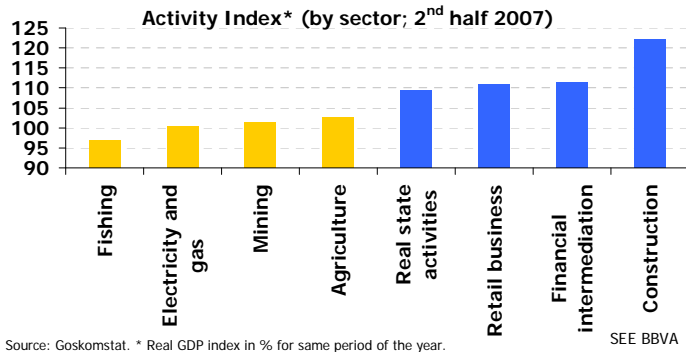
<sup>1</sup> The corruption perceptions index measures the extent of corrupt activities in the public sector and in politics, through surveys to country risk analysts and consultants (both resident and non-resident ones). Lower rankings imply higher incidence of corruption



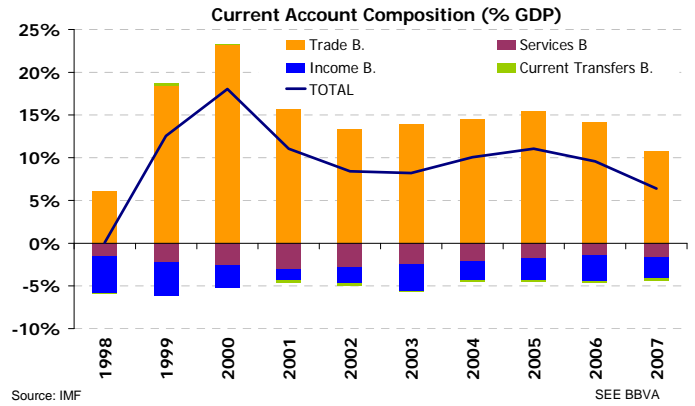
These political statements help us verify the Russian government's concern to improve the institutional environment. Second, the type of measures mentioned above also indicate the new *modus operandi* of the Executive, which will probably start to gradually implement marginal improvements, instead of a drastic transformation of the business regulation. The experience of many countries suggests the advisability to wait and see the concrete results of these initiatives before issuing judgement.

**CURRENT MACROECONOMIC SITUATION**

The year 2007 closed with a surprising upward growth rate (8.1%) that has remained steady in the first half of 2008.

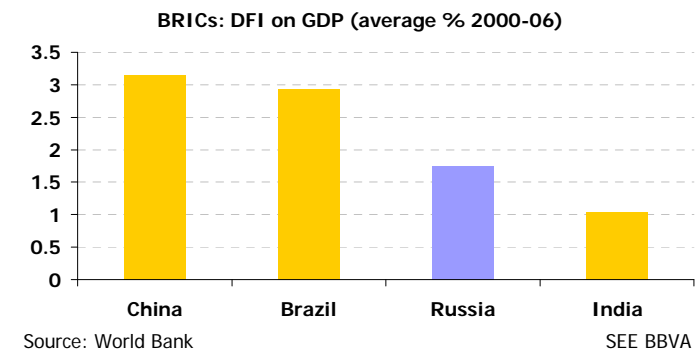


The incidence of domestic demand on growth continues, along with the dynamism of non-tradable sectors. Thus, further increments are recorded in the Construction (16.4% in 2007), Trade (12.1%) and Financial sectors (11.4%). The rapid and continuous development of service industries, practically nonexistent during the Soviet era and Yeltsin's administration, should be specially noted.



The lower relative relevance of the foreign demand on the most recent growth of the economy is also reflected on the rapid reduction of the current account surplus, going from 1% of GDP to 6% of GDP, despite energy price increases. This trend will probably continue in the future, expanding the possibility of deficit current account balances, especially in case of a reduction of fuel prices. In fact, several analysts foresee a current account deficit by 2011. Within this process, exports, focused on energy commodities<sup>2</sup>, have been favoured by price mark-ups. However, imports have grown much more dynamically, supported by the increase of revenues and the real appreciation of the Russian currency. Foreign exchange markets' trend does not seem to favour the Russian trade scenario, as the reference currency for most exports is the dollar, whereas the euro is the reference for imports.

In turn, the financial account balance has experienced a strong increase during the last year. This process has been characterised by the following highlights: Direct Foreign Investment (DFI) has experienced a major increase in the last two years, despite Russia not being generally a very attractive country for foreign capital (compared to the rest of BRIC, Russia is only ahead of India in terms of DFI inflow on GDP).

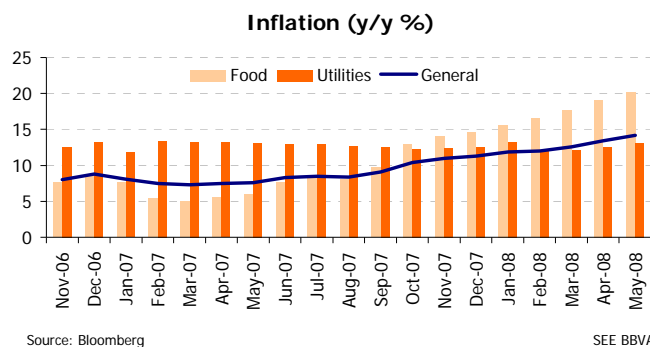


Which sectors does DFI aim at in Russia? Clearly, service industries seize foreign capital's interest, as they have been the recipients of more than half of DFI inflows in the last few years. In addition to the tertiary sector, natural resources currently concentrate 17% of DFI flows, after an evolution featured by volatility. If in 2004 the share of DFI in the extraction sector reached 24%, a year later it

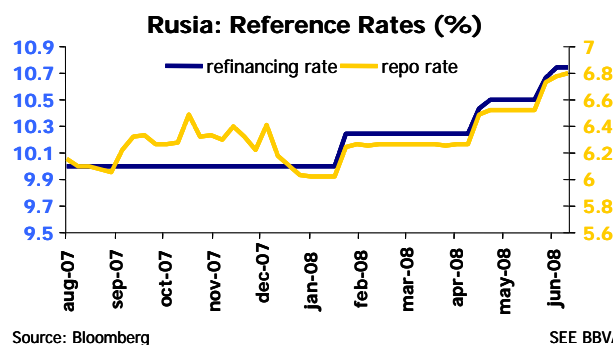
<sup>2</sup> Approximately 2/3 of export income comes from oil and gas.

plummeted to 11%<sup>3</sup>. Finally, a fourth of investment flows goes to manufacturing products, with the steel industry as the main target of these inflows.

Another crucial contributor to the financial accounts balance comes from private sector foreign borrowing, especially from financial institutions, and up to the first half of 2007. The strike of the liquidity crisis on international financial markets momentarily cut Russia's commercial debt inflows, which were, however, recovered by late 2007. The high level of commercial debt in the financial account, though symptomatic of the Russian economy's creditworthiness, has also exposed it to higher volatility in the last few months, given the international financial markets' current scenario.



First, the effectiveness of monetary policy has been restricted by the dilemma faced by the Russian Central Bank after the international liquidity crisis unravelled during the summer of 2007. The monetary authority had to control the spiralling inflation while the crisis unleashed a liquidity situation in the financial system. Given this scenario, the Central Bank has increased the refi rate by 75 bps since August 2007.



## Inflation and Monetary Policy

Not long ago, one of the most evident signs of the new path of economic stability where Russia was heading for was a gradual reduction of inflation. The country experienced a significant reduction of this indicator since 2005, down to an interannual 7.4% rate in March 2007. Since then, inflation has doubled, reaching 15.1% in May 2008.

With inflation becoming society's main economic concern, the official stance has pinpointed the global commodity price shock as the main element responsible for the inflation acceleration in Russia. In order to control it, during 2007 the government adopted a number of food price control measures through agreements with supermarket chains, with scant effect on inflation. An unsurprising outcome, since the causes clearly go beyond the global increase of commodity prices: together with the commodity prices shock and the high domestic demand rate, economic policy has had a decisive effect on inflation.

It should be noted that the refi rate in Russia plays a key role in indicating the Central Bank's stance on inflation, without being a direct tool to affect market rates. Repo rates are much more important here, as they establish a floor on rates applied in the interbank market. Thus, the fact that the latter are around 400 bps below refi rates evidences the compromise policy between both objectives (inflation vs. liquidity) that the Central Bank has been implementing since the onset of the crisis.

To complement an interest rate policy that is clearly not enough to stop price rises, the Central Bank has relied on the exchange policy. A measure that has also had a limited impact since the appreciation of the rouble has fostered further foreign private borrowing and capital inflows, additional causes of the aggregate demand expansion. Given the monetary policy's limited leeway, and with inflation at 15.1%, meeting the inflation target in late 2008 (10.5%) is obviously impossible. However, we expect a slight slowdown of inflation throughout the second half of 2008, thanks to the curb witnessed in the growth of some domestic aggregates (mainly monetary supply and domestic credit).

## Fiscal Policy

As mentioned above, the fiscal policy implemented by the Kremlin has clearly boosted inflation. The combination of oil-dependent fiscal revenues (and therefore on the

<sup>3</sup> In 2004, the largest oil company at that time (Yukos) went bankrupt. Its assets were mainly transferred to state-owned companies.



upside) and last March presidential elections have accelerated public expenditure markedly during 2007 and the first quarter of 2008, leaving a 46% interannual federal expenditure variation. Despite this eased fiscal scenario, Russia has been able to translate its highest oil revenues into a remarkable improvement of its creditworthiness ratios. Currently, the country ranks third in terms of accumulated reserves, with a reserves balance of approximately 545 billion dollars. By late May 2008, public surplus was round 550 billion roubles (6.6% of GDP). Finally, the public debt-to-GDP ratio shows a significant reduction, from 140% in 1998 to 7% in 2007.

With sound public accounts, the future role of fiscal revenues is most probably aimed at sustaining the economy's growth, and favouring its diversification through the ambitious infrastructure program mentioned above. In short, if the state's current financial reorganization is added to the country's infrastructure deficit, or the political pressures to channel oil revenues toward an active industrial policy, there are no reasons to justify a return to the fiscal austerity witnessed at the beginning of last decade.

## Risks

Given the fiscal and export dependence on fuels, Russia's main economic risk today is a sudden price drop of this product. Yet, a significant fall of oil prices could be buffered for some time, using the hefty international reserves and public borrowing capacity generated in the last few years to finance the maintenance of public expenditure levels.

Together with the foreseeable deterioration of public accounts, the foreign sector will be another victim of a sudden reduction of oil prices. The current oil prices have enabled a gradual decrease of the current account surplus, a balanced scenario being foreseen by 2011. A sudden price drop would accelerate the current account deficit level even further. This scenario would also weaken the rouble, which would not only feed inflationary pressures, but also worsen foreign debt repayment conditions.

In the long term, the true challenge faced by Russia is the need to diversify its economy. The increase of the relative weight experienced by non-energy industries in the current expansive cycle is driving the productive structure toward a stronger tertiary sector. However, this higher diversification has not yet been materialised in either the export or fiscal spheres.

For this sector balance to reach all areas of the economy, and in addition to the public boost on infrastructure and education, the business initiative regulatory framework, with an emphasis on private investment, should also be improved. These considerations have never been among Putin's administration priorities, which have mainly focused on stabilizing the economy first, and gaining further state control over it later. An interventionism

that, given the figures shown by several indicators from different institutions (World Bank, International Transparency, etc.), has ultimately eroded the business environment quality in Russia during the last few years.

## Summary of Indicators

Macroeconomic Indicators	2003	2004	2005	2006	2007
Production and Prices - Annual Variation (%) - Real GDP	7.30	7.20	6.40	7.40	8.10
Consumer Price	13.61	10.95	12.50	9.76	9.03
Period Average	11.99	11.68	10.88	9.02	11.93
Period Total	13.96	20.08	19.16	15.43	12.75
GDP Deflator					
<i>Public Sector - GDP percentage-</i>					
Federal Government	1.71	4.29	7.46	7.51	4.03
General Balance	19.54	20.10	23.71	23.58	23.24
Expenditure	17.83	15.81	16.25	16.07	19.21
<i>Currency - Annual Variation (%) -</i>					
Domestic Credit	26.50	18.66	2.65	28.40	-
M2	38.53	33.74	36.28	40.51	-
M2 (rate)	-11.74	-3.74	-6.97	-12.35	-
M1	45.61	30.54	35.47	45.09	-
Monetary Reserves	54.12	24.14	22.39	41.39	-
<i>Foreign Sector</i>					
Exports (FOB - in million dollars)	183,207	243,798	243,798	303,926	374,400
Imports (FOB - in million dollars)	-76,070	-97,382	-125,382	-164,692	-236,300
Current Account / GDP (%)	7.85	9.61	10.93	9.64	6.15
Exports / GDP (%)	31.50	30.96	31.90	31.04	-
Debt Service / Exports (%)	13.02	21.88	22.48	18.15	10.93
Foreign Debt / GDP (%)	40.31	34.41	30.64	28.93	30.84
Foreign Public Debt / GDP (%)	21.06	15.14	7.81	3.58	0.00
Monetary Reserves / Foreign Debt (%)	42.07	59.34	77.84	104.25	115.27
Monetary Reserves / Imports (%)	57.43	77.50	90.62	111.47	120.57

Source: (Institute of International Finance)

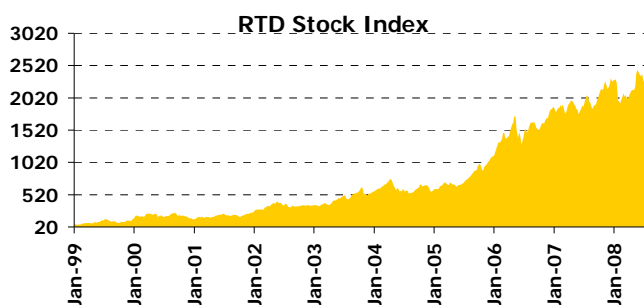




# Banking

## FINANCIAL SYSTEM

The Russian financial system has been almost exclusively dominated by banks. Other types of entities (pension funds, insurance companies or institutional investors) have still a marginal relevance on the Russian financial scenario. However, the stock market has experienced an important growth, evidenced by the Moscow stock exchange. In 1996, the stock capitalisation ratio-to-GDP was around 6%, whilst it is currently reaching 95%. Two processes explain this rapid growth: first, and just as in most Eastern European countries, the initial development of the stock market was triggered by privatisation process of state-owned companies. As for Russia, the recent development of financial markets has also been benefited by the increase of commodity prices. As a result, the Russian stock exchange shows a high exposure to natural resources-related industries (around 50% of its capitalisation).



Source: Bloomberg

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In turn, over the past years the stock index has recorded a powerful revaluation, with interannual variation rates reaching 85% in 2005. In 2008, however, there has been a slight adjustment, and the RTS index lost 2.3% since early this year.

With the development of the stock market, new financing lines have emerged for Russian companies. This is the case of public invitations to bid, which have grown strongly in the last few years: between 1996 (when the RTS index was implemented) and 2005, there were only 28 public invitations to bid. In 2006 only, there were 30. Another financing method that has been made available recently is corporate debt issuance. The bond market, originally dominated by sovereign bond issuance, has grown in the last few years thanks to the heavy increase of corporate issuance. This process was influenced by the

emergence of the fiscal surplus, which has reduced the need of public administrations to issue debt. In turn, this market's foreign share was fostered by the elimination of restrictions in July 2006. From the issuer's side, local companies have been able to issue bonds in much better conditions than those granted by commercial banking loans, both with regard to interest and terms.

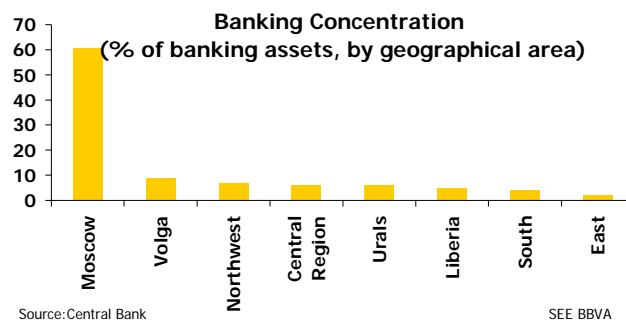
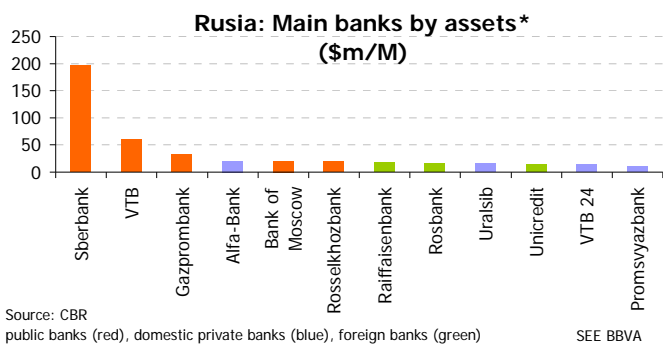
## BANKING SECTOR: STRUCTURE

With data as of April 2008, there are 1084<sup>4</sup> banks operating in Russia. A high number compared to most banking sectors, showing a slow consolidation process, as there were 1277 banks in 2003. In addition to this slight reduction in the number of banks, it should be noted that some of these institutions only conduct treasury management for associated companies, not offering, therefore, a large range of financial services.

All in all, and despite these figures, the Russian banking sector is dominated by a small number of institutions. Public banking is found on top, with 24 state-controlled banks concentrating 39.2% of the overall assets of a financial system with clear advantages for this type of institutions. First, public banks have the implicit guarantee of a highly liquid public sector. Moreover, and unlike most private banks, the large state banking has an extensive network of branches beyond the region of Moscow, with a subsequent better risk diversification. A final advantage of these institutions is the tendency of state-owned companies to operate with public banks<sup>5</sup>. Within this group, the public bank Sberbank has an overwhelming domain of the market, both in terms of its assets, approximately exceeding a fourth of the sector, and the number of branches (around 20,300).

<sup>4</sup> An extra number of 45 non-banking credit institutions with a license to carry out financial operations can be added to this figure.

<sup>5</sup> This is an especially relevant point to attract deposits. According to Lee (2008), state-owned companies are the most important source of corporate deposits in Russia.



As regards domestic private banking, 147 firms concentrated 41% of banking assets by early 2007, Alpha Bank and Uralsib being the most important institutions.

Finally, the foreign banking plays a secondary role, despite its rapid growth in the last few years. According to the Russian Central Bank, there were 41 banks in 2003 with local capital (32) or mostly foreign capital (9). Currently, there are 90 institutions (63 with exclusively foreign capital and 27 with majority interest), holding 17.2% of assets altogether. The increase of foreign banking in Russia has been favoured by regulatory changes, driving foreign capital to the sector since the 90's. Currently, and even though there are no limits to foreign holding of domestic banks, the federal government has the prerogative to restrict the presence of foreign capital in the sector if the market share exceeds 50%.

Thanks to this regulatory framework, the main foreign capital inflow to the sector has occurred through mergers and acquisitions (M&A). There have been 46 corporate operations of this type since early 2006 until mid 2007. The acquisition of the Impex Bank by the Austrian bank Raiffaisen (for 550 \$M), the purchase of Absolut Bank by KBC (957 \$M) or the acquisition of 20% of Rosbank by Societe Generale (634 \$M) are among the most important transactions. Nevertheless, M&A activity has come to standstill with the arrival of the financial crisis. To conclude, the rest of the sector (929 institutions) consists of small and medium sized banks controlling 8.1% of the market, 382 of which are located in the region of Moscow.

This picture, therefore, corresponds to a highly concentrated market: 42.7% of the system's total assets belongs to the 5 leading banks, whereas the following 15 contribute 21.6% of assets.

Another dimension of the sector's concentration is shown by its geographical distribution. The banking sector concentrates most of its activity in the region of Moscow, whereas the less developed regions have a trifling share in the sector. A situation that seems to be partially changing, since credit is growing in some of the provinces outside the region of Moscow. Likewise, some banks (Uralsib) are choosing a more aggressive expansion in peripheral regions (Volga, Western Siberia, etc.) to access a population with less saving products available, which, among other things, facilitates the gathering of deposits.

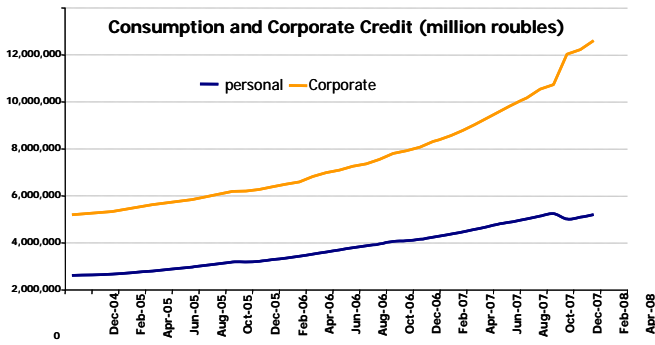
### RECENT EVOLUTION

For the Kremlin, the Russian banking has become a key component to achieve a higher diversification of the economy. The financial system's main task in this process is to channel the surplus generated by extraction industries to the rest of the economy.

As of 2004, the sector has been restructured in order to create a reliable and sensibly regulated financial system, after several years during which this activity was marked by scandals that undermined the confidence of the sector's economic stakeholders<sup>6</sup>. To restore confidence, the Central Bank adopted a more thorough surveillance policy, resulting in the revocation of licenses for those banks involved in fraudulent operations, introducing in this way more transparency to the sector. In addition, the creation of a deposit insurance has reduced the domain of public banking, and specially that of Sberbank, allowing an increased share of private banking in raising resources.

The combination of further surveillance, and the strong expansion experienced by the Russian economy since the beginning of this decade, has resulted in a strong development of this sector. Based on data at the end of March 2008, consumption credit is growing by 42% (y/y), whereas corporate credit is rising by 62%. Mortgages are also growing, though from very low levels, focusing on high revenues market, and financing only 5% of real estate transactions.

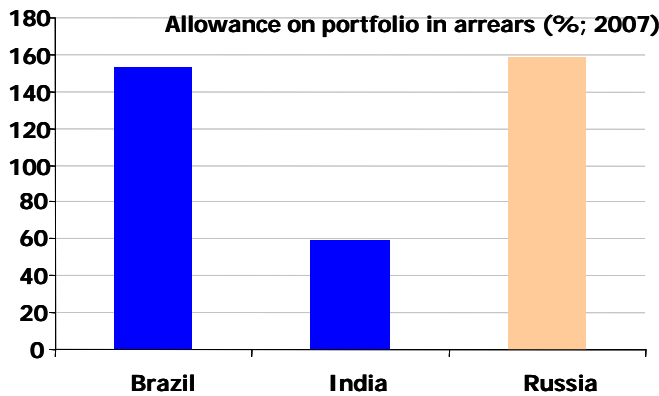
<sup>6</sup> More specifically, several banks participated in fraudulent operations aimed at artificially increasing their capital.



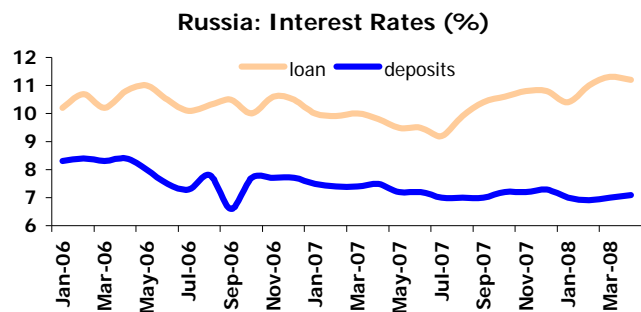
Source: Central Bank

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This growth rate has enabled the credit ratio-to-GDP to increase significantly, reaching a current 60% credit ratio-to-GDP. An increment that was not generated at the expense of its quality: although it is true that credit in arrears has recovered, according to Russian Central Bank statistics, it does not exceed 1.5% of the overall credit portfolio. According to unofficial estimations, this figure reaches around 5%, due to considerably higher arrears in the personal credit segment (12%). Even though there is a high allowance allocation, some concerns have emerged lately about a possible flexibilisation in the credit granting process.



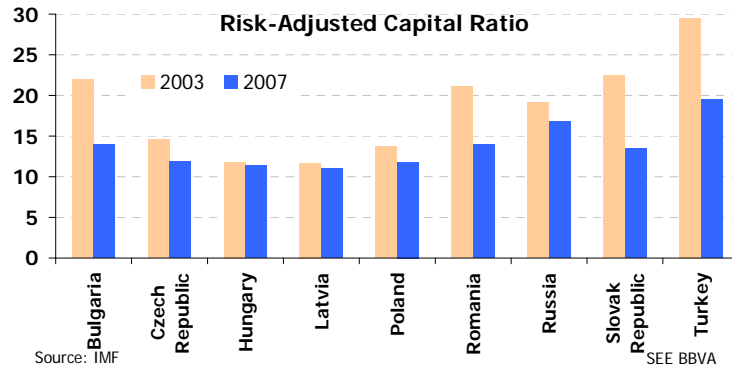
The credit portfolio growth has also been fostered by downward trend in interest rates, especially those related to corporate loans, which were 11.2% in March this year, considerably below the inflation rate, despite a slight increase since mid 2007.



Source: Central Bank. Average loans in rouble to non-financial institutions (up to 1 year maturity). Deposits up to 1 year.

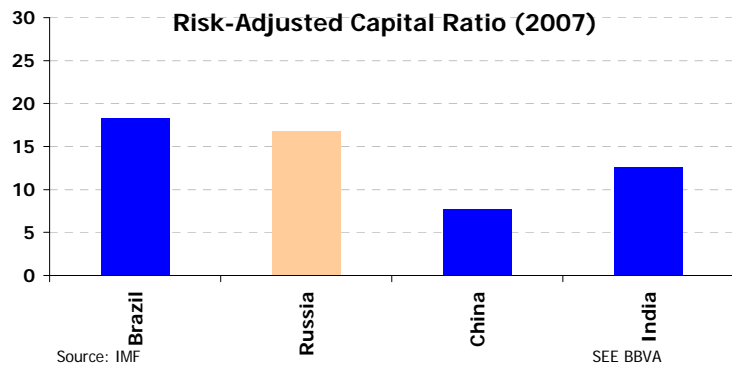
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As for resources, deposits have also increased (especially corporate ones), as a result of the general growth of the economy, though at a slower pace than loans. This is not surprising as interest rates are not enough to offset the depreciation caused by inflation. The share of deposits on the base of the banking sector's resources experiences a downward trend. As a consequence, Russia has a consumption credit to deposits ratio of 85% well above the values found in most countries (between 30% and 50%). Deposits weakness has, therefore, forced financial institutions to seek alternative sources to sustain their growth. These sources were mainly found in syndicated loans and Eurobonds.



Source: IMF

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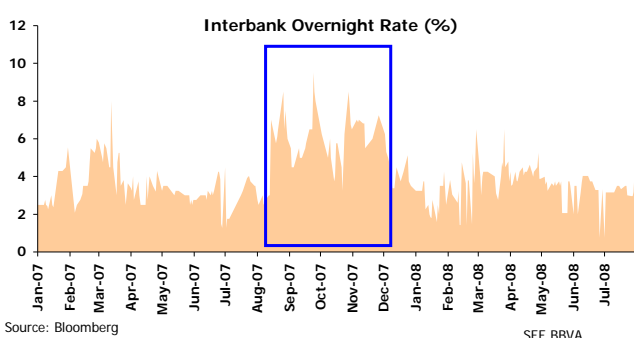
Source: IMF

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The intense growth of bank assets during the last few years has slightly affected the risk-adjusted capital ratio, although it has not dropped below the 10% established by the Central Bank. According to IMF data, the ratio has gone from 19.1 in 2003 to 14.9 in 2006, to later recover and close at 16.8 in 2007. Despite the fall of the last few years, these levels feature the Russian financial system's monitoring framework as one of the most cautious ones, both compared to BRICs and the rest of Emerging Europe.

### The Russian banking system in the face of the international financial crisis

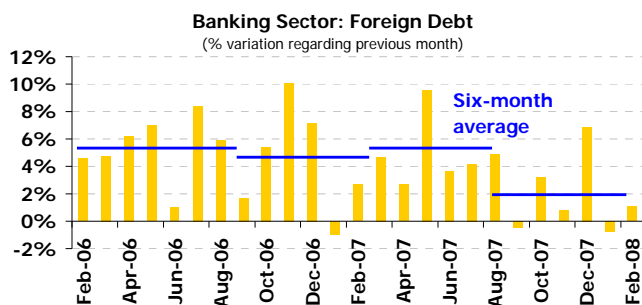
In Russia, like in other countries, the crisis unleashed in the financial markets in June 2007 put the strength of the banking sector to the test. Initially, the drastic liquidity reduction had a negative impact on the Russian banking sector, closely pegged to foreign financing. At the beginning of the crisis, this caused serious difficulties for several private banks to refinance their debt in the domestic market, momentarily tripling interbank market rates up to around 8%.



However, despite this less favourable global scenario, the Russian economy's creditworthiness made it possible for a small group of banks to reduce the impact of the crisis in a relatively short time. On one hand, the Russian Central Bank assumed a proactive attitude to prevent the financial system aftermath, increasing its liquidity through repos, reduction of the minimum reserve requirements (up to 3%), expansion of the list of financial instruments accepted as loan guarantees, or decrease of currency swap rates (from 10% down to 8%). In addition to these actions aimed at minimizing the consequences of the closure of international financial markets, the Russian banking sector was benefited by its close relation with other institutions.

Large public banks were backed by the state, injecting an extraordinary level of liquidity to those institutions. Something similar occurred with private banks' branches, supported by their head offices with limited exposure to subprime products, or by domestic industrial groups.

Given these defence mechanisms, the impact of the crisis has been restricted to a low number of small banks, which, having resorted to international markets, did not have the support of alternative sources of financing.



Source: IFS SEE BBVA

With this set of measures –especially the Central Bank liquidity injections– totalling up to 10 billion dollars in repos, we can state the crisis of confidence on the Russian financial system has been short. Already in Q3 2007, the net outflow was substantially lower than that in Q2 (\$9.4 billion vs. \$ 52.7 billion) and by the end of the year the system's liquidity returned to normal levels. Thus, interbank rates fell again to pre-crisis levels (3-4%).

In turn, another more tangible effect is the slowdown of foreign obligations assumed by the sector, showing an average rate well below that observed during previous years.

In addition, there has been a partial exchange of long-term foreign debt with public debt at shorter terms during this process. A replacement that generates an imbalance that should be avoided, and which can be sustained as a temporal measure to face the current turmoil, but which is not an appropriate pillar for the system's development. In order to restrain this mismatch between the terms of resources and assets, reforms should be introduced to foster the development of the domestic debt market, while domestic saving through deposits should be fostered.

Despite the adequate level of risk-adjusted capital, bank capital in Russia is sensitive to adverse shocks. Together with the high exposure to international debt, subordinate benefits and loans are a vital source of capitalisation (reaching 50% and 34% of the total in 2006).

### OUTLOOK AND RISK FACTORS

In the near future, growth expectations of the banking sector are favoured by a continued cycle of economic expansion, as well as the potential of a financial system with a long journey ahead to achieve a development level comparable to OECD countries. These growth expectations are also based on a monitoring framework that has improved its risk control, resulting in adequately capitalised and funded institutions.

Despite these positive aspects, the sector's growth is threatened by some risk factors. First, the fact that credit growth occurred simultaneously with a deterioration of risk-adjusted capital indicators, and an increase of default rate, particularly associated to

consumption credit, generates concern. Here, several institutions, the IMF among them, have warned about the possibility that the banking sector might have eased its loan granting policy to extend the banking assets increase.

There are additional sources of vulnerability in the emergence of sector resources imbalances. The development of banking assets has been strongly supported by foreign financing to sustain rouble-denominated credit growth, with the subsequent exchange mismatch. Another factor to bear in mind is the falling trend shown by deposits on the percentage of resources, a situation that will not probably improve if inflation is not controlled.

Negative real interest rates in a context of high domestic demand growth and twofold inflation forecast a significant increase of interest rates in the future, especially if authorities decide to seriously face the problem. This will undoubtedly affect financial system performance indicators.

At sector level, banks are also suffering the effects of bottlenecks in its labour market, triggering two effects: on one hand, a high turnover, reaching 20% and 30%, while labour costs have increased by 20% in those areas where the shortage of qualified labour in the financial sector is higher<sup>7</sup>.

Besides the unbalances in the labour market, we should note that the perception of Russian institutions has been increasingly negative in the last few years, placing the country at a disadvantage vis-à-vis main emerging countries. However, the growing state intervention in the economy has been mainly related to the energy sector and does not look as an important threat to the banking sector, where the state enjoys a dominant position inherited from the Soviet era. This has enabled a minimum intervention of public powers in the sector<sup>8</sup>. On the contrary, other factors whose effect is not restricted to a specific industry (corruption, administrative obstacles to business development, insufficient protection of property rights, etc.) have the same influence on the financial sector's development expectations. Taking into account the higher interest of the new government on the institutional environment, we expect these considerations will improve in the coming years, helping to implement a more predictable regulation on the business activity. But even under this scenario, and as a consequence of the Executive's stance on these processes, microeconomic reforms should follow a rather slow pace, rendering a deep -though necessary-

<sup>7</sup> Evidence of both effects is shown in Caplen (2007).

<sup>8</sup> One of the most important exceptions in this regard occurred in August 2007, when the main private bank in the consumption credit area (Russian Standard) had to reduce the interest rate applied to asset transactions and eliminate some of its conditions at the request of several public entities.

transformation of the institutional framework in the forthcoming years unlikely.

### Summary of Indicators

	2004	2005	2006
Credit to Private Sector / GDP	0.24	0.26	0.31
Banking Sector's Deposits / GDP	0.07	0.08	0.10
Banking Concentration*	0.20	0.17	0.20
ROA	2.9	3.2	3.2
ROE	20.3	24.2	26.3
Default Credit / Total Credit	5	3.8	3.2
BIS ratio	17	16	14.9

\* assets of 3 main Banks o/total  
SEE BBVA

Fuente: Source IMF, World Bank, national sources.

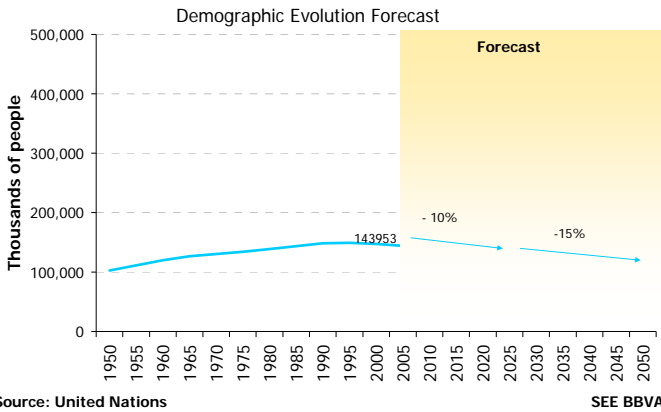




# Demography

## Population Forecast

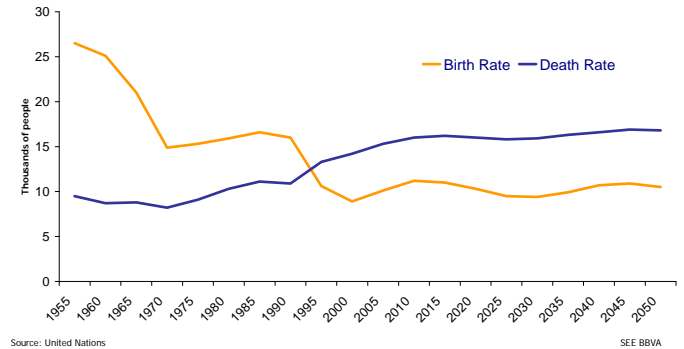
According to latest official data, Russia had 142.2 million inhabitants in 2007, making it the world's seventh most heavily populated country. However, when observing its evolution, we notice that the last decade heavily affected most of the Russian population. Since 1992, the balance between the birth rate and the death rate has been negative, generating a natural reduction of the population (a 6.1 million drop since 1990), expected to continue in the coming decades. According to the United Nations, in 2050 the Russian population will amount to less than 110 million people (implying a reduction of nearly 700,000 people/year).



## Demographic Transition

Russia presents an atypical demographic behaviour. The birth rate is barely half of what the country needs to replace the current generation of parents (1.1 vs. 2.1 children per couple). In addition, the death rate shows an upward trend (contrary to what would be expected in a typical demographic transition process) and reaches very high levels on working age males. There are 11.3 births and 15 deaths recorded every 1000 citizens. Should this situation continue --with no immigration-- the population will keep dropping.

Birth and Death Rates, 1950-2050

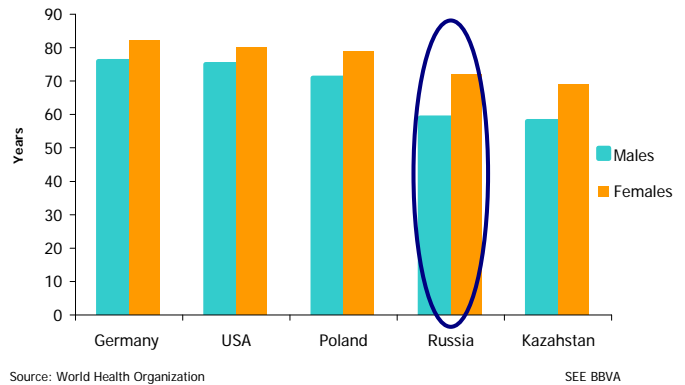


## Population by Gender and Age

The main factor behind this demographic evolution is the high death rate among working age males. Alcoholism, drug addiction, cardiovascular diseases, AIDS and tuberculosis are among the main causes of death, making Russians' life expectancy only 65.3 years, with large differences by gender: 58.9 years for men (14 years less than Western Europeans; while it was 70, 14 years ago) and 72 for women.

Life expectancy in good health conditions is 53 years old for men and 64 for women, which mirrors the country's difficult social situation and the complex financial scenario the health system is undergoing (limited budget, low salaries, shortage of specialists and lack of healthcare in rural areas).

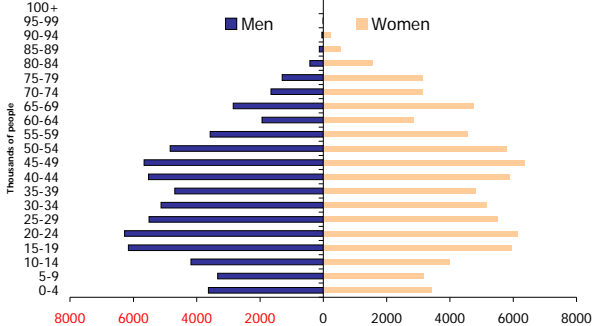
Life Expectancy at Birth, 2005





The aforementioned shows a paradoxical demographic situation in Russia, where the population grows older on the one hand, and the high death rate reduces life expectancy on the other.

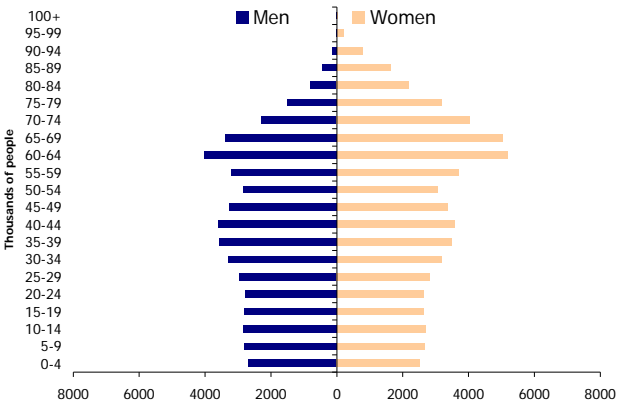
Demographic Pyramid in Russia, 2005



Source: United Nations

SEE BBVA

Demographic Pyramid in Russia, 2050



Source: United Nations

See BBVA

### Migration Flows

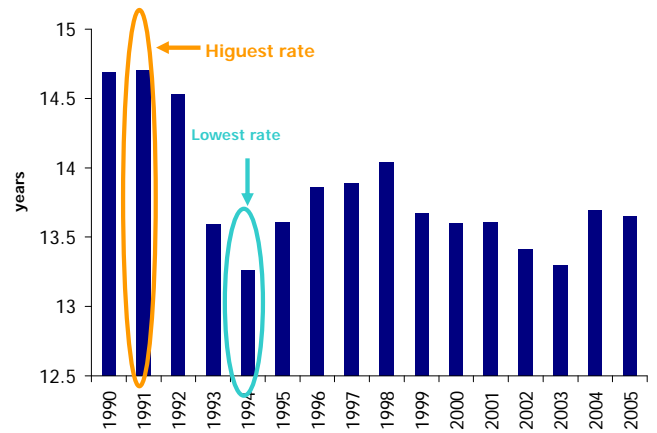
Since the mid 90'S, immigration is contributing to the increase of population. According to estimations, 240,000 people arrived in the country in 2007, mostly from the former Soviet countries, namely Kazakhstan, Uzbekistan and Ukraine and increasingly more from Afghanistan and China. This is a new situation in Russia, traditionally a country of emigrants.

In addition, this is a minority immigration compared to unofficial immigration, estimated between 7 and 14 million people. Most immigrants (approximately 80%) come from the Community of Independent States.

### Political Initiatives

Some of the abovementioned problems are the result of the collapse of the Soviet Union. The economic recovery has had a positive impact on the birth rate, from its lowest level in 1999 (8.27 birth/1000 inhabitants) to the current 11.3/1000, the highest level in the last 25 years.

Life Expectancy at 65



Source: World Health Organization

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In turn, aware of the demographic problem, the government has announced as part of its National Projects measures to foster childbirth, improvements in education and health, and access to housing. A change in the demographic scenario will depend on the support to these plans by society and the migration policies.

### Pension System

Russia is migrating its pension system to a multi-tier system, used in almost all Central and Eastern European economies. This new system, established in 2002, consists of a first non-contributory public tier; a second mandatory and contributory tier, complementing the pay-as-you-go scheme (public and financed via federal budget) granting basic pensions, and the individual funded scheme (private)<sup>9</sup>; and a third complementary private and voluntary tier offered by insurance companies and private pension funds. The second tier groups more than 60% of the active population and the third one is only chosen by 8% of the workforce.

The benefit cost rate to finance the first two tiers amounts to 28%. Even so, the public system sustainability is still being questioned due to the rapid ageing of the population, pensioners' low revenues, the system's poor efficiency and the difficulties to extend the pension age (60 years old for men and 55 years old for women) due to the obstacles imposed by the country's low life expectancy.

<sup>9</sup> The design of the second tier, combining a public pay-as-you-go and defined pension system with a private individual capitalisation and defined contribution scheme is seen in most of Central and Eastern European economies, and works similarly to that currently used in Argentina and Uruguay.

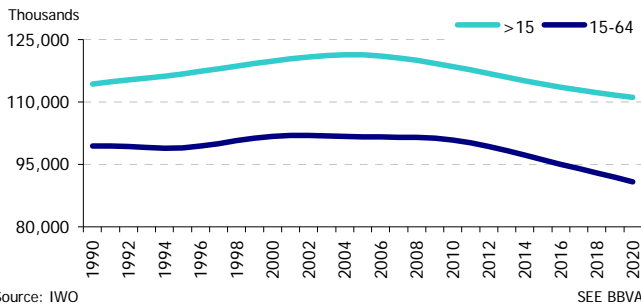


# Labor Markets

## Working Age Population

The problem of labour shortage, resulting from the demographic environment, is severe. Since 2003, population group between 15 and 64 years old is dropping. This evolution persists, even considering a broader definition of the working age population (15 years or older, including people above 64). According to United Nations projections, the 15-64 year-old population in industrialised economies will not fall until 2015, and the +15 year-old population until three more decades.

Working Age Population



## Unemployment, Activity and Employment Rates

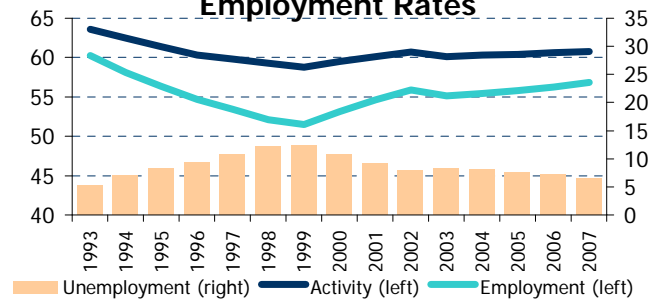
The remarkable unemployment rate reduction (from 12.4% in 1999 to 6.6% in 2007) and the increase of the active population (60% in 2007 compared to 58.8% in 1999) have offset this unfavourable demographic evolution. Thanks to this, the employment rate (employed/+15 year-old population) has increased since the late 90's up to 56.7% in 2007, akin to the OECD average. No significant margins of unemployment reduction or increase of labour share are forecasted<sup>10</sup>.

Therefore, the population's contribution to the GDP increase will fall by around one percentage point yearly (between 1990 and 2006, the population grew on average

<sup>10</sup> The female share rate is, in fact, above the OECD average, thanks to the high level of activity in the 25-54 year-old group (86.3% in 2006 vs. 77.2% in OECD). Russia presents a negative difference compared to more industrialised economies in the 55-64 year-old group (around 10 percentage points), as well as among men in the 25-54 year-old group (seven points).

by approximately 0.4%, whereas an annual 0.6% drop is projected for the period 2007-2020).

Unemployment, Activity and Employment Rates



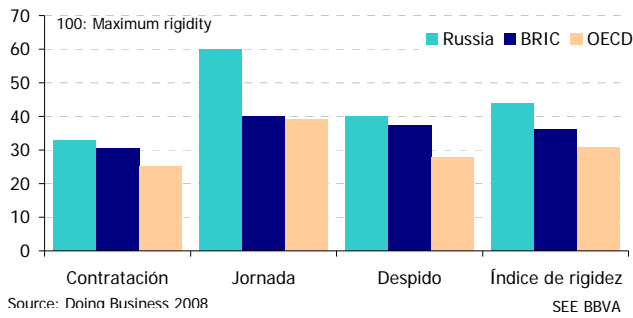
## Labour Flexibility

The Russian labour market is not very flexible, in line with the strictness of the overall economy. As per the World Bank labour regulation index (Employing Workers), the labour market in Russia ranks 101<sup>st</sup> in terms of flexibility (among a total of 178 analysed labour markets).

The country's regulation is generally stricter than the OECD and BRICs' (Brazil, Russia, India and China) average, especially as to the working day and non-salary costs level (mainly, social security contributions). In turn, redundancy costs are below average.

In any case, this stance is similar to the rest of the scenarios that determine the business climate (Ease of Doing Business). Hence, Russia is 106<sup>th</sup> in terms of ease of doing business.

**Rigidity of the Labour Market in Russia**



The informal economy offers the market some additional flexibility. The grey/informal economy level amounts to approximately 47% of GDP, according to Schneider, F. estimations (2007) “Shadow Economies and Corruption All Over the World: New Estimates for 145 Countries,” *Economics E-journal*, July). This level is significantly higher than that from the most prosperous OECD economies (reaching approximately 15%) and is consistent with the lower revenues level, with more stringent labour regulations and higher social security contributions.

**Human Capital**

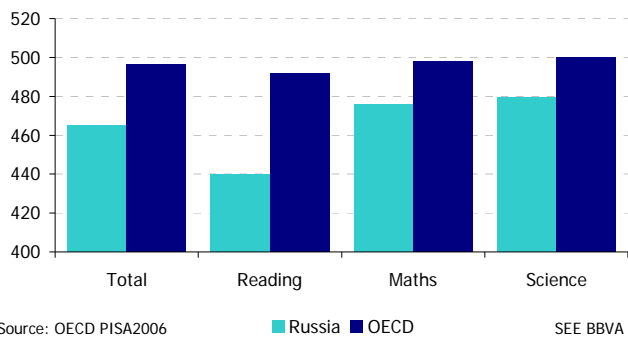
The labour force has a significant capital contribution. The number of workers with secondary school studies (approximately two thirds) and higher education (around 25%) positions Russia among the economies with the most qualified workforce, reaching levels similar to those of Germany, for example.

The challenges seem to lie in improving the educational system itself. Thus, according to the Programme for International Student Assessment (PISA 2006, OECD), testing 15-year-old schoolchildren’s academic performance in reading, science and mathematics, the educational system ranks 36<sup>th</sup> amongst all 57 analysed countries (sixth decile). The main disadvantage is found in reading (39<sup>th</sup>, seventh decile), despite some progress since PISA 2003. For the rest of the subjects, even though the country is below OECD average, indicators are similar to those of Spain.

**Summary of Indicators  
Russia. Main Labour Indicators**

	1996-2000	2001-2005	2006	2007
Population Million people	147.325	144.606	142.537	141.900
Active Million people	70.652	73014	73.337	73.368
Employed Million people	63.550	66.336	69.116	69.929
Unemployment rate %	11,0	8,2	7,2	7,2
Informality % Employment	---	13,9	---	---
Informality % GDP	46,1	47,9	---	---
Flexibility Doing Business Ranking	---	---	102 / 178	101 / 178
Human Capital PISA Ranking Secondary School Enrolment	---	---	36 / 57	---
Higher Education Enrolment	16,1	24,5	---	---

**Quality of the Russian Educational System**





# Energy

## Natural Resources

Russia counts with 25%, 17% and 5% of the world's natural gas, coal and oil reserves, respectively (Enerdata). Currently, it is the world's main producer and exporter of gas, second producer and exporter of oil and fourth producer of coal (behind China, USA and India).

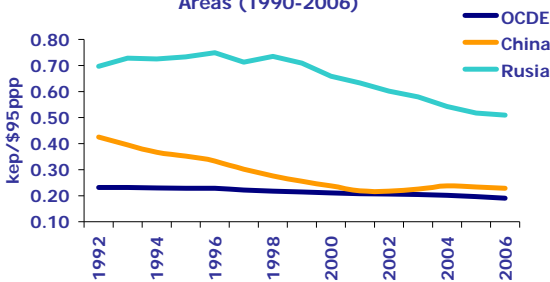
The Russian economy highly depends on energy, especially from the oil and gas sectors, which jointly provide around a fourth of the national GDP, 50% of public revenues and 65% of export revenues<sup>1</sup>.

Likewise, energy consumption both per inhabitant and GDP unit is among the highest in the world. Despite unfavourable climate conditions, the main factors accounting for excessive energy consumption are the industry and electric sector's low energy efficiency and the low domestic energy prices, especially gas and electricity.

## Oil Sector

In the 80's, Russia was producing 11 million barrels of crude oil per day (mmbbl/d). However, after the fall of the Soviet Union, the production fell to 6 mmbbl/d due to poor well maintenance and the collapse of industrial demand. Later, the privatisation process of the late 90's attracted private capital aimed at updating the techniques and infrastructures inherited from the Soviet era, mainly in Western Siberia. As a result, the production of oil increased rapidly, hitting a new maximum level of 9.9 mmbbl/d in October 2007. Since then, it has experienced a slight reduction and it is very

Evolution of Energy Intensity in Several Economic Areas (1990-2006)

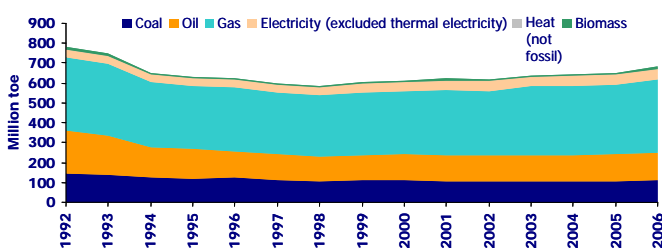


Source: Enerdata

SEE BBVA

Around 95% of primary energy needs are covered with fossil energies, mainly gas and oil, and almost 50% of the electricity is produced with gas. The weight of renewable energies, including hydraulic energy, is reduced and there are no plans of a future significant increase.

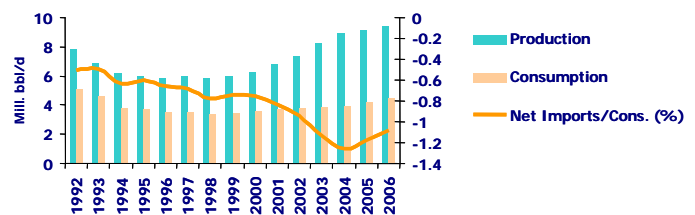
Primary Energies Mix Evolution Russia 1992-2006



Source: Enerdata

SEE BBVA

Oil Balance. Russia 1992-2006



Source: Enerdata

SEE BBVA

unlikely that in the coming years Russia will manage to produce more than 10 mmbbl/d on a sustainable basis<sup>11</sup>.

<sup>11</sup> There is much uncertainty about Russia's real oil and gas reserves and it is very likely that only the Russian government knows the real figure. Available public estimations range between 70 Gb, acknowledged by most data bases to 170 Gb, including Eastern Siberia and the Arctic's potential. With 70 Gb reserves, the Russian production should inevitably start falling shortly at rates above 4%; while with 170 Gb, Russia could increase its production until 2035 if the country manages to mobilise the necessary capital. An intermediate scenario of 120 Gb is the most plausible one, as it would enable Russia to maintain its current production until 2015-2020, when it would start falling at an annual average of 4%-5%. This production profile is compatible with the current scenario and will also offer the possibility to maximize the necessary large investments in transport and production infrastructures in the coming years.

## Natural Gas

The recent production slowdown has been associated to the increasing state intervention. Since 2004, one of the main objectives of the Russian government has been to recover the control of the country's energy resources through the creation of national public champions, such as Rosneft (24% of the national oil production)<sup>12</sup> and Gazprom (84% of the national gas production). In the last few years, both companies have allocated a large portion of their financial resources to the purchase of strategic assets (Yukos, Sibneft and others) to the detriment of investments in the research and expansion of the production capacity<sup>13</sup>. These companies high leverage has made some analysts question their capacity to make the necessary investments to maintain the current level of production in the medium term<sup>14</sup>.

In turn, private capital entities, facing a relatively hostile environment with high regulatory uncertainty and growing fiscal pressure<sup>15</sup>, have implemented a conservative investment policy, restricted to exploiting Western Siberia oil fields to their maximum capacity.

The concerns about the Russian capacity to maintain its current production level persist in the long run. Technical and economic difficulties to profitably exploit the regions with the largest growth potential in the future are added to the increasing problems to maintain Western Siberia's production (exhaustion of main oil fields<sup>16</sup>, poor margin to increase recovery rates, heavy fiscal pressure, growing costs inflation, etc.): offshore fields in the Arctic, sea of Japan (Sakhalin) and Barents sea (Shtokman) as well as onshore oil fields in Eastern Siberia and the Yamal Peninsula. Initially estimated costs for the development of Eastern Siberia oil fields, for example, amount to figures in excess of 20 billion dollars.

<sup>12</sup> Between 2005 and 2007, the private sector's production share has moved from 89% to 61% (Institute of Energy Policy, 2006).

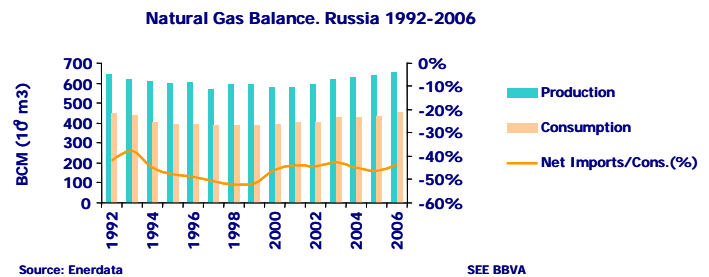
<sup>13</sup> According to the Institute of Energy Policy, Gazprom's investments in expanding production capacity in 2007 were 50% below its strategic plan projections.

<sup>14</sup> However, both companies have important cash flows and, if necessary, the Stabilization Fund backup.

<sup>15</sup> Above 25\$/bbl the Russian government withholds around 90% of obtained revenues per produced barrel of crude oil. Vertically integrated companies recover part of their revenues with the increasing margins obtained during the refining stage (refined products export faces a lower fiscal burden than crude oil); however, in any case, the Russian government withholds around 80% of the oil sector overall revenues.

<sup>16</sup> Three fourth of exploited oil rigs (concentrated in Western Siberia, Urals-Volga and Timan-Pechora) are estimated to have already started their decline stage, with 3%-7% annual production reduction rates.

In the gas sector, the concern is focused on the short and medium term, as the volume of reserves is higher than that of oil. Nevertheless, even though Gazprom has recently increased its investment in production development, several experts have pointed out that the capacity expansion forecasted for the upcoming years will only compensate the expected natural reduction of existing fields and slightly increase the overall production. It is estimated that Gazprom will only be able to meet its export commitments if the domestic natural gas demand grows below an annual 1% until 2010.



Since domestic natural gas demand during the 2000-2006 period grew above an annual 2%, an internal shortage and/or Russian gas exports restriction scenario in the medium term could not be dismissed unless one of the following circumstances arises: (i) considerable increase of private production; (ii) significant reduction of domestic demand as a reaction to the forecasted gas fare increase<sup>17</sup>; or (iii) import of Central Asian gas.

## New Measures to Boost Production

The government is increasingly aware of the problems faced by the oil and gas sectors and has announced an increase of the public budget allocation for exploration (currently 0.5%). In relation to the regulatory framework, the legal and fiscal measures adopted in the next two years will be crucial to the future of the oil and gas sectors. Recently, the Ministry of Finance has proposed a package of fiscal measures to boost oil and gas production, which could be passed by the Duma before the end of summer. The proposal includes, among others, freezing the tax on gas production until 2011 and increasing the non-taxable minimum on oil production, from the current 9 \$/bbl to 15 \$/bbl, as from 2009. In addition, plans are being designed to grant fiscal exemptions for a period between 10 and 15 years to those companies investing in exploration and development of offshore and Eastern Siberia oil fields; as well as a

<sup>17</sup> Domestic gas prices are around 80% below the world average. To eliminate this unbalance, the Russian government has planned to increase the industrial price by 200% until 2011 and residential fares by 27% until 2009.



reduction of the fiscal burden on higher quality refined products<sup>18</sup>.

Even though the scope of the measures is limited (assuming 4.2 billion dollars injection to the industry from 2009), it is a first step in the right direction while the finally passed package could be expected to incorporate more ambitious measures. The Minister of Energy recently stated that the government could consider the introduction of the Production Sharing Agreements (PSAs) to foster the development of large projects in the new basins if tax incentives are insufficient<sup>19</sup>.

In addition, a "Foreign Investment Act" has just been passed, demanding the approval by the Russian government of any purchase exceeding 5% or 10% of a Russian company capital by a public or private foreign company respectively. Very unlikely the new act will negatively affect the investment climate, as it is only limited to formalise the current rules of the game in the energy industry.

Finally, the Duma has introduced a number of changes to the "Act on the use of the subsoil", which will probably promote the execution of a larger number of public-private agreements as the public companies will preserve at least 50% of control over new giant and offshore fields development projects<sup>20</sup>.

## Investment Opportunity

The investment needs accumulated in the energy sector until 2030 are enormous. According to the International Energy Agency, the country will have to invest 0.6 trillion (10<sup>21</sup>) dollars in the oil sector, 0.3 trillion dollars in the gas sector, 0.4 trillion dollars in electricity and 30 billion in the coal sector, including production transport and distribution infrastructures. However, the private sector

<sup>18</sup> The Russian oil sector is levied with four specific taxes: extraction, export, production and final consumption. Fiscal revenues corresponding to the first two are allotted to a Stabilization Fund, managed by the government. By late 2007, that fund had accumulated 0.157 trillion dollars (12% of GDP). The Fund has been divided into two portions since February 2008. The new Reserves Fund has 80% of the Stabilization Fund's provision and will collect the fiscal revenues from oil and gas sectors from now onwards.

<sup>19</sup> The PSAs system does not levy income, but revenues.

<sup>20</sup> Gazprom will publish in autumn its new development plan up to 2030. (Footnote number 11)

<sup>21</sup> Both Transneft and Gasneft have repeatedly cited capacity restrictions to deny private companies access to their networks, leaving them no choice but to sell their gas production to Gazprom (at lower price) or transport oil by train to the export centres, incurring in transport costs 30% higher. The Russian competition policy authority is working on the design of rules that prevent this type of scenarios, ensuring free access to third parties to the national network of oil and gas pipes.

estimates that 1 billion dollars will have to be invested in the same period to maintain the current level of production.

The overall oil reserves replacement until 2020 is estimated to demand a total investment of 160 billion dollars, half of which will be invested in Western Siberia (almost all by the private sector) and 5% in Eastern Siberia (80% by the private sector). The state's average share in forecasted investments will amount to 12%.

As for gas, by 2020, 30% of Gazprom production is expected to come from the Yamal Peninsula and the supergiant Shtokman gas field, in the Barents Sea. In order to develop these projects, Gazprom will have to invest more than 75 billion dollars in Yamal and 6 billion dollars in the first phase of Shtokman (corresponding to a 50% share)<sup>21</sup>. The company has stated that the development of both projects is now a priority and has announced a strong increase of investment, which will amount to 4.2 billion dollars in 2008.

Oil and gas transport infrastructure investment needs are also important. Oil and gas pipe networks controlled, respectively, by Transneft and Gazprom state monopolies<sup>22</sup> are old (more than 60% of Gazprom gas pipes are over 20 years old) and/or are under maximum utilisation level (growing amounts of oil are being exported by train to China and the ports of the Black Sea). Investments in streamlining and replacement, already in progress (Baltic Pipeline System), do not seem sufficient to supply the forecasted demand and everything indicates that hefty additional investments will be necessary in the next decade. However, the Russian government is against allowing private companies getting involved in the construction of new transport infrastructures in Russian territory.

In addition, there is much concern as to the number of international oil and gas pipes construction projects (Nordstream, South Stream, Nabucco, Blue Stream, East-Siberian Pacific Ocean, Novorossiysk-Bulgaria), some of which will compete against each other. Most of them are still in the pipeline and everything indicates that no significant headway will be made until new fields are built and international negotiations advance.

Initial costs for the development of the international section of the Nordstream gas pipe, connecting Russia and the European Union through the Baltic Sea, are estimated in 12 billion dollars (more than half of which corresponds to the international section), although they are expected to increase in the future due to higher operating costs.