Russia

Economics

General Political Environment: Since the election of President Vladimir Putin in early 2000, political stability has gradually increased in Russia and the development of policy has become more predictable. The president enjoys substantial support from parliament and his public opinion ratings are substantially higher than for any other Russian politician. Putin was reelected handily in the March 2004 presidential election. At present there is no viable opposition alternative to Putin.

The next presidential election will be in March 2008. Putin is not able to run again unless he circumvents the constitution and most analysts believe he will not do this. If Putin does not take a third term, he will likely tip his hand toward a few possible individuals that he would like to see as possible successors. Current media debate suggests that Sergei Ivanov and Dmitry Medvedev are his current frontrunners. Ivanov was recently promoted from deputy to first deputy prime minister. (Medvedev was already a deputy prime minister).

Putin's appointment of Viktor Zubkov as prime minister in September 2007 surprised many observers given that Zubkov is a relative unknown. It is still not clear what Zubkov's role is vis-à-vis the upcoming presidential and legislative elections, but it is most likely as a place holder until mid-2008. Putin's reshuffling of the Cabinet in late September was also seen as another step in laying the groundwork for the upcoming presidential election.

Investment Environment: The last four years have seen many changes in the Russian business environment. In 2003 the main owner of the large oil company Yukos, oligarch Mikhail Khodorkovsky, was jailed and the tax fines against Yukos began. In 2004, the "Yukos Affair" continued, eventually resulting in the prolonged imprisonment of Khodorkovsky and the destruction of the company. Yukos' most lucrative assets were sold off to a state-controlled entity, Rosneft. The general view of analysts is that the Kremlin did not want to see its most strategic geopolitical asset, Russia's oil and gas production, under the control of the private sector. If there was a coherent strategy behind the attack on Yukos, it was blurred by the heavy-handed tactics of the government, specifically the Prosecutor General's office and the tax administration.

2004 continued with a lack of clarity in terms of the government's overall strategy for business-state relations: one main Kremlin figure said that "nationalizing the commanding heights of industry" was a possibility and the tax administration (the unit that investigates and fines for tax minimization and evasion) was running rampant with a total tax fine amount in the billions of roubles. Putin lectured the oligarchs on "social responsibility", seemingly a code for contributing to Russia's wealth rather than their own. Additionally, an anti-Western sentiment was acutely evident in some of the rhetoric surrounding these events.

In comparison to 2003 and 2004, 2005 was a positive year in terms of business-state relations. In various speeches and interviews the Kremlin and the government acknowledged a serious problem; Putin admitted that the investment climate needed to change. The language changed from the oligarchs' social responsibility to "mutual responsibilities" and the Kremlin began to rein in the tax administration. A law was proposed for a statute of limitations for investigations into back taxes and privatizations (three years rather than ten years) and an amnesty on the repatriation of capital. Although somewhat symbolic, since the state has many other mechanisms to investigate companies, the actions were seen as a concession by the Kremlin to those who said the investment climate had been irreparably damaged.

2006 was marked by greater clarity as to the role of the state. Large companies currently in Kremin-friendly oligarch hands could potentially be sold to the state-owned or state-controlled companies and their owners have spoken acknowledged this possibility. In terms of foreign investors, changes to the natural resources investment laws have effectively limited foreigners from owning majority stakes in strategic sectors.

Political Violence: Politically-motivated violence is generally limited to isolated incidents, with the exception of the conflict in Chechnya and the Caucasus region and a number of major terrorist attacks with high visibility, such as Beslan school hostage-taking in September 2004. While there have been attacks in Moscow, they have not yet targeted foreign or domestic companies.

Political

Political Structure
Federal Republic; President holds wide powers

President
Vladimir Putin

Prime Minister
Viktor Zubkov

National Legislative Bodies
- Lower House: State Duma (directly elected)
- Upper House: Federation Council (indirectly elected; comprised of regional officials)

Major Parties (seats in assembly)
- United Russia: 222
- Communist Party: 53
- Liberal Democratic Party of Russia (Zhirinovsky): 38
- Motherland: 37
- Union of Right Forces: 3
- Yabloko: 4

Last Elections
- Duma: December 2003
- Presidential: March 2004

Next Elections
- Duma: December 2007
- Presidential: March 2008

Press Freedom Survey:
- 2007 Score: 75 (Not Free)

(0: Free; 100: Not Free)
freedomhouse.org

Control of Corruption Index:
- 2006 Score: -0.76

(-2.5: Worst; +2.5: Best)
worldbank.org

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Political Outlook

Stability will continue under Putin until the 2008 presidential election and likely though the 2008 transition period. Policy continuity under Putin's successor is expected.

Russia

Economics

Economic

Credit Agencies

Moody's: Baa2

S&P: BBB

Fitch: BBB

Nominal GDP (USD, 2006)

USD960bn

Population (2005):

143.4 million

Total Trade / GDP:

49.4%

Currency:

Russian rouble

Exchange regime:

Managed float

Merchandise imports from Canada:

CAD788 million

Main sources of Foreign Exchange (excl. FDI):

Oil

Largest Merchandise Trading Partner:

Germany (12%)

United States (7.7%)

Main imports:

Machinery and equipment (27%)

Food (17%)

Risks to the Outlook

↑ Strong oil prices
Improving foreign direct investment

↓ Vulnerability to adverse developments in oil market
Governance Issues

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Market Spotlight: The Russian economy continues its rapid growth thanks to continuing high oil revenues. Real GDP grew by 6.5% in 2006, marginally higher than the 6.4% achieved in 2005 but down from the 7.2% realized in 2004. But inflation remains high - about 10% in 2006, and a forecast 8% in 2007. The external accounts are in excellent shape, with foreign exchange reserves having recently surpassed $300 billion, the third-highest in the world; and foreign debt continuing its steady decline.

Recent Economic Developments: After a sterling performance in 2004 with real GDP growth of 6.8%, real growth in 2005 slowed to an estimated 6.4%, but accelerated to 6.5% last year. Throughout much of the past two years, soaring domestic demand has been the main engine of growth for the Russian economy, particularly, private consumption. Growth is expected to slow further this year and next as a result of sluggish performance in key industrial sectors, notably oil extraction of which extraction is slowing. Inflation was stuck at around 10% in 2006, and may decline somewhat to 8% this year. Efforts to dampen inflation are hindered by large-scale foreign inflows from oil revenues which have been feeding monetary growth by adding to reserves. Current inflationary pressures appear rooted in supply-side constraints in goods and labor markets resulting from low fixed investment.

External Accounts Sharply higher oil prices widened the current account surplus to 10% of GDP in 2005 and 2006, although this should fall this year thanks to the combined effects of weaker oil prices ahd higher imports. While merchandise export revenues are booming thanks to high oil prices, in reality much of the growth has been from oil price increases. Russia's large merchandise trade surplus is thanks to high commodity prices, particularly oil prices. Moreover, crude oil export volumes s fell slightly in late 2005 – the first decline since the late 1990s - as domestic consumption rose sharply while oil production increased only marginally. In the past two years the government has made large net debt advance repayments of nearly US$20 billion to Paris Club creditors and the IMF. A final prepayment of nearly $20 billion of Soviet-era debt was reportedly agreed with Paris Club creditors in June 2006. External debt is currently equivalent to about 29% of GDP, with debt service at a very sustainable 30% of exports. Importantly, while public foreign debt is declining, corporate foreign debt is booming.

Government Policies: The Central Bank of Russia (CBR) has the difficult task of reconciling the competing demands of maintaining price stability - its primary mandate - with the goal of moderating the appreciation of the ruble to maintain the competitiveness of the industrial and manufacturing sectors. Massive current account surpluses are feeding money growth and causing huge appreciation pressures on the ruble, potentially placing the export-dependent sectors at a competitive disadvantage – the so-called Dutch Disease. Therefore the Central Bank is placed in the difficult situation of having to maintain both price stability (dampening inflation) while limiting ruble appreciation. A monetary policy that is too tight would incur the wrath of the strong industrial lobby, while conversely the neglect of domestic price increases would bring popular discontent. So far the Central Bank has managed to keep both sides reasonably content – limiting inflation, while ensuring that the ruble depreciation is not too fast.

Outlook: High oil prices and substantial foreign exchange reserves ($300 billion and rising) have shifted macroeconomic risks into the future. Still, there are signs the economy is operating either at full or near to full capacity, particularly GDP growth seemingly stuck at 6% of GDP in face of large oil revenues. For the country to maintain growth at anywhere near current level of 7.5% yearly it needs to reach its self-imposed goal of doubling GDP in 10 years it must remove the constraints to growth.

Economic Indicators

	01-05 avg.	2006	2007	2008
GDP (% growth, real)	6.1	6.6	5.8	5.3
Inflation (CPI, year-end)	14.8	9.7	8.8	7.7
Fiscal Balance (% of GDP)	3.9	7.7	6.0	4.7
Exports (USD bn)	18.3	24.1	9.0	3.4
Imports (USD bn)	22.8	29.8	22.9	17.6
Current Account (% of GDP)	9.7	9.8	7.7	4.9
Reserves (month of imports)	7.2	13.3	13.6	13.1
External Debt (% of GDP)	40.1	30.0	27.4	25.8
Debt Service ratio (% GSNFS)	11.2	9.6	11.5	11.6
Currency (per USD, year-end)	29.6	26.3	27.5	28.2

Bond Spreads

June 2003 - June 2006