Russia. An Economy with High Growth Potential Facing a Challenging Global Crisis

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Introduction

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After experiencing a decline of production and of the main economic indicators in the initial years of its transition to a market economy and on to 1998, Russia entered a long phase of rapid growth. Over the 1999-2008 decade, GDP grew at an average annual rate of around 7%, a brisker pace than that achieved in the same period by the Transition Economies and among the fastest in the world. Thanks to the gradual stabilisation of the macroeconomic framework, and to the advances of structural reform, the country enjoyed a long period of economic growth, fuelled by the commodity price cycle, the trend of foreign trade, and more recently, a strong inflow of foreign investments[1] .

The economic and financial crisis which began in 2007-2008 in the mature economies and subsequently spread to the other regions of the world, changed the underlying economic picture. Since the summer of 2008, commodity prices have dropped sharply. International trade and capital flows have started to slow. The driving factors of the past decade's economic cycle have turned into the main transmission channels of the current crisis, which is expected to be of particularly severity at global level. Together with other major economies, Russia must now face a delicate recession phase.

The crisis is touching on two of the country's main weaknesses: its economic and financial dependence on the commodities cycle, and the private sector's degree of foreign indebtedness. Following the reduction of oil revenues, Russia's public and current account balances have deteriorated. It should be said that the current levels of public debt (less than 10% of GDP) and foreign debt (around 30% of GDP, of which the government's share is nonetheless limited) make temporary deficits of both aggregates sustainable. Furthermore, the impressive reserves accumulated by the Central Bank during the favourable oil cycle years – Russia is one of the main holders of official reserves in the world – have significantly strengthened the country's foreign financial position, reducing its vulnerability to the global crisis.

As regards the currency, the drop in oil price indices led to a rapid depreciation of the nominal exchange rate, by over 30% against the major currencies compared to last year's peaks[2]. To ease pressures on the rouble, and to prevent it from falling too far, the Central Bank intervened resorting to part of its reserves, and putting in place restrictive monetary policy measures. In recent weeks, the currency's quotations have started to stabilise again. At current values, the real exchange rate has largely reabsorbed its appreciation over the past decade, returning to

[1] On this point see Vinhas de Souza L. (2008), A Different Country. Russia's Economic Resurgence, CEPS.

[2] An analysis of the trends of the nominal and real exchange rates of Saudi Arabia, Norway, and Russia (see Habib M. M., Kalamova M. M., *Are there Oil Currencies? The Real Exchange Rate of Oil Exporting Countries*, ECB WP Series, n. 839, Dec 2007), has revealed that in Russia's case a long-term correlation exists between the real price of oil and the real exchange rate. The estimate is robust to the addition of the trend of the productivity differential as a further explicative variable. According to the authors, the oil shock of recent years was transferred to the real exchange rate in Russia – with an elasticity of around 0.3 on the price of oil in real terms – through the partial sterilisation of oil revenues, and the adjustment of domestic prices.

quotations more in line with long-term equilibrium levels and at the same time restoring greater competitiveness to the manufacturing sector[3].

The uptrend in monetary rates, however, raised the cost of funding for banks, especially those with a smaller deposit base, and for the enterprise and household sectors. Given the greater difficulties encountered by economic agents in accessing the international capital markets, and the expected turnover of private sector debt, fears of a severe credit crunch have increased.

The aim of this paper is to provide – in the current, highly challenging economic situation – a contribution to reflections on the Russian economy, integrating a macroeconomic approach, based on the analysis of the economic cycle and of the medium/long term trends, with a microeconomic one, focused on the structure of the real economy and of the financial system. The paper is divided into three sections: the first, *Growth Determinants and Prospects*, by Giancarlo Frigoli, discusses the recent trends and the prospects of the Russian economy; the second, *Foreign Trade, FDIs and Industrial Structure*, by Wilma Vergi, analyses the structure of foreign trade and of Russia's industrial geography; and the third, by Davidia Zucchelli, *The Banking and Financial System*, focuses on the characteristics and main trends of financial intermediation in the country.

The first section upholds the view that the positive phase of the cycle was supported by foreign demand, in particular by commodity exports, as well as by domestic demand, primarily consumption as a result of the increase in the disposable income of households. Within a context characterised by excess of savings on investments and strong inflows, in the 2006-'07 period especially, of foreign direct investments, the Central Bank eased upward pressures on the nominal exchange rate by accumulating reserves. As the sterilisation of the increase of monetary aggregates was only partial, it fed an expansionary liquidity and credit cycle which also raised inflation to higher levels than in competing countries, resulting in a gradual appreciation of the real exchange rate.

An analysis of long-term growth determinants shows that the average GDP growth rate in the decade considered was more tied to factor productivity than to the specific contributions of employment and capital intensity[4]. Papers on the topic highlight that the trend of productivity is only partly the result of an initial underutilisation of productive factors. It is mostly to be referred to more efficient allocation of these factors across sectors, and to the advances of structural

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[3] In Beck R., Kamps A. and Mileva E. (2007), *Long-term Growth Prospects for the Russian Economy,* ECB Occasional Paper Series, n. 58, March., the authors investigate whether the primary role played by commodities, and the significant appreciation of the real exchange rate, may have undermined the competitiveness of the manufacturing sector, and contributed to the spreading of the *Dutch Disease* to Russia. While the authors ultimately offer a negative answer, they do conclude that the evolution of the real exchange rate, and the moderate investment trend, represent additional risk factors weighing on the long-term sustainability of high growth rates in Russia.

[4] On this point see P. Michaelides and J. Milios, *TFP Change, Output Gap and Inflation in the Russian Federation (1994-2006),* Journal of Economics and Business (2008), doi:10.1016/j.jeconbus.2008.10.001.

reforms[5] which have encouraged the country's openness to foreign direct investment[6] and increased the system's financial deepening[7].

An analysis of trade and foreign direct investment flows – provided in the second chapter of this paper – highlights the increasingly important role played by Russia in international trade. Trade between Russia and the rest of the world has grown at significant rates in the past few years, reaching USD 765Bn in 2008. The sum seems relatively small as a percentage of GDP, i.e. around 45%, based on 2008 estimates, but the ratio is in line with that encountered in the other large emerging economies such as China and India.

Russia mostly exports energy commodities: over 60% of the Russian total and over 10% of the world total in the sector. When non-energy commodities such as metals are also taken into account, the share of commodities on total Russian exports increases further. In turn, Russia imports machinery and equipment (mechanical and electronic), and means of transport, which together account for over 40% of total imports. The geographical distribution of trade establishes EU countries as Russia's main trade partners, both as buyers and suppliers, commanding a share of total trade of around 50%.

The wealth of natural resources has encouraged the country's productive specialisation in the mining, processing, and marketing of commodities. Russia is global leader in the production of natural gas (with a share of 22.1% of the world total); also, it is second only to Saudi Arabia in the offer of oil, producing around 10 million barrels a day, or 11.7% of world total. However, the importance of non-energy sectors in the Russian economy should not be underestimated. An increasing contribution to the trend of added value, estimated by some analysts at above 70% in the 2000-2006 period, is being made by the manufacturing and services sectors[8].

For what concerns foreign direct investments, Russia, in line with the other economies of the world, has recently experienced a significant growth of inflows. At the end of 2007, the FDI stock amounted to around USD 324Bn (UNCTAD estimates), mostly of European origin, corresponding to 25% of GDP. This rate is higher than that of other large economies such as

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[5] Debate is rife in literature over the state of advancement of structural reform in Russia. According to Vinhas de Souza L. (2008), A Different Country. Russia's Economic Resurgence, CEPS, Russia's performance compared to the other CIS and BRIC countries' is respectable. All the fundamental structures of a market economy have been introduced, often at a very high social and economic cost, together with a more robust economic management structure. Based on the traditional indicators used by EBRD to assess the state of advancement of Transition Economies towards a market economy, Russia ranks high among CIS countries. In the EBRD's latest report (2008), Growth in Transition, the recent progress made in the area of infrastructural services (electricity, telecommunications, and water management) is highlighted, together with further potential advances in the more delicate areas of competition policy and corporate governance systems.

[6] Melentieva N. (2000), *FDI in Russia: The Effect of Foreign Ownership on Productivity*, New Economic School, in line with a wide strand of literature on the topic, finds that companies under foreign ownership are more productive on the whole. According to the author, the impact of FDI on productivity depends specifically on the size of the company, on the advancement of economic reforms, and on the level of education in the region to which investments are addressed.

[7] In a paper published by the OECD, Ahrend R. (2008), *Understanding Russian Regions' Economic Performance during Periods of Decline and Growth. An extreme Bound Analysis Approach*, ECO/WKP n. 52, Oct., the author analyses data on 77 Russian regions referred to the 1993-2004 period, finding that, as of 1998, the relevance of initial conditions in explaining growth determinants has progressively waned, remaining confined to the hydrocarbon sectors and to the benefits of geographic location, to the advantage of structural reforms (price liberalisation, competition, privatisations) and of the quality of regional institutions.

[8] See Vinhas de Souza L. (2008), *A Different Country. Russia's Economic Resurgence*, CEPS.

China, India, and Brazil[9]. Russia also invests heavily abroad[10]. At the end of 2007, Russian FDIs abroad amounted to USD 255Bn, or around 20% as a percentage of GDP.

Trade and investment relations between Italy and Russia have developed in the two countries' respective sectors of specialisation. Italy is one of Russia's main commercial partners, and trade between the countries was worth around EUR 27Bn in 2008 (up by over 10% vs. 2007). It imports energy minerals and products, followed by metals and metal products, and exports machinery, mechanical and electronic equipment, together with typical *Made in Italy* products. An analysis of export flows originating from Italian industrial districts highlights the increasing importance of the Russian market. District exports absorbed by Russia almost tripled between 2000 and 2007, from 1.5% of the total to 4.5%. Especially upbeat trends were recorded in the districts specialised in machinery, whose exports to Russia accounted for 5.5% of their total, fashion consumer goods, with a share of 5.5%, furniture and household appliances, with a share of 6.7%.

Despite the country's huge potential, Italy does not rank as one of the main investors in Russia. Based on data referred to the first three quarters of 2008, Italian FDI inflows are estimated at around one billion dollars. However, it should be said that major Italian energy sector companies have made substantial investments in the Russia through their foreign subsidiaries.

Several empirical papers uphold the existence of a significant correlation between the level of advances of the banking and financial system on the one hand, and a country's productivity, per capita income, and GDP growth on the other[11]. In Russia as well, the upbeat economic cycle was supported by important advances in the financial system, and by the strong trend of credit. In the past few years – as explained in the third chapter of this document – customer loans have grown at annual rates of between 40% and 50%. The ratio of lending to the private sector and GDP, an indicator of the *financial deepening* of an economy, has increased to close to 50%, in line with that in other Transition Economies.

The process of financial intermediation, however, is still hindered by some weaknesses, partly amplified by the current global crisis. The number of companies listed on the stock markets is still limited. Equity market capitalisation, which increased rapidly in the 2003-'07 five-year period, shrank back somewhat in 2008, in step with the fall of commodity indices and the decline of the major foreign equity markets. Recourse by companies to the capital markets remains modest.

As regards the credit market, the number of banks is still high, and only a few hold significant market shares. Deposits are nevertheless still concentrated with the major banks, leaving the rest of the system more exposed, in the financing of loans, to the availability of funding through different channels, in particular from abroad. In the current negative phase of the cycle,

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[9] The new law on governing strategic sectors, which came into force in May 2008, identifies 42 sectors in which control by foreign investors must be authorised beforehand by a dedicated government committee. The law represents an evolution of the previous system, based on discretional approval procedures. On this topic, see OECD (2008), *Russian Federation. Strengthening the Policy Framework for Investment*, OECD Investment Policy Reviews.

[10] "The motivations of Russian companies that invest abroad have changed considerably in recent years. Their aim is now to internationalise their assets and acquire control of the value chain. In all likeliness, this trend, which involves both State-controlled companies and private enterprises, will continue in the future." (See OECD (2008), *Russian Federation. Strengthening the Policy Framework for Investment*, OECD Investment Policy Reviews.

[11] See, for all, Demirguç-Kunt A. and Levine R. (2008), *Finance, Financial Sector Policies and Long-Run Growth and Development*, World Bank , WP n. 11, 2008

numerous banks are also facing, in addition, higher risks of a deterioration of loans portfolio quality.

The measures promptly adopted by the Russian Authorities to take on the consequences of the global financial crisis should be read in this light. They have been aimed, as it has also been the case in other major economies of the world, at restoring the confidence on the markets and among its participants, strengthening the capitalisation and the M&A process in the banking sector, and encouraging the necessary inflow of credit to the economy.

1 Growth: Determinants and Prospects

1.1 Introduction

Giancarlo Frigoli

Russia, after having overcome the long recession of the 1990s and the financial crisis of 1998, has been growing at brisk rates in the past ten years. The country has paid back in advance the debts taken out with the Paris Club, and has accumulated large reserves in currency. The long growth trend has led to a significant improvement in the standard of living and in the wealth of the population. In the past 10 years, the gross domestic product has increased by almost seven times, in step with per capita income. The percentage of the population living below the poverty line has dropped from 37% in 1999 to less than 15% at present.

The strong devaluation of the rouble following the 1998 default, and the surge in the prices of exported commodities, gas and oil first among them, have undoubtedly been decisive economic growth drivers. However, structural reforms and a more efficient management of economic policy have also made a strong contribution.

The Russian Federation has evolved rapidly. The country has achieved a high level of stability and economic freedom, guaranteed by the Constitution. The presence of the State in the economy is still considerable, especially in strategic sectors. On the economic front, direct and indirect dependence on oil is still strong. Although the production of gas and oil has grown only moderately in the past five years, price increases have generated financial resources which have fuelled growth. Nonetheless, the combination of the dominant role played by oil in the economy, and the strong presence of the State (and its bureaucracy), have hindered the development of other business sectors, including the financial.

Compared to 1998, Russia, thanks to the reserves accumulated, is undoubtedly in a much sounder financial situation today. The country can count on substantial resources, which allow it to face the costs of the crisis. In addition, the structural and institutional reforms introduced guarantee improved economic policy management, and faster, more efficient responses to external shocks.

However, the drop in commodity prices and the global financial crisis have laid bare some weaknesses in Russia's economic development model, stoked in recent years by high oil prices and by the rising foreign debt of households and enterprises. Sustained demand for consumer goods, in the presence of moderate investment growth, has accentuated the restrictions embedded in the economy.

These limitations have increased the vulnerability of the Russian economy to the current hardships face by the global economy. Over the past few months, the authorities have put in place stabilisation measures aimed at buffering the negative impact of the global crisis on the domestic economy and on the financial system. In any case, the successful continuation of the structural reform process remains essential to achieve sustained long-term economic growth.

1.2 Economic Growth

1.2.1 Crisis in the Late 1990s Followed by 10 Years of Upbeat Growth

Between 1999 and 2008, the Russian economy achieved an average real GDP growth rate of close to 7%, as opposed to an average rate of 4% for the global economy and 6.2% for the emerging economies. However, growth drivers changed over time. As regards demand, in the period immediately following the 1998 crisis, the strongest thrust came from exports. Subsequently, the strongest contribution came from domestic demand, in the consumer goods segment especially, whereas foreign trade began to contribute negatively to, due mostly to the strong trend of imports.

Contributions to Growth							
Percentage points	1999-'04 avg.	2005-'08 avg.	2005	2006	2007	2008	2009E
Consumption	3,3	6,6	5,9	6,3	7,4	6,9	-1,3
State	0,4	0,4	0,2	0,4	0,7	0,5	0,8
Investments	1,8	3,4	2,0	3,6	4,6	2,8	-2,5
Trade	0,5	-4,0	-2,2	-3,4	-5,9	-4,3	1,3
Inventories	0,9	0,6	0,0	0,5	1,3	0,1	-0,3
GDP y/y % chg. Russia	6,8	7,0	6,4	7,4	8,1	5,6	-2.0
GDP y/y % chg. World	3,7	4,5	4,5	5,1	5,0	3,4	0,5
GDP y/y % chg. Emerging economies	5,4	7,3	7,1	7,9	8	6,3	3,3

Source: EIU, IMF

Data broken down by GDP component show that household consumption remained broadly stable in the period at around 50%. The investment component increased by around 50% in the past 10 years, to its current rate of 20%, but is still relatively modest when compared to the situation in other major emerging economies, such as China and India, and, more importantly, insufficient to guarantee sustainable fast-paced GDP growth in the medium period. Lastly, the weight of exports decreased by around one third (to just over 30%), with imports also contracting, albeit at a slower pace than exports (to 22%).

Macro Indicators							
	1999-'04 avg.	2005-'08 avg.	2005	2006	2007	2008	2009E
Real GDP y/y % chg.	6,8	7,0	6,4	7,4	8,1	5,6	-2,0
Private consumption y/y % chg.	6,8	11,8	11,2	11,1	13,5	11,4	-1,5
Public consumption y/y % chg.	1,9	2,9	1,0	2,4	3,4	2,5	2,5
Investments y/y % chg.	10,5	14,9	10,6	18.0	21,1	10,3	-6,0
Exports y/y % chg.	9,9	7,0	6,5	7,3	6,4	0,2	1,4
Imports y/y % chg.	15,0	21,3	16,6	21,3	26,6	17,7	-4,3
Budget balance /GDP	2,2	6,5	7,5	7,4	5,5	5,2	-8,0
Consumer prices (average)	28,1	11,4	12,7	9,7	9,0	14,1	12,6
Current balance /GDP	11,4	8,1	10,9	9,6	6,1	6,0	-5,0

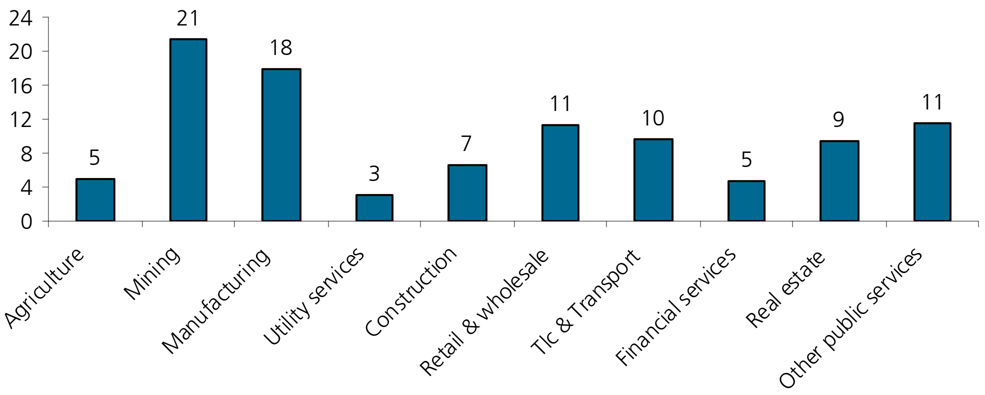
Source: EIU

By business sector, in the past six years the strongest impulse to growth came from the non-manufacturing sector (primarily the financial, transport, and communication sectors, in this order in terms of contribution to overall revenues, all showing high-single digit or double-digit growth rates), and from construction (average rate of 14%). The manufacturing sector, on the other hand, grew at a slightly slower pace than GDP (average rate of 6.5% vs. 7%), therefore proving broadly resilient. As regards the main sub-sectors, progress was made by the chemical industry and construction machinery. The physical volume of gas and oil production, on the other hand, grew on average by just over 3% in the period (oil +4.1% and gas +2.1%).

Official statistics tend to underestimate the weight of the extraction industry on GDP, while overestimating that of commercial activity.

This is because for fiscal reasons Russian companies transfer a large part of their proceeds from extraction to marketing. According to World Bank estimates, the extraction industry's real contribution to GDP is more than double the official figure (9.8% in 2008), at over 20%.

Added Value Shares at Current Prices in 2008



Source: Rosstat. (*) Shares adjusted based on World Bank estimates

1.2.2 The Russian Economy and the Global Crisis

Plummeting oil prices, the spiralling global financial crisis, and downward pressures on the rouble, have led to a sharp worsening of the Russian economy's growth prospects. The low price of commodities, and of oil in particular, dampens investment intentions and reduces the resources available to finance public spending. What's more, the drop in the terms of trade strips domestic demand of an important driver.

In addition to these factors, harder access to credit at both the domestic and international levels is also causing negative effects. Enterprises are being forced to revise their growth plans and risk facing difficulties in honouring their financial commitments. Debt in currency, the higher cost of money, rising unemployment and a more moderate wage trend, are limiting the spending power of households. In this context, in 2009 both consumption and investments are expected to decline in real terms, offset only in part by higher prospected public spending and by the positive contribution of foreign trade to GDP, as a result of an estimated slowdown in imports.

In 2009, GDP is forecast to contract in real terms. Estimates based on current data differ: -0.7% according to the IMF (World Economic Outlook update, end of January 2009), -2.2% to the Russian Finance Minister Kudrin in his address at the annual meeting of the Treasury at the end of February, and a hefty -3% according to some institutions, which are expecting consumption to drop by more than 4%. In 2010, a slight rise in the price of oil, as the global economy slowly starts to recover and the international financial crisis stabilises, could support a return to moderately positive growth rates (of around 1%).

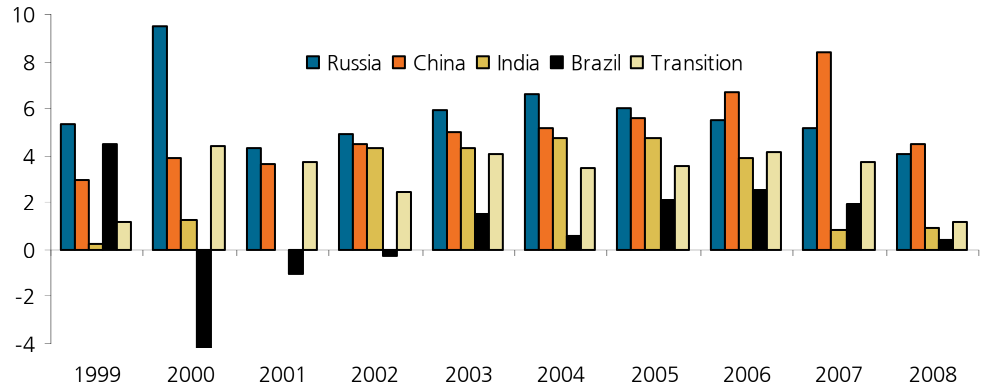
The deterioration of the international economic-financial scenario, and the industrial production plunge in January (-16% y/y, led by especially weak steel, cement, and auto sectors) highlight the downside risks weighing on growth. The trend of oil prices in particular weighs on economic prospects. The World Bank's forecasting model, for instance, estimates that stronger GDP growth by 0.7% is possible in the event of the price of oil increasing by 10% (from around USD 40 per barrel at present). The model adopted by the Bank of Finland, which also considers the indirect effects of the change in the price of oil on the economy, estimates an impact twice as high.

1.2.3 Growth Determinants

While gas and oil production and refining account for less than one fourth of Russia's GDP, this component has provided a decisive impulse to economic growth in the past ten years. Gas and oil are responsible for almost two thirds of revenues generated by exports. The remainder is accounted for by other commodities and low-added-value products, such as the processing of metals and wood. The weight of high-added-value products is limited to a few percentage points (see section on foreign trade). Two thirds of the export price per barrel is transferred to the State via taxation. Gas and oil generate almost 70% of total fiscal revenue (see section on fiscal policy).

The rise in the price of exported commodities has enhanced the profitability of the extraction industry, considerably improved the terms of trade, and provided the State with substantial resources to finance current spending and the construction of infrastructures. Economic growth has created the conditions for a more efficient use of both capital stock (higher utilisation rate) and workforce (more hours worked, workforce used in more remunerative sectors), and factor productivity has posted sustained growth rates. In the past 10 years, total factor productivity (TFP) in Russia has increased on average by 5.7%, compared to 5% in China and 3.2% in Eastern European Transition Economies. In the opening years of the period analysed, factor productivity growth in Russia offset the weak contribution made by capital stock.

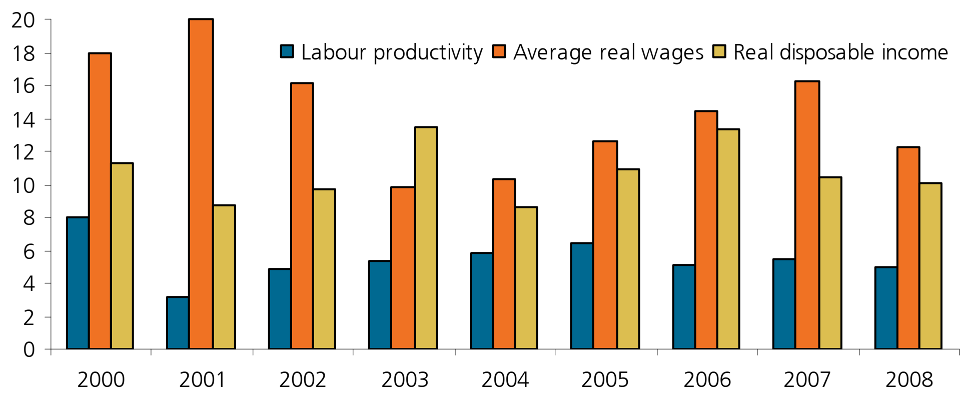
Total Factor Productivity (y/y % chg.)



Source: EIU

The uptrend in wages and disposable income – aided by rising productivity – made a decisive contribution to GDP growth. The spending and credit capacity of households increased, supporting demand for consumer goods, services, and financing. Private consumption accounted for more than half the growth of Russian GDP between 2000 and 2008. By business sector, the non-manufacturing and construction sectors benefited most from the strengthening of demand, fuelled by the resources generated by the oil industry. These sectors were also fuelled by Russia's gradual transition to a market economy. As mentioned above, investments made a more moderate contribution. In addition to the primary sector, however, double-digit investment growth was recorded in recent years by public utility services, the real estate sector, and means of transport.

Growth of Consumption, Income and Wages in Russia (% chg.)



Source: EIU

Nonetheless, Russia's development process has also revealed some weaknesses. Sustained domestic demand in the presence of limitations on the offer side have generated upward pressures on prices. The trend of inflation in Russia has proven stronger than in BRIC, Transition Economies, and the CIS (see box below). Lacking adequate offer from domestic productions, a large part of demand has been addressed to foreign markets. Imports have grown at double-digit rates, with the balance of trade making a significant negative contribution to GDP.

At the same time, the inflow of foreign funds and a high current account surplus supported the nominal exchange rate, which as a result of higher relative inflation, resulted in an appreciation of the real effective exchange rate (see "Foreign Exchange" box). This played against the competitiveness of the manufacturing industry. Lastly, strong demand for credit, faced with the insufficient resources made available by the domestic financial system, led to banks, enterprises and households stacking up a large foreign debt, and therefore becoming more vulnerable to the global financial crisis.

In addition to these conjunctural factors, growth potential is also hindered by more structural weaknesses, such as the low birth rate, the slow pace of growth of capital stock, and inadequate infrastructures and technologies, often inherited from the Soviet period.

Our analysis of growth determinants shows that labour productivity has been fundamental in raising per capita income, whereas the higher employment rate has played a secondary, albeit significant, role.

Growth Drivers

	Potential output % chg.	Real GDP % chg.	Population % chg.	Per capita GDP % chg.	Employment/ Population % chg.	Labour productivity % chg.	Factor productivity % chg.	Capital stock % chg.
				(1)	(2)	(3)		
1999	5,6	6,4	-0,3	6,7	-1,0	7,7	5,3	-2,9
2000	6,2	10,0	-0,4	10,5	2,5	8,0	9,5	-2
2001	5,3	5,1	-0,4	5,5	2,4	3,1	4,3	-1,4
2002	4	4,7	-0,5	5,2	0,3	4,9	4,9	-0,3
2003	7,2	7,3	-0,5	7,9	2,5	5,3	5,9	0,5
2004	7,8	7,2	-0,5	7,8	2,0	5,8	6,6	2,2
2005	6,8	6,4	-0,5	6,9	0,5	6,4	6,0	2,1
2006	7,3	7,4	-0,4	7,8	2,7	5,1	5,5	2,7
2007	7,3	8,1	-0,2	8,3	2,9	5,4	5,2	3,9
2008	6,1	5,8	-0,4	6,4	1,2	5,0	4,1	4,1

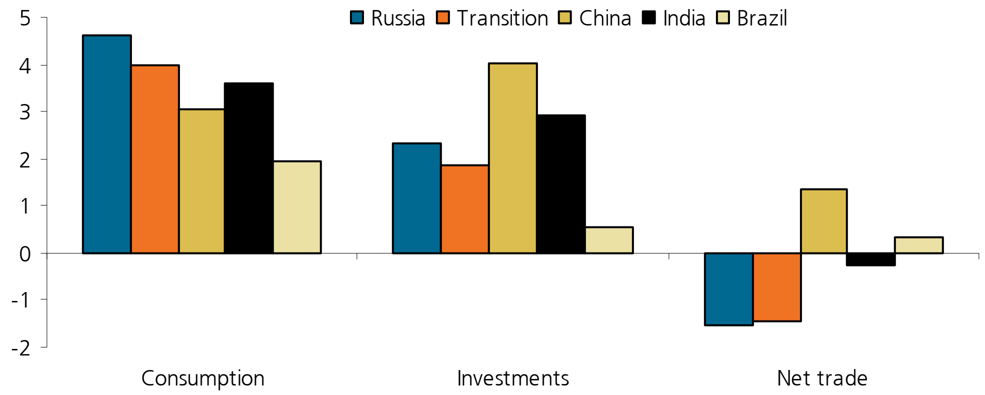
Source: EIU. Note: (1)=(2)+(3)

Box 1: Comparison with BRIC, Transition Economies and CIS

Russia is a medium income country with a population of just over 140 million. It is the largest Republic of the former Soviet Union, and its vast territory encompasses regions with different degrees of economic development. Russia commands the vastest reserves of natural resources in the world. Many of these resources are located in regions with inhospitable climates, and are costly and difficult to extract.

When compared to the emerging economies, the average Real GDP growth rate in Russia (6.9%) in the past 10 years emerges as having been much higher than in the so-called Transition Economies (CEE, SEE and the Baltic States), which achieved 3.8% in the period, but lower than the average rate recorded in the CIS (7.2%), driven by record-breaking growth in Armenia (10.2%), Azerbaijan (15%) and Kazakhstan (8.6%). The economies of these latter two countries are strongly dependent, as is also Russia's case, on gas and oil exports.

Contributions to GDP growth (1999-2008)



Source: EIU

A comparison with the large medium-income economies of the BRIC group shows that Russia's growth rate in the past 10 years has been higher than Brazil's, in line with India's, and lower than China's. Also in relation to BRIC, the weight of investments on GDP in Russia (around 20%) has been comparable to the rate in Brazil, but only half that of China (40%) and just under half of that of India. By contrast, in Russia consumption accounts for a larger share (50%) of GDP than in China (36%), but falls short of the rates recorded in Brazil (61%) and India (56%). In Russia and in the Transition Economies, consumption provided the strongest impulse to growth between 1999 and 2008, followed by investments. Foreign trade, on the other hand, weighed negatively on GDP.

At the end of 2008, Russia's Gross Domestic Product calculated at like-for-like purchasing power, was equal to less than 30% of China's, to 70% of India's, and was larger than Brazil's. Russian GDP was only slightly lower than the aggregate GDP of all the other Transition Economies, and more than double the aggregate GDP of CIS countries. Per capita GDP in Russia is relatively high, in line with the average in the Transition Economies, and two-and-a-half times the average in BRIC and in the CIS.

Compared to other Eastern European economies, Russia is a relatively less open economy. The Trade-to-GDP ratio is in line with the average for the other three BRIC countries, albeit much lower than China's, and less than half that of the Transition Economies and the CIS.

Macro Indicators: Russia vs. Emerging Economies

	Russia	China	India	Brazil	Transition(*)	CIS (**)
Real GDP avg. y/y % chg. 1999-2008 10Y period	6,9	9,8	7,0	3,0	3,8	7,2
Real GDP y/y % chg. in 2008	5,6	9,0	5,3	5,3	3,7	4,7
Nominal GDP - PPP USD Bn. 2008	2297	8252	3372	2010	1930	923
Per capita GDP - PPP USD 2008	16200	6210	2940	10480	17552	6432
Trade/GDP 2008	54	67	53	27	131	120
Average inflation % 1999-2008	21,3	1,9	4,9	6,8	6,7	16,4
Average inflation % 2008	14,1	5,9	8,2	5,7	8,5	16,4
Current account balance/GDP 2008	6,0	10,2	-3,6	-1,9	-11,0	3,8
Foreign debt/GDP 2008	21	9,1	14,0	14,3	76,8	40
Budget balance/GDP 2008	5,5	-0,1	-6,0	-0,7	-1,7	-1,7

Source: EIU. (*) CEE, SEE and Baltic countries; (**) Confederation of Independent States, excl. Russia

Also, inflation in Russia is high in relative terms, indicating that the presence in the economy of more inflexible elements. Mostly thanks to the revenues generated by oil, in recent years the country has recorded substantial surpluses on both the fronts of current accounts and public accounts, and unlike other CIS economies, its foreign debt and public debt are contained in relation to GDP.

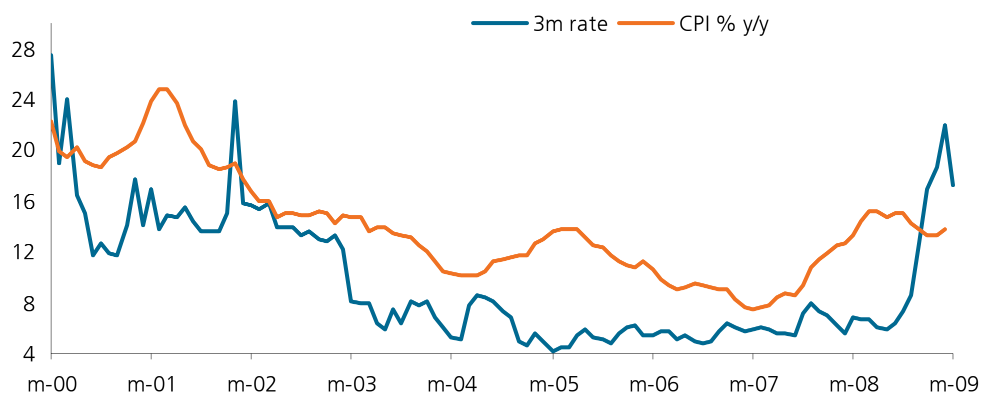
1.3. Economic Policy

1.3.1 Monetary Policy: High Rates to Support Currency

Until last summer, the Russian central bank's main concern was to contain inflation pressures at work in the economy. However, implementation of an explicit inflation-targeting policy was prevented by the rouble's controlled fluctuation regime vs. a basket of currencies, in place since 2005. The central bank had to strike a difficult balance between actions aimed at dampening inflation and measures geared to containing upward pressures on the rouble's quotations fuelled by large inflows of foreign funds. In the second half of 2007, the benchmark monetary policy rate was cut to a low of 10%, whereas to cool liquidity growth, the monetary authorities mostly acted on reserve coefficients. Starting in February 2008, with year-on-year inflation stably in double-digit territory, the central bank began taking restrictive action on rates, lifting the benchmark rate at 11% in several steps, while at the same time allowing a moderate appreciation of the rouble.

The scenario changed radically as of August 2008, first for the fallout of the conflict with Georgia, then due to the financial crisis. Since last summer, protecting the rouble has become the main monetary policy goal, given the fears that a drop in the Russian currency's quotations could spark a large-scale flight of capitals, spread panic in the country, and trigger a domestic financial crisis. The benchmark overnight rate has been raised to its current level of 13%, the highest since 2005, the rouble's fluctuation range has been repeatedly adjusted (18 times between early November and mid January), and then abandoned all together in favour of a threshold value (see below); more than one fourth of currency reserves were spent to protect the exchange rate. Financing rates have climbed above 20%, and since November 2008, credit standards have become more restrictive.

Interest Rates and Inflation



Source: Thomson Reuters (*)3M rate: Interbank rate 31 to 90 days – average bid-asked.

1.3.2 Fiscal Policy: Oil and the Weakness of the Economy Push the Balance into Negative Territory

National accounts have been showing a surplus since 2000. The funds accumulated have been used to pay back in advance debts taken out abroad with International Bodies and to feed the Stabilisation Fund, into which extra oil royalties are channelled. At the end of 1999, the Russian State had a foreign debt of USD 130Bn, almost 70% of which (USD 96Bn) taken out by the former Soviet Union. In September 2008, the public debt had dropped to just over USD 30Bn, of which USD 4.6Bn owed by the former Soviet Union.

In recent years Russia has implemented a fiscal policy geared to supporting the economic cycle, which has led to a significant growth in primary spending in real terms (+15% cumulated).

Therefore, the surplus-to-GDP ratio decreased to just over 5% last year, despite the persistently strong uptrend in oil revenues, whereas the non-oil deficit rose to around 9% of GDP.

Public Accounts

% GDP	2006	2007	2008	2009E
Revenues	23,3	23,6	21,8	13,0
- Energy revenues	14,7	12,9	14,2	6,3
Spending	15,9	18,1	16,6	21,0
Balance	7,4	5,5	5,2	-8,0
Non-oil balance	-7,3	-7,4	-9,0	-14,3
Urals USD/barrel	62,3	69,6	92,2	41,0

Source: Ministry of Finance. 2009 data referred to anticipations provided by the Minister of Finance Kudrin at the annual Treasury meeting.

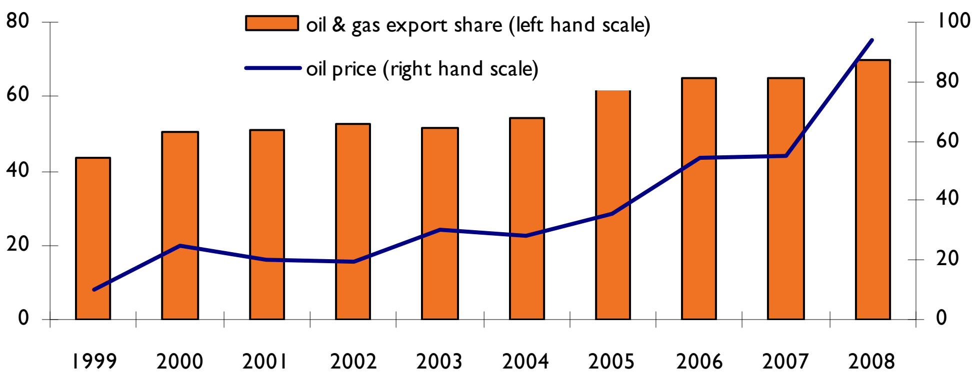
The increasing dependence of public accounts on energy revenues (65% of the total in 2008), and the significant drop in oil prices, will make the achievement of 2009 budget targets difficult. The 2009 Budget approved last January targeted a surplus of 1.5% of GDP, assuming an average price of oil of USD 95 per barrel. The Budget is about to be heavily amended to take into account the decline in the price of oil and the likely slowing of GDP growth this year. It has been estimated that a balanced budget, assuming spending in line with 2008 levels, could be achieved with an oil price of around USD 65 per barrel. If the price of oil fails to recover rapidly, the drop in revenues and the predictable increase in spending commitments to face the deterioration of the economy, could lead to public accounts in 2009 showing a deficit, estimated by Minister of Finance at around 8% of GDP. To cover this deficit, given the weakness of the capital markets, Russia is likely to resort widely to the extra oil revenues channelled in recent years to the Stabilisation Fund, and which at the end of 2008 amounted to around 10% of GDP, or USD 140Bn. The fund is part of the country's official currency reserves, and tapping into it would therefore subtract resources from the exchange rate protection policy. At the beginning of 2008, the Stabilisation Fund was transformed into a Reserve Fund, and coupled with the Fund for Future Generations. This latter fund includes resources set aside to cover social welfare spending for future generations.

At the end of 2008, the public debt/GDP ratio was modest (less than 6% in 2008), well below the average rate of peer countries (26% in 2008). The Russian public debt/GDP ratio is estimated to stabilise with an oil price of USD 62 per barrel; at current oil prices, with like-for-like spending and assuming a nominal GDP growth rate of 10%, over a period of three years the public debt/GDP ratio would align with the average rate in peer countries, possibly rising to around 40% in five years time.

1.3.3 External Balance: Solid Position Thanks to the Accumulated Reserves. Heading for a Current Account Deficit

In the past 10 years Russia has consistently achieved a current account surplus, of close to 10% of GDP on average. This surplus was entirely due to the goods component, which benefited from the surge in commodity prices, whereas services (mostly tourism) and transfers (mainly the remuneration or foreign investors) posted increasing deficits.

Exports and the Price of Oil



Source: Thomson Reuters

The financial balance showed a deficit for most of the period considered, due mostly to the repayment of debts by the State and to Russian investments abroad, offset only in part by direct foreign investment inflows and loans in currency.

Until 2007, the balance of payments generally showed a surplus. As a result, Russia accumulated substantial reserves over time, which touched a relative high of USD 597.5Bn at the beginning of August 2008.

Balance of Payments and Reserves

USD Bn	Current balance	Financial balance	Official reserve stocks
1999	24,6	-14,4	12,5
2000	46,8	-21,5	28,0
2001	33,9	-2,3	36,6
2002	29,1	-11,6	47,8
2003	35,4	0,1	76,9
2004	59,5	-8,4	124,5
2005	84,4	-15,1	182,2
2006	94,3	3,4	303,7
2007	76,2	85,9	478,8
2008	98,9	-128,4	427,1

Source: Russian Central Bank

The situation changed radically as of 3Q08, when political concerns (tensions with Georgia), fears over the hardships of the banking system and the deterioration of the economic situation, encouraged increasing outflows of funds from the country. Portfolio divestments, the growth of Russian investments abroad, and the more moderate trends of loans in currency and deposits, led to the balance of payments posting a deficit in 2008 for the first time in over10 years, despite the further expansion of the foreign trade surplus. These trends continued, and actually gained strength, in the opening months of this year, causing a drain on reserves, which dropped to less than USD 400Bn at the beginning of February 2009.

Components of the Balance of Payments		
USD Bn	2008E	2007
Current account balance	98,9	76,2
- Foreign trade balance	176,6	130,9
- Service s	-25,8	-19,8
- Transfers	-51,9	-34,9
Financial balance	-128,4	85,9
- FDI	-12,2	-0,2
- Loans	41,8	86,4
- Banks	-57,4	45,8
- Other items	-100,6	-46,1
Errors and omissions	-15,8	-13,2
Reserves chg. (*)	45,3	-148,9

Source: Russian Central Bank. (*) A negative value indicates growth of reserves

If the price of oil fails to make a solid recovery from current levels, Russia's foreign position will be upturned in 2009, changing from an estimated current account surplus of around 6% of GDP in 2008, to a deficit of around 5% of GDP .

Since the crisis of 1998, the Russian State has not issued bonds in currency. In fact, it has even paid back its debts with the Paris Club inherited from the Soviet Union. However, businesses and banks, both state-controlled and private, have become strongly indebted in currency, as a result of low rates of interest abroad. At the end of September 2008, Russia's foreign debt added up to USD 540Bn. The State's share was less than 8% of the total (mostly debt with the London Club and the EBRD). A 50% share was in the name of non-financial firms, and 36% of banks. The remainder was represented by FDI in banks and enterprises. Also at the end of September 2008, short-term debt amounted to just over 20% of the total (USD 113Bn), of which more than half will have to be paid back by banks, and the remainder by non-financial firms, primarily oil companies.

Despite the recent drain, the stock of reserves in currency remains well above the sum of liabilities at risk of roll-over. The reserve cover ratio, i.e. the ratio of reserves and the aggregate of the sum of short-term debts (one year maturity or less) and the current account deficit in the year, was slightly less than 2 in February 2009. Thanks to the reserves accumulated in recent years, Russia seems to be in the position to honour its short/medium-term financial commitments.

Foreign Debt	
USD Bn	Sep. 2008
Short-term debt	113,8
- government and authorities	11,8
- banks	63,6
- enterprises	38,4
Long-term debt	426,7
- government and authorities	31,0
- banks	133,1
- enterprises	230,3
- FDI in banks and enterprises	32,3
Foreign debt	540,5
Reserve cover ratio Feb 2009 (*)	1,93

Source: Russian Central Bank (*) ratio of reserves and the aggregate of the sum of short-term debts and current account deficit.

However, the situation may deteriorate rapidly. Specifically, it is estimated that, all other conditions being equal, to maintain balanced current accounts Russia needs the average price of oil to stay close to USD 70 per barrel. At the average oil price quotations of the opening two months of 2009 (around USD 40 per barrel for Ural oil), in 2009 Russia would accumulate a current account deficit of close to USD 80Bn (5% of GDP). Lastly, private sector players, and first of all the companies that have seen a plunge in the value of their assets pledged as security on loans, or that have been affected by the fast deterioration of business prospects, are facing increasing difficulties in refinancing foreign debt approaching maturity.

Box 2: Exchange Rate. Parities More Sustainable after the Sharp Depreciation

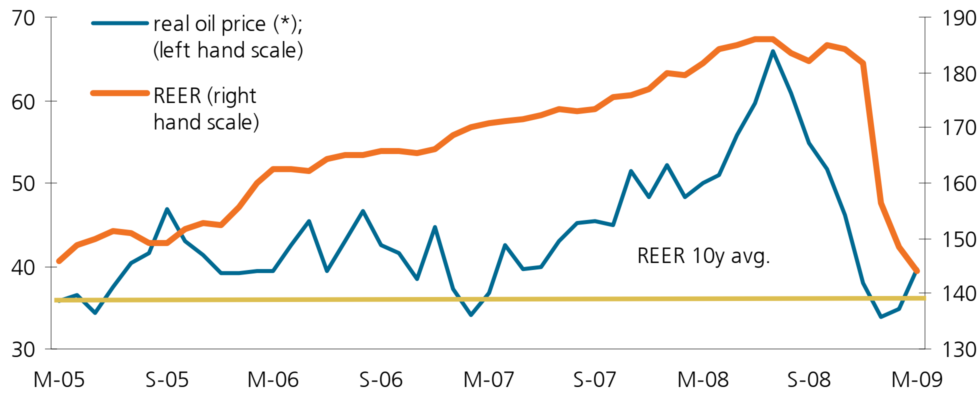
Starting in 2005, the Russian rouble has been subject to a policy of controlled fluctuation against a basket of currencies, which since February 2007 has included the US dollar (55%) and the euro (45%). Until last summer, the central bank had to work to contain appreciation pressures. The weighted exchange rate's fluctuation range was kept at between 29.6 and 29.9 for the better part of 2007 and in the first half of 2008. Last June, the weighted rouble was allowed to appreciate, and rose to a high of 28.9 early in August. The currency was subsequently hit by strong downward pressures, fuelled initially by geopolitical fears tied to the conflict with Georgia, and subsequently by the impact on Russia of the international financial crisis. These pressures induced the Central bank to gradually step up the benchmark rate, to repeatedly raise the limits of the fluctuation band, and intervene several times on the market to purchase currency using the substantial reserves available and, lastly, to dampen currency swap activity. To protect the rouble between early August 2008 and mid-February 2009, Russia spent over 35% of its reserves, which were down to around USD 390Bn in mid-February, from a high of USD 597Bn at the beginning of August 2008.

In 2008, the Russian currency depreciated by 18.5% in weighted terms (-19.7% vs. the US dollar and -13.8% vs. the euro). The downtrend continued throughout the opening weeks of 2009. At the end of January, the central bank decided to abandon the controlled fluctuation regime and set a roof for the rouble at 41 vs. the basket unit (a level which at the end of January, when the EUR/USD cross rate was 1.31, corresponded to 36 roubles for one US dollar and 46 roubles for one euro), committing to protect the limit. This was achieved on the whole through repeated interventions on the market and the hiking of monetary interest rates. At present, the trend of the Russian currency is still feeling the impact of low oil prices, the drop in the terms of trade (the price of oil adjusted by the price of industrial goods returned to levels in line with those recorded early in 2005), deteriorating macro fundamentals and current account position, the propensity of international investors to unwind positions on the Emerging Markets, and the hardships faced by some enterprises in honouring their financial commitments.

The authorities' actions aimed at supporting the rouble is justified both by political concerns (the current administration has founded part of its economic policy on the stability of the rouble) and economic (fighting inflation, fears of a strong devaluation generating panic and fuelling the financial crisis; default risk faced by enterprises and households indebted in currency). On the other hand, the defensive action is costly both in terms of financial costs and of the impact on interest rates.

The question is whether the current exchange rate level is sustainable. Different models may be run to identify an equilibrium rate in the long term. These models consider variables such as inflation differentials, financial flows and macroeconomic imbalances. A very simple method considers the misalignment, if any, between the current real effective exchange rate and its long-term average (10 years). Based on this approach, the marked depreciation of recent months should have placed the rouble's real effective exchange rate in February in line with its long-term average (reabsorbing the overvaluation accumulated over the past few years), and therefore at an equilibrium level.

Real Effective Exchange Rate of the Rouble and Real Price of Oil



Source: Thomson Reuters. (*) price of oil adjusted by the Economist Index of Industrial Goods Prices.

By contrast, according to some alternative models (see International Monetary Fund Staff Report, July 2008) the rouble may be undervalued at current levels. More in detail, considering the relative cost of labour (instead of the price differential) as a deflator of the nominal exchange rate, at the end of 2007 the rouble had almost entirely absorbed the undervaluation (estimated at 50% at the end of 2002) resulting from the devaluation which followed the 1998 default. Under this assumption, the recent, strong depreciation would seem to have offered advantages in terms of the country's competitive position. An undervaluation of the rouble is also signalled by models which take into account the sustainability of the financial position (estimated undervaluation of around 20% in mid-2008 under this assumption) and the macroeconomic equilibrium (estimated undervaluation of around 2%, also in mid-2008, under this assumption) as factors of the equilibrium exchange rate in the long term. However, it should be considered that the exchange rate's equilibrium levels have changed since mid-2008, due to the decline in terms of trade, caused by the drop in the price of oil and of other exported commodities. For instance, the two models mentioned above assume a stable current account surplus of 2.6% of GDP in the medium term. In the current situation, with a current account deficit, a weaker rouble would be required to restore equilibrium levels.

If the assumption that the rouble is undervalued at current values is embraced, the wide inflation differential still existing between Russia and its main trade partners should in any case also be taken into account, as it has the effect of recreating, at like-for-like nominal rates, overvaluation conditions.

In conclusion, the contrasting indications provided by the models mentioned above, and the findings of a European Central bank paper (ECB Working Paper No. 839, 2007), which shows that the rouble's real effective exchange rate is strongly correlated to the real price of oil, seem to suggest that a crucial factor in how the Russian currency fares is the oil price trend.

1.4 Rating and Financial Market Trend

The rating of Russia's sovereign debt in currency was upgraded to "investment grade" by rating agency Moody's in October 2003, by Fitch in November 2004, and by S&P in January 2005. Further upgrades followed, the most recent by Fitch and S&P in 2006 (to BBB+, 2 rating classes above investment grade), whereas Moody's upgraded Russia's sovereign debt to the corresponding class in its rating scale (Baa1) in July 2008.

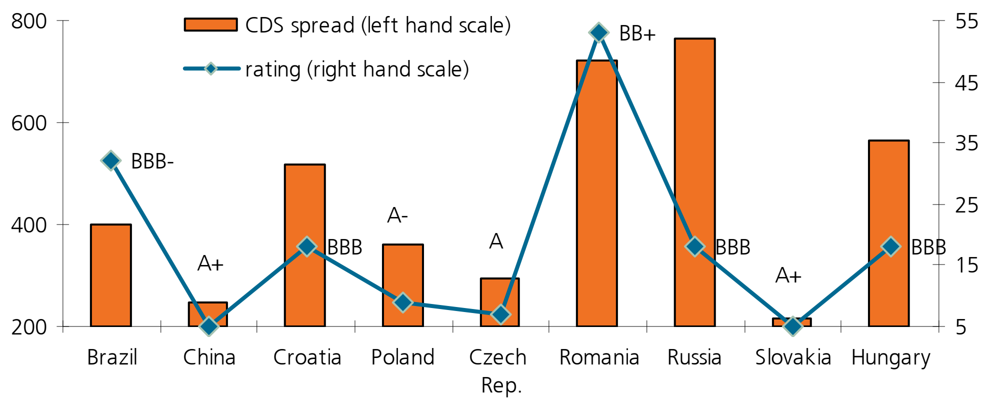
Ratings and Spreads.

	Latest	Previous
Spreads (5Y CSD spread)	746 (27 Feb 2009)	85 (18 Jun 2008)
Fitch*	BBB+/N (10 Nov 2008)	BBB+/S
Standard & Poor's*	BBB/N (8 Dec 2008)	BBB+/S
Moody's*	Baa1/S (12 Dec 2008)	Baa1/P (18 Sep 2008)

Source: Thomson Reuters, Bloomberg.

Last December, S&P downgraded its rating of Russia's sovereign debt in currency for the first time in 10 years, from BBB+ to BBB, due to the awareness that the efforts required to finance the public deficit, to recapitalise the banking system, and to protect the rouble, within a context of low commodity prices, will imply a serious drain on the substantial reserves accumulated by the country in recent years, including the funds available in the two sovereign funds. At the same time, Fitch and Moody's downgraded Russia's Rating Outlook.

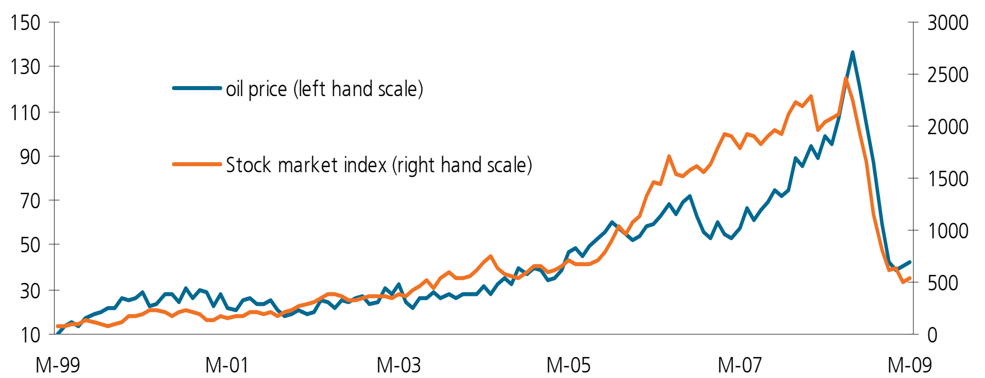
5Y CDS Spread (*) and Rating



Source: Bloomberg. (*) CDS spread as at 27 February 2009

The Russian Financial Markets have been hit hard by the financial crisis and by deteriorating growth prospects. The RTS equity index dropped by over 70% in 2008, and shed a further 18% in the first two months of 2009. The CDS spread, after having narrowed to a low of less than 90bps in mid-June 2008, widened to over 1,000bps at the end of October, at the height of the financial crisis for banks and enterprises, subsequently tightening back to around 700bps. Russia's CDS spread is currently wider than that of countries with equal or lower sovereign ratings, such as Brazil, Croatia, Romania and Hungary.

Equity Index and Price of Oil



Source: Datastream

Box 3: Recent Political Developments. A More Active Role on the International Scene

Last year, the handover of power from former President Putin to current President Medvedev took place upholding continuity. At the elections held in December 2007, Mr. Putin's United Russia party won a wide majority of seats at the *Duma*, the Lower House of the Russian Parliament. Medvedev, the presidential candidate chosen by Putin, subsequently won the presidential elections held in March 2008. At the beginning of May 2008, Putin, after having completed two consecutive mandates as President, totalling eight years, and not being eligible for a further mandate, was appointed Prime Minister by the new President, and confirmed in office (with almost 90% of votes) by the *Duma*. In his new role as Prime Minister, Putin continues to play a very prominent role in Russian politics.

The current economic-financial crisis seems not to have affected the strong consensus enjoyed by the Russian Government. Mr. Putin's party almost made a clean sweep at local elections held on March 1st for the renewal of nine Regional Administrations and 3,600 City Councils.

Having finally overcome the political and institutional crisis which followed the fall of communism, Russia is now set on resuming a leading role on the international political scene. Its renewed political activism has created tensions with many former Soviet Union states. In Augusts, these tensions erupted into an armed conflict between Georgia and Russia. The recent dispute with Ukraine on the Russian gas which crosses the country before reaching Europe has emerged as one of the most critical episodes in the difficult relations between Russia and its neighbouring countries.

In recent years, relations between Russia and the Western countries have repeatedly seesawed between cooperation and disagreement. On the one hand, Russia cooperated with the European Council and with NATO, and became part of the G8, which it chaired in 2006. On the other, Russia strongly opposes the potential entry of Ukraine and Georgia into NATO, and the deployment of NATO missiles in Poland and the Czech Republic. Furthermore, the Russian government has shown increasing reticence in collaborating towards putting in place international sanctions against countries such as Iran.

Also, the political establishment has shown a renewed propensity towards interventionism in the economic field. The Putin administration attempted to limit the influence of the "oligarchs" in the economy, and to this avail promoted the nationalisation of strategic industries, such as the energy sector. The economic crisis provided further impulse to state interventionism in support of struggling industries, such as the mining and commodity processing sectors. Prospects of a gradual integration of the Russian economy at the international level, through entry into the WTO, have weakened according to some commentators following the emergence of tensions between Russia and its neighbouring countries. As a result, the modernisation and liberalisation processes of the Russian economy have lost some steam.

2 Foreign Trade, FDI and Industrial Structure

2.1 Introduction

Wilma Vergi

In recent years, Russia has benefited from increasing global demand and the uptrend in the prices of commodities, which are a major component of the country's exports. In turn, demand for machinery and capital goods from abroad, fuelled by industrial development, supported and characterised Russia's imports. The country's main trade partners are European, although trade with important Asian economies is increasing. Based on preliminary data, foreign trade in 2008 should amount to around USD 765Bn, with a net surplus of around USD 180Bn. Due to the negative trend of the global economy, and to the resulting contraction in the demand of basic resources, import and export flows are expected to contract in 2009.

Italy plays an important role in Russia's foreign trade balance: in 2007 Italy was the country's second buyer and eighth supplier, accounting for shares of Russia's exports and imports of 6.4% and 4.3% respectively. Exports to Italy mostly consist of energy products, whereas industrial machinery make up most imports. Russia's interest in so-called *Made in Italy* sector products seems to be growing, thanks to rising disposable income.

FDI flows increased in recent years, amounting to USD 52Bn in 2008. In 2009, given the negative trend of the global economy, these flows could contract. In 2007 the FDI stock reached 25% of GDP (USD 325Bn, source: Unctad). Russian investments abroad are also impressive, and in 2007 added up to USD 255Bn. Italy is not one of the main investors in the country. However, it should be noted that the transfer of some capital flows by large Italian corporations have taken place through their foreign subsidiaries, and the sums involved are therefore not accounted among Italian investments. ICE (Bank of Italy data) reports that between 2004 and 2007, FDI averaged around EUR 50Mln a year.

Industrial production has increased considerably in all sectors in recent years, after the crisis experienced in the 1990s during the transition phase to a market economy. The wealth of commodities places the country among the first producers in the world of numerous metals and minerals.

2.2 International Trade

2.2.1 Exports and Imports

Russian trade with the rest of the world has increased in absolute terms in recent years, especially in terms of exports, driven by the trends of global demand and energy product prices. Imports also grew considerably, supported by rising domestic demand and the development of the country's industrial setup. In 2008, according to preliminary data released by the Russian Central Bank, foreign trade was worth USD 763.8Bn, or around 46% of the GDP of the same year, with an estimated surplus of around USD 180Bn. In 2009, as a result of the negative trend of the global economy, and of the contraction in the demand for commodities, the main international observers expect exports to drop (to around USD 300Bn according to EIU). Imports are also estimated to decline (USD 260.6Bn, also according to EIU).

Trend Trade Balance

Bn $	2002	2003	2004	2005	2006	2007	2008 *	2009 **
Export	107.3	135.9	183.2	243.8	303.6	354.4	471.8	300.1
% on GDP	31.1	31.5	30.9	31.9	30.7	27.6	28.6	19.5
Import	61	76.1	97.4	125.4	164.3	223.5	292	260.6
% on GDP	17.7	17.7	16.5	16.4	16.4	17.3	17.7	17.0
Trade balance	46.3	59.8	85.8	118.4	139.3	130.9	179.8	39.5

Source: Russian Central Bank (*estimates) - EIU 2009** forecast

The geographical breakdown of trade data shows that European countries are the main purchasers of Russian products, whereas the main suppliers also include important Asian economies such as China, Japan and South Korea. The CSI plays a more moderate role, accounting for little more than 15% of both total exports and total imports in 2008.

Export Geographical Details - 2007	$ Bn	% on total
Total	352.3	100.0
Netherlands	41.8	11.9
Italy	22.6	6.4
Germany	18.6	5.3
Belarus	17.2	4.9
Ukraine	15.9	4.5
China	15.2	4.3
Switzerland	13.9	3.9
Turkey	13.4	3.8
Poland	11.8	3.3
Kazakhstan	11.5	3.3
EU27	167.5	47.5

Source: Comtrade

Import Geographical Details - 2007	$ Bn	% on total
Total	199.7	100.0
Germany	26.5	13.3
China	24.4	12.2
Ukraine	13.3	6.7
Japan	12.7	6.4
USA	9.4	4.7
Belarus	8.9	4.5
South Korea	8.9	4.5
Italy	8.5	4.3
Francia	7.7	3.9
UK	5.6	2.8
EU27	85.1	42.6

Source: Comtrade

Broken down by product category, trade data sheds light on Russia's economic picture and its production structure. Given the abundance of mineral resources, exports mostly consist of minerals, for use both in the energy and non-energy sectors, which in 2007 accounted for around 65% of the total, and by a large number of metals (around 16% of total exports). The other categories of goods are less important. Imports mostly consist of machinery, equipment and means of transport. Chemical products used in the mining industry and in the processing of commodities and foodstuffs are the other main items purchased abroad. Over the past few years, the development of industrial activity has fuelled an ongoing increase in the demand for capital goods, which in 2007 accounted for over 50% of total imports.

Export Commodity Structure in % - 2007	
Total	100,0
Food, agricoltural products	2.6
Mineral products	64.7
Chemical products, rubber	5.9
Leather products, furs	0.1
Wood and paper	3.5
Textile and clothing, footwear	0.3
Metals and precious stones	16.1
Machinery and transports	5.6
Other	1.2

Source: GSK

Import Commodity Structure in % - 2007	
Total	100,0
Food, agricoltural products	13.8
Mineral products	2.3
Chemical products, rubber	13.8
Leather products, furs	0.4
Wood and paper	2.7
Textile and clothing, footwear	4.3
Metals and precious stones	8.2
Machinery and transports	51.0
Other	3.5

Source: GSK

2.2.2 Trade Agreements

The Russian Federation is a member of numerous economic bodies, also committed to encouraging the development of international trade, and in the past few years has signed several bilateral agreements. It has been part of the WTO with observer status since 1993.

International Agreements		
Russian Federation joins		from
APEC	Asia- Pacific Economic Cooperation	1998
ASEAN	Association South East Asian Nation	observer
EBRD	European Bank for Reconstruction and Development	1992
IBRD	International Bank for Reconstruction and Development	
IMF	International Monetary Fund	1992
OSCE	The Organization for Security and Co-operation in Europe	1994
UNCTAD	United Nation Conference on Trade and Development	
WTO	World Trade Organization	observer since 1993
EAEC	Eurasian Economic Community	1992
CIS	Commonwealth of Independent States	1994

Source: Various

2.2.3 Trade Specialisation

Trade specialisation with regards to Russia's exports sees the processing of oil products as the main area of activity, followed by mining and the processing of minerals and metals. Data published by the WTO, while still referred to 2006, allows a visualisation (see table below) of the structure of the country's sales abroad, and of the weight on the total exports of both Russia and the world, of each single category of goods. Delocalisation by foreign companies to the Russian territory is still limited to a handful of manufacturing sectors.

Specialisation of Main Export Cathegories - 2006

Industry	Export Value Mln $	% on tot. export	% on tot. world	Growth of annual export %	Growth of annual world export %	Net Trade	Specialisation index Balassa (1)	Specialisation index Lafay (2)
Mineral fuels	190010.7	63.1	10.8	36	30	188183.4	4.3	118
Commodities not els. Spec.	25145.4	8.3	7.8	20	21	17788.2	3.1	6
Iron and steel	17847.4	5.9	5.4	29	27	14267.4	2.2	6
Alluminium and articles thereof	7601.6	2.5	5.5	20	20	6935.5	2.2	4
Wood and articles thereof	6639	2.2	6.0	23	13	6137.7	2.4	4
Nickel and articles thereof	6027	2.0	20.8	32	34	5994.5	8.3	4
Boilers machinery, nuclears reactors	4947.4	1.6	0.3	14	14	-16915.8	0.1	-27
Copper and articles thereof	4494.3	1.5	3.3	48	40	4249.9	1.3	3
Organic chemicals	3069.8	1.0	1.0	28	16	2175.3	0.4	1

Note: (1) Specializzation Index Balassa: BI = (Quote of exp.sector A country B/total Exp. country B)/(Quote of exp.sector A/total world export) or BI = (Exp. sector A country B/world exp. sector A) x (World Exp./Total exp country B) If it is more than 1 there is specialization. (2) Specializationi Index Lafay: Considers export and import. It is more suitable to extimate a country that works for other countries (delocalization) LI = 100[(Xij-Mij)/(Xij+Mij)-Sk(Xik-Mik)/Sk(Xik+Mik)] (Xij+Mij)/Sk(Xik+Mik) Where: country i, good j, exp. X, imp. M If it is positive, there is specialization, if it is negative there is despecialization. Source: WTO

Specialisation of Main Export Cathegories - 2006

	Export Value Mln $	% on tot. export	% on tot. world	Growth of annual export %	Growth of annual world export %	Net Trade	Specialisation index Balassa (1)	Specialisation index Lafay (2)
Boilers machinery, nuclears reactors	21863.2	15.9	1.4	33	14	-16915.8	0.1	-27
Vehicles other than railway, tramway	18670.5	13.6	1.9	68	12	-16234.4	0.1	-24
Electrical, electronic equipment	14862	10.8	0.9	41	16	-12440.8	0.1	-19
Commodities not eslewhere specified	7357.2	5.3	2.0	15	32	17788.2	3.1	6
Pharmaceutical products	6220.7	4.5	2.1	41	17	-5993.9	0	-9
Plastics and articles thereof	4952.3	3.6	1.3	37	17	-4109.2	0.1	-6
Meat	4498.2	3.3	6.8	18	11	-4491.5	0	-6
Optical,tecnical, medical apparatus	3913.9	2.8	1.0	30	17	-3138.9	0.1	-5
Iron and steel	3579.9	2.6	1.1	53	26	14267.4	2.2	6

Note: (1) Specializzation Index Balassa: BI = (Quote of exp.sector A country B/total Exp. country B)/(Quote of exp.sector A/total world export) or BI = (Exp. sector A country B/world exp. sector A) x (World Exp./Total exp country B) If it is more than 1 there is specialization. (2) Specializationi Index Lafay: Considers export and import. It is more suitable to extimate a country that works for other countries (delocalization) LI = 100[(Xij-Mij)/(Xij+Mij)-Sk(Xik-Mik)/Sk(Xik+Mik)] (Xij+Mij)/Sk(Xik+Mik) Where: country i, good j, exp. X, imp. M If it is positive, there is specialization, if it is negative there is despecialization. Source: WTO

2.2.4 Trade with Italy

Italy is one of Russia's main trade partners, and the worth of trade between the two countries has grown consistently over time. Italy ranks second among the target markets of Russian exports, accounting for 6.4% of the total in 2007. In the same year, as a supplier of goods, Italy accounted for 4.3% of Russian imports.

According to data provided by ISTAT, trade in 2008 was worth almost EUR 26Bn. The rise in disposable income and industrial renovation opened up excellent opportunities for Italian companies, which have found an increasing number of purchasers for their products in the vast Euro-Asian territory.

Export/Import Italy vs. Russia

Bn €	2002	2003	2004	2005	2006	2007	2008
Export	3.8	3.8	5.0	6.1	7.6	9.6	10.5
Import	7.9	8.2	9.7	11.7	13.6	14.4	16.1

Source: ISTAT

Nonetheless, la Russia still accounts for a modest share of Italy's aggregate exports and imports, although trade flows in both directions are increasing. In the first ten months of 2008, Russia's share of total Italian exports was around 3%, and imports from the Russia accounted for just over 4% of the total.

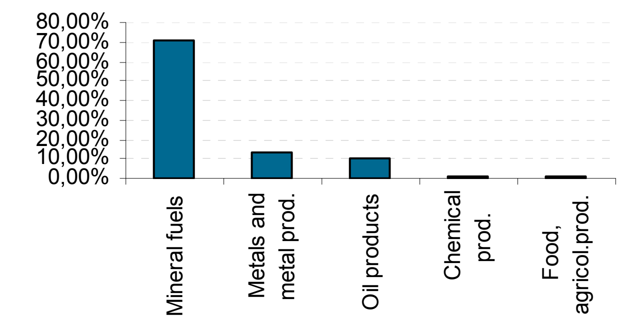
Russia on Total Italian Trade Balance

	2002	2003	2004	2005	2006	2007	2008
% Russia on tot Italian exp.	1.4	1.4	1.8	2.0	2.3	2.7	2.9
% Russia on tot italian imp.	3.0	3.1	3.4	3.8	3.9	3.9	4.3

Source: ISTAT

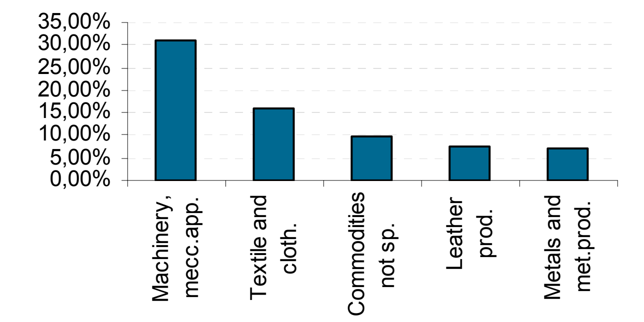
By product category, trade between Italy and Russia is characterised, among imports, by a prevalence of energy-sector minerals and derivatives, followed by metals and metal products. The exports of Italian companies to Russia mostly consist of machinery and tooling machines, as well as of typical "Made in Italy" sector products, such as textiles, clothing & apparel, and fashion accessories, followed by finished steel industry products. In its latest report, on the first half of 2008, ICE highlights Russia's increasing interest in Italian food products, supported by the population's rising disposable income. High-end and niche products are the most sought-after, such as those bearing the certifying quality marks: DOP (*Denominazione d'origine protetta*), DOC (*Denominazione d'origine controllata*), DOCG (*Denominazione d'origine controllata e garantita*), IGP (*Indicazione geografica protetta*), IGT (*Indicazione geografica tipica*), and STG (*Specialità tradizionale garantita*).

Import Italy - Russia (2008 % on Total)



Source: ISTAT

Export Italy - Russia (2008 % on Total)



Source: ISTAT

2.2.5 The Italian Districts[12]

In the past few years, Russia has represented an important source of growth for many Italian industrial districts, allowing many district companies to overcome the problems encountered on several traditional target markets, such as Germany and the United States.

An analysis of export flows originating from Italian industrial districts offers direct confirmation of the increasingly central importance of the Russian market: between 2000 and 2007, the share of district exports absorbed by Russia almost tripled, rising to 4.2% from 1.5%. This is a substantial share, which further increased in 1H08 (to 4.6%), and is significantly higher than the average Italian rate.

The importance of the Russian market for Italian industrial districts Italian is grounded in the high propensity towards exporting to Russia of manufacturers of furniture and household appliances, fashion system consumer goods, and machine tools. In these sectors, the share of exports addressed to Russia increased significantly, to over 5%, with peaks of 7.9% for furniture, 7.5% for clothing, and 7% for shoes.

Export to Russian Federation from Italian Industrial Districts

	Bn Euro		% tot.Export	
	2000	2007	2000	2007
Forniture and electric appl.	246.7	665.3	2.6	6.7
- Forniture	215.3	517.1	3.2	7.9
- Electric appliance	31.4	148.2	1.2	4.3
Fashion: consumer goods, of which:	387.5	1,107.50	2	5.5
- Clothes	88.8	462.2	1.7	7.5
- Footwear	185	426.1	2.9	7
.- Knitware and socks	91.9	89.6	4.2	5.7
- Jewelry	5.7	82.9	0.1	2.4
Mechanical instruments	86	400.1	1.4	5.1
Home system: manufacturers not sp.	17	145.1	0.6	3.5
Construction products	42.4	204	0.8	3.1
Metal products for industrial use	5.4	24.2	0.6	1.8
Fashion: intermediate goods, of which:	48.9	90.3	0.6	1.4
- Textile products	36.4	54.4	0.9	1.6
Food	19.3	36.5	1	1.2
Other productions	24.1	114.1	0.5	1.7
Total	877.3	2,787.00	1.5	4.2

Source: elaboration Intesa Sanpaolo on Istat

Propensity to export to Russia, while on the rise, is still moderate among producers of intermediate fashion system goods, due to the limited development of the Russian fashion system consumer goods industry, and in agricultural districts, also hindered by the lack of Italian retail chains in the country. The low propensity of Italian agricultural districts to export to Russia does not necessarily imply a limited presence on the Russian territory, as several important district food sector companies market their products in Russia through local production facilities.

When an analysis by single industrial district is carried out, the share of exports absorbed by Russia emerges in some cases as being as high as 30%: this was the case, for instance, of the San Mauro Pascoli shoe district, which experienced sustained export growth in 1H08, thanks to the brilliant performance achieved on the Russian market. A similar trend was observed in other small and medium-sized districts (such as the Rimini clothing district, and Neapolitan shoes). Russia is also a very important market for some of Italy's major industrial districts, specialised in

[12] Written by Giovanni Foresti and Stefania Trenti

shoes (Fermo), furniture (Livenza and Quartier del Piave, Brianza, Pesaro), and machinery (Bologna packaging machinery district).

The success of the Italian districts on the Russian market was also aided by Russia's production specialisations, lacking in the fashion system and in the home and interior design sectors. In these two latter sectors, along with Machine tools (typical district specialisations), Italian presence in Russia has increased significantly.

In the closing months of 2008, however, a sharp trend reversal was recorded: the economic and financial crisis has not spared the Russian economy, also hit by the sudden downturn in energy commodity prices. In this context, the figures available to date (aggregate data) reveal a serious deterioration in the trend of district product exports to Russia as of October, leading up to a sharp decline in January 2009.

First 35 Italian Industrial Districts in Terms of Export to Russian Federation

	Bn Euro		% tot. Export		
	2000	2007	2000	2007	I sem 2008
Shoes of Fermo	122.2	245.6	7.7	15	15.7
Forniture of Livenza nad Piave river valleys	78.8	193	5.1	9.1	10.7
Taps and Pots of Lumezzane	23.1	151.6	1.9	5.6	4.9
Forniture and wood of Brianza	39.8	137.3	2.8	8.2	7.8
Cooker hoods and electric appliance of Fabriano	19.2	114.2	1.7	6	7.8
Packaging machinery of Bologna	43.8	107	4.1	6.4	7
Tiles of Sassuolo	15.1	98.1	0.6	3.5	3.8
Machine-building of Vicenza	13.1	93.2	1.3	8	11.4
Clothes of Rimini	19.6	69.4	9.5	17.3	16.4
Textile and clothes of Treviso	34.6	68.6	2.4	4.9	4.8
Clothes of Empoli	10.3	65.8	1.2	6.5	7
Textile and clothes of Seriana Valley	7.2	64.6	0.8	8.5	8.6
Forniture of Pesaro	38.9	62.1	7.6	14.8	15.2
Shoes of San Mauro Pascoli	16	61.1	11.9	26	28.2
Footware of Brenta	10.3	54.5	1.8	7.8	8.4
Textile of Prato	33.8	53.7	1.6	3.4	3.4
Thermomachinery of Verona	3.8	51.8	0.6	4.8	5.3
Textile and clothes of Schio-Thiene-Valdagno	9.7	51.2	0.7	3.5	4.2
Socks of Castel Goffredo	71.9	51	14.7	10.5	7.8
Jewelry of Vicenza	2.8	49.9	0.1	3.5	2.8
Machine-building of Varese	9.4	45.7	1.1	4.6	8.3
Knitware and clothes of Carpi	6.8	44.9	1	5.8	7.6
Metalworking of Brescia and Brescian Valley	6.6	40.8	0.5	1.3	1
Artistic forniture of Bassano	13.4	39.8	3.2	11.7	14.7
Clothes of Napoli	7.4	38	3.7	13.7	14.1
Machine-building of Brescia	3.6	37.7	0.5	4.1	4.6
Clothing of South Abruzzo	3.9	33.1	2.2	7.4	8.5
Plastics of Treviso, Vicenza and Padova	5	32.1	0.8	3.5	4
Machine-building of Seriana Valley	3.9	29.9	0.6	3.8	3.5
Chairs and tables of Manzano	8.9	29	0.9	4.3	4.9
Metalworking of Mantova	7.5	25.6	1.3	3.6	3.3
Leather of Florence	3	23.9	0.2	1.3	1.9
Tools machinery and woodworking machinery	5.2	21.7	1.9	5.5	8.5
Shoes of Napoli	2.4	17.5	1.2	10.2	14.8
Food machinery di Parma	1.7	17.4	0.6	4.7	6.9

Important: districts are listed on value of exports in 2007; Source: elaboration Intesa Sanpaolo on Istat data

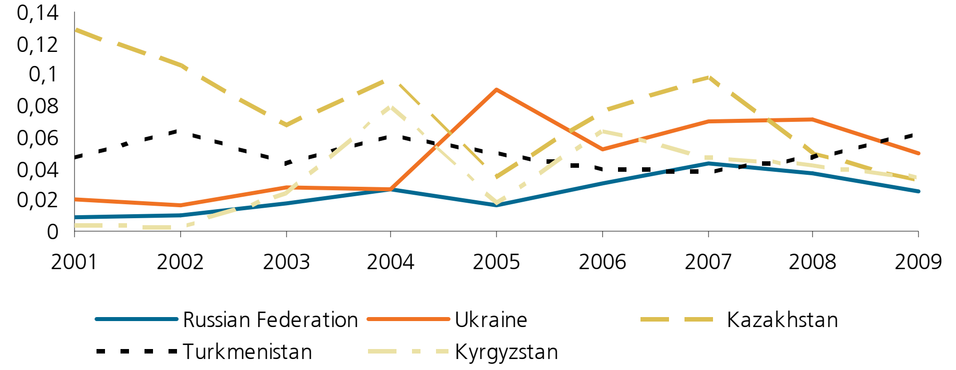
2.3 Foreign Direct Investments

In recent years, Russia has enjoyed a considerable increase in direct investment inflows from abroad, which nonetheless remain smaller than the potential of the economy could command. In the past, the cumbersome bureaucratic apparatus is thought to have affected the trend of

FDI. A further obstacle was the uncertainty tied to the reform process required to complete the Russian economy's transition to a market economy. The situation is gradually improving, thanks to the efforts being made to improve the economic-productive set up in line with the standards of mature countries, and to integrate the country in the international economy. In May 2008, a new law was approved that lists the sectors in which foreign investments must be authorised beforehand, clarifying what had been a rather uncertain situation until then.

In the first three quarters of 2008, according to data provided by the central bank, around USD 52Bn flowed into the Russian Federation. EIU estimates set the whole-year FDI figure at USD 60Bn. Due to the effects of the international economic and financial crisis, EIU expects FDI to contract to around USD 30Bn in 2009.

Flows of FDI on GDP in some CIS Countries



Source: EIU (2008 estim. – 2009 forecast)

Data on the trend of Russian FDI addressed to foreign productive assets are also interesting. Such flows have increased consistently in recent years, exceeding the USD 45Bn mark in 2007, or around 20% of GDP (source: UNCTAD), thanks to the increasing international openness of local companies to investments.

Trend FDI

Flows Bn $	1990/2000*	2004	2005	2006	2007
Inward	2.4	15.4	12.9	32.4	52.5
Outward	1.6	13.8	12.8	23.2	45.7
Stock Bn $		1995	2000	2006	2007
Inward		5.6	32.2	271.6	324.1
% of GDP			12.4	27.9	25.1
% of GDP			7.8	21.3	19.8

Source: UNCTAD (* annual avarage)

Based on UNCTAD data, up to 2007 Russia had attracted FDI for a total worth of USD 324Bn, corresponding to around 25% of GDP in the same year. The rate is in line with Brazil's, but well above the rates recorded in China and India. On the other hand, FDI outflows from Russia are significantly higher, in relation to GDP, than in other BRIC countries.

International Comparison Stock FDI/GDP 2007		
Russia	Inward	25.1
	Outward	19.8
China	Inward	10.1
	Outward	3.0
India	Inward	6.7
	Outward	2.6
Brazil	Inward	25
	Outward	9.9
CIS	Inward	26.0
	Outward	16.4
USA	Inward	15.1
	Outward	20.2

Source: UNCTAD

The European economies are the ones that have invested most in Russian companies. However, figures are distorted in part by the investment flows channelled through the foreign subsidiaries of parent companies. An important role is also played by tax havens, often used to overcome the limitations imposed by the countries of origin of the investments.

Main Investors (Stock June 2008)	% on total	Bn $
Cyprus	23.4	56.8
Netherlands	18.3	44.3
UK	12.9	31.4
Luxembourg	12.6	30.5
Germany	5.5	13.2
USA	3.9	9.4
Ireland	3.3	8.1
France	2.8	6.7
Virgin Island	2.4	5.7
Italy	n.d.	n.d.

Source: Central Bank

Main Investors (Flows Jan/Sept. 2008)		
Total	% on tot.	52,2Bn $
Cyprus	244.0	18.3
Netherlands	117.3	8.8
Bermuda	100.0	7.5
UK	49.3	3.7
Germany	32.0	2.4
Virgin Islands	29.3	2.2
USA	26.7	2
Finland	21.3	1.6
Italy	13.3	1
Switzerland	10.7	0.8

Source: Central Bank

Russian FDI outward flows have a geographical structure similar to the inward flows.

FDI Flows from Russia to other Countries (Mln $)	2007
Cyprus	15,352
Netherlands	12,688
Bermuda	2,693
UK	2,433
Ukraine	1,519
Virgin Islands	1,450
Switzerland	1,428
USA	969
UAE	901
Italy (29°)	87

Source: Central Bank

The interest shown in recent years by Russian companies in the CSI has been mostly focused on the largest producers or distributors of energy products (Ukraine, Belarus, and Kazakhstan). A similar trend is also evident in the investments made in Russia by the other former USSR economies.

Russian FDI in CIS Countries				
% on total	2000	2005	2006	2007
Azerbaijan		1.1	0.2	0.3
Armenia		22.3	0.1	0.1
Belarus	59.0	16.5	13.8	48.7
Georgia	0.1			
Kazakhstan	2.6	32.9	4.6	16.5
Kyryzstan		0.2	2.7	7.7
Moldova	23.8	0.8	1.1	0.2
Tadjikistan		0.1	0.5	3.9
Turkmenistan	2.3			
Uzbekistan	0.7	1.1	4.3	3.6
Ukraine	11.5	25.0	72.7	19.0
Total Bln $	131.0	620.5	4127.8	2696.8

Source: Central Bank

CIS FDI in Russian Federation				
% on total	2000	2005	2006	2007
Azerbaijan	3.7	3.3	2.4	2.0
Armenia		0.3	0.1	0.5
Belarus	4.5	26.9	20.6	20.5
Georgia	0.9	0.5	0.1	0.2
Kazakhstan	25.2	44.0	36.8	31.4
Kyryzstan	3.8	8.4	14.9	11.4
Moldova	4.8	1.1	0.6	0.5
Tadjikistan	0.1	0.8	0.6	0.7
Turkmenistan	4.6	0.1		0.1
Uzbekistan	12.2	0.6	0.7	1.3
Ukraine	40.2	14.0	23.2	31.4
Total Bln $	22.4	1665.3	3032.1	4671.4

Source: Central Bank

Italy does not rank among the ten top investors. However, it should be noted that many of the largest Italian companies (ENI and ENEL first among them) have invested in Russia also through their foreign subsidiaries (source: ICE). Therefore, Russia accounts for a very modest share of total Italian FDI, of around 0.04% of the total.

Gross FDI Flows from Italy to World (Bn €)										
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Russia	188	3.9	8.4	29.5	12.8	14.2	64.8	57.6	31.3	42.5
% of world	0.63	0.01	0.03	0.06	0.03	0.04	0.18	0.11	0.04	0.04
World	29825.7	26664.6	31215.7	47142.5	36909.1	38375.5	36825.7	51404.3	74329.2	101677.9

Source: ICE on Bank of Italy data

On ICE data, the main italian firms in Russia are ENI and ENEL, although the presence of other companies is also noteworthy. These include: AGIP, Alenia, B.Ticino, Benetton, Camozzi, Candy, Cremonini, Danieli, De Longhi, Esaote, Fantuzzi, Ferrero, Fiat, Finmeccanica, Gewiss, Indesit, Italtel, Lavazza, Mapei, Martini & Rossi, Marrazzi, Marconi, Martini Rossi, Merloni Elettr., Parmalat, Perfetti, Pirelli, Riello, Rossetti, Tecnimont, Telecom It. and Welco, as well as many other medium-sized companies which operate in a variety of business sectors.

Relations between ENI and Gazprom are by now well-established, and not limited to collaboration in production, as direct investments are also in place. ENEL also holds large shareholdings in many Russian companies active in the production and distribution of electric power. Following the agreements signed last March between the Italian and Russian governments, Alenia has acquired a stake in Sukhoi Civil Aircraft Company, and will collaborate with Yakovlev in the civil aviation industry. Fiat has confirmed the launching of a joint venture with Avtovaz, and will invest around USD 800Mln in the production of diesel and gasoline engines, and in the manufacture of motor vehicles in the Togliattigrad area. Iveco signed a contract in June 2007 for the construction of a motor vehicle production chain near Nizhiniy Novgorod. Pirelli & C. has entetred into a joint venture with the State Corporation Russian Technologies, for the production and sale tyres, light and industrial vehicles, and metal components for tyres.

The main Russian names present in Italy include Severstal, which has acquired control of Lucchini steelworks, and Gazprom, which has obtained from ENI access to the distribution of Russian gas on the Italian market, through A2A and Iride. Lukoil controls 49% of Raffinerie Mediterranee (ERG), which owns the oil refinement pole in the Siracusa area.

FDI Destination - Stock in % at 2007			
Total investments			100.0
agriculture, hunting and forestry fishing and fish farms			0.9
mining and quarrying			28.9
of which:			
	mining and quarrying of energy producing materials		97.5
	mining and quarrying of other mat.		2.5
manufacturing			39.2
of which:			
	manufacture of food products		13.6
	manufacture textile and textile products		0.3
	manufacture of leather and footwear		0.0
	manufacture of wood products		3.7
	manufacture of pulp, paper products;		2.6
	publishing and printing		0.0
	manufacture of refined petroleum		12.6
	manufacture of chemical products		3.1
	manufacture of rubber and plastic prod		2.5
	manuf. of other non-metallic prod		5.3
	manufacture of basic metals		49.7
	of which:	manuf. of basic metals	96.4
	manuf. of machinery and equipment		3.4
	manuf. of electrical, electronic equip		1.9
	manufacture of transport equipment		2.8
	including:		
		manuf. of motor vehicles	96.0
		manuf. of ships, aircraft and spacecraft	4.0
electricity, gas and water supply			0.5
construction			1.4
trade			8.3
hotels and restaurants			0.3
transport and communication			3.6
of which	communication		21.4
	transports		78.6
financial intermediation			4.9
real estate and business activities			11.3
of which:			
	maintenance of housing stock		0.4
	research and development		1.0
public administration and defence			0.0
education			0.0
Health and social work			0.1
other personal service activities			0.6

Source: Central Bank

The largest investments in Russia's European regions are concentrated on the steel and mechanical industries, light industry, and the chemical and food sectors. Numerous small and medium enterprises are present in these regions, with Italian investments mostly addressed to the production of typical "Made in Italy" products. (See Appendix).

In the Urals, Siberia and the Far Eastern regions, investments are mostly addressed to the mining sector, minerals and energy. (See Appendix).

2.4 Industrial Structure

2.4.1 Production Breakdown

National accounts data fail to provide an accurate picture of the energy and mining business, a key sector of the Russian economy, as part of the activity in the field is charged to different items, such as trade (distribution of oil and gas via pipelines, for instance). The manufacturing sector makes an important contribution to creating national wealth, and in 2008 accounted for 17.3% of GDP. The main sectors of activity are the processing and transformation of commodities.

The largest Russia corporations are active in the energy, mining and minerals sector. The major industrial giants are world leaders in the production and distribution of oil and natural gas. Metallurgic and metal processing companies are also prominent.

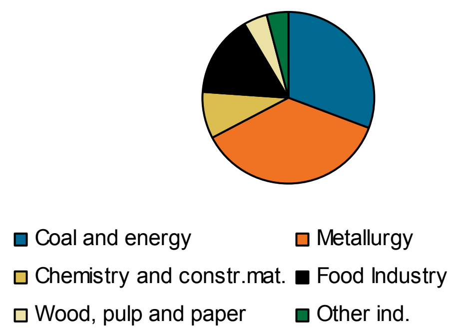
The other business sectors, considered of secondary importance at present, in many cases hold vast potential for growth and development.

Composition GDP – Employment by Kind of Activity

	GDP 2008 %	Empolym. 2007 %
Agriculture	4.7	10.0
Fishing	0.2	0.2
Mining and quarrying	9.2	1.5
Manufacturing	17.3	16.8
Electricity, gas and water supply	3.0	2.8
Construction	6.4	7.8
Wholesale and retail trade	20.7	17.4
Hotels and restaurants	0.9	1.8
Transport and communication	9.4	8.0
Financial intermediation	4.7	1.5
Real estate, rent.and business act.	11.0	7.4
Public administration and defence	5.0	5.2
Education	2.6	8.8
Health and social work	3.2	6.8
Other community, social and personal service act.	1.8	3.8

Source: GSK

Structure of Russian Manufacture Industry - 2005



Source: GSK

After the crisis of the 1990s, during the initial phase of Russia's transition to a market economy, industrial development began at a lively pace starting in 1998. In the last five years especially, industrial production has experienced significant growth, most notably in the mining & minerals and manufacturing sectors, and holds interesting development potential, the current negative phase of the global economic cycle notwithstanding. The important role played in Russian industry by the processing of commodities will inevitably determine a slowdown in production in 2009. As a result of the slowdown of the world economies, and of the decline in the quotations of minerals and metals, the industrial sector's contribution to GDP is estimated by EIU to drop by around 4% y/y. The industrial production index already suffered significant setbacks in the last quarter of 2008, slowing at the sharpest rates 10 years, and pointing to a negative trend for full-year 2009 as well.

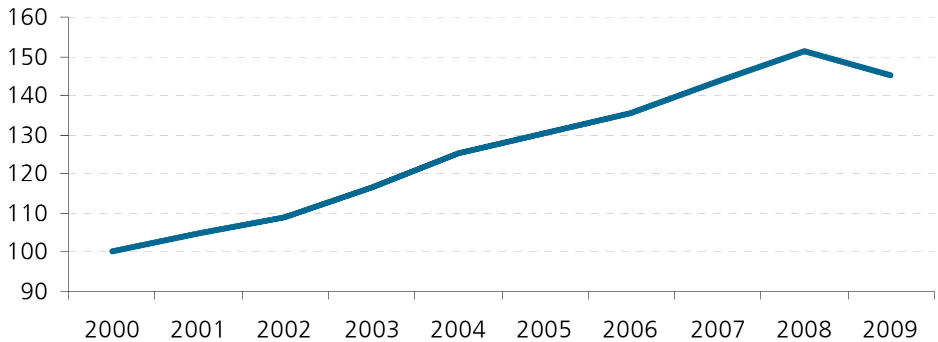
Starting in 2005, Special Economic Zones have been established, dedicated to industrial production, technological research, the promotion of tourism, and port infrastructures. They are located in different areas of the country and offer numerous fiscal, administrative and structural incentives. (See box).

Production Indices (2000 = 100)

		2004	2005	2006	2007	2008*
Mining and quarrying		131.5	133.4	136.7	139.3	140.0
	mining and quarrying of energy prod. mat.	135.2	137.9	141.4	144.1	144.3
	mining and quarrying. except of energy prod. mat.	106.0	103.5	106.2	107.8	111.0
Manufacturing		125.7	135.3	146.5	160.4	173.9
	Man. of food products	129.4	138.0	147.7	156.7	164.6
	Man. of textile and textile prod	102.1	106.0	118.8	117.1	119.7
	Man. of leather and leather prod.	140.6	140.6	171.6	171.6	184.5
	Man. of wood and wood prod.	121.1	129.6	134.1	142.4	161.3
	Man. of pulp. paper and paper prod. publishing and printing	129.2	133.9	143.2	156.3	167.1
	Man. of coke. refined petroleum prod.and nuclear fuel	112.5	117.5	125.8	129.5	133.8
	Man. of chemicals. chemical prod. and man-made fibers	112.9	117.5	123.1	130.5	135.0
	Man. of rubber and plastic prod.	121.7	141.7	172.4	210.5	243.4
	Man. of other non-metallic mineral prod.	122.1	128.0	140.7	163.3	177.9
	Man. of basic metals and fabricated metal prod.	122.6	131.1	144.0	147.0	150.0
	Man. of machinery and equipment n.e.c.	139.9	139.6	152.6	181.7	200.6
	Man. of electrical. electronic and optical equipment	192.7	256.7	298.7	334.0	308.2
	Man. of transport equipment	92.7	99.2	103.2	119.0	139.0
	Man. n.e.c.	137.7	149.7	167.9	176.5	200.8
Electricity. gas and water supply		110.9	112.0	117.4	117.2	122.0

Source: GSK (*2008 – 1° half year)

History Production Index (2000 = 100)



Source: EIU (2008 –estim. 2009 –forecast)

2.4.2 Territorial Distribution of Production

Geographically, the Russian Federation may be divided into seven Districts, each of which includes numerous regions[13]. The vastness of the territory, and the considerable difference in terms of climate and geomorphology, combine to create a variety of environmental and human structures, as well as an immense wealth of natural resources, as is rarely the case elsewhere on the planet. From an administrative point of view, the country is divided into 48 Regions (*Oblastey*), 1 Autonomous Region (*Avtonomnaya Oblast'* – Jewish Autonomous Region) - 21

[13] Federal Constitutional Law 14.10.2005 and following, 6-FKZ, January 1st 2007

Republics (*Respublik*), 2 Federal Cities (*Goroda* – Moscow and St. Petersburg), 7 Districts (*Krayev*) and 7 Autonomous Territories (*Avtonomnykh okrugov*).

Geographical Details of Russian Federation

Source: Regionirusse (Informest)

The Districts of the Russian Federation

1 - Central Federal District	2 - South Federal District	3 – Privolzhsky (Volga) Federal District	4 - North West Federal District	5 - Urals Federal District	6 - Siberian Federal District	7 - Far East Federal District
Belgorod	Republic of Adygeya	Republic of Bahkortostan	Arkhangel'sk	Chelyabinsk	Aginsky Buryat	Amur
Bryansk	Astrakhan'	Republic of Chuvashiya	Republic of Kareliya	Khanty - Mansi	Republic of Altai	Chukotka
Ivanovo	Republic of Chechnya	Kirov	Kaliningrad	Kurgan	Altay	Kamchatka
Kaluga	Republic of Dagestan	Republic of Mariy El	Republic of Komi	Sverdlovsk	Republic of Buryatiya	Khabarovsk
Kostroma	Republic of Ingushetiya	Republic of Mordoviya	Leningrad	Tyumen'	Irkutsk	Koryaks
Kursk	Republic of Kabardino-Balkariya	Nizhny Novgorod	Murmansk	Yamalo - Nenets	Kemerovo	Magadan
Lipetsk	Republic of Kalmykiya	Orenburg	Nenets		Republic of Khakasiya	Primorskiy
Moscow	Republic of Karachayevo-Cherkesiya	Penza	Novgorod		Krasnoyarsk	Jewish Autonomous Region
City of Moscow	Krasnodar	Perm'	Pskov		Novosibirsk	Republic of Sakha Yakutia
Oryol	Republic of North Ossezia - Alania	Permyak	City of Saint Petersburg		Omsk	Sakhalin
Ryazan'	Rostov on Don	Samara	Volgoda		Tomsk	
Smolensk	Stavropol'	Saratov			Republic of Tyva	
Tambov	Volgograd	Republic of Tatarstan			Ust-Ordin Buryat	
Tula		Republic of Udmurtiya			Zabaykal'sk	
Tver'		Ul'yanovsk				
Vladimir						
Yaroslavl'						

Source: Regionirusse (Informest)

In the Western and Central regions the density of the population, and consequently of the manufacturing and services industries, is high. The Urals Federal District, and the Far Eastern

District, have a particular vocation for the mining industry, given the abundance of mineral resources, but are scarcely inhabited due to the inhospitable weather conditions.

Regional Production Details % on Total - 2006

	Central	South	Privolzhsky (Volga)	North West	Urals	Siberia	Far East
Mining and quarrying	4.3	6.6	17.5	13.6	57.8	17.6	47.1
Manufacturing	81.8	76.2	71.1	74.7	35.5	68.6	28.2
Electricity, gas and water supply	13.9	17.1	11.4	11.7	6.6	13.9	24.7

Source: Regionirusse (Informest)

Regional weight on National Production (% on tot) - 2006

Central	South	Privolzhsky (Volga)	North West	Urals	Siberia	Far East
24.2	6.1	22.3	10.5	21.9	11.8	3.1

Source: Regionirusse (Informest)

People (Mln – 2006)

Central	South	Privolzhsky (Volga)	North West	Urals	Siberia	Far East
37.4	13.6	22.8	30.5	12.2	19.7	6.5

Source: Regionirusse (Informest)

Further details on the morphological and productive characteristics of the Russian territories are provided in the Appendix.

Box 4: Special Economic Zones – SEZ

Special Economic Zones were established in Russia by Federal Law n. 116 of 22 July 2005, subsequently amended by Law n. 76 of 3 June 2006.

There are currently four kinds of Special Zones: Industrial Production zones, Technological Innovation zones, Tourist zones, and Ports.

The main aims of the SEZ are to:

- develop hi-tech sectors
- expand new types of manufacturing, and develop products capable of replacing imported products
- enhance transportation infrastructures
- encourage and develop tourism and health tourism (thermal resorts, sanatoriums, rehabilitation centres)

There are two industrial production SEZ at present:

- in the Lipetsk region
- in the Republic of Tatarstan (which also enjoys export incentives)

Companies intending to establish activities in the zones must satisfy a number of geographical, administrative and economic requirements.

The Technological Innovation SEZs are located:

- in the St. Petersburg region
- in the Zelenogradsky (Moscow) administrative district
- in Dubna, in the Moscow region
- in Tomsk, in the Tomsk region

Companies wishing to operate in these areas must be active in the sector of technological innovation, and have specific geographical, administrative and economic characteristics.

The Tourist SEZs are located:

- in the Kaliningrad region

- in the Krasnodar territory
- in the Stavropol territory
- in the Altai territory
- in the Republic of Altai
- in the Republic of Buryatia (Baikal)
- in the Irkutsk region

Companies intending to establish activities in these zones must meet specific geographical, administrative and economic requirements.

Law n. 240 of 30 October 2007 also assigned SEZ status to a number of sea and river ports, and airports, with the aim of supporting and developing infrastructures and trade flows.

Investors enjoy administrative benefits, for instance simplified financial reporting obligations, a particular social contribution regime on wage incomes, lower or all together absent local estate taxes and custom duties, for a period of around 20 years (49 years for Infrastructure SEZs). Companies must invest at least one million euros in their first year of activity, and a total of EUR 10Mln in the following fiscal years.

There are also a number of Free Economic Zones, aimed at encouraging the production of export goods and import replacement goods, mostly located in areas well connected at both the domestic and international level in terms of infrastructures.

- Agidel and Kumertau, in Bashkortostan
- Yantar, in Kaliningrad
- in the City of Moscow
- Nahodka, in Primorsky:

Some SEZs have been established to encourage foreign investments:

- in the Magadan region

The Ministry of Economic Development of the Russian Federation creates new SEZs every year, resorting to a competition system among all the candidate regions (final decision made by a Competition Committee).

2.4.3 Natural Resources

Russia is undoubtedly one of the richest countries in terms of mineral resources in the world. Its vast territory includes several regions with a high concentration of commodities.

The most important coal and iron fields are located in the Urals and in the European part of Russia. Large oil and natural gas fields are located in the entire area between the Caucasus and Siberia, and the Eastern-most reaches of the country, also rich in gold, platinum, diamonds, copper, nickel, tin, uranium, beryllium, cobalt, manganese, tungsten, zinc, phosphates, and chrome.

Russia is the world’s largest producer of natural gas, accounting for 22.1% of global production. The network of gas pipelines which crosses the entire country is as dense as it is extensive, and reaches the main European and Asian countries, although a significant portion of gas is still transported by ship via the main ports of the North Pacific, the Black Sea, and the Caspian Sea. Amounting to around 10 million barrels a day, or approximately 11.7% of the entire world production, Russia’s offer of oil is second only to Saudi Arabia’s. The oilfields, while very large, require major investments to improve productivity, and the exploration and development of new oil wells is increasingly important. Extreme weather conditions in the regions being explored feed the demand for capital and advanced technology. According to EIA, overall supply from Russia could increase over the next few years at a rate of 1.5-2.5%, mostly thanks to the Sakhalin Island oilfields. Electricity is mostly generated in thermal power stations, fuelled with gas and coal, although hydroelectric generation is also widespread. There are 31 active nuclear power plants in the country.

ENI entertains well-established industrial relations with Gazprom, also thanks to the construction of major infrastructures, such as the "Blue Stream" pipeline, which connects the Russian natural gas fields with Turkey, crossing the Black Sea, and the "South Stream" pipeline, under construction, which will connect Southern Russia to Europe, also with an offshore section. Facilities on the Island of Sakhalin, where one of the largest oilfields in the world is located, have mostly been built by ENI, which also owns important stales in several Russian energy companies. ENEL also directly operates many thermoelectric power stations, and has large shareholdings in sector companies. It plans to step up these shareholdings upon liberalisation of the electricity market, to be completed by 2011.

Main Natural Gas Producers - 2006

	Bn m^3	% of world
World Total	2969	
Russia	656	22.1
Usa	525	17.7
Canada	185	6.2
Iran	105	3.5
Norway	90.5	3.0
Algeria	87	2.9
UK	80.1	2.7
Netherland	77	2.6

Source: EIA

Main Oil Producers - 2007

	Bn b/d	% of world
World total	84.4	
Saudi Arabia	10.2	12.1
Russia	9.9	11.7
USA	8.5	10.1
Iran	4.0	4.7
China	3.9	4.6
Mexico	3.5	4.1
Canada	3.4	4.0
UEA	2.9	3.4

Source: EIA

Natural Gas Reserves - January 2009

	(Bn'000 m^3)	% of world
World Total	177.1	
Russia	47.57	26.9
Iran	26.85	15.2
Qatar	25.6	14.5
Saudi Arabia	7.2	4.1
USA	6.7	3.8
UAE	6.1	3.4
Nigeria	5.2	2.9
Venezuela	4.7	2.7

Source: EIA

Oil Reserves - January 2008

	Bn Barrels	% of world
World total	1331.7	
Saudi Arabia	266.8	20.0
Iran	138.4	10.4
Iraq	115.0	8.6
Kuwait	104.0	7.8
Un.Arab Emirates	97.8	7.3
Venezuela	87.0	6.5
Russia	60.0	4.5
Libya	41.5	3.1

Source: EIA

The wealth of minerals and metals available in large amounts makes Russia one of the main suppliers of natural reserves. Russia ranks as one of the main producers of nickel, asbestos and mica.

The production of wood is also impressive, lumbered in the vast forests which cover a large part of the Russian territory. (See Appendix).

Range of Russia on Production and Reserve of Minerals - 2006

Prodution	% of World	Range	Reserves % on World	Range
Aluminum	11.2	2	n.a.	n.a.
Antimony	2.5	5	9.5	2
Arsenic	2.5	5	n.a.	n.a.
Asbestos	40.2	1	wide	
Bauxite	6.2	7	0.8	13
Boron	8.4	5	24.4	2
Cadmium	5.3	8	0.02	8
Cement	2.2	6	n.a.	n.a.
Cobalt	8.9	5	2.7	9
Copper	4.7	8	3.2	11
Diamonts	17.6	3	5.0	6
Fluor	3.9	6	3.8	5
Gold	6.5	6	40.0	1
Gypsum	2.0	12	n.a.	n.a.
Helium	4.1	4	16.8	4
Iron and Steel	6.1	3	5.8	4
Lime	6.5	4	n.a.	n.a.
Lithium	10.4	4	n.a.	n.a.
Magnesium (comp)	8.1	4	20.3	3
Magnesium (metal)	7.7	2	n.a.	n.a.
Mica	35.7	1	wide	
Mica (natural)	28.8	2	wide	
Mineral of Iron	6.2	5	15.1	3
Mobildeno	1.7	6	1.9	6
Nickel	20.6	1	6.6	6
Nitrogen and Ammonia	8.2	3	n.a.	n.a.
Peat	7.8	4	50.0	1
Phospahtes	7.6	4	2.0	7
Platinum	14.3	2	87.5	1
Potassium	17.7	2	12.9	2
Precious Stones	20.9	2	n.a.	n.a.
Rhenium	3.1	6	4.0	5
Salt	1.2	15	n.a.	n.a.
Silicon	12.8	2	n.a.	n.a.
Sulfur	10.6	4	n.a.	n.a.
Tin	1.2	6	3.2	7
Titanium	29.1	2	1.0	15
Tungsten	6.1	2	6.8	3
Vanadium	30.1	2	31.6	2
Vermiculite	4.8	6	n.a.	n.a.

Source: US Geological Survey - Mineral Commodity Summaries

2.5 Infrastructures

Infrastructural development on the Russian territory has been considerable in recent years. Thanks to this process, the country can now count on a more extensive network of connections and services, greater than in other major emerging economies, such as China and India. The trend of the infrastructure index, as calculated by the EIU, highlights the commitment of Russian authorities to improving the system of public services, to support the country's productive and industrial development. Obviously, limitations exist tied to the extreme weather conditions in some peripheral regions, which remain hard to reach.

The transportation network, quite far-reaching already in the past, has been improved, conferring added value to the utilization of the natural resources available, and to industrial settlements.

The extensive network of oil and gas pipelines connects the country with both Europe and Asia.

Infrastructure Index (maximum value = 10)

	2005	2006	2007	2008	2009
Russia	5,6	5,7	5,9	6	6,1
China	4,8	5	5,3	5,5	5,8
India	3,4	3,6	3,8	4	4,3
Brazil	5,9	6,1	6,2	6,3	6,5

Source: EIU (2008 estim. - 2009 forecast)

Index of Main Infrastructure Index

	Russia	China	India	Brazil
Electricity prod. Kwh per inhab.	7221,0	2448,1	579,5	2219,8
Telephone lines every 100 inhab.	31,2	27,5	3,4	20,0
Paved Roads Km/Country area	0,04	0,17	1,12	0,01

Source: CIA

Appendix
Morphological and productive characteristics of Russian Federal Regions

1 – Central Federal

	Territory characteristics	Natural resources
Belgorod	80% agricultural	water, iron, wood
Bryansk	50% forests	phosphate rocks, chalk, silicates, conifers
Ivanovo		clay, silicates, sands, peat
Kaluga	46% agricultural, 43% forests	coal and peat
Kostroma		water, wood
Kursk		Met. and non-met. minerals, phosphate rocks, peat
Lipetsk	forests	peat, clay, sands, lime, iron, lignite, phosphate rock, dolomite
Moscow	forests	construction materials, water, wood
City of Moscow	10.4Mln inhabitants	
Oryol	80% agricultural	minerals met, lignite, peat, water
Ryazan	forests	cereals, livestock, bees, wood
Smolensk	43.3% agricultural	cereals, potatoes, flax
Tambov		sands, zirconium, min pigments, phosphate rocks, wood, construction materials
Tula	75% agricultural	lignite, rock salt, iron, ferrous metals, wood
Tver	56% forests	water, wood, peat (reserves 2.051 Bn Tons)
Vladimir	50% forests	peat, limestone, sands, clay – non-energy
Voronezh		water, clays, sands, chalk, marble, limestone, zeolites, phosphate rocks
Yaroslavl	40% forests, 32% agricultural	

Source: Regionirusse (Informest)

	Industries	SMEs*	Foreign industries	Relevance of Italy	Characteristics
Belgorod	ferrous metals, agricultural & food, metal & mech., chemical and petrochemical, constr. mat.	32.80%	no		High pollution
Bryansk	mechanical engineering, metalworks, agricultural & food, constr. materials, glass, wood, paper and cellulose	10%	no		Annual prod. Of wood: 1.6 Mln m3
Ivanovo	Light industry, energy, mechanical engineering, metalworks	n.a.	no	yes***	*** Imports cotton fibre, raw agricultural prod., plastics, oil proc. prod. from Italy
Kaluga	stock farming, nuclear energy developing, aerospace ind., radio prod.	23.71%			Primary sector relevant
Kostroma	energy, wood, paper and cellulose, mechanical engineering, metalworks		yes***		***Main investors S, SF, CH, P
Kursk	ferrous metals, energy	yes	yes***		***main investors D, SL, CK, NL
Lipetsk	ferrous metals, agricultural & food, mechanical engineering, metalworks	25%		yes	Presence of Italian SMEs and large groups.
Moscow	agricultural & food, mechanical industry, metalworks, energy, construction mat., chemical and oil, furniture	22.20%	yes***	yes	
City of Moscow	agricultural & food, mechanical engineering, metalworks		yes***	yes	25% of retail sales in Russia
Oryol	agricultural & food, metal & mech., energy, constr. materials, ferrous metals	yes			Very limited FDI
Ryazan	met. & mech. ind., energy, oil ref., construction mat., light industry, chemical, non-ferrous metals				Well-developed, underused transportation system
Smolensk	energy, jewellery, petrochemical, textile and clothing	12.40%			High tourism potential, excellent transportation
Tambov	mechanical engineering, metalworks, agricultural & food, energy, chemical, petrochemical	19.20%	yes***		*** Main investors D, Cyprus
Tula	ferrous metals, chemical, petrochemical, drinks, mechanical engineering, metalworks	n.a.			Large metallurgical centre
Tver	wood processing, furniture, paper and cell, agricultural & food, glass, printing, light industry, mech. engin., metalworks, construction mat.				Tourism relevant
Vladimir	mechanical engineering, metalworks, agricultural & food	yes			
Voronezh	agricultural & food, mechanical engineering, metalworks, chemical, petrochemical		yes***		***main investors D, NL
Yaroslavl	Diesel engines, aircraft engines, electric mach., mech. engin., metalworks, agricultural & food, chemical, petrochemical.	yes			Developed transportation system

Note: * Share of total companies. Source: Regionirusse (Informest)

2 – Southern Federal

	Territory characteristics	Natural resources
Adygea	36% forests	minerals, water, also thermal, wood - no energy
Astrakhan	70% desert	nat. gas, oil, construction min., clay, sale
Chechnya		nat. gas, oil
Dagestan	Part. mild climate	water, oil, gas, coal, hydro-energy res., fishing
Ingushetia		construction mat., wood, oil, water
Kabardino-Balkaria	10% forests	tungsten, molybdenum (half of world reserves), water
Kalmykia		oil, nat. gas, magnesium, construction mat.
Karachay-Cherkessia	80% hilly	coal, gold, lead, zinc, copper, tungsten
Krasnodar	forests	60 types of minerals, oil, nat. gas, marble, mineral waters
North Ossetia - Alania		oil, zinc, lead, copper, silver, granite, limestone, dolmite, water
Rostov		coal, nat. gas, construction mat., non-metal minerals, anthracite
Stavropol	40% fertile	nat. gas, oil, construction min., asbestos, water
Volgograd	84% agricultural	nat. gas, oil, potassium, magnesium, sodium, phosphate rocks, titanium, zircons, water

Source: Regionirusse (Informest)

	Industries	SMEs *	Foreign industries	Characteristics
Adygea	agricultural & food, wood, paper and cell, mech. engin., metalworks	31.80%	yes***	***main investors USA, D, Turkey, Syria
Astrakhan	gas and oil, minerals, fishing		yes***	Gas fields, reserves: 2.5k Bn m^3
Chechnya	gas and oil (OAO Grozneftegaz)			Important pipeline node, industry/agr. destroyed by war
Dagestan	agricultural & food (32%), fuels (20%), energy (20%)	11.50%	yes***	***main investors USA, Turkey, Cyprus
Ingushetia	fuels (55,3%), construction mat., agricultural & food	11.50%		Oil reserves estimated at 7.8 Bn Tons
Kabardino-Balkaria	agr. & food, mech. ind., construction mat., non-ferrous metals, chemical, light industry, stock farming, wood	19.70%		
Kalmykia	energy (45%), fuels (40%)	4%		No foreign investors
Karachay-Cherkessia	chemical, petrochemical, agricultural & food, textile, metal & mech., mineral ind., wood, apiculture	16.06%		Developed tourism
Krasnodar	agricultural & food, Black Sea tourism			Tourism relevant, excellent transportation node
North Ossetia - Alania	agricultural & food, metalworks non ferrous, energy	3.40%		Irrelevant FDI, high tourism potential
Rostov	mechanical engineering, metalworks, electric locomotives, agricultural & food (24%)		yes***	***main investors CH, D, USA, Cyprus, Ukraine
Stavropol	energy, agricultural & food, chemical, petrochemical, mechanical engineering. metalworks	20%	yes***	***main investors USA, Turkey
Volgograd	metalworks, fuels, energy, chemical, petrochemical, mech. engin., construction mat., textile, agricultural & food	22.20%		Third prod. of cereals in Russia

Note: * Share of total companies. Source: Regionirusse (Informest)

3 – Volga Federal

	Territory characteristics	Natural resources
Bashkortostan	forests	nat. gas, oil, iron, non-ferrous met., copper, zinc
Chuvashia	33% forests	nat. gas, oil, clay, peat, sands, chalk, opals, cristobalite
Kirov	60% forests	peat, oil, bituminous clay, wood
Mari El	57% forests	oil as yet unexploited
Mordovia		
Nizhny Novgorod	50% forests	scarce miner.- no energy
Orenburg		oil, nat. gas, lignite, ferrous metals and non, rock salt, limestone, marble, asphaltite
Penza		clay, chalk, sands, water
Perm		
Permyak		wood, oil, manganese, diamonds
Samara	forests	oil, nat. gas
Saratov	forests	nat. gas, oil, construction mat., clay oil, phosphate rocks, gravel, cement, Salts, zeolite, water
Tatarstan	agricultural	
Udmurtia	40% forests	Oil
Ulyanovsk		oil, peat, clay, sands, chalk

Source: Regionirusse (Informest)

	Industries	SMEs*	Foreign industries	Characteristics
Bashkortostan	fuels, chemical, petrochemical, metal & mech. (77.2% combined), wood	yes		Potential wood industry growth
Chuvashia	metalworks (45%), energy (14%)	23.70%	yes***	***around 40 foreign capital companies present
Kirov	chemical, petrochemical, mechanical engineering, metalworks, energy, paper and cell, wood, agricultural & food	15.70%		
Mari El	Steel industry, metalworks, energy, agricultural & food, wood, paper and cellulose	22%		
Mordovia	mechanical engineering, metal & mech., agr. & food, chemical, construction mat., petrochemical, pharmaceutical	15.50%		High investment growth rate
Nizhny Novgorod	mech. and metal ind. (40%), chemical and petrochem. (8), fuels (4%), energy (8%)			
Orenburg	coal, ferrous metal works, energy (70.5% combined)	yes	yes***	***around 200 foreign companies
Penza	mechanical engineering, metalworks (30%), electronic prod., radios, flight controls	yes		
Perm	oil, aerospace ind., data transm., chemical, metalworks, defence, fertilizers, paper, veneering	yes	yes***	***main investors GB, USA, D = 67% tot FDI
Permyak				
Samara	Aerospace metals, metal & mechanical, petrochemical, agricultural & food	31.48%		Samara is the aluminium industry hub, the largest supplier in Europe
Saratov	mechanical engineering (24%), metalworks (19%), wood processing	20%		wood reserves 52 Mln m3
Tatarstan	oil (40%), mechanical industry (24%) of which auto and aviation relevant		yes***	***main investors Ireland, GB, Lux.
Udmurtia	agricultural & food, machinery, metalworks, chemical, wood, arms	22.58%		
Ulyanovsk	mechanical engineering (auto, aviation, tools), agricultural & food, energy	18.80%	yes***	***Limited FDI – around 50 foreign cap. companies

Note: * Share of total. Source: Regionirusse (Informest)

4 – North-Western Federal

	Territory characteristics	Natural resources
Arkhangelsk	50% forests	peat, bauxite, sands, clays, manganese, copper, zinc, diamonds, amber, agate, lead, chalk
Karelia	49% forests	26 types of minerals, water, wood
Kaliningrad		amber (90% world total), alite, glauconite, zeolite, peat - no energy
Komi		quartz (80%n at. prod.), titanium (50% nat. prod.) bauxite (30% nat. prod.) ,barite(13% nat. prod.), gold, silver, diamonds, min. multi-metalliferous metals
St. Petersburg	56% forests 14% lakes	Electric power, pink marble
Murmansk		phosphorus, titanium, iron, aluminium, copper, nickel, oil and gas, mica, construction mat., semi-precious stones
Nenetsia		74 oil fields, 6 gas fields, fluorite, amber, agate, copper, nickel, cobalt, gold, diamonds
Novgorod	50% woodland	peat, clay, carbonates, quartz, lime mortar, gravel, natural pigments, mineral waters
Pskov		diamonds
St. Petersburg		

Source: Regionirusse (Informest)

	Industries	SMEs *	Foreign industries	Characteristics
Arkhangelsk	wood processing, diamonds, paper and cellulose			
Karelia	paper and cell, wood, ferr. metals, energy, agricultural & food		yes***	wood reserves =1.726 Mln m^3
Kaliningrad	agricultural & food, yard ind., military ind. conversion, port equipment, refrigeration	22%		
Komi	paper and cell, wood, metalworks, agricultural & food	16%		
St. Petersburg	petrochemical, oil ref., agricultural & food, energy, wood	19.50%	yes***	***main investors A, GB, D, USA, CH, Cyprus = mostly paper sector
Murmansk	metalworks non-ferrous (28,3%), energy (21,1%), agr. & food (15,3%), chemical and oil (15,2%)	30%		presence large national corporations(prod. steel, paper, chemicals)
Nenezia	fuels (98,2%)	14.60%		Agricultural & food = mostly fish processing (84,5%)
Novgorod	mineral ind., construction mat., wood	yes		potential growth mining industry and precious metals
Pskov	energy, radio comp, tools, textile mach., textile manuf., printing, constr. mat, agricultural & food	20.80%	yes***	***modest percentage. Around 150 foreign capital companies
St. Petersburg	mechanical industry and metalworks (65,5%)	32%		

Note: * Share of total. Source: Regionirusse (Informest)

5 – Urals Federal

	Territory characteristics	Natural resources
Chelyabinsk	forests	titanium, gold, silver, magnesite (95%nat. prod.), copper (15% nat. prod.), zinc (25% nat. prod.), kaolinite (100% nat. prod.), talcum (70% nat. prod.), iron (15% nat. prod.), facing stones (37% nat. prod.)
Khanty-Mansi	50% forests 8% nat. res.	395 oil and natural gas fields
Kurgan	60% arable land 20% forests	uranium, ferrous min., tungsten, titanium, zirconium
Sverdlovsk	80% forests	Platinum, gold, coal, bauxite (70% nat. prod.), vanadium (98% nat. prod.), asbestos (74% nat. prod.), iron (21% nat. prod.), copper (8% nat. prod.), nickel (14% nat. prod.), chrome, manganese
Tyumen	90% far north	oil, peat, sand, clay
Yamal-Nenets	Arctic climate	nat. gas, oil, gold, lead, phosphates, barite, marble, bauxite, copper, chrome, molybdenum, zinc.

Source: Regionirusse (Informest)

	Industries	SMEs *	Foreign industries	Characteristics
Chelyabinsk	metalworks, ferrous and non met., mechanical engineering, energy			
Khanty-Mansi	energy and fuels (96,6%)	yet (medium size)		wood reserves 53.6 Mln m3
Kurgan	metal & mech., energy, agricultural & food		yes***	***high FDI tied to oil/gas
Sverdlovsk	metallurgy, metal & mech., technical & scientific inst., research & design centres		yes***	***very limited
Tyumen		19.90%		One of the richest regions in Russia
Yamal-Nenets	fuels (94%)			Originates 91% of all Russian natural gas, 12% of oil

Note: * Share of total. Source: Regionirusse (Informest)

6 - Federal Siberian

	Territory characteristics	Natural resources
Agin Buryats		minerals, water, gold, silver, bismuthum, tantalum, tungsten, antimonium, copper, manganese, coal - no energy
Altai		minerals, water, forests
Altay	forests	Complex met. min., salt, soda, coal, wood
Buryatia	forests	zinc (48% nat. prod.), lead (24% nat. prod.), molybdenum (20% nat. prod.), asbestos (15% nat. prod.)
Irkutsk	86% forests	oil, nat. gas, coal, wood
Kemerovo	forests	coal, ferrous metals and non
Khakassia	61% forests	coal, iron, gold, molybdenum, barite, precious stones, facing stones, magnetite
Krasnoyarsk	forests	platinum, copper, nickel, cobalt, zinc, cadmium, chrome, molybdenum, tin, mercury, phosphates, graphite, manganese, talcum, helium, facing stones
Novosibirsk	11% forests	oil, nat. gas, coal, gold, peat, clays, ceramics
Omsk	Fertile soil, taiga, forests 42%	oil, nat. gas, peat, clay, bentonite, zirconium, sands, titanium, ossidi di zirconium, ceramics
Tomsk	60% forests	lignite, peat, oil, nat. gas, iron, titanium, zirconium
Tuva	50% forests, 29% agr. land	silver, gold, bismuthum, copper, nickel, cobalt
Ust-Hordinski Buryats	54% forests	Coal ,nat. gas, oil, clay, chalk
Zabaykal'sk	forests	Coal, ferrous metals and not, tantalum, niobium, uranium, zeolite, manganese, precious and semi precious stones, buildings materials

Source: Regionirusse (Informest)

	Industries	SMEs *	Foreign industries	Characteristics
Agin Buryat	metalworks non ferrous, energy, agricultural & food, fuel (83.1% of tot ind.)			
Altai	agricultural & food, non ferrous metal proc., construction mat., wood, energy	5.70%		
Altay	mechanical engineering, metalworks, agricultural & food, energy	7.80%		30% of energy produced in Siberia
Buryatia	mechanical engineering, metalworks, energy		yes***	*** modest FDI
Irkutsk	prod. aluminium, cellulose and paper (63%), wood (23%)	Yes		Hydroelectric power stations of new construction
Kemerovo	metalworks non ferrous, energy, mechanical industry	15.22%		produces 35% of all Russian aluminium
Khakassia	metalworks non ferrous, energy and fuels	28%		Home to the largest coal mine in the world
Krasnoyarsk	Non-ferrous metal works (70%)	14%		wood reserves: 7.8 Bn m^3, around 10% of Russia's total forest resources
Novosibirsk				
Omsk	Aerospace ind., precision instruments, agricultural & food, wood	21.25%		Reasonably good transportation network
Tomsk	fuels (53,7%), wood industry (1.4%, of which around 40% exported)	11%		
Tuva	energy (28,6%), metalworks non ferrous (gold), agricultural & food (21,3%), stock farming	20%	yes***	***around 250 foreign capital companies
Ust-Hordinski Buryats	energy, fuels, agricultural & food, wood, cellulose	4%		
Zabaykal'sk	Ferrous metals, energy, agricultural & food	22,4%		Detains 20% of world's freshwater (Baikal lake)

Source: Regionirusse (Informest)

7 – Russian Far East Federal

	Territory characteristics	Natural resources
Amur	56% forests	coal, gold, water
Chukotka		gold, tin, mercury, coal, lignite, natural gas
Kamchatka	95% forests	gold, silver, nat. gas, coal, pumice rock, volcanic minerals
Khabarovsk		Minerals, water, wood
Koryaks		Rare metals, precious stones, thermal sources
Magadan	Sub-Arctic climate	One of the richest regions in the world in terms of mineral resources: gold, silver, tin, tungsten, copper, peat, nat. gas, oil
Primorsky	77% forests	coal, lignite, tin, zinc, lead, tungsten, wood
Jewish Autonomous Region	Forests	Wood
Sakha Yakutia	1/4 of Russia's territory	minerals, diamonds (98% nat. prod.)
Sakhalin	forests	gold, silver, titanium, iron, fishing

Source: Regionirusse (Informest)

	Industries	SMEs *	Foreign industries	Characteristics
Amur	energy, non-ferrous metals, agricultural & food, mech. engin., metalworks, wood, fuels			
Chukotka	non-ferrous metal works (gold), energy (34,5%), agricultural & food (13,5%), fishing			Developing tourism ed infrastructures.
Kamchatka	agricultural & food (58,6%), energy	10.90%		Wealth of minerals, unutilized due to weather conditions
Khabarovsk	mechanical engineering, metalworks, also non-ferrous, energy, agricultural & food, wood, paper and cellulose			UNESCO – World Heritage Site
Koryaks	fishing, minerals mining	18.50%		
Magadan	Precious metal mining, fishing		yes***	***still below potential
Primorsky	mechanical engineering, metalworks, shipyards, fishing, wood	19.20%		Sea abounds with fish
Jewish Autonomous Region	constr. materials, energy, mechanical engineering, wood, paper and cell, light industry, agricultural & food	32.90%		20% of total fishing catch in Russia, 7% of all wood exported by Russia
Sakha Yakutia	Utilization of mineral resources	Yes		Excellent infrastructure network (transportation)
Sakhalin	Fuels (51%), agricultural & food (28%)			Reserves: gold (1867 Tons), silver (9284 Tons), titanium (39.7Mln Tons), iron (273Mln Tons)

Source: Regionirusse (Informest)

3 The Banking and Financial System

3.1 Introduction

Davidia Zucchelli

The Russian banking system has undergone deep transformation in recent years. While significant progress has been made, as proved by the strong trend of the main banking aggregates, elements of weakness persist, amplified in part by the recent international crisis. The central authorities have wasted no time in putting in place measures aimed at countering the slowdown in banking intermediation, resorting to numerous instruments such as substantial injections of liquidity into the system, the lowering of the compulsory reserve ratio, the opening up of credit facilities to banks and enterprises, and the purchase of shares and bonds on the market.

Despite its upbeat trend over recent years, lending to the private sector as a ratio of GDP, one of the main indicators of financial deepening, is still modest (around 40%). The number of banks is still high, and deposits are mostly concentrated with the two largest institutions, Sberbank and VTB; no other bank holds a market share of more than 4%. The contribution made by foreign banks, especially European, to the development of the local banking system has been important. Nonetheless, the presence of foreign investors in the sector is still limited.

In the following chapter, we will first analyse the structure of the Russian banking system, and subsequently focus on the trend of the main aggregates and of profitability, highlighting the system's main strengths – important in promoting recovery - and weaknesses. In this perspective, the current crisis may represent an opportunity to accelerate the implementation of further important reforms for the development of the system's structure and operation, governance processes, and transparency.

3.2 The Banking System

3.2.1 Evolution and Structure

The international economic and financial crisis impacted Russia through various channels, and in particular through the drop in oil prices, the economic slowdown in mature economies, higher risk aversion among international investors, and the significant indebtedness of the private sector.

In this context, the weaknesses of the banking system, which despite the progress made after the serious crisis of the late 1990s is still in the midst of a transition phase, have worsened[14] .

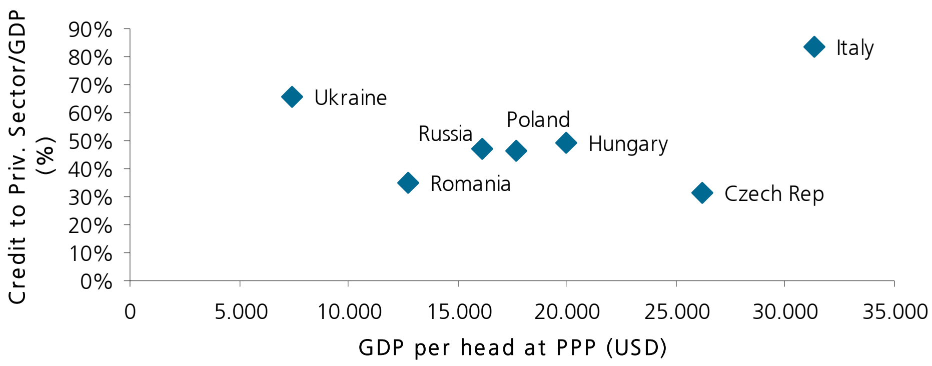
Important reform measures have been adopted starting in the second half of the 1980s, within the wider process of economic reform, known as Perestroika. Until 1987, the USSR's State Bank (Gosbank) issued over 95% of total financing to corporate clients. On 1st January 1988, intermediation activity was extended to specialised banks controlled by the State: Promstroybank (Industry and Construction Bank), Agroprombank (Agricultural and Industrial Bank), Zhilsotsbank (Housing and Social Bank), Vnesheconombank (Bank for Foreign Economic Relations), and Sberbank (Savings Bank, the only one authorized to collect deposits from private clients until the

[14] For an interesting overview of the development of the Russian banking system in the years 2000, see Stephan Barisitz, *Russian Banking in Recent Years: Gaining Depth in a Fragile Environment, Oesterreichische Nationalbank, January 2009.*

implementation of the reform). The first private retail banks began operating in 1989, spearheaded by the International Moscow Bank (now part of the Unicredit Group)[15].

Despite the progress made, the degree of banking intermediation remains modest: the ratio of total assets and GDP, of 32% at the end of 2000, rose to over 60% in 2008, and the Loans/GDP ratio increased from 11.5% to 47%. Further confirmation was provided by the ratio of lending to the private sector and GDP, still at around 40%, in line, nonetheless, with the situation in CEE and SEE countries, although still considerably far off the ratios in the main European countries. However, it should be noted that the Russian ratios more than doubled in a matter of a few years[16].

Credit to the Private Sector/GDP and GDP per Capita (2007)



Source: EIU.

One of the weakest elements is the low deposits/GDP ratio, still at 37% in 2008. The loans/deposits ratio, of 135% (taking into account loans and deposits issued to/by banks[17]), is therefore higher than the average found in the most important countries, and reflects significant dependence of lending activity on foreign funding and on the capital markets.

The Russian Banking System: Selected Indicators

	2004	2005	2006	2007	2008
Total Assets/GDP (%)	41.7	44.8	51.9	61.0	60.8(Sept)
Tot. Deposits/GDP (%)	24.4	27.3	32.0	37.1	36.9(Sept)
Tot. Loans/GDP (%)	26.2	29.5	35.2	43.3	47.2(Sept)
Loans/Deposits (%)**	125	121	119	120	135

Sources: CB, IMF. ** the ratio includes also loans and deposits issued to/by banks.

[15] On the front of legislation, two fundamental laws were passed in December 1990: the first regulating the USSR's State Bank, and the second the other banks and banking activity, both amended in 1993 following the dissolution of the USSR. In the following years many banks pursued speculative activities, made particularly fruitful by financial instability within an uncertain juridical framework. The 1998 crisis resulted in hundreds of intermediaries leaving the market. It took over three years to overcome the crisis, in a context of political stability and economic recovery.

[16] For an investigation into the drivers which led the evolution of the Russian banking system (such as economic growth, and more importantly the regulatory framework and the presence of foreign banks), see Alexander Lehman (EBRD), *Banks and financial reform: their role in sustaining Russia's growth,* a paper presented at the SUERF Workshop *Current Trends in the Russian Financial System,* 23 January 2009, Vienna.

[17] Without taking into account loans and deposits with banks, the ratio was 162% at the end of November 2008, and at year-end 2007 144%.

The Russian banking system is formed by a large number of banks (around 1,100), few of which of national scope and with significant market shares.

M&A activity, which was limited until the closing months of 2008, picked up as the financial crisis worsened, also as a result of the supervising authorities' efforts to encouraging the merger and incorporation of smaller banks. To this avail, the central bank (CB) has simplified the rules governing mergers and integrations[18]. The process began in the autumn with the acquisition of Svyazbank by Vneshekonombank (VEB), the public development bank, followed in December by the merger between MDM Bank, one of the country's largest private institutions, with regional bank Ursa, whose access to the international markets was more limited: from this latter operation, Russia's largest private bank was born. Alfa-bank acquired Bank Severnaya Kazna early in December, and has announced other operations in 2009. BIN Bank has purchased 76% of Bashinvestbank, in Tatarstan[19].

The M&A process is guided by the Deposit Insurance Agency (DIA), and based – according to the financial press – on a list of 200 banks that are "too large to go bankrupt", compiled by the central authorities. On 20 November 2008, the DIA announced the quantitative guidelines it must adhere to in rescuing banks, established in function of the amount of deposits held: over USD 4Bn in the case of federal banks, and USD 1Bn for regional banks, although exceptions are possible.

The Russian Banking System

	2004	2005	2006	2007	2008*
Number of Banks (Total)	1,299	1,253	1,189	1,136	1,108
Foreign banks (100%)	42	52	65	63	76
Market share (% on Tot. Asset) state-owned banks	na	40.7	37.8	39.2	na
Market share (% on Tot Asset) foreign banks	7.6	8.3	12.1	17.2	19.1(Sept)
Branches (per 100.000 inhab.)	2.3	2.3	2.3	2.4	2.5
Market share (% on Tot. Asset) 5 biggest banks	na	na	42.5	42.3	42.3
Market share (% on Loans) 5 biggest bank	na	na	45	na	45
EIU Banking Sector Risk **	62	57	59	48	47
EIU Banking System Openness **	2	2	2	2	2
EBRD index of banking sector reform **	2.0	2.3	2.7	2.7	2.7
EBRD index of reform of non-bank financial institutions**	2.7	2.7	3.0	3.0	3.0

Sources: CB, IMF, EIU, EBRD. *as of 30 June 2008. **EIU Index Risk 100=high. EIU openness= 5 good. EBRD 4=high.

Mergers and acquisitions are also desirable from an operating point of view. In recent years, domestic banks had adopted a strategy of organic growth, focused on developing the retail bank model. One priority which must still be pursued is customer and product diversification, especially in the retail segment. In this context, size is a crucial variable in achieving critical mass and supporting long-term profitability.

Banks are mostly located in the European part of Russia, in the few large cities, and in the more developed and densely populated regions, which do not correspond to the regions of greater economic wealth tied to the presence of natural resources. Fifty per cent of banks are based in the capital. Territorial penetration is low, with around 11 branches every 100,000 inhabitants.

The presence of the State is still significant. The four major banks in terms of total assets are state-controlled, and Sberbank enjoys a strong dominant position. Even before the outbreak of

[18] According to the financial press, at the end of 2009 the number of banks is expected to be 800, from 1,100 at present. See *The Banker*, "Banks merge to combat crisis", 2 February 2009.

[19] A significant fact is also that, in case of bankruptcy, the recovery rate – according to S&P – is very low. The average recovery rate for all creditors of the 113 banks liquidated between 2002 and February 2008 was 5.3%.

the current crisis, the State showed no intention of privatising the largest banks it owns. At present, in the wake of recent events, such a prospect is even more distant[20].

The presence of foreign groups has gradually increased in the past few years[21]. In terms of the number of intermediaries, France is still the leading foreign player in the domestic sector, followed by Germany, the United States, Italy, Holland, and the United Kingdom[22]. Major recent operations included the acquisition by Raiffeisen, in February 2006, of the medium-sized retail bank Impeksbank; in July 2006, Hungarian group OTP acquired Investsberbank, and in November of the same year Nordea took over Ogresbank, and Société Générale bought an initial shareholding in Rosbank, which it subsequently stepped up to over 50%. The most active non-American and non-European banks are Turkish. Focused at first on the offer of products and services to international and export companies, foreign banks then gradually expanded into the retail banking business[23]. Thanks also to the expansion of their networks on the territory, in recent years they have seen their total assets and deposits grow at much stronger rates than the system average. Foreign banks are very active on the Interbank market, both as borrowers and as lenders.

Lastly, it should be said that hundreds of credit cooperatives operate in Russia, which operate much like banks although they lack status as banks, in microfinance especially. This is a fast-expanding phenomenon in areas where the offer of banking services is more limited, and for which adequate regulation is lacking for the time being.

3.2.2 Deposits and Liquidity

Despite the introduction of deposit insurance schemes, greater transparency, and the offer of a wider range of funding products, aimed at improving the confidence of savers, savings deposits – which account for 30% of total deposits – are still heavily concentrated with the country's leading bank, Sberbank (which holds 53% of total deposits, evidently also because it is perceived as offering an implicit form of deposit insurance). Furthermore, a hefty 60% of retail funding, is long term, through instruments issued in the past with the aim, among others, to meet deposit-holders' demand for return. The corporate sector plays an important role in funding, accounting for a 34% share of total deposits in November 2008.

In recent months, the financial press has only reported of few instances of deposit-holders rushing to withdraw their savings from banks branches. Based on the latest official data available, the trend of deposits seems to be proving resilient, although total deposits slowed from +49.5% in 2007 to around +24% in November 2008[24]. The slowdown of deposits from

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[20] For a summary of the privatisation process in Russia, see EBRD*, Transition Report 2008, p.172.*

[21] Moody's estimates the share held by foreign entities in the capital of Russian banks at 25%: see Moody's*, West European ownership of East European banks during financial and macroeconomic stress, February 2009.*

[22] Opposite to the situation in other countries, most notably China, there has been no news of the disposal of significant stakes held by foreign banks in Russian banks. In fact, the leading African bank in terms of total assets, Standard Bank, intends to acquire 33% of Troika Dialog, Russia's second-largest investment bank; see *Financial Times*, March 6, 2009, p. 13.

[23] On this topic, see Helena Zukowska, Marian Zukowski, Maria Curie Sklodowska*, The role of banks with foreign capital in the banking system of Russia after 2000,* paper presented at the SUERF Workshop "Current Trend in the Russian Financial System", 23 January 2009, Vienna, which highlights the engaging pre-financial crisis debate on how foreign entities could be prevented from gaining control over Russian banks without adequate protection of national interests.

[24] The most recent figure on the M2 trend is the negative rate of -11% m/m released on 1st February 2009 (-7.2% y/y), vs. +1.7% m/m (+1.7% y/y) the previous month: the first drop since 1998, which has fuelled

households, which began in 2006, is also the consequence of funds being diverted to the purchase of shares, especially those issued by the country's largest corporations.

Deposits	2004	2005	2006	2007	2008*
Deposits (Bn RUB)	3,502	5,152	7,738	11,569	14,328
Customer Dep. (share %)	79	79	78	76	73
of which households %	57	54	49	45	39
of which corporates %	22	25	28	30	34
Dep. with banks (share %)	21	21	22	24	27
Total Deposits (y/y %)	36.0	47.1	50.2	49.5	23.8
Customer Deposits over 1 year (Bn RUB)	1,442	2,196	3,311	4,935	6,174
Deposits over 1 year (y/y %)	73.7	52.3	50.8	49.0	25.1
Deposits over 1 year (share % on Tot. Dep.)	52.7	54.5	55.6	56.5	59.5
Deposits in foreign currency (Bn RUB)	1423	2150	2845	3909	5518
Deposits in foreign currency (share % Tot. Dep.)	40.6	41.7	36.8	33.8	38.5
Loans in for. currency/Dep. in foreign currency (%)	93.0	91.3	94.2	95.6	104.5

Source: CB. *November 2008

Private banks, which have greater access to the international capital markets, reduced recourse to the domestic market, taking advantage – until a few months ago – of abundant liquidity and of the strong interest shown by foreign investors. Increasing recourse to international funding by this category of banks was encouraged by the need to diversify funding sources, on the long end of the maturity curve especially, to finance the investments of fast-growing corporations. The need to cut the cost of deposits was another factor.

Within the context of the current crisis, foreign debt represents a risk factor[25]. Funding in currency has mostly increased in terms of US dollars and euros, to take advantage of the interest rate differential. At the end of June 2008, the country's foreign debt had risen to USD 527Bn, 37% of which accounted for by banks (around USD 200Bn, vs. USD 32Bn at the end of 2004), and 56% by the corporate sector (around USD 300Bn, from USD 77Bn at the same two dates). As a ratio of GDP, however, the private sector's foreign debt declined by around 33% at the end of 2007 to 30% in June 2008.

Funding in deposit certificates and savings certificates are very limited indeed, amounting in November 2008 to 34Bn roubles in total (52.5Bn roubles at the end of 2007). The issue of bonds is also still very modest, worth a total of 370Bn roubles in November 2008 (290Bn roubles at the end of 2007), i.e. 2.6% of total deposits.

Lastly, the credit card segment also deserves a mention, given its significant growth in the past few years: in January 2008 – according to Fitch estimates – the number of credit cards outstanding was 8.9 million. However, it is reasonable to expect this segment, and more in general the consumer credit market as a whole, to contract somewhat as a result of the current financial crisis.

3.2.3 The Measures Put in Place

In response to the international financial crisis, the central authorities have prompty acted with numerous measures, geared to supporting deposits, strengthening the capitalisation banks, encouraging M&A activity in the sector, and preventing the economy from being starved of credit.

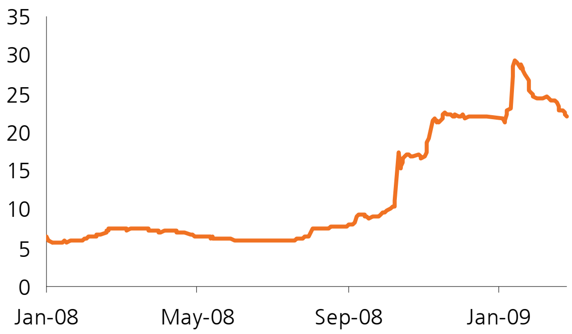
expectations for a further slowdown of the deposits aggregate in the past few months, compared to the data published in the CB's latest statistical bulletin, referred to November 2008.

[25] Net banking inflows to Russia amounted to USD 107Bn in total in 2007, as estimated by the Institute of International Finance (IIF), and dropped to USD 28Bn in 2008. See IIF*, Capital Flows to Emerging Market Economies, January 27, 2009, p. 7.*

The lack of liquidity on the interbank market has left numerous banks in troubled waters in the past few months. As a result of this difficult situation, Svyazbank, the country's 28th bank, was acquired by State bank VEB, and at least 12 of the 50 largest Russian banks are reported to be incurring significant imbalances[26]. After the default of investment firm Kit Finance last September, the overnight rate rose on average to 10% in November, peaking at 26.4% at the end of January, and subsequently backtracking to an average of 10.8% in February.

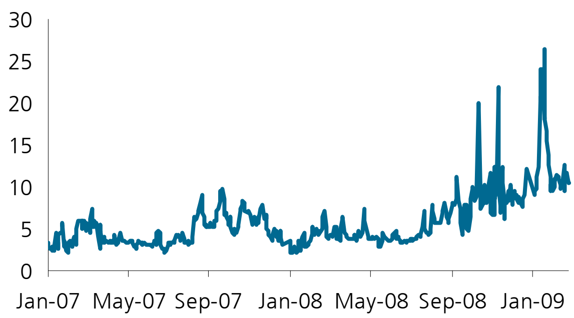
These changes were recorded against a background of sharply rising interest rates. In December 2008, the CB raised the refinancing rate to 13%, essentially to support the rouble. Rates on the Interbank market soared last January, with the MosPrime surging to 29.7%, and subsequently easing back somewhat.

MosPrime 3M



Source: Thomson Reuters. The MOSIBOR is the Moscow Interbank Offered Rate. National Foreign Exchange average of interbank offered rates for rubble deposits in the Moscow market based on quotation at 16 major banks.

Mosibor Overnight Rate



Source: Thomson Reuters.

The central authorities have taken a number of actions, for a total estimated worth of around 12% of GDP, some of which already put in place in the final months of 2008. More in detail, the CB injected into the system several billion roubles a day in liquidity, it lowered the compulsory reserve ratio from 4% to 0.5%, issued a loan to VEB for the take-over of Svyazbank, acquired Globeksbank and Sobinbank through other State banks, opened up credit facilities of around USD 50Bn to banks and companies to help them repay foreign debt by the end of the year, cut the refi rate from 9 ¾ to 8 ½ on 15 October, and raised the currency swap rate from 8% to 10% to discourage speculation on the currency market. To support quotations, the CB also plans to purchase shares and bonds for a total of USD 25Bn[27].

In the meantime, the Government used the country's three largest State banks (Sberbank, VTB and Gazprombank) to finance smaller banks and investment firms, by issuing 3M loans for a total of around USD 60Bn. A further USD 2Bn were issued directly to the smaller institutions. Lastly, the Housing Reform Fund was allowed to deposit 180Bn roubles with retail banks.

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[26] The IMF has also declared that, although many small banks are facing real risks, there is no perception of a system-wide risk; also, it believes that the BC is committed to stabilising the country's financial system, and that it has the tools it needs to act in rescue of the smaller banks, should this be necessary. The IIF has expressed similar considerations: see *Outlook update* on Russia, December 23, 2008, p.2.

[27] International financial institutions have not yet intervened. We only report the EUR 120Mln loan issued to utility OGK-5 by EBRD, with a 12Y maturity, for the construction of a new electric power plant.

Insurance on deposits was raised to 700,000 roubles from the 400,000 roof set in March 2007[28]. Rating agency Fitch considers the guarantee credible, given the limited weight of total deposits on GDP (around 36%, including deposits larger than the maximum secured amount).

Other special measures included the extension of the list of securities acceptable as collateral (for instance bonds issued by Gazprom, VTB and Sberbank) on transactions with the CB, or even to obtain financing, of the non-secured kind as well.

Despite the injections of liquidity, the hardships encountered by banks, as reported by the financial press, have not been entirely overcome. Emblematic cases were those of Renaissance Capital, one of the most aggressive investment banks in recent years, and of small retail bank Globux, to whose branches panicked deposit-holders rushed to withdraw their savings. The troubles faced by companies – especially in the construction, retail and real estate sectors – are being transferred to banks: the drop in commodity prices, and most of all the greater difficulty in accessing credit abroad, will imply losses at both the loans portfolio and security portfolio levels, already visible in 3Q08 results.

Actions in support of the capital of banks, taken directly or by means of subordinated loans, have been substantial, albeit mostly concentrated in the public sector. A thousand billion roubles have been announced for 2009, in addition to the 950Bn roubles allocated in 2008. Most of these funds were issued to the major State banks (in the opening months of 2009, more than half of the total to Sberbank alone, i.e. around 500Bn, and around 200Bn roubles each to VTB and VEB), as opposed to around 100Bn roubles to private banks, unless shareholders also contribute by adding further resources.

Foreign contributions to this sector have contracted sharply, and capital flows are slowing fast[29].

3.2.4 Loans

Driven by strong economic growth, loans increased at sharp rates in the past few years: over 50% in 2007 and around 45% in 2008, but are now being affected by waning demand and funding difficulties. This year, a slowdown in lending activity is expected, which will probably turn into a decline, due to the lingering effects on the country of the current international economic and financial crisis[30].

As already mentioned, despite the economic growth trend, lending to the private sector and to State-controlled non-financial firms, as a percentage of GDP, added up to around 40% at the end of 2007, well below the rate recorded by peers.

Loans to the corporate sector accounted for the largest share of the total (66% in November 2008), most of which in roubles (70%). Within an aggregate annual growth of 52% in 2007, particularly upbeat trends were recorded in the construction (+85%) and agriculture (+56.4%) sectors. The share of medium/long-term loans increased from 45.9% in 2006 to 51.6% in 2007.

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[28] The Deposit Insurance Scheme (DIS) was established in 2004 as an addition to a set of measures put in place by the central authorities since 1998 to manage the Russian crisis of the late 1990's. At the end of 2008, 893 banks were members of the scheme.

[29] To this avail, recent news is that control over capital flows, which had been removed in 2006, may be restored. However, it should be said that the effectiveness of such an action would by now be limited, as capital outflows from Russia in the past few months have already been very substantial, according to press reports.

[30] An interesting IMF paper highlights the important role played by foreign banks in the credit boom phase experienced by CEE and SEE countries. Driven by economic growth and high margins, these banks fuelled the fast-paced growth in lending, resorting to international funding. Also, the size of the loans issued was not related to the economic conditions of the country of origin of the lending banks. See IMF, *Banking Structure and Credit Growth in Central and Eastern European Countries, September 2008, WP/08/215.*

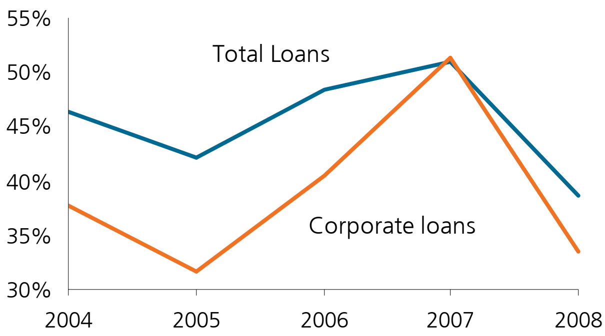
Loans

	2004	2005	2006	2007	2008*
Loans (Bn RUB)	4,373	6,212	9,218	13,924	19,306
Customer Loans (share, %)	90	89	89	90	87
of which to households %	12	17	20	21	21
of which to corporate %	78	72	68	68	66
Loans to banks (share, %)	10	11	11	10	13
Loans (y/y %)	46.4	42.1	48.4	51.0	38.7
Loans to households (y/y %)	116.4	96.2	78.3	57.8	36.5
Loans to corporate (y/y %)	37.7	31.6	40.4	51.4	33.6
Loans in foreign currency (Bn RUB)	1323	1964	2679	3739	5768
Loans in foreign currency (share % on total loans)	30.2	31.6	29.1	26.9	29.9
Loans in foreign currency/Dep. in foreign currency (%)	93.0	91.3	94.2	95.6	104.5
NPL (incl. Doubt Loans)/Tot. Loans (%)	16.0	15.2	13.0	11.0	na
NPL/Tot. Loans (%)	3.3	2.6	2.4	2.5	2.5(Sept)

Source: CB, IMF, EIU. * November 2008

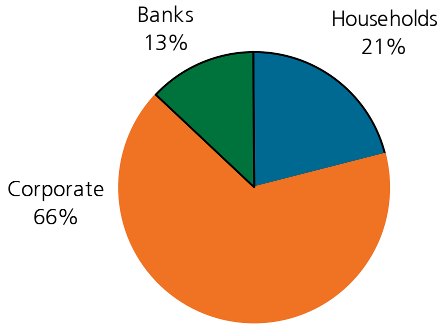
To support profitability, banks have focused on the growth of lending to private individuals (consumer credit or personal loans, as opposed to still weak residential mortgages), and to medium-sized companies.

Loans and Deposits (y/y %)



Source: CB. Data as of November 2008.

Structure of Loans by Sector (Nov 2008)

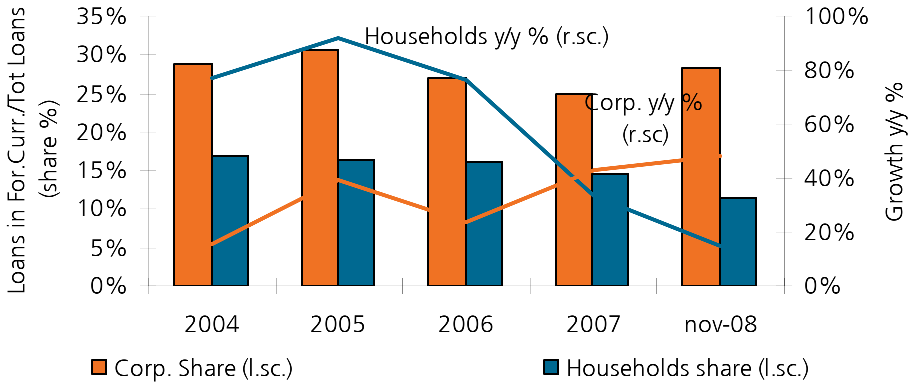


Source: CB.

The trend of loans to households slowed from +78% in 2006 to +58% in 2007, and to +36% in November 2008, although the share of total loans issued to households increased from 23% to 24% in November 2008. Most loans to households (89%) are issued in local currency. The large State banks, and the major private banks, are dominant in this segment, and respectively control 40% and 32% of total loans to households.

The relatively limited weight of loans in currency in Russia should be noted (around 30% of the total), as opposed to the situation in other Central and South Eastern European countries, or in CIS countries. Also, loans in currency are entirely funded by deposits in currency: the ratio of loans in currency and deposits in currency has consistently been close to 100% in recent years.

Loans in Foreign Currency (Share and Growth y/y %)



Source: CB. As of November 2008.

Portfolio quality in terms of the weight of non-performing loans is still modest, although updated official data, could not be reliable according to the rating agencies, are still unavailable. The CB has claimed it expects the NPLs/total loans ratio of retail banks to increase to al 4-4.5% in 1Q09, from 3.8% at the beginning of January[31]. As a result, provisions are estimated to grow to 5.5-6% at the end of March, from 4.9-5.0% in early January. It is reasonable to expect the crisis to also have a potentially severe impact, on this front, as has already been the case in the past[32], due first of all to the economic slowdown, but also to tensions on the real estate market and to the depreciation of the rouble, which may turn the forex risk faced by customers into credit risk, should the latter lack adequate coverage. Several studies signal that State banks have higher NPLs/total loans ratios than private banks. By contrast, the ratio is lowest for foreign banks, probably due to their shorter period of activity in the country, as well as to the adoption of more adequate risk management policies[33].

Russian banks do not appear to be significantly exposed to US subprime securities and to so-called toxic securities. The possibility of establishing a bad bank for Russian banks as well is currently being considered, with the aim, however, of restructuring the balance sheets of banks, asset management firms, and pension funds, by removing bonds issued by defaulting national corporations.

Sberbank, Russia's largest bank, has declared that it is currently seeking to improve the quality of its credit portfolio, rather than step up loans. The bank has also eliminated some non-secured technical forms of lending, used to meet urgent requirements or the requirements of pensioners, and has raised the minimum deposit imposed on households to obtain a mortgage from 10% to 20%. On the front of consumer credit, Sberbank now finances 80% of the cost of automobiles instead of 100%.

The weight of the security portfolio on total assets decreased in 2007 from 14% to 12.6%. The portfolio mostly included bonds.

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[31] More recently, the CB has declared that the NPLs/total loans ratio could soar to 12% at the end of 2009, from 2.6% at present.

[32] A number of papers provide evidence that during past banking crisis phases, NPLs have even risen as high as 50% of the loans portfolio/GDP. In Russia's case, at the height of the 1998 crisis, non-performing loans amounted to 40% of GDP: see IMF, *Financial Stress and Economic Downturn, WEO, October 2008.*

[33] See Zuzana Fungacova and Laura Solanko, *Risk-taking by Russian banks: do location, ownership and size matter?, Bank of Finland, BOFIT, paper* presented at the SUERF Workshop "Current Trends in the Russian Financial System", 23 January 2009, Vienna, p.11

3.2.5 Profitability and Capital

A gradual repositioning towards retail clients has supported the profitability of banks in the past few years. The total income of banks has grown at brisk rates, of close to 40%. According to the CB, 94% of banks showed a net profit in September 2008 (99% at the end of 2007).

Profitability and Capital

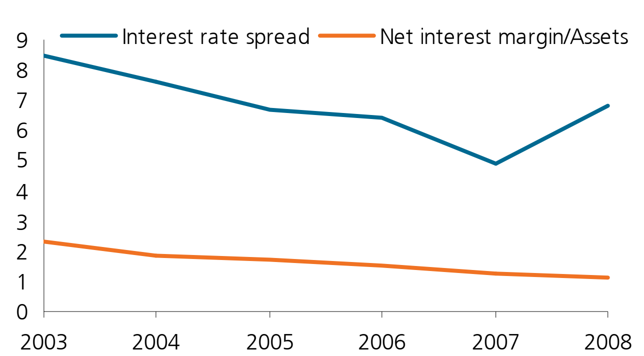
	2004	2005	2006	2007	2008E
Interest rate spread (pp)	7.61	6.69	6.40	4.89	5.50
Net Interest Inc./Assets (%)	1.8	1.7	1.5	1.3	1.2
Net Profit (y/y %)	na	51	38	37	na
ROA (%)	2.9	3.2	3.20	3.0	2.9(Mar)
ROE (%)	20.3	24.2	26.30	22.70	19.5(Jun)
Capital/Risk Weighted Assets (%)	17	16	14.9	16.8	na
Capital/Assets (%)	13.3	12.7	12.1	na	13.2**

Source: SBV, IMF, EIU. *EIU 2008 Estimates.*** 6 biggest banks (average).

ROE dropped in 2007 as a result of lower leverage, following more upbeat capital growth tied to the IPOs of Sberbank and VTB Bank. The ROE of foreign banks increased from 23.5% in 2006 to 25% in 2007, and ROA from 3.0% to 3.1%[34]. The share of total income accounted for by interest income rose from 59.9% in 2006 to 60.1% in 2007. The second most important component, net fees generated by security trading, remained above 27%.

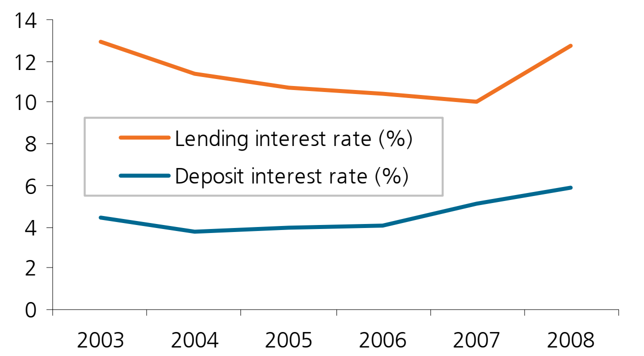
New international tensions may lead to a rise in funding costs and to a heightening of market risks. The depreciation of the rouble in particular may lead to a deterioration in asset quality and higher bad loans, as enterprises and households (without adequate coverage) are currently seeing their debt grow. Lastly, the depreciation of the rouble also implies a drop in capital ratios, due to forex losses. As regards interest rates, after a years-long downtrend in the loans segment, and a slight uptrend on deposits, driven by competition more than by any other factor, within the context of an expansive monetary policy, rates picked up suddenly in the closing months of 2008.

Banking Interest Rate Spread and Margin



Source: CB.

Banking Interest Rate



Source: IFS.

At the beginning of 2007, the minimum required capital to engage in credit activity was raised from EUR 1Mln to EUR 5Mln. Although 43% of banks did not meet this requirement, the law allowed them to continue operating unless their capital would not drop below the amount available as at 1st January 2007. At the end of 2007, 36% of banks had a lower capital than the required minimum.

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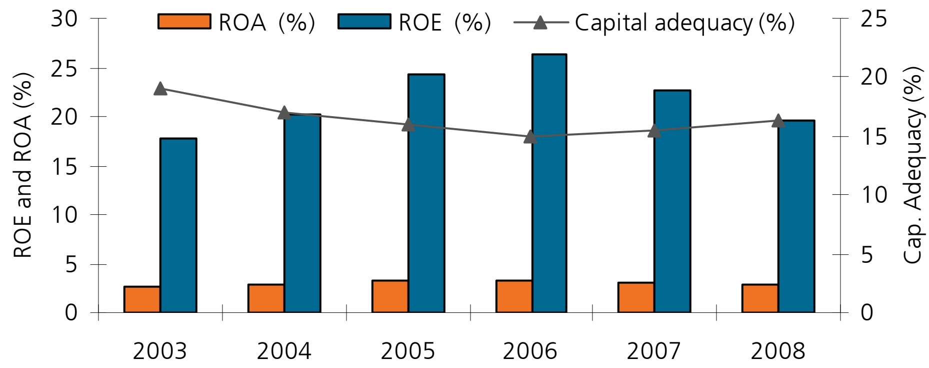
[34] As regards efficiency, several papers point out that foreign banks are more efficient than private national banks, which are also – apparently – less efficient than state-controlled domestic banks. See Alexei Karas, Koen Schoors and Laurent Weill, *Are private banks more efficient than public banks? Evidence from Russia, Bank of Finland, BOFIT, Discussion Paper n.3/2008.*

Profitability and Capital



Source: CB. As of March 2008 (ROA), June (ROE) and November (Cap. Adequacy).

In order to accelerate the concentration process in the sector, new capital adequacy requirements were introduced at the beginning of March: as part of these measures, banks with a capital of less than 180Mln roubles (around USD 5Mln) on 1st January 2007, were required to have a minimum capital of 90Mln roubles by January 1st 2010. According to the CB, at the start of 2007, 706 banks had authorised capital of 150Mln roubles or less. The measures currently affect around 730 banks, i.e. 2/3 of the total[35]. At the beginning of 2008, the number of banks with 150Mln roubles or less in authorised capital had fallen to 586, whereas banks with a larger capital had risen to 550 from 483 a year earlier. However, the widespread losses suffered by the banking sector over the last year suggest that over 700 banks are expected to find it hard to meet the new requirements (and will therefore necessarily have to merge with other institutions).

Capital adequacy ratios have worsened slightly in recent years as a result of strong asset growth. Also, capital ratios drop as banks increase in size: smaller banks have much higher ratios than larger institutions, in line with the difficulties the former face in accessing the Interbank funding market. The major banks can count on a wider range of funding sources, and incur lower funding costs[36]. Lastly, private banks have higher capital ratios compared to both State banks and foreign banks.

The number of institutions with a capital in excess of 60Mln roubles increased from 757 at the end of 2007 to 787 in November 2008 (+4%).

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[35] See EIU, Viewswire, *Russian Finance: Fixing the Banks*, March 2, 2009.

[36] The five leading banks held 43.2% of total capital at the end of 2007, on the rise also as a result of two bank IPOs launched in 1H07 (from 35.9% at the end of 2006).

10 Biggest Banks (Total Asset 2007).	Governance	Total Assets (USD m)	NPL/ Cred. Tot 2006	Equity/ total assets	Cost/ income	ROA %	ROE %	Rating*
Sberbank	Public (60,3%)	200.8	1.50	14.50	55.43	2.84	30.6	-/-/BBB
VTB - Bank	Public *(77,5%)*	92.6	1.16	16.28	47.23	1.96	16.7	BBB/-/BBB
Gazprombank	Public	38.8	0.98	22.70	79.80	5.30	33.4	BB+/-/-
Bank of Moscow	Public *(City of Moscow 44% dir +15% ind)*	21.5	ND	14.80	46.63	2.50	33.7	-/-/BBB-
ZAO Raiffeisenbank Austria	Private	18.1	1.53	12.49	50.73	2.00	33.5	BBB/-/BBB+
Rosbank	Private *(57,6% SocGen)*	16.6	ND	14.40	65.10	2.02	27.5	BB+/-/BBB+
Bank Uralsib	Private *(Standard Chartered)*	15.3	ND	13.40	77.66	0.97	9.0	BB-/-/B+
Russian Agricultural Bank	Public *(100%)*	14.5	1.01	13.60	54.19	1.64	21.3	-/-/BBB
MDM Bank	Private	13.1	2.84	14.45	48.35	2.37	24.9	BB/-/BB
International Ind.rial Bank	Private *(ANZ)*	5.4	0.02	35.49	12.71	4.62	16.4	BB-/-/B

*Rating: S&P/Moody's/Fitch, as of 5 March 2009. The rating of the Russian Federation is BBB/Baa1/BBB. Sources: The Banker, Fitch.

3.2.6 Ratings

In the past two months, the rating agencies have reviewed their rating of the Russian Federation in light of the worsening of the international crisis, and the deterioration of macroeconomic fundamentals, and in particular following the reduction of currency reserves (down to around USD 386Bn, from around USD 600Bn in August). As a result, the ratings or Outlooks of many Russian banks have been reviewed[37].

Specifically, in December S&P downgraded Russia's sovereign rating from BBB+ to BBB, affirming its Negative Outlook, due to the high cost of bank rescues and to the substantial outflow of foreign capitals. In September, S&P had changed the Outlook of seven banks to Stable, given the difficult market conditions and of their adverse effects on the short-term performance of banks, as well as on their operating and financial flexibility. A further review is now expected, in the wake of the sovereign rating downgrade. It should be noted that the ratings assigned by S&P to the major banks are supported by the fact that their shareholders include the State, or international banks. As stand-alone entities, the ratings of these banks would be lower.

At the end of December, S&P moved Russia to Group 8 from Group 7 in its Banking Industry Country Risk Assessment (BICRA - on a scale ranging from Group 1, the strongest, the Group 10, the weakest), due to increased macroeconomic and sector-specific risks (primarily in terms of funding, liquidity, and asset quality), the deterioration of the financial and operating context, and the system's high vulnerability to the international crisis. S&P expects macro parameters to worsen in 2009, with high inflation, weaker public accounts, smaller reserves, and a further depreciation of the rouble.

Moody's, which changed Russia's Outlook to Stable from Positive in December, with a Baa1 rating, pointed out that the measures adopted by the central authorities are mostly addressed to the larger banks, and will offer only temporary support. The agency subsequently confirmed its issuer ratings, while downgrading the ratings and/or Outlooks of issuers in national currency. Further downgrades are a possibility, especially for banks with weak business models. Moody's assigns a low rating to the Financial Strength of Russian Banks (D-, on a scale ranging from A to E).

Lastly, early in February Fitch downgraded Russia's sovereign rating to BBB from BBB+, affirming its Negative Outlook; consequently, it downgraded the Issuer Default Rating of 14 banks. The agency claimed it fears a worsening of the position of many smaller banks. Fitch underlines the fact that around 1,000 banks are of very small size and very vulnerable. The agency believes several of them have already gone bankrupt, and signals a lack of transparency on the matter. Fitch assigns a low

[37] Only around 120 banks are rated by an international agency.

rating to the country's banking system: its Banking System Indicator (BSI) – which measures the quality of the banking system in stand-alone terms, based on the individual rating assigned to single banks – is D for Russia (on a scale ranging from A, the strongest, to E, the weakest).

3.3 The Financial Markets

3.3.1 The Equity Markets

The international financial crisis has triggered an outflow of capitals from Russia[38], resulting in a strong decline of market indices and high stock market volatility. The central authorities have taken strong action in support of the equity and bond markets in the past few months, but indices continued to decline nonetheless.

The country's two main stock exchanges are the Moscow Interbank Currency Exchange (Micex), controlled by the State, in which the better part of trading in roubles is concentrated, and the Russian Trading System (RTS), a private company established by market participants themselves. In recent months there have been many calls for a merger of the two stock exchanges, with the aim of achieving more efficient cost control and greater synergies.

The Russian population owns a very modest portion of shares. The number of individual Micex accounts increased from 60,000 in 2005 to 472.000 in June 2008. In August, domestic banks accounted for around half of the Micex's turnover, funds for a further 20%, and foreign investors for the remainder (around 30%). Although the weight of equity investments by Russian banks grew by 60% in 2007, the portion of shares held by banks is still lower than 2%.

The capitalisation of Micex increased by 15 times between 2003 and 2007, to over 1 trillion US dollars, only to plunge in 2008 to USD 331Bn, or around 20% of GDP. Similarly, the capitalisation of RTS decreased to USD 55.8Bn from USD 196Bn at the end of 2007. NAUFOR – the organisation which groups around 400 market participants – points out that taking into account total capitalisation of the domestic market, the ratio would be much higher (99% in June 2008).

Selected Indicators

	2004	2005	2006	2007	2008
Market Cap. (Bn USD)*	221	458	892	1167	331
Market Cap/GDP (%)*	37.4	59.9	90.3	90.5	19.8
Numb. of listed companies Micex	na	163	190	208	185**
Numb. of listed companies RTS	na	261	281	302	265**
Turnover ratio (%)	na	45.98	48.81	46.74	na
Trading volume (Bn USD)	na	151.3	471.5	621.2	na
Micex Index	548	1,011	1,693	1,889	619.5
Performance (y/y %)	7	84	68	12	-67
RTS Index	614	1126	1922	2291	631.9
Performance (y/y %)	8	83	71	19	-72
m.i. MSCI Emg.	13	32	26	30	-47
Dividend yield ratios	1.21	1.07	1.83	0.53	na
Price to book ratios	1.18	2.19	2.53	2.82	na
Price/earnings ratios	10.8	24.1	16.6	18.4	na

Sources: EIU, STX, WFE, FMI. MSCI=Index MorganStanleyEmerging Markets. *by Datastream, it refers to Micex Index (78,2% of the official market). **as of 30 June 2008.

The main listed companies are Gazprom, Rosneft, Lukoil, as well as the two major banks (Sberbank and VTB). Concentration is high, in terms of both the number of companies and of business sectors, albeit on the decline. The top 10 companies accounted for around 66% of the Micex's capitalisation at the end of June 2008, vs. 78.5% in 2006. Also, the Oil & Gas sector was

[38] Capital outflows have been particularly strong in recent months in several countries, of Eastern Europe in particular: see IIF, *Capital Flows to Emerging Market Economies*, January 27, 2009.

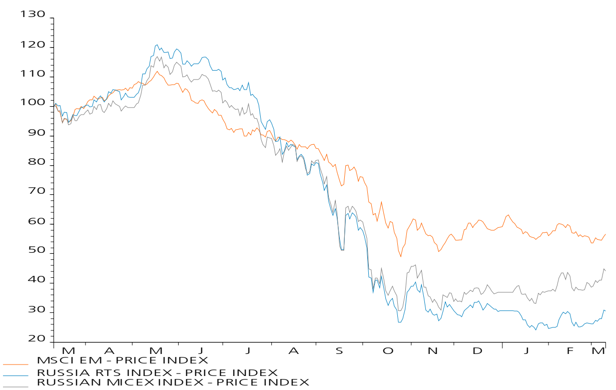
responsible for around 50% of total capitalisation, with Utility accounting for 12.5%, and Banks for 12%.

One element of weakness is the low number of listed companies: 185 on the Micex as at last June. In the first half of the year the number of Russian companies listed on both the national and foreign markets (LSE, NYSE and Nasdaq) decreased, according to a S&P survey, from 328 at the end of 2007 to 312 last June. It should also be noted that the trading of officially unlisted securities is very intense: at the end of 2007, the aggregate capitalisation of the shares listed on the domestic market was estimated by NAUFOR at USD 1.3Bn. A large number of issuers are traded simultaneously on the Micex and on the RTS. Lastly, 30% of Russian securities are listed in London.

Compared to the previous years, the trend of the main equity indices began to slow already in 2007. Performance in 2008 was negative, even compared to the other emerging economies, despite ongoing support from the government, which invested several billion roubles a day to purchase shares, spending a total of 175Bn roubles (USD 6.4Bn). The main index in local currency, the Micex, slipped by 67%, after having gained 12% in 2007 to 1,889. The Micex touched an all-time high on 19 May 2008, and subsequently slipped back rapidly, in a highly volatile market. The RTS index in US dollars suffered a greater loss (-72%) in 2008. On 5 March 2009, the Micex's year-to-date performance was positive (+8%), although volatility remains very high, with repeated trading suspensions of varying length, whereas the RTS index lost further ground (-12% YTD on 5 March 2009), declining more sharply than the aggregate index of the other emerging markets (-7%).

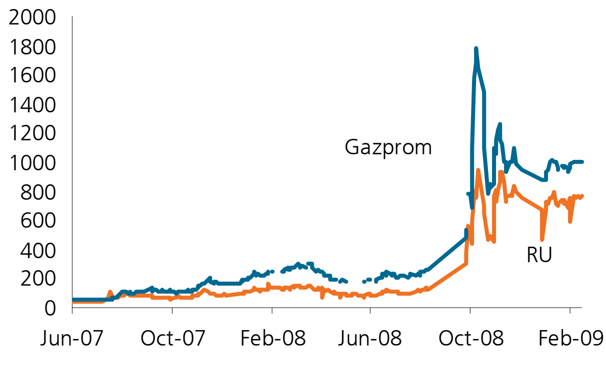
Trading volumes increased rapidly in the 2005-2007 period. In 2007 in particular, they more than doubled on the Micex, from 15 trillion roubles to 31 trillion. In 1H08, volumes amounted to almost 20 trillion roubles.

Index Micex, RTS and MSCI Europe



Source: Datastream

Russia and Gazprom: CDS 5years.



Source: Reuters

The trading of shares is markedly concentrated: at the end of 2007, the top 10 Micex companies accounted for around 95% of total turnover, with shares of 28.4% for Gazprom, 21.3% for UES, and 11.1% for Sberbank. The weight of banking shares on total volumes more than doubled in 2007, also as a result of the increase in the number of listed banks, with the notable addition of Sberbank and VTB.

In line with the international markets, in 2008 the number of IPOs plummeted: a single IPO was launched on the foreign markets by a Russian company, for USD 449Bn. Capitals attracted through IPOs and capital increases rose to over USD 30Bn in 2007, from USD 22Bn in 2006. The IPOs of Sberbank and VTB were worth USD 8.8Bn and USD 8Bn respectively. In 3Q08, Acron was listed for USD 2.7Mln, and capitals attracted amounted to USD 1.1Bn in 2Q08 vs. USD 566Mln in 1Q08. In the region comprising Russia & the CIS, 33 IPOs were launched in 2007 (vs. 24 in 2006 and 17 in 2005).

3.3.2 The Bond Markets

On the bond market, the deterioration of Russia's country fundamentals led to a surge in both the Sovereign CDS and in the CDS issued by Gazprom, two of the few issuers whose CDSs are traded with relative continuity. The movement was reabsorbed in part at the end of October.

In recent years, the corporate bond segment has experienced a gradual increase in the number of issuers and of listed bonds, as well as in trading volumes. However, this segment is also being affected by the international crisis. At the end of 2007, 607 bonds were up for trading, issued by 465 companies, around 25% more than in the previous year. The percentage of issues not carried out on the market, and therefore with no outstanding bonds in the past two years, stayed very low, at around 0.25-0.4% (Naufor estimates).

The volume of transactions on corporate bonds has gradually increased in the past few years: +61% in 2006 and +51% in 2007.

Corporate bond issues on the Micex declined slightly in 2007: from 464 to 456Bn roubles, with 188 issues. The total value of outstanding corporate bonds rose by 39% in 2007 (+80% in 2006) and by 32.7% in 1H08, to 1,497.11Bn roubles. The value of bond issues by banks increased by 160% y/y in 2007. The share of corporate bonds held by banks dropped from 50% in 2006 to 41% in 2007. In the January-March 2008 period, 29 issues corporate bond issues were launched, worth a round 5.2Bn roubles in total. In January 2009, the issues of Eurobonds picked up again sharply, but mostly by initiative of investment grade companies based in mature economies, offering proof of lingering risk aversion among international institutional investors with regards to emerging economy issuers[39].

Corporate Bond	2004	2005	2006	2007	2008*
Number of listed issuers	183	230	483	607	642
Number of listed bonds	189	302	370	465	468
Total Turnover (Bn RUB)	na	1,514	2,438	3,669.50	1,696.20
Trading on official markets / Total Turnover (share %)	na	60.3	72.2	73.9	74.7

Source: NAUFOR, Russian Capital Market. Facts and events, many years. *as of 30 June 2008.

[39] On this topic, see IIF, *Capital Markets Monitor, February 2009, p.2.*

Glossary	
CIS	Commonwealth of Indipendent States
EBRD	European Bank for Reconstruction and Development
EIA	Energy Information Administration
EIU	Economist Intelligence Unit
ENEL	(Ente Nazionale Energia Elettrica) Italian National Society of Electric Energy
ENI	(Ente Nazionale Idrocarburi) Italian National Society of Hydrocarbons
FDI	Foreign Direct Investment
ICE	Italian National Institute of Foreign Trade
IIF	Institute of International Finance
IMF	International Monetary Fund
ISTAT	Italian National Institute of Statistics
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

Data included in this document are updated at 12 March 2009

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