4th floor
Ropemaker Place
25 Ropemaker Street
London
EC2Y 9LY
United Kingdom

tel +44 20 7260 2000
fax +44 20 7260 2001
www.markit.com

Markit Economic Research

05/04/2011

Russia

Service sector continues to hold back Russian economic growth.

- **Growth remained solid in Q1, but Russia still laggard of BRIC group.**
- **Manufacturing expansion gathering momentum, but services yet to move up a gear.**
- **Inflationary pressures eased in March but substantial upside risks remain.**

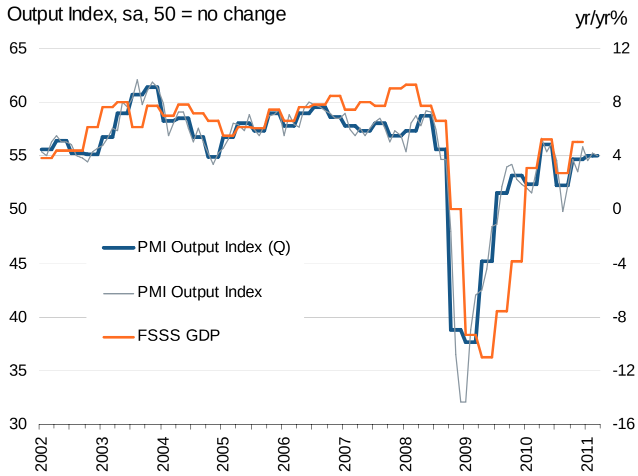
The latest Russian services PMI data published by HSBC and Markit failed to show strengthening momentum in the sector, after earlier manufacturing data signalled the best overall improvement in business conditions in the goods-producing sector since August 2006. PMI data for Q1 as a whole pictured a solid rate of expansion of the Russian economy, following the 5% annual rate of GDP growth seen in Q4. But Russia continues to rank poorly on international competitiveness and remains the weakest-growing of the four major emerging markets that make up the so-called BRIC group (Brazil, Russia, India and China), lagging China and India in particular.

Q1 strongest quarter since Q2 2010

The combined March PMI data for manufacturing and services signalled a solid overall rate of growth that was little-changed from February. The PMIs signalled in advance the stronger rate of economic growth in Q4 2010, and figures for Q1 2011 suggest that this pace will be broadly maintained, with Q1 set to be the strongest quarter of growth since Q2 2010.

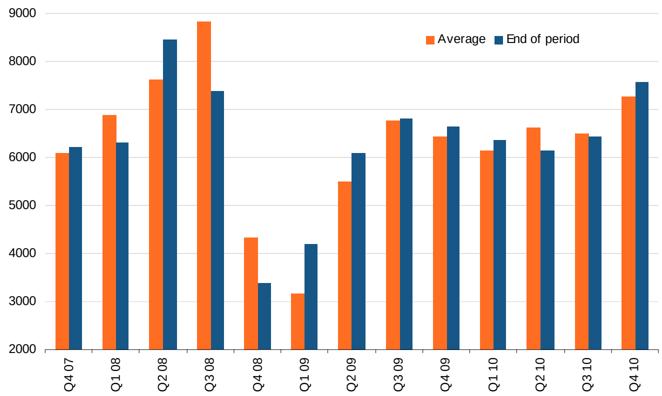
Recent official GDP data for Q4 were slightly stronger than the PMIs' signal, showing a 5% year-on-year expansion. That compared to a PMI-based estimate of 4.2%, with the difference most likely reflecting the resurgence in oil prices. Russia's economy is still heavily reliant on the energy sector, an area not directly covered by PMI surveys. Together, manufacturing and services account for around 49% of Russian GDP. At the time of writing a sector breakdown of official gross domestic product was not available for Q4 2010.

HSBC Russia Composite Output Index vs GDP



Sources: HSBC, Markit, FSSS.

Crude Oil (RUB)

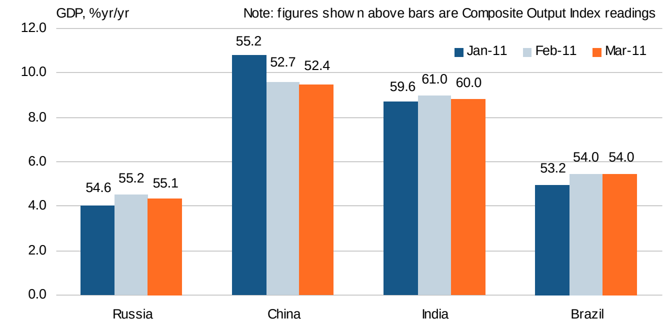


Source: FSSS.

Russia still lagging other BRIC members

PMI data for the first three months of 2011 show that Russian economic growth remains the weakest among the BRIC group. Converting composite (manufacturing and services combined) PMI data for January, February and March to implied GDP growth rates for the four economies shows Russia rooted in fourth place. The PMI-derived growth rates for Russia are broadly consistent with the Economy Ministry's latest monthly estimate of 4.4% in February.

Economic growth derived from PMI Composite Output Index



Sources: HSBC, Markit.

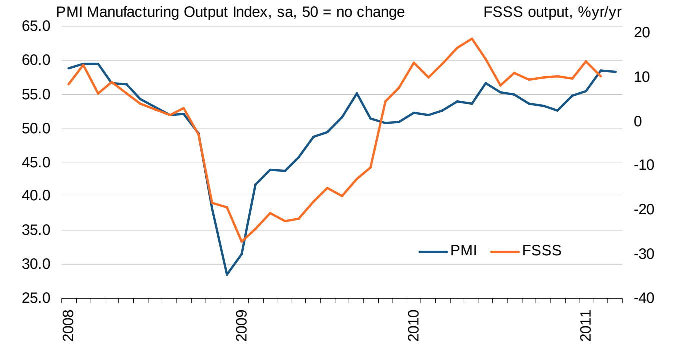
The International Monetary Fund currently forecasts Russian GDP to grow by 4.5% in 2011, while the World Bank has downgraded its estimate to 4.4%. While these would be impressive rates for any major advanced economy, in the context of emerging markets they are sluggish – especially considering Russia's immense natural resources. In comparison, the economies of China and India are forecast to grow by 9.6% and 8.4% respectively. Those countries outperform Russia on a key measure of competiveness, the World Bank's Global Competitiveness Index. Russia is 33rd out of 35 OECD countries covered, and also behind Brazil, the fourth economy of the BRIC group. The Russian government has placed a high priority on improving the country's investment climate, and any success will be key to releasing the shackles from services in particular.

Services growth remains sluggish, but manufacturing recovery finally gaining traction

The rates of growth for total services activity and incoming new business both eased to six-month lows in March, signalling that the recovery in the tertiary sector remained fragile. Firms were also less optimistic overall about the longer-term outlook, with confidence sliding to a six-month low.

In contrast, the manufacturing sector recovery finally appears to be gaining momentum after relatively slow growth in 2010. Production grew in March at a rate close to February's recent high, while new orders increased at the fastest rate in three years. The latest data are consistent with an annual rate of expansion of manufacturing output of 11.1% in March. Official manufacturing growth was running at 10.2% in February.

Manufacturing Output Index vs official data



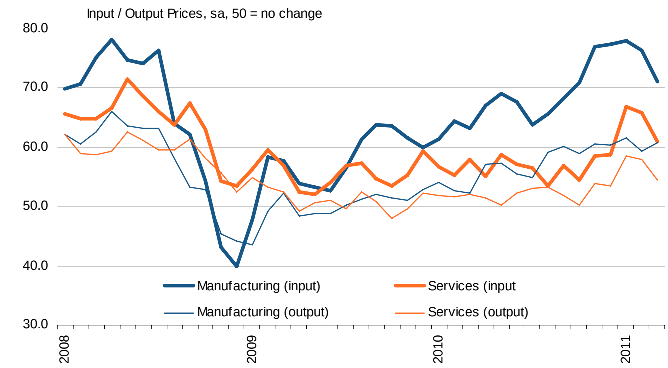
Sources: HSBC, Markit, FSSS.

Inflationary pressures eased in March

Controlling inflation is a major challenge for the authorities, with producer prices up 24.1% year-on-year in February and consumer price inflation running at 9.5% year-on-year in the same period.

The World Bank doubts that the Russian government will meet it's stated (consumer price) inflation target of 6-7% in 2011, currently forecasting a rate of 8-9%, but recent PMI data provide some encouragement that cost pressures are beginning to ease for manufacturers and service providers. Input price inflation slowed for the second month running in both sectors, while service sector charges rose at the slowest rate in three months in March. Less encouragingly, manufacturers' charges increased at the second-fastest rate in nearly three years.

Inflationary pressures eased in March



Sources: HSBC, Markit.

April PMI data will be closely watched to see if any further rises in oil prices linked to events in the Middle East and North Africa, as well as commodity price hikes resulting from supply disruption from the Japanese crisis, cause a reacceleration in firms' input costs. Any pre-election budget spending by the government also poses a considerable upside risk this year.

4th floor
Ropemaker Place
25 Ropemaker Street
London
EC2Y 9LY
United Kingdom

tel +44 20 7260 2000
fax +44 20 7260 2001
www.markit.com

Trevor Balchin

Senior Economist
Markit
Tel: +44 1491 461065
Email: trevor.balchin@markit.com

For further information, please visit www.markit.com