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Russian Federation: Few changes after the tandem shuffle

After a robust first quarter, Russian GDP growth has begun to slow down. wiiw forecasts unspectacular growth during 2012-2014, assuming no abrupt policy changes or severe external shocks. Export revenues will grow rather slowly due to stagnating volumes of exported oil and gas; imports are expected to grow at a faster rate as household consumption and investment will gradually pick up, both fuelled by the ongoing real currency appreciation. In the medium and long run, reforms and investment (including FDI) may be stimulated by WTO membership, while the attempted large scale modernisation will bring few of the desired benefits any time soon.

After nearly 5% growth in the first quarter of 2012, Russian GDP growth is currently slowing down and the growth forecast for the year as a whole has been revised downwards accordingly (to less than 4%). Falling oil prices and the lack of progress in diversification are the main culprits; the worsened growth outlook may be aggravated by the crisis in the eurozone. The current rate of GDP growth results from a robust recovery of fixed investment and also from growing consumer expenditures. The contribution of net exports to GDP growth remains negative because import volumes are growing faster than those of exports. On the supply side, industry remains sluggish (growth of just 3.4% in Jan-May 2012 against the same period of the previous year. Last year's strong upturn in agricultural output (+22%) will definitely not be repeated. Agriculture not only helped GDP growth in 2011 however, but was also instrumental in the reduction of consumer price inflation, an effect which spilled over to 2012. These developments together with a slight increase in employment (and the related drop in unemployment) and last year's fiscal surplus have been the positive economic developments in the past 12 months.

Positive economic news has been overshadowed by the popular disillusionment related to the alleged falsification of Duma and presidential elections however, especially among the middle class intelligentsia in Moscow and St. Petersburg. Disillusionment has been escalating since the Medvedev-Putin tandem shuffle. The formation of a new government in May 2012 revealed Prime Minister Medvedev's weakness: many former ministers switched to Putin's presidential administration and were replaced in the government by

their previous deputies. The influential “spin doctor” V. Surkov will head and ‘supervise’ the government apparatus; the former Deputy Prime Minister I. Sechin will head the leading state energy company Rosneft. On the more positive side, some political reforms (such as the reintroduction of regional governors’ elections and an easier registration of political parties) have been introduced as well.

Inflation has calmed down since the end of 2011, in part thanks to the absence of food price hikes following last year’s favourable harvest. Another factor mitigating inflationary pressures has been the nominal rouble appreciation – a by-product of surging export revenues. In real terms (deflated with the consumer price index), the rouble appreciated by more than 20% against the euro between January 2009 and May 2012. Nevertheless, the volatility of the rouble exchange rate has been considerable: after a short-lived but sharp nominal and real depreciation at the turn of 2009, and the period of real appreciation during 2011 and early 2012; since May 2012 the rouble has been weakening again. That notwithstanding, foreign exchange reserves are being replenished (they exceeded USD 510 billion in mid-2012), despite sizeable capital flight: the outflow of capital from Russia exceeded USD 85 billion in 2011; another USD 40 bn is estimated to have left the country in the first half of 2012. These outflows are partly linked to genuine outward FDIs, and partly due to lasting political uncertainties. Corruption and the hostile domestic investment climate have also played an important role.

The banking sector is slowly consolidating, with credits to both households (including housing mortgages) and enterprises growing sharply again (+30% at the end of March 2012 compared with the end of March 2011). Still, investment growth is clearly insufficient and much more investment is needed, especially for the envisaged modernization and diversification. According to Putin’s announcement at the recent St. Petersburg Economic Forum, the share of investment in GDP is planned to increase from the current rate of 20% to 27% by the year 2018. With this target in mind, a substantial improvement in the investment climate is required. To foster this new privatization plans have been announced.¹ Unfortunately (as mentioned repeatedly in our previous assessments), the recent years have not been used for launching economic restructuring and institutional reforms which would bring about the badly needed improvements in the business climate. Russia is as dependent on exports of commodities as ever: oil and gas account for about two thirds of export revenues. Restructuring, modernization and the ‘innovation

¹ The government has announced ambitious plans to privatize - either fully or by selling minority stakes in a number of state owned companies such as Sovkomflot (sea transport), Sberbank, Rosnano, Russian Railways, Aeroflot, Sheremetyevo Airport, Transneft, etc.

development' preached by the authorities over a number of years have so far remained empty slogans.

The elements of Putin's future policies have been made public over the last couple of months. In his first programmatic declaration in October 2011, Mr. Putin underlined the importance of Euroasian (EurAz) integration of the post-Soviet space.² Another Putin's article praised the macroeconomic stability achieved under his rule as well as own leadership qualities.³ Finally, the economic programme of Putin's forthcoming presidency was made public in a lengthy article published under the heading 'We Need a New Economy' in January 2012.⁴ All these programmatic theses were reiterated by President-elect Putin in his welcoming adress at the above mentioned St. Petersburg Economic Forum in June 2012. Besides – apart from WTO accession which will be completed in the coming months – Putin also expressed the hope that Russia will join the OECD in 2014.

All the rhetoric notwithstanding, we basically stick to the previous assessment regarding the reform outlook and are convinced that any significant breakthrough is unlikely in the near future. Uncertainties have increased and Mr. Putin's current presidency is assumed to be much weaker than the previous one. External risks have also increased: a more pronounced recession in Europe and a slowdown in the global economy may result in lower oil prices. The wiiw baseline forecast scenario assumes that oil prices will stay at or slightly below USD 100 per barrel in 2012 and thereafter. The 'horror scenario' (for Russia), with oil prices falling below USD 70 per barrel and the resulting severe consequences for Russian export and fiscal revenues is unlikely – although the government allegedly makes plans based on a scenario which assumes oil prices falling to USD 60 per barrel.⁵

In the current baseline scenario, the wiiw has revised the GDP growth forecast for 2012 downwards (below 4%), but continues to forecast an accelerating yet unspectacular growth rate of GDP during 2013-2014. This scenario assumes no abrupt policy changes or external shocks and is charged with substantial downside risks. In particular, a more

² The Customs Union of Belarus, Kazakhstan and Russia was launched in 2010. According to plans, this will be expanded to include Kyrgyzstan and Tajikistan, with the ultimate Russian aim to eventually get Ukraine on board also. The Customs Union was upgraded to a Common Economic Space in January 2012.

³ See *Izvestiya*, 16 January 2012. Indeed, inflation dropped to record low levels (below 4%) in Jan-May 2012 (producer price inflation to 10% in the same period).

⁴ See *Vedomosti*, 30 January 2012.

⁵ The baseline assumption for the 2013 budget plan regarding the oil price is USD 90 per barrel. Each 1 USD/bbl lower oil price costs the Russian budget Rbl 60 bn in foregone revenues; the non-oil budget deficit is expected to reach 10.6% of GDP in 2012 – see *Vedomosti*, 21 June 2012.

severe recession in Europe would have serious consequences, largely via falling export (and fiscal) revenues.⁶ In the baseline scenario, export revenues will grow slowly due to stagnating volumes of exported oil and gas in the forecasting period, while there will be not much else to export since progress in export diversification will be limited. Simultaneously, import volumes are expected to grow at a faster rate as household consumption and investment gradually pick up, both fuelled by the ongoing real currency appreciation. In the medium and long run, economic reforms and investment (including FDI) may be stimulated by WTO membership. In summary, we stick to this relatively optimistic scenario which implies another negative contribution of real net exports to GDP growth in the coming years and, in nominal terms, gradual reductions of the trade and current account surpluses. With some luck the annual CPI inflation will gradually drop below 5% and the budget deficit will remain balanced.

⁶ Some analysts are fairly upbeat claiming that nowadays Russia is much better prepared to face the challenges which would stem from a crisis in Europe – see, for example, the analysis of the Gaidar Institute published in *Vedomosti*, 19 October 2011. Indeed, Mr Putin argued on a similar stroke in the above quoted speech stressing the USD 510 bn Forex reserves.

Table RU

Russia: Selected Economic Indicators

| | 2008 | 2009 | 2010 | 2011 ¹⁾ | 2011 1st quarter | 2012 | 2012 Forecast | 2013 | 2014 |
|---|---------|---------|---------|--------------------|---------------------|---------|------------------|--------|--------|
| Population, th pers., average ²⁾ | 141956 | 141902 | 142938 | 142500 | . | . | 142000 | 141500 | 141000 |
| Gross domestic product, RUB bn, nom. ³⁾ | 41277 | 38807 | 45173 | 54586 | 11680 | 13491 | 62600 | 70000 | 78000 |
| annual change in % (real) ³⁾ | 5.2 | -7.8 | 4.3 | 4.3 | 4.0 | 4.9 | 3.8 | 4.0 | 4.2 |
| GDP/capita (EUR at exchange rate) | 8000 | 6200 | 7800 | 9400 | . | . | . | . | . |
| GDP/capita (EUR at PPP - wiiw) | 13100 | 11900 | 12600 | 13500 | . | . | . | . | . |
| Consumption of households, RUB bn, nom. ³⁾ | 19967 | 20986 | 23482 | 27229 | 6049 | . | . | . | . |
| annual change in % (real) ³⁾ | 10.6 | -5.1 | 5.2 | 6.8 | 6.1 | . | 5 | 5 | 5 |
| Gross fixed capital form., RUB bn, nom. ³⁾ | 9201 | 8536 | 9829 | 11620 | 1524 | . | . | . | . |
| annual change in % (real) ³⁾ | 10.6 | -14.4 | 5.8 | 8.0 | -0.6 | . | 5 | 6 | 6 |
| Gross industrial production ⁴⁾ | | | | | | | | | |
| annual change in % (real) | 2.1 | -9.3 | 8.2 | 4.7 | 5.9 | 4.0 | 6 | 5 | 6 |
| Gross agricultural production | | | | | | | | | |
| annual change in % (real) | 10.8 | 1.4 | -11.3 | 22.1 | 0.7 | 4.0 | . | . | . |
| Construction output | | | | | | | | | |
| annual change in % (real) | 12.8 | -13.2 | 3.5 | 5.1 | 1.6 | 5.2 | 6 | 5 | 6 |
| Employed persons - LFS, th, average | 70965.1 | 69284.9 | 69804.0 | 70732.0 | 69426.7 | 69895.0 | 70500 | 70000 | 70000 |
| annual change in % | 0.6 | -2.4 | 0.7 | 1.3 | 2.1 | 0.7 | -0.3 | -0.7 | 0.0 |
| Unemployed persons - LFS, th, average | 4791.5 | 6372.8 | 5636.0 | 5020.0 | 5617.3 | 4869.7 | 5000 | 5000 | 5000.0 |
| Unemployment rate - LFS, in %, average | 6.3 | 8.4 | 7.5 | 6.6 | 7.5 | 6.5 | 6.6 | 6.7 | 6.7 |
| Unemployment rate, reg., in %, end of period | 2.0 | 2.9 | 2.1 | 1.7 | 2.2 | 1.8 | . | . | . |
| Average gross monthly wages, RUB | 17290.1 | 18637.5 | 20952.0 | 23532.0 | 21340.7 | 24423.0 | . | . | . |
| annual change in % (real, gross) | 11.0 | -3.0 | 5.2 | 3.5 | 0.5 | 11.7 | . | . | . |
| Consumer prices, % p.a. | 14.1 | 11.8 | 6.9 | 8.5 | 9.5 | 3.9 | 6 | 5 | 5 |
| Producer prices in industry, % p.a. ⁵⁾ | 21.4 | -7.2 | 12.2 | 19.0 | 21.3 | 10.8 | 10 | 9 | 8 |
| General governm.budget, nat.def., % GDP | | | | | | | | | |
| Revenues | 38.8 | 35.0 | 35.5 | 38.4 | 37.6 | 37.8 | . | . | . |
| Expenditures | 33.9 | 41.4 | 39.0 | 36.8 | 30.6 | 34.0 | . | . | . |
| Deficit (-) / surplus (+), % GDP | 4.9 | -6.3 | -3.5 | 1.6 | 7.0 | 3.9 | 0 | 0 | 0 |
| Public debt, nat.def., in % of GDP ⁶⁾ | 5.7 | 8.3 | 8.6 | 9.2 | 7.5 | 8.0 | 8 | 7 | 6 |
| Central bank policy rate, % p.a., end of period ⁷⁾ | 13.00 | 8.75 | 7.75 | 8.00 | 8.00 | 8.00 | . | . | . |
| Current account, EUR mn ⁸⁾ | 70642 | 34961 | 53861 | 70976 | 22519 | 32256 | 60000 | 50000 | 40000 |
| Current account in % of GDP | 6.2 | 4.0 | 4.8 | 5.3 | 7.7 | 9.5 | 3.9 | 3.0 | 2.2 |
| Exports of goods, BOP, EUR mn ⁸⁾ | 321792 | 218221 | 303580 | 374872 | 82792 | 102717 | 410000 | 445000 | 480000 |
| annual growth rate in % | 24.3 | -32.2 | 39.1 | 23.5 | 20.9 | 24.1 | 9 | 9 | 8 |
| Imports of goods, BOP, EUR mn ⁸⁾ | 199148 | 137960 | 188404 | 232553 | 47580 | 55896 | 280000 | 320000 | 360000 |
| annual growth rate in % | 22.0 | -30.7 | 36.6 | 23.4 | 39.5 | 17.5 | 20 | 14 | 13 |
| Exports of services, BOP, EUR mn ⁸⁾ | 34921 | 29918 | 34085 | 38797 | 7735 | 8922 | 45000 | 49000 | 53000 |
| annual growth rate in % | 21.8 | -14.3 | 13.9 | 13.8 | 7.1 | 15.3 | 16 | 9 | 8 |
| Imports of services, BOP, EUR mn ⁸⁾ | 51495 | 44185 | 55834 | 64612 | 12397 | 14946 | 80000 | 95000 | 100000 |
| annual growth rate in % | 21.2 | -14.2 | 26.4 | 15.7 | 10.5 | 20.6 | 24 | 19 | 5 |
| FDI inflow, EUR mn ⁸⁾ | 51177 | 26254 | 32802 | 37973 | . | . | 45000 | 50000 | 55000 |
| FDI outflow, EUR mn ⁸⁾ | 37934 | 31407 | 39800 | 48318 | . | . | 45000 | 40000 | 35000 |
| Gross reserves of CB, excl. gold, EUR mn | 291916 | 290432 | 335191 | 350786 | 330657 | 348683 | . | . | . |
| Gross external debt, EUR mn | 340688 | 325697 | 369458 | 421258 | 362040 | 423250 | . | . | . |
| Gross external debt in % of GDP | 30.1 | 37.0 | 33.0 | 31.5 | 27.1 | 27.7 | . | . | . |
| Exchange rate RUB/EUR, average | 36.43 | 44.14 | 40.30 | 40.87 | 40.03 | 39.67 | 41 | 42 | 43 |
| Purchasing power parity RUB/EUR, wiiw ⁹⁾ | 22.13 | 22.91 | 25.00 | 28.54 | . | . | . | . | . |

1) Preliminary. - 2) Resident population. From 2010 according to census October 2010. - 3) FISIM reallocated to industries, real growth rates based on previous year prices etc. - 4) Excluding small enterprises. - 5) Domestic output prices. - 6) wiiw estimate. - 7) Refinancing rate of Central Bank. - 8) Converted from USD with the average exchange rate. - 9) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.