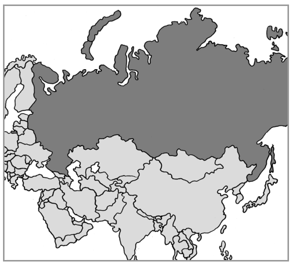

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Russian Federation:
heading for crash and clash?

Russia has been seriously hit by the current global crisis. In 2008, economic growth still reached nearly 6%; fixed investment rose by 10% and household consumption by 11%. Export revenues grew by 24% (imports by 22%, both in euro terms) and the current account surplus increased as well. In the fourth quarter of 2008, however, growth virtually collapsed and the economy plunged into a deep recession. GDP contracted by nearly 10% in the first quarter of 2009, investment and construction dropped by 15-20%, exports and imports revenues by 30-40% in the same period. ROSSTAT also reports a 40% decline in FDI inflows in the first quarter of the year and a huge increase in FDI outflows. Industrial output, in particular in manufacturing, fell at double-digit rates as well. The decline in household consumption and retail sales (both dropped by about 2% compared to the first quarter of the previous year) could be mitigated by government anti-crisis measures (see below). At the same time, unemployment (as well as wage arrears) increased and consumer price inflation remained at double-digit rates – in part as a result of the rouble devaluation at the beginning of the year.

The stock market dropped by more than 70% between May 2008 and January 2009 – one of the largest declines among the emerging markets. A number of Russian blue chip companies (such as Gazprom, Rosneft, Lukoil, Sberbank, Norilsk Nickel) were initially hit particularly hard, reflecting partly investors' overreaction, although fundamental factors played a role as well (a decline in world prices for oil and metals and high exposure to short-term foreign debts). The adverse external shocks that triggered these events may have been compounded by domestic political factors, such as the Mechel and TNK-BP affairs of early summer 2008, the August war in Georgia and the gas conflict with Ukraine at the beginning of 2009. However, the shallow depth and relative immaturity of the domestic stock market should keep repercussions on the real economy in check. Yet the stock market developments reflected more a temporary overreaction on the part of the market participants rather than a lasting deterioration of the domestic investment climate (the stock market increased by more than 50% between January and end-June 2009).[1]

Indeed, potentially more serious than the highly volatile performance of the stock market – especially as far as repercussions on the real economy are concerned – is the tightening of credit conditions. There is no doubt that several large Russian companies (such as Mr Deripaska's Basic Element) and smaller Russian banks in particular have been facing difficulties servicing and refinancing their outstanding foreign debts. The lack and/or dearth of domestic, especially long-term credit financing –

1 See *The Economist*, 27 June 2009, p. 106.

a by-product of past restrictive monetary policies in Russia and easy credits abroad – have motivated Russian companies, even the state-owned or state-controlled ones such as Gazprom or Rosneft, to seek external financing. Private foreign debt reached some USD 400 billion as of end-March 2009 with short-term obligations declining (to 16% of the total at the beginning of 2009) and refinancing becoming more difficult.

Similar to the USA, the EU and China, the Russian government has adopted various rescue and stimulus packages in order to improve the liquidity of the banking sector, restore confidence and to support domestic consumption. The Central Bank released more than USD 200 billion out of its reserves in order to provide additional liquidity and to support the rouble exchange rate. New loans to the banking sector with a maturity of up to six months are provided via the state-owned Vneshekonombank (VEB) with no collateral required. In addition, the VEB is providing credit for refinancing short-term foreign loans, while acquiring shares in those companies as collateral. The bank guarantee on private deposits was raised to RUB 700,000 (EUR 20,000). Altogether, more than USD 200 billion of state assistance in various forms were earmarked in an endeavour to ease liquidity in the financial sector. Critics point to the usual dangers of misappropriation and corruption; they also expect that in the main the large (or well-connected) banks and companies stand to gain disproportionately. They wonder in fact – up until June with some justification – whether the money will reach the companies facing the liquidity squeeze. It is to be expected that a number of small and medium-sized banks will eventually collapse, the banking sector will be streamlined and the state will exert greater influence on companies seeking and obtaining financial help.

The revised federal budget for 2009 also entails a huge fiscal stimulus as it reckons with a rise of expenditure (+7%) despite falling revenues. As a result, the budget is expected to shift from a surplus (6% of GDP in 2008) to a deficit of 7% of GDP in 2009. Previously accumulated resources in the Reserve Fund and the issuance of domestic debt will be used to support government expenditures on various investment and social programmes. In sum, the above anti-crisis measures cost about 10% of Russian GDP but their effects are hard to measure.

Russian authorities, as well as the IMF, OECD, The World Bank and others (including wiiw) have been busily revising GDP forecasts downwards. The range of GDP growth forecasts for the year 2009 fluctuates between -2% and -10%, largely depending on assumptions regarding the level of energy prices (the official data for May were very bad). In the past couple of years, Russian GDP growth has been driven mainly by booming private consumption and, increasingly, also by expanding investments. The contributions of real net exports to GDP growth has become negative as the volume of exports was growing only at a modest pace whereas import volumes were surging by more than 20% per year. On the supply side, the major part of the overall GDP growth resulted from booming trade, financial services, telecoms and construction activities while the manufacturing industry and agriculture expanded less than the overall gross value-added.

With export revenues down by about 30% as a result of lower energy prices and rapidly falling investments, GDP growth will not only slow down substantially in 2009 (as previously expected) but will even turn negative. The revised wiiw forecast reckons with a GDP decline by about 5% in 2009, largely due to a reduction of investment, and growth will resume towards the end of the year. The outcome, however, may also be much worse. Most current forecasts of Russian GDP reckon with negative growth for 2009 (-6.5% according to the IMF, -7.9% according to The World Bank), with stabilization or even some modest increase possible in 2010. The domestic financial market may stabilize and even recover fairly soon, yet the investment climate (including financing and the climate for investments in general) will remain difficult. Nominal exports and imports will contract substantially; the volume of exports and imports will also decline in 2009 – possibly even in 2010.

GDP growth slowdown appears inevitable also in the medium term, before any (uncertain) modernization and diversification efforts start to bear fruit. Our forecast for 2010 is based on a modest recovery of oil prices (Urals costing not more than USD 70 per barrel) and a limited lasting impact of the current financial market turmoil. Both private consumption and investment are expected to grow faster than GDP; real exports will continue to be sluggish at best since the volumes of exported oil and gas will hardly increase, while imports will grow at a faster rate – roughly in line with private consumption and investment. This implies an ongoing negative (albeit diminishing) contribution of real net exports to GDP and, in nominal terms, a gradual reduction of the trade and current account surpluses. In fact, the current account surplus, which leapt to EUR 70 billion in 2008 (about 6% of GDP), will diminish. Inflation will remain above 10% in 2009 and stubbornly close to 10% thereafter.

More than the direct effects of the global financial crisis, the oil price in particular constitutes a crucial variable for Russia in the short, medium and possibly even long term. The current global turmoil notwithstanding, the main challenge for the Russian economy is whether it will succeed in replacing energy exports as the key growth driver by developing other sectors (diversifying towards manufacturing, high-tech branches, services, etc.) and the manner in which it will cope with the acute demographic crisis. The major challenges for the Russian economy – institutional developments, economic diversification and modernization – thus remain unchanged. The accession to WTO was postponed again, this time after the agreement about forming a Customs Union with Belarus and Kazakhstan starting from January 2010 was finalized.

Apart from energy issues, it is probably the EU's (and NATO's) Eastern enlargement as well as the EU's Neighbourhood (Eastern) Policy (ENP) vis-à-vis the CIS countries (in particular Ukraine and Georgia) where Russian and EU interests are clashing. Russia is considering its 'near abroad' as its traditional sphere of influence and the ENP is perceived by Russia as an unwelcome foreign inroad. Also the Western support of the 'colour' revolutions in several CIS countries is perceived by Russia as a deliberate attempt at regime change, ultimately aiming at the reduction of Russian influence in the CIS. It remains to be seen how successful a 'reset' of Russian relations with the USA will be. For the time being, Russian external relations have been deteriorating across the board (even with Belarus there are disputes over trade and relations with the EU). In sum, neither the economic nor political prospects for Russia are currently encouraging.

Table RU

Russia: Selected Economic Indicators

	2005	2006	2007	2008 [1]	2008	2009	2009	2010	2011
					1st quarter			Forecast	
Population, th pers., average [2]	143114	142487	142115	141956	141820	141900	140500	140000	139500
Gross domestic product, RUB bn, nom.	21625.4	26903.5	33111.4	41668.0	8891.0	8482.8	42000	46700	52000
annual change in % (real)	6.4	7.7	8.1	5.6	8.7	-9.8	-4.7	4.0	4.1
GDP/capita (EUR at exchange rate)	4300	5500	6700	8100	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	10000	11100	12400	13100	.	.	.	.	.
Consumption of households, RUB bn, nom.	10590.0	12887.9	15900.9	20054.2	4258.1	.	.	.	.
annual change in % (real)	11.8	11.4	13.7	11.3	12.2	.	-2.2	4	5.6
Gross fixed capital form., RUB bn, nom.	3836.9	4980.6	6982.5	9136.4	1433.9	.	.	.	.
annual change in % (real)	10.6	18.0	21.1	10.0	23.5	-15	-16	10	10
Gross industrial production									
annual change in % (real)	5.1	6.3	6.3	2.1	6.2	-14.3	-15	5	5
Gross agricultural production									
annual change in % (real)	2.3	3.6	3.4	10.8	2.1	5.5	.	.	.
Construction industry									
annual change in % (real)	10.5	18.1	18.2	12.8	29.0	-19.2	.	.	.
Employed persons - LFS, th, average	68169.0	68855.0	70570.5	70965.0	69491.0	67664.0	68000	68500	69000
annual change in %	1.3	1.0	2.5	0.6	0.4	-2.6	.	.	.
Unemployed persons - LFS, th, average	5262.8	5312.0	4589.0	4791.0	5308.0	7107.0	8000	7500	7000
Unemployment rate - LFS, in %, average	7.2	7.2	6.1	6.3	7.1	9.5	10.5	10	9
Reg. unemployment rate, in %, end of period	2.5	2.3	2.0	2.0	2.0	2.9	.	.	.
Average gross monthly wages, RUB	8554.9	10633.9	13593.4	17226.0	15424.0	17441.0	.	.	.
annual change in % (real, gross)	12.6	13.3	17.0	10.3	-2.3	13.4	.	.	.
Consumer prices, % p.a.	12.5	9.8	9.1	14.1	13.9	12.8	12	10	8
Producer prices in industry, % p.a. [3]	20.7	12.4	14.1	21.4	25.7	-8.3	-5	5	5
General governm.budget, nat.def., % GDP									
Revenues	39.7	39.5	40.4	38.4	37.5	35.8	.	.	.
Expenditures	31.5	31.1	34.4	33.6	26.3	33.1	.	.	.
Deficit (-) / surplus (+), % GDP	8.1	8.4	6.0	4.8	11.2	2.7	-5	.	.
Public debt, nat.def., in % of GDP [4]	14.9	8.6	7.2	5.7	5.4	.	.	.	.
Base rate of NB % p.a., end of per.	12	11	10	13	10.3	13.0	.	.	.
Current account, EUR mn [5]	67858	75474	56266	69824	25405	8486	30000	25000	25000
Current account in % of GDP	11.1	9.6	5.9	6.1	10.4	4.4	3.1	2.4	2.2
Exports of goods, BOP, EUR mn [5]	195545	241960	258930	321792	73626	44200	220000	240000	280000
annual growth rate in %	32.7	23.7	7.0	24.3	34.6	-40	-32	9	17
Imports of goods, BOP, EUR mn [5]	100608	130948	163282	199148	40257	29100	140000	160000	190000
annual growth rate in %	28.4	30.2	24.7	22.0	23.4	-28	-30	14	19
Exports of services, BOP, EUR mn [5]	20028	24791	28798	35008	6881	.	33000	35000	38000
annual growth rate in %	20.9	23.8	16.2	21.6	17.5	.	-6	6	9
Imports of services, BOP, EUR mn [5]	31077	35643	43151	52096	9953	.	50000	55000	60000
annual growth rate in %	16.1	14.7	21.1	20.7	20.0	.	-4	10	9
FDI inflow, EUR mn [5]	10336	23675	40237	47982	13730	.	25000	35000	45000
FDI outflow, EUR mn [5]	10240	18454	33547	35748	10575	.	30000	35000	40000
Gross reserves of NB, excl. gold, EUR mn	148094	224306	318840	292483	316495	278624	.	.	.
Gross external debt, EUR mn	216553	235714	317918	343637	303877	343223	.	.	.
Gross external debt in % of GDP	34.2	30.4	34.5	34.2	30.2	36.0	.	.	.
Average exchange rate RUB/EUR	35.26	34.11	35.01	36.43	36.29	44.46	44	45	46
Purchasing power parity RUB/EUR, wiiw [6]	15.06	17.01	18.84	22.38	.	.	.	.	.

1) Preliminary. - 2) Resident population, quarterly data: end of period. - 3) Based on domestic output prices. - 4) wiiw estimate. - 5) Converted from USD with the average exchange rate. - 6) wiiw estimates based on the 2005 International Comparison Project benchmark.

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