EMERGING MARKETS

RUSSIA: Home economics

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Russia has had a bad few months. There are signs that the economy is growing again – but not at a rate that will make everyone happy

The summer's reverses in emerging markets reached Russia when two government bond auctions failed, in August and September.

Although most economic indicators remain relatively strong, an auction of domestic OFZ bonds was cancelled in late August because it only attracted one bidder; the next one in September was less than half taken up, selling Rb6.07 billion ($182 million) of bonds out of an offer of Rb13.6 billion. The average yield was high at 6.5%.

A $7 billion issue of dollar- and euro-denominated Eurobonds was then delayed, but sold out quickly. However, interest rates on a $3 billion, 10-year tranche rose above 5% from 4.5% on similar bonds in 2012.

All this came on top of a sudden decline in growth in the first half of the year. Most economists say economic growth will recover in 2014, but there is a longer-term question of whether consumer demand can replace energy exports as the economic driver, as Russia feels the impact on gas prices of the US shale revolution.

In the second quarter, gross domestic product expansion fell sharply to 1.2%, giving rise to fears in some quarters of a recession. The IMF reduced its 2013 growth forecast to 2.5%, compared with 3.4% in 2012 and 4.3% in 2011.

Leading economists interviewed by *Emerging Markets* expect the slowdown to be short term, caused by rapidly growing consumer debt at excessive interest rates. They foresee a quick revival of growth, although not at the annual rates of 6–7% seen before 2008. Darya Isakova, economist for Russia at VTB Capital, foresees a 1.7% growth rate for this year, accelerating in the second half, and a 2% growth rate by the second quarter of 2014. Investment is growing, the 2013 harvest was good, government expenditure will expand in the second half-year, and there is a global recovery, she says.

Isakova believes that the slowdown in the first quarter of this year was mainly due to "the underperformance of export and investment demand, while consumer activity remains the key driving force." The current "unimpressive investment dynamics" is mainly due to stalling oil prices and declining gas and metal prices, she says. Weak commodity prices translated into very slow growth of government revenues. This in turn has meant weak spending growth, therefore a decline in investment spending, as social spending continued to grow in real terms. Low prices and a weak outlook for commodities also meant "bleak investment activity" at companies in the mining and metals

sectors.

"As we are unlikely to see big changes in the commodity cycle in the near term, the only way to stimulate investment growth is through further improving the investment climate, which would support non-commodity, non-public investments," Isakova says.

WORRIES AHEAD

Julian Cooper of Birmingham University, England foresees growth of 3.5% in 2014 and 4% in 2015, as a consequence of European economic recovery. Evgeny Gavrilenkov, the chief economist of Sberbank, Russia's largest bank, is similarly optimistic as the government has corrected a policy error which provoked the consumer debt problem. Nevertheless, a Bloomberg survey of 13 economists in July found a 30% chance of recession next year.

In September the central bank kept its refinancing rate at 8.25%, unchanged for the 13th month. After months of decline, by mid-September the rouble had partly recovered to 32.49 per dollar. Foreign exchange reserves have fallen from $561 billion to $504 billion this year.

To encourage a revival, the government approved a stimulus package in July. The exact size is unknown, but in June President Putin said it would spend Rb450 billion ($14 billion) on road and railway developments, to be drawn from the $87 billion National Welfare Fund. This will be aided by $5 billion of further investments in infrastructure from Abu Dhabi, announced in September. It will be paid into the $10 billion Russian Direct Investment Fund, established in 2012.

"Russia's strength was always strong macroeconomic policy, with relatively weak institutions," says Gavrilenkov. But that has deteriorated in the last 12 months.

The government's budget, balanced in 2012, has fallen into a small deficit. However, government debt remains very low at about 12% of GDP. The balance of payments is strong, with a current account surplus of $32 billion in the first half, but this is down from $55.5 billion a year earlier.

Unemployment was stable at just over 4 million people, or 5.3% of the working population, in July. Consumer price inflation in the year to August was 6.5%, down 0.1 percentage points from the end of 2012.

Going forward, Russia's budget gap in the next two years will be wider than previously targeted, reaching 0.5% of GDP next year and 1% in 2015, compared with targets of 0.2% of GDP and 0% previously, the finance ministry said in the second half of September. Another danger is that "Russia's financial vulnerability is high," analysts at Bank of America Merrill Lynch say, pointing to three-year cumulative real loan growth of 76%. "While each lending boom is often presented as somehow necessary and different from others, we remain sceptical about these explanations," they add.

POLICY MISTAKE

Gavrilenkov said the government's policy mistake was a new budget rule, which restricted spending in line with the trend in oil prices. According to Cooper, this diluted Putin's plan to increase pensions and state benefits. But at the same time there was extra rouble borrowing to replenish the Reserve Fund, which was drawn on in the 2009 recession. The domestic bond market was also opened up to foreigners, a move that crowded out the domestic financial market, according to Gavrilenkov.

Consumer lending is still rising fast and is up 40% from 2011, but with relevant interest rates around 25%, people are borrowing to roll over debts rather than make new purchases. Many leading export companies are deeply in debt and not investing, says Cooper.

He emphasizes Russia's vulnerability to fluctuations in the world economy. Leading factors for future development include oil and gas prices, and the attractiveness of investment in Russia. Energy and resource dependence has increased over the last 10 years. "The fact is that Russia has not been at all successful at diversifying the economy," he says. According to the Ministry of Finance, the share of oil and gas revenues in the federal budget more than doubled from 20% in 2002 to 50% last year.

Oil prices remain above $100 a barrel, but international gas prices weakened because of the US shale gas revolution.

Prices of aluminium, nickel and other mineral exports are also down. Gazprom, the state-owned monopoly gas supplier, is renegotiating its export prices to Europe; in August they stood at $10.97 per million British thermal units – still three times the level of August 2003. US natural gas costs $3.43 per mBtu – above the lows of 2012 but down 31% from 10 years earlier.

The question of Europe's gas supplies will be resolved by market forces as gas is becoming more like a normal market, Cooper believes. "This is good for Europe and Russia," he says. It will force Gazprom to modernize since its position as Russia's top company is passing to Rosneft, the state-controlled oil producer in which BP holds a minority stake.

Economic growth now comes from mid-sized companies, which respond to domestic demand, and changes in gas prices will have a "very limited impact", Gavrilenkov says. However, doubts remain about the investment climate in Russia, and this could affect these companies' performance. Many emerging countries, including China and India, have challenged the World Bank's Ease of Doing Business (EDB) Index, but for Putin raising Russia's position in it is a centrepiece of national policy. In June he assigned this task to the Ministry of Economic Development and the Agency for Strategy Initiative, a business intermediary body.

DIFFERENT DIRECTIONS

Some progress has been made. Russia rose to 112th place in the 2013 index from 118th in 2012, but Putin has ambitious targets: he wants his country to climb to the 50th place by 2015 and as high as 20th in 2018.

In Russia's case, the index's 11 components point in dramatically different directions. Among 185 countries listed this year, Russia was placed 11th for contract enforcement and 46th for registering property, but 178th for acquiring construction permits and 184th for companies' access to electricity.

However, the validity of the whole exercise has been questioned. In a separate survey of G20 member countries, Ernst & Young, the consultancy firm, concluded: "The conditions of doing business in the Russian Federation are, in general, comparable to those in Brazil, China, Mexico and Saudi Arabia" and better than in Argentina, India, Indonesia, Italy and Turkey.

An international panel which reviewed the index for the World Bank reported in June that the Bank should make a "clean break" with its single, consolidated index. "It should retain the rankings for each item, ranking each country separately in terms of contract enforcement, ease of resolution and so on, but it should not provide an overall or aggregate ranking," it said.

Andrei Yakovlev, who led Russia's EDB assessment in 2011–12, agrees with that. He, Cooper and Gavrilenkov also agree that the index is useful. Yakovlev, the vice-rector of Moscow's Higher School of Economics, said Ernst & Young's assessment was based on large corporations while the World Bank emphasizes the needs of smaller businesses, identifying where the bottlenecks are, such as electricity and building permits.

The business climate needs to improve in Russia's regions, where performance varies widely, Yakovlev says. Real changes will depend on changes in staff at regional level. However, for Gavrilenkov the macroeconomic environment is just as important as the ease of doing business.

To some extent, Russia is still suffering from the poor reputation of its chaotic economic transition in the 1990s. However, Cooper thinks the ease of doing business is improving faster than the World Bank's index implies. Signs of an improving business climate started in reaction to the 2009 crisis, Yakovlev points out.

A recent survey by the Russo-British Chamber of Commerce supports this, finding that 60% of British businesses and investors in Russia "feel that the business climate has improved" in the past five years. "An overwhelming majority of both Russian and British businesses feel that western media has a negative impact on conducting business between the two countries," the survey concludes.

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