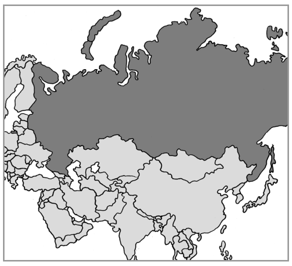

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Russia: economy hit by global turmoil

Until very recently, Russia was awash with money: both foreign exchange reserves and capital inflows were at record levels, the current account and government budget showed large surplus. The downside of that economic boom was – apart from growing assertiveness, nationalism and a revival of some ugly remnants of past Soviet stereotypes – the return of double-digit inflation and a sizeable rouble appreciation in real terms. Russian economic growth still reached some 6% in 2008; fixed investments grew by 13% and real money incomes by 8%. Export revenues grew by 24% (imports by 22%, both in Euro terms) and the current account surplus increased as well (Table RU). However, GDP growth virtually collapsed in the fourth quarter 2008 while inflation remains high and may even accelerate as a consequence of the recent government rescue measures and the depreciation of the rouble.

Despite strong economic fundamentals, Russia has been seriously hit by the global crisis – especially after September 2008. The stock market dropped by more than 70% between May 2008 and January 2009 – one of the largest declines among emerging markets. Market capitalisation declined by about USD 1000 billion over the same period. For the whole of 2008, net capital outflow reached nearly USD 140 billion (net capital inflows exceeded USD 80 billion during 2007). The stocks of a number of Russian blue chip companies (such as Gazprom, Rosneft, Lukoil, Sberbank, Norilsk Nickel, etc.) were hit particularly hard – reflecting partly investors' overreaction, although fundamental factors played a role given the recent decline in the world prices for oil and metals and high exposure to the 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 from early summer 2008, the 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. The current developments probably reflect more of a temporary overreaction on the part of the market participants rather than a lasting deterioration of the domestic investment climate. Medium- and long term prospects for economic growth are not bad.

Indeed, potentially more serious than the dismal and 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 especially smaller Russian banks have been facing difficulties to service and refinance their outstanding foreign debts. The lack and/or dearth of domestic, especially long term credit financing – 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. The private foreign debt reached more than USD 350 billion as of end-September 2008 (an increase of USD 80 billion since the beginning of the year).

Similar to the USA and the EU, the Russian government has adopted various rescue and stimulation packages in order to improve the liquidity of the banking sector and restore confidence. The Central Bank released more than USD 100 billion out of its reserves (amounting to USD 430 billion as of end-2008) 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 will be provided via the state-owned Vneshekonombank (VEB) with no collateral required. In addition, the VEB will provide credit for refinancing short-term foreign loans, while acquiring shares in those companies as collateral (e.g. Mr. Deripaska's Basic Element). 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 have been 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 stand to gain disproportionately from this facility. They wonder in fact 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 financial help.

With lower export revenues, GDP growth will slow down substantially in 2009; the trade and especially current account surpluses will diminish. A number of ambitious future spending and investment plans will have to be scaled down and government revenue will drop markedly following lower export duties on oil. Taken together, a substantial slowdown of GDP growth – to about 1% in 2009 – will now definitely materialize. The outcome, however, may be much worse: until recently, the range of GDP growth forecasts for the year 2009 fluctuated around 4-6% – largely depending on assumptions regarding the level of energy prices. Most current forecasts of Russian GDP growth are in a range of 1-3% for 2009, with some acceleration possible even in 2010. Both investment and consumption are expected to expand by 3%-7% in 2009. Owing to the albeit limited role of credits in financing both consumption and investments (the latter are still largely financed from own resources or by the government), any effect of the financial crisis should be relatively modest and short-lived. The domestic financial market may stabilise and even recover fairly soon, yet the investment climate (including financing and the climate for investments in general) will remain difficult. Nominal export and import growth will slow down substantially; the volume of exports will even decline slightly in 2009.

The expected GDP growth slowdown appears inevitable in the medium term, at least until the end of the decade before any (uncertain) modernization efforts start to bear fruit. Our forecast for 2010 is based on a modest recovery of oil prices (Urals costing not more than USD 50-70 per barrel) and limited (potential impact of current financial market turmoil). Both private consumption and investments are expected to grow faster than GDP; real exports will continue to be sluggish since volumes of exported oil and gas will hardly increase, while imports will expand rapidly – roughly in line with private consumption and investments. This implies an ongoing negative (albeit diminishing) contribution of real net exports to GDP and – in nominal terms – a gradual reduction of trade and current account surpluses. In fact, the current account surplus which leapt to EUR 70 billion in 2008 (about 6% of GDP) will soon disappear. 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 modernisation – thus remain unchanged.

Table RU

Russia: Selected Economic Indicators

	2003	2004	2005	2006	2007	2008 [1]	2009	2010	2011
								Forecast	
Population, th pers., average [2]	144566	143821	143114	142487	142115	141900	140500	140000	139500
Gross domestic product, RUB bn, nom.	13243.2	17048.1	21625.4	26903.5	33113.5	41540.4	46500	53000	60000
annual change in % (real)	7.3	7.2	6.4	7.7	8.1	5.6	1.1	3.7	4.6
GDP/capita (EUR at exchange rate)	2600	3300	4300	5500	6700	8000	.	.	.
GDP/capita (EUR at PPP - wiiw)	8300	9200	10000	11100	12400	13500	.	.	.
Consumption of households, RUB bn, nom.	6540.1	8405.6	10590.0	12965.3	15976.5	20155.7	.	.	.
annual change in % (real)	7.6	12.1	11.8	11.3	13.6	11.5	3.4	5	4.8
Gross fixed capital form., RUB bn, nom.	2432.3	3130.5	3836.9	4980.6	6982.4	9178.5	.	.	.
annual change in % (real)	13.9	12.6	10.6	18.0	21.1	10.3	4.1	7.8	9.1
Gross industrial production									
annual change in % (real)	8.9	8.0	5.1	6.3	6.3	2.1	0	3	5
Gross agricultural production									
annual change in % (real)	1.3	3.0	2.3	3.6	3.3	10.8	.	.	.
Construction industry									
annual change in % (real)	14.4	10.1	10.5	18.1	18.2	12.8	.	.	.
Employed persons - LFS, th, average	66432.2	67274.8	68169.0	68855.0	70570.5	70992.3	70500	70600	71000
annual change in %	-0.3	.	1.3	1.0	2.5	0.6	.	.	.
Unemployed persons - LFS, th, average	5959.2	5674.8	5262.8	5312.0	4589.0	4791.5	5100	5000	4800
Unemployment rate - LFS, in %, average	8.2	7.8	7.2	7.2	6.1	6.3	6.7	6.6	6.3
Reg. unemployment rate, in %, end of period	2.3	2.6	2.5	2.3	2.0	2.0	.	.	.
Average gross monthly wages, RUB	5498.5	6739.5	8554.9	10633.9	13527.4	17112.0	.	.	.
annual change in % (real, gross)	10.9	10.6	12.6	13.3	16.2	9.7	.	.	.
Consumer prices, % p.a.	13.6	11.0	12.5	9.8	9.1	14.1	15	10	8
Producer prices in industry, % p.a. [3]	15.6	24.0	20.7	12.4	14.1	21.4	18	15	10
General governm.budget, nat.def., % GDP									
Revenues	31.3	31.9	39.7	39.5	40.4	38	.	.	.
Expenditures	29.9	27.4	31.5	31.1	34.4	30	.	.	.
Deficit (-) / surplus (+), % GDP	1.3	4.5	8.1	8.4	6.0	8	.	.	.
Public debt, nat.def., in % of GDP [4]	28.6	21.6	14.9	8.9	7.2	.	.	.	.
Base rate of NB % p.a., end of per.	16	13	12	11	10	13	.	.	.
Current account, EUR mn [5]	31329	47867	67703	75198	55703	67483	10000	-10000	-20000
Current account in % of GDP	8.2	10.1	11.0	9.5	5.9	5.9	1.0	-0.9	-1.8
Exports of goods, BOP, EUR mn [5]	120264	147358	195545	241960	258930	320016	275000	285000	300000
annual growth rate in %	6.0	22.5	32.7	23.7	7.0	23.6	-14	4	5
Imports of goods, BOP, EUR mn [5]	67304	78327	100608	130948	163282	199584	230000	255000	270000
annual growth rate in %	4.4	16.4	28.4	30.2	24.7	22.2	15	11	6
Exports of services, BOP, EUR mn [5]	14359	16564	20029	24791	28798	34663	32000	33000	35000
annual growth rate in %	-0.2	15.4	20.9	23.8	16.2	20.4	-8	3	6
Imports of services, BOP, EUR mn [5]	23996	26774	31173	35741	43244	52267	55000	60000	65000
annual growth rate in %	-3.4	11.6	16.4	14.7	21.0	20.9	5	9	8
FDI inflow, EUR mn [5]	7041	12422	10336	23675	40237	40000	25000	35000	45000
FDI outflow, EUR mn [5]	8606	11085	10240	18454	33547	35000	40000	30000	30000
Gross reserves of NB, excl. gold, EUR mn	58531	88663	148094	224306	318840	292483	.	.	.
Gross external debt, EUR mn	148776	156689	216553	235714	316620	370000	.	.	.
Gross external debt in % of GDP	41.4	34.8	34.2	30.4	34.4	36.9	.	.	.
Average exchange rate RUB/EUR	34.69	35.81	35.26	34.11	35.01	36.43	45	50	55
Purchasing power parity RUB/EUR, wiiw [6]	11.02	12.92	15.06	17.01	18.84	21.75	.	.	.

Note: The term ‘industry’ refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) Resident population. - 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.