

RussCasp Russia Update

1/2010 The Russian economy on its way out of the crisis

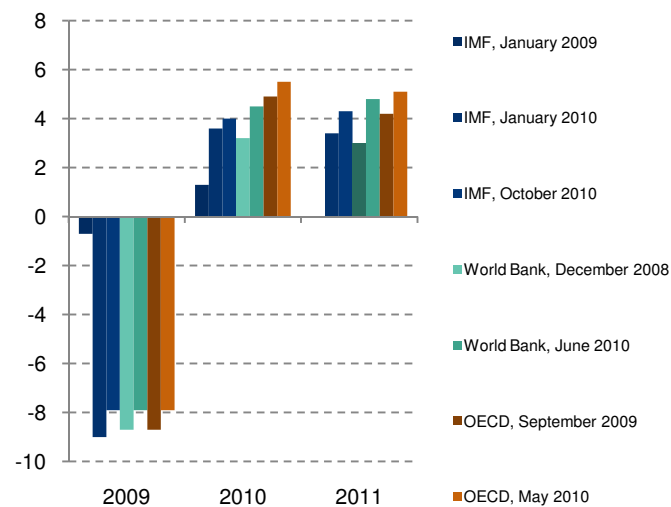
After several years of high economic growth rates, Russia experienced a major economic downturn in late 2008 and 2009. The economic crisis resulted in a drastic fall in the oil price, reductions in the international demand for Russian goods and services, and increased uncertainty among foreign banks and investors about economic fortunes. In this Russia Update, we look into the Russian economic recovery from the financial crisis. We examine how the main macroeconomic indicators are developing in Russia these days. Is the Russian economy back on track, or does it continue to struggle to come out of the recession?

Forecasts suggest Russian economy back on a growth path

To get a better idea about how outlooks for the Russian economy have altered throughout the crisis period, we compare four important forecasters; the IMF, the World Bank and the OECD as well as the Ministry of Economic Development of the Russian Federation. Of particular interest are the forecasts for 2010 and 2011. However, first we note that there was disagreement in late 2008 and early 2009 how deep the recession would be for Russia. Whereas the World Bank forecasted a large contraction of Russian GDP of

-8.7 percent in 2009, the IMF in January 2009 projected a negative growth of only -0.7 percent. Already in April, however, the IMF downgraded its 2009 forecast to -6.0 percent. All the forecasters have increased their projections of Russian 2010 growth, but both the IMF and the Ministry for Economic Development have downgraded their forecasts slightly in October and September to 4.0 percent. All institutions agree that the positive economic trend will continue also next year. The projections for 2011 vary between 4.3 to 5.1 percent growth.

Figure 1: Forecasts of Russian economic growth, 2009-2011

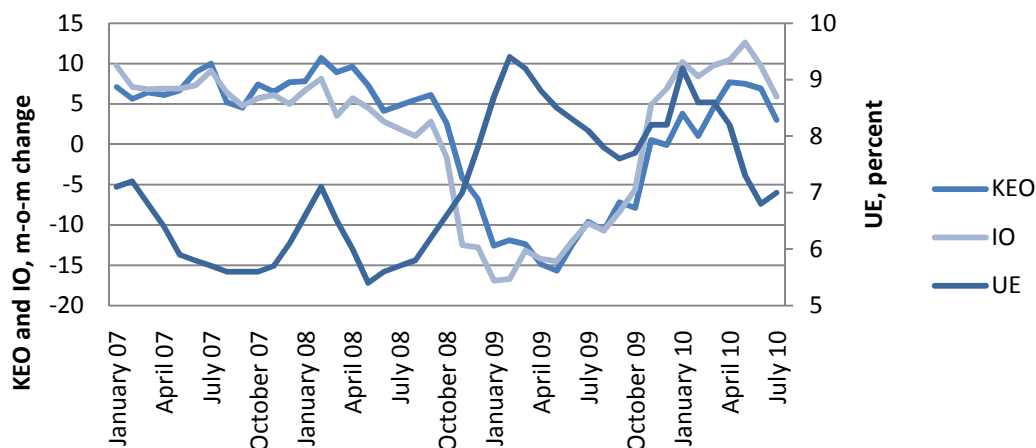


Source: IMF, World Bank, OECD

Russia is recovering from a deep, albeit short recession

While we above examined how main international institutions assess the future of Russian economic growth, we are below looking at the actual growth rates in key economic activities and in industrial output. 2007 and most of 2008 was a great period for the Russian economy, with growth in every month compared to the same month the year before. After the financial crisis started, however, both the output index for key economic activities and industrial output index did not show positive growth rates before November 2009. We can see from Figure 2 that from May the growth rates are turning upwards, signalling still tough but recovering times. Thus, the first seven months of 2010 have been quite positive compared to the same months in 2009 with a mean growth rate of 4.9 percent for the key economic activities¹ and 9.6 percent for the industry index. The unemployment rate grew from mid-2008 but accelerated in September the same year. It reached a peak in February 2009 on 9.4 percent. 2010 has been a better year for the Russian labour market, with a reduction in the unemployment from 9.2 percent in January to 7 percent in July. There is still room for reductions, but this may also require reforms of the labour market, a more efficient public sector and increased domestic demand.

Figure 2 *Growth rates of key economic activities (KEO) and industrial output (IO), month-over-month change, and unemployment (UE), percent, 2007-2010*



Source: Bank of Russia

The observant reader will note that June and July 2010 experienced a slight reduction in the positive growth rates seen through 2010. This may be due to the weather conditions and the major fires that raged Russia this summer. Alexander Morozov, chief economist at the NCSC Bank in Moscow, argues that these fires can reduce the Russian growth rates with 1 percentage point.

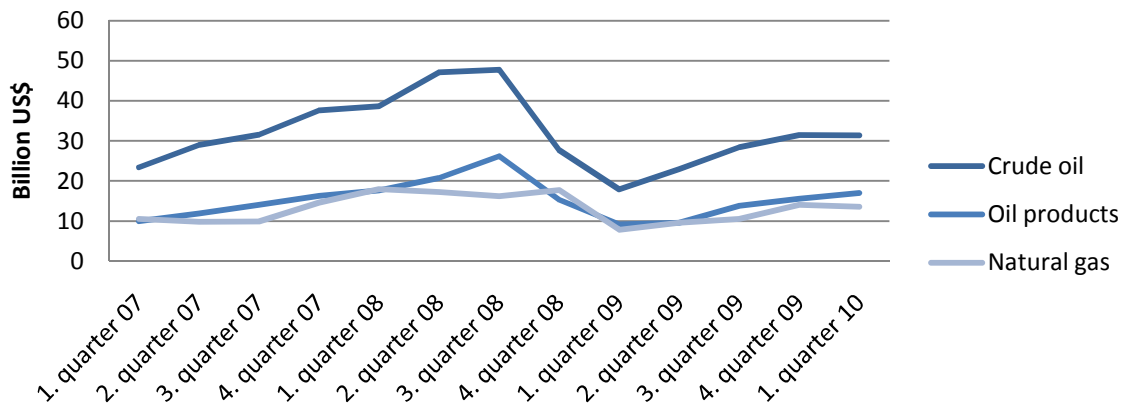
Petroleum exports are picking up, while gas exports are still struggling

As oil prices fell dramatically during the financial crisis, Russia experienced major reductions in the value of its petroleum export (see Figure 3). There has been a steady increase in the value of the export since the worst period during the first quarter of 2009. The natural gas export value has lately been reduced again, due to the lower prices on gas in

¹ Calculated on the basis of data on changes in output volumes in agriculture, mining, manufacturing, the production and distribution of electricity, gas and water, construction, transport, retail and wholesale trade (Bank of Russia).

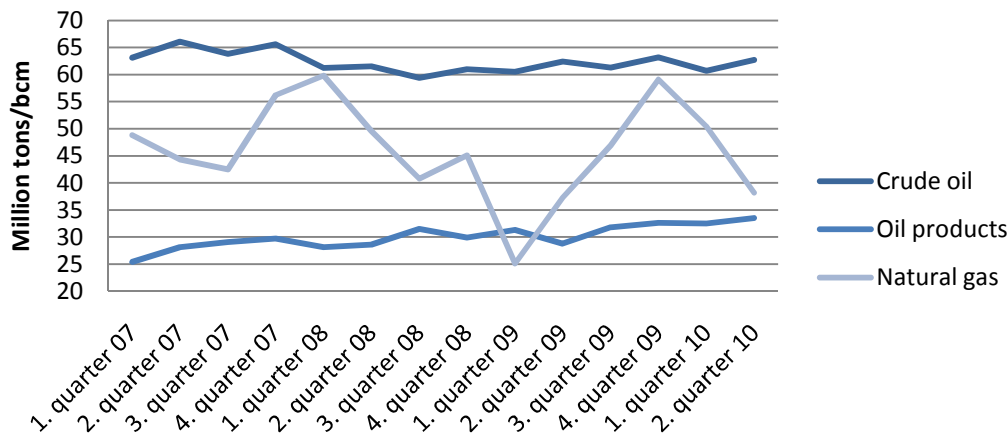
Europe in 2010. In Figure 4, the changes in the petroleum export volume are shown. From this figure, it is quite visible that the reduction in export value is mostly due to lower prices on oil and oil products, since the export level is stable or actually increasing for oil products through the period. Russian natural gas, on the other hand, has experienced large fluctuations in foreign demand, because European consumers reduced their energy needs during the financial crisis and possibly also feeling the effects of increased LNG imports from the Middle East. Moreover, a dispute with Ukraine in January 2009 resulted in less natural gas support to the European market from Russian sources.

Figure 3 Value of crude oil, oil product and natural gas exports, 2007-2010



Source: Bank of Russia

Figure 4 Volume of petroleum export 2007-2010, oil and oil products in million tons, gas in bcm



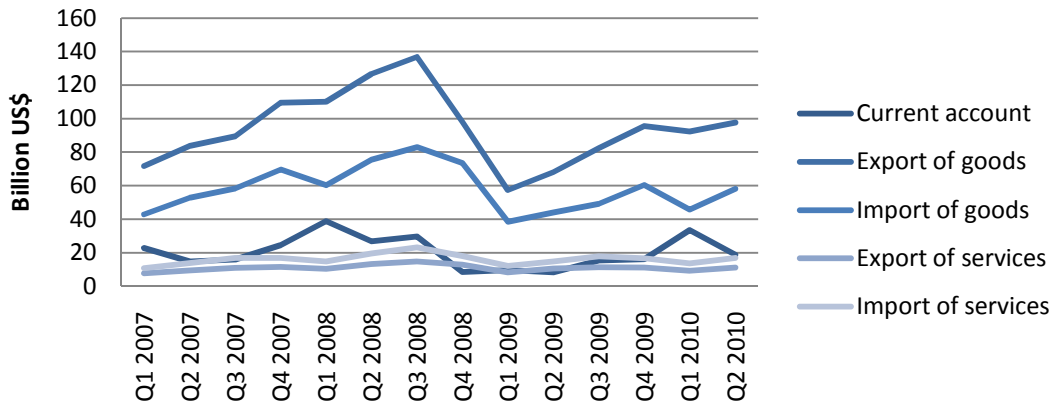
Source: Bank of Russia

Current account is developing positively

The impact on the Russian current account of the financial crisis has been large. In Figure 5, the development in the current account and the major components are shown. Whereas there were small fluctuations in the export and import of services through the financial crisis, export and import of goods experienced major changes. Since the petroleum sector consists of between 60 and 67 percent of the total Russian export in the period, the impact of oil and gas prices on the current account is significant. The export of goods fell drastically from the third quarter of 2008 till the first quarter of 2009. On the other hand,

since Russia entered an economic crisis, the reduction of domestic demand also resulted in less imports. Therefore, the current account did not fall at the same rate as the export. Both import and export have increased lately, but in the second quarter of 2010, the import increased more and the current account surplus consequently fell slightly compared to the first quarter this year.

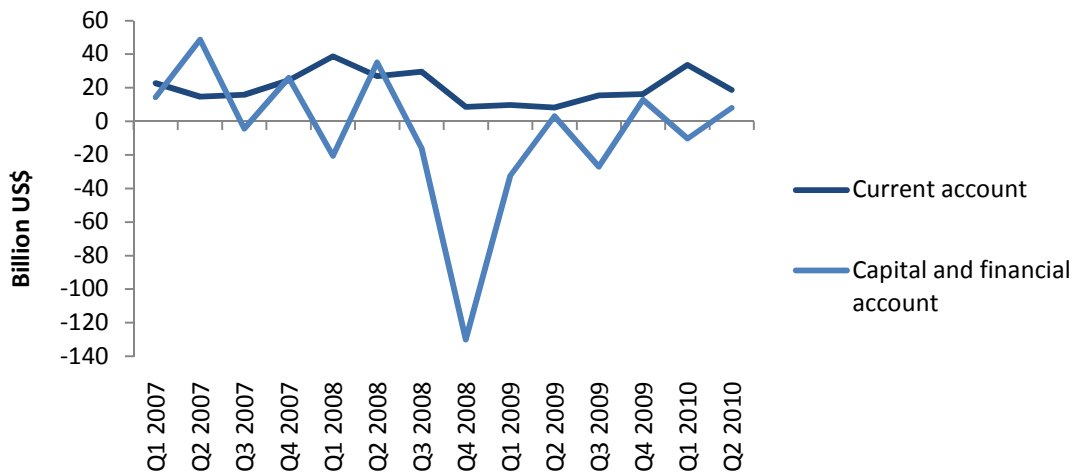
Figure 5 *Export and import of goods and services and the current account 2007-2010, billion USD*



Source: Bank of Russia

A major problem for the Russian (and the world) economy during the financial crisis was the tightening of the international financial markets, the fast withdrawal of foreign money from domestic markets, less investments etc. These financial challenges had impacts on the financial and capital account, which is visible in Figure 6. Even though the period from the fall of the Lehman Brothers presented Russia with major financial difficulties, the capital and financial account has improved substantially since the beginning of 2009.

Figure 6 *Current account, and capital and financial account, billion US\$, 2007-2010*

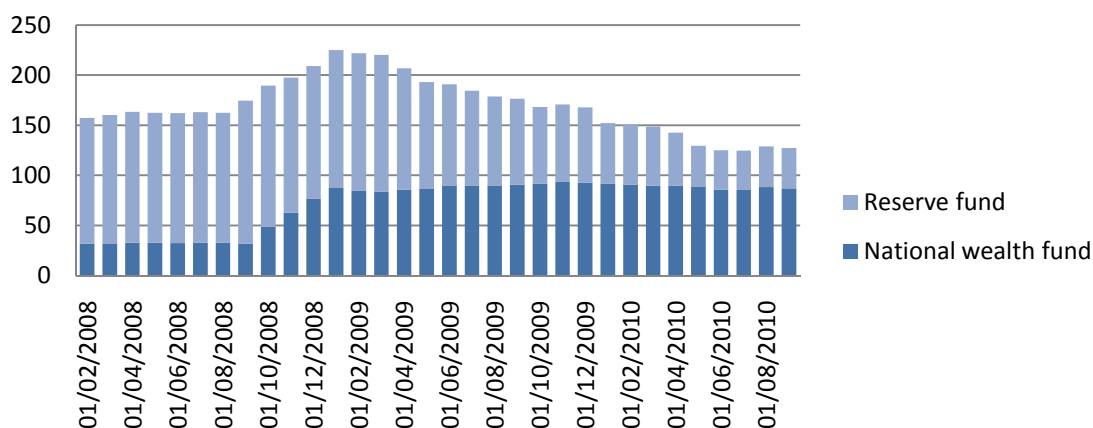


Source: Bank of Russia

The Reserve Fund has been used to stabilize the economy

In this section we examine how the development in the two Russian Petroleum Funds, the Reserve Fund and the National Wealth Fund, has been through the financial crisis. The funds were established in 2008 when the four-year old Stabilization Fund was split in two. While the National Wealth Fund is built up to improve Russia's financial ability to deal with economic challenges in the future (for instance, the ageing population), the Reserve Fund's purpose is to enable the Russian government to operate contra-cyclical, i.e. save money in periods of high growth and spend money when demand is reduced. Figure 7 shows the value of the Reserve Fund and the National Wealth Fund from 2008 till August 2010. It illustrates that during the financial crisis, the Russian government chose to spend a huge amount of the Reserve Fund, in accordance with the purpose of the fund, to increase domestic demand. Prognoses from mid-2009 showed that with a continued low oil price, and continued high spending, the government would drain not only the Reserve Fund, but would also have to eat into the National Wealth Fund by late 2010. However, recovering oil prices and a public spending slow-down made the Russian government able to reduce the outflows of the fund. The Reserve Fund has been stable at around 50 billion USD since April 2010. The National Wealth Fund has seen just minor fluctuations in the value since the outbreak of the financial crisis. Thus, we see that during the period of a major recession, the Russian government spent large portions of its contra-cyclical fund and let the fund for future generation on hold. The savings from the good economic times enabled the government to support the Russian economy with a huge stimulus package, totalling about 9 percent of GDP. Though it may seem that the government wisely spent its fund to stimulate the economy, it is a danger signal that the stimulus package consisted of permanent measures (around 75 percent), which may contribute to a difficulty of entering a period of normal growth

Figure 7 Value of the Russian Reserve fund and National Wealth Fund 2008-2010, billion US\$



Source: Bank of Russia

Will the crisis lead to a reform of the economic policy?

In this Russia Update we have examined the Russian economic recovery from the financial crisis. Several macroeconomic indicators point to a rather positive economic recovery. This development is largely due to two reasons. First, since Russia's foreign trade is heavily based on its petroleum sector, the price increase on oil has improved the current account, the government's incomes and the inflow of capital to Russia. Second, the

Russian government countered the economic crisis with a major stimulus package using the Reserve Fund as a true stabilization fund. This has probably helped increase domestic demand and thereby created new jobs.

The point with the large stimulus package was to support the economy in a time of recession and then cut back the spending when the need for it diminished. According to the macroeconomic indicators as well as the main forecasters, 2010 and 2011 offer economic improvements. The government should therefore reduce the stimulus spending. This may be difficult. A concern is that the economic package to fight the financial crisis was largely spent on permanent measures (such as increasing pensions).

Our look at the main forecasters' projection of the 2010 and 2011 growth showed a common positive view on the future of Russia's economy. The forecasters point to domestic demand as important to future growth for Russia. The IMF argues that a self-sustained consumption-led development should lead the recovery, supported by increased real wages and lower unemployment. It will indeed be an exciting time for macroeconomic analysts the next few years.

Though the crisis showed that the government was able to implement a counter-cyclical policy due to the oil funds built up through the budget surpluses of the 2000s, at the same time it showed how vulnerable the Russian economy is due to its oil and gas export dependency. In that latter context Dmitriy Medvedev's campaign to modernize Russia and diversify the Russian economy seems well timed. However, now that the economy is recovering on the back of high oil prices, there is a serious danger that the reluctance to change will prevail once more. It seems difficult to find the perfect timing for comprehensive reform: In a time of crisis, there is little room for expensive reform packages, whereas in good times it is difficult to argue for the need of reform.