

## Russia

### Domestic economy is the Achilles' heel

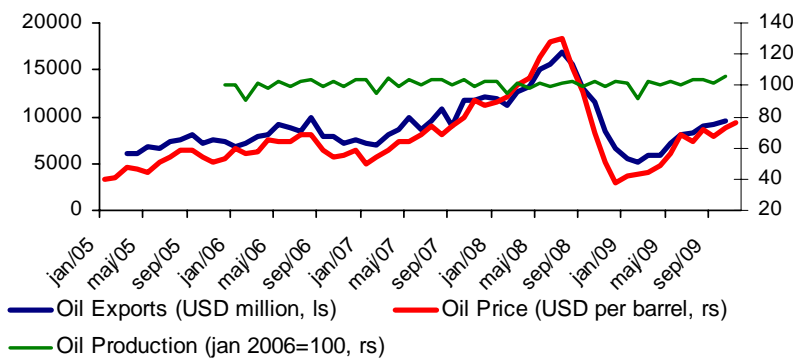
- Recent economic developments have been positive in Russia. A rebound of global energy prices has stabilized Russian markets and provided some relief to fiscal balances. Low international funding costs have spurred capital inflows, alleviating foreign currency liquidity constraints.
- Expansionary monetary and fiscal policies are mitigating the economic downturn, but risks remain. The growing fiscal deficit will be difficult to reverse, and domestic demand is vulnerable to weak corporate balance sheets, increasing unemployment, eroding real wages, and a banking sector still under recovery.
- Against the background of increasing oil prices, the reversal of the inventory cycle, and economic stimulus packages, we are raising our growth forecasts for 2010 to 4.3 % from 1.5 %. Growth is driven mainly by a rebound from the deep falls in 2009. In 2011, we expect the economy to grow at 4.5 %, supported mainly by a continued high oil price. The economic recovery will be protracted unless significant reforms are undertaken to resolve financial sector imbalances and, in the medium term, raise the level of competition and productivity in the Russian economy.

## External inflows provide breathing space

Recent global developments have cushioned the economic downturn in Russia. The rebound in world market oil prices has increased foreign exchange inflows and lessened the deficits in both fiscal and external balances. External demand has benefited not only energy related products but also exports of machinery and equipment, which have reached levels not seen since mid-2008. In addition, the relative stabilization on the Russian financial markets, together with increased risk appetite and low funding costs, has spurred a resumption of portfolio inflows to Russian assets, easing the external debt service burden but also creating an upward pressure on the ruble.

*Positive external developments*

### Oil-related transactions, 2005- 2009

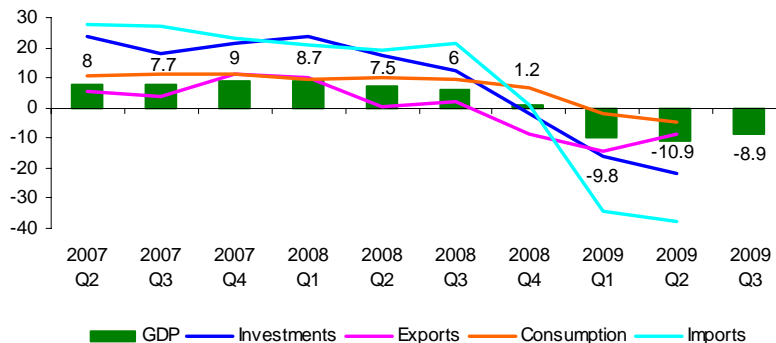


Source: Rosstat

The rate of contraction of real economic growth in the third quarter in 2009 decreased and is estimated at an annual rate of -8.9 %, compared with -10.9 % in the second quarter. Investments are the main drag on economic activity, with exports also falling sharply in the early days of the downturn. Consumption has held up better but is falling as a share of GDP, compared with 2008 when it added about 5 percentage points to growth.

*Sharp economic contraction reversed in the third quarter*

### Components of growth, 2007 – 2009 (annual real growth rates in %)



Source: Rosstat

## Policy interventions are large – but challenges remain

After maintaining a tight policy in early 2009, the Russian authorities have now turned on the taps. Following the initial crisis, when the ruble was allowed to depreciate, monetary policy was tightened in early 2009 while fiscal spending fell. This contributed to the sharp fall of GDP in 2009. Since then there has been a large shift in policy. Monetary policy has been reversed and fiscal policy is now expansive, creating a new set of challenges.

*Economic policy is now expansive*

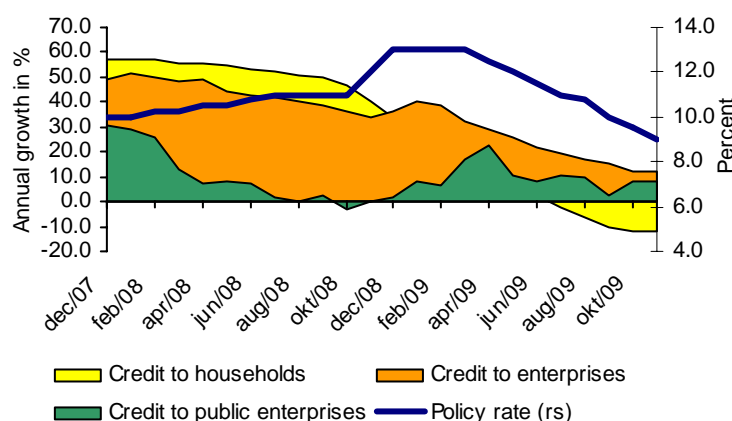
Amidst concerns of an appreciating ruble and with the benefit of falling inflation, the Russian central bank has continued to lower its policy rate. The policy rate has been decreased from 13 % in the first quarter of 2009 to 9 % in November, and the ruble's current trading band was tightened to 35-38 ruble from the 26-41 corridor determined in January. There has also been speculations of actions to limit capital inflows, in line with steps taken by Brazil earlier this fall.

*Ruble appreciation worries authorities*

The central bank policy rate is not yet binding, and borrowing rates are significantly higher. This mutes the direct impact of monetary policy on credit volumes in the economy. In addition, lending to the private sector has fallen sharply in 2009 and credit to households turned negative in July. This is an indication that the large inflow of foreign capital is not yet finding its way to increased investment, but instead ending up in equities. The stock market has increased by more than 100 percent in dollar terms since the beginning of the year.

*Monetary policy loosening not yet affecting credits*

**Credit market developments, 2007 - 2009**



Source: Central Bank of Russia

Fiscal policy is adding stimulus to the economy. The federal budget balance is expected by the government to shift from a surplus of 6.2 % of GDP in 2007 to a deficit of 6.8 % of GDP in 2010 (the corresponding non-oil balances are -4.9 % of GDP in 2007 and -14.2 % of GDP in 2010). Expenditure expansion is weighted mainly towards structural increases in social transfers, such as pensions, or towards spending on direct or indirect

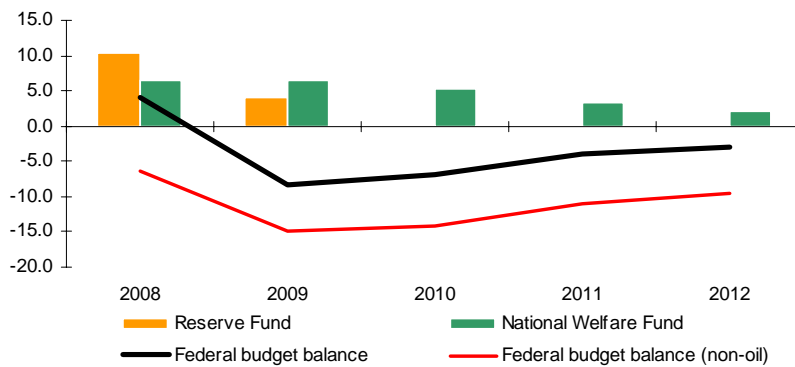
*Increasing fiscal imbalances undermine stability*

subsidies to private enterprises to support their operations. This leads to either inefficient spending or expenditures levels that will be difficult to reverse when the economy picks up. Thus, it is likely that the fiscal position will be weakened over the medium term, which could lead to a crowding out of private sector growth.

There will be significant pressures on government savings over the medium term. According to government estimates, already in 2010 one of the two government savings funds, the Reserve Fund, will have a zero balance, compared with a surplus of 10.3 % of GDP recorded at end-2008, while the other, the National Welfare Fund, is expected to decrease to an equivalent of 2 % of GDP in 2010 from 6.6 % of GDP in 2008.<sup>1</sup> However, this is based on a conservative oil price projection of 60-70 USD per barrel in 2010 and 2011, respectively. With a higher oil price the savings funds will see lower pressure. The highly volatile oil price will, thus, be the main factor determining the sustainability of the fiscal position.

*Decreasing reserve funds will increase government borrowing*

**Government savings and fiscal balances (% of GDP)**



Source: Ministry of Finance, Russia

## Domestic demand the weak link

Households have seen reduced strains since mid-2009. Although labor market statistics are unreliable, the unemployment rate seems to have fallen. The unemployment rate was reported to have fallen from 9.2 % in the first quarter of 2009 to 7.6 % in the third quarter, and wage arrears have decreased from RUB 8.8 billion in May to RUB 5.1 billion in September. The government has raised unemployment benefits and launched active labor market programs, which, together with increased pensions, limit the fall in household demand.

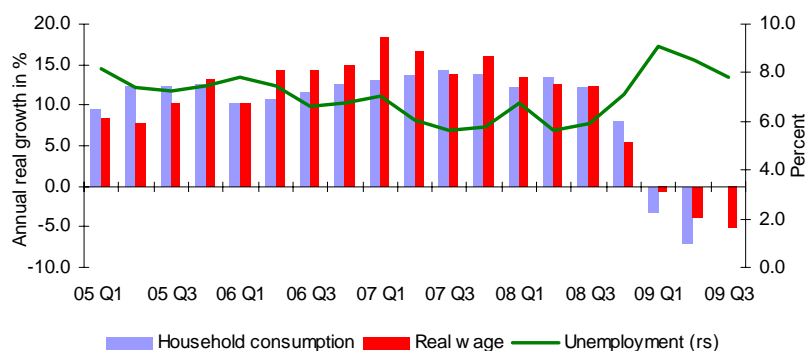
*Unemployment rate is easing and wage arrears are reduced*

*Russian hit by unemployment and wage decline, but with light debt burden*

<sup>1</sup> The Reserve Fund is invested abroad in low-yield securities and used when oil and gas incomes fall to stabilize fiscal policy and the economy. The National Wealth Fund invests in riskier, higher return vehicles, and is dedicated to support the pension system.

Nonetheless, households are likely to come under renewed stress in the near future. As the financial situation will deteriorate for many local companies, their ability to hold onto personnel will diminish, again putting pressure on the unemployment rate. Furthermore, real wages fell by 5.4 % in the third quarter 2009, compared with the same period last year, and the lack of profitability in the private sector is likely to limit wage pressures. Despite the relatively low exposure of Russian households to the credit markets, where debt amounted to slightly above 10 % of GDP in 2008, household consumption is likely to be muted over the next couple of years.

### Unemployment, consumption and real wages



Source: Rosstat

Private sector enterprises have been hit hard by falling demand and increased debt service. After a sharp contraction in production and employment, the government has increased support through either direct subsidies or liquidity injections, or through banks via directed lending.

*Many private companies receive state support*

Many of the hardest hit companies are located outside the big urban areas in so-called monocities, which rely almost exclusively on one company for employment and revenues. This makes the political fallout severe from letting these companies go into bankruptcy. Furthermore, a large share of these companies stem from the Soviet era, which in many cases means that their technology is obsolete and that they probably would not be able to compete without state support or shielded markets. A restructuring of this part of the manufacturing sector will be necessary to raise productivity levels in the economy and potential growth, while keeping them operating during the current downturn will further aggravate the slow expansion of domestic demand.

*Companies in monocities are the worst affected*

The banking sector remains under stress, and the resolution of serious imbalances will impact the pace and stability of economic recovery in the years to come. The rapid credit expansion during recent years has been sharply reversed during 2009. Many banks are now plagued by a growing share of non-performing loans. As of September 2009, 8.8 % of total loans were classified as non-accrual, up from 3.8 % at end-2008. The official statistics are likely to underestimate the real magnitude of troubled loans, as regulatory forbearance has become more

*Domestic credit institutions are unlikely to provide support for domestic demand*

generous and the rollover of assets in distress is likely to have increased (so called evergreening). Many banks have also taken possession of collaterals, such as large apartment buildings, thereby postponing the realization of potentially large losses. Public liquidity injections have alleviated the most urgent threats to the banking sector, but households and companies are not likely to benefit from any significant expansion of credit over the next year.

## Decent growth prospects – but only compared with the sharp fall in 2009

The crisis management by the Russian authorities succeeded in stabilizing the financial markets and the banking sector, but the withdrawal of stimulus early in 2009 likely exacerbated the downturn in 2009. The rebound of global energy markets and return of capital inflows, coupled with an expansive domestic policy, will boost economic activity in 2010. However, existing vulnerabilities in the economy and new emerging imbalances create significant uncertainties regarding the outlook for 2010 and 2011.

For 2009, we expect GDP in real terms decline by 8.3 %. Inflation rates are falling and will remain in the single digits. For 2010, we forecast real economic growth at 4.3 %, boosted not only by higher oil prices<sup>2</sup> and an international recovery, but also by the very large contraction in 2009 (the so called base effect). Labor market conditions are expected to worsen as many local enterprises will find it untenable to maintain the number of employees at current wage rates, and the unemployment rate is likely to again exceed 10 %. The pressure on domestic demand will partly be compensated by increased public sector transfers. As a consequence of rising budget deficits, inflationary pressures will emerge, and we expect inflation to reach 10 % at end-2010. Monetary policy will tighten only slowly, renewing concerns about the stability of the ruble. Credit growth to the private sector will be hampered by the weakness of the banks, thereby limiting household consumption and private sector investments.

In the medium term, we see only a gradual recovery of economic activity. Global developments, including the increasing oil price, will continue to support a modest growth in Russia, but domestic demand will remain muted. The public stimulus packages will be scaled back relative to 2010, but it is unlikely private sector productivity will be boosted by structural reforms or stepped up liberalization programs. Thus, our outlook for 2011 is a continued modest growth of around 4-5 %, with annual inflation remaining close to 10 %. The potential for higher sustained annual growth of 7-8 % in Russia is there, under the condition that difficult reforms are implemented.

Magnus Alvensson

*Despite external relief, domestic vulnerabilities remain*

*A negative growth rate of 8.9 % is expected in 2009 before a recovery of 4.3 % in 2010*

*Medium term growth will be muted, but potential remains*

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<sup>2</sup> We have raised our forecasts of world market prices for oil from 70 USD/barrel to 80 USD/barrel in 2010, and from 80 USD/barrel to 90 USD per barrel in 2011.

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