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The Russian Economy in October 2012: Preliminary Data and Major Trends

The Political Background: the Kremlin Will Control Elections and Oil

In October, for the first time after an eight-year ‘break’, gubernatorial elections were held in Russia. The revival of gubernatorial elections by no means implies a revival of competition at the regional level – existing legislation ensures that this should not be allowed. At the same time, the new electoral pattern, while still granting to the Kremlin broad opportunities for interfering with the process of elections, also provides the regional elites with some significant means for their consolidation. At the first election that took place of 15 October, all the incumbent governors running for reelection (of Belgorod, Briansk, Ryazan, Amur and Novgorod oblasts) were soundly reelected, and this process was under the Kremlin’s control. However, later on this pattern will bring about a significant change in the balance of forces between the federal center and the regions, especially if the current downward trend in the level of the population’s support for the federal authority continues.

The major specific feature of the single day of voting on 15 October was the low voter turnout at the election of deputies to local bodies of authority. On the one hand, this made easier the demonstration of victory by *United Russia*. On the other, it exposed both the opposition’s organizational weakness and the weakened support of the current political regime – and of *United Russia* as the institution created for the purpose of mobilizing such support.

October’s most important development was the announcement of the buyout, by the government represented by the state-owned corporation *Rosneft*, of shares in TNK-BP from its private owners. This transaction was the largest de-privatization deal in Russia’s contemporary history, which demonstrated that, in spite of regularly voiced declarations to the effect that the State’s presence in the national economy is going to diminish, the real course of the Putin Government towards nationalization of the oil and gas industry has remained unchanged since the early 2000s. As a result of that transaction, the State will be in control of more than one half of Russia’s oil production (vs. 36% as of today).

Although this deal will make *Rosneft* one of biggest oil companies, its financial situation will be very unstable. Thus, *Rosneft*’s net debt will increase from approximately $ 20bn to $ 70bn. Meanwhile, its debt to proceeds ratio was as high as 25% even prior to the deal (the norm for big oil companies being 10%), and its transaction costs amounted to more than $ 40 per barrel, which is approximately 1.5 times above the market’s average. So, by buying out TNK-BP from its private owners at a huge premium to its market price, the State is going to acquire a company that will be weak in its market qualities. The deal looks even more doubtful in view of the increasingly frequent speculations of analysts as to the probability of structural changes on the oil market. It is interesting that it was in the same October that Vladimir Putin was forced to acknowledge the structural changes that had occurred on the gas market – after both the government and *Gazprom*, for several recent years, had been adamant in ignoring the issue and denying any prospects of such changes.

October also saw some conflicts unfolding inside the new government. Thus, in particular, Minister of Regional development Oleg Govorun was dismissed from his post; he has actually given in his notice a month earlier, after having received an unjustified public reprimand from Vladimir Putin. His notice was not accepted, but the Minister, nevertheless, from then on did not attend his office. Besides, the RF Investigative Committee initiated a criminal case over the misappropriation of funds at *Oboronservice*, a state-controlled company subordinated to the RF Ministry of Defense; the police and investigators searched the apartment of Yevgenia Vasilieva, a close associate of Defense Minister Anatoly Serdiukov. The majority of experts view this development as a renewal of the apparatus-instigated struggle around the Minister of Defense and a manifestation of his seriously weakened position.

The Macroeconomic Background: Capital Is Flowing Out, Rates Are Climbing

The external macroeconomic background in October turned out to be sufficiently calm. Although oil prices displayed multi-vectored and rather sharp fluctuations, on the whole the per-barrel price of Brent as of the month's end was only 3.6% below its index as of 1 October. The ratio within the euro-USD pair over the month also remained nearly the same ($ 1.29 and 1.30 per euro as of the month's beginning and end respectively). As demonstrated by October's results, the Russian ruble became somewhat weaker by comparison with the major currencies (by 1.4% relative to the USD, and by 0.9% relative to the euro); so, the bi-currency basket's value increased from Rb 35.25 as of 2 October to Rb 35.66 as of 31 October. The movement of stock market indices traditionally followed that of oil prices, and so the MICEX index fell by 4.3% (to 1426 points), and the RTS index – by 5.3% (to 1435 points)

As seen by October's results (1–29 October), monthly inflation growth amounted to 100.5%, and its full-year since January – to 105.7% (in 2011: growth over October – 100.5%, full-year index – 105.1%). As in September, the full-year inflation rate amounted to 6.6%. Over autumn, the prices of wheat flour, millet, sunflower oil, and gasoline were on the rise (+2%), having overcome the effect of the recent seasonal decline in the prices of fruits and vegetables. The accumulated inflation rate since 1 January was as high as 5.7% (5.1% in 2011).

In September, broad money base continued to display its downward trend, having shrunk over the month by 0.3% to Rb 8,082.8bn. This happened as a result of the nearly twofold drop in the volume of commercial banks' deposits with the RF Central Bank: as of 1 October, it amounted to Rb 90.8bn. Excess reserves of commercial bank were also on the decline in September, having dropped as of the month's end by 5.4% to Rb 844.5bn. At the same time, the monthly weighted average Moscow interbank interest rate (MIACR) on overnight credit rose in September to 5.5% against 5.3% in August. Banks' aggregate debt to the RF Central Bank as of the end of September remained at a high level, amounting to approximately Rb 2.2 trillion. Nevertheless, the Bank of Russia has no intention to bring down the scale of refinancing granted to banks: according to First Deputy Chairman of the RF Central Bank Aleksey Uliukaev, the amount of gross debt of Russian banks to the regulator is going to more than double over the next 3 years, increasing to Rb 6–7 trillion.

September once again witnessed net capital outflow from Russia. According to the RF Central Bank's preliminary estimates, in Q3 2012 net capital outflow amounted to $ 13.6bn, thus exceeding the index recorded in Q2 by $ 4.2bn. Still, this figure is lower than the one recorded in the same period of last year, when capital outflow became as high as $ 18.4bn. By the results of the period of January–September 2012, capital outflow amounted to $ 57.9bn, which is by $ 12.4bn higher than in 2011.

The Real Sector: Rising Incomes and Hopes in Face of Stagnation

In Q3 2012, the growth rate of GDP dropped to 2.8% against 3.9% in Q2 2012 and 4.9% in Q1 2012. Thus, GDP growth over the period of January-September 2012 on the same period of last year amounted to 3.8%.

The upsurge in investor activity in the first half-year gave way to a dramatic slowdown in the rate of investment over the period of July–September. In Q3 2012, investment in fixed assets exceeded only by 1.4% their index for the same period of last year, whereas in Q1 their increase amounted to 16.6%. In September 2012 the movement of investment shifted to the negative zone (–2,3%). In September 2012, the volume of work in the construction industry dropped on September 2011 (–5.6%), as did the index of the volume of new housing put in operation (–7.2%).

The industrial production index over January-September 2012 amounted to 102.9% (against 105.2% a year earlier), including for mineral resources extraction – 101.0% (against 102.4% in 2011), and for the processing industries – 104.5% (against 107.2% in 2011). The declining growth rate in September gave rise to negative indices: the production volumes in mineral resources extraction and the dropped on August 2012 by 1.5% and 1.2% respectively.

The change in the general trend manifested itself most graphically in machine-building: in the post-crisis period, it was growth machine-building that acted as a significant positive factor that influenced the general indices. However, in September 2012 the production index for the manufacturing of machines and equipment amounted to 89.5% on the same period of 2011 (over January-September – 100.4%). A positive dynamics in the production means of transportation and transport equipment (117.2% over January-September on January-September of 2011) was preserved due to a high output of passenger cars; but even in that sector, zero growth on September 2011 was observed in September 2012.

In the majority of sectors manufacturing intermediate products, a significant drop on the previous month was noted in September 2012: in the chemical industry – by 5.7–8.0%, depending on a given subsector; in forestry – by 3.4–7.3%. In September 2012, agricultural production amounted to 92.3% of the index for the same period of 2011 (over January-September – 97.7%), and output of foodstuffs – to 103.6% (105.6%).

Consumer demand growth over the period of January-September 2012 remained one of the major factors that sustained the economic indices. The retail turnover growth rate in January-September amounted to 106.3% (as it also did last year). This year’s specific feature, however, is the trend towards intensive growth displayed by the population’s real income and real wages against the backdrop of a stable slowdown in the rate of economic growth. On the whole, over January-September 2012, real income increased by 3.6%, and real wages – by 9.4% on the same period of 2011. In September 2012, growth of real disposable income was 103.8% on September 2011, and that of real wages – 106.6%. The accelerated growth rate of wages against that of labor productivity increases costs and brings down the financial and economic indices of companies. The share of gross profit in GDP in the first half-year of 2012 amounted to 26.2%, thus being 1.7 pp. below the same index for 2011.

On the whole, the trends that became visible in the national economy throughout Q3 make it doubtful that the full-year forecasted production growth index of 3.6% can indeed be achieved. At the same time, an acceleration of the growth rate in Q4 is very likely. According to the results of the business surveys conducted by the Gaidar Institute, in spite of lack of any fundamental changes in the actual movement of demand, output, prices and employment, the forecasts are becoming more optimistic. The combination of all the components of the Industrial Forecast Index produced an eight-month record high of the aggregate index value. Although, as demonstrated the estimates of enterprises, the rate of production growth in September once again amounted to zero (and so, according to industrialists, stagnation has persisted for four months in a row), the output plans demonstrate their growing desire to break through stagnation.

At the same time, enterprises have seemingly come to terms with the situation when it have become impossible to increase prices any further: the share of reports registering unchanged producer prices reached the level of 84%, which represents an absolute record high of the entire post-default period (since 1998). This, however, may become a problem in its own right: the share of reports where product cost is increasing at a higher rate than the level of prices has reached 25%. This is also a record high of the past ten quarters in a row, and is indicative of a decline of profitability in industry, which may restrict the potential of enterprises to increase their output.