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Russian Economy in September 2012: Preliminary Data and Major Trends

The Political Background: Pensions in the Cross-Hairs

The beginning of the autumn was marked by an onset of fundamental conflicts in the ranks of the new Russian government and by some fresh signs of political reaction fomented in the State Duma by *United Russia* deputies. President Putin publicly expressed his dissatisfaction with the federal budget's draft for its failure to secure the achievement of the targets set by the President's executive orders, and also with the government's delay in producing a properly coordinated plan of pension reform. As a result, the plan of reform, which the RF Ministry of Labor and the other ministries constituting the government's economic block had failed to agree upon in August, was now, at last, submitted for government consideration. In the main, the new plan closely follows its initial version. According to the draft, the pension reform is aimed at reducing the pension fund's deficit in the medium-term perspective. The reform is clearly redistributive at the expense of the funded component of the pension system. The second conflict situation that emerged in September was manifested by the growing disagreements between the government and the head of *Rosneft* Igor Sechin, who is eager to maintain his grip on the dividends of the state-owned Rosneftegaz company and to use them for the purpose of further expansion in the oil and gas sphere. This conflict is being heated up by the personal rivalry between Sechin, believed to be one of the officials closest to Putin, and Prime Minister Dmitry Medvedev.

So far, the key highlights of the autumn 2012 session of the State Duma were the unseating of the deputy head of the *Fair Russia* faction, Gennady Gudkov, and the introduction into the State Duma of a draft law designed to make it a criminal offence 'to offend religious feelings'. The unseating of Gudkov, based on the decision of a State Duma commission, seems to have been politically motivated (Gudkov has taken an active part in the protest movement and clearly displays the ambition to become one of the leaders of the non-systemic opposition). Also, the legitimacy of Gudkov's dismissal is very questionable from the constitutional point of view, because his 'guilt' as a parliamentarian was established in a non-judicial process. As far as the draft law designed to introduce greater accountability for 'offending religious feelings' is concerned, it obviously follows the trend toward the clericalization of Russia's public life and toward the strengthening of the repressive character of her legislation. Apparently, the Kremlin is going to continue its onslaught on the opposition: the authorities have announced that more arrests will be made in the Bolotnaya Square case. The new tactics used by the authorities in persecuting the opposition involved relying on the mechanism of prejudice: one of the accused is enticed to strike a deal with the prosecution; once the deal has been struck, the court will deem his or her guilt to be proven on the basis of their own admission thereto; as a result, the objective fact of the criminal deed will be deemed to be established, thus making it possible for the court to convict the other co-defendants in the case. These tactics will apparently also be used against suspects in the Bolotnaya Square case, and against one of the opposition leaders, Aleksey Navalny, who is implicated in the far-fetched *Kirovles* case.

The political course of the Kremlin was further confirmed by the public refusal of State Duma Speaker Sergey Naryshkin to attend the October Session of the PACE, where a tough resolution on Russia's non-implementation of her obligations before the Council of Europe was to be discussed and adopted.

The Macroeconomic Background: Money Comes…And Goes

In September, the macroeconomic situation was determined by external events: the expectations of the Federal Reserve's decision to begin a third round of quantitative easing and then the decision itself caused a wave of hectic trading on the markets, which generated a sharp rise in raw materials prices and stock exchange indices. As a result, on 15 September the price of Brent crude oil hit a several-month high of $ 116.9 per barrel. Over the course of the first two weeks of September, the MICEX and RTS indices rose 8% and 14% respectively. These same factors also determined a substantial strengthening of the ruble against the US dollar in the first half of September. However, a sharp drop in global oil prices in the next four days (the price of Brent crude plummeted by 9%) revealed the profiteering nature of the preceding rise in prices and indices. Russia's stock indices rapidly and radically descended, and the ruble weakened against the US dollar. As a result, by the end of September the value of the bi-currency basket had dropped from Rb 36.24 to Rb 35.25.

At the same time, oil prices remained high: in September, the average price of Urals crude amounted to $ 111.56 per barrel, and its level over the period of January-September 2012 remained at $ 111.02 per barrel, which practically corresponds to its last year's level of $ 109.48 per barrel. However, this means that 2012 will be the first post-crisis year showing no increase in the price of oil in annual terms (in 2010 and 2011, it had grown by 30% and 40% respectively). It is noteworthy that this circumstance has already resulted in a considerable narrowing of Russia' trade surplus.

The most important trend in Russia's dynamics was the ongoing acceleration of inflation, which had begun in mid-summer. In August 2012, the monthly inflation rate amounted to 0.1%, while in August 2011 Russia experienced deflation of 0.2%. Over the period from 1 September to 24 September 2012, the Russian Consumer Price Index climbed up by 0.5% (vs. zero-rate inflation in September 2011). As a result, annual inflation in September rose above 6%, while the inflation rate since the beginning of the year amounted to 5.1%, which was considerably higher than last year's index (4.6%). Among the various driving factors behind this rise in prices, one should note the step-by-step increase in state-regulated tariffs and the growth in food prices. The latter trend is typical of global markets (many experts consider it to be one of the consequences of the excess liquidity created by the loose monetary policies pursued by the developed countries). It seems likely that this trend will continue to exert significant influence on the inflation situation during the whole autumn of 2012.

The rising threats of inflation were the most important reason for the Bank of Russia's decision to increase by 0.25 pp, from 14 September 2012, its refinancing rates and the other key interest rates on liquidity provision and absorption operations; the refinancing rate was set at 8.25%. Thus, after a nine-month interval, the regulator returned to the rate that existed from 3 May 2011 to 26 December 2011. Although the Bank of Russia's representatives expressed their confidence that the rate increase would have no negative consequences for economic growth, it should be admitted that the choice between inflation and economic growth was not made in favor of the latter, which is contrary to the practices of the developed countries but corresponds to those typical of a number of developing economies. Also, experts believe that one of the reasons for increasing the refinancing rate was the excessively high growth rates of consumer lending. According to First Deputy Chairman of the RF Central Bank Aleksey Simanovsky, consumer loan growth over the course of 2012 will amount to 20–25%. However, the rise in the interest rate on loans will undoubtedly have a notable impact on the behavior of consumer demand.

In August, the excess reserves of commercial banks continued to decline. By the end of that month, they amounted to Rb 889.8bn (-11%). The situation with bank liquidity did not change, and the banking sector continued to experience liquidity shortage, as was shown by the movement of the growth rate of borrowings from the Bank of Russia. In August 2012, banks' asset growth slowed down owing to a decline in the growth rates of the main types of attracted resources – foreign liabilities and the assets of enterprises and organizations. However, a considerable rise in government assistance and a reduction in investments in foreign assets made it possible to prevent a decline in the volume of lending to the economy.

According to the Bank of Russia's preliminary estimates, in Q3 2012 capital outflow from Russia amounted to $ 13.6bn, which represented a moderate increase on Q2 2012 ($ 9.7bn). On the whole, since the beginning of 2012, capital outflow from Russia has climbed up to $ 58bn. The RF Government has already announced that it expects full-year capital outflow to be at the level of $ 65bn. However, it should be noted that such forecasts (constantly failing to materialize) are more therapeutic than analytical. For their part, analysts working for commercial banks (for example, *Alfa Bank*) predict that in Q4 2012 capital outflow from Russia will amount to $ 20bn.

Thus, Russia's persistent macroeconomic stability looks very vulnerable, which makes it impossible to accumulate capital and to allocate it for economic development, as is apparent from capital outflow data, the rise in inflation risks, and the behavior of stock markets.

The Real Sector: The Investment Passivity and the 'New Normality'

The main trend of the past few months was a notable decline in macroeconomic dynamics, brought about, in particular, by the ongoing slowdown in investment activity taking place against the background of contracting external demand and unstable internal demand.

Over the period of July-August 2012, the parameters of the basic types of economic activity continued to display further weakening. The industrial production index in August 2012 was 102.1% against 106.2% in August 2011, including for mineral resources extraction – 100.8% against 103.3%; and for processing industries –104.1% against 107.1% respectively. GDP growth in the 2nd half-year 2012 is estimated to be at the level of 102.7% on the corresponding period of the previous year, and the 2012 full-year results against 2011 will amount to 103.5%.

From June 2012 onwards, there has been noted a slowdown in the per annum retail turnover rate. The retail turnover index in August 2012 was 104.3% on the corresponding period of the previous year, including 100.8% for foodstuffs and 107.4% for nonfood commodities. An alarming phenomenon in this situation is the accelerating rates of growth displayed by the population's real income and real wages, which increased by 7.2% and 7.8% respectively on

August 2011. On the one hand, the rapid movement of these indices functions as one of the few available drivers of production growth. On the other hand, the upshot of the growth of production costs in response to rising wages is the deteriorating overall result of production activity. Increasing basic rates and the interest rates on consumer credits will have a negative effect on one of the most dynamic demand sectors – the demand for nonfood commodities.

The situation with regard to investment is also pessimistic. In June – August 2012, the movement of investment in fixed assets became weaker, production volume in the construction sector declined, and the housing construction indices demonstrated sharp fluctuations. The volume of investment in fixed assets over the period of January – August 2012 amounted to Rb 6,206.8bn, which represented a 8.8% increase on the corresponding period of the previous year. Meanwhile, in July the per annum rate of growth of investment in fixed assets dropped to 3.8%, and in August – to 2.3% against 107.0% in August 2011. In view of these developments, growth of investment in fixed assets in the 2nd half-year is expected to be at the level of 102.4%, and the 2012 full-year results against 2011 will be 105.5%. In the structure of investment funding sources, the downward trend displayed by the share of bank loans (including loans issued by foreign banks) and corporate borrowings became more prominent. The volume of production in the construction sector remained almost at the same level as in August 2011.

Foreign investment in the Russian economy in the 1st half-year 2012 amounted to $ 74.8bn, which is 14.7% below the index for the 1st half-year 2011. As of 1 July 2012, the amount of accumulated foreign investment in Russia, including investment from the CIS countries, was $ 334.7bn, which is 3.6% below the level achieved as of 1 January 2012. It should be reminded that in Q1 of the crisis year 2009 the accumulated investment volume dropped by 8.3%, then it began to increase throughout the entire pre-crisis period, and only in the 1st half-year 2010 this index demonstrated a decline by 2.08%.

However, the Gaidar Institute's surveys of industrial enterprises have demonstrated that in late summer their optimism somewhat increased, thus giving rise to hopes that the aforesaid trends may become weaker or altogether disappear. After several months in a row when demand estimates (both actual and expected) had been declining, they displayed an improvement. Nevertheless, these improvements should be interpreted with due regard for the ongoing adaptation of enterprises to the situation of reduced demand ('a new norm'): thus, in late 2010 – early 2011 the level of demand was considered to be normal if it ensured capacity load at the level of 76–77%; at present, the level of 72–73% is estimated by industrialists to be satisfactory. As result, demand forecasts for Q3 2012 display a zero balance: growth expectations are equally balanced against the expected decline in sales. On the one hand, such a situation appears to be better than the increasing pessimism observed in Q2 2012, when the balance of expectation lost 13 points over the course of three months and reached a three-year low. On the other hand, it points to a high level of uncertainty, because enterprises give up their plans for replenishing their stocks, are very moderate in regard of increasing any further the prices of their products, and are more strongly orientated towards cutting their personnel number. The plans of enterprises give no indication of any changes in their human resources policies: in August, the initial balance of employment forecasts went down by another 6 points (or 4 points when cleared of seasonality), and so dismissals of workforce in industry will continue – more likely, with increasing intensity.