

## RUSSIA'S ECONOMY IN DECEMBER 2013: PRELIMINARY DATA AND MAJOR TRENDS

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A few words about **the socio-political background** that triggered some of the key economic events of December 2013. The most important political event of the month was the unexpected release from jail of former oil tycoon Michail Khodorkovsky who had spent 10 years and 2 months behind bars. As Khodorkovsky's jail term had been expiring, Putin was facing a dilemma – either to give the go-ahead to the long-anticipated third Yukos case, or to let Khodorkovsky go free. With his decision to release Mikhail Khodorkovsky Putin intended to show that he was the boss of everything happening in Russia, to get political kudos (Khodorkovsky's appeal for pardon) as well as Khodorkovsky's promise not to engage in politics and not to try to regain Yukos assets.

The most frequently given reason for both Khodorkovsky's release and the concurrent amnesty that freed a number of detainees widely considered to be political prisoners (two *Pussy Riot* members and some of the defendants in the Bolotnaya Square riot case) is that Russia's authorities badly needed to boost her image abroad ahead of the Sochi Winter Olympic Games and Russia's chairmanship of the G8.

Another key event was the conclusion of the latest round of Russia-EU tug of war over Ukraine. In December 2013, Russia lavished Ukraine with a huge bailout package, seen as a *quid pro quo* for the suspension, by Kiev, of signing the Association Agreement and a free trade pact with the EU, which had caused massive protests in the Ukrainian capital. The price of Russian natural gas delivered to Ukraine was cut by almost half. Also, Russia promised to buy \$ 15bn worth of Ukrainian Eurobonds (the money would come from Russia's National Welfare Fund). The RF Finance Ministry, which manages the National Welfare Fund, will have to change the rules to let the Fund invest in Ukrainian debt because Ukraine's credit rating is lower than the Fund's current charter permits. On the whole, the outcome of the recent standoff that has increased Ukraine's economic dependence on Russia should be considered as an intermediate victory for the Kremlin.

Despite the amnesty (seen by many as a purely cosmetic gesture), the State Duma continued to toughen Russia's repressive legislation. In December, it further hardened the severe penalties envisaged under the 'anti-extremist' Articles 280 and 282 of the RF Criminal Code. The State Duma also penalized the expression of

separatist opinions, making it a criminal offence punishable by deprivation of liberty for a term of up to five years.

In December, Vladimir Putin delivered his annual Presidential Address to the Federal Assembly. The Address placed very little emphasis on political matters and was mostly devoted to economic issues. Actually, the political portion of the Presidential Address contained nothing noteworthy, except for the promise '[...] to clarify the general principles of local self-government, develop strong, independent, financially sustainable local authorities'. The thing is that on the eve of the Presidential Address, some analytical centers issued a number of documents designed to justify a local self-government reform abolishing mayoral elections, and there were rumors that plans for this reform would be announced in the Presidential Address. It seems that the Kremlin's plans for radical reform were suspended at the very last moment. However, the trend toward abolishing mayoral elections survives, as indicated by the fact that experts continue to devise plans for further curbing the scope of local self-government (for more details, see the section entitled 'New Proposals for Local Self-government Reform').

In December 2013, the **macroeconomic situation** was determined by the prevalence of favorable global market trends. Oil prices remained persistently high (in December, the average price of Brent crude oil amounted to \$ 110.4 per barrel vs. \$ 107.8 per barrel in November). On the whole, the global raw material market did not respond to the long-awaited decision of the US Federal Reserve System to begin winding down its third round of quantitative easing (QE3). As a result, the MICEX Index was on the rise through most of December, returning to its mid-November level (1,500 points).

In spite of the positive situation in world markets, Russia's macroeconomic indicators were rather lackluster. In December 2013, the monthly inflation rate was higher than expected, and the ruble remained under pressure. As of 27 December 2013, the Bank of Russia's currency interventions amounted to \$ 3.64bn (vs. \$ 3.56bn in November). The value of Russia's bi-currency basket dropped from Rb 38.39 as of 30 November to Rb 38.14 as of 27 December. In December 2013, the average monthly value of the bi-currency

basket amounted to Rb 38.35, which represented a 10.4% increase on January 2013, when it amounted to Rb 34.75.

In December, monthly inflation stood at 0.5-0.6%, bringing annual inflation to 6.5%, similar to 2012. It should be noted that the Bank of Russia had expected inflation to drop in 2013, and had promised to keep it within 6%. The main factors behind the rise in inflation in October-December 2013 was the growth of food prices and the weakening ruble (for more details, see the section entitled 'Inflation and Monetary Policy').

In December, the narrow monetary base increased by 2.06%, although, on the whole, it was on the decline through most of the year. Between 1 and 27 December 2013, the surplus reserves held by commercial banks rose by 33% to Rb 1.342bn, while the amount of banks' repo debt increased by 20% to Rb 3.12 trillion. Thus, the banking sector's debt to the RF CB exceeded its pre-crisis record high. In the situation of continuing structural liquidity deficit experienced by the banking sector, the interest rate in the interbank market in November was on the average at the level of 6.2% (vs. 6.06% in October 2013), having risen above the similar index for January 2013 by 14.9% (5.4% in January 2013). As of 20 December 2013, the average interest rate in the interbank market amounted to 6.44%. It should be noted that one of the main factors behind the upward movement of interest rates in the interbank market over the period of November-December 2013 was the revocation of licenses of a number of Russian banks.

The purge of the banking system by the Bank of Russia, that culminated in the revocation of the license of Master Bank, unnerved the banking market, pushed up interest rates, created a panic in some of Russia's regions and triggered a significant exodus of customers from small banks to big ones. In November 2013, the banking sector's aggregate profit hit a two-year low of Rb 64bn, while its return on equity dropped to 12% per annum vs. about 17% in January–October 2013 (for more details, see the section entitled 'Russia's Banking Sector in November 2013').

As regards **Russia's real sector**, the final months of 2013 saw a continuation of several negative trends first observed in the second half of 2012. Contrary to expectations, the situation in this sphere did not improve. Moreover, major investment trends indicate that this state of affairs will remain unchanged until at least mid-2014.

In the January–November 2013 period, the volume of investment in fixed assets amounted to 99.2% of its volume in the corresponding period of 2012. In January–September 2013, the investment share in GDP amounted to 16.6% (vs. 17.1% in the same period

of 2012). Investment in large and medium-sized enterprises was declining at an accelerated rate (-6.9% from its level in the January–September 2012 period). There was a sharp drop in investment in industrial construction and the transportation sector: the volume of investment in the latter dropped to 81.5% of its level in the January–September 2012 period, which can be explained by the completion of a number of major pipeline transport investment projects and a decline in investment in railroad transport. There was a slight rise in investment in the processing industry (+3.0% on January–September 2012) and a fall in investment in mineral extraction (-6.9%) and natural gas and water distribution facilities (-9.4%). It should be added that the growth of investment in the processing industry was partly caused by the completion of a number of major oil refinery projects and the beginning of polypropylene production at the Tobolsk-Polymer complex owned by CJSC SIBUR Holding.

In the January–September 2013 period, the share of bank loans in aggregate financing amounted to 9.9%, which represented a 1.7 p.p. rise on the same period of 2012. Foreign bank investment was in sharp decline (-24% on January–September 2012), while investment financed by higher-level organizations contracted by 33.7%. It should be noted that due to the weakness of Russia's banking system, such organizations have traditionally been the main source of external finance for enterprises. In the January–September 2013 period, the share of investment financed by higher-level organizations in aggregate financing dropped to 12% vs. 18.9% in the same period of 2012. In January–September 2013, the amount of foreign investment in fixed assets significantly declined, while its share in total investment dwindled to 2.5% vs. 3.3% in the corresponding period of 2012 (for more details, see the section entitled 'Investment in Fixed Assets').

As seen by the results of January–November 2013, industrial output fell by 0.1% on the same period of 2012. By the end of November, the processing industry had been on a downward course for 7 months in a row. In the January–November 2013 period, the volume of industrial production slumped by 0.6% on the same period of 2013. In November 2013, it dropped by 0.9% on November 2012.

By the end of 2013, Russia's economic growth had begun to be negatively affected by the ongoing decline in domestic demand. In November 2013, the growth rates of the real incomes and wages of the population amounted to 1.5% and 4.8% respectively vs. 9.1% and 6.7% respectively in November 2012. Moreover, the consumer credit boom was rapidly losing momentum in the face of the exploding rise in household debt. As a result, in January–November 2013, retail turnover

and the paid services market rose by 3.9% and 2.2% respectively, while in January–November 2012 they had risen by 6.5% and 3.8% respectively. Unemployment had been on the rise since June 2013; in November 2013, the unemployment rate in Russia increased to 5.5%, vs. 5.2% in November 2012.

Having been on the decline in the second half of 2012 and the beginning of 2013, the net financial results of enterprises stabilized in mid-2013 at relatively

low levels. Compared with the January–November 2012 period, the lowest net financial result, 68.3%, was recorded in the processing industry, while the average net financial result of Russia's economy as a whole amounted to 83.3%. In January–November 2013, return on sales amounted to 7.7%, which represented a 2.3 p.p. drop on the same period of 2012 (for more details, see the section entitled 'Russia's Real Sector of the Economy: Factors and Trends'). ●