THE REAL SECTOR OF THE ECONOMY IN 2013: FACTORS AND TRENDS

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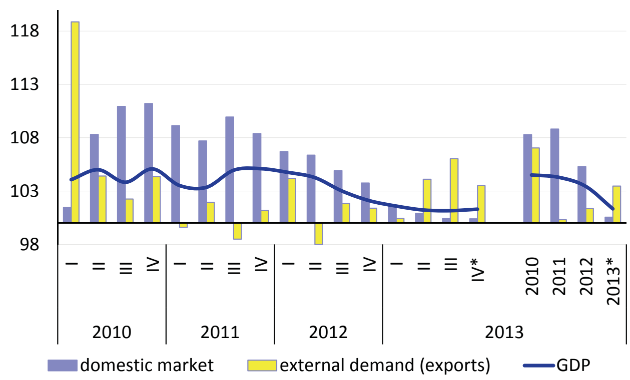
According to the RF Ministry of Economic Development's preliminary estimates, GDP annual growth in 2013 was 1.3%, while its average per annum growth over the period of 2010–2012 had hovered around of 4.1%. The slowdown of Russia's economic growth in 2013 was determined by a low domestic demand. Investments in fixed assets declined by 0.3%, and the consumer market's growth rate dropped from 6.3% a year earlier to 3.9% on 2012. The processing industries displayed growth of 0.1% on 2012, while the quarterly rate of production decline in machine-building and metallurgy was on the rise against the backdrop of shrinking investment demand. Dwindling profits, rising production costs, an accelerated growth of wages vs. labor productivity, shrinking demand for labor all contribute to the very unfavorable business situation in 2014.

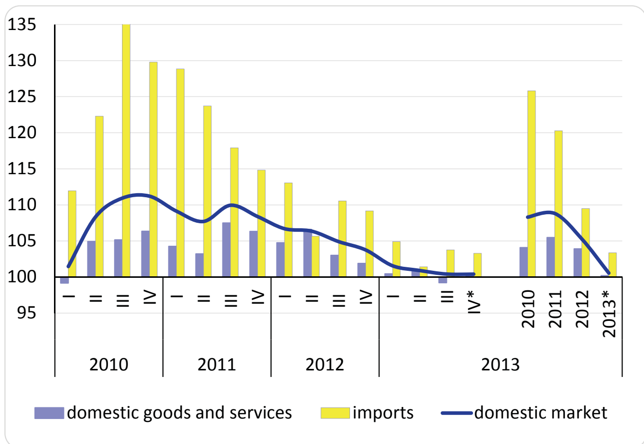
In 2013, the macroeconomic situation was characterized by a gradually declining rate of economic growth and worsening short-term development prospects. As estimated by the RF Ministry of Economic Development, the GDP year-on-year growth rate in 2013 was 1.3% against, while the same index for 2012 stood at 3.4%. It should be noted that, throughout 2013, the RF Ministry of Economic Development and the International Monetary Fund three times lowered their previously published GDP growth target for 2013 and the period until 2015. The current situation was determined by the domestic constraints imposed by the quite unsatisfactory progress achieved in the national economy's modernization and absence of appropriate mechanisms for creating investment incentives. According to experts, Russia's economy has exhausted its growth potential, and so it needs structural reforming and a tougher monetary policy.

An analysis of the main production and GDP indicators in 2013 has demonstrated that the principal factor responsible for the low rate of economic growth is the slowdown, from Q4 2011 onwards, of the domestic demand growth rate. In 2013, this trend in the movement of domestic demand became especially prominent, and so exports of goods and services actually became the only factor that was sustaining the movement of the growth rate of GDP in the upward direction, however weakly.

The domestic market was strongly influenced by the steady decline of the domestic production growth rate and the simultaneous downward trend in the volume of imports. At the same time, over a long period of time already, the accelerated growth rate of imports against that of domestic production has remained the major factor supporting the domestic market. This is caused by the lower production efficiency in the segment oriented to the domestic commodity market by comparison with the export-oriented sector of the na-



* based on preliminary estimates.
Source: Rosstat.
Fig. 1. GDP Changes, by Domestic and External Demand Components in 2010–2013, as % of the Same Quarter of a Previous Year



* based on preliminary estimates.
Source: Rosstat.
Fig. 2. The Movement of Domestic Market, by Resource Component, in 2010–2013, as % of the Same Quarter of the Previous Year

tional economy, coupled with the low competitive capacity of domestic goods and services by comparison with their imported counterparts.

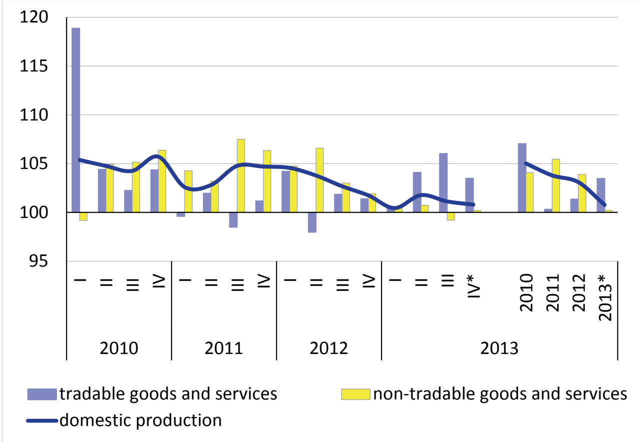
The progressive slowdown of the domestic production growth rate since Q4 2011 gave way, in Q3 2013, to output decline in absolute terms. The processing industries, which are oriented in the main to the domestic market, over the course of the year 2013 demonstrated growth in per annum terms on the corresponding periods of 2012. Output volumes in the processing industries over the period of January–November 2013 amounted to 99.4% of the corresponding index for 2012, and it is only due to the increased output in December by 1.6% in per annum terms that the results of Q4 2013 demonstrated slight revival of growth (+0.2%) and an increase of the annual output volume by 0.1%.

The movement of the index of industrial production was positively influenced, from Q2 2013 onwards, by the slight growth observed in the mineral extraction sector, which occurred largely in response to the increased demand for fuel and energy resources on the domestic market, as well as on the markets of countries – traditional importers of Russia's fuel, in anticipation of the heating season of 2013–2014. As seen by the year-end results of 2013, output growth on 2012 in the mineral extraction sector with regard to production of fuel and energy resources amounted to 1.1%, and with regard to other types of mineral resources - to 1.7%.

The decline of business activity in 2013 resulted in lower demand for electric energy: the index of production and distribution of electric energy amounted to 98.2% of its 2012 level. Output growth observed in the processing industries and the mineral extraction sector was the factor that compensated for the drop, by 1.8% on 2012, in the volume of production and distribution of electric energy, natural gas and water, and so the year-end results of 2013 displayed a positive industrial production growth rate – by 0.3% on its previous year's level.

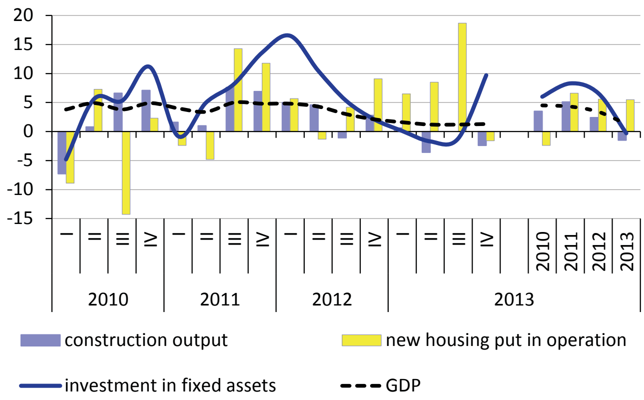
The factors that sustained the GDP growth rate in 2013 were an increase in agricultural production (by 6.2%) and the upward movement of the production index in the services sectors.

The strongest negative impact on the situation in the domestic market in 2013 was produced by the shrinking volume of investment in fixed assets and the production volume in the construction sector (by 1.5% and by 0.3% on 2012). According to preliminary estimates, the GDP share of investment in fixed assets in 2013 dropped by around 1.3 pp. against its previous year's level. The index of investment in fixed assets was pushed down by the increasing capital outflow and shrinking share of gross domestic saving: capital



* based on preliminary estimates.
Source: Rosstat.

Fig. 3. The Movement of Domestic Production in 2010–2013, as % of the Same Quarter of the Previous Year



Source: Rosstat.

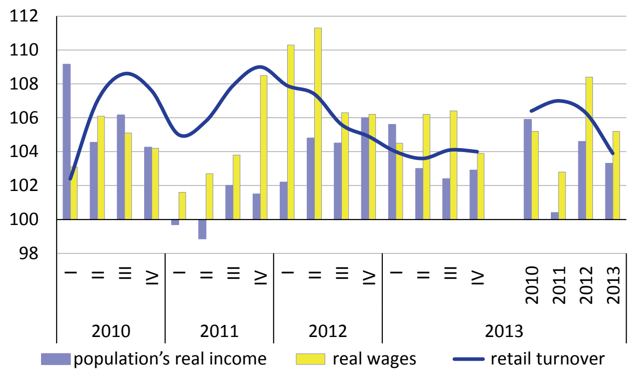
Fig. 4. The Movement of Main Indices of the Investment Construction Complex in 2010–2013, as % of the Same Quarter of the Previous Year

outflow in 2013 rose by 14.8% on 2012, whilst gross domestic saving's share in GDP dropped by nearly 2.0 pp. on its previous year's level. That the dynamics of investment finally entered positive zone in Q4 2013 was caused by a massive rise in the volume of investment inflow in Russia's economy in December: the December 2013 volume of investment amounted to Rb 2,337 bn, which represented a 70% rise on November. However, given the existing time lags, this phenomenon did not influence the production volume in the investment construction complex: due to the accumulated negative potential, the stabilization of the level of production and the accelerated rate of housing stock being put in operation in Q3 gave way to a slump in Q4 2013. The insufficient share of completed construction projects, declining volume of unfinished housing development and the traditional for a new year's beginning delay in the financing of investment projects were the factors that complicated the situation in the investment construction sphere in Q1 2014.

The principal factor that helped to mitigate the negative effect on the domestic market of the very low rate of production growth in industry and the production decline in the investment construction complex was the upward movement of retail turnover and the volume of commercial services rendered to the population. In 2013, retail turnover increased on 2012 by 3.9%, and the volume of commercial services rendered to the population – by 2.1%. The persisting slowdown of the growth rate of retail turnover, since early 2012, was accompanied by the diminishing differentiation of its growth rate by the commodity type. In 2013, the growth of retail turnover of foodstuffs amounted to 2.5% vs. 3.6% a year earlier, and that of non-food commodities – by 5.0% vs. 8.6% respectively.

The positive trend displayed by the growth rate of a retail turnover in response to the policy of raising the level of remuneration in the budget-funded sectors to the national economy's average became markedly weaker in 2013. In 2013, the population's real income increased by 3.3%, and real wages – by 5.2% against their previous year's levels.

The accelerated upward movement of real wages from Q2 2013 proved to be insufficient to boost the growth rate of retail turnover. In Q3 2013, the share of labor costs in GDP declined to 49.7% from 54.7% in Q2 and 55.3% in Q1. From Q2 2013 onwards, the growth rate of the population's real income was on the decline, thus amounting in Q3 2013 to only 101.7% of its level in the corresponding period of the previous year, which produced a negative effect on the situation in the consumer market. In GDP's composition by end use, the share of households in Q3 2013 amounted to 49.4% against 53.5% in Q1. It should be noted that the growth of retail turnover observed over the last two years largely occurred due to the increased volume of consumer credit, and so the decline in the volume of issued individual credits from October 2012 onwards resulted in a lower growth rate in the consumer market.



Source: Rosstat.

Fig. 5. The Growth Rate of the Population's Real Income, Real Wages, and Retail Turnover in 2011–2013, as % of the Same Quarter of the Previous Year

While the economic growth rate in 2013 declined, wages displayed an accelerated growth rate by comparison with that of labor productivity, which strengthened the upward trend in the growth rate of costs and the downward trend in the movement of the economy's profitability index. Over the period of January–September 2013, the share of gross profits in GDP amounted to 17.6%, which is 1.5 p.p. below its level in the corresponding period of the previous year. In this connection it should be noted that, in spite of the negative behavior of the production index, until June 2013 the rate of unemployment in Russia's economy was on the decline, and only in the second half of 2013 the demand for workforce began to display a downward trend. In Q3, the average monthly unemployment growth rate (as estimated by the ILO methodology) amounted to 103.0%, and in Q4 it increased to 106.7%; as a result, the overall number of unemployed in December 2013 was by 375 thousand higher than its corresponding 2012 index. Thus, the starting conditions for economic development in 2014 r. are complicated both by the rising tension both in the investment sector and on the labor market.