RUSSIA'S ECONOMY IN JANUARY 2014: PRELIMINARY DATA AND BASIC TRENDS

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The Political Background: An Echo of Ukraine's Turmoil

The political background of January was mainly determined by the events unfolding in Ukraine. The adoption, by the Ukrainian parliament, of a package of repressive laws restricting freedom of assembly and introducing harsh penalties for their violation, resulted in the situation in Ukraine spiraling out of control into a full-blown political crisis. Russian state and pro-government TV channels have interpreted the recent escalation of fiery confrontation in Kiev and other Ukrainian cities as a Western-inspired attempted coup against Ukraine's legally elected government. According to recent public opinion polls, this point of view is becoming increasingly popular among Russians.

The Ukrainian crisis has further soured relations between Russia and the European Union. The growing negativity between them was manifested, for example, by EU leaders and President Putin cutting short their long-planned summit and its agenda. The summit had initially been planned to take place in December 2013, but had been postponed until January 2014 because of the events in Kiev. Finally, the summit was held in late January. However, just days before its scheduled opening, it was announced that the summit would be shortened from two days to one, that it would not have a fixed agenda, and that no official final documents would be signed by its participants. A traditional joint dinner was cancelled. In fact, the summit was turned into informal discussions behind closed doors, focused on the Ukrainian crisis and a number of controversial energy issues. One of the few public results of the summit that can be considered as a sign of compromise is Vladimir Putin's promise not to revise the recently signed package of economic agreements with Ukraine if the opposition comes to power there.

Meanwhile, the events in Kiev prompted Russia to adopt new tough laws: in January, the RF State Duma passed several amendments to Russia's 'anti-extremist' legislation, designed to toughen penalties under a number of Criminal Code articles. It also passed a bill authorizing the Prosecutor General's Office to block websites without a court ruling. Among the content that can be banned are incitements to participate in 'public events held in violation of the established order', that is, unauthorized political rallies. Human rights activists and the opposition are sure that these legislative innovations will be used by the Kremlin in its struggle against political opponents of the regime.

Macroeconomics and Finances: Prelude to a Storm?

In the first few days of 2014, oil prices began to slide sharply. However, their decline was short-lived and followed by stabilization. The January 2014 average price for Brent crude oil was $ 106 per barrel (a 3.3% drop on December 2013), while the price of Urals crude oil declined by 4.8% (to $ 106.43 per barrel). Thus, international oil prices have remained at levels acceptable to Russia, because her 2014 budget is estimated to balance at an oil price of $ 101 per barrel.

Bearing in mind that in the last few months of 2013 the ruble had come under significant pressure, the ruble's gradual weakening during the first three weeks of January came as no surprise to anyone. In the period from 31 December through 22 January, the value of Russia's bi-currency basket increased by 1 ruble, to Rb 39.22 (+2.6%). However, during the final week of January, there was a sharp increase in pressure on the ruble, which caused the value of Russia's bi-currency basket to climb to Rb 41.3 as of 31 January 2014 (which represented a 7/3% rise on 31 December 2013). It happened in spite of the fact that over the course of the month the Bank of Russia had spent $ 8.2bn to support the ruble, with $ 5.1bn of those dollars being spent during the last week of January alone. Thus, CB interventions to support the ruble hit a post-crisis record high. As a result, over the course of the period from 27 December 2013 through 31 January 2014, the RF Central Bank's gold and foreign exchange reserves dropped by 2.9% to $496.7bn, their lowest level since February 2011. Over the May 2013 – January 2014 period, the RF CB's gold and foreign exchange reserves dwindled by 6.9%.

The sharp weakening of the ruble was determined by a number of fundamental factors, including a decline in Russia's current account surplus. According to preliminary estimates released by the Bank of Russia, in Q3 2013, Russia's current account surplus amounted to $ 4.7bn, and in 2013 as a whole – to $ 33bn. For reference: in Q3 2012 and 2012 as a whole it amounted to $ 12.8bn and $ 74.8bn respectively; and in Q3 2011 and 2011 as a whole – to $ 27.1bn and $ 97.3bn *respectively. Thus, the almost three-fold drop in Russia's current account surplus took place against the background of a very small (3%) decline in oil prices.*

The second fundamental factor behind the weakening of the ruble, which manifested itself in particular during the final week of January, was the huge capital outflows from the global equity funds oriented to emerging markets. According to data compiled by Bloomberg, in January 2014, $ 7bn was withdrawn from such equity funds (vs. $ 9bn over the whole year 2013). According to data compiled by Emerging Portfolio Fund Research, Inc. (EPFR), over the period 2 January – 22 January 2014, capital outflows from the equity funds oriented to the Russian market amounted to $ 135m; however, in the final week of January, those funds lost an additional $ 230m in withdrawals. The aforesaid huge capital withdrawals from emerging markets are part of the general trend determined by the rolling back of the US Federal Reserve's Quantitative Easing Program. Analysts expect this trend to continue over the next few months.

According to preliminary estimates released by the Bank of Russia, net capital outflow from Russia in Q4 2013 and 2013 as a whole amounted to $ 16.6bn and $ 64.7bn respectively. Thus, last year, capital outflow from Russia was on an upward trend: in 2009–2013, Russia had an average annual net capital outflow of $ 57bn.

Russia's January inflation (January 1–27) amounted to 0.5% (prices for fruit and vegetable products and dairy products continued to grow). The considerable weakening of the ruble during the last ten days of January has not push up prices as yet; this will certainly happen in the next few months.

In December, the surplus reserves held by commercial banks grew up by 61.8%, to Rb 1,788bn. Although that growth in surplus liquidity was seasonal in nature, it exerted a considerable influence on the situation in the foreign exchange market. In February, the surplus reserves held by commercial banks will begin to decline, and it can be expected that the downward pressure on the ruble will subside for the time being if the external environment remains relatively neutral. As of 27 January 2014, banks' repo debt to the RF Central Bank had fallen to Rb 2.7 trillion. During the period 1–23 January 2014, the average interest rate in the interbank market amounted to 5.95% (against 6.4% in December 2013).

The Real Sector:
A Farewell to Consumer-Driven Growth

In January, the Russian Federal State Statistics Service (Rosstat) released its preliminary estimates of the dynamics of Russian GDP and industry in 2013. GDP grew by 1.3%, as compared to 3.4% in 2012. In annual terms, industrial production rose by 0.8% on 2012. In Q4 2013, industrial production climbed by 0.3% on Q4 2012.

Although the growth rate of mineral extraction in Q4 2013 remained as small as in Q3 2013 (+1.5%), the dynamics of industrial production significantly improved due to the unexpectedly robust growth in output of the processing industry: in December 2013, its output grew by 1.6% in annual terms after showing negative growth rates in annual terms during the previous seven months. This result can be explained not by an improvement in the market situation (business opinion surveys indicate the contrary), but by the base effect: in December 2012, the production growth rate of the processing industry considerably decreased, to 1.5% in annual terms, as compared to the 2012 average monthly growth rate of 4.3% in annual terms. 4.3%. The state of affairs in the mineral extraction sector was the same: as extraction rates from mineral ores and mineral deposits were rather low in late 2012, the 1.5% growth of mineral extraction in Q4 2013 can be viewed as an indication that, in fact, over the last three months of 2013 Russia's mineral output was not growing but shrinking, compared to Q3 2013. On the whole, according to Rosstat's estimates, in the year 2013 Russia's industrial production grew by a flat 0.1%, while her mineral output increased by 1.2%, compared to the previous year.

One of the key factors behind Russia's ongoing economic slowdown is stagnation and the persistent mild slump in the investment and construction sectors of her economy. The investment sector's full-year 2013 results indicate that investment remained in negative zone (according to preliminary estimates, it dropped by 0.3% as compared to 2012). The growth rate of the construction industry was also negative (a 3.4% drop on 2012).

The growth rate of real disposable income (RDI) was on the decline throughout 2013: in Q1 2013, RDI rose by 5.6% on Q1 2012; in the first half-year of 2013, RDI grew by 4.2% on the corresponding period of 2012; in the period of January–September 2013, it grew by 3.5% on the same period of 2012; and in 2013 as a whole, RDI went up by 3.3% on 2012 as a whole. As a result, the growth rates of the retail trade and paid services turnover suffered yet another decline. For reference: in the pre-crisis period (2005–2008), the average annual growth rate of retail trade amounted to 14.2%, and in the post crisis period (2010–2012) – to 6.6%, whereas in 2013 it plummeted to 3.9%. The decline in the growth rate of the volume of paid services rendered to the population was equally drastic – it dropped from 3.5% in 2012 to 2.1% in 2013.

In 2013, Russia's economy was hovering at just above stall speed, its growth being almost solely generated by a moderate rise in consumption. Final consumption expenditure as a percentage of GDP increased to 71.2% (against 68.3% in 2012), while the share of net saving dropped from 24.3% to 21.4%. The share of net exports shrank from 7.4% to 5.7% (as the growth rates of imports were higher than those of exports). Thus, Russia's economy has remained focused on the long-standing consumption-driven growth model despite the fact that today, when oil prices are not rising but slowly declining, the potential of this model seems to be exhausted. In 2012, the rise in final consumption expenditure (+6.9) was accompanied by a moderate rise in net saving (+1.4%), including net fixed capital formation (+6.4%), whereas in 2013, the growth rate of final consumption expenditure sharply reduced (the growth rate of household final consumption expenditure dropped to +4.7%, against +7.9% in 2012; the growth rate of the final consumption expenditure of public administrative agencies dwindled to -0.01, against +4.2% in 2012), while net saving notably decreased (by 0.4%, compared with the previous year).

The crisis of the consumption-driven growth model, the continuing downward trend in raw material prices, and the growing capital outflows from emerging markets will remain the Russian economy's main challenges in 2014.