THE RUSSIAN ECONOMY IN MARCH 2014: PRELIMINARY DATA AND KEY TRENDS

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Political background: turning towards "cold war"

The main event in March which is having long-term political and economic consequences was the accession of Crimea to Russia, based on the results of the referendum conducted on 16 March. It has resulted in the most serious tension in the relations between Russia and Western countries since the "cold war".

At the moment, the West has introduced a limited range of sanctions against Russia, including its exclusion from the G8, 'a ban on travel to the West and a freezing of the assets of a number of officials and businessmen close to the Kremlin, and the closing of programmes of cooperation with Russia in several fields. Moreover, the sharp rise in tension between Russia and the West has led to a reassessment of the market prospects of the Russian economy, and this has been expressed as a massive outflow of capital and a growth in the cost of borrowing for Russian companies.

These limited sanctions in respect of Russia were applied in the context of a possible invasion of the Ukrainian mainland by Russian military forces, that, in the opinion of the West, Russia is preparing. Despite the limited nature of these practical actions, the West's response is definite evidence that there will be a cardinal change in its long-term strategy for relations with Russia. In its present form, Russia will be considered as a threat to the international safety and interests of the EU and the U.S. Furthermore, what has happened will become an important motivation for Europe to accelerate the reduction of its dependency on Russian energy resources, with a further restructuring of the energy markets and closer cooperation between the U.S. and Europe. For the next few years Russia will remain in a state of political and economic confrontation, a "cold war", with the West, which will considerably weaken its economic position, its opportunities for technological development and the diversification of its economy.

From the domestic political aspect, the accession of the Crimea will contribute to a consolidation of the conservative aspectsof society and a further toughening of the political regime, with a movement towards becoming ever more closed. In Russia the accession of Crimea caused patriotic enthusiasm and political mobilisation: the Levada Centre index, which estimates the current state of affairs, and which had been stagnating around zero for the last two years, soared to +34 points. Putin's approval ratings, which had been around 63–65%, increased to 80%. The Kremlin is using the current situation to build political and ideological control over public life, with the further dismantling of democratic procedures. In addition, the house-arrest of the opposition leader Alexey Navalny and the blocking of a range of Internet websites, are probably linked to Parliament's draft laws on the cancellation of elections for the mayors of the largest cities and a further toughening of the punishment for participation in unauthorised protest meetings (for further information see the section on Political and Economic Results of March 2014).

Macroeconomic background: Crimea as a crisis

President Vladimir Putin's authorisation by the Federation Council to use Russian Federation armed forces of the on Ukrainian territory resulted in a collapse in the Russian markets. The MICEX index fell by 10.8% on 3 March and from 3 to 4 March the Bank of Russia spent $12.5bn supporting the ruble. The Central Bank was forced urgently to increase the base rate from 5.5% to 7%.

During the month, stock market indices won back a part of the fall, with the MICEX index standing at 1,366 points on 29 March, however its average monthly value (1,319 points) was still 10.6% lower than the corresponding indicator for February (1,475 points). The loss of capitalisation of the stock market during March was Rb 1.72 trillion, with a total capitalisation of Rb 21.7 trillion as of March 26. The structure of the Russian domestic corporate bond market was also worsening across all the indicators (for further information see the section on Financial Markets).

The Bank of Russia spent $22.3bn and EUR 2.3bn supporting the ruble in March (interventions in January-February were $13.97bn and EUR 1.27bn). The cost of the dual currency basket increased from Rb 42.21 on 1 March, reaching Rb 43.08 by 18 March, and then decreasing to Rb 41.70 on 29 March. As a result, the gold currency reserves of the Central Bank decreased from the Rb 493.3bn of 28 February to Rb 484bn on 28 March (-1.9%). Compared with their peak values in May 2013, international reserves decreased by 9%.

According to preliminary estimates, the capital outflow in the 1st quarter was about $70bn, out of which $35bn occurred in January-February, being associated with the general capital outflow from emerging mar-

kets, while the second half of the total outflow took place in March, reflecting the market participants' response to the events around Ukraine and Crimea. World Bank experts are not ruling out the possibility of an annual outflow of $150bn in the case that a high level of tension continues in association with Ukraine. The Minister for Economy, A. Ulyukaev is standing by a more favorable forecast of about $100bn. In general annualised terms, the capital outflow from Russia (2nd quarter of 2013 — 1st quarter of 2014) has reached a near-crisis level of $120bn, despite the persistence of high oil prices.

Consumer prices in March grew by 1%, resulting in a total price growth of 2.3% since the beginning of the year, while, in annual terms, they grew by 6.9%. The main driver of this growth in prices was continued ruble depreciation in January-March (the average monthly value of the dual currency basket was Rb 42.39, i.e. 110.6% of the corresponding value for December 2013 and 121% of the corresponding value for March 2013).

At the same time, the decrease in ruble exchange rate provided for a growth of federal budget revenues: in January-February 2014 they reached 22.5% of GDP, which is 1.6 p.p. higher than the revenues for the same period in 2013. The simultaneous reduction in expenses, by 1.4 p.p. of GDP as compared with January-February 2013, created a budget surplus of 0.3% of GDP, or Rb 30.5bn. This reserve, together with additional revenues relating to the increase in oil prices above the basic budgeted price, has created conditions for financing additional expenditure (in particular, those related to the accession of Crimea) in the second half of the year.

The increase of the refinancing rate by the Bank of Russia caused a growth of rates on the interbank market. The average interest rate on the interbank market in February was 6.0% (6.1% in January 2014); from 1 March to 26 March the average interbank interest rate increased to 7.8% (for more information see the section on Inflation and Monetary Policy).

In general, it can be said that the macroeconomic background of the 1st quarter of 2014 was formed by two factors: the general deterioration of the situation in countries with emerging markets reflected in a tendency towards increased capital outflow, and the "Crimean shock" in March, which worsened the gneral unfavorable trends. All this has created conditions for a further decrease in investment activity and deteriorating dynamics of the economy.

Real sectors: investments go into dollar

The ruble depreciation that has been continuing for the last six months has had a key influence on the funding opportunities for economic growth in the banking sector. In the first months of 2014 the focus of activities for banks has been the build-up of foreign assets. In February, the growth in their corporate loan portfolio was close to zero (+0.1%), with annual growth slowing down to 12.3%. At the same time, the foreign assets of banks grew by $21.4bn during these two months, while the total indebtedness of resident individuals and of legal entities for the same two months increased only by $12.6bn, i.e. the capital outflow from the banking sector exceeded lending in the domestic economy by almost two times.

Meanwhile, there was a considerable decrease in household savings deposits with banks: in February 2014, individuals placed 3.3% of their monetary income in bank accounts and deposits, whilst, in February 2013, the figure had been 8.1%. The rapid growth in foreign currency deposits continued and, as a result, their share in the total volume of the funds of individuals on deposit exceeded 20.3%, having returned to the level of November 2010. There was a continuing tendency towards the slowdown of growth in the banks' retail loan portfolios: from March 2013 the volume of indebtedness increased by 26.1% (by 27.7%, based on the results of 2013). The share of loans not repaid in due time increased from 10.4% in February 2013 to 12.5% in January-February 2014 (for more information see the section on Russian Banks in January-February 2014).

The February data on the real sector show a number of trends. Firstly, there is a steeper decline in investment. In January, investments in fixed assets stood at 93%, and, in February, at 95% of the figures for the corresponding months of 2013. In January and February the construction sector suffered a decline to 94.6% and 97.6% of the corresponding levels for the previous year.

The data on industry look more reassuring. The mining sector has experienced its typical weak growth, reaching 100.8% of the 2013 February figure, while annual growth in manufacturing was surprisingly high at 3.4%. These results are partially explained by the base effect of the low industry indicators for February 2013. At the same time, manufacturing, which had been in the negative zone from May to November 2013 indeed did show some signs of improvement. However, it should be noted that the indicators for manufacturing industry are highly differentiated. The manufacture of machinery and equipment as well as that of electrical, electronic and optical equipment are in severe recession (88.6% and 93.5% of the levels of last year). Meanwhile, manufacturing of vehicles and transportation equipment is demonstrating considerable growth (in January-February it was 108.9% of the figure for the corresponding period of 2013) while, in the automotive industry the figures are 95.1% for February and

87.8% for January-February compared with the corresponding periods of last year. The differences in these data are evidence that the fundamental drivers causing slowdown of the economy are still operating.

In addition to declining investment activity, growth in the short term will be negatively affected by the dynamics of household income, which is continuing to worsen. Based on the results of January-February, the disposable income of households was 99.7% of the level for the corresponding months of 2013. Meanwhile, the growth of average real accrued wages was quite high (+5.2% in annual terms). The cessation of income growth and the slowdown of consumer lending (the major part of which is used for refinancing earlier loans) is depriving the economy of the driver which had supported economic growth in 2011-2012 to a considerable extent.

In general, the massive capital outflow, a steeper decline in investment and the lack of resources for consumer growth by households, make a transition to a phase of recession the most probable future scenario.