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Russia's Economy in January 2013: Preliminary Results and Major Trends

Political Background: Political Conservatism Plus Economic Dirigisme?

The beginning of 2013 was marked by yet another outburst of opposition-led protest activity in Moscow, this time unexpectedly strong: according to different sources, between 20 and 50 thousand people took part in the *March Against Scoundrels*, which was aimed against the 'Anti-Magnitsky Law' adopted by the State Duma at the end of December 2012. Meanwhile, Parliament resumed business after the New Year recess, and once again began to churn out legally ambiguous, conservative and thoroughly repressive legislative acts.

Thus, the State Duma rushed the adoption, at first reading, of a draft law designed to make it possible for regional assemblies to abolish direct gubernatorial elections and to select the governor of a region from a list of candidates nominated by the RF President. The new procedure represents a revision of the political reform declared one year ago, which looks very dubious from the point of view of basic constitutional principles. It is clear that this legislative innovation exclusively serves some specific, pragmatic and tactical goals (such as, say, the possibility to keep in power an unpopular governor). At the same time, it is equally clear that the new law will further destabilize Russia's federal system. Another dubious draft law, 'On the Protection of the Population's Health…', designed to deal a heavy blow to small businesses (including small retail outlets), was somewhat mitigated at its second reading. And finally, the draft law on the imposition of a ban on 'homosexual propaganda', also passed by the State Duma in January, looks like a yet another declaration of the extreme conservatism typical of the Kremlin's domestic policies.

January saw a number of important discussions on the desirability of changes in Russia's economic policy. The sharp drop in the growth rate of the Russian economy registered at the end of 2012 caused concern among Russia's top officials: thus, President Putin once again declared his opinion that the refinancing rate should be reduced in order to increase the credit available to the economy. In response, the Chairman of the Bank of Russia said that the rate would indeed be reduced, but that first inflation should recede. It is evident that the President's statement reflected the growing demands that Russia's authorities should abandon their conservative monetary policy. And it was the necessity to stimulate Russia's economic growth that forced the RF Ministry of Economic Development to request that the authorities should mitigate the 'budgetary rule' adopted last year and begin to spend money from the State's reserve funds, even if the volume of those funds has not yet reached the prescribed level of 7% of GDP. The same is true of many other suggestions on economic development issues made in January - for example, the proposals that a Russian financial agency should be created, and that pension savings funds should be invested in the domestic market.

This combination of extreme conservatism in domestic politics and the strengthening of state dirigisme in Russia's economic policy is fraught with some strong political and macroeconomic risks in the medium-term perspective.

Macroeconomic Background: Inflation, Capital Flight and the Sprouts of Optimism

The macroeconomic background of January was largely determined by the situation in the global economy - which was characterized, on the one hand, by a rise in optimism over the future of the Eurozone, and on the other, by strong concerns over the major budget problems of the USA. This mixture of optimism and pessimism is reflected in the continuing strengthening of the Euro (1.32 USD per Euro as of 31 December 2012 and 1.36 USD per Euro as of 31 January 2013). The last ten days of January saw the beginning of a slow upward trend in oil prices (the price of Brent crude oil climbed from $ 111.03 per barrel as of 17 January to $ 115.05 per barrel as of 31 January). Against the background of this environment, the ruble was relatively strengthening against the U.S. dollar and weakening against the Euro. As a result, the value of the bi-currency displayed practically no changes at all over the course of January.

The MICEX Index climbed from 1,475 points (the last trading session of 2012) to 1,547 points as of 31 January 2013, which points to a relative rise in investor optimism. The rise in the MICEX Index was caused by the increased capitalization of consumer-sector and banking companies, notwithstanding a simultaneous drop in the capitalization of companies operating in the petrochemical and oil-and-gas sectors. It should be noted that the rise in prices was determined by the massive infusions of domestic investment carried out at a time when foreign investors were actively withdrawing funds from the Russian market. This situation clearly delimits the extent of the stock market's potential for growth that has just begun to manifest itself.

January also witnessed a continuation of December's accelerating inflation: while in December 2012 inflation amounted to 0.5% (vs. 0.4% in December 2011), the rise in prices from 1 January to 28 January 2013 amounted to 0.8% (vs. 0.4% in January 2012). It can be expected that January monthly results will show a price rise of around 0.9%, which would mean that in January Russia's annual inflation amounted to 7%. Meanwhile, the Core Consumer Price Index continued to decline throughout December. In December 2011, the Core CPI stood at 0.4% (same as in December 2011), while core inflation dropped to 5.7% (from +6.6% in 2011). The acceleration of general inflation taking place against the background of a deceleration of core inflation indicates that the price rise in 2012 was largely determined by some non-monetary factors. It is typical that the afore-mentioned acceleration in price growth was taking place against the backdrop of stagnation and decline (at the end of the year) in the disbursing prices of enterprises, registered by business surveys (see below).

Throughout most of 2012, the broad monetary base had remained practically unchanged, but at the end of the year it experienced a considerable growth – thus, in December alone it increased by 19%. So, over the course of 2012, the growth rate of the broad monetary base amounted to 14% (vs. 5.5% in 2011). December 2012 also saw a rise in the excess reserves of commercial banks: over the course of that month they grew almost twofold, to Rb 1,806.3bn. The amount of funds kept on correspondent accounts with the RF Central Bank rose to Rb 1,403bn, while the amount of funds kept on deposits therewith rose to Rb 403.3bn. The inflow of budget funds into the banking sector, observed during the end of the year, was of seasonal nature, and by the end of January, the excess liquidity kept by commercial banks on their correspondent accounts and deposits with the RF Central Bank began to dwindle because of the beginning of the tax payment period. As a result of the rise in the volume of liquidity available to commercial banks, the debt incurred by banks under REPO transactions declined to Rb 2 trillion. However, it is evident that any further fall in liquidity will cause a corresponding increase in the volume of refinancing.

In Q4 2012, capital outflows from Russia increased to $ 9.4bn. After the Bank of Russia's re-estimation of the balance of payments for the first three quarters of 2012, preliminary estimates of net capital outflow from Russia over the course of 2012 put it at $ 56.8bn (vs. $ 80.5bn in 2011).

The Real Sector of the Economy: A Threat of Stagnation

Preliminary data on the dynamics of GDP in 2012 have confirmed the most pessimistic expectations: the 3.4% annual rise in GDP means that its growth rate dropped from 2.4% in Q# to 1.8% in Q4.

This drop in the growth rate of GDP indicates that the possibilities of maintaining a high growth rate in the economy by stimulating consumer demand are largely exhausted. Over the course of 2012, the turnover in retail trade increased by 5.9% vs. by 7.0% in 2011. At the same time, there was a decline in the growth rate of consumer demand, taking place against the backdrop of high annual growth rates of the population's real disposable money incomes and wages (+4.2% and +7.8% respectively vs. +0.4% and +2.8% respectively in 2011) and a continuation of robust growth in credits granted to the population (the volume of credits granted to physical persons in November 2012 was 1.5 times higher than that in November 2011). It is noteworthy that the share of domestically produced goods in the structure of retail trade commodity resources declined by 2 pp. on 2011.

A decline in the growth rate of investment was the most important negative factor behind the slowdown of Russia's economy. Over the course of 2012, investment in fixed assets grew by 6.7% over the previous year (vs. by 8.3% in 2011); the construction work rose by 2.5% (vs. by 5.1% in 2011); and the commissioning volume increased by 4.7% (vs. by 6.6% in 2011). Investment activity was most robust from January through August, but much less so in the rest of the year, especially in Q4, which saw a persistent downward trend in investment activity, a phenomenon absolutely untypical of the Russian building construction cycle. However, this drop in investment activity could have been expected because of the significant worsening in the financial performance of enterprises over the course of 2012 by comparison with their performance in 2011.

There was a considerable drop in growth rates across the board, including in mineral resources extraction – from 101.9% in 2011 to 101.1% in 2012, and in the processing industry – from 106.5% in 2011 to 104.1% in 2012. Especially noteworthy was the sharp drop in the growth rate of the processing industry: having stood at between 4.1 and 4.5% during the previous four quarters, the growth rate dwindled to 2.8% in the final quarter of 2012.

Business opinion surveys carried out by the Gaidar Institute demonstrated a continuing prevalence of extremely pessimistic opinions. The Industrial Optimism Index was on the decline throughout the last three months of 2012. In December, it hit its lowest level since the end of 2009. Demand for industrial products continued to display a downward trend: industrial enterprises' level of satisfaction with sales dropped 12 percentage points in November and

December alone. While in the period from June through November the balance of opinion on output hovered around stagnation (-2 .. +2), in December the balance of opinion dropped with an intensity that had not been registered by surveys for 3.5 years (- 9 points). That drop in the balance should have been expected: at the beginning of Q4, the share of industrial enterprises whose output outpaced demand rose to 29-30%, although in the previous quarters this index had stood at 20-21%. In December the share of such enterprises fell back to its habitual 20% - but at a price of a significant decline in output.

For two months in a row business surveys demonstrated an absolute year-end drop in prices - the strongest ever recorded throughout the period of 2009-2012. It should be mentioned that October 2012 saw rise in prices at all, while August and September witnessed some very insignificant price growth. The aforesaid absolute drop in prices observed over the period of November and December affected almost every industry, except for the fuel industry (balance +14 points), the food industry (+10), and the timber industry (+2).

As far as employment in industry is concerned, it has been on a relatively steady decline since July 2012: the number of workers (the rate of change) has been changing within the range between -13 and -8 points. In Q4, the most intensive drop in the number of workers was registered in the timber industry, ferrous metallurgy, light industry and machine building. Recruitment was registered only in the electric power industry. Most of the industries are characterized by the predominance of expectations of personnel dismissals. These expectations are especially widespread in light industry (-25 points), ferrous metallurgy (-24 points), and machine building (-21 points).

In December 2012, the balance of investment plans collapsed by 10 points to its 3-year low. At year end, positive investment plans survived only in the timber industry (+7 points) and the construction industry (+3 points). In the rest of industries, investment plans reflected enterprises' intention to scale down their investment activity. This trend was especially apparent in the food sector and light industry.

In December, the aggregate ('above the norm' + 'in accordance with the norm') availability of credit in Russia's industry declined from 69% to 62%. That drop in credit availability was caused by access to credit having been constrained for very large enterprises (with more than 1,000 employees). For the rest of enterprises, credit terms remained unchanged, although it should be noted that they had been steadily worsening throughout several previous months.