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

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Socio-political Background: Struggling to Initiate Combat against Corruption

The socio-political situation in February was shaped by the escalating conflicts within this country's elite. The State Duma was shaken by scandals that resulted from the exposure of the ownership, by certain eminent representatives of the party in power, of real estate abroad that they had somehow neglected to report in their tax declarations. While some of these absent-minded politicians were forced to resign from their posts in response to the attacks of bloggers representing the opposition, others decided to give up their mandates in view of the course towards 'nationalization of the elite' announced by President Putin. The draft law (adopted in February at first reading) that is designed to prevent Russian officials from having any accounts with foreign banks smacks more of a populist measure than of any genuine ban on any foreign property (while mentioning bank accounts and stocks, the draft law is altogether silent about the existing more sophisticated products and legal forms of control over property).

It is evident that the Kremlin is striving to snatch the theme of struggle against corruption away from the opposition. The numerous criminal cases initiated over the course of February (in particular, the exposure of certain officials took place in the mayor's offices in St. Petersburg and Murmansk). The events associated with the dismissal of former Minister of Defense Anatoly Serdiukov demonstrated that any corruption-linked scandals at the top level are detrimental to the authority of the leaders of the State and the political regime as a whole. So, the spearhead of the anticorruption campaign is now aimed at regional-level officials, 3rd or 4th-tier executives, and businesses affiliated with the state system.

The second set of recent conflicts have to do with struggle for control over the 'energy' assets owned by the State. According to expert observers, this struggle goes on between the group headed by Prime Minister Medvedev and Igor Sechins's group, the latter aiming at concentrating control over those assets in the hands of Rosneftegaz, thus making it a 'second Rosimushchestvo'. However, it seems that the person benefitting the most from that conflict is Vladimir Putin, who can manipulate both parties by alternatively supporting one against the other.

Macroeconomic Background: Inflation Refuses to Slow Down, Markets Are Stagnating

As usual, in February the macroeconomic situation in Russia was strongly influenced by the situation on the world markets. While January was characterized by rapid strengthening of the Euro against the US dollar (from 1.30 to 1.37 USD per Euro), in February the US dollar fully reestablished its former position. A number of other indicators also demonstrated a reversal of their previous trends. Thus, the growth cycle of oil prices that began in early December gave way to an energetic downfall in the second half of February. As a result, oil prices returned to their level recorded at the very end of last year ($ 111.1 per barrel as of 28 February instead of $ 117–118 per barrel in the month's first half). However, there are no indications that this is indeed a major trend: for two years already – or, more precisely, since March 2011 – the price of Brent crude oil has been fluctuating around $ 110 per barrel, while Russia's Urals has been traded at a slightly lower level. The February futures for Brent initially rose as high as $ 103.5 per barrel, but then declined to $ 101.2 per barrel towards the month's end.

The movement of the world markets' conjuncture is reflected by the fluctuations of Russia's indicators. Thus, the ruble's strengthening against the US dollar in January coupled with its simultaneous decline against the Euro gave way to strictly reverse trends in February. As a result, the bi-currency basket's value has remained stable, with slight fluctuations around the Rb 34.75 mark. Over the course of February, the stock market lost everything that it had gained in the optimistic January: the MICEX Index plummeted from its record high –1,563 points as of 28 January – to 1,474 points as of 1 March, which is practically the same level as on the last trading day of December 2012. However, downward trends were observed in February also in the stock markets of the other developing economies (in contrast to US markets).

The most important phenomenon in February was the persistent trend towards acceleration of the inflation rate. Over February, inflation climbed by nearly 0.6% (against 0.4% in February 2012). Thus, the rate of acceleration, although lower than in January when it doubled against its last year's index, has remained at a significantly high level. As a result, the inflation rate in February became as high as 7.3% in per annum terms. Similarly to the situation in January, the growth rate of prices was significantly influenced by the rising prices of fruits, vegetables, and millet, as well as by the aftereffect of the January increase of the urban transport fares and the prices of excisable goods (thus, over February, the price of vodka rose by nearly 3%, while the overall rise of that product's prices on December 2012 amounted to 19%).

So – just as in January – the movement of the inflation rate was influenced by seasonal factors and the measures introduced by the regulator (increased excises and tariffs). The low rate of inflation in January – February 2012, in its turn, was determined by the political environment, when in the course of the presidential election campaign the influence of regulated prices and cartel markets (petroleum products) was deliberately and intentionally minimized. So, the inflation rate over the period of January through April 2012 remained at a level below 4% per annum, then in the summer it surged over 6%. This circumstance coupled with the trends observed early in 2013 is indicative of the fact that the government, most likely, will be unable to keep inflation within its target range of 5–6% – just as it had failed to do so last year.

Meanwhile, it was the impressive movement of the inflation rate resulting from a more intense redistribution of money flows towards the budgetary sphere and natural monopolies that has been referred to by the Bank of Russia as the main argument in the dispute concerning the possibility of softening its monetary policy. On 12 February, the Bank of Russia announced that the refinancing rate and interest rates on its main operations would be left unchanged. The RF Central Bank's position is based on the assumption that, at present, the Russian Federation is experiencing neither any significant deviation of output from its potential level, nor any discrepancy between the levels of demand for money and money supply; so, a tougher monetary policy cannot be justified because the current growth of inflation is caused by non-monetary factors.

In addition to keeping the interest rates on their previous level, the RF Central Bank, from 1 March onwards, established a unified norm of 4.25% for the size of required reserves for all types of liabilities. In late 2009, the norms for non-resident legal entities were established at a higher level than those for other types of liabilities. This differentiation resulted from the desire of monetary authorities to create negative incentives for banks to attract credits from abroad. However, more recently the importance of that issue has diminished due to the increased flexibility of the exchange rate policy pursued by the RF Central Bank.

January 2013 saw a seasonal shrinkage of the broad monetary base after its expansion towards the end of last year. The declining volume of currency in circulation coupled with a simultaneous increase of the volume of required reserves resulted, in January, in a parallel shrinkage of the narrow monetary base (cash plus required reserves) – by 8.6%. The volume of surplus reserves of commercial banks, after having doubled in December 2012, then dropped again in January 2013, thus returning to its level observed in November 2012. The volume of the RF Central Bank's repo operations with commercial banks over the period of January-February turned out to be significantly lower than in December 2012. However, this can only be regarded as a temporary trend, because the liquidity reserves (obtained by banks due to the substantial budget expenditure typical of a year's end) will gradually be exhausted.

According to the preliminary estimates released by the RF Ministry of Economic Development, net capital outflow in January amounted to $ 8–10bn, which is lower than in January 2012 ($ 15.3bn), but higher than its index for the entire period of Q4 2012. Thus, early this year, capital outflows from Russia visibly accelerated, thus reaching the level forecasted in the second annual development scenario (geared for the price of oil at the level of $ 97 per barrel) included in the RF Central Bank's Main Directions of Monetary Policy for the next three years.

The Real Sector of the Economy: Acceleration of Slowdown

In January, the main development in the real sector that determined its overall dynamics was the negative per annum growth rate in industry. The decline of industrial production by 0.8% was caused by a decline in the mineral resources extraction sector (by 98.2% on January 2012) and stagnation in *the processing sector (99.7% on January 2012). Our analysis of annual dynamics reveals that growth in industry halted as early as Q2 2012. Late 2012 saw a sharp slowdown in the growth rate of investment in fixed assets; later on, in January 2013, it increased by 1.4% on January 2012. The volume of output in the construction sector increased by 1.8%, while the production of construction materials dropped by 2.2%. The production of machinery and equipment had been declining (against the previous year's indices) since April 2012, and in January 2013 the volume of output in that sector amounted to 83.4% of its index for the same period of the previous year.*

January also saw a continuation of another trend that had emerged in late 2012 – a slowdown in the retail sector. The accelerated growth of real wages and real incomes of the population since late 2011 induced rapid growth of the retail market in the first half-year of 2012 – by 7.3% on the first half-year of 2011; in the half-year of 2012, however, its rate turned out to be significantly lower – 4.7%. This pattern may, in part, be explained by the base effect – the aftermath of the dynamic growth of retail turnover in the second half-year of 2011. In January 2013, retail turnover amounted to 103.5% of its volume recorded over the same period of the previous year (in January 2012 – to 107.4%). To a certain extent, this can be explained by the declining growth rate of real wages in late 2012, as well as by income redistribution: the growth rate of the volume of commercial services in January 2013 increased on January 2012 by 5.3% against 3.7% a year earlier. At the same time, the annual growth rate of loans to individuals remained practically unchanged, amounting to 39.0% as of 1 March 2013. All these circumstances make it possible to hope that retail turnover may at least in part recover over the next few months.

However, on the whole the development of the real sector observed over the period of December–January points to the probability of further slowdown in the economic growth by comparison with its rate observed over the second half-year of 2012. If the targets forecasted for the year 2013 (growth of GDP by 3.5%, of industrial production – by 3.6%, retail turnover – by 5.4%, and investment in fixed assets – by 6.5%) are indeed to be achieved, significant acceleration of the growth rate will be required.

Meanwhile, the business opinion surveys carried out by the Gaidar Institute have provided no evidence of a possible acceleration of growth. The composite indicator from these surveys shows that Russian industry's prospects continue to decline. As before, the main driver behind this downward trend has been a low demand for industrial products. In January 2013, only 40% of enterprises were satisfied with the level of demand for their products, whereas a year earlier this index amounted to 48%. The movement of output in January (when cleared of seasonal factors) was estimated by enterprises to be the same as a year earlier. At the same time, this year, an optimistic view of the expected movement of demand and output (traditional for January) was especially noticeable.

One rather alarming factor is, however, the growing balance of estimates of surplus finished stock, which points to the probability of output decline. The current pricing policy of enterprises is also indicative of their uncertainty as to the potential growth of demand in industry in 2013: the leap of producer prices in January is the lowest since 1999 (the only exception, of course, being January 2009). In this connection it should be reminded that, in November 2012, Russian industrial enterprises had to bring down their producer prices on a large scale, in hope for a revival of demand towards the year's end.

The investment plans of enterprises offer no promise of any revival over the next few months, either. This index failed to recover in January after its seasonal decline in December. The balance of these plans became negative as early as November 2012, then stabilized at that level, and the investment vector remained clearly downward in early 2013. The volume of investment is expected to increase only in the construction materials industry. The deepest investment downfall is observed in the food industry, light industry and ferrous metallurgy. It seems that there is no hope for any revival of the investment activity in 2013.

In January, the aggregate availability of credit in Russia's industry increased by only 4 points and now amounts to 71%. This figure falls well within the traditional range (66–72%) where the value of that index has remained for the last one-and-a-half years. However, the average minimum interest rate offered by banks increased to 12.9% (against 12.7% in December 2012). Interest rates grew for all size groups of enterprises. But this level of interest rates (and even their growth), according to enterprises' estimations, has a minimum negative influence on the dynamics of output in Russian industry. For eight months in a row, only 2 to 4% enterprises have been referring to shortage of credits as a factor that hinders their production growth.