ALLIANZ DRESDNER ECONOMIC RESEARCH

Working Paper 102

23.06.2008

MACROECONOMICS | FINANCIAL MARKETS | ECONOMIC POLICY | SECTORS

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Russia: Beyond the oil boom

Allianz

Dresdner Bank
Die Beraterbank

Working Paper
No. 102

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OVERVIEW

Russia's economic growth exceeded 8 % in 2007, almost reminiscent of Chinese growth rates. No one, including ourselves, had expected such economic momentum. The **economic success** is attributable primarily to the surge in energy prices which, albeit in a weaker form, have propelled aggregate demand. But to attribute the booming economy solely to oil and gas would certainly overlook other factors. In Russia's major cities, the private service sector is flourishing - not surprisingly, given the country's great need to recover lost ground. And, as is currently the case in nearly every emerging market, the construction industry is booming.

Understandably, however, this is not enough for the government. It is vital to **diversify the economy** if the upswing is to be shielded from falling energy prices. And finally the broad mass of the population should also benefit from the economic upswing which has not been the case so far. In spite of rising real incomes and falling unemployment, the earnings gap is widening. Seventeen years since the collapse of communism and the Soviet Union, income in Russia is less evenly distributed today than in most western European countries.

For this reason, Putin - while still president - initiated the so-called Agenda 2020[1]. Having pursued an austerity drive for many years, the agenda now makes provisions for the government to use the income from the commodities sector and **invest** it above all **in the country's infrastructure, education, research and development.** In addition, tax cuts are aimed at improving the economy's competitiveness and higher welfare benefits at lifting the standard of living of the population, above all in the rural areas.

Naturally, political will and actual implementation do not necessarily go hand in hand, least of all when dealing with a plan with such a long-term horizon. A positive point, however, is that the current political constellation with Medvedev as president and Putin as prime minister ensures a degree of continuity.

NEW ECONOMIC DEVELOPMENT

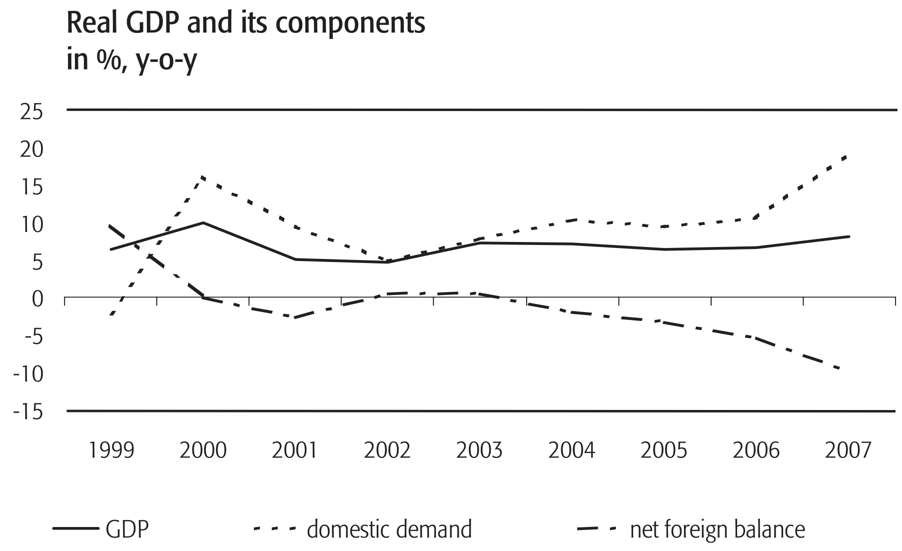
High commodity prices and improved access to international capital markets have been creating **exceptionally advantageous economic conditions in Russia for years.** This was not only reflected in high growth rates. It also had **implications for the structure of GDP**. The share of private consumption, which in 2000 had still stood at only 46 % of GDP, has risen noticeably in recent years to almost 63 %. Apart from higher disposable income, easier access to consumer loans for private households also contributed towards the consumption boom.

Investment to promote economic diversification

However, in an economy with a meanwhile decrepit capital stock, where domestic industrial production is barely able to hold its ground in the face of imported products, consumption alone will be unable to secure growth in the longer term particularly given that the expansion in export volume has declined from year to year and in 2007 stood at only 6.4 %. Slowing export momentum was evident above all in the commodities sector. Considerable bottlenecks are being experienced in production and in the pipeline system owing to the dearth of investment in recent years. Imports, by contrast – powered by buoyant consumer demand – gained an impressive 27 %. The net contribution of exports has therefore fallen sharply in recent years and was even negative for the first time in 2007. A positive point is that Russia is now also increasingly importing capital goods in addition to consumer goods in order to modernize the capital stock. And, indeed, invest-

[1] Speech at Expanded Meeting of the State Council on Russia's Development Strategy through to 2020, February 8, 2008; The Kremlin, Moscow: http://www.kremlin.ru/eng/speeches/2008/02/08/1137_type82912type82913_159643.shtml

ment is clearly picking up. Its share in GDP climbed from 19.4 % in 2000 to nearly 30 % last year.



THE NEW BUDGET

Investment in R&D and strengthening of private sector

Russian industrial products are struggling to compete against imported goods on the home market, and in the low-wage segment Russia will have no chance in the future either compared with China. The government would therefore like to establish high-tech industries in the country as part of the **Agenda 2020.** Examples are airplane construction, the aluminum sector, the petro-chemical industry and nuclear energy. To this end it is investing intensively in education, research and development. Besides numerous state projects, plans also exist to **improve the framework for the private sector.** Other measures are the fight against burgeoning corruption and steps to streamline the unwieldy bureaucracy which, however, have always been included in any economic program. The situation here in Russia is currently far from desirable, as also confirmed by the „Corruption Perception Index“ of Transparency International. For years, Russia has only been given just over 2 out of 10 possible points, and last year the country actually dropped to 143rd place from 121st place in the global comparison. Deploying capital to eliminate the bottlenecks in infrastructure – above all in road construction, goods traffic and in the electricity networks, should prove easier than overhauling the bureaucracy. Reforms in the financial sector and a continuation of the tax reform also appear attainable. By already introducing a reduction in the tax burden on the oil sector, the government has created initial investment incentives.

The medium-term implementation and funding of Agenda 2020 has been laid down in **the three-year budget plan**, with the funding of the projects unlikely to pose a problem. In relation to GDP, public debt is well below 10 %. To insulate the budget from swings in oil and gas prices, Russia had already set up an **Oil Stabilization Fund** in 2004. Income from export taxes and license fees from the oil sector had only passed directly into the budget at a price of USD 27 per barrel. Everything in excess of this price was channeled into the fund which the central bank managed as part of its currency reserves. For this reason, the same conservative investment strategy was applied for the fund as for the reserves. The central bank invested the funds exclusively in USD, EUR or GBP denominated foreign government bonds with AAA ratings. In addition, the government has massively reduced its foreign debt by using the fund to prematurely redeem its foreign debt.

More use made of oil revenues

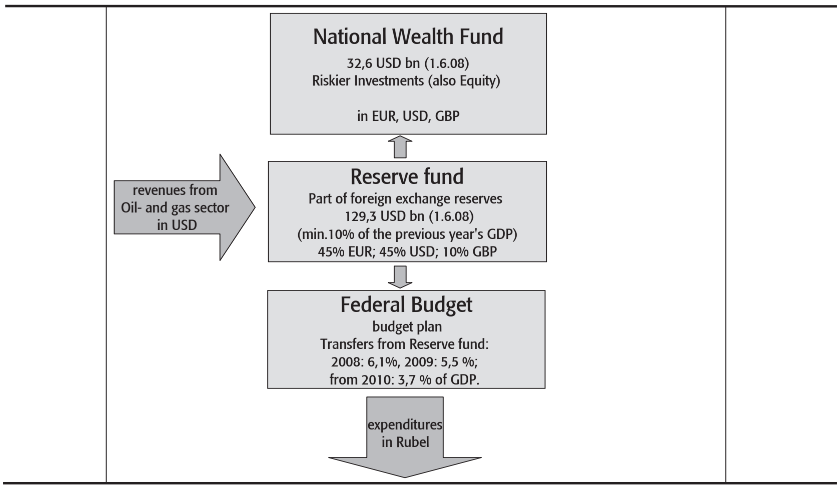
The oil price soared from one high to another, with the fund volume reaching USD 157bn in January 2007. By converting most of the income from the oil sector into foreign capital, neither the economy nor the population has profited to any great extent from the high oil price. For this reason, voices were being increasingly raised in politics calling for an expansion in the fund's investment possibilities and for a portion of the income to be passed on to the population via budget spending. The government has embarked on this course and plans to additionally finance projects aimed at improving the economic structure.

For this reason, in February the government split the fund into a **Reserve Fund** and a so-called **„National Wealth Fund"**. In addition, a Russian development bank was founded with the intention of focusing primarily on the structural development above all in the regions. The National Wealth Fund will now also invest in more speculative investments in order to generate higher returns. The idea here is to invest the income from non-renewable resources as best as possible for future generations – i.e. with the highest possible return. In contrast, the Reserve Fund takes over the function of the former Oil Stabilization Fund, maintaining deposits of at least 10 % of the previous year's GDP. By so doing, the government wants to ensure that sufficient currency reserves are available to react to short-term price fluctuations on the oil market. Furthermore, in future all levies and tax revenues from the oil business and, most recently, also from the gas business will be passed on in full to the new fund, with nothing flowing directly to the budget any more.

Budget funding no problem in medium term

The government is thus rendering the budget independent of oil price fluctuations as long as sufficient funds are contained in the Reserve Fund. For 2008 it expects a budget deficit, without transfer payments from the Reserve Fund, of 6 % of GDP. This rate is also more or less commensurate with the estimates of the IMF which for 2008 forecast a deficit without commodity income of 6.6 %[2] . Financing the deficit will not pose a problem in the years to come: until 2011, the government will be able to finance supplementary budgets with higher expenditure by resorting to the funds of the Reserve Fund. However, the Fund – as already mentioned above - must always maintain reserves to the tune of at least 10 % of the previous year's GDP. With oil prices currently at a record high and given the accompanying strong inflows into the Reserve Fund, this should not pose a problem.

[2] Account is only taken here of income from export duties and license fees from the oil and gas sector. Excluding commodity revenues, the IIF (Institute of International Finance) actually expects a deficit of 13 % of GDP for 2008. It also includes the income tax from the oil and gas companies into its calculations. However, these taxes will continue to flow into the budget as regular corporate tax revenue.



STRUCTURAL PROBLEMS OF MONETARY POLICY

Price subsidies and the strong ruble briefly brought inflation down to below 8 % in 2007. With the increase to 15.2 % in May, inflation has become one of Russia's most pressing problems. As elsewhere in the world, rising energy and above all food prices are stoking up inflation in Russia. However, a monetary component is also playing an important role here.

Rise in inflation due to structural problems

The whopping current account surplus and large net capital imports have created an oversupply of foreign currency on the Russian currency market, putting upward pressure on the ruble in the process. To limit the feared losses in competitiveness resulting from a currency appreciation, the central bank intervened and thus bloated domestic liquidity which in turn has intensified price pressure via rising demand. The inflation rate has now risen well above ruble interest rates, creating negative real interest rates and giving a further spin to the inflationary fly-wheel. On the road towards greater price stability, the central bank is faced with the following problems:

- In an environment of expansive monetary policy, fiscal policy ought to be restrictive. But the opposite is the case. The government is planning to finance additional expenditure from the National Welfare Fund. However, the funds contained in this fund have been invested abroad, i.e. in foreign currency, and drawing on them would mean converting them into rubles, thereby putting still more upward pressure on the exchange rate.

- The Russian banking market is still grappling with structural problems. The interbank market is underdeveloped, and investors' interest-rate sensitivity low, with the result that monetary stimuli easily fizzle into nothing. The central bank has already raised interest rates and the minimum reserve requirements on several occasions, but largely to no avail.

To mop up the surplus liquidity on the money market stemming from the interventions, the central bank could of course issue short or medium-term government bonds. China has been taking this course of issuing so-called „sterilization papers" for some time. In China, the volume of such bonds outstanding has certainly long exceeded desirable levels, as they increasingly prevent banks from granting loans. In Russia, by contrast, this would be less problematic. This is because the capital market here has been instrumentally thinned out as a result of the budget surpluses of the past and the consequent general lack of government bonds.

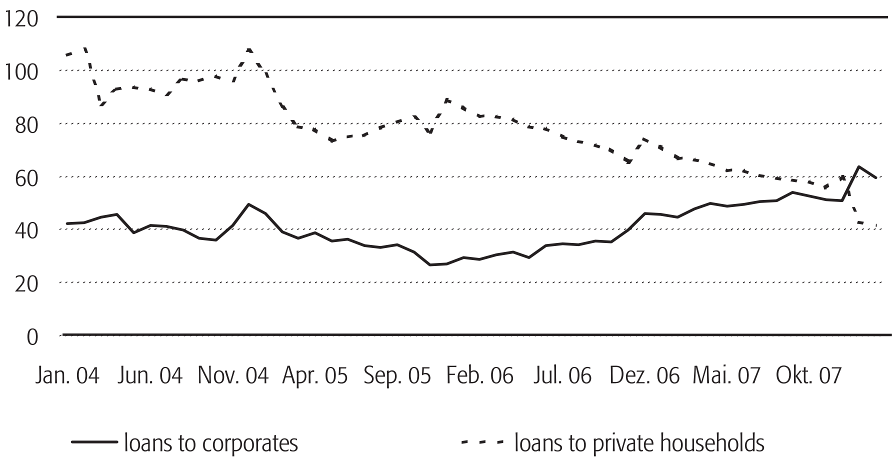
The ideal way would certainly be to **import more capital goods** which could contribute towards a more even balance of payments and a more competitive real capital stock. In the past, this frequently proved unsuccessful due to the reluctance by banks to grant business loans – certainly also one of the knock-on effects of the 1998 financial crisis which had tipped large sections of the Russian banking landscape into the abyss.

Encouragingly, however, lending to companies has picked up significantly in recent years. Last year new business loans already corresponded to 28 % of GDP compared to only 10 % in 2000. This year business loans have for the first time actually expanded more quickly than consumer loans which have mushroomed in recent years. This is joined by the swiftly expanding capital market for Russian corporate bonds; the outstanding volume of this market now amounts to the equivalent of USD 60bn. Above all, this market offers smaller and medium-sized companies the possibility of funding investments.

Progress in banking sector bolstering economy

Companies‘ improved access to the banking and capital market is stimulating investment and imports, both of which are notching up strong gains at the moment, and is also altering the import structure: the share of machinery and plant equipment in total imports is already likely to have exceeded 50 % last year. At all events, sufficient capital is available for brisk investment activity in Russia. The aggregate savings rate has settled down at over 30 % of GDP in recent years, equivalent to far eastern levels.

Loans to corporations and private households
in %, y-o-y



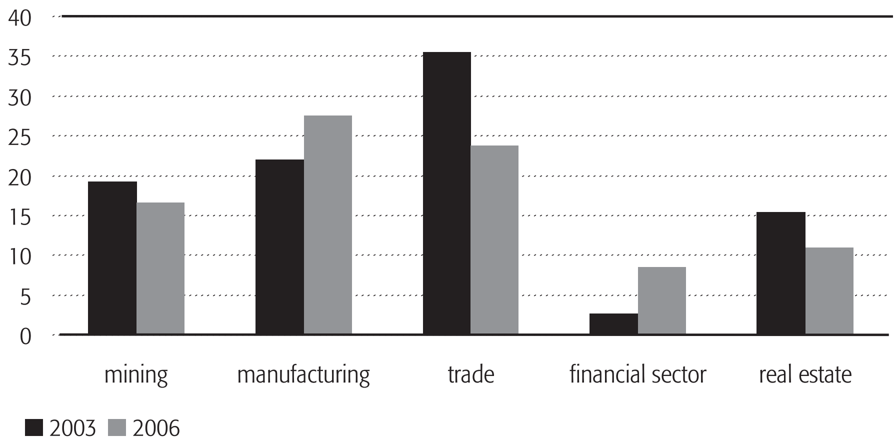
FOREIGN DIRECT INVESTMENT: RUSSIA AHEAD OF CHINA

Russia does not enjoy the best reputation as a location for foreign investment, due not least to the fragile legal system and political meddling in the economy. As one of his last acts while still in the Presidential office, Putin signed a law defining 42 sectors as „strategic“[3], i.e. placing these sectors under special state regulation. Accordingly, company

[3] CF. Alfa Bank: Strategic Investment Bill, April 8, 2008

stakes in excess of 50 % in these sectors require government approval[4]. If the investor is a foreign state fund or a state-owned company, its share in the company may not exceed 25 %. Even harsher regulations apply for the commodities sector: here, stakes in excess of 10 % for private companies and 5 % for companies with state participation are only possible with government consent. For many foreign investors, however, little will alter as a result of this law being passed. In areas in which foreign investors are strongly represented, there are still no restrictions. For example, neither the retail sector nor the insurance and banking sector are affected.

FDI inflows into sectors, in % of total

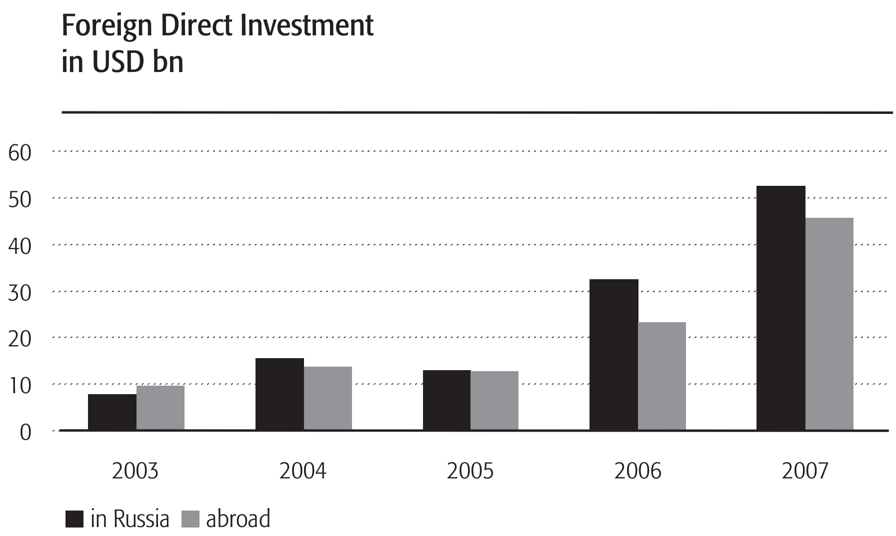


source: cbonds

FDI rising steeply despite political uncertainties of recent years

To underscore Russia's lack of popularity with foreign investors, low net inflows of foreign investment are often quoted. In 2007 these stood at just under USD 7bn. This represents the balance of foreign direct investment in Russia and Russian investment abroad. However, as a net exporter of energy, Russia benefits from the high oil and gas prices, as a result of which the Russian current account has been recording whopping surpluses for years. And any country which exports more than it imports has by necessity to invest abroad. It is therefore not surprising that Russian direct investment abroad totaled no less than just over USD 45bn in 2007. As a **measure of the confidence of foreign companies in the Russian economy, the only meaningful figure is gross inflows of foreign direct investment to Russia.** And last year these stood at a good USD 52bn or 4.3% of GDP. Russia thus marginally outstripped Poland (4.2%) and was well ahead of China (3.5%), Brazil (2.7%) and India (1.6%). Foreign investors were particularly active in the Russian manufacturing sector and in the financial sector. These flattering figures for Russia are by no means marred by the fact that a hefty chunk of the inflows stems from refugee capital from earlier years, in other words actually from Russian investors.

[4] The Anti Monopoly Authorities (FAS) are responsible for the approvals procedure. In addition, the FSB obtains information on the investor and also has a right of say.



RISKS AND GROWTH OUTLOOK

When looking ahead to the future, the risks must also be borne in mind. On the positive side, the list of risks used to be considerably longer in the past than it is today, as of course is also reflected in Russia's better credit standing on the international financial market. We see the following risks for the future economic development:

1. Sharp fall in commodity prices

2. Political uncertainty

Healthy economic backdrop reduces risks to the economy

In the current environment of record-smashing oil prices, it is difficult to imagine commodity prices plummeting to such an extent that Russia's future economic development might seriously be questioned, even if in the more distant past there have been very substantial fluctuations in this area. Naturally this risk also depends greatly on the length of the projection period. Over a long-term horizon more can happen than over the short term. At all events, we consider this risk to be very manageable up to and including 2010, thanks also to the huge foreign currency liquidity reserves which Russia has built up and which serve as a buffer against such external shocks. After all, Russian currency reserves amount to over USD 500bn, way in excess of a whole year's imports and lying close to 40 % of GDP. Furthermore, Russian foreign debt is very low by international comparison.

As regards the political risk, we take a similar view. The tandem solution of Medvedev/ Putin stands for a gradualistic approach and continuity, promising a high degree of stability at least over the near term. More so than in the industrialized countries as well as in most emerging markets, Russian political leadership culture is geared to individual persons and less to institutional and transparent institutions, a factor naturally hampering longer-term forecasts. This is supplemented by other problems such as disadvantageous demographic developments and the ever increasing weight in number terms of the Islamic peoples and the minority problems possibly associated with this.

We nonetheless caution against overstressing these risks. Political stability stands in close symbiosis with economic prosperity. Among other things, high economic growth strengthens the self-confidence of the political leadership strata and encourages them to establish stable political institutions which in the end cushion the implications of a power change for the economy. The arguments in favor of Russia also pursuing this course in the longer term outweigh the arguments against.

Positive outlook thanks to diversification

Accordingly, our **forecasts are indeed buoyed by a certain degree of optimism**. As can be seen in the table, we expect the pace of growth this year to weaken up slightly to 7.5 % compared to 2007, not least because of the current slowdown in global economic activity which will not leave Russia unscathed either. For 2009 and 2010, we expect real GDP to expand by 7.0 % and 6.8 % respectively, figures which are by all means compatible with far lower oil prices than those prevailing at present.

Above and beyond the next few years, we expect annual average economic growth of 5.5 to 6 % which, however, does not preclude strong annual fluctuations around this average. Another factor propelling this economic momentum is that the **economic upswing,** which - with the exception of the commodity sector – has so far been confined to the country's biggest cities, is now also spreading to other urban areas not belonging to the major agglomerations. The state will actively contribute towards this with high infrastructure investment.

RUSSIA | Economic indicators and forecasts

		2005	2006	2007	2008f	2009f
Domestic economy	GDP change in % (real)	6,4	6,7	8,1	7,5	7
	GDP (USD bn)	764	980	1227	1622	1959
	Inflation in % (annual average)	12,5	9,79	9,05	13,5	10
	Budget balance in % of GDP**	7,5	7,4	5,4	3,5	1,4
External sector	Merchandise exports	243,799	303,926	355,465	440	479,6
(USD bn)	Merchandise imports	125,433	164,692	223,421	302	392,6
	Current account balance	83,942	94,466	78,31	67,1	18
	Current account balance in % of GDP	10,984	9,641	6,380	4,135	0,918
	Net foreign direct investment	0,003	10,752	6,824	5	2
	Gross foreign debt	257,2	310,6	459,6	490	556
	Short-term foreign debt	62,64	76,93	105,3	110	120
	Foreign debt in % of exports*	89,993	86,112	104,547	91,230	93,665
	Foreign debt service in % of exports*	22,475	18,152	11,228	9,805	9,693
	Foreign exchange reserves excl. Gold	175,891	295,5	464,379	567	635
	Import cover in months*	10,500	13,385	15,574	14,569	13,284
Interest rate	Credit rate (up to 1 year, weighted, annual average)	10,7	10,4	10	10,5	9,5
	Spread (EMBI+) (basis points, year-end, 2008: 06/06)	118	109	147	159	
Stock market	RTS index (year-end, 2008: 06/06)	1125,6	1642	2290,51	2377	
Exchange rate	Year-end (RUB/USD)	28,782	26,32	24,563	22	20
	Annual average (RUB/USD)	28,284	27,17	25,568	23,6	23

* Goods, service and income. f= forecast..