# Rebalancing Russian growth

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Russia has been the outlier among the BRICs during the world financial crisis. While the other three had at worst a very shallow recession, Russian economic activity collapsed by 7.9 per cent in 2009.

However, the economy bottomed out in mid 2009 and has been consistently growing since. Growth was initially export-led, given that Russia exports goods that remain in demand as long as emerging markets continue to grow. There is also now consistent evidence that the domestic economy is recovering, being led by consumption with construction and investment showing tentative signs of recovery from very low levels. In short, it does look to us like a normal business cycle recovery.

Apart from the world going once more into a tailspin, most investors are, in our view, agreed on this and it is reflected in the recovery of asset prices. Russia displays fewer domestic risks than most other major economies; inflation is finally in mid-single digits, the current account remains in surplus, the central bank has ample reserves, the budget deficit is coming down and the state is supported by a very clean public sector balance sheet, with hardly any net debt. The banking sector (even excluding the CBR) is a net international creditor and while asset quality has deteriorated substantially, the trend has stabilised or reversed and banks are highly capitalised and very profitable on a pre-provisioning basis. There is, furthermore, little sign of significant social discontent or any political tension.

Still, Russian asset prices have not recovered to the same extent as those in the other emerging economies. One reason might be that oil prices are only half of the US$140/bbl that they were pre-crisis. However, the RTS essentially reached its pre-crisis highs already in late 2007, when oil prices where in the mid 80s and it is at least questionable if investors were really foreseeing oil prices to march on all the way to US$140/bbl. Thus we are sceptical that the discount Russian equities are trading at is really driven by the lower oil prices. Instead, we think scepticism is still widespread that Russia can really outgrow the developed world at constant oil prices by any significant margin – in other words whether it is really a BRIC country or simply a play on energy prices.

Our view remains that while oil prices are clearly important, there are good reasons to believe that Russia will grow fast even if oil prices remain constant. In fact, we believe that stable oil prices would be very positive for Russia. It's far from easy to operate in an economy where

**Table 1: Oil prices and Russian GDP growth**

| | Shares in GDP (2003) | Actual growth | Hypothetical growth | | |
|---|---|---|---|---|---|
| | | Average growth (2003-08) | If C and GDP had grown at same rate | If additionally M had outgrown C by the actual factor (20.2/11.3) | If additionally I had outgrown C by the actual factor (14.5/11.3) |
| | % | % annual | % annual | % annual | % annual |
| Private consumption (C) | 49 | 11.3 | 2.9 | 6.3 | 4.7 |
| Government Consumption (G) | 18 | 2.6 | 2.6 | 2.6 | 2.6 |
| Investment (I) | 21 | 14.5 | 14.5 | 14.5 | 6.0 |
| Exports (X) | 35 | 7.5 | 7.5 | 7.5 | 7.5 |
| Imports (M) | 24 | 20.2 | 20.2 | 11.3 | 8.4 |
| GDP=C+G+I+X-M | 100 | 7.0 | 2.9 | 6.6 | 4.7 |

the price of a sector that accounts for about between a fifth and a quarter of the economy rises by 50 per cent one year only to fall by 50 per cent the next .

It is difficult to dissect the influence of rising oil prices on Russia's trend growth pre-crisis. One way to think about it is to look at the imbalances in growth that were caused by the country's leverage into the rising oil prices. The most obvious one of these is that an average consumption growth of 11.3 per cent compared to a GDP or output growth of 7.0 per cent in 2003-2008 would not have been possible if oil prices hadn't been rising. The rising oil prices essentially meant that the economy's output price was rising significantly faster than the country's consumption price and thus Russia could grow its consumption more than its output without ever having to borrow, in other words show a significantly deteriorating current account. Thus, one could argue that the actual trend growth without rising oil prices was that at which consumption and GDP had grown in line. With some simple math and given that consumption accounts for c50 per cent of GDP, this reasoning would imply a trend growth rate of c2.9 per cent rather than 7.0 per cent – hardly higher than Western Europe's.

Does that mean that the sceptics are right who say that all of Russia's fantastic outperformance was due to oil prices? Not really, because stopping the reasoning there is misleading as well. Lower consumption growth would also have meant that imports wouldn't have grown by 20 per cent pre-crisis. Therefore, if we rebalance consumption, we also need to rebalance imports. Assuming additionally that imports would have outgrown consumption by the same factor they actually did (20 per cent growth compared to 11 per cent, or roughly twice as fast) implies a trend GDP growth rate of around 6.3 per cent and hardly 0.7 percentage points (ppt) lower than the actual one.

We can continue this kind of exercise as clearly investment volumes, for instance, would have been different as well, assuming different consumption rates. In our view, we would ultimately arrive at a growth rate of around c5 per cent with these exercises, pointing towards oil prices having raised growth in Russia by around 2ppt in 2003-8.

Clearly, this exercise in rebalancing Russian growth over the last decade is to some extent arbitrary, though not implausible. The above estimate of oil prices having raised trend growth by about 2ppt is, in fact, similar to our estimates based on other methodologies. While significantly lower, this would still be close to what our colleagues think trend growth in Brazil now could be and what we think the per capita trend growth in India could be. China still would be in a different league even in per capita terms (see Table 1). While we find this exercise helpful, the past is still not necessarily a good guide to the future and this is never more true than currently, when there is a lively global debate about a 'new normal' or potentially lower trend growth rates.

Changes to trend growth should be driven first of all by changes in productivity growth. Furthermore, changes in the cost and availability of capital matter and thirdly, demographic factors play a role.

Now, while the government is addressing the population decline, Russia is not going to be a country where the labour force will be growing for the foreseeable

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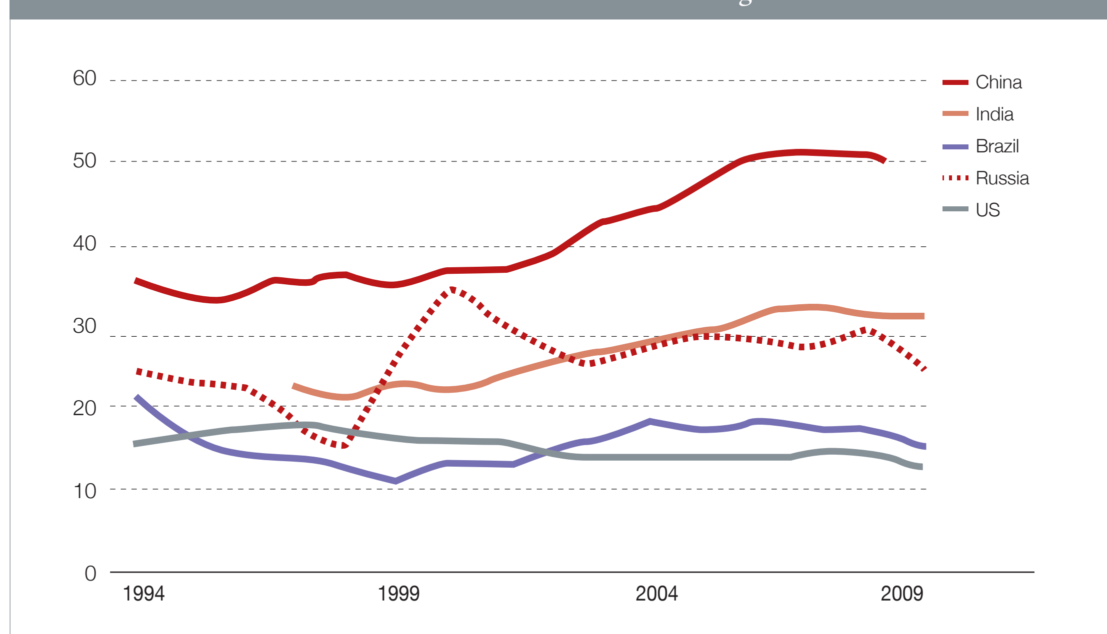
**Table 2: BRIC and US national savings rates**



**Although Russia has had an almost Asian savings rate there has always been a shortage of medium- to long-term funding inside the country**

future. Productivity growth is notoriously difficult to predict, while the recent emphasis by the government on innovation is very important for Russia's growth in the long term, sectors immediately benefiting from it are, in our view, too small to make much of a difference to Russian growth in the next few years. In Russia's case, changes to productivity growth in the short term are going to be mainly dependent on more competition in domestic markets and structural reforms – where, apart from Gazprom, reforms to the state institutions (the judiciary, law enforcement and regulatory bodies) matter most – a priority of the Medvedev presidency. On competition, WTO entry might very well help. However, progress on these factors is by definition difficult to measure and to predict.

That leaves the cost and availability of capital. We think that there are good reasons to believe that significant – and to some extent predictable – positive changes on this front are very likely in Russia over the next few years. Although Russia has had an almost Asian savings rate there has always been a shortage of medium- to long-term funding inside the country. This is curious. Normally a country with a high savings rate has a deep financial sector and relatively low interest rates. This is the story of Asia. Russia instead has had high savings, but a small banking sector and high interest rates (see Table 2).

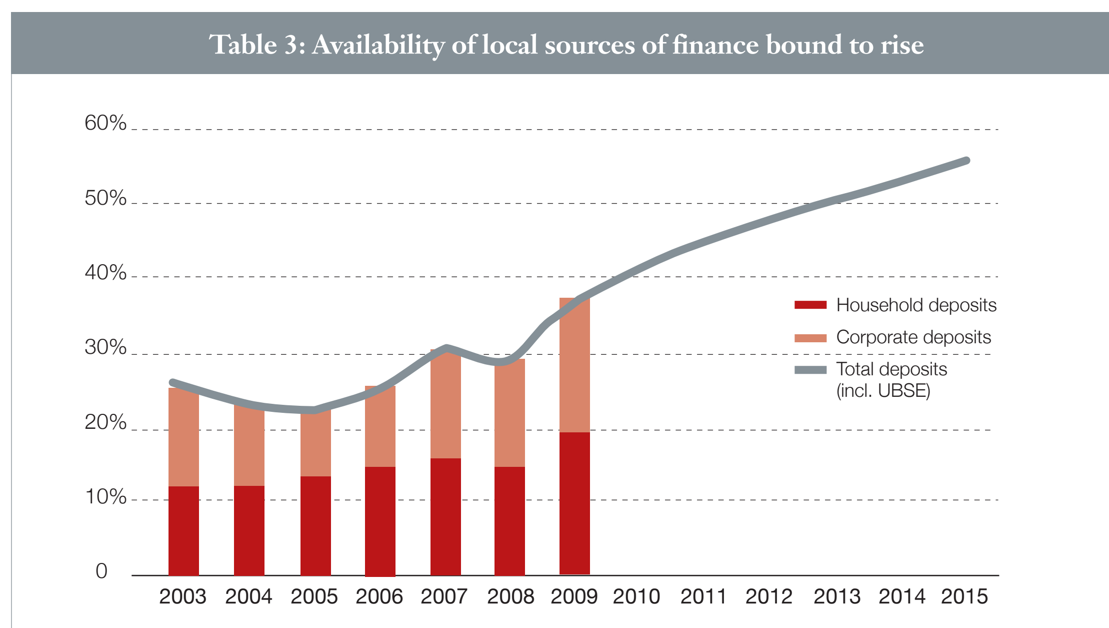
One reason for high savings and little availability of ruble funding has been the stabilisation policy of the government. However a more important factor, in our view, has been Russia's historically high inflation rate.

Under the stabilisation fund policy the government used to put significant parts of the country's savings into international financial assets. This makes sense from a risk perspective to limit the impact of oil prices on the economy. However, to be fully effective it would require foreigners to some extent to replace those Russian savings with foreign savings. While this did to some extent happen pre-crisis, most of those flows raised the availability of hard currency but did little to provide long-term ruble funding, and in any case those flows proved fickle in the crisis. The government arguably therefore had no choice but to suspend the stabilisation framework and, while it plans to balance the budget by 2012, there seems little appetite to go back to the old policies.

Thus in all likelihood, the oil money that would have been saved abroad previously will now remain inside the country. Given the size of this change in flows – on our estimates about US$90bn (7 per cent of 2009 GDP) at US$70/bbl for oil – this has wide ranging implications. Most of these funds are redistributed through transfers and lower taxes to the private sector, rather than being absorbed by the state in the form of higher wage bills. As such, it should prove a very powerful demand boost to the economy in the short term and this is one of the reasons why we expect to see Russia rebound sharply this year. However, it will also raise the domestically available savings, as part of this translates into higher corporate profits and households also don't spend the additional income fully. Thus this translates into higher deposit inflows into the banking system, as we have already seen this year.

However, even more important for the availability of ruble funding, in our view, is what we see as a structural change in Russia's inflation rate. Russia had by far the highest inflation rate among the BRIC countries going into the crisis. While China and India both have a long history of maintaining relatively low inflation, Brazil had battled for years to break that habit, at a sizeable

**Table 3: Availability of local sources of finance bound to rise**



cost to its growth. What the CBR and the government have achieved in the crisis is breaking the inflationary expectations in Russia. Thus, part of the output cost of the crisis can also be ascribed to paying the output cost of lowering inflation that other countries like Brazil paid spread over a considerable time period. It seems implausible to us that the authorities, after having paid this cost, will not now act to consolidate those gains. This judgement is also supported by the CBR having introduced far more flexibility into its exchange rate policies and making use of a far larger range of policy instruments to steer monetary policy than in the past.

Thus, in our view, the currently lower inflation rate of c6 per cent is a structural break and together with the change in fiscal policy it has wide ranging implications for Russian growth going forward. High inflation in the past, in our view, is the main reason why Russia's high savings never translated into a high stock of financial wealth in terms of deposits in the banking sector or other mutual funds. The two are linked because the stock of deposits depreciates essentially at the rate of inflation. Thus, lowering the trend inflation rate from 12 per cent pre-crisis to 5-6 per cent, together with the change in the stabilisation policy, should raise the depth of the domestic financial sector massively and we expect to see the deposit to GDP ratio in Russia rise from less than 40 per cent currently to close to 60 per cent in the next five years (see Table 3).

This kind of healthy financial deepening should have a sizeable impact on both the type and the speed of growth. It should favour the domestic sectors that mainly suffered from the lack of ruble finance, given that the exporters always had access to international US$ finance. It should also boost the chances of a more diversified ownership structure emerging. In the past, the only stable source of finance for smaller successful companies were essentially the existing financial groups, and thus, even to the extent that new sectors developed, the control rights in those sectors often ended up with the same group of companies that typically earned their money in the commodity sectors.

What are the risks? The above clearly assumes that the rest of the world is well behaved, which in Russia's case mainly means that oil prices somehow remain range-bound around what OPEC and UBS see as the sustainable oil price of US$75/bbl. As the crisis showed, at least in the short term, oil prices can fall significantly below that level and whenever they do this does have a significant impact on Russia. However, we think that even if there say is going to be renewed serious strain in the global financial system, the impact currently on Russia should be much smaller than it was in 2008. Firstly inflation is now under control, secondly the economy destocked massively in 2009 with a negative inventory contribution to growth of 6ppt of GDP, and thirdly corporates are far less dependant on the banking sector for their working capital needs. The Russian banking system is actually now a net creditor to foreign banks not a debtor, thus pressure on foreign banks will not translate into tightening credit conditions in Russia in same way that they did previously.

While Russia was the BRIC country with the lowest net capital inflows pre-crisis, this did not stop it from having the highest net capital outflows during the crisis. So how do we know that this is unlikely to happen once more? One way to think about this is that the money is out and has not returned yet. Another reason is the change in total size of cross-border transactions. While Russia had the lowest net flows pre-crisis, it did have the highest gross flows of international capital (measured by the absolute value of how much foreigners bring into the country and how much Russians take out of the country without netting out in and outflows). When financial markets are impaired, netting flows becomes much less possible, and gross flows matter a lot more. One leg breaking away (such as inflows in Russia's case) has a very sizeable impact on the net flows and thus financial conditions inside the country. With absolute flows now much smaller, the impact of trouble in the global financial system on Russia should be much lower.

Summarising, we believe that Russia could see a decade of very healthy growth of c5 per cent, driven by better availability of Ruble financing if the outside world stabilises. We also think that the market currently overestimates the risks. Russia is very open, especially to capital flows, which proved its undoing in 2008. However, given the scale of outflows in 2008/09 and the fact that the money hasn't returned yet, another foreign induced shock is unlikely to have as severe an impact as the financial crisis of 2008/09. F

What the CBR and the government have achieved in the crisis is breaking the inflationary expectations in Russia

**Table 4: Net capital flows (+ = inflow)**