

External Constraints Reshape Russia's Economy

March 2009
Evgeny Gavrilenko, Chief Economist



Troika Dialog

Russia needs to find a more balanced path to growth

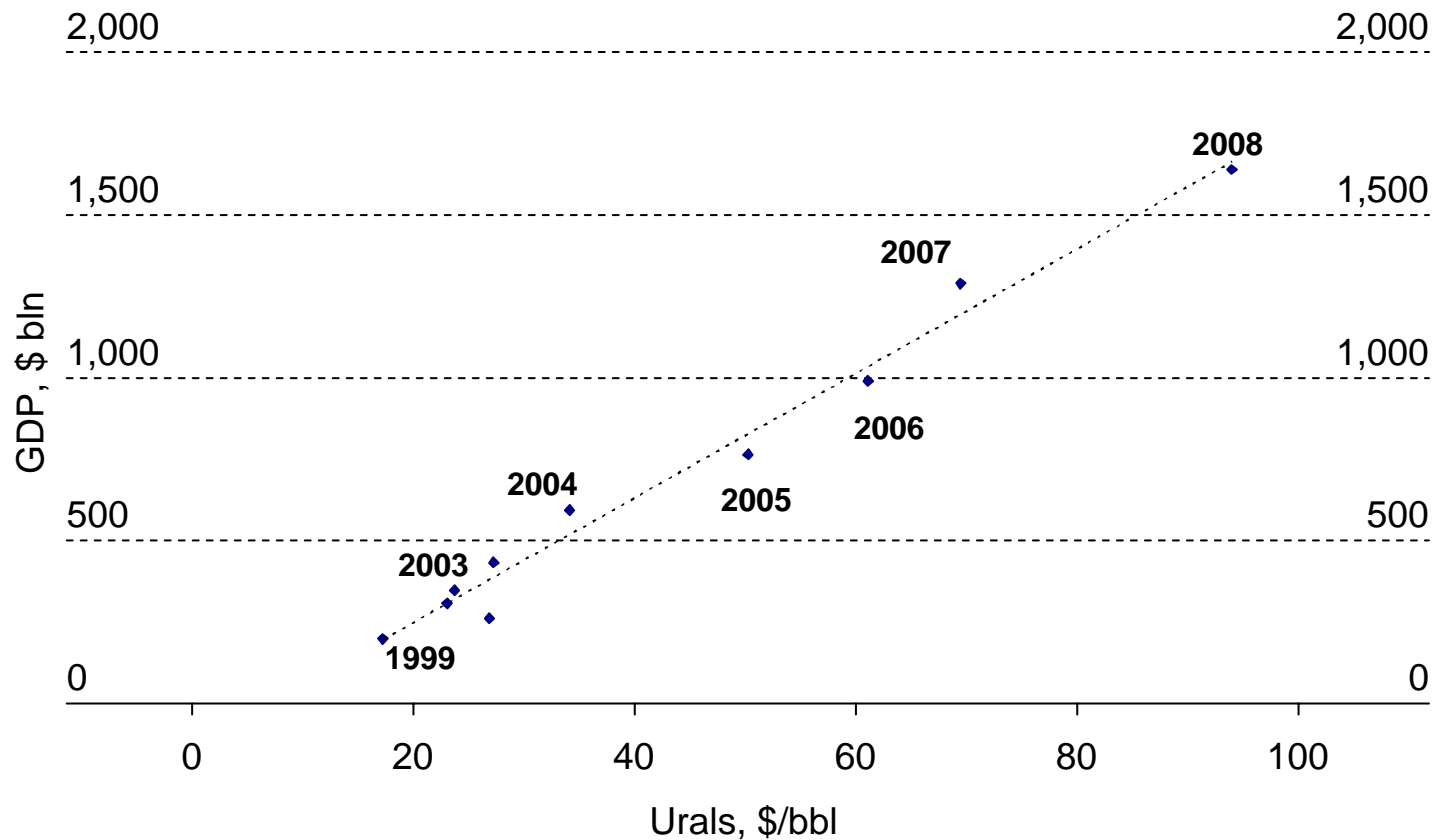
Russia needs to moderate growth after a period of overheating. Not only high, but perpetually rising oil prices accompanied by soaring external borrowing led to overheating of the Russian economy. The country needs moderate growth in domestic demand, which had been artificially inflated by excessive external borrowing. The country has a greater chance of overcoming the crisis faster than many other countries – Russia is not exhibiting a “balance sheet recession”.

Endogenous factors should play a more important role once Russia resumes growth. On the back of a cheaper ruble, import substitution will once again help the economy recover in 2009. This will clearly not be on the same scale as in 1999, and nobody expects the same magnitude of devaluation. Growth would then become more internally driven – the domestic market looks large enough to secure positive growth this year, even if physical export volumes (and export prices) were to decline. We may see GDP grow in real terms, but contract in dollar terms, due to weakening of the ruble. However, a more pessimistic scenario cannot be ruled out (and even looks more likely).

Russia’s economy was – and still is – able to grow fast amid “low” oil prices. However, this requires a weaker currency, and ideally a floating exchange rate. Strong devaluation expectations and the authorities’ slow reaction were to blame for “killing” growth, as money stopped circulating.

As the global economy is no longer “overheating”, Russia must adjust to a new environment. The country desperately needs to bring inflation down, restore confidence in the ruble and get rid of the sort of currency board regime it has implicitly implemented since 1999. Money should become more “endogenous” and borrowing costs must decline.

Nominal GDP correlates with oil price



Source: State Statistics Service, Troika estimates

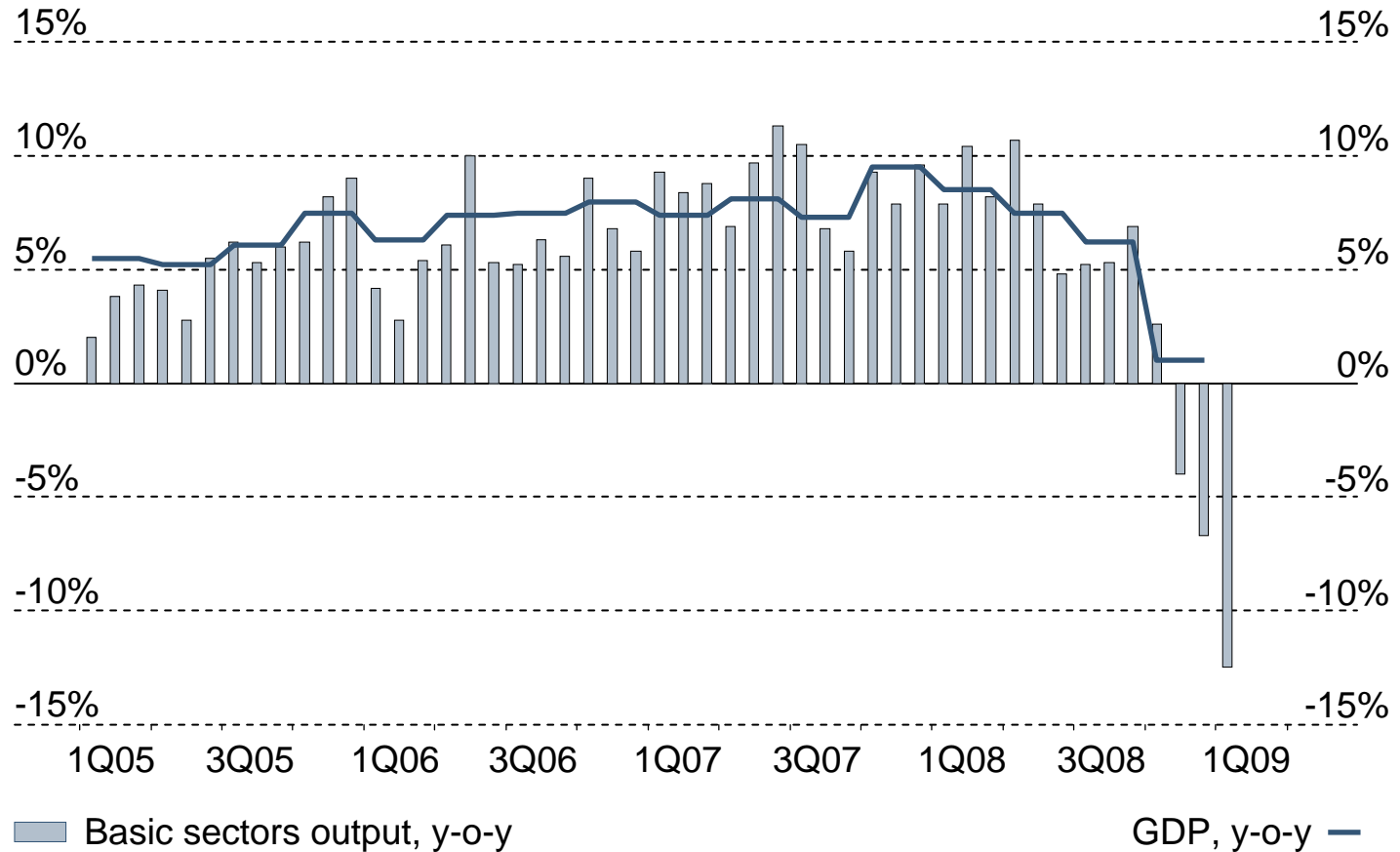
How Russia differs from other countries

	Eurozone	Russia	US
M2, local currency, bln	8,075	11,991	8,280
M2, \$ bln	10,255	330	8,280
M2 growth, % y-o-y	7.5	-7.2	10.5
CPI, 2008, %	3.1	13.3	3.8
GDP, 2008, \$ bln	14,100	1,670	14,200

Note: M2 numbers given as of February 1, 2009.

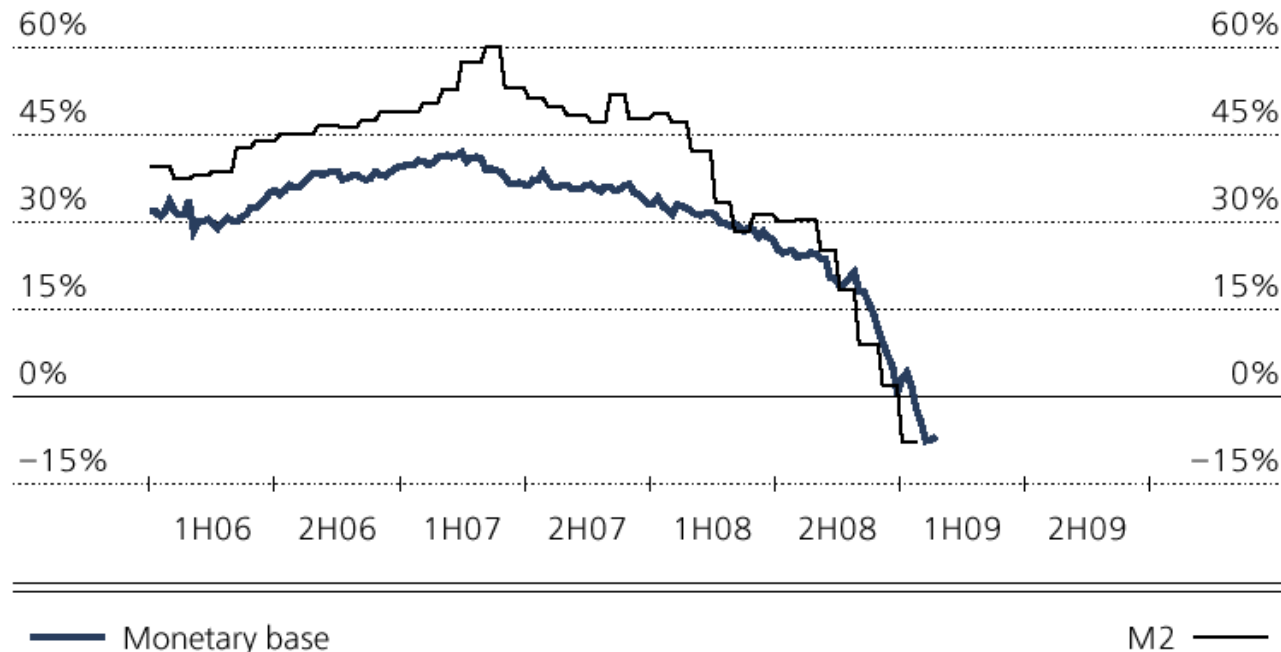
Source: State Statistics Service, Bloomberg, Troika estimates

The decline in economic activity was sudden...



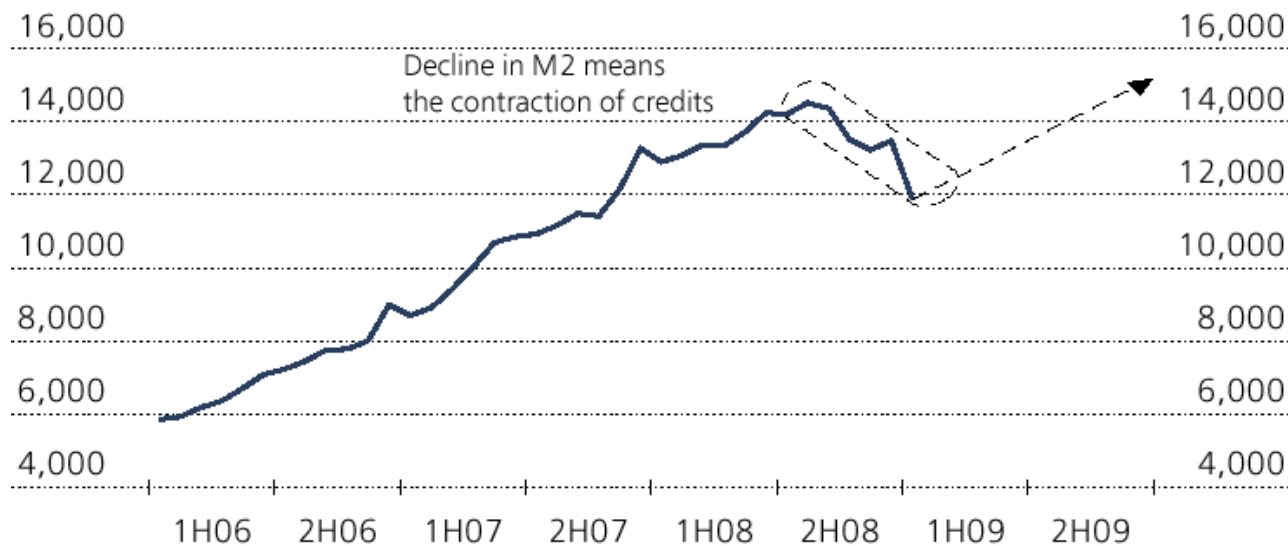
Source: State Statistics Service

...and was accompanied by rapid demonetization of the economy



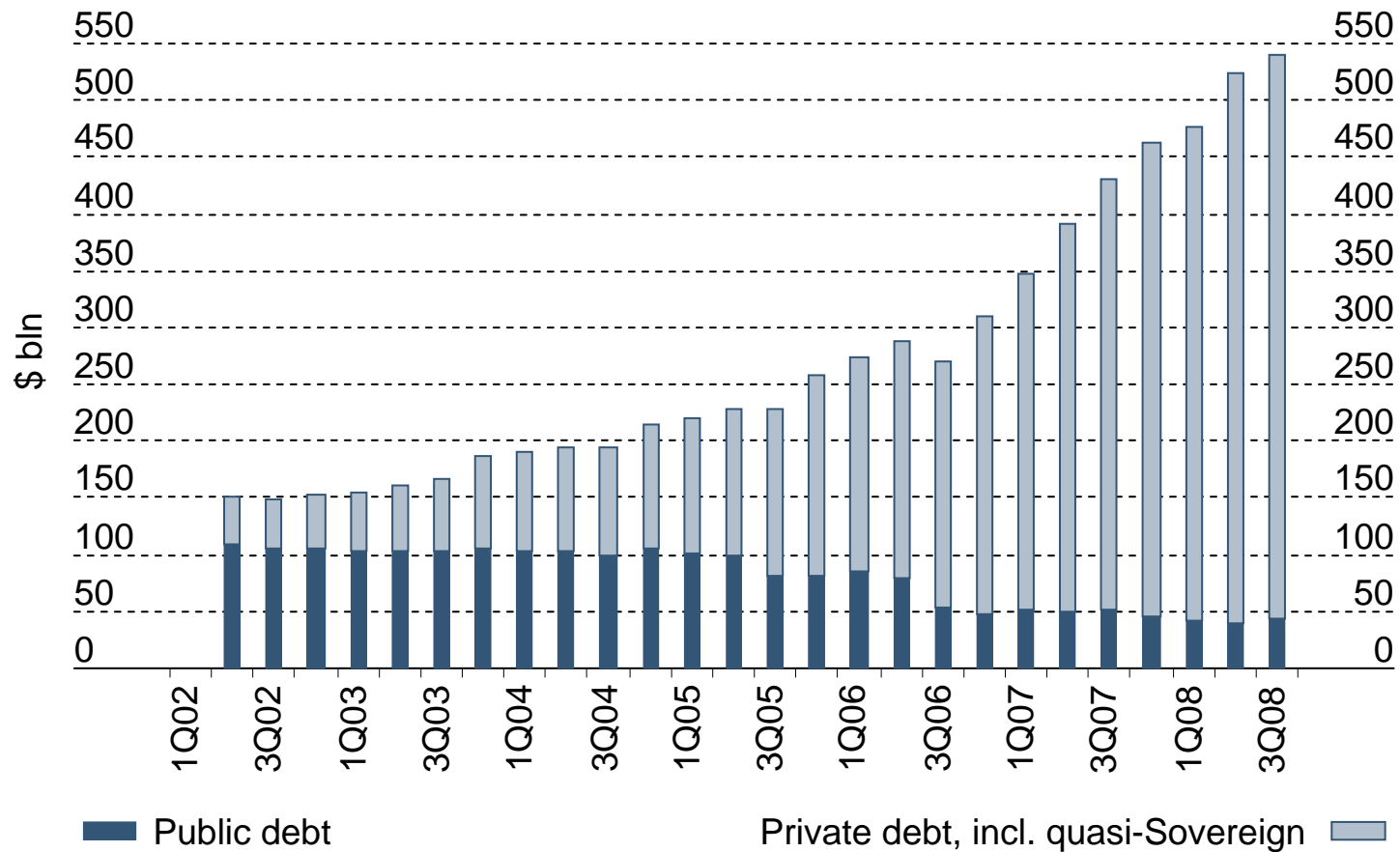
Source: Central Bank, Troika estimates

M2 declined even in nominal terms, R bln



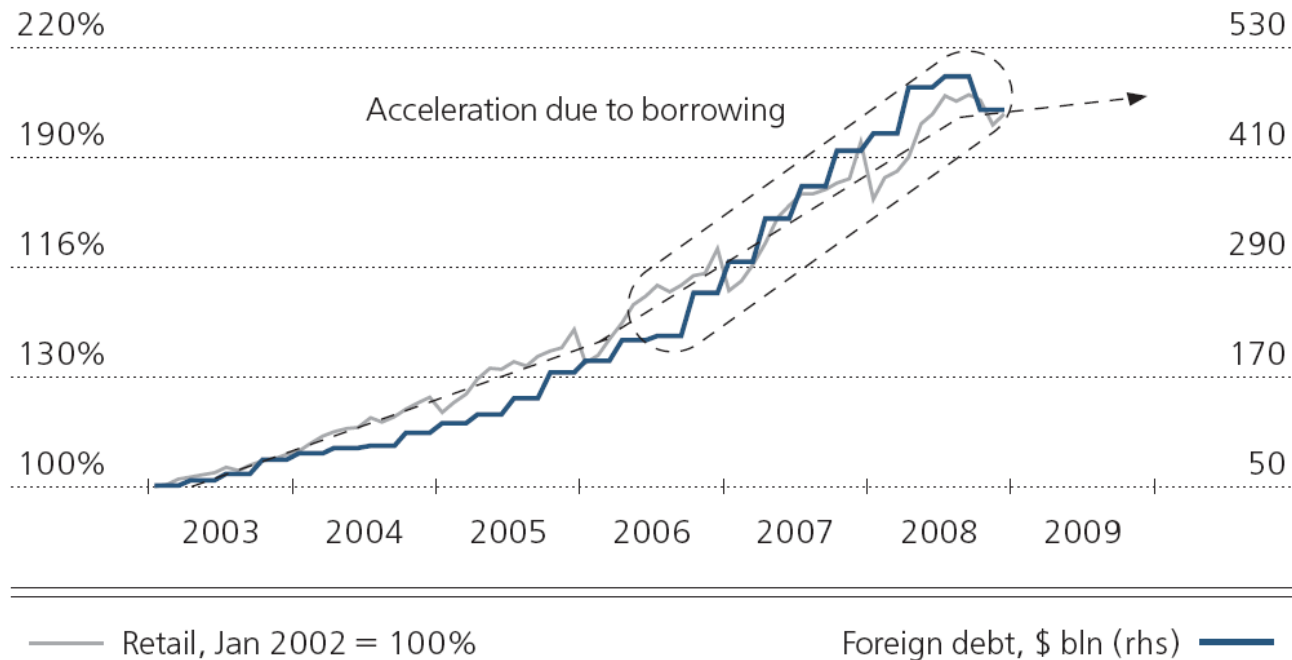
Source: Central Bank

Private foreign debt has been growing fast in recent years



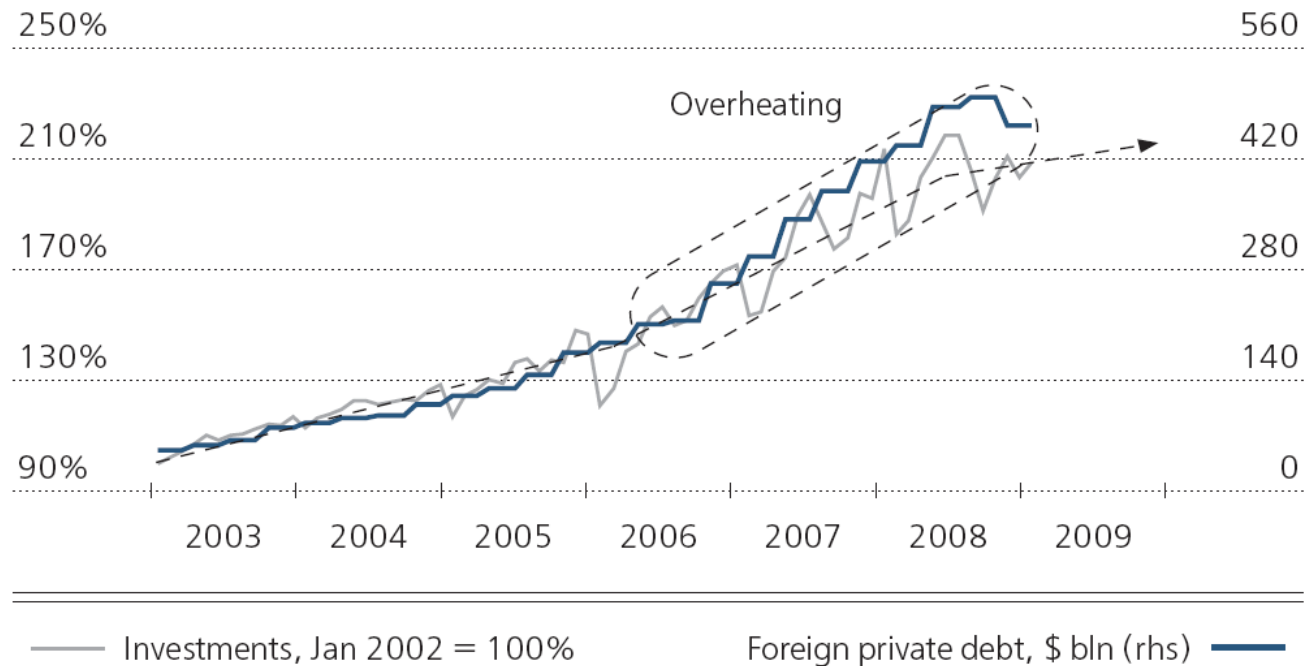
Source: Central Bank

Retail was booming due to foreign borrowing...



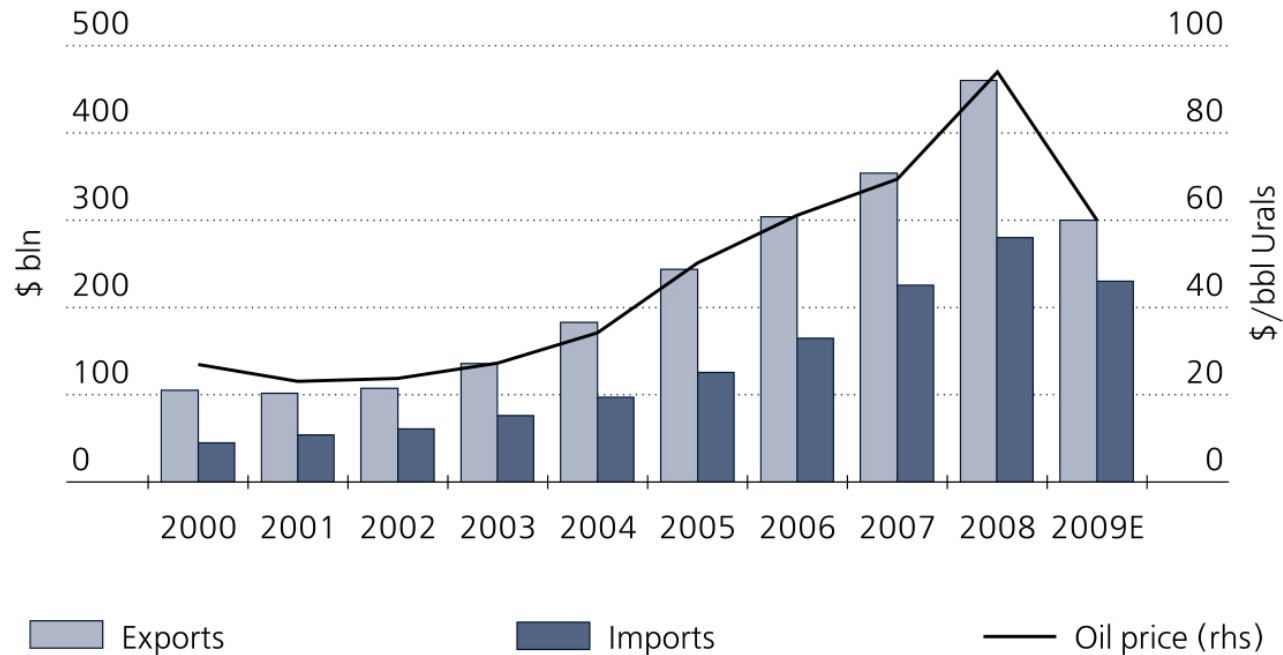
Source: State Statistics Service, Central Bank, Troika estimates

... as well as investment activity



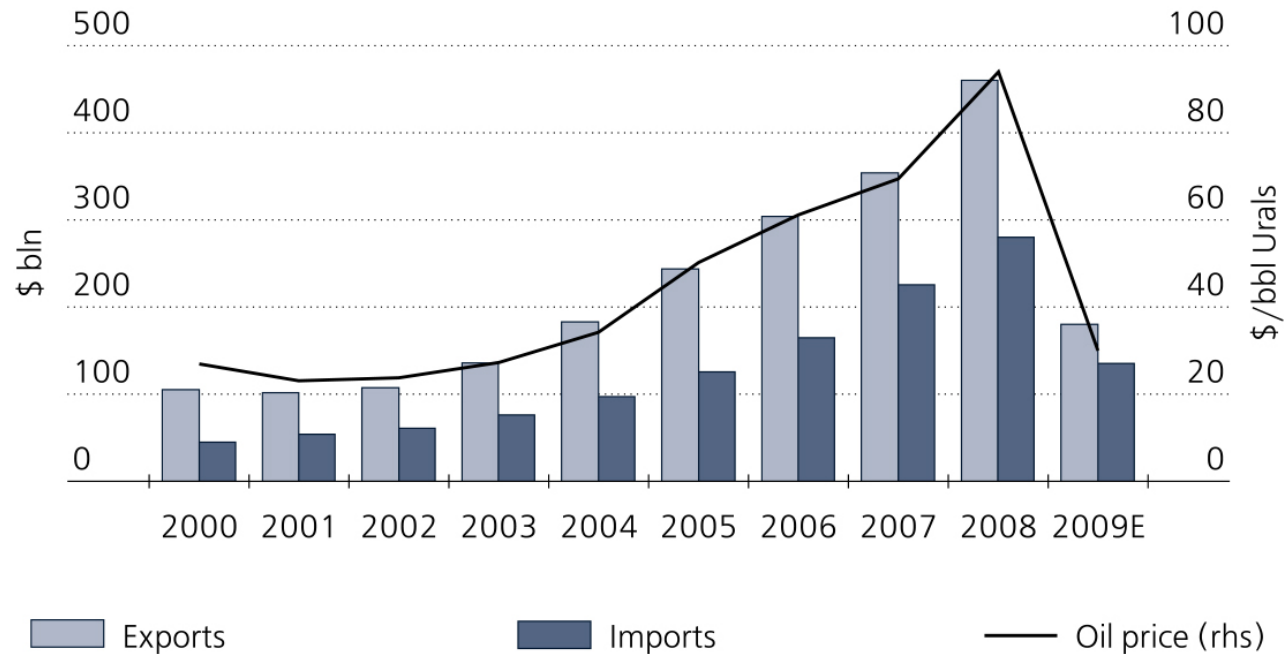
Source: State Statistics Service, Central Bank, Troika estimates

Foreign trade turnover is highly dependent on oil prices...



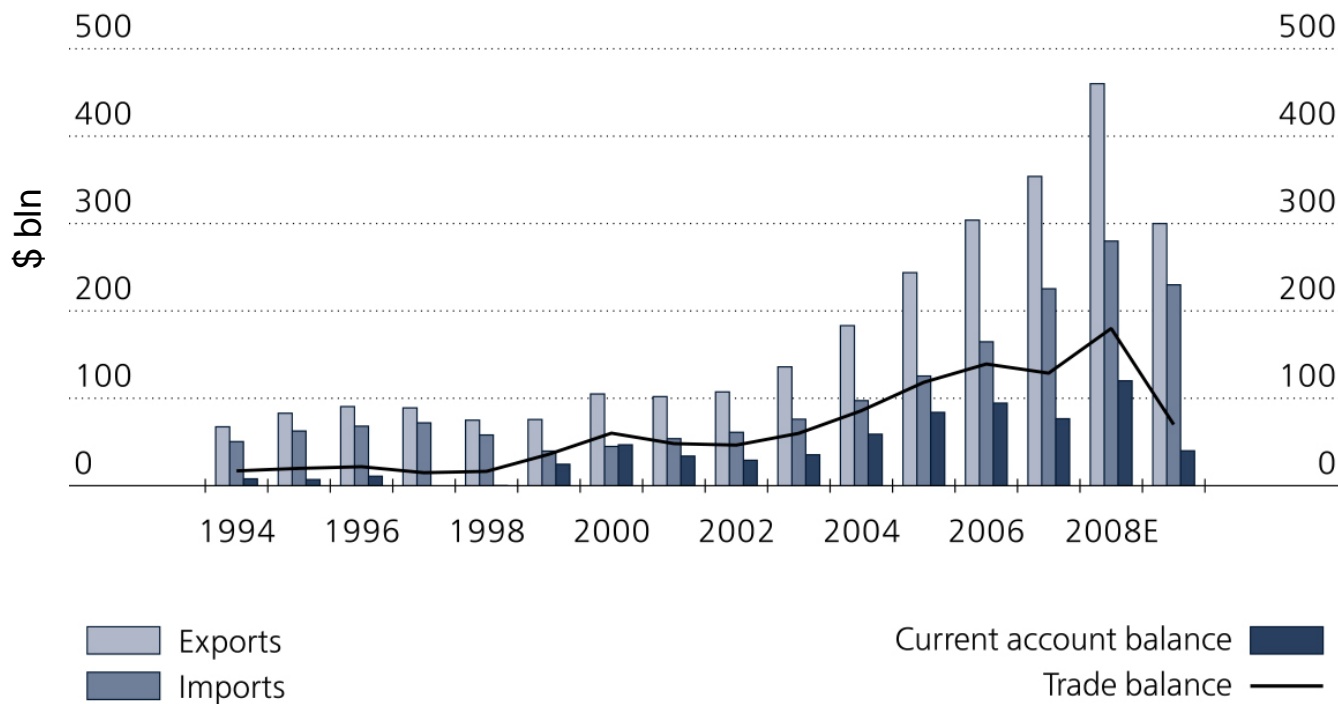
Source: Central Bank, Troika estimates

... and will shrink amid a correction of commodity prices



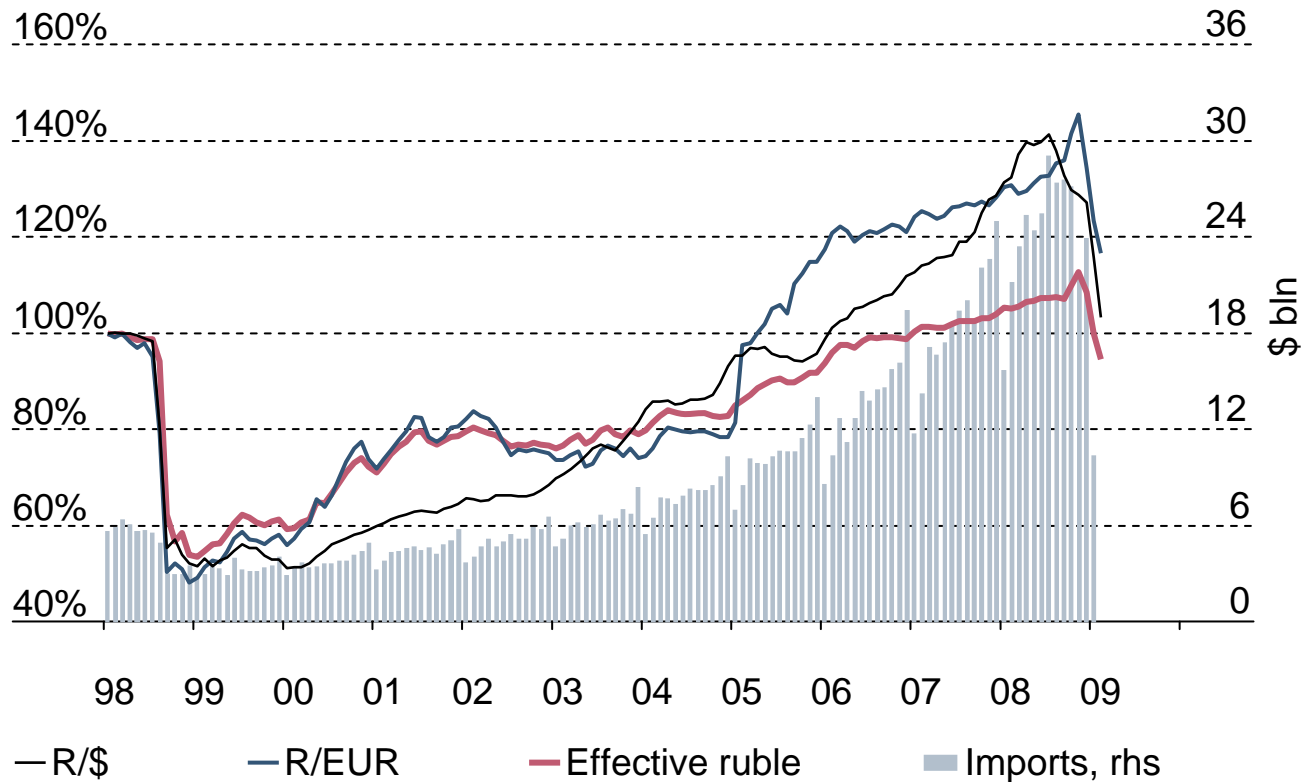
Source: Central Bank, Troika estimates

Current account will shrink as well, so that the ruble should follow a retreat of the oil price



Source: Central Bank, Troika estimates

Real exchange rate depreciated and helped imports contract and unlock import substitution



Source: Central Bank, Troika estimates

Positive current account should ease pressure on the ruble, as foreign debt repayments will be huge in 2009

Foreign debt service and redemption, \$ bln

	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10
Debt payments	60.4	78.3	33.1	34.5	35.3	32.0	20.0	24.3
Interest	5.8	5.4	5.1	4.3	4.3	4.1	4.2	3.4
Redemption	54.6	72.9	28.0	30.2	31.0	27.9	15.8	20.9
Public sector	2.4	7.9	1.7	0.8	1.6	0.8	1.6	0.8
Interest	0.8	0.3	0.8	0.2	0.8	0.2	0.7	0.2
Redemption	1.6	7.6	0.9	0.6	0.8	0.6	0.9	0.6
Private sector	58.0	70.4	31.4	33.7	33.7	31.2	18.4	23.5
Interest	5.0	5.1	4.3	4.1	3.5	3.9	3.5	3.2
Redemption	53.0	65.3	27.1	29.6	30.2	27.3	14.9	20.3
Banks	22.7	26.9	15.0	13.3	17.5	12.7	6.1	10.5
Interest	2.3	2.0	1.8	1.7	1.5	1.4	1.3	1.2
Redemption	20.4	24.9	13.2	11.6	16.0	11.3	4.8	9.3
Non-banks	35.3	43.5	16.4	20.4	16.2	18.5	12.3	13.0
Interest	2.7	3.1	2.5	2.4	2.0	2.5	2.2	2.0
Redemption	32.6	40.4	13.9	18.0	14.2	16.0	10.1	11.0

Source: Central Bank

First signs of stabilization appeared in February

Domestic demand dropped in January. Investments were down 15.5% y-o-y and returned in real terms to the level of January 2007. Though retail was still up 2.4% y-o-y, the seasonally adjusted estimate declined m-o-m. The Economics Ministry estimates that GDP fell 8.8% y-o-y.

Gross forex reserves remain relatively stable. The Central Bank has reported that its gross international reserves stood at \$380.5 bln in early March. Minor fluctuations in reserves are mostly associated with valuation effects.

In January, M2 contracted 11.8% m-o-m. While the monthly decline in money supply is a seasonal event, it has never been so huge. As a result, M2 fell 7.8% in y-o-y terms, while it was up 1.7% at the beginning of the year. January's M2 contraction correlated with the decline in economic activity that month. The decline in M2 in 2H08 and January 2009 was caused by the loss in gross international reserves. In February, the Central Bank stopped losing reserves and thus M2 may stabilize, as did the monetary base. This may be cautiously treated as a sign of stabilization.

Economic performance will depend on government policies more than ever before

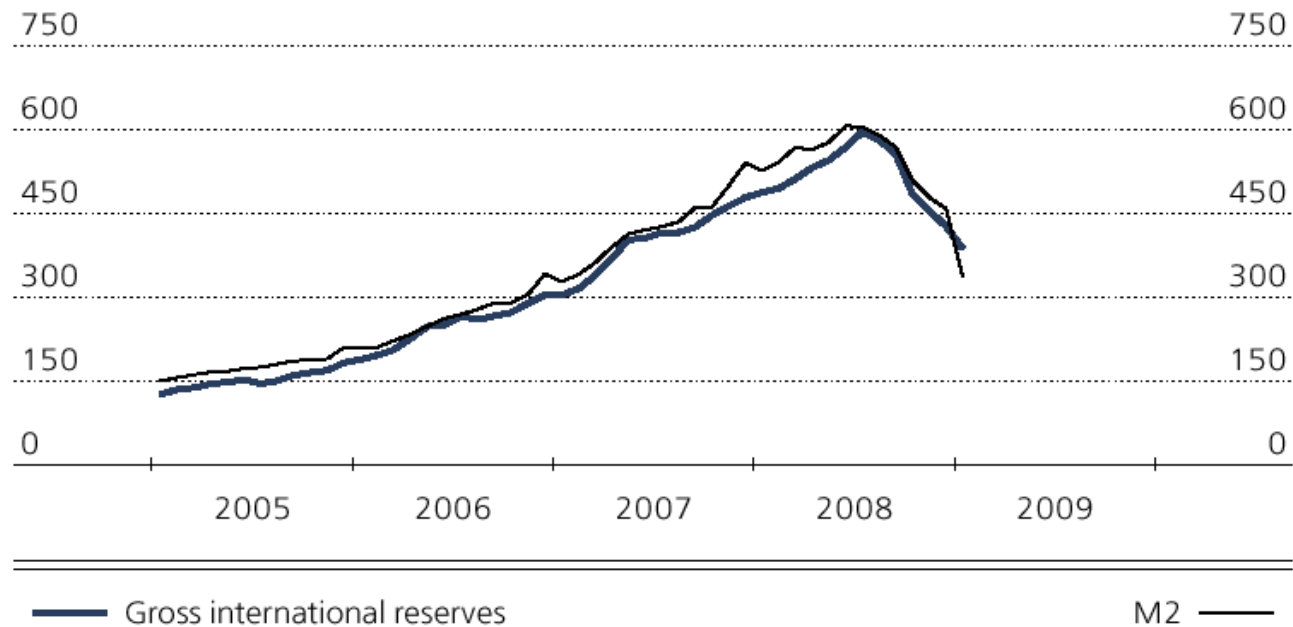
The role of the state (both the Central Bank and the budget) has substantially increased of late, becoming the major source of ruble liquidity, and growth is impossible without liquidity. However, too much liquidity could destabilize the situation on the forex market and stimulate inflation. This year, the state will have to seek a balance, which we believe is possible.

Finance Ministry and Central Bank synchronize policy in February

Federal budget expenditures grew substantially in February, reaching R691 bln (compared with R412 bln in January). As a result, the budget ran a deficit of R244 bln (\$6.8 bln), which was covered by previously accumulated cash in budget deposits (the Finance Ministry did not use reserve funds).

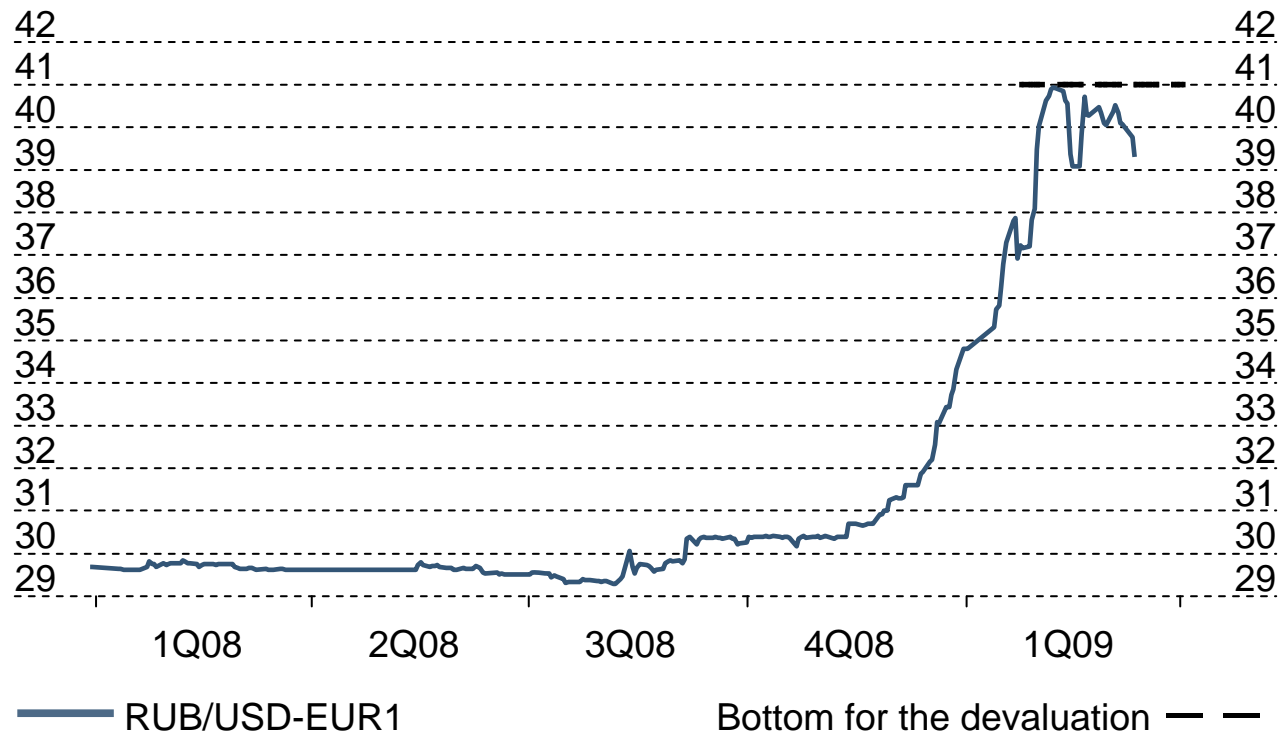
This liquidity injection did not destabilize the situation on the forex market, as the Central Bank managed to sterilize the bulk of this sum, having substantially reduced the amount of repo crediting. The Finance Ministry and the Central Bank will conduct synchronized monetary and budgetary policy, as they did in February.

A sort of currency board: M2 follows the dynamics of gross international reserves, \$ bln



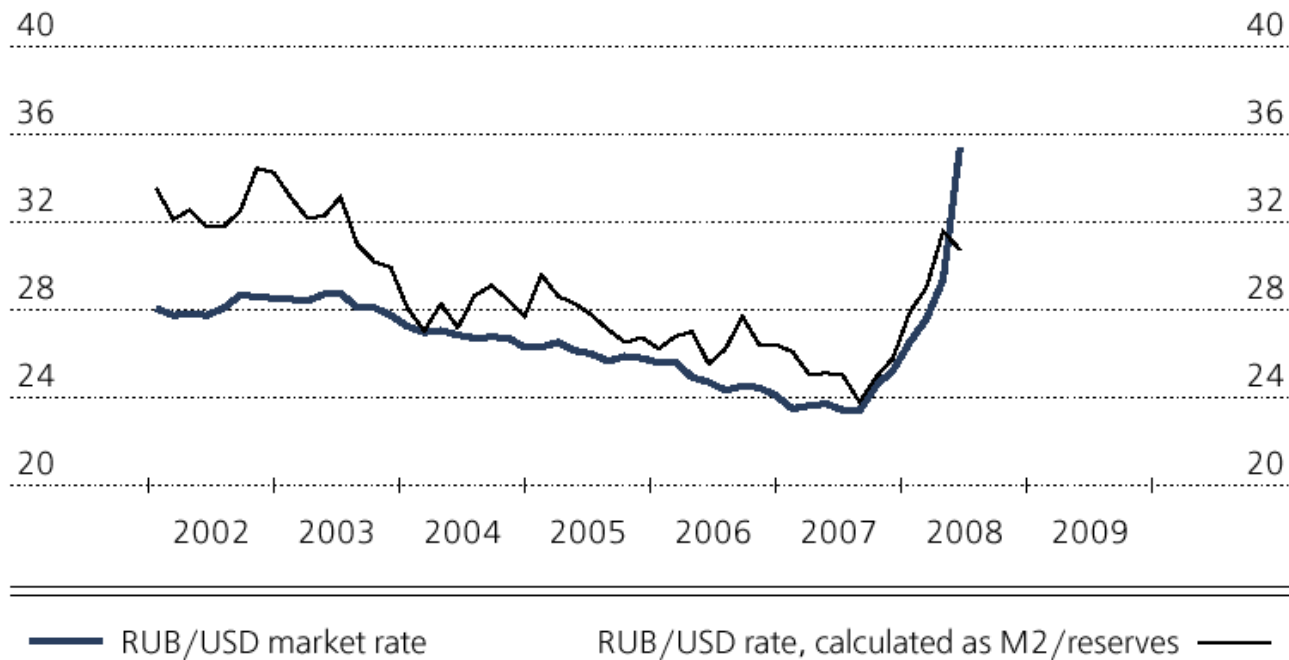
Source: Central Bank, Troika estimates

Gradual depreciation of the ruble killed growth: Central Bank depreciated the ruble faster in January



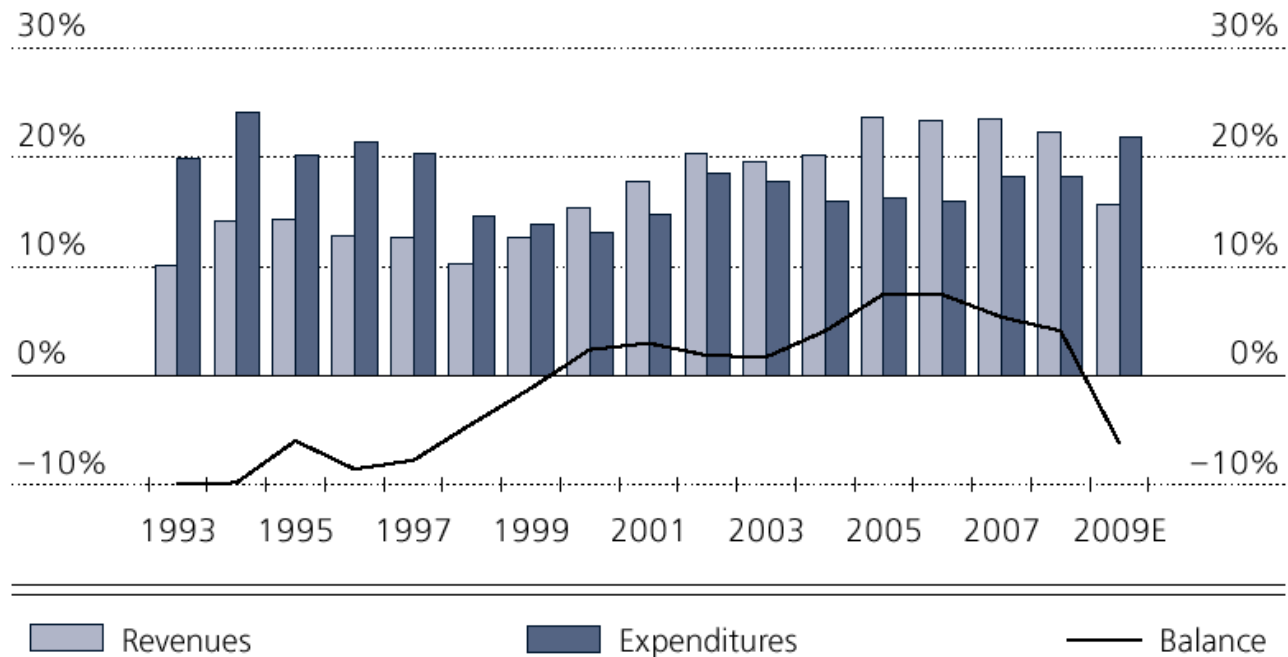
Source: Central Bank, Troika estimates

Ruble is stronger than ever: every “dollar” in M2 is backed by \$1.15 in reserves



Source: Central Bank, Troika estimates

Budget will run a deficit in 2009 and become a source of liquidity for the system



Source: Finance Ministry, Troika estimates

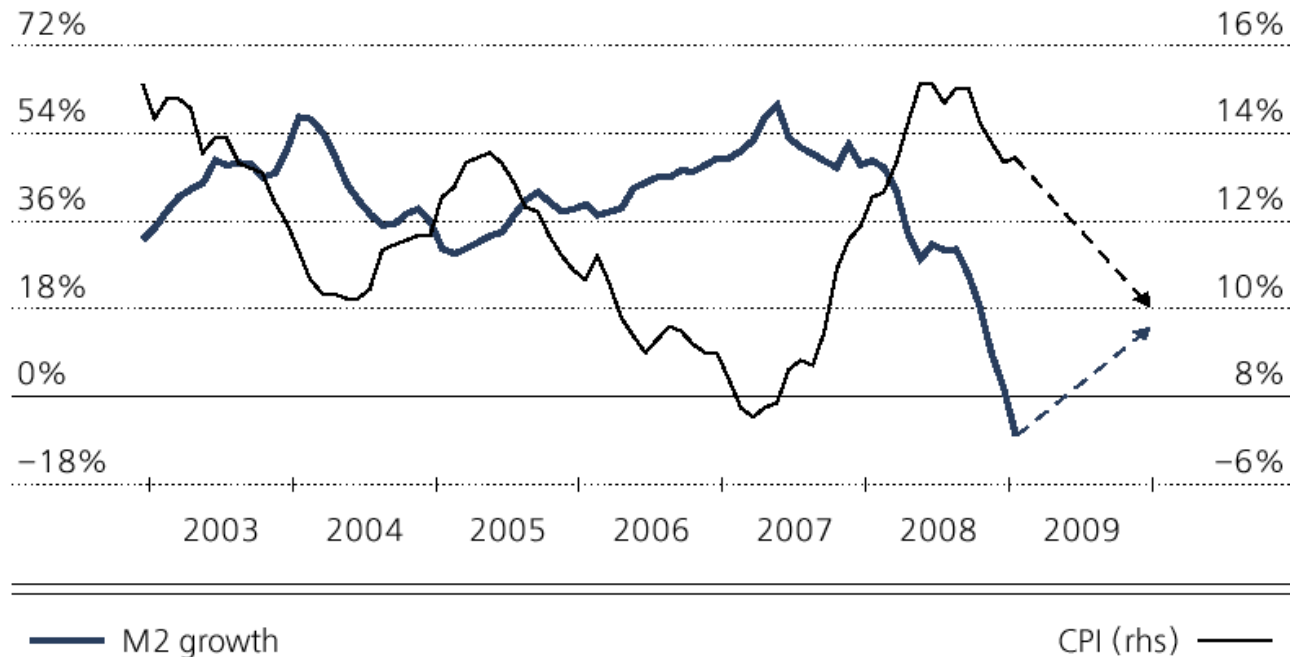
The budget will be the major source of liquidity in 2009

2009 preliminary budget parameters, R bln

	Budget law	Updated
Revenues	10,927.1	6,349.7
<i>% of GDP</i>	21.2%	15.7%
Expenditures	9,024.7	9,583.3
<i>% of GDP</i>	17.5%	23.7%
Decrease in initial expenditures	–	–1,901.4
Additional expenditures	–	2,460.0
Surplus/(deficit)	1,902.4	–3,233.6
<i>% of GDP</i>	3.7%	–8.0%

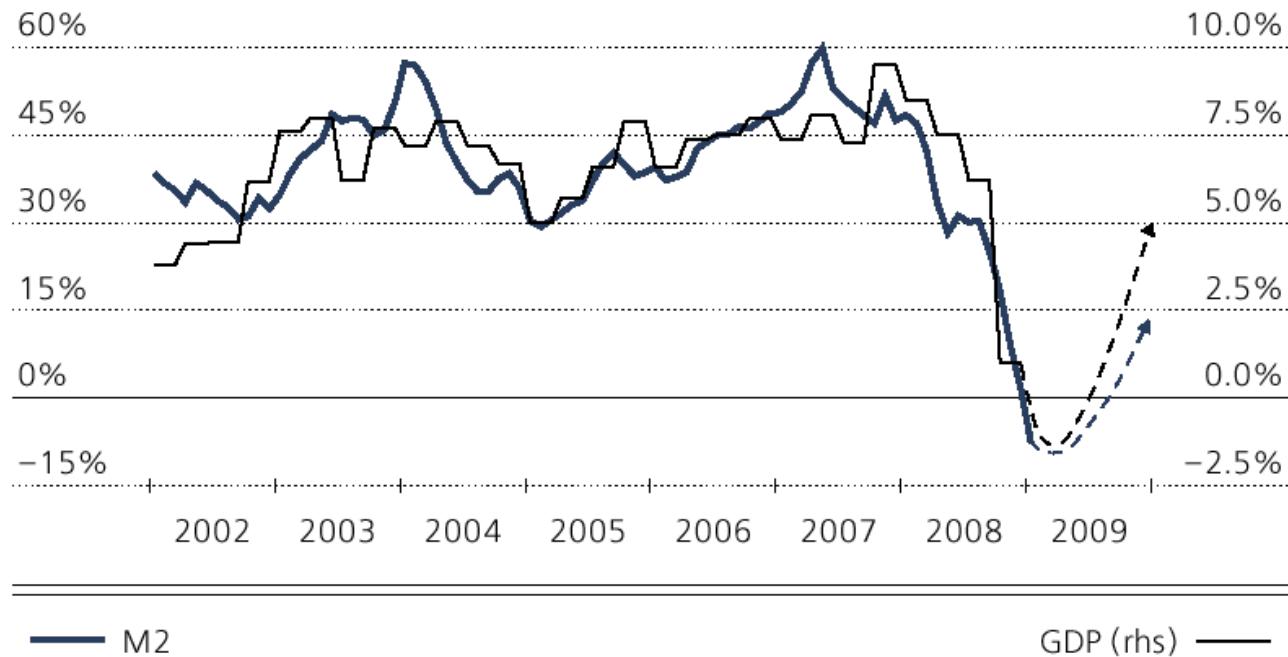
Source: Finance Ministry

Despite a soaring budget deficit, inflation may slow rapidly in 2009, y-o-y



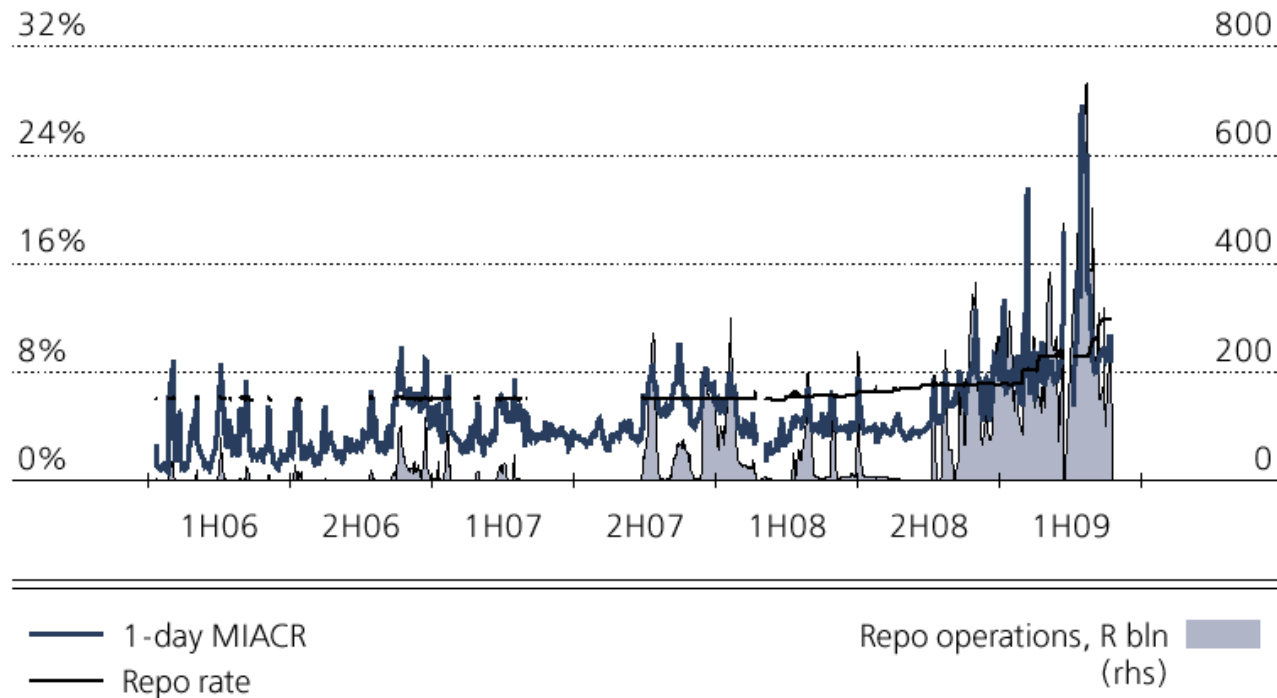
Source: Central Bank, State Statistics Service

An upturn is impossible without remonetization of the economy, y-o-y



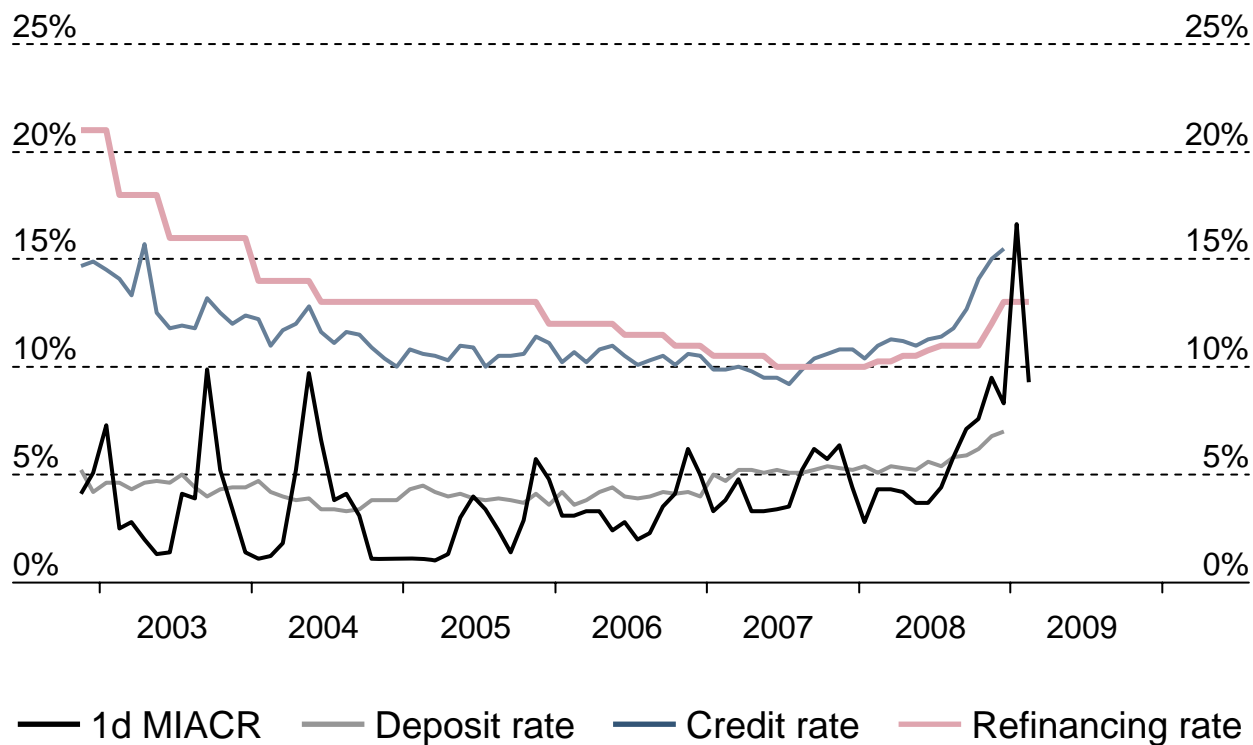
Source: Central Bank, State Statistics Service, Troika estimates

The role of the Central Bank as lender of last resort grew in importance



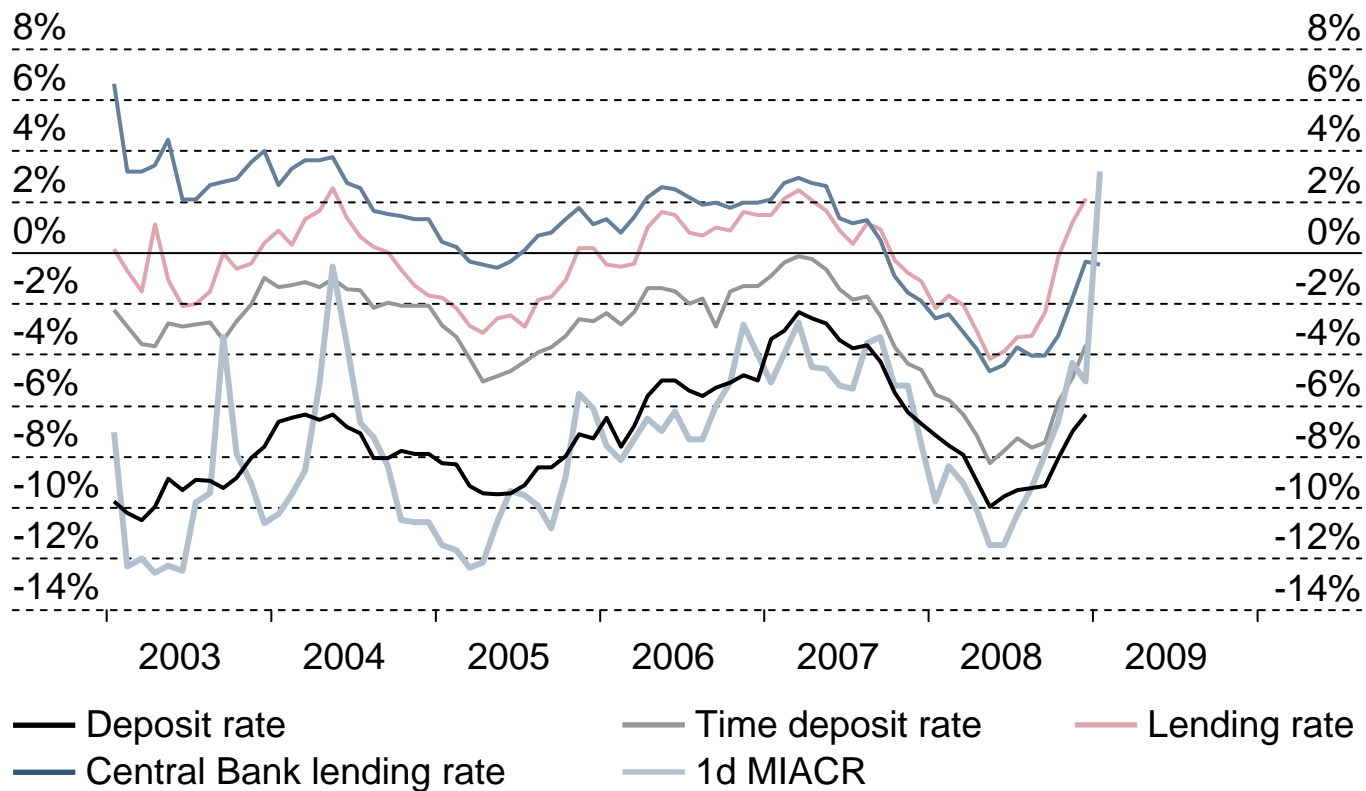
Source: Central Bank

Repo and refinancing rates are becoming real benchmarks for money markets



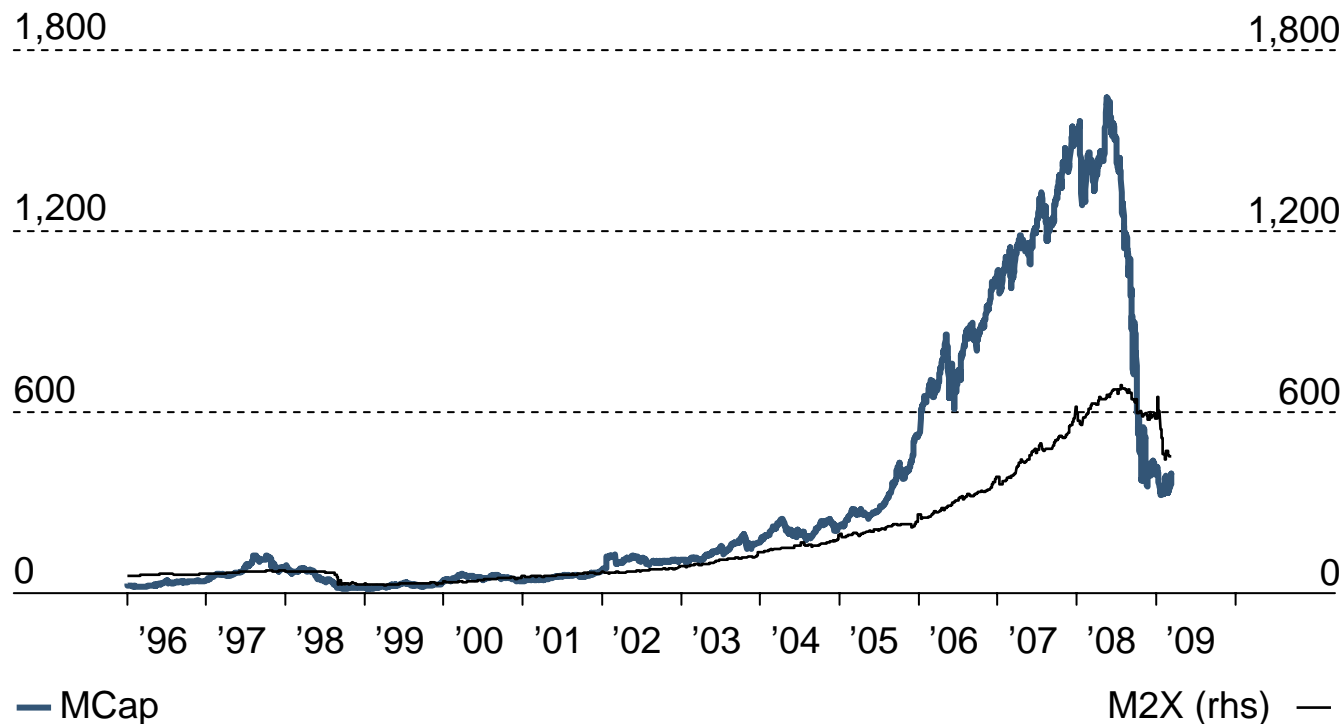
Source: Central Bank

Interest rates remain negative in real terms, but have again started to move toward positive territory



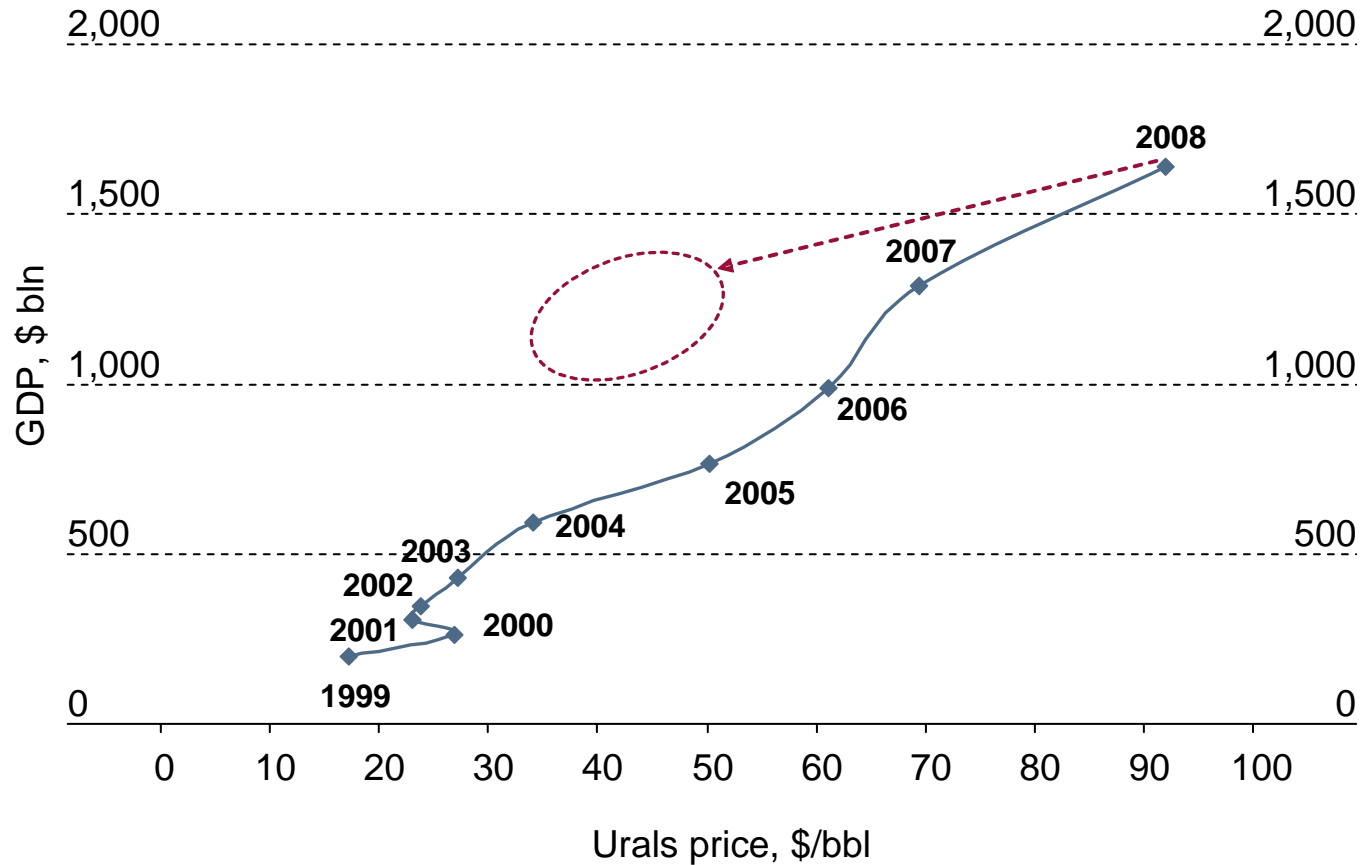
Source: Central Bank, State Statistics Service, Troika estimates

Domestic liquidity is shrinking, but has already started to support the stock market, \$ bln



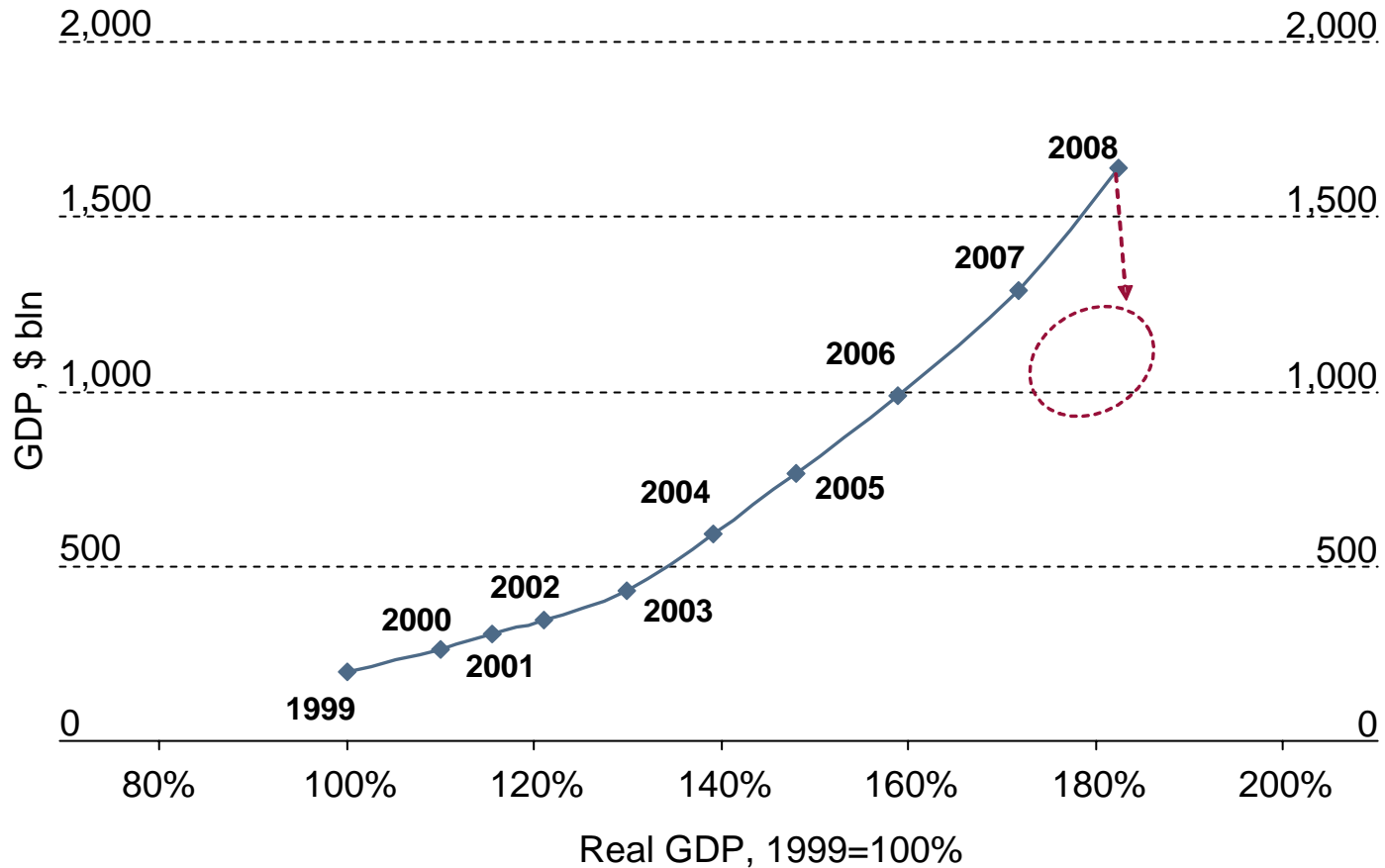
Source: Central Bank, Troika estimates

Russian GDP will shrink in dollar terms...



Source: State Statistics Service, Troika estimates

... but may even increase in real terms



Source: State Statistics Service, Troika estimates