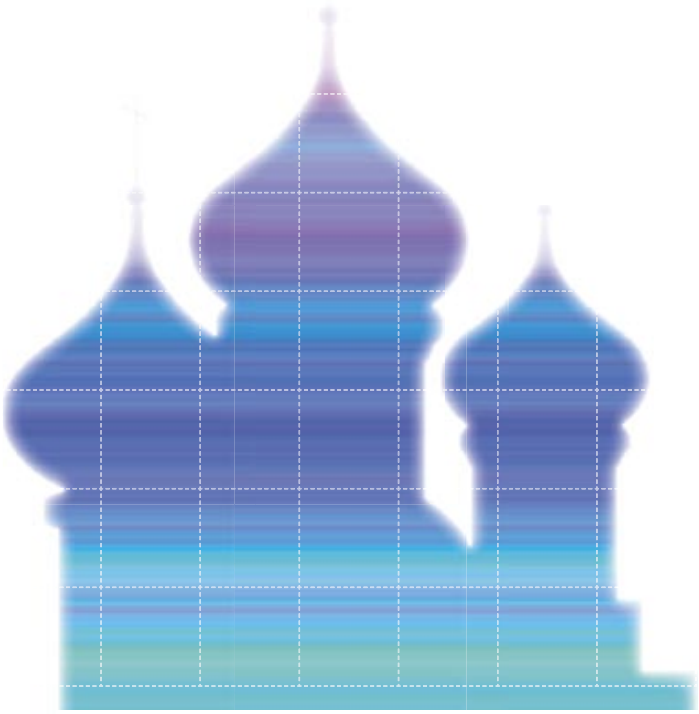


Russia's uncertain economic recovery



Martin Gilman

Finally joining with economists in the rest of the world, analysts of the Russian economy are beginning to recognize that the country is starting to recover from the plunge recorded at the end of last year that continued into the first half of 2009. In contrast to the downward spiral early in the year of increasingly pessimistic forecasts trying to play catch-up with worsening data, these same analysts for the most part started revising their projections upward starting in July. The process is hesitant and ongoing, as it has been in most other countries.

For Russia it is useful to recall that the gloom and doom when real gross domestic product fell by 9.8 percent in the first quarter over a year ago were overdone: approximately 7 percentage points of that

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drop was accounted for by inventory destocking (largely from Gazprom, which is likely to be temporary). Focusing on month-to-month rather than annual data, it looks as if the economy has stabilized. Evidence of a return to growth started to appear in the second quarter, even though base effects pushed the growth number down by 10.9 percent over a year earlier. In July physical data, such as those on industrial production, rail loadings, natural gas production, and metals sector performance, all started to point to a return to growth.

Credit crunch easing

Personal income indicators have also shown a good recovery, largely reflecting an increase in government social benefits. After a long period of lending compression in Russia's financial system, the credit crunch started to ease in July. Loans by the aggregated banking system were unchanged for the month and should start rising in coming months, because deposits have grown and banks are flush with liquidity. As resources gradually start flowing into the real economy again, this should provide positive momentum for economic recovery.

The shift in the government's budget position from a surplus of 8 percent of GDP in the first nine months of 2008 to an expected deficit of almost 8 percent in 2009 is arguably the biggest government stimulus package globally on a relative basis. The opening up of credit markets, looser monetary policy, and fiscal stimulus all suggest that economic growth can resume more strongly than many observers, including overly cautious government officials, would suggest. With positive growth in the second half, the real decline in GDP this year should be no worse than 5 percent.

Of course, it goes almost without saying that oil prices remain a major risk. Globally, oil inventories are close to all-time highs and utilized capacity is historically low. Financial demand in commodity markets clearly makes economic sense as a hedge against dollar depreciation, but at some point there has to be actual demand. The risk to the current $70 per barrel oil price is considerable in the short run should current optimism in advanced economies prove to be premature. In general, an increase in global economic activity is a necessary condition for continued improvement in Russia.

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Uncertainties

Those who seek certainty are likely to be confounded by the period of instability ahead. Even the best economists and financial analysts do not know what letter of the alphabet to use to describe the shape of the recovery — V, U, W, or L. Historical parallels

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are inexact, and economic theory about debt crises is of only limited help. Volatility in exchange, commodity, bond, and equity markets is more likely over the next couple of years than a nice linear trend.

For Russia the uncertainty is poignant, although contradictory. It is poignant because the country has been severely, even if temporarily, affected by the external crisis. People are worried about their economic prospects, and for historical reasons there is an unfortunate but understandable lack of confidence in the government. This is manifested in uncertainty about the ruble exchange rate in the face of decelerating but still high inflation, which is projected to be 10.5 percent for 2009. It is also contradictory because Russia — as a large, low-debt, emerging economy — should inherently be in a better position than most of its Group of 20 partners. Whereas some highly indebted advanced economies may face a double-dip recession, this is highly unlikely for Russia unless there is a plunge in energy prices. So the recent euphoria on Russian equity markets (with the RTS index up 82% since the beginning of the year) may actually be warranted—although you would not know it when even senior officials warn of trouble ahead and difficulties for the banks because of escalating bad loans.

Leaving aside longer-term issues and given the wait-and-see attitude of the Russian population, the real test in the short run is whether inflation can be brought down permanently to the rates prevailing in leading financial centers. This is critical because so many seem to think that another ruble crisis is inevitable — as indeed it will be if the exchange rate continues to appreciate in real terms relative to the currencies of other countries. Perhaps more than any other single factor this uncertainty about the future strength of the ruble clouds the country's economic prospects by keeping nominal interest rates too high and discouraging savings and investment.

Budget at risk

The key policy variable here is the budget. Excessive government spending — especially if it occurs all at once — is the major risk. From a budget of about 10 trillion rubles ($318 billion), only 4.7 trillion rubles ($149 billion) were spent in the first seven months of the year. This suggests that 5.3 trillion rubles would need to be spent in the remaining five months, which would mean an increase in the monthly rate of expenditure of 64 percent. If that happens the fiscal deficit would jump by 2.5 trillion rubles between August and December. The economy would be overwhelmed by excessive government spending, with most of it bunched in late November or early December.

Even though in reality the budget deficit may be smaller than the expected 3.4 trillion rubles, an enormous spike in ruble liquidity could occur by year-end. This would obviously create turmoil on the foreign exchange market and translate into high inflation in January and February. It looks as if the economy will once again receive money at year-end that it does not need, and the financial system will experience undesirable volatility. Too many in the Russian Government still do not seem to appreciate the risks created by budgetary spending in terms of excessive aggregate demand, and hence the persistently high rate of inflation.

So even though the ruble currently appears to be in equilibrium, with the balance of payments strong and no need for artificial appreciation or depreciation (as some commentators have recently suggested), the massive increase in ruble liquidity to finance the budget may fuel even more speculation and as a result additional volatility.

Excessive liquidity

From a flow perspective, there is no pressure at all on the ruble to weaken. The current account was positive to the tune of $17.2 billion in the first half of 2009, and with higher oil prices it should be even stronger in the second half, probably leading to a current account surplus of about 4% of GDP. Net private capital flows turned positive in the second quarter, with inflows of $7.2 billion. Thus, the balance of payments is over-financed and there should be pressure for the ruble to appreciate, not depreciate. Net foreign holdings of the public sector, including foreign exchange reserves and the Central Bank's likely accumulation of Russian foreign liabilities, are keeping the ruble where it is.

The only serious threat to stability on the foreign exchange market comes from the financing of the budget deficit. Hence, greater exchange rate volatility can be expected during the traditional end-of-year growth in public expenditures. The issue, then, is whether the government is prepared to curb its spending in order to break inflationary expectations. Finance Minister Alexei Kudrin is already sending appropriate signals regarding the 2010 budget, which he proposes to freeze in 2009 nominal terms, but he must stand up to the spending pressures from his colleagues in government and lay the foundation for the country's new economic paradigm in the last quarter of 2009. The next few weeks will be critical. It is by no means assured that the stalwart Finance Minister can prevail.

If he does, however, the economy has a chance to increase its competitiveness through higher productivity. This could lead to a long-term strengthening of the ruble and lower interest rates, which would help stimulate investment and private demand. In other words, while some advanced economies risk an extended period of stagnation, it may be possible for Russia to enter a virtuous cycle along with the other BRIC economies. The ball is in the government's court.