Economics

International topics

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Russia: A safe haven?

- Russia has been on a path of economic growth for four consecutive years. The expansion was spurred by very high oil prices and the real depreciation of the rouble after the economic crisis of 1998. These effects have petered out in the meantime, though, so the pace of growth declined by half to 4-5% p.a. in 2001/2002. Given the recent acceleration of the reform process, we consider a growth path of 4-5% p.a. realistic over the medium term.
- Inflation (latest reading about 15% yoy) has fallen more slowly than planned in the last few years, a major reason being administered price hikes for basic services. With two key rate cuts in the past few months, the central bank has signalled that it will pursue a more active monetary policy.
- The government posted respectable budget surpluses in 2000 and 2001. With the price of oil still relatively high, the budget looks like it will be in surplus again for the current year, though to a smaller degree.
- The central bank pursues a policy of nominal rouble depreciation; lately, the pace of depreciation has been less than the inflation gap separating Russia and its main trading partners. Therefore, the rouble has appreciated in real terms vis-à-vis the US dollar and the euro since about mid-2000.
- Real rouble appreciation and declining export revenues are weighing on the trade surplus. Nonetheless, there are likely to be sizeable current account surpluses – in the region of 5-7% of GDP – again in 2002 and 2003.
- External debt has decreased markedly over the past few years. Russia has become successful at active debt management.
- Since President Vladimir Putin took office, the pace of structural reform has increased. However, the success of the reform laws depends on determined implementation; much remains to be done in this respect, though.
- Enjoying considerable popular support in Russia, President Putin has pursued a remarkably pro-Western course in foreign policy since the terrorist attacks on September 11, 2001. Most of the benefits of this policy are yet to come.
- After an impressive upswing, the Russian equity and bond markets have shown robustness over the past few months in the face of the worldwide downtrend and relinquished only a small part of their advances.
- The biggest risk still facing the economy, besides an – at present rather unlikely – extreme deterioration of the oil price, is a dilution of the reform process in election year 2003. The implementation of the proposed bank reform and the creation of a broad-based small and medium-sized business sector are particularly important for sustainable growth.

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Moderate but robust growth

Real economic growth in Russia is set to outstrip that of the euro area for the fourth consecutive year. After very high rates in the past two years (2000: 9%; 2001: 5%), we can this year – with oil prices well over USD 20/bbl – expect relatively high growth of around 4%.

The performance in 2000 and 2001 was supported by high oil prices and by the real depreciation of the rouble following the crisis of 1998. This latter effect has since petered out. As production capacities are now being almost fully utilised, economic growth going forward will depend on productivity gains and new investment.

Investment growth is slowing, however. For one thing, foreign direct investment is still low (2001: USD 1.0 bn or 0.4% of GDP). But more importantly, the economic upswing of the last few years has been accompanied not only by a strong rise in real wages, which triggered a noticeable increase in private consumption, but also by a steep fall in corporate profits. As investment in Russia is usually financed not through bank loans but from retained profits, this has led to slower investment growth. In 2001, it slackened to barely 9% in real terms from almost 18% in 2000.

Despite the weaker investment momentum, we consider GDP growth rates of 4-5% p.a. to be feasible over the medium term. If this potential is to be fully exploited, though, the structural reforms will have to be resolutely continued. The proposed bank reform and the creation of a small and medium-sized business sector are particularly important here.

More active monetary policy recently

Inflation has fallen more slowly than planned in the last few years (see chart). This is largely a result of necessary hikes in administered prices with an estimated weight of 15% in the consumer price index. Prices for utilities and transport services as well as rents were affected by the adjustments. Such increases are necessary if costs are to be covered. The new leadership at the central bank has signalled this year that it will pursue a more active monetary policy. It lowered the key rate – the deposit rate – in May (from 12% to 9%) and then further in June (to 5%).

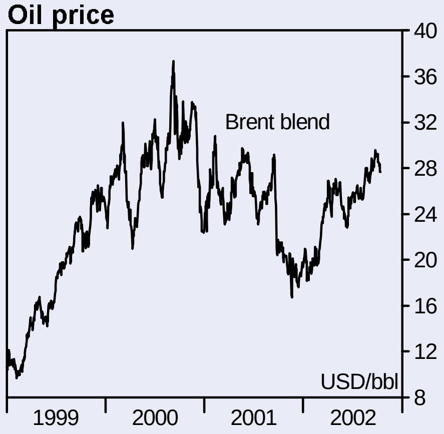
Controlled, nominal rouble devaluation

The Russian central bank is devaluing the rouble by managed float. The pace of devaluation has not matched the development of inflation over the past years, so the inflation differential with Russia's major trade partners has exceeded the devaluation rate. As a result, the Russian currency has gained around 30% in real terms versus both the dollar and the euro since around mid-2000.

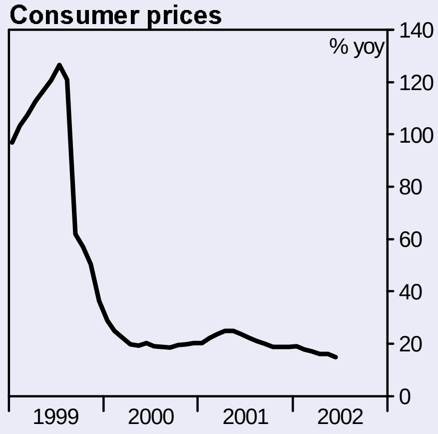
Small but still comfortable current account surpluses

The real appreciation of the rouble has made imported goods more affordable. Hence import demand has risen in line with private consumption. At the same time, export revenue has fallen considerably, so the current year will see a smaller surplus in the trade balance. Even though the trade surplus will probably shrink further next year, there should still be comfortable – albeit declining – surpluses on current account of around USD 20-25 bn (5-7% of GDP) in 2002 and 2003. The 2001 reading was still much higher at USD 34 bn (11% of GDP).

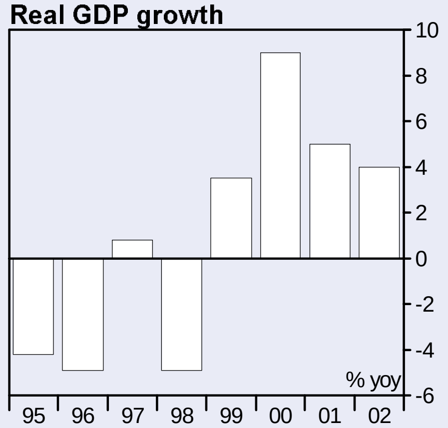
Oil price



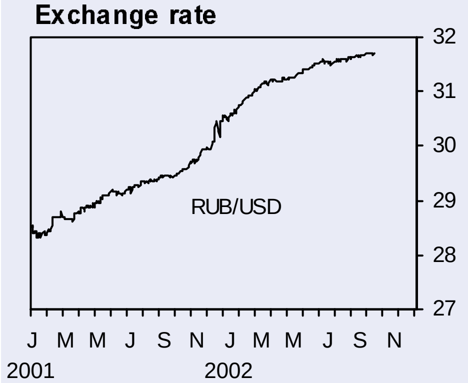
Consumer prices



Real GDP growth

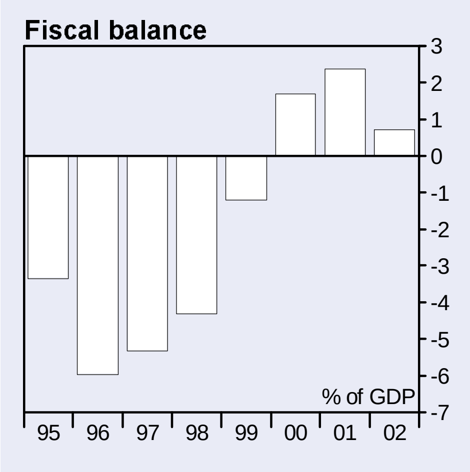


Exchange rate



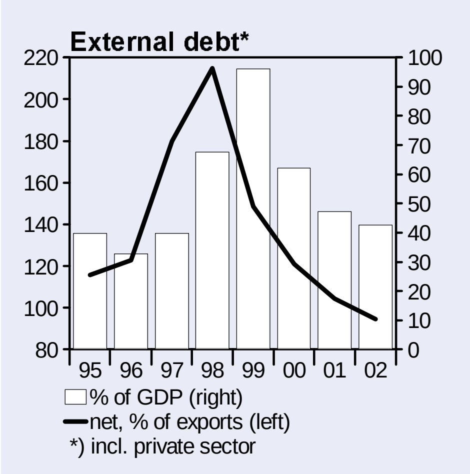
Further budget surpluses possible

Respectable surpluses were registered in the government budget over the last two years. For the most part, this is attributable to the high oil price: roughly one-fifth of revenues are directly linked to oil prices via export tariffs, corporate taxes and production levies. For the first time in Russia's history, a budget surplus is planned for 2002. Moreover, the budget contains a fall-back clause: if the oil price drops below the assumed level of USD 18.50/bbl (Ural), government spending can be cut by about 10%. Since the oil price will average well above USD 20/bbl this year, a budget surplus seems within reach again, though it will probably be much lower than the surpluses in 2000 and 2001 owing to the deviations from budgeted figures in the first half of 2002. It is expected that the 2003 budget will be based on more cautious assumptions for the oil price.



Decline in external debt

External debt has decreased markedly over the past few years (see chart). Russia is meanwhile actively managing its debt and plans to set up a special agency to handle this. Russia has succeeded, for instance, through premature repayments in bringing down its debt service for 2003, which had looked set to reach a record high. Russia is also seeking to reach agreement with creditors on a restructuring of old Soviet debt. The agreement with Germany on the translation of transfer rouble debt was favourable for Russia, but in light of Russia's budget and current account surpluses the Paris and London Club creditors will probably not be inclined to accept further large-scale write-downs in the cash value of their loans.



Long list of reforms launched

Success of reform laws depends on determined implementation

During their two years in office President Putin and his government have launched a remarkable number of market-oriented reforms (see table in appendix). The full consequences of many of these measures currently taking effect will only be felt in several years' time. Moreover, whether the measures will be a success depends crucially on their implementation. Application of legal regulations must be ensured, particularly in the remote provinces. After all, only practical implementation of the new regulations will show whether they are contradictory or need to be supplemented. A new, voluntary code of conduct for companies could boost transparency for investors and hence improve Russian companies' access to the international capital market. It remains to be seen, though, whether market forces will suffice to ensure broad application of the new rules. The OECD and the World Bank pointed out in their „White Paper on Corporate Governance in Russia", published in April, that the implementation and enforcement of corporate governance standards must now have priority. It remains doubtful, though, whether all Russian companies will apply the International Accounting Standards (IAS) from 2004.

New direction in foreign policy

Will Mr. Putin's pro-Western policy undermine Russia's strategic interests?

Thanks to the economic recovery and the fast pace of reforms, President Putin is very popular at home, with an approval rating of roughly 70%. Since the terrorist attacks on September 11, 2001, Russia has pursued a remarkably pro-Western course in foreign policy. Against the backdrop of a Russian-American partnership in the war on terrorism, and with Russia joining the WTO soon and developing closer relations with NATO, many experts see the start of a new era in the West's relations with Russia. But Mr. Putin will have to prove to Russians that the new stance really benefits Russia. So far, the political reorientation has been accompanied by a loss of influence in Central Asia and the Caucasus region. The fact that Russia tolerates US military support for Georgia, the former Soviet republic, is an impressive case in point. Recently, however, the Russian-American differences of opinion in the question of the international weapons inspections in Iraq suggest that Russia is not, or no longer, prepared to accept a loss of influence in world politics without receiving appropriate compensation. The agreement with Germany regarding the old debts can be seen as a first step by the Western states to accommodate Russia; further concessions, especially by the US, will (have to) follow.

Financial markets robust after boom

Russia's higher standing led to a huge fall in bond spreads from the beginning of 2001. Since June 2002 they have risen again slightly, though, owing to contagion effects (Brazil) and budget problems (tax revenues lower and expenditure higher than planned) (see chart). Moody's and S&P last upgraded Russia's rating at the end of 2001 and in spring 2002. Both agencies have indicated that a further upgrading is not anticipated for the time being, but could be in the cards in the next few years if reforms continue at a rapid pace. The coincidence of strong economic momentum, a faster pace of reform and, possibly, closer integration of Russia into the international community has caused some market observers and participants to pay little attention to longer-term risks. Towards the end of 2000 a rally set in on the Russian equity market (see chart). Here, too, prices peaked shortly before the middle of this year and, pulled back by the fall in the international stock markets, have since relinquished part of their advances (see chart).

Remaining risks

Whether the recovery will be sustainable will depend, above all, on whether the Russian economy can become more diversified. The oil price will continue to pose a risk to the country's economic and political stability for a number of years to come. Nonetheless, there will only be a real threat to budget discipline and debt servicing if oil takes a protracted nosedive.

Another obstacle to lasting growth is the still very low number of small and medium-sized enterprises. Removing red tape is a step in the right direction. The new leadership at the central bank is now starting to take action to revitalise the banking sector. It is above all smaller companies that would benefit from efficient financial intermediation.If such sustainable structural reforms can be pursued over a longer period, Russia should be able to move away from its very low level of economic efficiency and start to catch up with its neighbours in Central and Eastern Europe.

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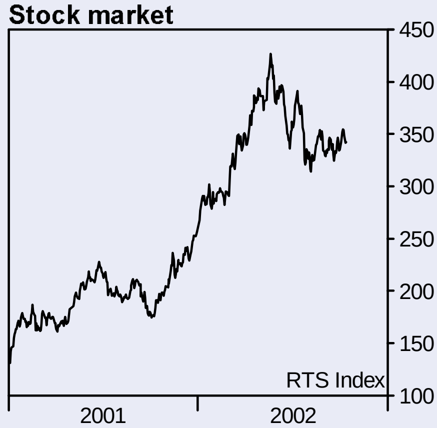
Eurobond spread

Stock market



GDP per capita, in EUR (2001)

Reforms launched in Russia since the start of 2001 (selected)

Reform / law	Description	In effect since
Income tax	Uniform tax rate of 13%	January 2001
Trade policy	Reduction in import tariffs	January 2001
Foreign trade law	Obligatory exchange of foreign-currency export revenues reduced from 75% to 50%	Summer 2001
Law on the protection of companies from state control	Reduction in arbitrary bureaucratic controls	Summer 2001
New land law	Purchase, sale and collateral lending possible for industrial property	October 2001
Corporate taxation	Profit tax lowered from 35% to 24%	January 2002
Pension reform	Supplementation of tax-financed basic pension by personal savings	January 2002
Change in stock corporation law	Strengthening of shareholder rights	January 2002
Corporate governance	New corporate code of conduct (participation voluntary)	January 2002
New labour laws	Clear definition of rights and obligations for employees, employers and unions	February 2002
Licensing of companies	Reduction of obligatory licensing for business areas, from 500 to approx. 120	February 2002
Third part of civil code	First detailed codification of inheritance law	March 2002
New privatisation law	Privatisation of "strategic areas" still dependent on government aproval	April 2002
Company registration	Simplification of registration procedure	July 2002
Agricultural land reform	Purchase, sale and collateral lending possible for agricultural land	Passed by govt. in March 2002; ratification by Duma probably end-2002
Reformed arbitrage procedure	Strengthening of arbitrage courts; clarification of competences between arbitrage courts and normal civil courts	September 2002
New bankruptcy law	Orderly bankruptcy proceedings possible	Enactment expected end-2002
Bank reform	State deposit guarantee system, liquidation of undercapitalised banks	Planned: 2004/2005
Accounting	Application of IAS obligatory for all companies	Planned from 2004

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