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Economic Overview

"Russia is a land of optimists because all the pessimists have already left."

Zhores Alfyorov, Nobel laureate 2000

Russia's economic outlook – another good year... but what next?

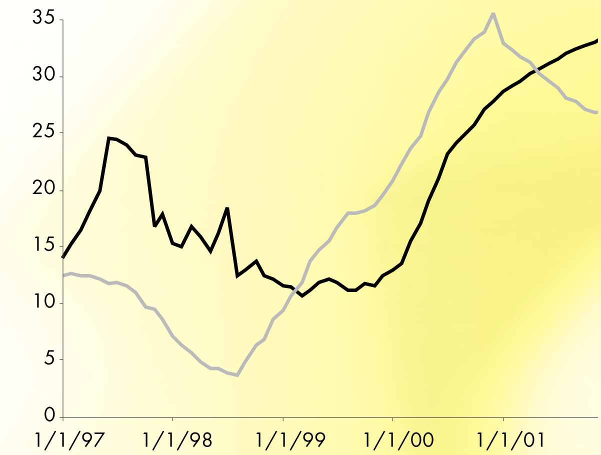
In early 2000, no one would have expected the Russian economy to perform so well. With the first signs of growth in H2 1999, the consensus was that growth would disappear, at best by the summer of 2000. In January 2000, 3% annual economic growth seemed to be the upper limit of expectations. Forecasts for rouble/dollar exchange rate (nominal) depreciation reached 30%, and inflation was expected to be 25%. Now that annual GDP growth is hitting 7.6%, the rouble fell only 4.5% in nominal terms over 2000 (a 17% real appreciation), and with inflation a modest 20.2%, a renewed round of skepticism about Russia's economic prospects appears. The main questions are whether these positive results are sustainable; how realistic the prospects for Russia's financial stability and for continued growth are; and whether a new crisis is likely.

We believe that Russia will likely enjoy at least another year of relatively benign macroeconomic conditions – though with slower growth than in 2000 – and that Russia's economy has a good chance to embark on a stable growth path in the medium to long term (approx. 3% GDP growth annually). However, any positive medium-term developments are critically dependent on the success of the reforms – political, economic and social. If the reforms become bogged down, the currently favourable starting conditions will be wasted and Russia will almost certainly face another period of stagnation.

Remarkable financial stability: a highlight

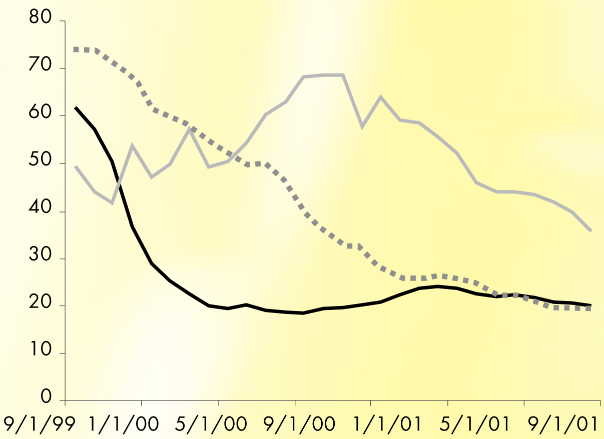
The major factors behind Russia's economic growth are the traditional "beggar-thy-neighbour" ones: favourable oil prices and a devalued currency. While the first resulted in rapid export growth (38% in 2000), the second led to considerably

Chart 1. Trade Balance and Foreign Reserves



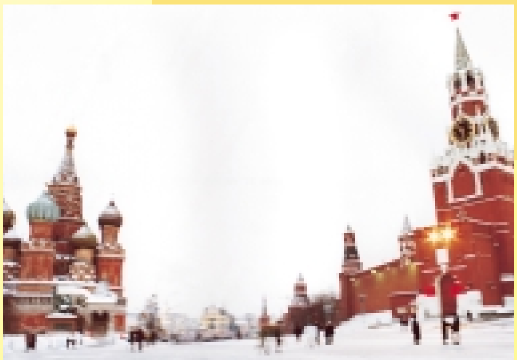
Foreign reserves, $bn, hs
Trade balance, annualized, $bn
Source: CBR, Goskomstat, RBA

Chart 2. Inflation and Monetary Base Growth



CPI, yoy %
PPI, yoy %
Monetary base, yoy %

Source: CBR, Goskomstat, RBA



lower import levels which, in turn, provided the impetus for domestic industry to grow. The resulting strong current account surplus (approaching 20% of GDP) allowed for strong foreign exchange reserves accumulation by the Central Bank of Russia (CBR), and thus, for exchange rate stability (chart 1). Throughout 2000, the CBR followed a "corridor-type" exchange rate policy, smoothing daily fluctuations on the forex market and keeping the rouble in check to avoid a too quick real (and, for a time, even nominal) appreciation.

Another consequence of surging export profits, on the one hand, and overall real sector growth on the other, was a healthy fiscal surplus for 2000 – a key factor behind Russia's financial and monetary stability. Though federal budget revenues had risen to 16.5% of GDP in 2000 (excl. December), up by 3.5% of GDP compared to 1999, fiscal tightening (expenditures as a % of GDP tightened by 0.7% to 13.5% in 2000 on average) allowed the government to pay off the outstanding debt without increasing its leverage. Apart from debt repayment, large surpluses were used to contain excess liquidity, by accumulating funds on government accounts with the CBR.

The newly-issued liquidity by the Central Bank in 2000 resulted from increasing forex reserves. The massive increase in net international reserves of RUB 440 bn (USD15.6 bn equivalent) was accompanied by a net domestic asset (NDA) decline. These decreased sharply, from RUB 355 bn to RUB 50 bn, mainly on the back of rising governmental deposits with the CBR. These grew nearly 2.5 times, to RUB 260 bn by year-end 2000. The monetary base inflated by RUB 176 bn over the year. So the lion's share of cash, which appeared as a result of the large accumulation in reserves, went to federal and sub-federal CBR accounts, as surplus and was thus withdrawn from circulation.

The impact on the economy of these two fundamental factors – the high oil price and a low rouble – is steadily weakening. First, declining oil prices and an appreciating domestic currency will result in a smaller current account surplus (from an expected USD 47 bn to some USD 30-32 bn) and, consequently, slower reserves accumulation (from a USD 15.5 bn increase in 2000 to USD 6-7 bn in 2001). While it may not be immediately apparent in H1 2001 (because oil prices remain sufficiently high, and gas prices will follow with a lag), the effect might well play itself out in H2 2001 – with a resulting faster rouble depreciation. At the same time, however, this scenario will lead to lesser inflationary pressures due to the decreased inflow of new roubles (Chart 2). Another stabilising factor keeping inflation at bay may be the CBR's open market operations (legislation necessary for that is currently in the pipeline), and more active government borrowing.

We expect exchange rate policy (and thus, monetary policy) to remain linked to the size of external accounts (and thus, to oil prices). Both will likely continue to follow the same path as they did in 2000, which has the following implications:

- continued reserves accumulation, allowing the CBR to maintain a competitive rouble
- stabilising inflation, which is expected to reach 18% by year-end (though a slight increase in y-o-y price growth may be evident in the first months of year).

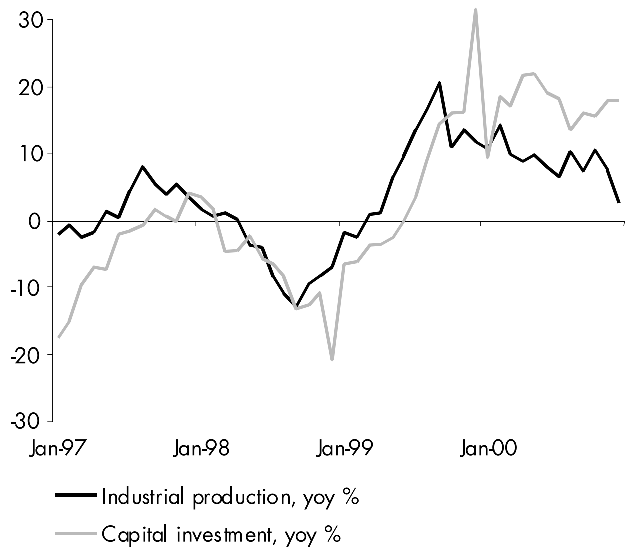
Full payment to the Paris Club, and no IMF loans, mean that there is a financial "gap" of about USD 5-6 bn in the budget. To fill part of this gap, the government plans to borrow an extra RUB 30bn in the domestic fixed income market, over and above the borrowing limits budgeted for 2001. Though the debt financing appears achievable without extra borrowing on the markets, by means of extra tax revenues on the back of economic growth and greater fiscal discipline, increased privatisation revenues, and finally, some borrowing from the CBR's huge reserves, we still cannot exclude the possibility of additional government bond issues.

Second, a certain fiscal expansion is envisaged for 2001.While it may assist the real sector of the economy, it also means an increase in the money supply through the reduction of government funds in the CBR. Fiscal expansion involves, first, reduced tax rates (due to the introduction of the new tax code), and second, increased state expenditures (the 2001 budget is balanced, as opposed to a budget surplus of 2.3% of GDP in 2000).

Another factor impacting on exchange rate stability is capital flight, which remained high in 2000, at approx. USD 1.5-1.8 bn per month. The strong growth in export revenues notwithstanding, a large portion of this capital is not used in the domestic market. The key to reversing this situation are reforms targeted at improving the investment climate.

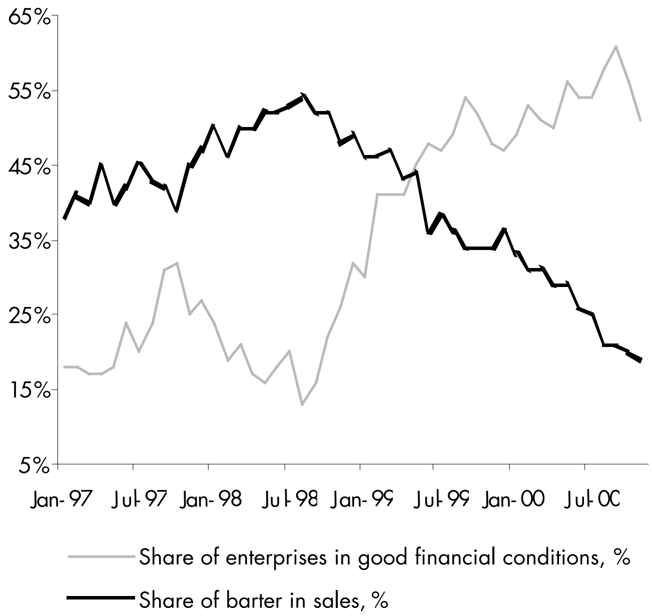
The more investor-friendly the reforms (i.e. consistency and transparency in legislation, improvements in corporate governance, reduction in bureaucracy), the less capital flight there will be from Russia.

Chart 3. Growth of Industrial Production and Capital Investment



Source: Goskomstat, RBA

Chart 4. Use of barter in sales and financial status of enterprises



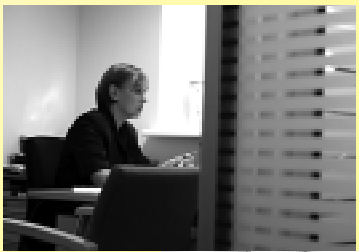
Source: Russian Economic Barometer (industrial survey data)

Real sector – primed for growth if only...

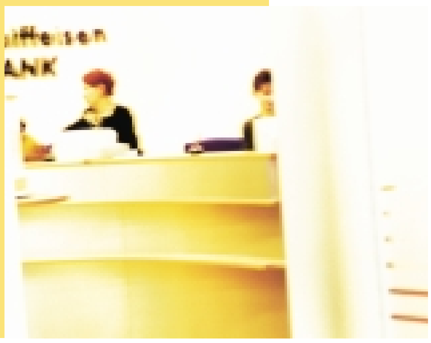
A stable macro environment, growing export revenues (as oil and gas exports account for over 50% of total exports), together with increased demand for domestically-produced commodities, were the main drivers behind Russia's spectacular 9% industrial growth in 2000 (Charts 3 and 4).

There is a strong possibility that industrial production growth will continue at least into 2001. Fixed capital investment was high in 2000, increasing 18% annually, and the continued propensity of Russian entrepreneurs to reinvest retained earnings into their companies, is a positive sign for 2001, at least. At the same time household demand surged 8% y-o-y. Strong demand for domestically produced goods, both on the consumer and investment sides, is expected to remain high in 2001 as well though not as high as in 2000. Industrial production may thus end up in the 4-5% growth range by end-2001.

On the negative side, the basic malady of domestic production remains: the inherent inefficiency of industrial enterprises, Russia's inheritance from the Soviet planned economy. This includes 40-60% of all enterprises, according to various estimates, and fuels the vicious circle of inter-enterprise payment arrears and the ongoing practice of barter. Another negative point for domestic industry is the gradual disappearance of the favourable external conditions associated with an appreciating rouble. For growth to become more sustainable, it is therefore critical that Russian industry develop higher-value-added production oriented towards the domestic market.



This is where structural reforms become critical. First and foremost, uncompetitive, inefficient enterprises must be closed down. Adoption of new bankruptcy legislation is planned, according to the Gref reform program, for July 2001 so a quick jump-start to the restructuring process this year seems unlikely. Among the reasons for the delay in this legislation is the absence of a social welfare net that will be immediately needed to deal with the resulting massive unemployment, worker retraining and so



forth. Yet industrial restructuring, based on viable bankruptcy legislation, is vital for economic growth to continue in the medium term.

Another set of structural reforms desperately needed to support the real sector is reform of the banking sector. Industry suffers from a chronic lack of working capital, while traditional banking activities – western-style financial intermediation – remain underdeveloped. The banking sector, unfortunately, is the area with the worst track record in reform-oriented activity: virtually nothing has been done since the August 1998 financial crisis. If banking sector reforms do not begin soon, and once self-financed investment in industry exhausts itself, a capital shortage will develop and the economy may enter a recession.

Conclusion

Short-term prospects for Russia's economic performance look fairly good. In the medium term, however, it is still too early to tell whether the positive stimulus the economy experienced in 2000 is temporary or more lasting. Whether or not the economic advantages of the last 18 months can be transformed into sustainable economic growth depends on a range of political and economic factors, and particularly the successful implementation of the liberal reform program within a climate of continued political stability, both on the domestic and international fronts.

Economic Indicators

Economic Indicators	1998	1999	2000	2001 (forecast)	2002 (forecast)
GDP, % yoy	-4,9	3,2	8,3	4,5	3,5
GDP, USD bn	312,6	181,6	250,8	303,0	336,7
Industrial Production, % yoy	-5,2	8,1	9,0	5,0	4,5
Capital Investment, % yoy	-6,7	4,5	18,0	7,0	6,0
CPI-Inflation avg, %	27,7	85,7	20,8	22,1	15,7
CPI-Inflation eop, %	84,5	36,6	20,2	21,0	15,0
PPI-Inflation avg, %	6,9	59,0	46,3	22,5	17,4
Money supply (M2) growth, %yoy	19,8	57,2	62,4	35,9	32,0
Central budget balance, % GDP	-5,4	-1,7	2,3	0,0	-0,5
Exports, USD bn	74,8	74,7	105,2	100,0	90,0
Imports, USD bn	59,5	39,6	44,2	50,0	55,0
Export growth (% yoy)	-16,0	-0,1	40,9	-4,9	-10,0
Import growth (% yoy)	-19,2	-33,4	11,6	13,1	10,0
C/A Balance, $bn	2,4	25,0	46,3	32,6	17,3
C/A Balance, % GDP	0,8	13,8	18,5	10,8	5,1

Source: MinFin, CBR, Goskomstat, RBA