Russia: A sleeping bear

- Growth has slowed in Russia, but not in any dramatic way. There are prospects of growth below the potential in the coming years.

- The underlying macroeconomic foundations are solid. Russia enjoys large human capital, abundant natural resources, a flexible labour market, a rapidly increasing middle class, major catch-up potential relative to the developed countries as well as low public and private debt.

- But Russia is lagging behind in a large number of central areas, which means that the growth potential is not optimised. In order to increase the growth potential, comprehensive structural reforms are required. The most obvious weak points are the poor business climate, particularly attributed to poor institutional conditions, problems of corruption, public security, etc.

- We see small signs of political will to implement reforms, but the extent of the political will is still uncertain.

Growth has slowed but not in any dramatic way

Growth declined in Q3 to 2.9% y/y from 4.0% in Q2. The national accounts showed that agriculture and construction depressed growth considerably. With respect to demand, especially investments pulled down the y/y rate. However, investments accelerated in Q3 relative to Q2.

We believe that growth is close to have bottomed out for now – although the y/y rate will probably decline even more in the coming quarter. This is due to the strong growth in late 2011 and early 2012, as well as fewer working days in Q1 2013 than Q1 2012. Growth was strongly supported by the government (and Putin) up until the presidential election in March 2012. Private spending was lifted by substantial wage increases to public-sector employees and the state-owned banks were urged to increase credit growth.

Accordingly, part of the current slowdown in growth (in y/y terms) should be seen in the light of this. Growth in 2012 and 2013 looks set to land in the range of 3.0%-3.5%. For 2014 we expect growth to approach the potential of 4% again.

Industry lagging slightly behind

Sentiment indicators have shown signs of stabilisation. Particularly within service, trade and construction, while industrial indicators continue to lag slightly behind. But the general picture is that the economy has bottomed out and is slowly recovering again.
The sluggishness in industry has also been reflected in the actual industrial production which has seen a slightly declining trend. The monthly investment indicators were weak in H2, although recent surveys point to stabilisation. As we expect manufacturing industry to recover, we also expect investments to gradually improve.

Robust private spending
Monthly retail sales, car sales and credit growth point to sustained robust private spending. Growth in retail sales has declined but is still growing by more than 4% y/y (in real terms). Private spending has been supported by a strong increase in real wages in H1 which saw wage increases of more than 10%. Wage increases are still most robust although they have declined. Private spending is furthermore supported by strong growth in household lending which in H1 exceeded 40%. However, lending growth has decelerated lately but still appears to be very strong. Household debt remains low, accounting for less than 10% of GDP.

The labour market looks robust. Employment is enjoying a positive trend and at only 5% unemployment is low. The tight labour market will continue to support wage growth. But we do not expect to see significantly rising wage increases as growth remains relatively moderate. In this respect, it should be noted that the Russian labour market is relatively flexible.

Foreign trade dependent on commodities
Exports in percentage of GDP account for more than 30% of GDP and in terms of this parameter, Russia is a relatively open and export dependent economy. However, there is the reservation that approximately 70% of exports are in the form of oil and natural gas. Including other commodities, the proportion is almost 80% of exports.

The development in exports (in volume terms) has been almost flat over the past three years, while imports have been steadily increasing. This clearly indicates that export of commodities (in volume terms) is not on the rise, which should to some extent be seen in the light of the sluggish global growth. But is also a sign that competitiveness in the processed part of industry is lagging behind the competitors.

Russia’s accession to WTO in August 2012 entails a risk of putting the economy under intensified competitive pressure. However, Russia has been allowed a transitional period of eight years to qualify for full membership of WTO; this will be to the advantage of engineering and agriculture, which may otherwise risk facing major competitive pressure.

We consider the membership of WTO, which became a reality 18 years after Russia applied for accession, an important signal in relation to the image Russia would like to obtain among international investors. The accession will probably attract more foreign direct investments (FDIs) to Russia.
WTO membership may also serve as a positive driver in respect of implementing the necessary structural reform that may increase Russian competitiveness and make the country less dependent on oil.

In his yearly speech to the Russian parliament in December, President Putin spoke about increased fiscal and monetary stimuli to boost growth. This includes means from the National Welfare Fund to be allocated to infrastructure investments in 2013. This will be an important element in maintaining momentum in the economy.

**Monetary policy is changing**

The monetary policy in Russia is changing and the central bank (CBR) is slowly heading for an inflation target rather than focus on the currency. CBR’s ambition is to fully target inflation in the coming three years. In this respect, CBR has an inflation target of 5%–6% this year, while the target is to reduce inflation to 4%–5% in 2014–15. In a historical perspective, however, this sounds most ambitious. A change of focus from currency to inflation presumably means that inflation will become more stable and probably also decrease, while the currency will be more volatile.

**Decreasing currency intervention**

Today, CBR intervenes in the FX market in two ways. One of these ways is a planned intervention based on an expected net current-account inflow. In addition to this, aiming to reduce the daily fluctuations in the currency, rule-based intervention is applied. If the currency breaches above the band of 34.65–35.65 on a basket against USD and EUR (55% USD and 45% EUR), the CBR will intervene. The present intervention band is from 31.65 to 38.65. The rule implies that the intervention amounts rise, the more the exchange rate deviates from the mid-band. In this respect, the intervention band is adjusted currently (as are intervention amounts), on the basis of the total purchase/sale of currency. In this way, the currency band is slowly extended to become broader and broader.

Attributed to currency intervention, the CBR has, in a historical perspective, injected plenty of liquidity into the banking system, and in the light of the steep increase in the money supply, this indicates that the CBR has had difficulties sterilising the currency purchases. This indicates that the growth in money supply has contributed to lift inflation. A less active currency intervention from the CBR, due to its major focus on inflation, among others, already now seems to have had an effect on the money supply, liquidity in the banking system and hence inflation which has declined.

**Food prices with great effect on inflation**

Food prices are also decisive for inflation. Wide fluctuations in food prices have historically had a great effect on total inflation.
This is partially due to the fact that food accounts for around 37% of the consumer basket in the inflation index. Moreover, food prices are affected by the fact that import of food accounts for almost 15% of total imports, for which reason there is a strong effect from global food prices to Russian food prices.

Russia removed all capital restrictions back in 2006, which has made the rouble a fully convertible currency. And there are no indications of a return to capital control. Even during the crisis in 2008, when Q4 alone saw an outflow of USD 130.2bn (almost 10% of GDP), there were signs of a reintroduction of capital restrictions.

**Positive elements in the macroeconomic foundations…**

The underlying macroeconomic foundations in Russia are solid, with large human capital, abundant natural resources, a flexible labour market, a rapidly increasing middle class, major catch-up potential relative to the developed countries as well as low public and private debt. Public debt accounts for less than 10% of GDP, which also applies to households. Corporate indebtedness is limited, constituting about 35% and GDP. Overall, this points to underlying solid growth potential.

**…and quite a few negative elements**

However, Russia is lagging behind in a large number of areas, which means that the growth potential is not optimised. And it takes comprehensive economic and structural reforms to trigger the potential. The most obvious weak points are the poor business climate, among others attributed to poor institutional conditions, problems of corruption, public security, etc.

In terms of the World Bank’s “Doing Business”, Russia only ranks 112 out of 185 countries in 2013. This is in line with Costa Rica and El Salvador. It is, however, worth noting that recent years have seen fair progress in sub-areas such as, for instance, taxation and resolving insolvency. The positive picture here is destroyed by deterioration (in relative terms) in other areas such as credit granting and protection of investor rights.

The weakness in competition is also reflected in the World Economic Forum’s Competitiveness Index, where Russia ranks 67 out of 144 countries. Here, Russia is just above Sri Lanka and slightly below Iran. Particularly in the survey of institutional conditions, such as corruption, property rights, public sector efficiency and security measures, Russia has a poor ranking as a number 133 out of 144 countries. Transparency’s corruption index supports this by ranking Russia as a number 133 out of 176 countries and in line with Honduras and Iran.

In relation to the poor corporate climate, investigations show that the number of new businesses (in percentage of existing business) are far
lower in Russia than many places and the number is lower today than it was ten years ago.

This indicates that the poor corporate climate to a greater extent hit small- and medium-sized enterprises than the major ones. The contribution to the economy (in percentage of GDP) from small- and medium-sized companies is also significantly lower in Russia (about 15% of GDP are generated by small- and medium-sized enterprises) than in the EU (average of about 40%) or in other Eastern European countries such as Hungary, Rumania or Kazakhstan (about 30%–35%).

There may be several reasons for this, but there are many indications that when enterprises grow to a certain size, they will quickly be challenged by administrative burdens, inspections, license requirements, taxes, etc. An investigation from 2009 of small enterprises showed that 53% of the licenses paid by enterprises were, in fact, not legally required. Although the licenses were time-consuming and costly for the companies, most of these decided to pay the license (to the authorities) rather than discussing the necessity of this.

**Weak management structure**

Russia is also lagging behind with respect to management structure. In an investigation conducted in 2009 among 25 countries (including 10 Eastern European countries), Russia had the third lowest ranking in terms of management structure. Improved management structure usually leads to higher growth, higher productivity, increased research and more new products. In order to create improved management structure, keen competition is important as it puts pressure on the companies to optimise their management practice. A large representation of multinational companies will contribute to the extension of management tools and practice as well as increased competition. A burden in this respect is that the foreign trading and investment climate is very restrictive in Russia compared with other OECD countries.

**Solid education level and fair research**

The education level remains reasonable in Russia compared with other EM countries. Russia has historically performed well with respect to technical and natural science education where the country ranks above the OECD average. In the broader part of the education system (e.g. according to PISA surveys), there is a trend towards Russia lagging behind the other OECD countries. This might indicate that the effort in the school system has declined. Efforts are required, otherwise the growth potential may deteriorate further.

With respect to research and development, Russia ranks at level with the other EM countries but the number of scientists per capita is significantly higher. However, there is no visible effect of this on Russian exports which do not require much know-how.

### Rapidly rising middle class

<table>
<thead>
<tr>
<th>Av. income per capita, RUB</th>
<th>2004 (% of population)</th>
<th>2008 (% of population)</th>
<th>2011 (% of population)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 3,500</td>
<td>33.8</td>
<td>7.3</td>
<td>2.8</td>
</tr>
<tr>
<td>3,500–5,000</td>
<td>18.3</td>
<td>8.6</td>
<td>4.6</td>
</tr>
<tr>
<td>5,000–7,000</td>
<td>17.0</td>
<td>12.5</td>
<td>8.1</td>
</tr>
<tr>
<td>7,000–10,000</td>
<td>14.3</td>
<td>16.9</td>
<td>13.5</td>
</tr>
<tr>
<td>10,000–15,000</td>
<td>10.0</td>
<td>20.2</td>
<td>19.8</td>
</tr>
<tr>
<td>15,000–25,000</td>
<td>6.6</td>
<td>19.8</td>
<td>24.8</td>
</tr>
<tr>
<td>25,000–35,000</td>
<td>7.7</td>
<td>12.1</td>
<td></td>
</tr>
<tr>
<td>&gt; 35,000</td>
<td>7.0</td>
<td>14.3</td>
<td></td>
</tr>
</tbody>
</table>

Source: Russian statistics

### Flexible labour market in Russia

- **The US**
- **The UK**
- **South Africa**
- **Japan**
- **Russia**
- **Denmark**
- **Chile**
- **Hungary**
- **South Korea**
- **Brazil**
- **Poland**
- **Italy**
- **India**
- **Germany**
- **China**
- **France**
- **Indonesia**
- **Spain**
- **Mexico**
- **Turkey**

Source: Russian statistics

### Slow recovery in business climate

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>112</td>
<td>112</td>
<td>123</td>
<td>120</td>
</tr>
<tr>
<td>Starting a business</td>
<td>101</td>
<td>105</td>
<td>108</td>
<td>106</td>
</tr>
<tr>
<td>Construction permits</td>
<td>178</td>
<td>180</td>
<td>182</td>
<td>182</td>
</tr>
<tr>
<td>Property registration</td>
<td>46</td>
<td>48</td>
<td>51</td>
<td>45</td>
</tr>
<tr>
<td>Credit granting</td>
<td>104</td>
<td>97</td>
<td>89</td>
<td>87</td>
</tr>
<tr>
<td>Investor protection</td>
<td>117</td>
<td>114</td>
<td>93</td>
<td>93</td>
</tr>
<tr>
<td>Tax payment</td>
<td>64</td>
<td>94</td>
<td>105</td>
<td>103</td>
</tr>
<tr>
<td>Cross-border trading</td>
<td>162</td>
<td>162</td>
<td>162</td>
<td>162</td>
</tr>
<tr>
<td>Enforcing contracts</td>
<td>11</td>
<td>12</td>
<td>18</td>
<td>19</td>
</tr>
<tr>
<td>Resolving insolvency</td>
<td>53</td>
<td>61</td>
<td>103</td>
<td>92</td>
</tr>
</tbody>
</table>

Source: the World Bank
Great state involvement

The Russian model is known for the major role played by the state. And state involvement in the Russian economy is widespread. According to the Economy Ministry of Russia, the state-owned sector’s contribution to value creation accounted for approximately 40%-45% of GDP in 2009.

And with the raging of the financial crisis, this proportion has probably increased to constitute almost 50% today. In terms of employment, the proportion in 2011 was about 36% (including mixed state/private). The state plays a very influential role in many sectors. This almost inevitably means that competition in certain sectors has decreased and there is a risk that the economic resources are not applied optimally. This is probably one of several reasons why Russian competitiveness is relatively weak.

Privatisation plans and reform signals

Privatisation plans used to be high on the agenda, and back in 2009, the government presented a privatisation plan which, however, never materialised. Again in 2012, the government launched a privatisation plan for 2013-2016.

In this respect, Putin expressed intentions to privatise most industries, excluding energy, military and defence. According to the plan, the state intends to reduce its stake significantly in several of the large enterprises and banks. Some of them to 0%. Part of the argument in favour of a privatisation plan is to increase public revenue. But given the prospects of sustained solid public finances in the coming years, there is a risk that privation may not be implemented until towards the end of the period. And there is a risk that they may not even be implemented since state-owned businesses serve as an important contributor in many public projects. Thus, state-owned enterprises have been involved in the construction of roads, football stadium, 2014 winter OL projects, environmental projects, etc.

Nonetheless, Putin has sent a number of positive signals to the corporate sector, in which has signalled several ambitious goals that may have great implications for the medium term. A committee is, for instance, to be established, aiming to improve the conditions for the corporate sector and attract foreign investments. Moreover, it is a political target to lift Russia’s ranking at the World Bank’s “Doing Business” from a number 112 to a number 20 in 2018. It is most uncertain if and how the statements of intent will be implemented in actual politics.

Major scepticism about reform plans

Russia has for a long time been characterised by status quo. Hence, there have been no major reforms and lack of liberalisation measures. We therefore remain very sceptical with respect to the implementation

Strong position of state in the economy in terms of GDP

Privatisation plans

<table>
<thead>
<tr>
<th>State privatisation plans for businesses</th>
<th>State share proportion 2012</th>
<th>Estimated share proportion 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>VTB</td>
<td>75.5%</td>
<td>0%</td>
</tr>
<tr>
<td>Agriculture Bank</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>RosAgrolLeasing</td>
<td>99.9%</td>
<td>0%</td>
</tr>
<tr>
<td>SovKomFlot</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Sheremetyevo</td>
<td>83%</td>
<td>0%</td>
</tr>
<tr>
<td>Aeroflot</td>
<td>51%</td>
<td>0%</td>
</tr>
<tr>
<td>United Grain Company</td>
<td>60%</td>
<td>0%</td>
</tr>
<tr>
<td>ALROSA</td>
<td>75%</td>
<td>0%</td>
</tr>
<tr>
<td>RosGidro</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Rosnef</td>
<td>75%</td>
<td>0%</td>
</tr>
<tr>
<td>Zarubezhneft</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Inter RAO UES</td>
<td>20%</td>
<td>0%</td>
</tr>
<tr>
<td>Russian Railways</td>
<td>100%</td>
<td>75%</td>
</tr>
<tr>
<td>FSK UES</td>
<td>77.7%</td>
<td>75%</td>
</tr>
<tr>
<td>Transneft</td>
<td>100%</td>
<td>75%</td>
</tr>
<tr>
<td>United Shipbuilding Corp.</td>
<td>100%</td>
<td>50%</td>
</tr>
<tr>
<td>United Aviation Building co</td>
<td>93%</td>
<td>50%</td>
</tr>
<tr>
<td>UralVagonMash</td>
<td>100%</td>
<td>50%</td>
</tr>
</tbody>
</table>

Source: Russian statistics and BNP Paribas

Too few investments in Russia

Source: Reuters EcoWin and The World Bank
of the political announcements. Also because some of the necessary measures, e.g. in the public sector, with respect to public security, corruption, etc. will be very difficult as rather deep-rooted norms in society must be changed. Other issues such as improvement of the education system, are, after all, easier to implement and may also have great implications on growth. If the implementation of reforms turns out to offer a surprise, it would be most positive. We consider it necessary to implement a series of reforms if the growth potential is to be lifted. But, in fact, also to prevent a gradual fall in the growth potential and to avoid future problems with trade-balance deficits and indebtedness.

The reform initiatives are also necessary to attract more FDIs, that may bring knowledge, technology and increased competition to the country. And hence, as a minimum, lift the investment quota to the same level as other EM countries. This may boost productivity and growth.

In spite of the series of lacking elements in Russia, the economy has grown by almost 7% a year on average in the period 2000–2008. But there are many indications that the growth potential has declined and that the IMF and OECD estimates the potential to be around 4% today. But reform initiatives may lift the growth potential again. Putin has several times talked about growth of 5% for the medium term. In order to obtain this level, ambitious and comprehensive reforms are required.

**Strong public finances but dependence on oil**

The public finances are an example of a success story as the public debt in percentage of GDP has been reduced considerably over the past ten years. In 1999, the public debt was almost 100% of GDP, but already in 2007, it was below 10%, which is also the level today.

Russia is also known for low private public debt and low budget deficits. But the budget deficits are only kept down by large oil revenues, which account for around 50% of the state’s revenue. Consequently, the public finance are very dependent on oil and very sensitive to fluctuations in oil prices.

A fiscal policy rule has been that the budget deficit, excluding oil, must only account for 4.7% of GDP. However, Russia has not been able to live up to this since the crisis in 2008 and Russia has allocated means from the Stabilisation Fund (from oil revenue) to stabilisation of the economy. The size of the Stabilisation Fund (reserve fund and welfare fund) peaked at almost 15% of GDP back in 2007. Today, the Stabilisation Fund constitutes less than 10% of GDP. Accordingly, there is a need to build up the Fund’s means again to have a buffer should the economy be hit by new major economic slowdown.
Oil funds do not last forever and pose a challenge

Even before the crisis, the Stabilisation Fund in Russia was relatively small compared with other oil–rich export countries like Norway, Saudi Arabia, United Arab Emirates, Qatar, etc. For instance the Norwegian Oil Fund constitutes far more than 50% of GDP. The latest production estimates indicate that Russia with the current known oil reserves can only maintain the present production for 20 years. This is a relatively short period compared with 60 years for Kazakhstan, 70 years for Saudi Arabia and 90 years for United Arab Emirates. It also points to a strong need for implementation of a series of reforms to increase diversification in Russian industry, aiming to reduce the country’s dependence on oil.

Following several years of large deficits on the public finances (excluding oil), a number of steps have been taken to steer the fiscal policy in the right direction. This also serves to rebuild the Stabilisation Fund that was drained considerably in the years after the crisis. As from 2013, the plan is to introduce a new fiscal policy rule implying an expense ceiling based on oil income at a “basis” price (weighted average over the past five years and later 10 years), non-oil income and a net loan limit of 1% of GDP. If oil income exceeds the estimates of the “basis” oil price, the surplus must be accumulated in the Reserve Fund, and if the surpluses are sufficiently great, the means must also be accumulated in the National Welfare Fund.

The advantage of the rule is that it will decouple the public budgets from short-term fluctuations in oil price. On the other hand, it is difficult to communicate and there is a need to ensure that the rule is not undermined by use of additional budgets. Also, the rule is only dependent on oil price rather than oil volume.

The oil issue also entails a generation conflict. In a situation with an ageing population that is expected to live longer than its predecessors, there is risk that the oil funds may soon be used.

Current-account surplus and capital outflow

For a long time, Russia had a solid surplus on its current account. On the other hand, there is an almost permanent outflow of capital. The current-account surpluses are typically greatest in the first six months and vice versa in last six months when the surplus are normally much smaller. Moreover, the surpluses are highly dependent on the oil price. Net capital outflow from Russia, on the contrary, is highly dependent on the global risk appetite. In periods of crisis sentiment, capital outflow from Russia tends to increase significantly.

There are no prospects that oil export volumes can be increased significantly over the coming years, which means that the trade deficit will probably slowly come under pressure. To avoid that the currency is squeezed, this would require that the net capital outflow decreases...
and/or that the trade-balance surplus can be maintained. This will either take much higher oil prices and/or political stability, reforms and an ensuing improved corporate climate that may increase inflow of FDIs, but, of course, also portfolio investments.

For the medium term (three to five years), circumstances point to a weakening of the currency. This is also crucial if Russia is to improve its competitiveness.

The real effective trade-weighted currency has almost lastingly strengthened in the past 10 years except for the crisis in 2009. The main reason is the sustained higher inflation in Russia than among the country's trading partners. An explanation of this is, among others, that the solidly rising commodity prices have increased the state's revenue significantly and, accordingly, the public sector's and public employees' purchasing power. Thus, the rising commodity prices have boosted demand for other goods (services, consumer discretionaries, building, etc.), whose prices (wages) have increased, and the real effective exchange rate has therefore strengthened. Higher wage increases and a stronger currency leads to reduced competitive power as it is relatively more expensive to produce in Russia. A weaker currency for the medium term is necessary to rebuild competitive power.
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