



TALKS ON RUSSIAN ECONOMY

**WHAT IS TO BE DONE TO TURN AROUND
THE RUSSIAN ECONOMY? FORECASTS
AND PERSPECTIVES**



Association
of European
Businesses

Stuart LAWSON

Welcome address



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SBERBANK

Russia: Policy Mistakes Dragging on Growth Are Likely to Be Corrected in 2014

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February 2014

INVESTMENT RESEARCH

Sluggish economic growth in 2013, but there is a chance for a rebound in 2014

- **Even though Russia was not ranked as an ideal country in which to do business, growth was strong in past years due to reasonable macroeconomic policy.** As the latter now bears certain shortcomings, growth has decelerated, which paradoxically occurred alongside improvements in rankings like the World Bank's Ease of Doing Business. Growth can bounce back once policy improves.
- **Domestic demand weakened in 2013, eroded by high inflation and interest rates.** According to official statistics, retail sales grew 5.9% and investments rose 6.7% in 2012. In 2013, retail sales were up 3.9% and investment was reportedly down 0.3% y-o-y. Economic growth has decelerated largely because nominal private consumption, in the past fueled by rapidly expanding consumer lending, has softened as households are spending a rapidly growing proportion of their income on interest payments. Meanwhile, nominal wage growth remained strong (at double digit level, y-o-y).
- **On top of this, regulators' interventions on money markets, which have fueled devaluation expectations, have had a negative impact on economic activity.** The currency band and related regulations have forced the Central Bank to sell forex to defend the ruble and thus absorb liquidity being provided to banks on an increasing scale. Interest rates are thus still high, which negatively affects investment activity. Regulators can be blamed for inconsistent action that caused growth to decelerate and the balance of payments to deteriorate in 2013. GDP reportedly grew 1.3% y-o-y in 2013, while industry was slightly up 0.3%. Policy will hopefully improve in 2014 ("targeted" interventions on the forex market have been already abolished – effective January 13, 2014), and the accumulated imbalances will diminish, which will support growth.

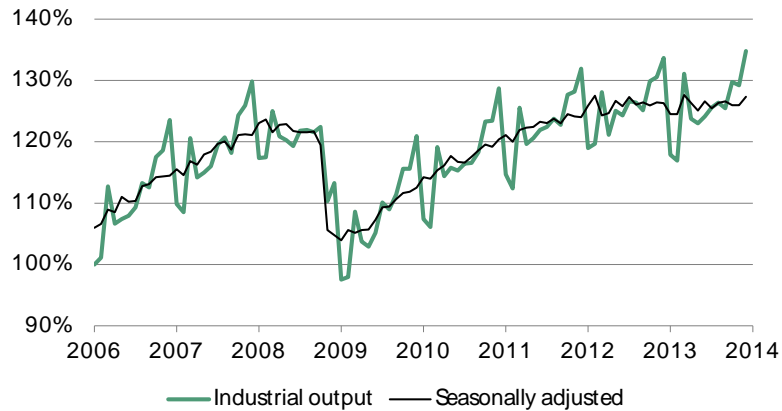
GDP grew by a mere 1.3% in 2013, while the financial sector expanded by 12%

	2010	2011	2012	2013
Agriculture, hunting and forestry	-12.1	14.3	-2.9	3.2
Fishing	-9.1	4.1	1.9	3.8
Mining and quarrying	6.6	4.1	1.6	0.9
Manufacturing	8.6	6.4	2.7	0.8
Electricity, gas and water supply	4.0	0.3	0.2	-1.6
Construction	4.4	5.2	2.5	-2.4
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	5.8	3.2	3.8	1.1
Hotels and restaurants	6.5	6.6	3.8	1.9
Transport, storage and communications	5.5	6.6	3.8	0.9
Financial intermediation	0.3	3.6	19.6	12.0
Real estate, renting and business activities	6.0	2.7	6.4	1.6
Public administration and defence; compulsory social security	-0.3	-3.2	0.8	1.1
Education	-1.8	-0.8	0.3	0.0
Health and social work	0.3	1.1	3.0	3.1
Other community, social and personal service activities	2.2	-0.4	-3.4	-0.9
Net taxes on goods	7.3	7.0	3.4	1.2
GDP at basic prices	4.1	3.8	3.4	1.3
Gross Domestic Product	4.5	4.3	3.4	1.3

Source: State Statistics Service

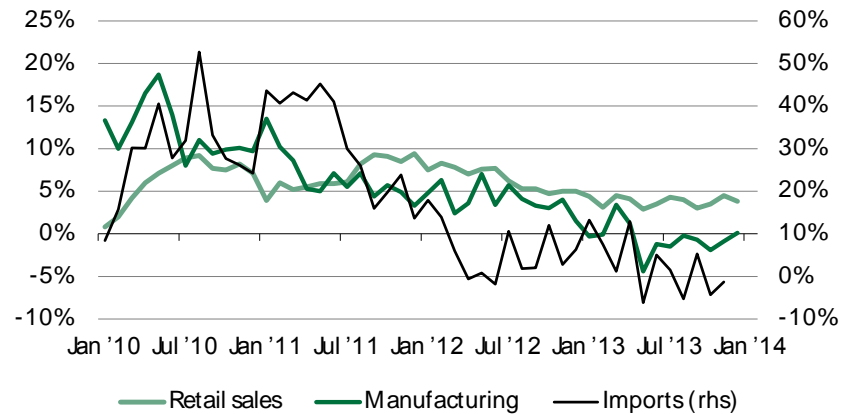
Industry stagnates amid decelerating domestic demand

Industrial output growth decelerating as generally expected, January 2006 = 100%



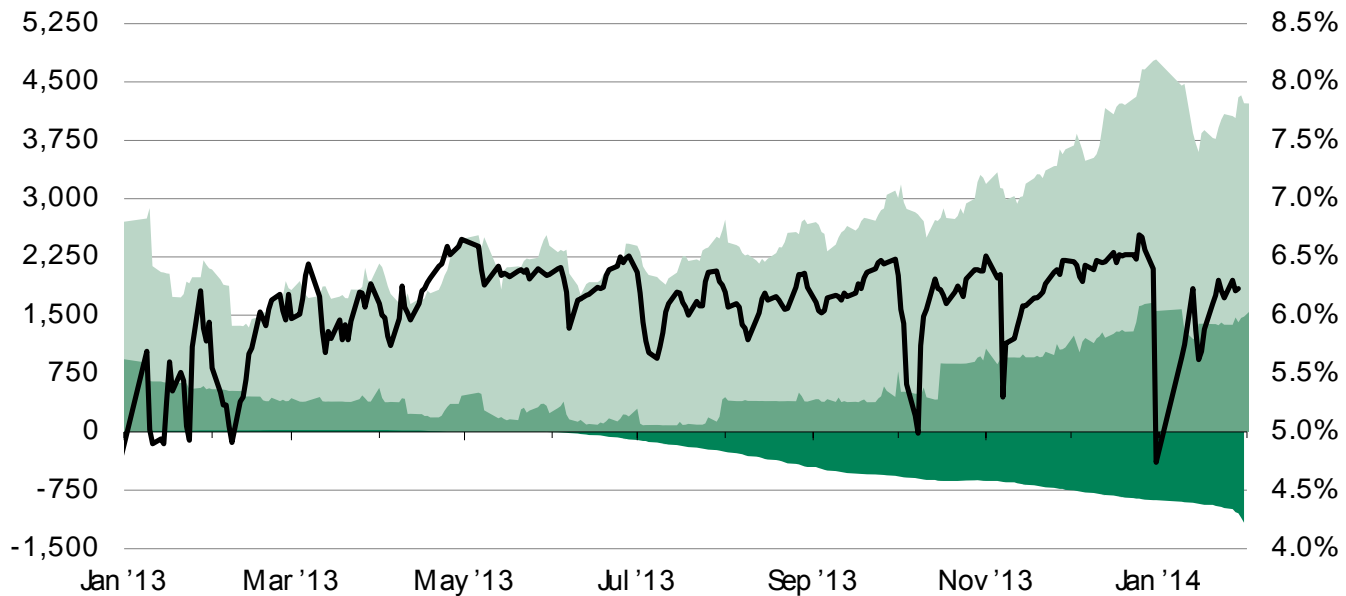
Source: State Statistics Service, Sberbank Investment Research

Retail, manufacturing and import growth, y-o-y



Source: State Statistics Service, Sberbank Investment Research

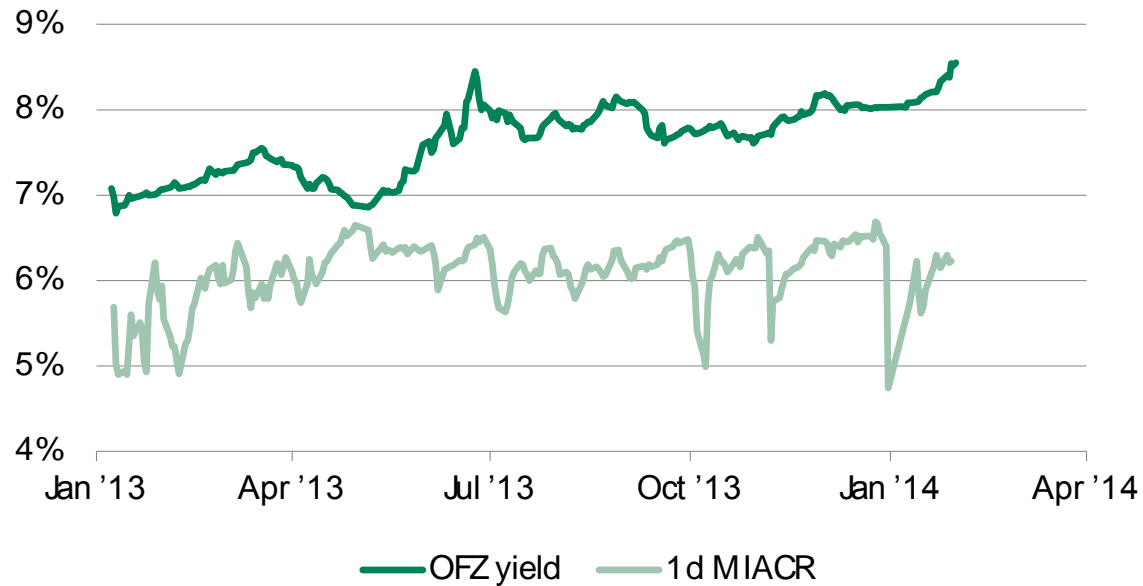
The Central Bank is increasing efforts to refinance banks but absorbs liquidity at the same time by buying forex; rates do not come down as a result.



- Central Bank credit to banks via repo. R mln
- Central Bank credit to banks excluding repo. R mln
- Accumulated Central Bank interventions. R bln (minus= selling)
- 1d MIACR (rhs)

Note: Central Bank credit includes currency swaps
 Source: Central Bank, Sberbank Investment Research

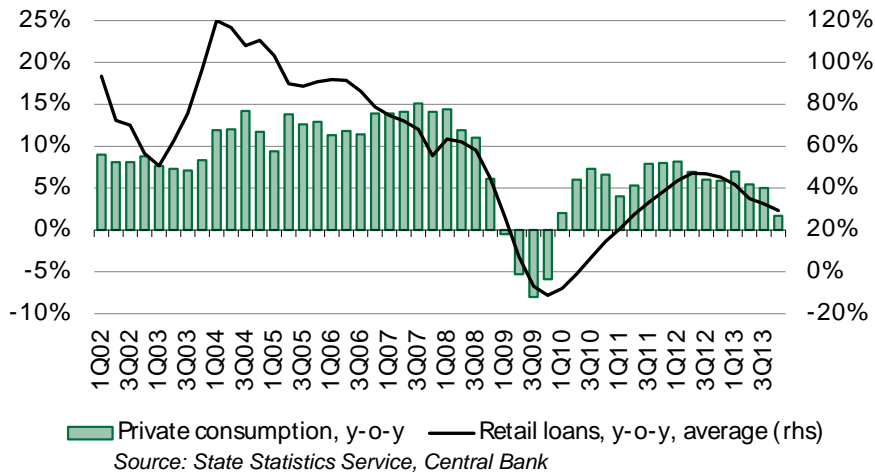
Despite massively increased refinancing to banks ODZ yields climbed



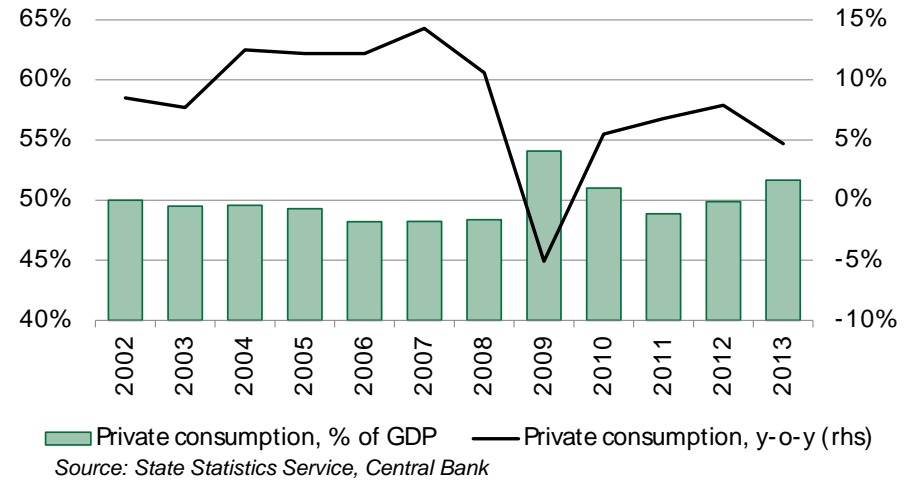
Source: Bloomberg, Central Bank

Consumption supported by consumer lending was a key driver of economic growth

Consumer credit supported consumption

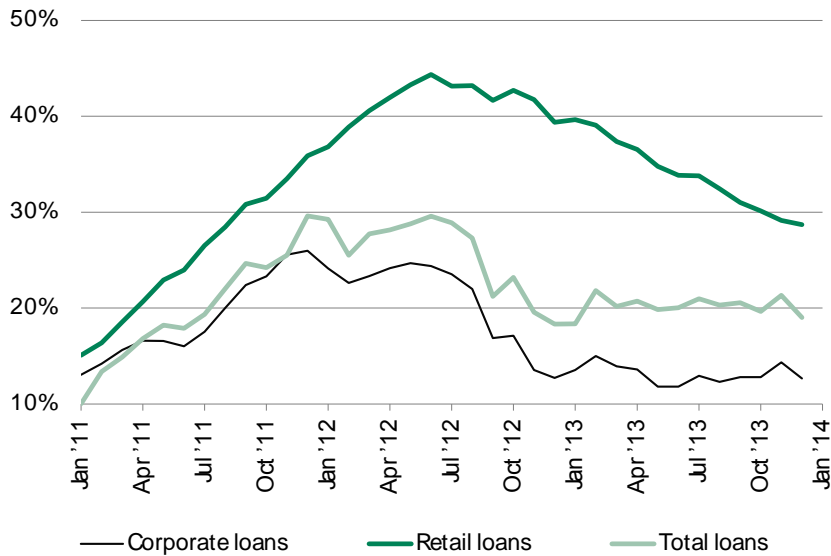


Private consumption was a key driver of economic growth, but its share in nominal GDP did not increase



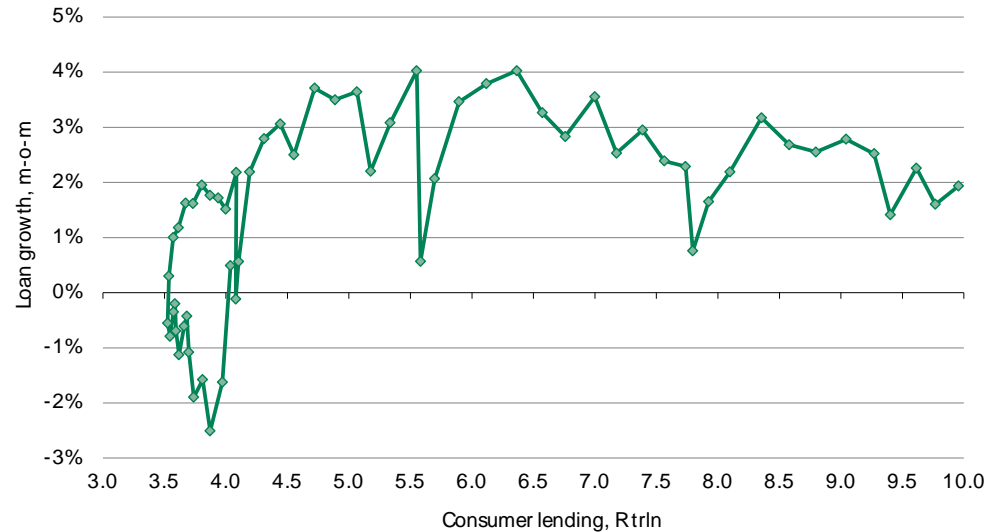
Consumer lending still grows too fast in 2011-13

Consumer lending expanded more than 40% in 2011 and early 2012, which also contributed to an acceleration in inflation, y-o-y



Source: State Statistics Service, Central Bank

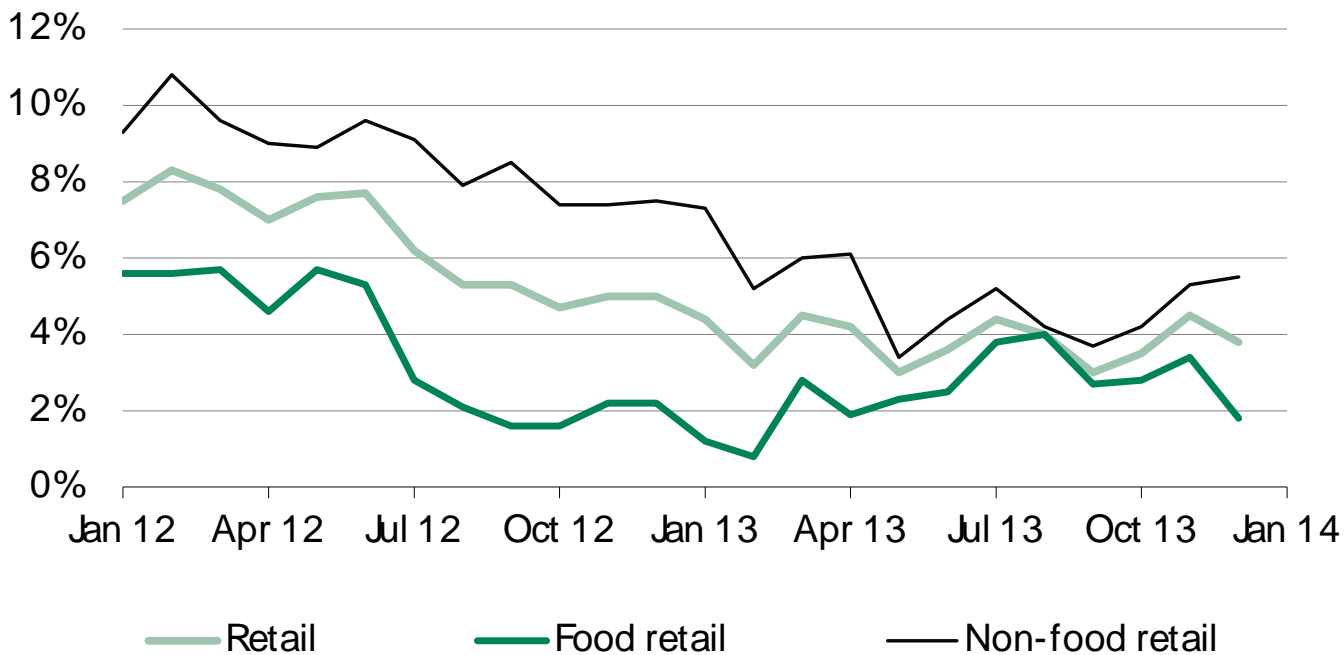
Consumer credits



Data: 2009-2013

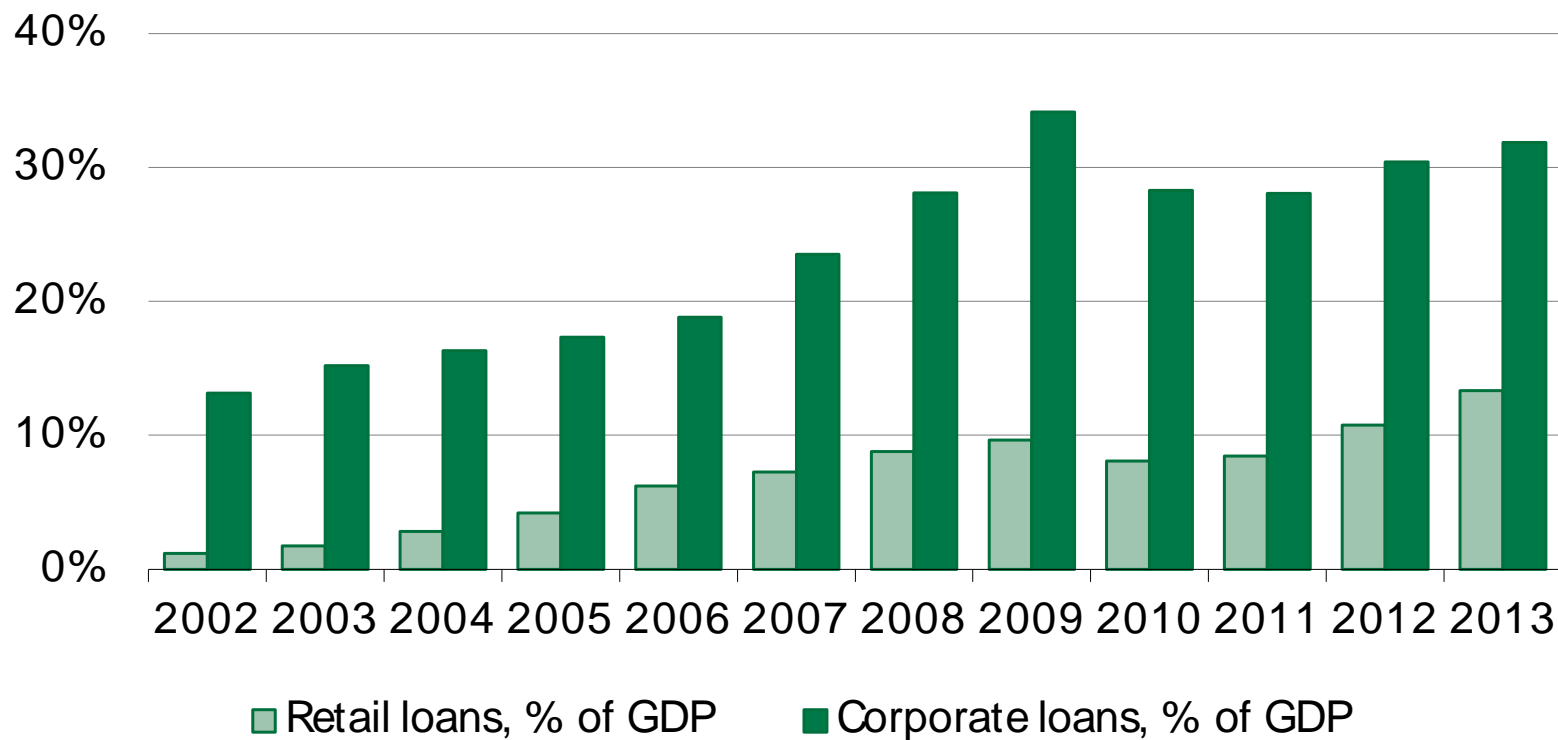
Source: State Statistics Service, Central Bank

Total, food and non-food retail growth, y-o-y



Source: State Statistics Service, Central Bank

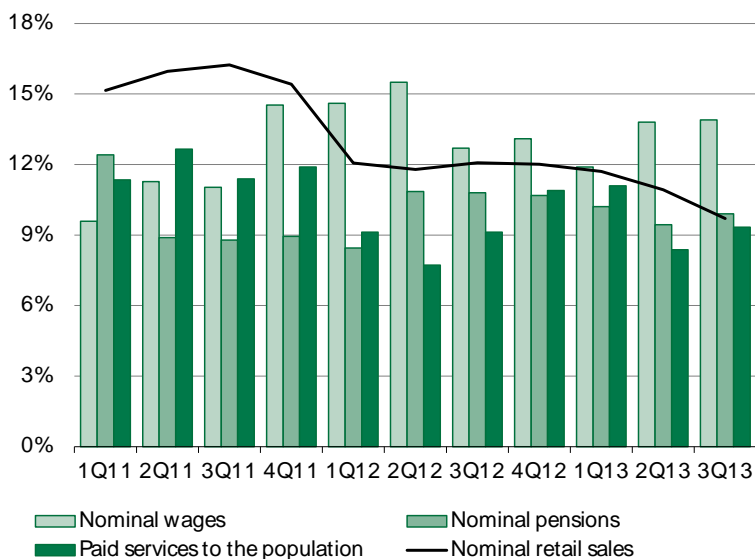
Bank credit/GDP ratios remain low and are set to rise, albeit moderately



Source: Central Bank, State Statistics Service

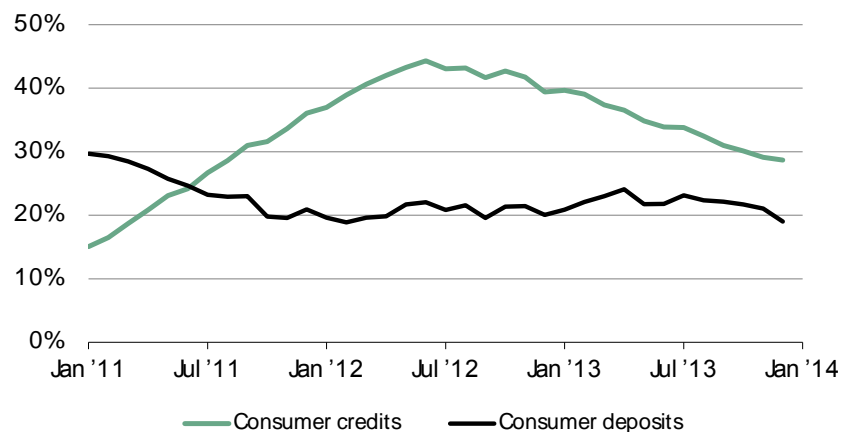
Nominal consumption growth decelerates despite stable and even accelerating nominal income growth...

Nominal income and retail sales, y-o-y



Source: State Statistics Service, Central Bank

Consumer credits and deposits, y-o-y



Source: State Statistics Service, Central Bank

... as interest rate on consumer loans are too high

Household income structure

	Total income	Income from business activities	Wages, including hidden wages	Social payments	Property income	Other income
1Q12	100%	9.1%	66.0%	18.8%	4.2%	1.9%
2Q12	100%	8.2%	64.9%	19.5%	5.4%	2.0%
3Q12	100%	8.8%	65.0%	18.5%	5.7%	2.0%
4Q12	100%	8.0%	68.5%	16.5%	5.0%	2.0%
2012	100%	8.5%	66.2%	18.2%	5.1%	2.0%
1Q13	100%	8.6%	66.2%	18.7%	4.6%	1.9%
2Q13	100%	8.0%	65.0%	19.3%	5.7%	2.0%
3Q13	100%	8.8%	64.9%	18.9%	5.4%	5.0%

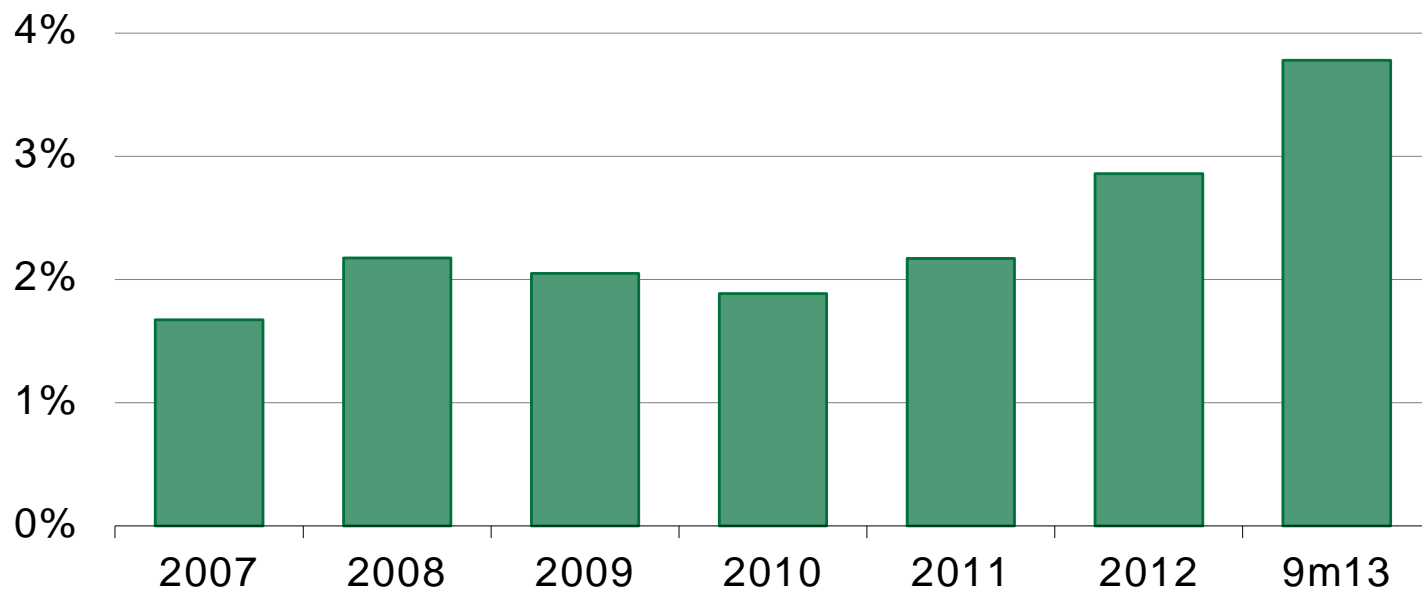
Source: State Statistics Service

Nominal interest rates on retail loans

	Individuals, maturity					
	<30d	31-90d	91-180d	181d-1y	<1y	>1y
Jan '11	14.0%	19.5%	31.8%	30.4%	27.2%	17.5%
Jul '11	12.6%	15.5%	27.3%	25.9%	22.7%	17.3%
Jan '12	13.7%	15.7%	31.9%	27.6%	25.4%	17.7%
Jul '12	13.3%	16.3%	27.6%	26.1%	24.7%	19.0%
Jan '13	15.4%	16.8%	27.9%	25.1%	24.0%	20.8%
May '13	19.8%	16.1%	28.4%	26.5%	25.2%	20.1%
Jun '13	20.6%	17.9%	28.3%	24.9%	24.4%	19.3%
Jul '13	21.9%	16.0%	27.0%	24.7%	24.0%	19.3%
Aug '13	23.5%	16.0%	25.5%	23.8%	23.6%	18.7%
Sep '13	24.1%	16.6%	25.2%	24.3%	24.1%	18.6%
Oct '13	24.3%	15.3%	25.3%	24.8%	24.2%	17.9%
Nov '13	23.6%	16.4%	24.3%	24.6%	24.1%	17.8%

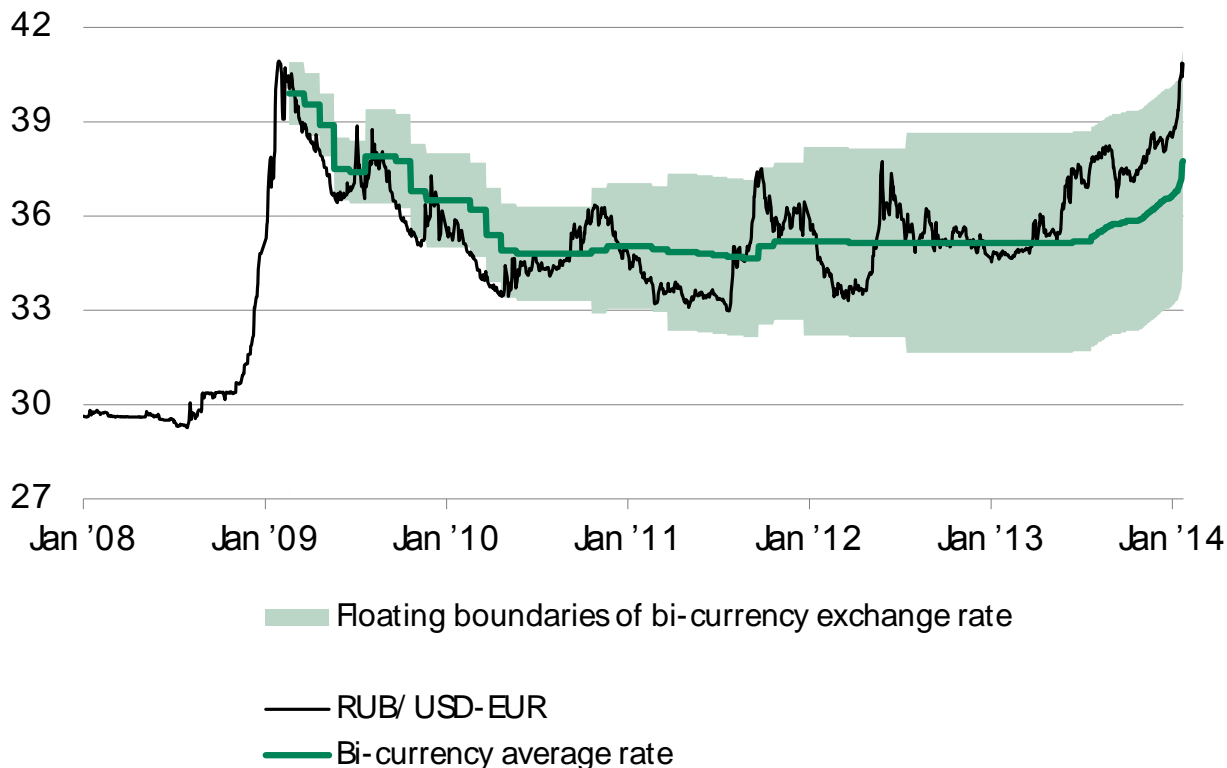
Source: State Statistics Service

Interest paid on retail loans/income ratio started to grow exponentially



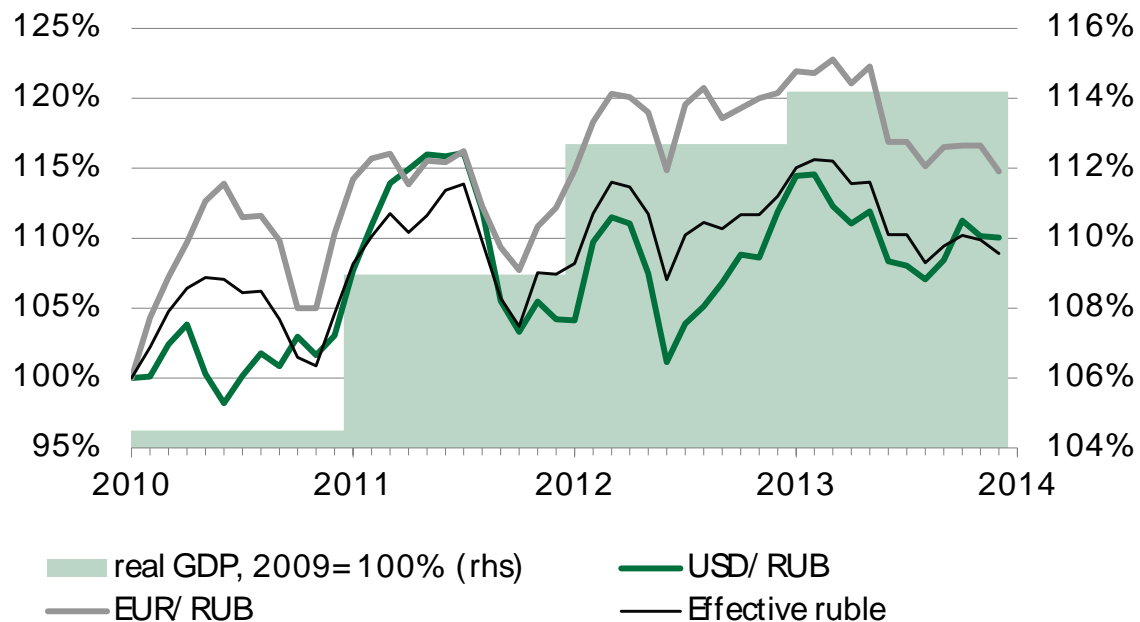
Source: Central Bank, State Statistics Service, Sberbank Investment Research

Flat currency band looks unreasonable amid high inflation and in fact it organically and quietly faded into oblivion.



Source: Central Bank

Real appreciation of the ruble was moderate in the past years



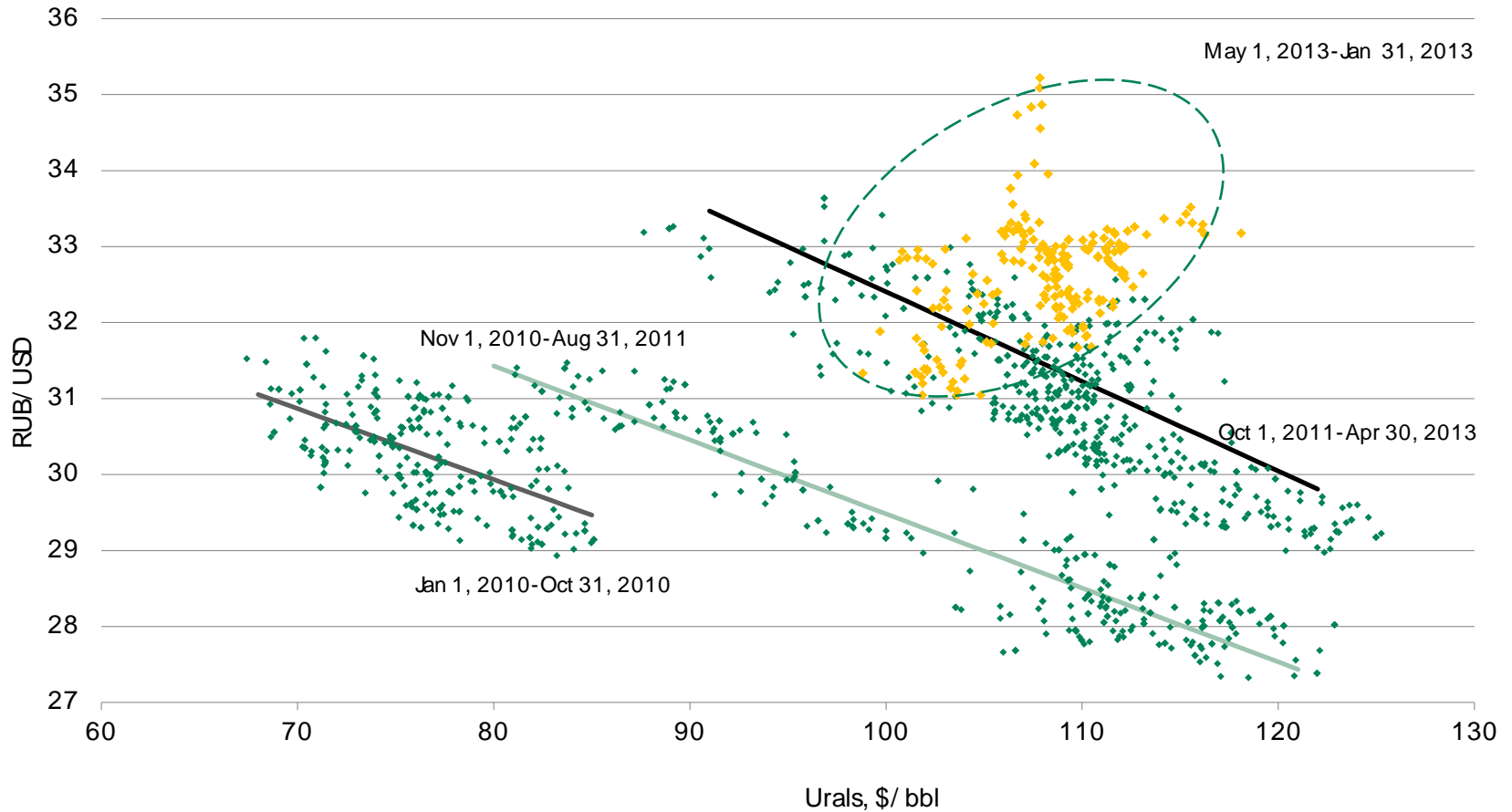
Source: Central Bank, State Statistics Service, Sberbank Investment Research

Oil price and domestic inflation are key determinants of the exchange rate moves in the long run



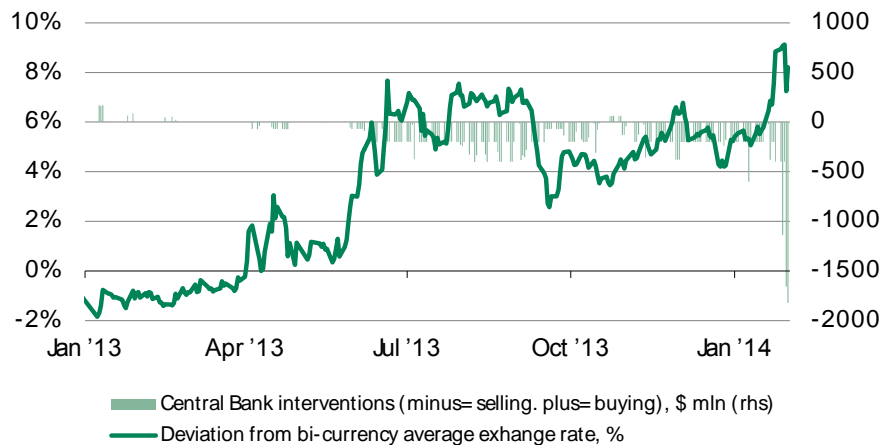
Source: Central Bank, Bloomberg, Sberbank Investment Research

New equilibrium has yet to emerge

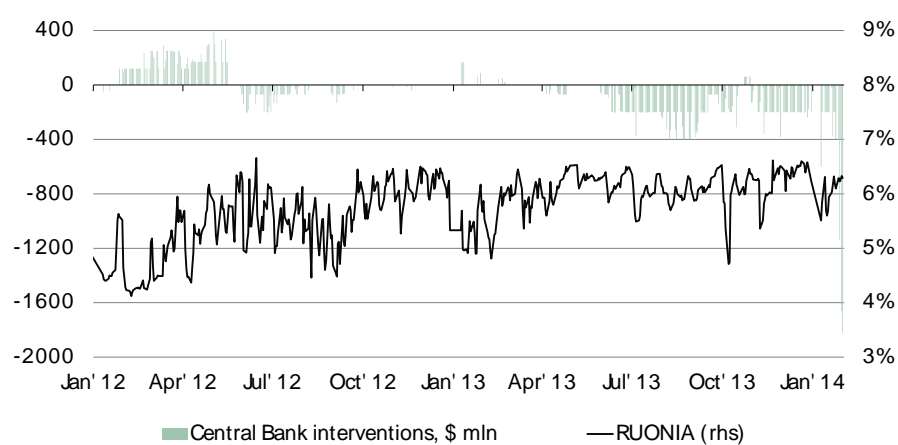


Source: Central Bank, Sberbank Investment Research, Bloomberg

Internal regulations force the Central Bank to support the ruble if it moves away from the median of the band

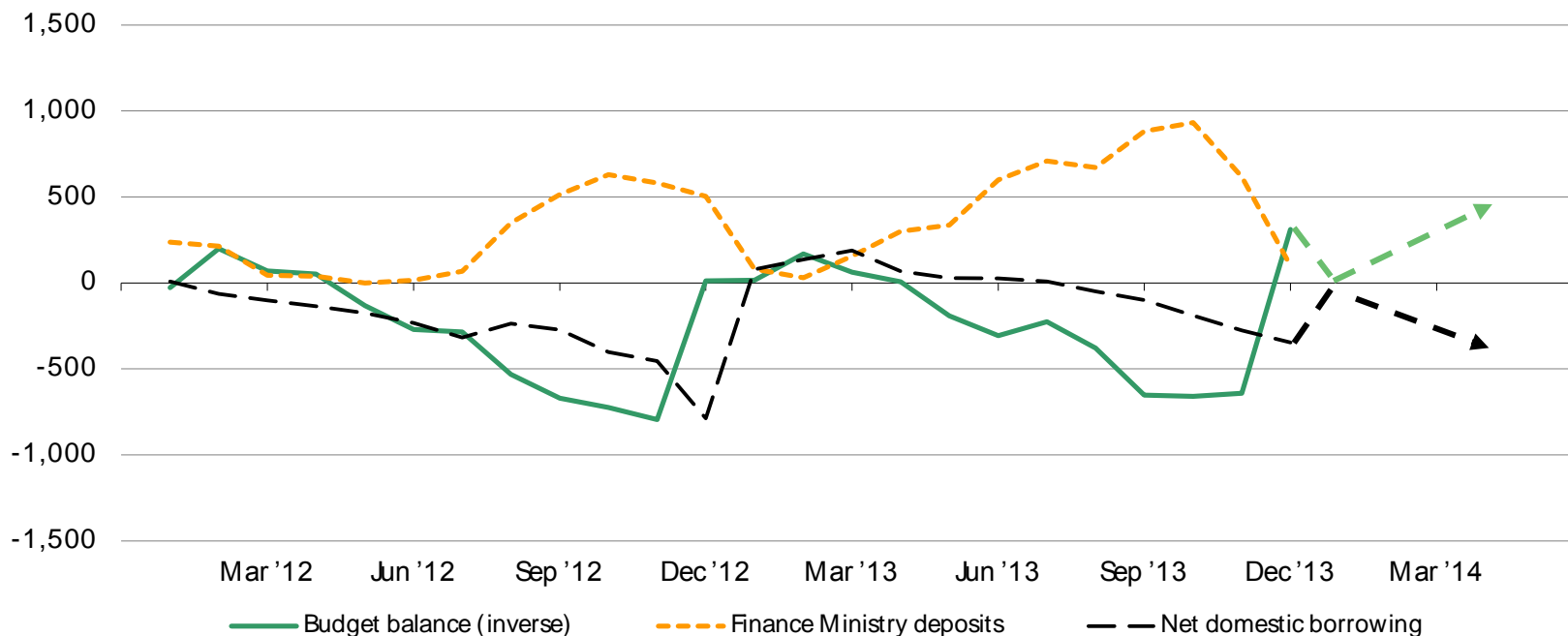


Source: Central Bank, Sberbank Investment Research



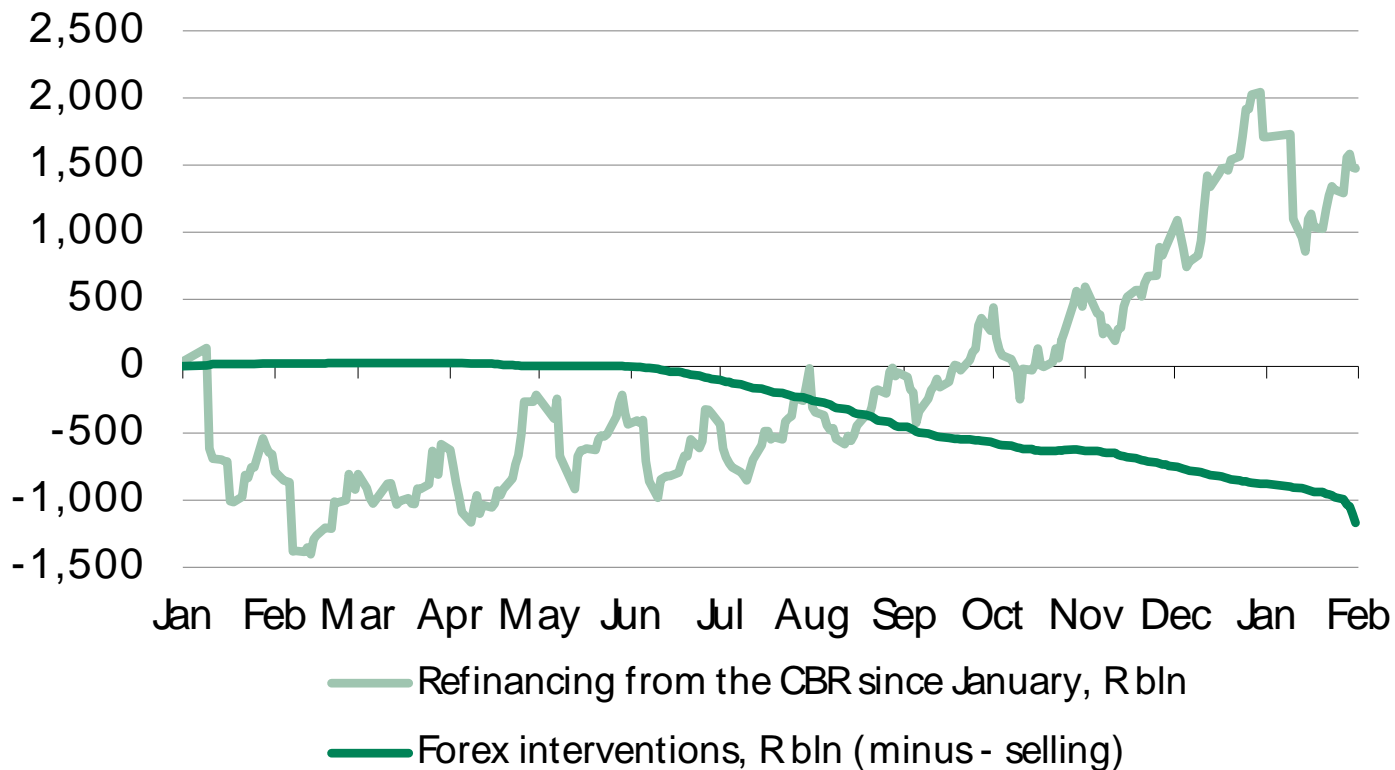
Source: Central Bank, Sberbank Investment Research

The massive liquidity absorption by the Finance Ministry destabilized money markets in mid 2012, R bln



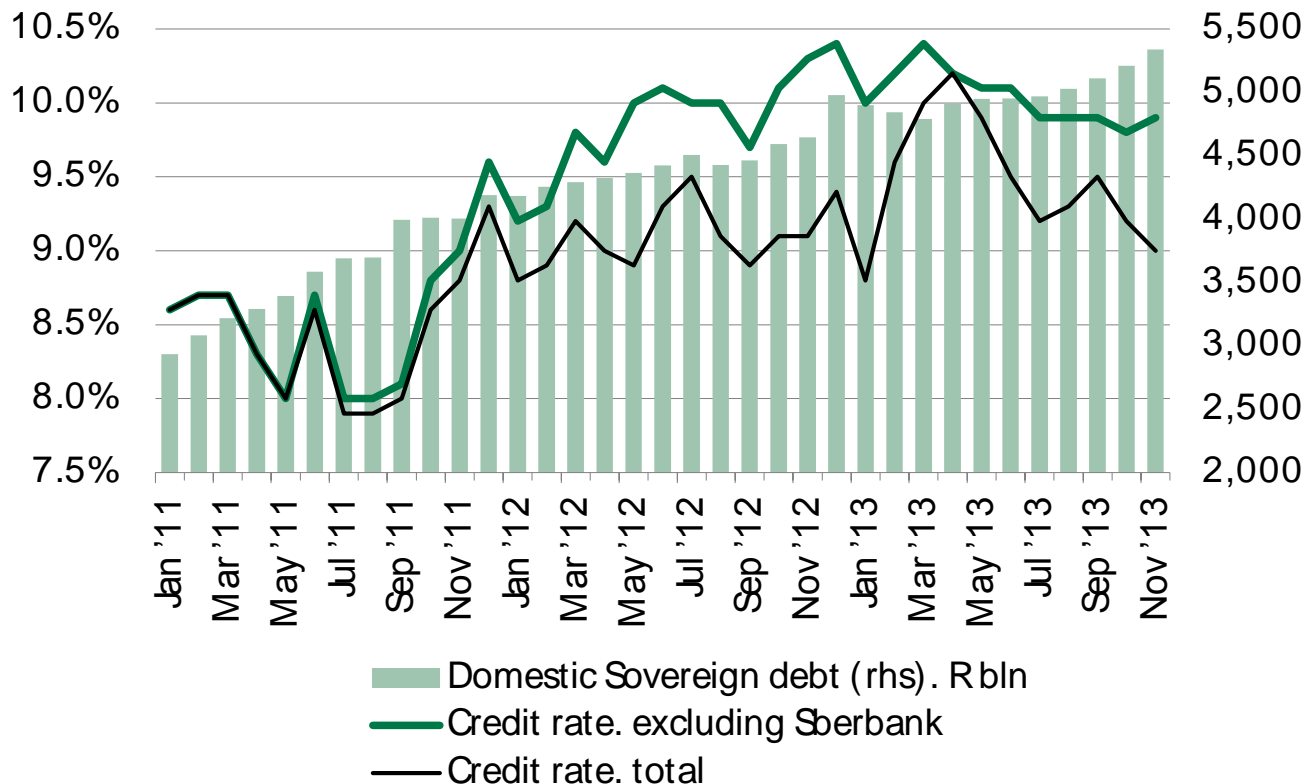
Note: Injection of liquidity (+), absorption of liquidity (-)
 Source: Finance Ministry, Central Bank, Sberbank Investment Research

Increase in refinancing to banks by the CBR and interventions on the forex market in 2013 and January 2014



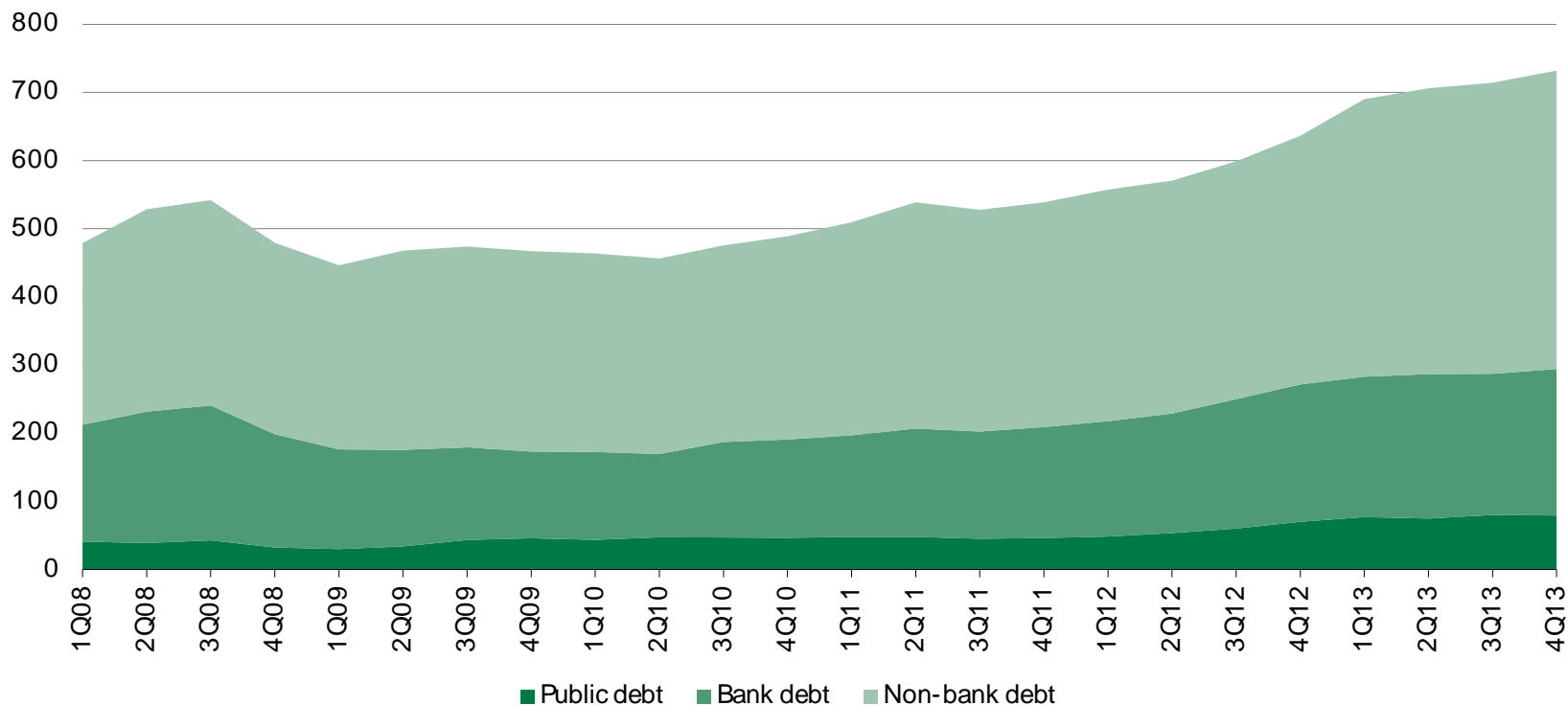
Source: Finance Ministry, Central Bank, Sberbank Investment Research

Credit rates for the corporate sector grew in 2012 amid increased and domestic Sovereign borrowing, but both stabilized in 2013



Source: Central Bank, Finance Ministry

Although external debt has grown, foreign debt payments are bearable, \$ bln

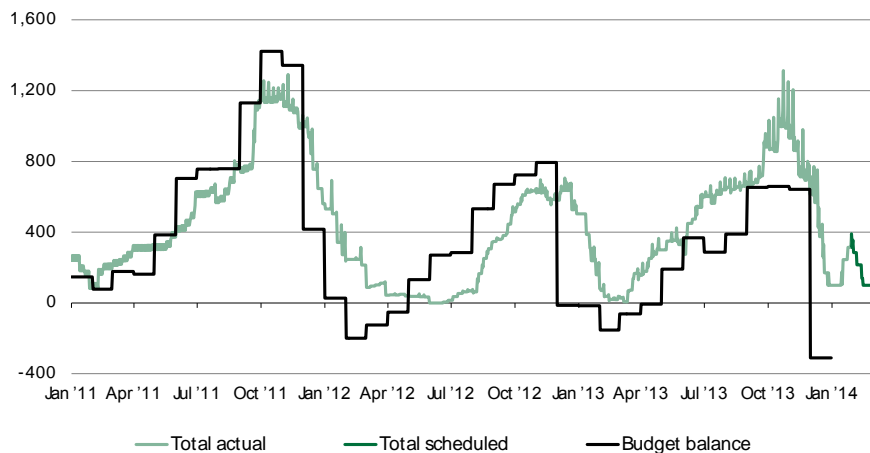


	Total debt as of Jan 1, '14	Demand debt	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	Over 2 years	Schedule undetermined	No schedule
Total	732.0	40.2	28.7	27.9	18.1	28.4	22.1	11.8	378.1	36.5	16.4
Public debt	79.3	4.4	1.2	0.3	0.8	0.3	0.7	2.1	48.6	0.5	0.3
Bank debt	214.9	22.5	8.5	15.8	6.3	4.7	5.2	1.8	91.3	26.9	0.0
Non-bank debt	517.1	13.3	19.0	11.8	11.0	23.3	16.3	7.9	238.1	9.0	7.5

Source: Central Bank

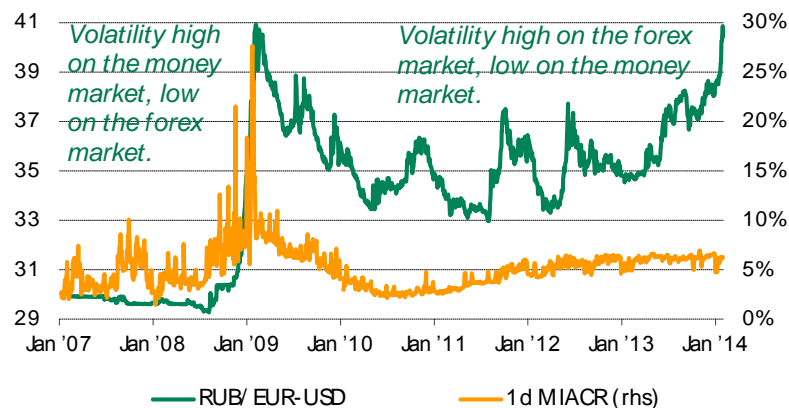
The Central Bank and the Finance Ministry intervene on the money markets jointly but with little coordination

The Finance Ministry has become an important player on the money market, R bln



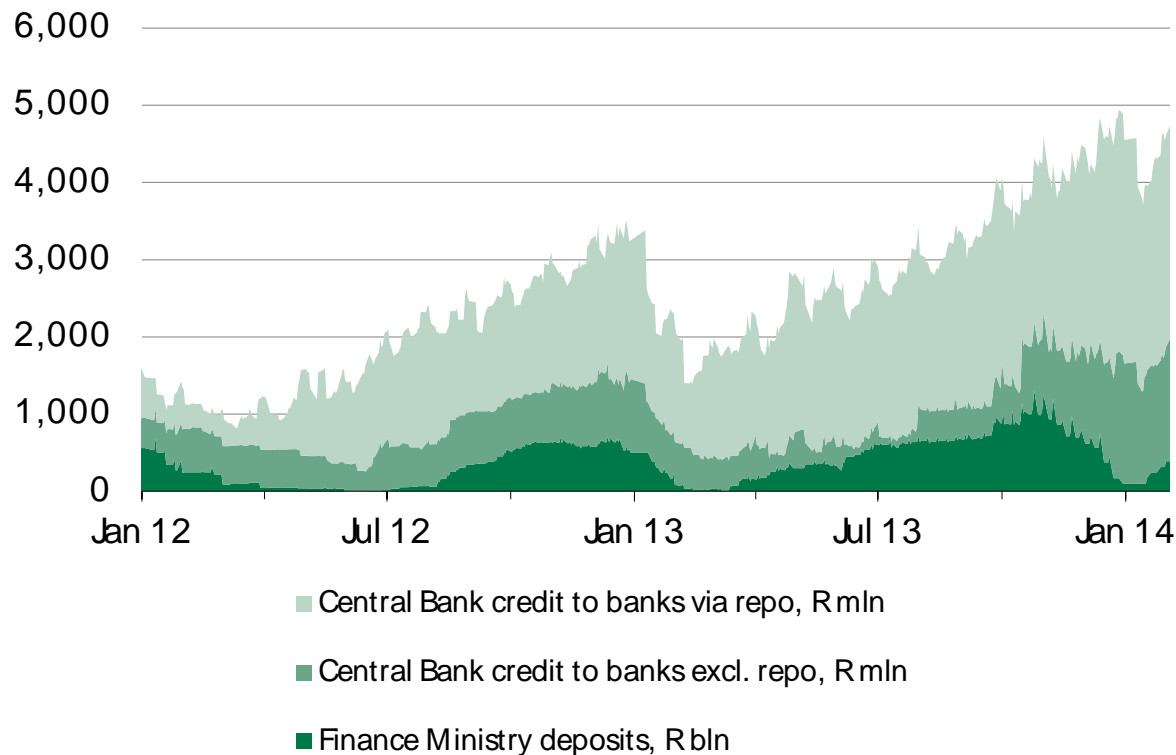
Source: Finance Ministry, Central Bank

Since 2009, the forex market is more volatile than the ruble money market as monetary policy has changed



Source: Central Bank

The Central Bank again increased long-term lending to banks against illiquid collateral since July 2013

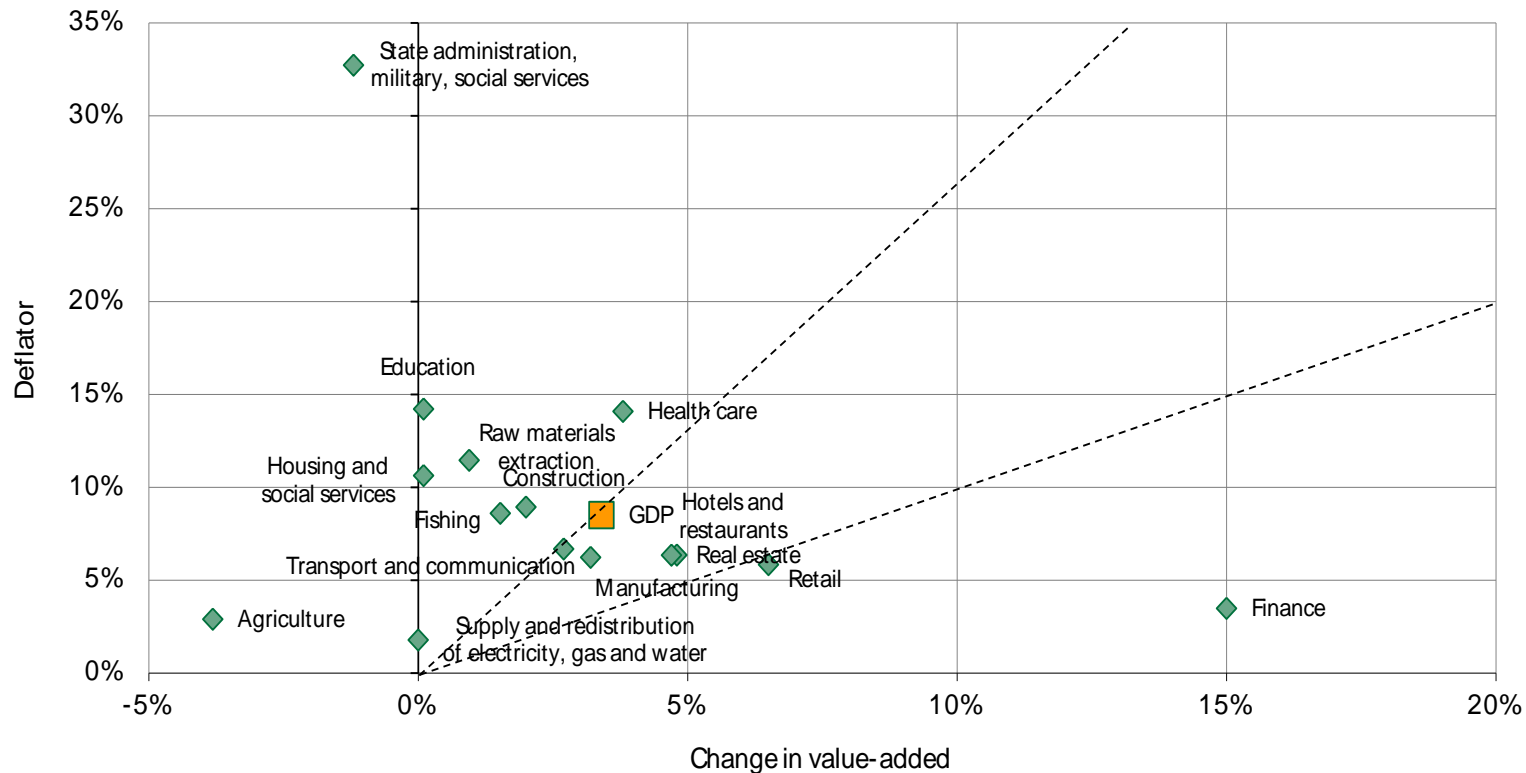


Source: Finance Ministry, Central Bank

Inflation remains the key problem for Russia

- **The CPI edged up 0.5% m-o-m in December 2013, while in y-o-y terms it remained at 6.5% in 2013, which higher than from 6.1% in early September.** In our base case, annual inflation will be around 6% in 2014 (could be even lower) once the CBR policy is corrected.
- **Contrary to the IMF, EBRD, etc., we do not think that the Russian economy is slowing down because it has reached capacity (car production and sales are shrinking, for instance), nor do we think that capacity constraints are causing inflation.** We think it is slowing down because of policy mistakes that can be rectified. These mistakes also contribute to inflation, as does excessive redistribution of income.
- **High inflation combined with regulators' chaotic interventions, such as those aimed at limiting nominal depreciation of the ruble, cause the real effective ruble to appreciate, thus limiting growth and deteriorating the balance of payments (current account fell to \$33bln in 2013).**
- **Persistently high inflation remains Russia's major macroeconomic problem and points to a number of shortcomings in economic policy.** As said, the latter are expected to be gradually resolved in 2014.
- **Russia has no major macroeconomic constraints on growth (i.e. high leverage, which limits the growth potential of some countries).**

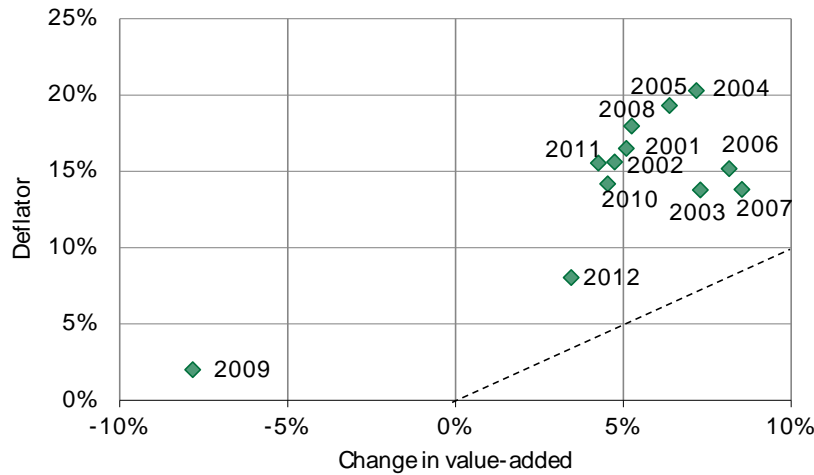
Too high inflation is many sectors: value-added growth and deflators by sector, 2012, y-o-y



Source: State Statistics Service, Sberbank Investment Research

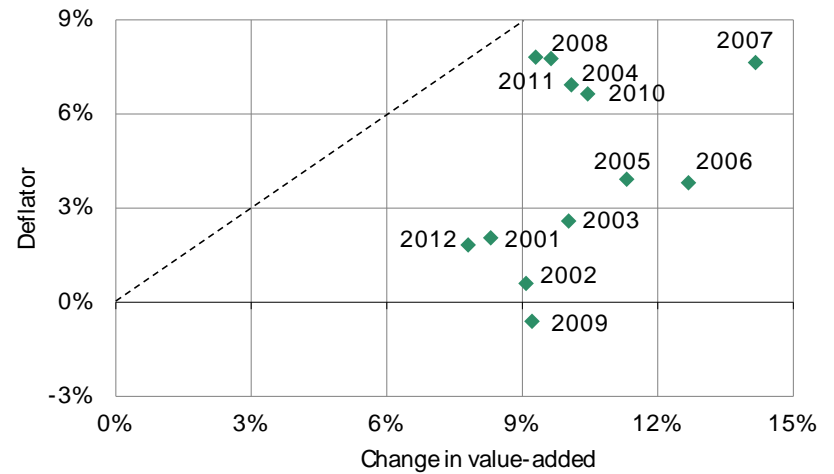
As opposed to many other countries, such as China, Russia's nominal GDP growth is more driven by inflation than by real output

Russia's GDP growth and deflators, 2001-2012



Source: State Statistics Service, Sberbank Investment Research

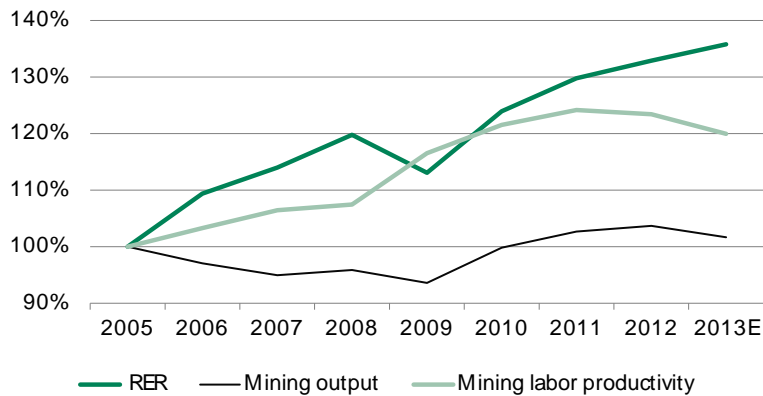
China's GDP growth and deflators, 2001-2012



Source: State Statistics Service, Sberbank Investment Research

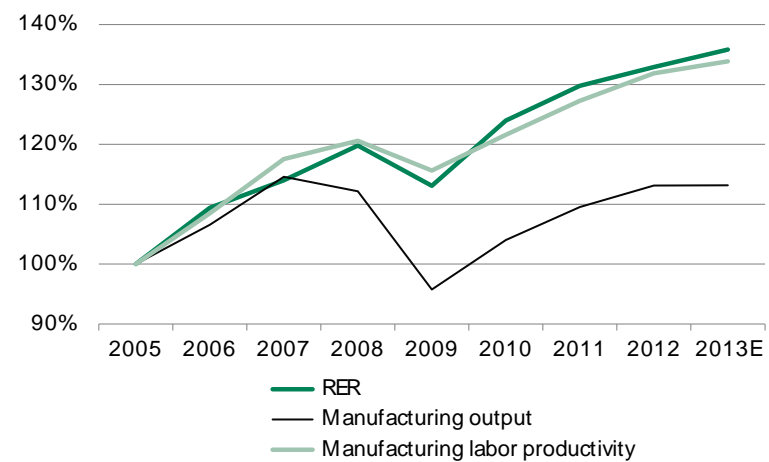
Real appreciation of the ruble limits growth in the tradable sector

Valued added, labor productivity of the mining sector and real effective rate (REER), 2005=100%



Source: Rosstat, Central Bank, Sberbank Investment Research

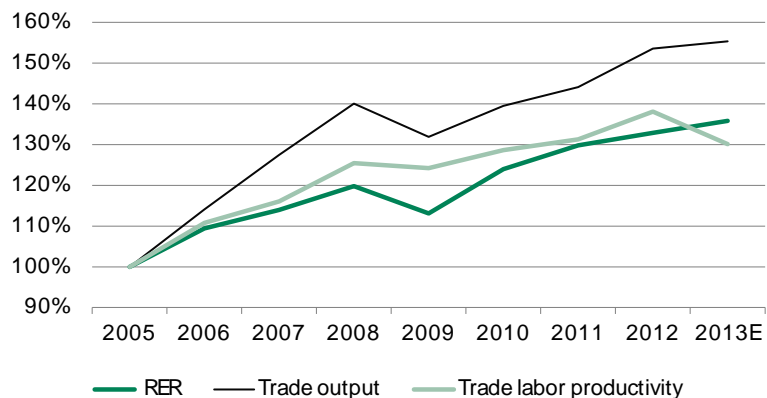
Valued added, labor productivity of the manufacturing sector and real effective rate (REER), 2005=100%



Source: Rosstat, Central Bank, Sberbank Investment Research

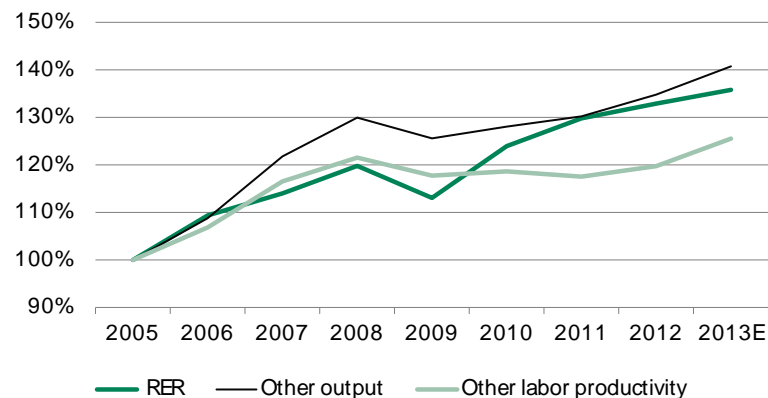
... while the non-tradable sector grows faster

Valued added, labor productivity of the trade sector and real effective rate (REER), 2005=100%



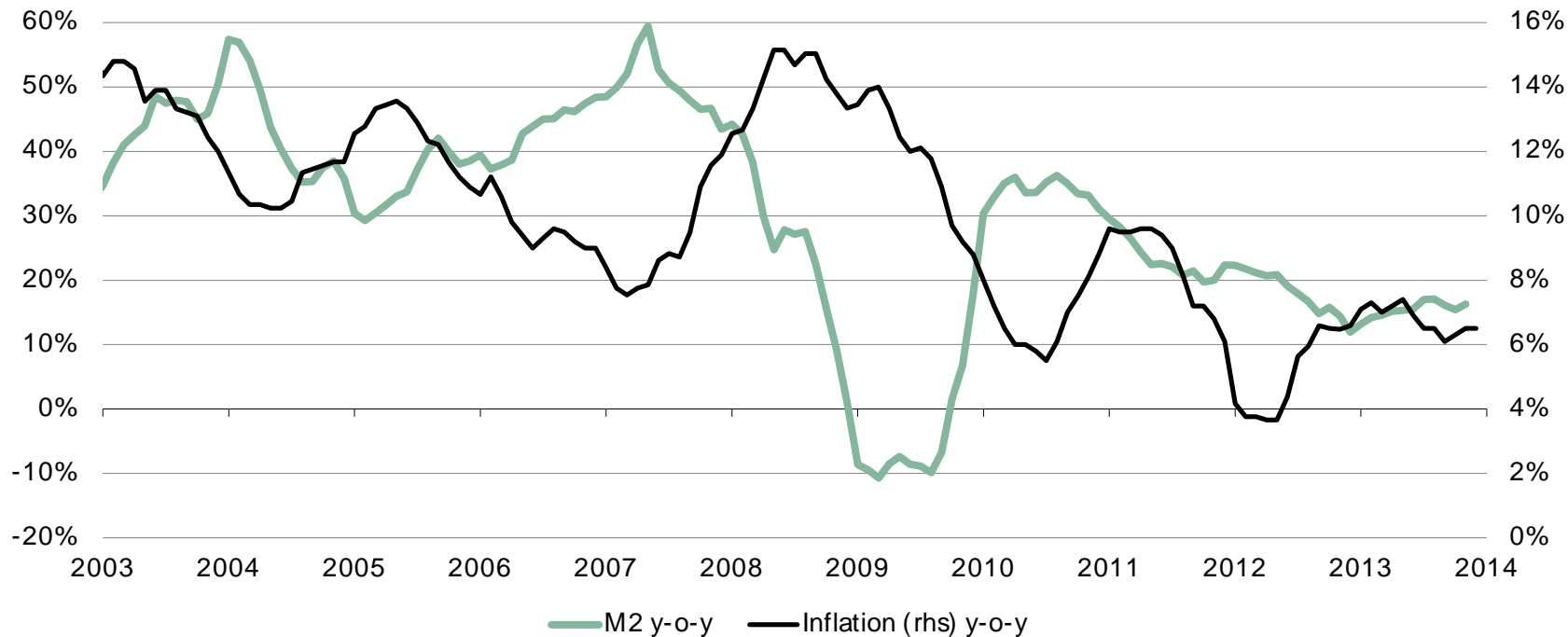
Source: Rosstat, Central Bank, Sberbank Investment Research

Valued added, labor productivity of the other sectors and real effective rate (REER), 2005=100%



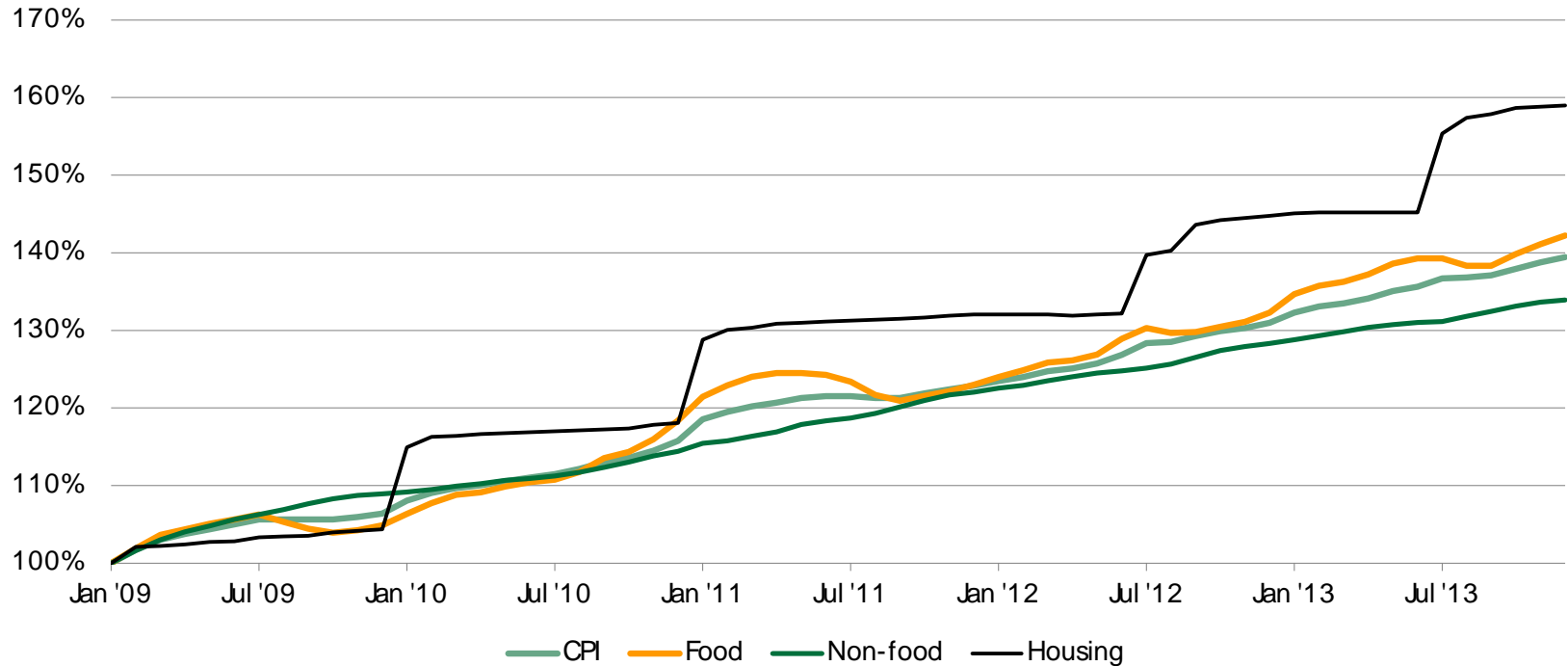
Source: Rosstat, Central Bank, Sberbank Investment Research

Inflation accelerated in 2H12 amid moderate money supply growth, but should decelerate in 2H13



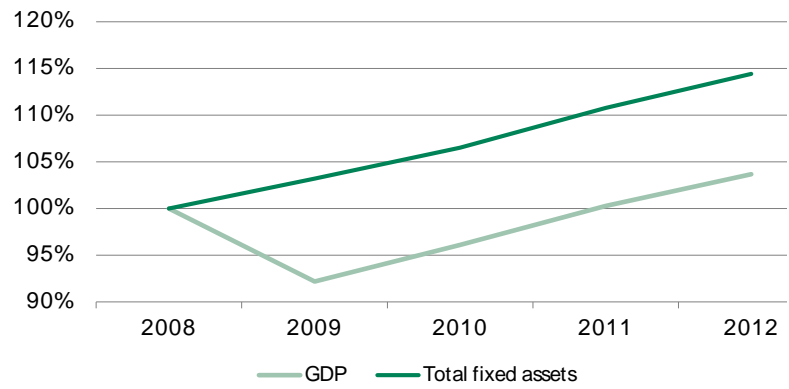
Source: State Statistics Service, Central Bank

Utility tariff indexation has a limited impact on CPI, January 2009=100%

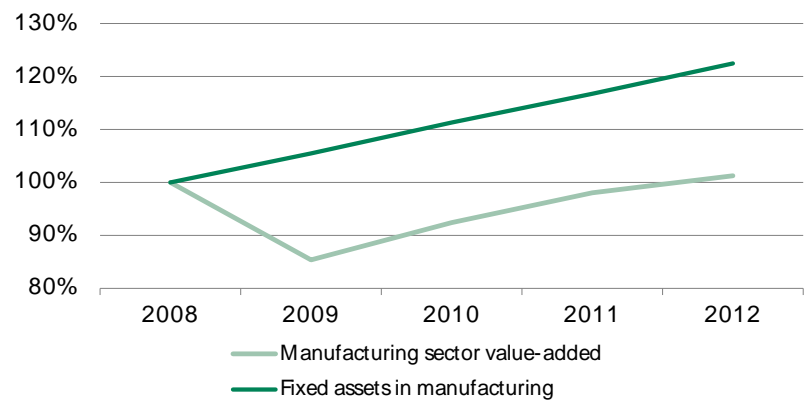


Source: State Statistics Service

Russia's high inflation is not caused by the disappearance of the output gap, as potential output is not increasing fast enough due to a lack of investment, 2008 = 100%

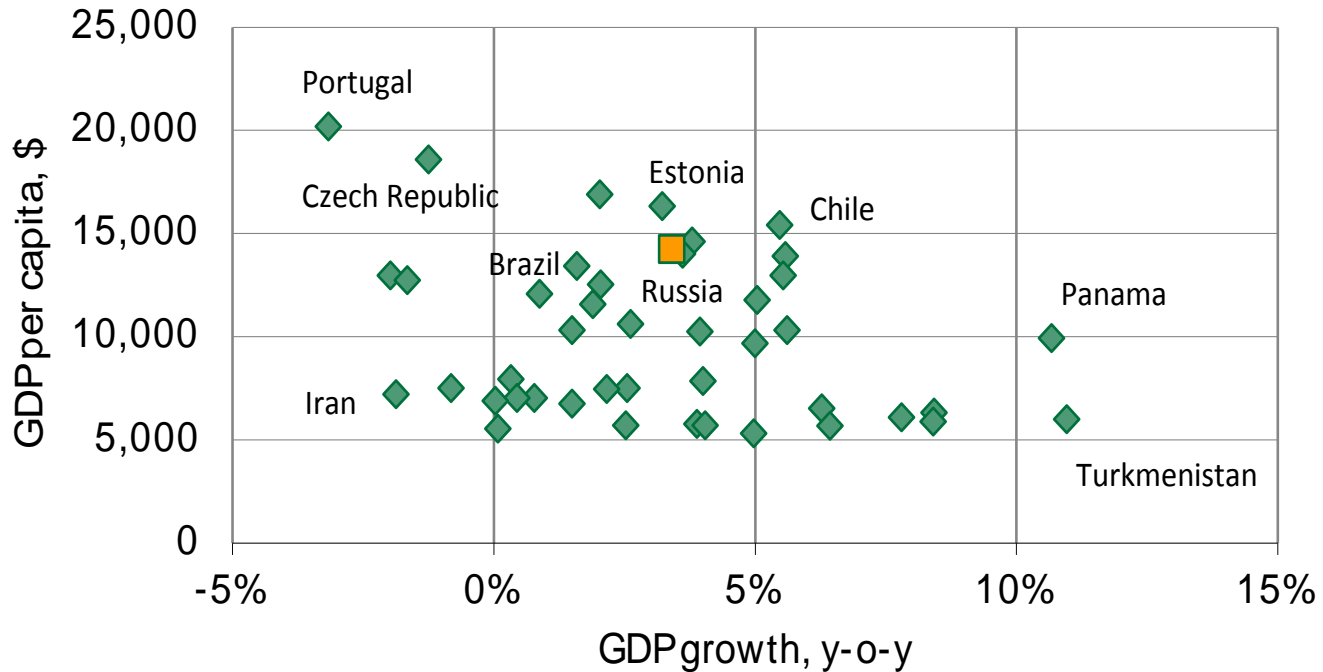


Source: State Statistics Service, Sberbank Investment Research



Source: State Statistics Service, Sberbank Investment Research

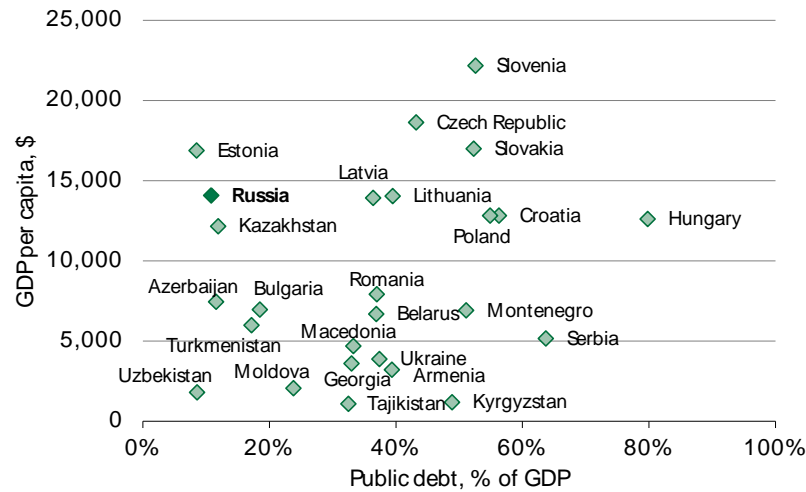
The wealthier the country, the slower the growth expected



Source: IMF, Sberbank Investment Research

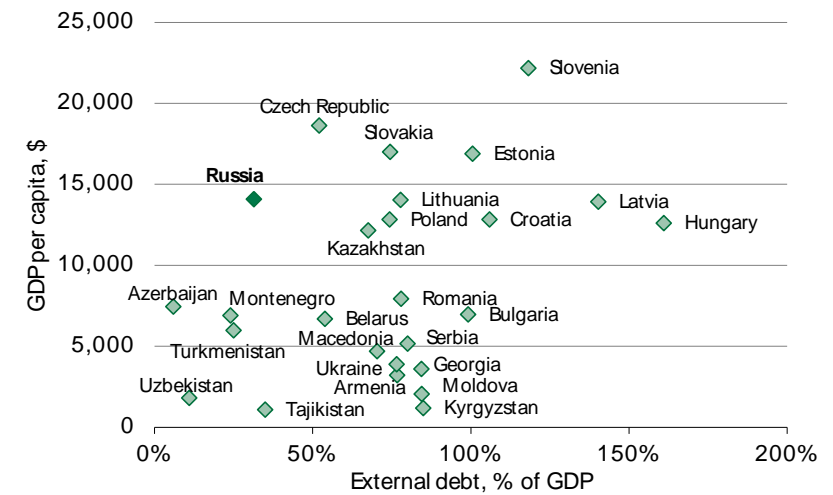
Russia's indebtedness is low compared with peers

GDP per capita and gross public debt in East European countries and the FSU, 2012



Source: State Statistics Service, Sberbank Investment Research

GDP per capita and external debt in East European countries and the FSU, 2012



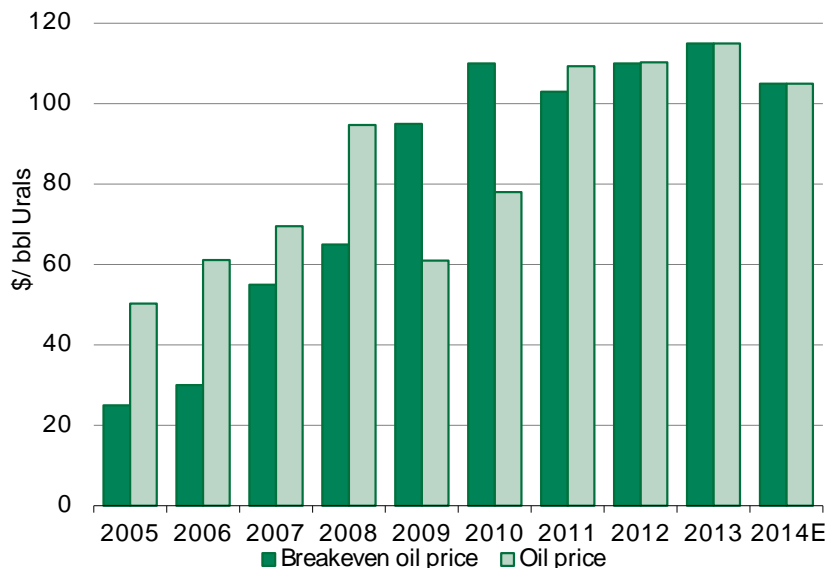
Source: State Statistics Service, Sberbank Investment Research

Budget will remain in good shape, the fiscal rule having been effectively abandoned

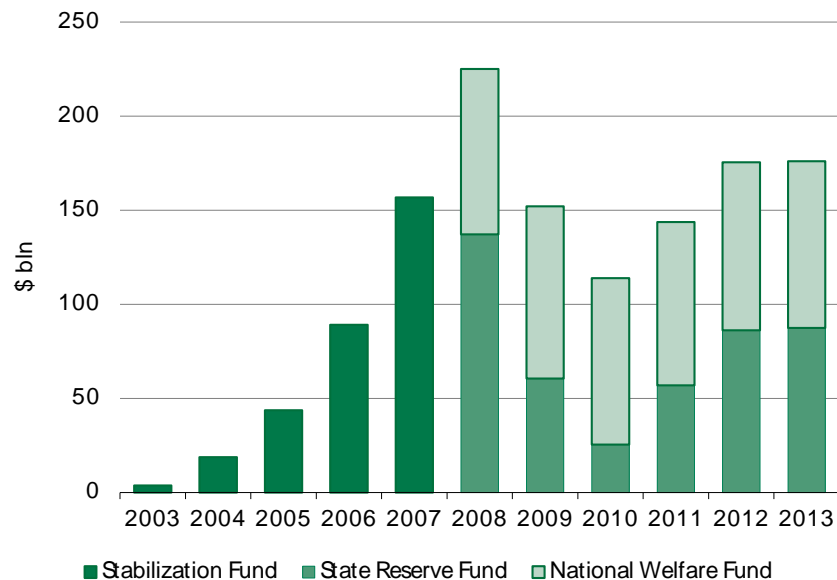
- **One risk associated with the idea of reintroducing the fiscal rule from 2013 and replenishing the State Reserve Fund was that the government planned to continue to borrow on the local market even in the event of a budget surplus.** A “borrowed safety net” appeared to be costly and does not seem reasonable, as it has crowded out other borrowers.
- **The budget ran a surplus in 11m13 but moved into deficit by year end as expenditures were behind target.** As rates are high, the government’s local borrowing plans are also behind target, implying limited scope to replenish the State Reserve Fund. The weaker ruble will keep the breakeven oil price relatively unchanged.
- **The breakeven price in 2012 was around \$110/bbl and was probably around the same level in 2013.** It is impossible to calculate the future breakeven price of oil accurately, as it depends not just on budgetary expenditures but on revenues as well. The latter is a function of the exchange rate, which itself depends on the current oil price. Hence, the future breakeven oil price is a function of the future oil price. The more flexible the exchange rate policy is, the more resilient the budget is to external shocks; however, the currency band limits ruble depreciation.
- **We expect the currency band to be gradually abolished at some point in 2014, while the budget is unlikely to run a surplus during the year.** Locally borrowed money will therefore be returned to the economy (not to the reserve fund, as happened in 2012), implying a neutral impact on money markets. No deposit auctions are expected this year, leaving the Central Bank as the sole provider of liquidity to the system.

Russia's breakeven oil price has risen substantially in recent years but seems to have stabilized as the ruble started to float

Budgetary policy was generous in the past decade, and the State Reserve Fund shrank in 2009-10 before returning to growth in 2011.

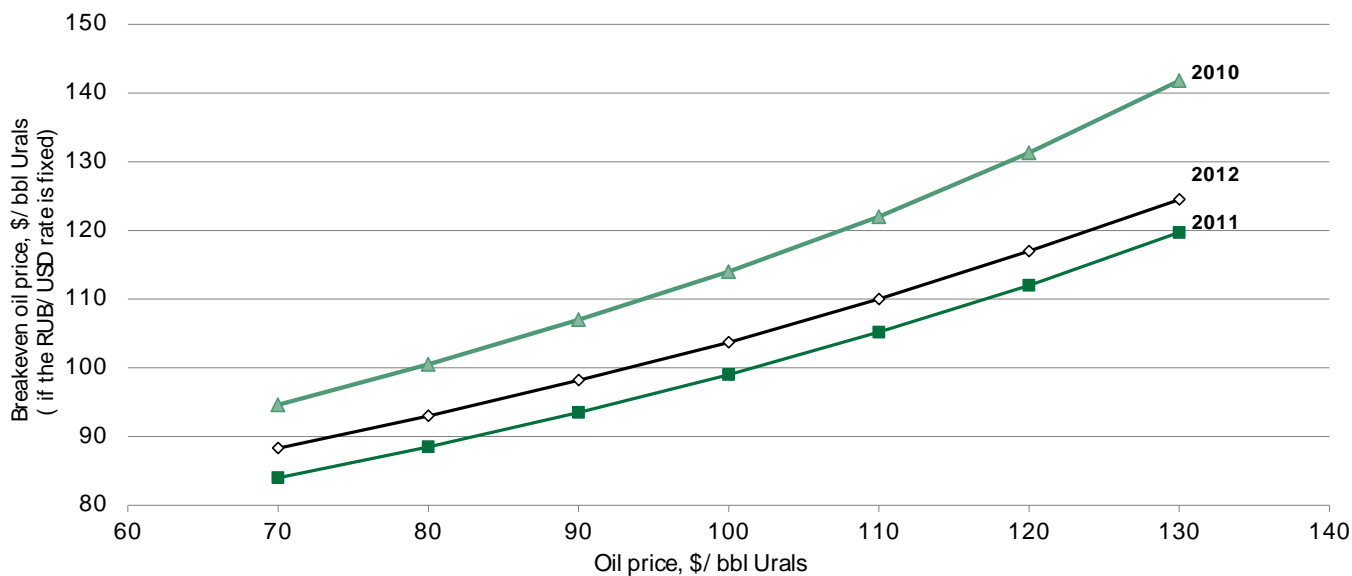


Source: Finance Ministry, Sberbank Investment Research



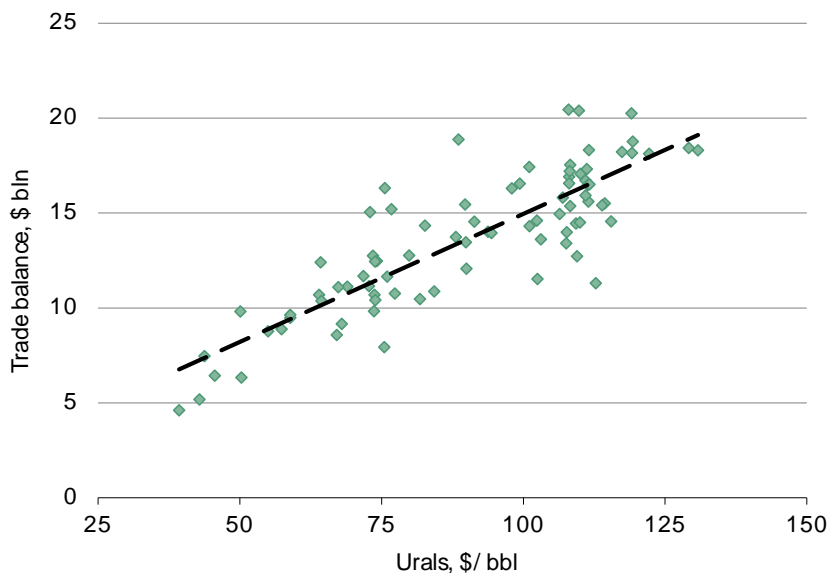
Source: Finance Ministry, Sberbank Investment Research

The budget breakeven oil price is only a theoretical concept and is a function of the oil price itself, not expenditures alone

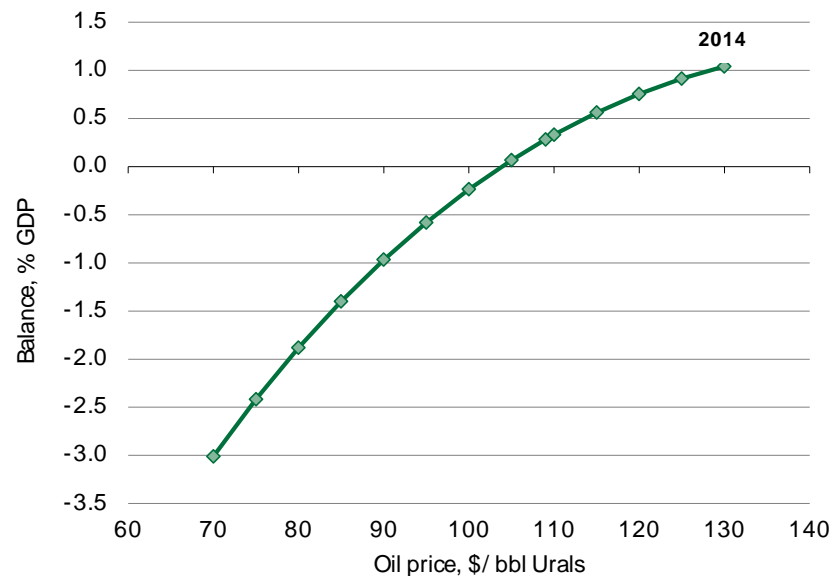


Source: Sberbank Investment Research

Case study: the trade balance would remain highly positive and the budget deficit would be limited if the oil price were to stay at \$80/bbl



Note: Data from January 2007 to November 2013
Source: Central Bank, Finance Ministry, Sberbank Investment Research



Source: Central Bank, Finance Ministry, Sberbank Investment Research

Expenditures will rise moderately in 2014 which will support disinflation

	2013	2014	2015	2016
Revenues, R bln	13,020	13,571	14,565	15,906
Revenues, % GDP	19.2%	18.5%	18.3%	18.3%
Expenditures, R bln	13,330	13,960	15,362	16,392
Expenditures, % GDP	19.6%	19.0%	19.3%	18.9%
Balance, R bln	-310.5	-389.6	-796.6	-486.5
Balance, % GDP	-0.5%	-0.5%	-1.0%	-0.6%
Cutoff price (5y average)	93.0	93.0	95.0	95.0
Oil price, \$/ bbl, average	108.8	101.0	100.0	100.0

Source: Finance Ministry, Federal Law «On the Federal Budget for 2014 and the planning period of 2015 and 2016»

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