Economics

ING FINANCIAL MARKETS

Russia

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The 1998 crisis in retrospect

Now a distant memory

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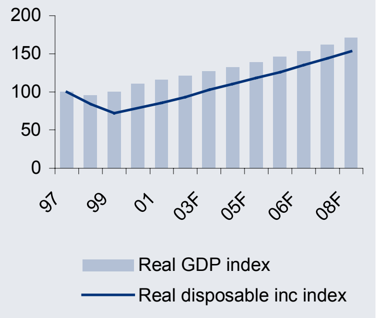
Russia has emerged from crisis in better shape than at any time during the transition. Growth should continue as structural reforms are applied. 1998 is now a distant memory and an investment grade rating is possible in 2004/05.

Inter-related economic and political problems made the 1998 crisis unavoidable. It resulted in domestic debt default, a 50% devaluation in real terms and selective default on external debt. Financial asset values collapsed and the banking system was decimated.

Recovery from crisis has been swift. Domestic production was revived on the back of import substitution and the positive supply response was extremely encouraging. The government managed to significantly improve fiscal performance and to avoid hyperinflation. Russia is now enjoying its fifth year of the consequent economic growth and political stability. World trade conditions also played an important part in recovery and firmer commodity prices strongly supported the return to growth from mid-1999.

We are optimistic about economic development in the mid term. We expect further political consolidation and promotion of structural reforms. Reform implementation should stimulate productivity growth and improvement in competitiveness and help to reduce the on-going economic dependence on external factors. Structural reforms will also help to accelerate economic growth and improve the business environment in the mid term.

GDP and income growth



Source: Goskomstat, ING estimates

What was the nature of the problem in 1998?

Political instability led to economic weakness

During the Yeltsin years (particularly his second term) extremely divergent economic and political interest groups made finding common ground virtually impossible. Yeltsin also played 'all sides against the middle' in an effort to neutralise competing influences and politicians who became too popular or influential were removed. The result was an undermining of the process of government and led to inconsistent and erratic economic policies that created damaging instability and left Russia vulnerable to external financial contagion.

Fiscal policy was overly loose

Fiscal imbalance was the root of the internal liquidity crisis that increasingly led to short-term (GKO) financing. Revenue collection was low and expenditure control weak. Fiscal indiscipline led to a chronic budget deficit and a build-up of tax arrears. As a result, demand for budget deficit financing was high and constantly growing. Loose fiscal policy was accompanied by tight monetary policy. The substantial slowdown in inflation resulted in the highest real interest rates in the world, which made the growing debt stock very expensive to service and accelerated the deterioration into crisis.

External factors were also unfavourable. Capital flight combined with low global oil prices

External factors were also unfavourable. Capital flight combined with low global oil prices (after the Asian crisis), an overvalued currency that priced domestic producers out of their own market and a short-term capital overhang from the foreign ownership of GKOs that increased vulnerability.

These inter-related problems led to internal debt default, devaluation, partial default on external debt and a collapse in the value of financial assets. In addition, an already weak banking system was further undermined. Depositors lost a substantial part of their savings held in commercial banks and the budget failed to receive a large part of taxes transferred via the banking system. The banking crisis deepened and compounded the negative consequences of fiscal, debt and currency problems.

Recovery from crisis

Putin's tenure has delivered political stabilisation

Putin has re-centralised power back to the Kremlin and reduced the political influence of business groups. Competing political structures are no longer a concern. Putin's rating is impressively high, at around 80%, and this has been successfully transferred into political power for his administration. A new relationship has been forged between the federal centre and the regions and the result is a much higher level of coordination between local and federal policies. The quality of the legislature has also improved significantly and the Kremlin has developed a parliamentary power base to support legislative approval of key reforms.

Economic stabilisation was driven by several important factors

The economy began quickly recovering shortly after the crisis and the rebound was the result of a range of factors:

- Import substitution on the back of competitiveness gains that resulted from rouble devaluation. Domestic goods crowded out imports from the local market. The trade balance significantly improved on the back of the drop in imports but Russia failed to diversify or significantly increase its exports in 2H98-1999.

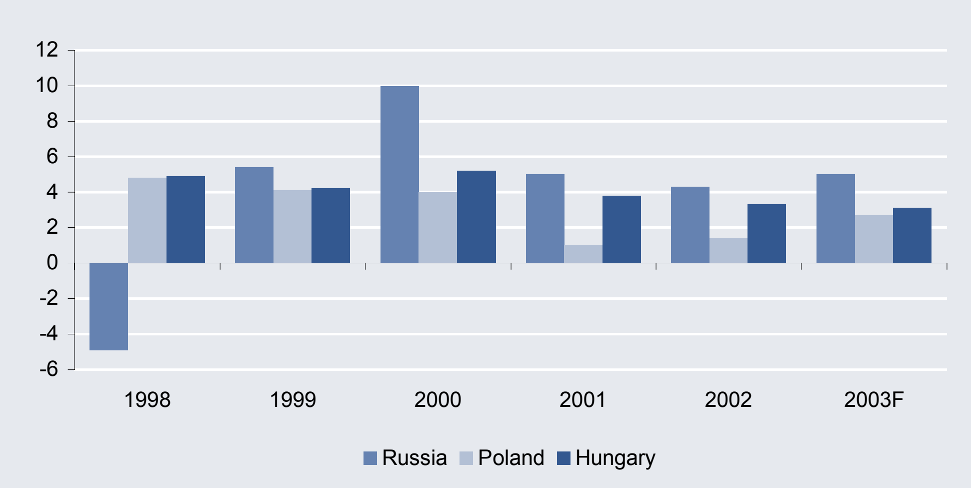
- A substantial improvement in net exports from stronger commodity prices supported economic growth from 2H99 and this continues to be the case.

- There was also an element of dissaving from domestic US dollar balances that helped maintain consumption in the face of falling incomes (in US dollars and in real terms).
- In the last couple of years, this incipient recovery has been broadened to include a rebound in domestic demand.

Economic growth remains impressive

Russia is now enjoying the fifth consecutive year of economic growth, strong fiscal performance and falling inflation.

Fig 1 Russian economic growth in a regional context (%)

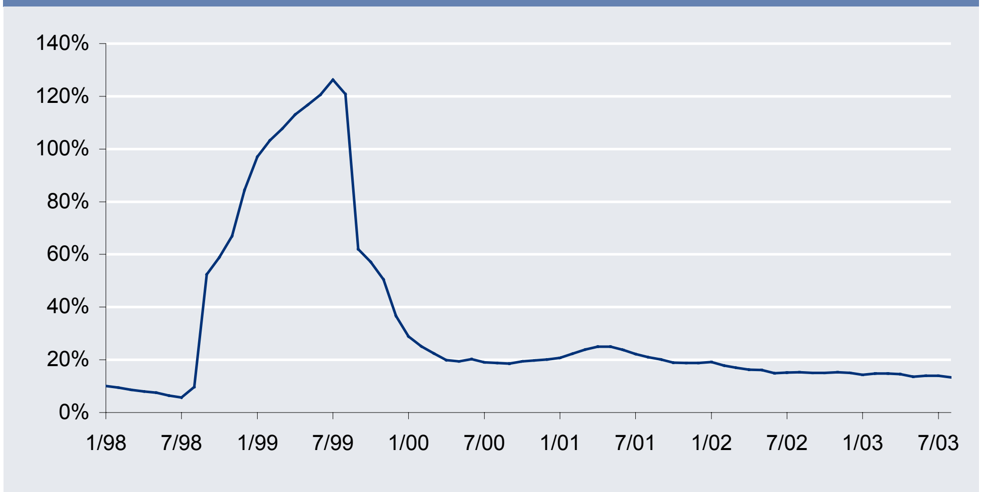


Source: National sources, ING

Inflation is falling

Hyperinflation was avoided by the application of orthodox monetary policy and rising demand for real money balances as a result of improving confidence in the rouble and a general re-monitisation of the economy. Inflation remains on a declining trend, despite upward pressure from administered prices as the price of such goods and services are moved up towards world levels.

Fig 2 CPI (annual-average)



Source: The State Statistics Committee

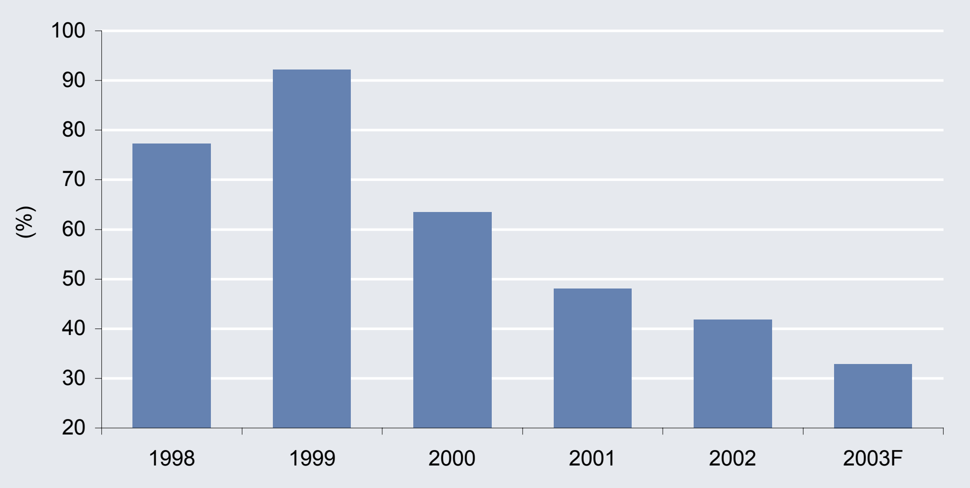
Fiscal performance is solid and sustainable

Fiscal performance improved significantly with revenue and expenditure largely on track:

- The quality of revenue collection is much better and the tax base has been broadened on the back of tax reform and strengthened tax discipline.
- Offsets have been outlawed as a form of payment at both the federal and regional levels and all collection is now in cash.
- Budgetary revenue has increased as a proportion of GDP from 12.9% in 1999 to 17.1% in 2002 (adjusted for unified social tax collection).
- Expenditure has been controlled and part of the surplus in revenue resulting from higher-than-anticipated oil prices has been channelled to a stabilisation fund (we forecast that this fund will be in the region of US$8-9bn by the end of 2003).

Debt ratios have improved significantly as a result of debt restructuring, substantial economic growth, real currency appreciation, the paying down of maturing debt and the running of fiscal surpluses. At the same time, the CBR managed to increase international reserves from a low of less than US$12bn in the wake of the crisis to the current US$62bn, which creates a solid financial cushion and reduces exchange rate risk and risks related to future foreign debt servicing.

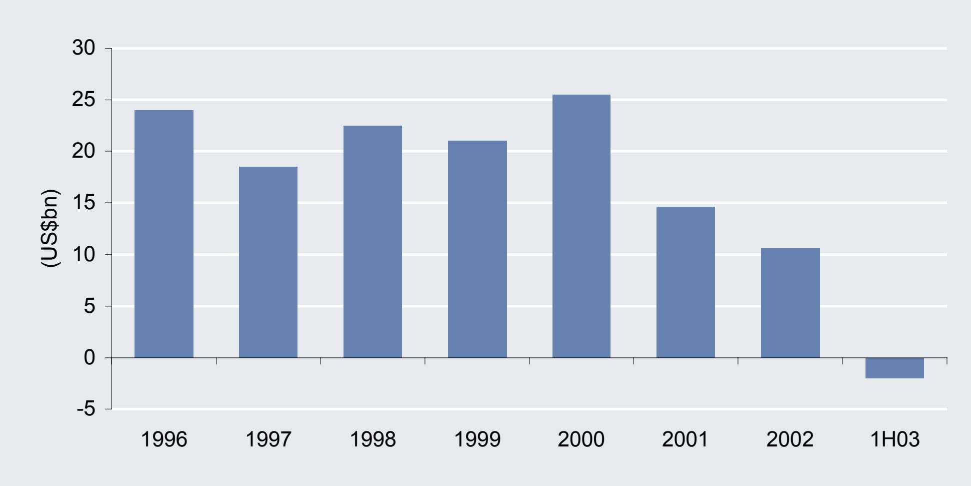
Fig 3 Government debt (% of GDP)



Source: Ministry of Finance

Capital flight has fallen significantly in net terms and flight capital has been returning, helping to fund a pick-up in investment. This is also bound up with improved compliance in respect of tax payments.

Fig 4 Net capital outflow



Source: CBR, ING Research

Structural reforms should make economic growth more sustainable

To make these positive improvements sustainable and accelerate economic growth the government has promoted important structural reforms. This wide range of reforms is essential to establish property rights, improve the investment climate and the broader business environment in Russia. Tax reform considerably simplified tax legislation and reduced the tax burden, which, in turn, is helping to stimulate investment. Reform of the land and residential property codes represents an essential component of establishing property rights. Curbs on non-cash payments (barter, etc) and enforcement of bankruptcy legislation have also helped to accelerate corporate restructuring and improve productivity. Pension reform has opened new avenues for institutional investors and has helped to reduce asset price volatility. A new Customs Code and gradual currency liberalisation have created a base that will facilitate increased integration into global trade flows and WTO entry. Judicial reform has also made courts more independent and the court procedure clearer and more transparent.

Prospects

In our view, Putin is neither a liberal politician in the Western sense nor committed to economic reform for its own sake. His primary motivation is to reverse the decline in Russia’s regional and global political influence. One of the lessons learned from the collapse of the Soviet Union is that political influence cannot be sustained in the face of economic weakness. For this reason, effective economic reform is seen as the means to the end rather than the end in itself but, by the same token, there is a clear understanding that additional reform must be legislated and implemented.

Much will depend on whether growth can be sustained. It can, but there is a need to maintain fiscal discipline and introduce additional reforms to improve long-term productivity and competitiveness. Renewed commodity price weakness and excessive real appreciation of the rouble are risks in this respect but they are manageable.

Although domestic demand is likely to be one of the main drivers of economic growth, the oil and gas sector still accounts for some 30% of GDP and 55% of exports. Lower oil prices, however, would not be a catastrophe for Russia. We have estimated the impact of a potential oil price decline on Russia’s current account, fiscal performance and economic growth. Our analysis points to several important thresholds for Urals:

- US$18/bbl for fiscal performance – turning surplus to balance (US$1/bbl decline in Urals will reduce federal budget revenues by RBL42bn, or US$1.4bn).
- US$13/bbl average breakeven for Russian oil sector profitability.
- US$12/bbl zero-growth for the Russian economy.
- Each US$1/bbl decline in Urals results in a US$2bn decline in exports.

Structural reforms could also help to make Russia less dependent on commodity prices

To reduce economic dependence on oil prices and substantially accelerate economic growth, the implementation of structural reform must continue – in particular banking reform and natural monopoly restructuring, where progress has been limited so far. These reform will help to enlarge the share of the market sector of the economy by preventing natural monopolies increasing their power. At the same time, natural monopolies' prices should become market determined, which would help to eliminate distortions to resource allocation, improve economic efficiency, attract investment and stop the subsidising of non-competitive industrial branches in the mid term. Banking reform will also help to strengthen the banking system, which represents more of a 'payments mechanism' than a mechanism to tranfer savings into investments. Banking reform will improve financial market intermediation and should also result in substantial growth in the volume of banking loans to the corporate sector, stimulating investment and creating a base for future economic growth. Our estimates show that the successful implementation of these reforms could add as much as 20ppt to economic growth over the next five years.

Conclusion

Russia has successfully emerged from crisis and is in better shape economically than at any time during the transition. The political situation is vastly improved. Putin has enhanced stability, re-centralised power and enjoys a much-improved relationship with parliament. Growth is likely to continue but there is a need to maintain fiscal discipline and implement structural reform to improve productivity and competitiveness. The overhang of short-term debt has been removed and debt ratios now compare very favourably with other large emerging markets. Renewed catastrophe is not on the agenda. Indeed, Russia is likely to receive an investment grade rating by end-2005.

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