

EMERGING EUROPE FOCUS

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Editors: Roger Bootle and Jonathan Loynes

Russia: What Next After Putin?

- **This weekend's parliamentary elections underlined that while President Putin will hand over the keys to his Presidential residence next March, he will retain the reins of power. For the economy this means business as usual. Growth should remain strong in the face of a US slowdown and, with investment set to boom, we expect Russia to become an increasingly important driver of growth in Western Europe.**
- Putin has overseen the transformation of Russia from an economic basket case to a global energy superpower, with growth averaging 6.7% per annum during his time as President. **Conventional wisdom is that Russia's resurgence owes much to record high energy prices. But the bigger point is that the recent strong growth is largely a reflection of Russia's dire economic performance during the 1990s.** Either way, it has propelled Putin's approval ratings to over 80% and will ensure that he is able to retain a tight grip on power after he steps down as President.
- From the point of view of the economy this is likely to mean a renewed emphasis on national priority projects, further clampdowns on foreign investors in sectors deemed to be of 'strategic importance' and the continued use of energy as a bargaining tool with international partners.
- **In the near-term, Russia looks well placed to weather a US-led global slowdown. But sustaining current rates of growth over the medium-term will be critically dependent on adding new capital and labour to the supply side mix.** With the demographic outlook nothing short of disastrous, much will depend on investment picking up.
- The government is planning a massive investment programme, worth \$1 trillion over the next ten years. Properly targeted, we estimate that this could boost potential GDP growth to around 6% per annum. What's more, **with investment set to boom Russia could become a regional driver of growth as it sucks in capital goods from Western Europe.** But there is always a risk that corrupt officials will benefit most from the extra spending.
- The recent pick-up in inflation means that further ruble appreciation is likely. This should support ruble denominated assets and, although Russian equities have underperformed this year, they should have a much better time of it in 2008. By contrast, we see limited upside for Russian bond markets.

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Russia: What Next After Putin?

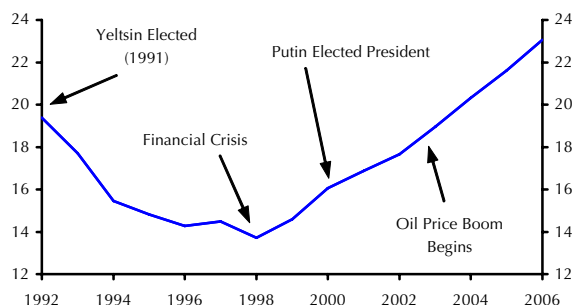
This Focus is an adapted version of a presentation given at the Capital Economics International Forum at the Royal Automobile Club in London on December 3rd 2007.

Winston Churchill famously labelled Russia as a ‘riddle, wrapped in a mystery, inside an enigma’. This description seems as apt today as it did in 1939. On the 2nd March next year the second term of President Vladimir Putin will end. During his time in office Putin has overseen the transformation of Russia from an economic basket case to a global energy superpower. But with the constitution preventing him from seeking a third successive term as President, the Putin era looks to be drawing to a close. Or is it? This *Focus* looks at what the future might hold for Russia.

Background

Since taking office on New Year’s Eve, 1999, President Putin has presided over a remarkable resurgence in the Russian economy. After contracting by 35% under President Yeltsin, the economy has grown by an average of nearly 7% per annum under Putin. **GDP is now around 70% greater in real terms than it was in 1999, and the unemployment rate has halved.** (See Chart 1.)

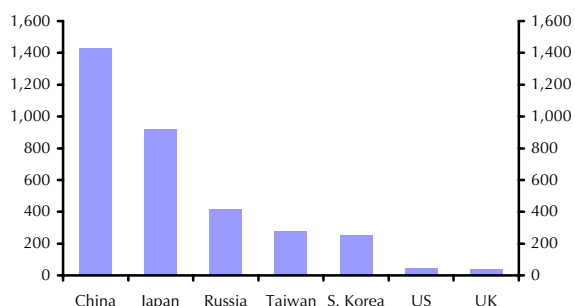
CHART 1: REAL GDP (Rb, TRN, CONSTANT PRICES)



Source – IMF

At the same time, record oil prices have swelled the state’s coffers and allowed the Central Bank to amass the third largest pot of foreign exchange reserves in the world. (See Chart 2.)

CHART 2: TOP 5 FOREIGN EXCHANGE RESERVE HOLDERS (\$BN)



Source – Thomson Datastream

Perhaps more importantly though, Putin has restored a sense of national pride. While the West tends to view his posturings as increasingly inflammatory, most ordinary Russians believe that he has merely reclaimed the country’s rightful position on the world stage. Given the humiliation endured when the country was forced to go cap in hand to the IMF less than ten years ago, it is no surprise that Putin currently enjoys approval ratings well above 80%.

More to growth than oil

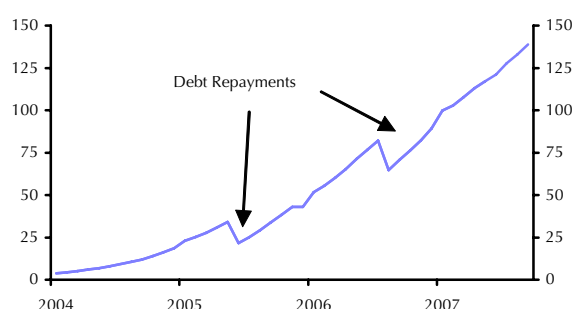
Conventional wisdom holds that the resurgence of Russia’s economy owes much to record high energy prices. After all, Russia produces more gas than any other nation and is challenging Saudi Arabia for the top spot in global oil production.

But while Russia is much better off as a result of higher energy prices, they have had no direct impact on real GDP growth. This is because national accounts protocol treats a rise in the price of oil exports as a price effect rather than a real effect. As such, higher oil prices are picked up in the export price deflator and thus real GDP is unaffected.

Of course, Russia now earns more from its exports than was previously the case – in technical jargon its terms of trade have improved. If this extra income is then spent on domestic production, real GDP will increase. But high marginal rates of tax mean that 85 cents of every \$1 increase in oil

prices goes to the government, which then saves the bulk in its Stabilisation Fund. So far, the Fund has drained a massive \$140 billion of oil income from the economy. (See Chart 3.)

CHART 3: STABILISATION FUND (\$BN)

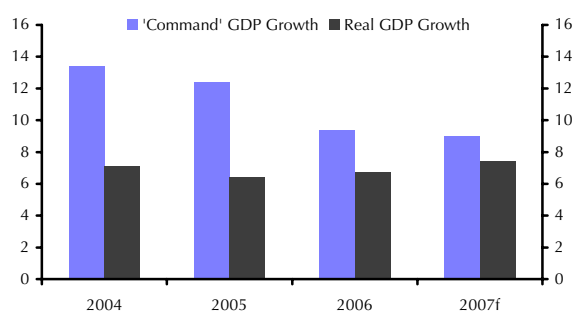


Source – Central Bank of Russia

The upshot is that record oil prices have had little impact on real GDP growth. In fact, we estimate that without the recent increases in energy prices real GDP would still have grown by around 5.5% per annum since 2004, rather than the 6.7% it actually averaged.

Now, that's not to say that Russia hasn't benefited from high oil prices. It's just that the boost to welfare is not fully reflected in the official GDP figures. **In other words, rising energy prices mean that Russia has grown even more rapidly than the official GDP figures suggest.** An alternative measure of welfare called Command GDP fully captures the boost to the terms of trade - and this puts average growth since 2004 at a massive 11% per annum. (See Chart 4.)

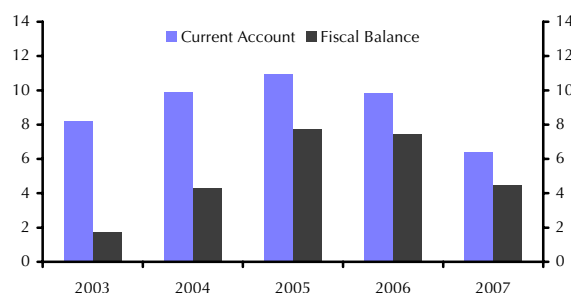
CHART 4: DIFFERENT MEASURES OF GDP GROWTH (% Y/Y)



Sources – Thomson Datastream, Capital Economics

This extra boost to welfare is reflected in the government's huge fiscal surplus and the massive improvement in the country's balance of payments. Indeed, Russia has now run budget surpluses for each of the last seven years and the current account surplus has averaged 10% of GDP since 2004. (See Chart 5.)

CHART 5: CURRENT ACCOUNT & FISCAL BALANCE (% OF GDP)



Source – Thomson Datastream

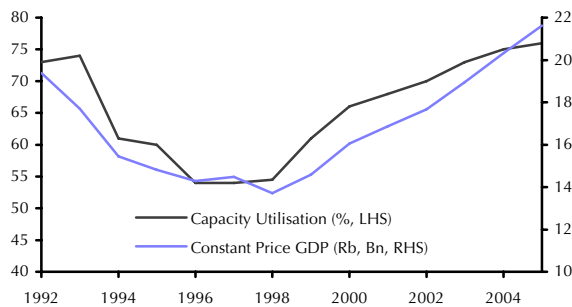
So what can explain the recent rapid growth in *real* GDP? Well, Putin deserves some credit for the reforms he instigated during his first term of office. For a start, the centralisation of power within the Kremlin reinstated the rules of the game. Even though the rules have, at times, alarmed many in the West, it is fair to say they are an improvement on the free-for-all under Yeltsin.

But the bigger point is that recent strong growth has largely been a response to the years of decline witnessed under Yeltsin, which culminated in the 1998 financial crisis. This saw the ruble fall by 75%, which restored the competitiveness of exporters that had suffered from the strong ruble policy during the 1990s. This in turn caused the current account to move into surplus, which allowed the Central Bank to start rebuilding its foreign exchange reserves. At the same time, falling government debt levels led to a drop in real interest rates and a rebound in domestic demand.

But extra demand is only beneficial if supply can respond. The key point to understand is that Russian producers were only able to increase output because of the massive amount of spare

capacity that existed in the economy following years of recession. As a result, the recent pick-up in real GDP has been accompanied by a rise in capacity utilisation. (See Chart 6.)

CHART 6: REAL GDP & CAPACITY UTILISATION



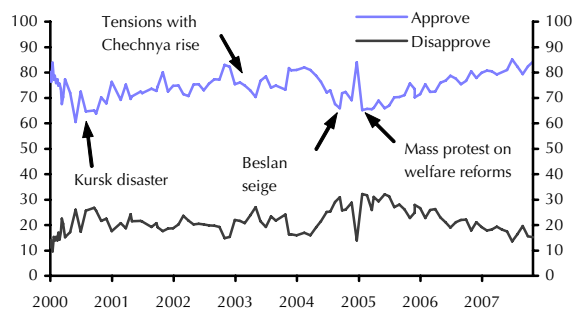
Source – IMF

Put another way, the recent boom in Russian output has been achieved by working existing inputs harder rather than by adding either capital or labour to the supply side mix. So **despite attempts to lump them together, Russia's recent growth story is very different from China or India's.**

More of the same on the political front

But what might the future hold? We all know that while Putin will hand over the keys to his Presidential residence this March, he is unlikely to hand over the reins of power. As Chart 7 shows, his approval rating has been hovering around 80% for most of this year. This should mean that he is able to simply anoint a successor.

CHART 7: PUTIN'S APPROVAL RATING (%)



Source – Levada Center

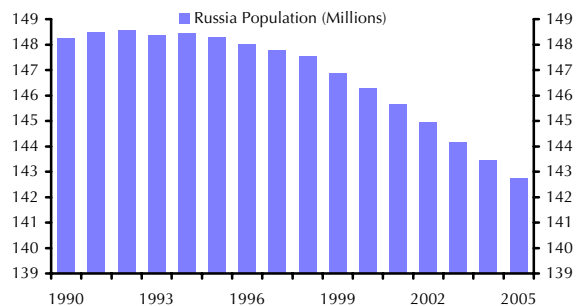
In the meantime, he could assume a number of prominent roles – a return to Prime Minister is the latest being touted. But with his own man installed as President, a large majority for the pro-Putin United Russia party in the legislature and a tight grip on the state-owned media, Putin will still be able to operate as the de-facto head of state.

From the point of view of the economy this is likely to mean a renewed emphasis on national priority projects such as housing and infrastructure, further clampdowns on foreign investors in sectors deemed to be of 'strategic importance' and the continued use of energy as a bargaining tool with international partners.

Boosting investment remains policy priority

So with no appreciable change in the political environment expected, what should be the priorities for economy policy over the next four years? As we noted earlier, recent rapid growth in real GDP has only been made possible by the existence of spare capacity, stemming from years of recession in the 1990s. With this now largely used up, future growth will be dependent on adding new capital and labour to the supply side mix.

CHART 8: POPULATION FORECAST (MILLIONS)



Source – United Nations

The bad news is that the demographic outlook is nothing short of disastrous. Life expectancy for males has dropped to just 59 years, due in part to the national obsession with the demon drink. Russia also suffers from an incredibly low birth rate. Consequently, the population is falling and is

projected to continue falling by around 35 million over the next forty years or so. (See Chart 8.)

It goes without saying that against this backdrop it is unlikely that increases in the labour supply will add much to output growth. Indeed, once the participation rate stops rising in a few years time, labour will probably start to *subtract* from potential GDP growth.

CHART 9: INVESTMENT/GDP RATIO (%)



Source – EBRD, Capital Economics

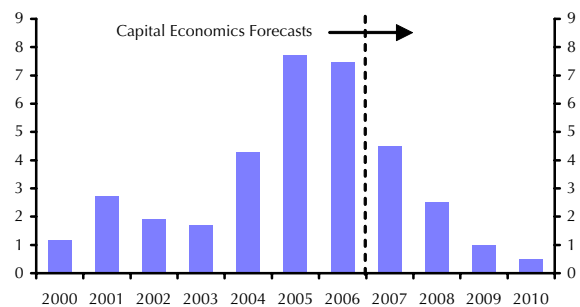
The bottom line is that in order for present growth rates to be sustained over the medium-term, there will have to a massive increase in capital investment. Investment is currently running at around 20 per cent of GDP – much lower than in both Asian emerging markets and other eastern European countries. (See Chart 9.) Consequently, Russia suffers from notoriously inadequate infrastructure, much of which dates from the Soviet era.

The good news is that the Russian government is planning a huge investment programme, worth one trillion dollars over the next ten years. Details are unclear at the moment, but we expect it to focus on all the usual favourites – roads, railways, housing, telecoms and the energy sector can all expect to benefit from vast sums of investment over the next few years.

The private sector is expected to provide around 80% of the funding, which means around \$200bn will come from the government’s coffers. But coupled with the rising cost of state pensions and further hikes in public-sector salaries, this is likely

to mean that the fiscal surplus all but disappears by the end of the decade. (See Chart 10.)

CHART 10: FEDERAL GOVERNMENT BALANCE (% OF GDP)



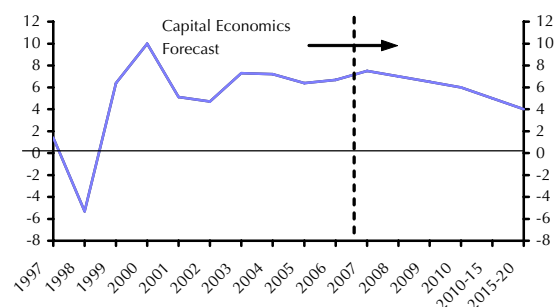
Source – IIF, Capital Economics

With such a huge increase in infrastructure spending planned, the government’s priority must be to ensure that it does not go to waste. The use of Public-Private Partnerships could be helpful in this regard, but the overriding concern remains that corrupt officials will benefit most from the fiscal splurge.

Medium-term prospects look good

If the government is successful in carrying out its investment plan then **we estimate potential GDP growth will hover around 6% per annum until the end of the decade, before falling back to around 4% by 2015 as the demographic crunch begins to bite.** So while growth will not rival that of China, the outlook remains pretty favourable and it is still possible that Russia could become the largest European economy by 2050.

CHART 11: GDP GROWTH FORECAST (% Y/Y)

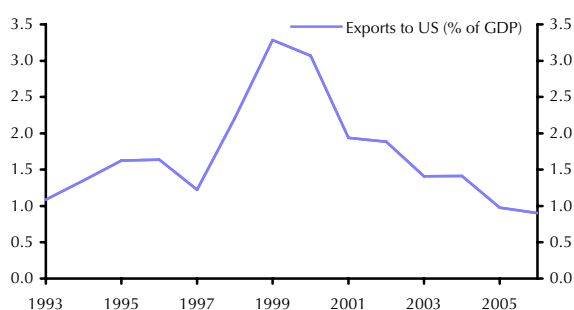


Source – Thomson Datastream, Capital Economics

Well placed to weather a US slowdown...

In the near-term, the Russian economy should be able to escape relatively unscathed from the sharp slowdown in the US. As Chart 12 shows, exports to the US as a share of GDP are pretty small and have been falling. Of course, Russia would suffer were energy prices to slump in response to a global slowdown, but as we have seen that would not have a huge impact on the official GDP numbers.

CHART 12: EXPORTS TO UNITED STATES (% GDP)



Source – IMF

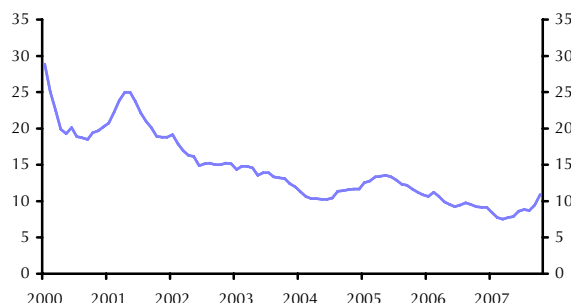
All told, we expect real GDP to grow by a pretty impressive 7% next year. **Indeed, Russia could actually become a vital prop to growth in Western Europe.** With investment set to boom, producers of capital goods – notably Germany - stand to benefit the most from Russia's ongoing growth spurt.

...but inflation pressures building...

The big risk in the short-term is that, rather than easing capacity constraints, the planned fiscal relaxation will simply increase demand and price pressures. Under Putin, the annual rate of inflation fell from 30% in 2000 to 9% last year (see Chart 13). But food prices have pushed inflation back into double-digit territory in recent months.

What's more, **policymakers will find it much harder to bring inflation rates back down this time around.** For a start, there is the possibility of a demand boost from fiscal policy. And domestic energy prices are also likely to accelerate over the next few years as government price subsidies are gradually lowered.

CHART 13: CONSUMER PRICE INFLATION (% Y/Y)



Source – Thomson Datastream, Capital Economics

Part of the problem is that Russia's underdeveloped money markets limit the tools available to policymakers to fight inflation. In an economy awash with liquidity, the conventional interest rate setting mechanism is rendered impotent and the Central Bank of Russia must instead rely on exchange rate appreciation to dampen inflationary pressures.

So far the Bank has intervened in the foreign exchange market to limit the pace of ruble appreciation and thus protect the competitiveness of non-energy exporters. But this comes at a cost. Immature domestic debt markets have hindered any attempts to sterilise this intervention and the money supply is growing at 50% per annum as a result. While this is in itself not sufficient to cause inflation to accelerate, it clearly adds to the upside risks to prices.

...so further ruble appreciation look likely

The bottom line is that the ruble needs to rise further in order to contain inflationary pressures. **We expect it to appreciate by something like 3% against its dollar/euro basket in 2008,** which, together with various administrative measures to cool food prices, should bring inflation down to 9% by the end of next year.

On balance, further currency appreciation should support ruble-denominated assets. The equity market has disappointed this year, lagging well behind other emerging markets, particular those in Asia. (See Chart 14, overleaf.) Despite the fact that energy firms account for around half of the total

index, high tax rates mean that record oil prices have had a surprisingly small effect on the market.

CHART 14: EQUITY MARKET INDICES (1ST JAN = 100)

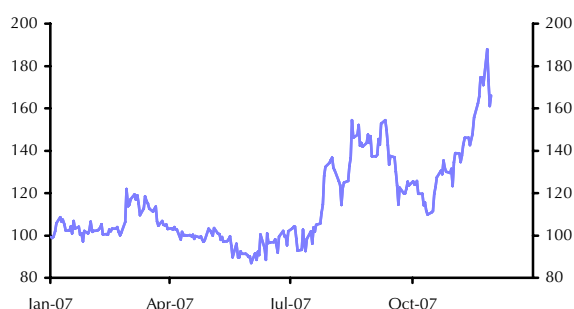


Source – Bloomberg

It could be that political concerns are weighing on investors' minds. The high volume of new share issuance over the last year or so might also explain the sluggish performance. **Either way, with GDP growth set to remain pretty strong and the political outlook stabilising, equities should perform well in 2008, particularly those exposed to the enduring construction and retail booms.**

The outlook for bonds is arguably less rosy. Spreads against US ten-years have risen above 170bps in recent weeks. (See Chart 15.) This reflects both a fall in US yields and a fresh bout of investor risk aversion. But while spreads could narrow in the immediate aftermath of next year's election, **it is difficult to see much medium-term value in bonds given the outlook for inflation and the public finances.**

CHART 15: BOND SPREADS VS US 10 YEARS (BPS)



Source – Thomson Datastream

Conclusions

While Russia has enjoyed an extended period of strong and stable growth, this owes more to its dire economic performance in the 1990s than to booming energy prices. Either way it has propelled Putin's approval ratings to over 80% and will ensure that he retains a tight grip on power after he steps down as President in March.

The economy looks well placed to weather a US slowdown and should grow at a brisk pace of 7%-odd next year, before slowing gradually to around 5% by the end of the decade. In fact, with investment set to boom, we expect Russia to become an increasingly important driver of regional growth as it sucks in capital goods from Western Europe.

With inflation set to remain at double-digit rates for the next twelve months or so, further ruble appreciation looks inevitable. This should support ruble denominated assets and, although Russian equities have underperformed this year, they should have a much better time of it in 2008. By contrast, there seems little upside for Russian bond markets.