



Russia in the financial crisis and beyond

December 11, 2009

Russia's boom in 2003-2007 was driven by rising oil prices and capital inflows. Economic diversification remained limited. High trade and current account surpluses increased confidence in the capacity of Russian borrowers to service their external liabilities. External debt increased strongly, so did sovereign wealth fund assets and FX reserves.

In mid-2008, Russia was hit by a commodity price shock and a reversal of capital flows. A deep recession followed. However, the situation has started to stabilise as of mid-2009. Massive monetary and, with a delay, fiscal stabilisation efforts have provided support, as have higher oil prices.

Without strong capital inflows and rising commodity prices long-term growth will be lower than in the "boom" years. It is still open whether Russia will be able to reduce its vulnerability to oil price fluctuations by generating non-oil growth. An improvement in Russia's conditions for doing business would be necessary to improve the country's growth potential.

Nevertheless, economic growth at reasonable rates is feasible. Raw materials-based exports could still provide a sound basis for economic growth, provided that commodity prices remain supported and natural resources are managed well. Average GDP growth of 4% p.a. over the next few years is a plausible baseline, with risks on the upside.

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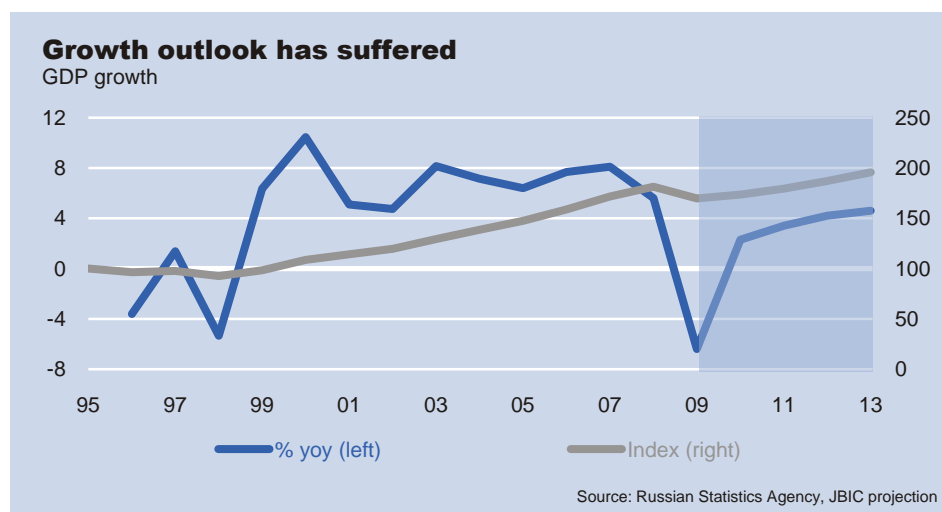
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1. Russia before and during the crisis

Over 2003-2007, the Russian economy boomed with annual GDP growth averaging 7.5%. Due to high real growth and a strong real appreciation of the RUB, Russia's nominal GDP has increased five-fold since 2002; GDP per capita approached USD 12,000 in 2008 (table 1). However, the economic boom and RUB appreciation were mainly driven by rising commodity prices and massive inflows of foreign capital, which were temporary factors.

Overdependence on oil and gas

According to official statistics, oil and gas production, like other parts of Russia's mining sector, did not make a major direct contribution to GDP growth in 2005-2008. Instead, the service sectors, particularly trade, real estate, construction and finance, enjoyed double-digit growth. However, the importance of oil and gas should not be underestimated. Closely related sectors accounted for about 60% of manufacturing, transport services benefited from oil and gas shipment, and trade benefited from mining companies that sold their output at notional transfer prices to parent companies (or subsidiaries) that are located in tax havens within the Russian Federation and statistically classified as trading companies. Further, rising commodity prices leveraged capital inflows, which financed private consumption and investment, and generated business for the financial and real estate sectors. Finally, since 2005 taxation has siphoned off most of the oil sector's profits above USD 25 per barrel for the federal budget or Russia's sovereign wealth funds. In the case of the budget, the funds fuel state consumption and investment.

Strong economic performance over recent years

		1995	2000	2005	2006	2007	2008
Nominal GDP	USD bn	313	260	765	989	1,294	1,677
GDP per capita	USD	2,110	1,770	5,340	6,940	9,120	11,860
Population	Million	148	147	143	143	142	141
Domestic savings	% of GDP	28.8	34.9	28.8	28.1	27.0	28.0
Domestic investment	% of GDP	25.4	16.9	17.7	18.5	21.1	21.9
GDP growth (real)	% yoy	n.a.	10.5	6.4	7.7	8.1	5.6
Industrial production growth	% yoy	-4.6	8.7	5.1	6.3	6.3	2.5
Crude oil production	m tons	307	324	470	481	491	488
Natural gas production	bn cubic m.	595	584	641	656	651	664
Unemployment rate (official)	%	8.9	10.7	7.6	7.2	6.1	7.7

Sources: Central Bank of Russia, International Monetary Fund, OECD, Russian Statistical Agency

1

Russia has, as such, made insufficient progress with diversifying its economy away from oil and gas by generating non-oil growth. A key reason are the conditions for doing business in Russia, which are widely believed to be unfavourable. This is reflected in established international business surveys. According to the World Bank's Doing Business Index, Russia fell to rank 120 (out of 181 countries) in 2009 compared to rank 112 in 2008. According to the Index of Economic Freedom, published by the Wall Street Journal and Heritage Foundation, Russia is the 146th freest out of 179 countries.¹

¹ While these and other business and governance indices may have weaknesses, such as biases towards liberal premises and prescriptions, they represent serious



In the third quarter (Q3) of 2008, Russia was hit by a dual external shock, a commodity price shock and a liquidity shock. These shocks, which exposed the full extent of Russia's dependence on commodity prices and capital inflows, triggered a deep recession, almost exactly ten years after the 1998 "Russian crisis". GDP growth plummeted to 1.2% in Q4 2008, -9.8% in Q1 2009, and -10.9% in Q2 2009 (yoy). The downturn may now be bottoming out, although high frequency data do not give a clear picture yet (chart 2). The official unemployment rate rose to 8.3% in July 2009, up from 5.7% in July 2008, but latent unemployment may be higher, as enterprises have been sending staff on extended unpaid leave.

Commodity exports provided abundant liquidity and ...

Russia has changed in many respects over the past ten years, but commodity exports have remained the lifeblood of the Russian economy. Crude oil and gas account for two-thirds of exports. Another 30% is composed of metals, chemicals, timber and agricultural products. A continued increase in export prices over 2003-2008 improved Russia's terms-of-trade by more than 120%.² As a result, its merchandise trade surplus increased from around USD 50 bn to USD 180 bn and its current account surplus from about USD 35 bn to USD 102 bn. This kept the Russian economy highly liquid and increased the confidence of investors in the capacity of Russian borrowers to service their rising stock of liabilities.

... leveraged capital inflows

According to the Russian central bank private sector external debt rose from USD 48 billion in 2002 (of which banks: USD 14 bn) to USD 451 bn (USD 165 bn) in 2008 (table 3); this included USD 131 bn in debt of state-owned enterprises. The massive build-up did not lead to a deterioration of commonly used debt indicators, as it was accompanied by a decline in public external debt from USD 104 bn to USD 33 bn and an increase in official FX reserves from USD 44 bn to USD 597 bn (July 2008). Foreign direct investment inflows were also substantial but so was Russian investment abroad: net inflows amounted to only USD 34 bn in 2003-2008. Further, following the liberalisation of Russia's capital account in July 2006, portfolio investment increased, but here again net inflows were small compared to private borrowing abroad.

efforts to capture development constraints in a systematic and comparative manner.

² The improvement until July 2008 when oil prices peaked was even higher, but monthly figures are unavailable.



Rising oil prices improved external balances

		1995	2000	2005	2006	2007	2008
Current account balance	USD bn	7.0	46.8	84.6	94.7	77.0	102.3
	% of GDP	2.2	18.0	11.1	9.6	5.9	6.1
Trade balance	USD bn	19.8	60.2	118.4	139.3	130.9	179.7
Exports of goods	USD bn	82.4	105	243.8	303.6	354.4	471.6
	% yoy	22.3	39.0	33.1	24.5	16.8	33.1
Imports of goods	USD bn	-62.6	-44.9	-125.4	-164.3	-223.5	-291.9
	% yoy	24.1	13.5	28.8	31.0	36.0	30.6
Terms of trade	% yoy	6.0	49.0	16.7	11.4	3.4	21.1
World oil price (average)	USD per barrel	17.0	28.2	53.4	64.3	71.1	97.0
Urals oil price (average)	USD per barrel	n.a.	27.5	50.3	61.0	69.1	95.1
Exchange rate	RUB/USD	4.6	28.2	28.8	26.3	24.5	29.4
Real effective exch. rate	Index (eop)	92.2	75.0	102.2	111.2	118.6	122.5
Foreign direct inv. (net)	USD bn	1.5	-0.5	0.1	6.6	9.2	17.9
Portfolio investment (net)	USD bn	-2.4	-13.2	-11.4	15.7	6.9	-34.0
Official reserves (gross)	USD bn	18.0	28.0	182.0	303.7	478.8	427.1
Total external debt	USD bn	132.7	160.0	257.2	310.6	465.4	483.5
	% of GDP	42.4	61.6	33.6	31.4	36.0	28.8
<i>of which; short term</i>	USD bn	11.8	18.7	43.5	56.7	108.0	79.8
	% of reserves	65.5	66.7	23.9	18.7	22.6	18.7
<i>of which; private sector</i>	USD bn	7.6	31.4	175.1	261.9	419.0	450.7
<i>of which; banks</i>	USD bn	4.7	9.0	50.1	101.2	163.7	164.7

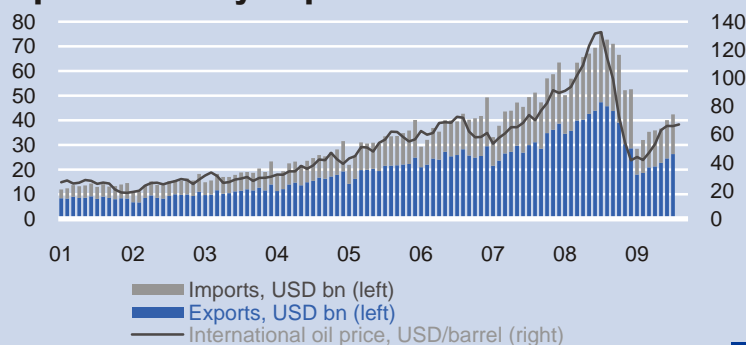
Sources: Central Bank of Russia, Institute for International Finance, IMF

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Two severe external shocks

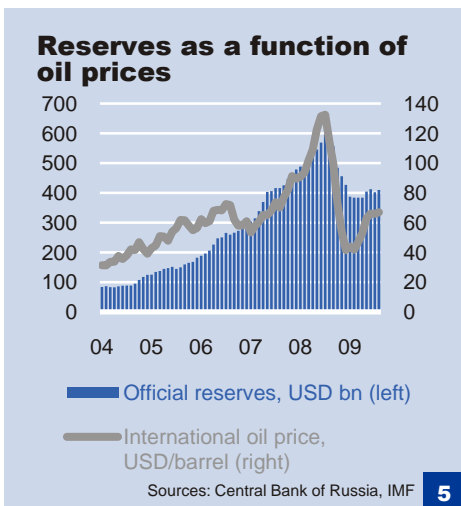
In July 2008 oil prices peaked above USD 140 per barrel and started to sharply decline to nearly USD 40 in December 2008 (chart 4). Prices for other commodities also plummeted. The surplus of Russia's merchandise trade balance, which had averaged USD 17 bn per month in January-September 2008, more than halved in Q4. Further, the escalation of the global financial crisis in September ("Lehman shock") made international investors more risk-averse and brought international banks under strong pressure to shrink their balance sheets. As a result, the external debt financing channel of Russian borrowers narrowed sharply. This made refinancing debt payments much more difficult. There were also massive outflows of portfolio investment and capital flight, partly due to the impact of the military conflict between Russia and Georgia in August 2008 on sentiment of foreign and domestic investors. Overall, Russia's capital account reported net outflows of USD 164 bn in the last four months of 2008.

Exports driven by oil price



Sources: Central Bank of Russia, IMF

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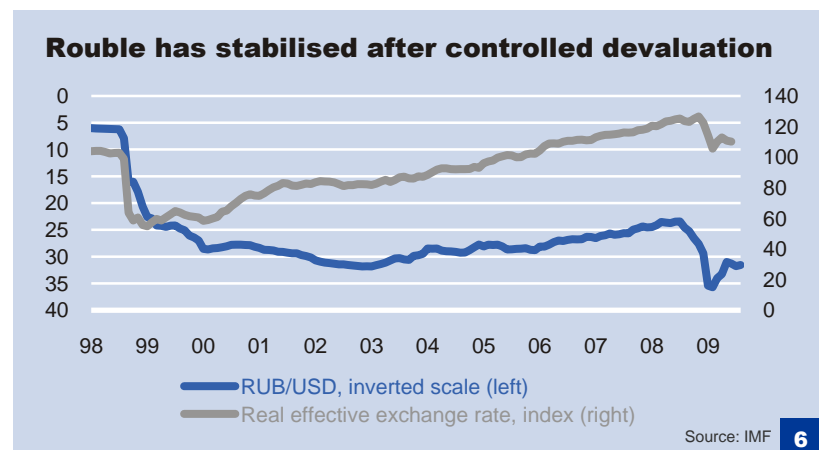


Strong negative impact on official reserves and ...

When the central bank intervened to smooth the impact of these outflows on the exchange rate and provide Russian enterprises (and households) with much needed foreign exchange, it lost official FX reserves in the amount of USD 170 bn by end-2008 and another USD 40 bn in January 2009 (chart 5). Cumulatively, this constituted a decline of 35%. This loss appeared to be the result of a serious policy mistake when it happened. However, with hindsight it was perhaps the price the authorities had to pay to ensure an orderly deleveraging of private-sector external debtors without major bankruptcies³, avoid massive deposit runs that could have brought the banking sector under additional serious stress, and avoid any resemblance of the 1998 Russian crisis that could have led to a significant loss of political capital.⁴ It is noteworthy that the authorities did not introduce capital account restrictions even when outflows accelerated strongly and stabilisation was not in sight.

... the rouble exchange rate

The RUB floats within a corridor against a basket comprising 55% USD and 45% EUR. While oil prices were rising and balance of payment surpluses large, the central bank kept the corridor on an upwards trajectory, and the RUB gained 36% against the USD between end-2002 and mid-2008, encouraging foreign borrowing (chart 6). Given a high inflation differential, the real appreciation was even more pronounced. In 2006 the real effective rate surpassed its level before the 1998 crisis. The real appreciation undermined the competitiveness of the non-commodity sector, increasing the commodities share in exports and driving import absorption as domestic manufacturers lost market shares. In mid-2008, the RUB came under pressure and started to depreciate. Despite massive sales of currency reserves, the depreciation continued, partly due to a shift of bank deposits from roubles to foreign currency.⁵ Until February 2009, the RUB weakened by 34% versus the USD and the real effective rate depreciated by 19%.



³ Russian banks used access to central bank liquidity and to official reserves to re-pay and, in some cases, pre-pay foreign liabilities. In addition, their foreign assets increased by almost USD 50 bn in H2 2008.

⁴ In 1998, the RUB lost two-thirds of its value within a month, and depositors lost most of their funds through this depreciation, bank failures and high inflation.

⁵ The share of foreign exchange in overall deposits, which had fallen to 30% in 2005, increased to 50% by early 2009, due to shifts in deposits and the RUB depreciation. Such a level had last been seen in 1999.

External sector stabilised in early 2009

Since then, Russia's external sector has stabilised. In the first seven months of 2009, the merchandise trade surplus averaged USD 7.7 bn per month, the same level as in Q4 2008, although much lower than before the crisis (chart 4). The capital account was more volatile, with strong net outflows in Q1 2009, particularly in January, and net inflows in Q2. In line with that, official reserves declined sharply in January 2009 but recovered to USD 412.6 bn during Q2. The RUB has appreciated by 13% against the USD since February. While the external stabilisation can be partly explained by policy changes, including a decision to widen the exchange rate band in January 2009, which helped to defuse devaluation expectations, it is perhaps mainly attributable to the oil price recovery. In fact, falling oil prices in early July triggered another spell of RUB weakness, reflected in declining reserves.

Most borrowers are servicing their debt

So far, most Russian borrowers have sustained their external debt service, thanks to credit support provided by the authorities through state-owned banks. There is anecdotal evidence, though, that in some cases forced rollovers have taken place to avoid outright default. External interest and principal payments, including short-term debt and sovereign debt, will amount to USD 155 bn in 2009 and USD 89 bn in 2010. Debt rollover ratios, which were extremely low in Q4 2008 and Q1 2009, have risen since. At end-June 2009, private-sector external debt amounted to USD 436.8 bn after a decline of USD 30 bn in Q1 and an increase of USD 16 bn in Q2. The Q2 increase was mainly due to a USD 25 bn credit from China Development Bank to the Russian oil sector, USD 10 bn of which was disbursed in June 2009. Nevertheless, larger state-owned enterprises have regained access to foreign credit, although underwriting standards have been strengthened.

Strong fiscal buffers ...

Russia has made noteworthy progress with fiscal reforms since 2001, including the introduction of a flat personal income tax of 13% and a regressive unified social tax, the abolition of various turnover taxes, a reduction of the maximum profit tax to 24%, improved deductibility of expenses, and simplified taxation for the oil sector and small businesses. In 2002, a fully-funded pillar was added to the pay-as-you-go pension system. In 2005, a new welfare system was introduced to monetise Soviet-era benefits and allow more targeted social support. The most important single achievement was the establishment of a sovereign wealth fund in 2004 to accumulate excess oil (and later gas) revenues. The objectives were preventing windfall gains from inflating the monetary base and creating a fiscal buffer to mitigate terms-of-trade shocks. In 2008, this fund was split into the Reserve Fund and the National Welfare Fund, with combined assets of USD 225 bn or 13.4% of GDP at end-2008.

As a result of fiscal reforms, better enforcement and the economic upswing, general government revenues increased from less than 30% of GDP before 2002 to 40% of GDP in 2007 (table 7). The budget surplus also increased to average 6.7% of GDP in 2004-2007. The non-oil balance, however, slipped into increasing deficits, particularly from 2007, when the government increased social and development spending. As such, Russia's fiscal policy was increasingly pro-cyclical before the crisis, despite the establishment of the sovereign wealth fund, which should, in theory, have prevented the government from spending windfall gains.

Build-up of substantial fiscal buffers

		1995	2000	2005	2006	2007	2008
Revenues	% of GDP	30.6	28.7	39.7	39.5	40.4	38.4
Expenditure	% of GDP	34.0	26.8	31.5	31.1	34.4	33.6
Primary balance	% of GDP	0	4.5	9.2	9.1	6.5	5.3
Overall balance	% of GDP	-3.4	1.9	8.1	8.4	6.0	4.8
of which; federal budget	% of GDP	-6.2	1.2	7.5	7.4	5.4	4.1
Non-oil balance	% of GDP	n.a.	n.a.	n.a.	-4.5	-5.1	-7.7
Sovereign wealth fund assets	% of GDP	-	-	-	9.0	12.1	13.4
Public debt	% of GDP	n.a.	58.1	14.1	8.2	7.0	6.3
of which; external public debt	% of GDP	39.9	49.5	10.7	4.9	3.6	2.0

Sources: Central Bank of Russia, International Monetary Fund, Ministry of Finance

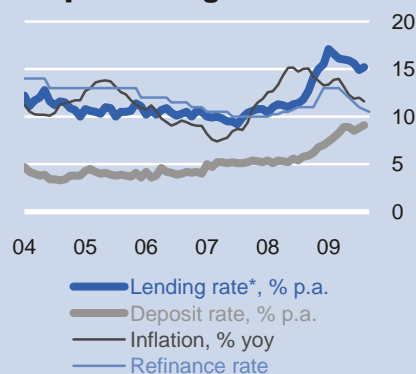
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... but ambiguous fiscal response to crisis

In Q4 2008, budget performance deteriorated sharply. This was due to the effect of declining oil prices and the economic downturn on budget revenues in combination with increasing government expenditures, which resulted from back-loading of annual expenditure towards the end of the year. This back-loading, which is typical for Russia, provided a large built-in demand stimulus for the Russian economy and helped to stabilise GDP growth in Q4 2008.

The flip-side of fiscal back-loading is under-spending at the beginning of each year. This happened in H1 2009, exacerbating the economic downturn. When the dimensions of the downturn became increasingly apparent, the government announced a discretionary fiscal stimulus to mitigate the economic and social impact of the crisis. The package was equivalent to 4.1% of GDP in 2009 and 2010, respectively, according to the Ministry of Economic Development and Trade, and, as such, very large from an international perspective. As a result of this package and the expected cyclical decline in tax revenues, the central government budget deficits are planned to increase to 7-8% of GDP in 2009 and 5-6% in 2010. However, the package was not approved before late April and its implementation was delayed: According to official estimates, Russia's budget deficit in H1 2009 amounted to just 3.7% of GDP. The budget deficits in Q4 2008 and H1 2009, and additional crisis-related expenditures of state-owned banks, were mainly financed by a drawdown of assets of the Reserve Fund (by USD 36 bn or 2.2% of GDP in H1 2009 alone), while public debt continued to decline.

Interest rates higher despite falling inflation



*In local currency up to one year

Source: IMF

8

Increase in broad money and inflation pre crisis

During the period of rising oil prices, strongly increasing export revenues and capital inflows fed through to strong monetary growth, given Russia's quasi-fixed exchange rate regime, which compelled the central bank to buy foreign currency to restrict the RUB appreciation; the scope for sterilising monetary growth was limited due to underdeveloped securities markets.⁶ Mitigating factors were the degree to which the central bank allowed the RUB to appreciate and, more importantly, fiscal sterilisation efforts (i.e. saving of oil revenues on the accounts of the sovereign wealth funds). Nevertheless, broad money growth averaged 40% in 2005-2007 (table 9). This pushed aggregate demand above aggregate supply,

⁶ The relatively small volume of securities in circulation does not allow the central bank to sterilise larger amounts of foreign exchange inflows over a longer period.

despite growing demand for the RUB, and generated inflationary pressure. Consumer price inflation, which had fallen below 10% in 2006, increased again to above 15% by mid-2008. Due to high inflation, lending rates were frequently negative in real terms (i.e. below inflation; chart 8) over the last few years and deposit rates strongly negative. This encouraged excess borrowing and impeded deposit mobilisation.

Strong monetary growth put pressure on prices

		1995	2000	2005	2006	2007	2008
Broad money	% yoy (eop)	112.6	58.0	36.3	40.6	44.2	14.6
	% of GDP	19.3	21.5	33.4	37.7	44.2	40.3
of which; local currency	% yoy	n.a.	61.5	38.6	48.8	47.5	1.7
	% of GDP	n.a.	15.8	28.0	33.4	40.1	32.4
	% official FX reserves	n.a.	146.6	115.4	112.5	112.9	107.5
Base money	% yoy (eop)	n.a.	n.a.	22.4	41.5	33.7	1.2
Credit to the private sector	% yoy	80.9	53.6	35.2	49.5	50.9	36.4
	% of GDP	9.4	13.3	25.7	30.9	37.9	41.0
Refinance rate	%	160.0	25.0	12.0	11.0	10.0	13.0
Consumer price index	% yoy (eop)	131.3	20.2	10.9	9.0	11.9	13.3
Producer price index	% yoy (eop)	175.0	31.6	13.4	10.4	25.1	-7.0

Sources: Central Bank of Russia, IMF

9

Swift response to monetary crisis

When Russia was hit by the crisis, the central bank started to massively sell FX reserves to stabilise the exchange rate and injected substantial amounts of RUB liquidity into the interbank money market and, through state-owned banks, the economy. For the first time in years, monetary growth was not entirely driven by changes in official reserves. The liquidity injections helped to stabilise the banking system but increased pressure on the exchange rate, which depreciated strongly despite the massive loss of reserves. In February 2009 the central bank essentially stopped injecting liquidity into the system. This, together with informal pressure on commercial banks and a weaker USD, increased RUB demand, which helped to stabilise its exchange rate.

Meanwhile, inflation has declined somewhat. However, it still appears high in view of weak domestic demand, suggesting high inflationary expectations. Due to falling inflation and increasing nominal interest rates, real lending rates turned positive just when aggregate demand collapsed. Since April 2009, the central bank has relaxed its policy by aggressively lowering its refinance rate (chart 8). The broader exchange rate band has somewhat increased the room for manoeuvre for interest rate policies and quantitative easing. However, the limits are still narrow, as demonstrated by RUB weakness in early July, which was triggered by lower oil prices and a policy rate cut, and forced the central bank into selling reserves to stabilise the rouble. Further, the impact of policy rates on banks' interest rates is weak. At this juncture, banks' increasing competition for deposits is driving deposit rates up. This, together with enhanced risk awareness and the desire to sustain high interest rate margins to generate the profits needed to finance loan losses is keeping lending rates up.

Banking sector dominated by state banks**Banking sector added to vulnerability**

Russia's banking system is characterised by high asset, deposit and capital concentration with a small number of state-owned or controlled banks and by a very large number of small banks. The competitiveness of the sector is undermined by the dominance of a few large state banks, which account for 41-65% of the sector's assets, depending on the definition used, and the small size of most other banks, many of which are below any plausible minimum efficiency scale. Earning and profitability indicators were high before the crisis, but this was mainly due to high interest rate spreads, which frequently point at structural inefficiencies, including insufficient competition. Further, the large number of banks (around 1,100) is a continuous drag on scarce supervisory resources. This at least partly explains why the central bank has not made much progress with strengthening banking regulation and supervision over recent years. Key weaknesses remain in the areas of risk management, loan classification, related-party lending, and deposit and loan concentration, particularly in smaller banks.

Banking sector still small but has grown fast

At 41%, private-sector credit was not high as a percentage of GDP at end-2008. The Russian banking sector is, as such, still underdeveloped. However, the ratio increased rapidly within a few years due to high credit growth averaging 43% per annum in 2002-2007. This, in combination with weak risk management, has bred loan quality problems, which are increasingly exposed during the economic downturn. Further, the credit expansion was not backed by adequate deposit growth, as reflected in high credit-to-deposits ratios. Instead, banks increased foreign borrowing, particularly from 2005. In mid-2008, when commodity prices declined and investor sentiment changed, foreign liabilities of banks peaked at USD 208.5 bn (net foreign liabilities at USD 101 bn); this was equivalent to 31% (15%) of their loan book. While these developments were not out of line with those in other banking systems in the region and less extreme than in some of them (table 10), they made Russian banks vulnerable.

Banking systems became vulnerable

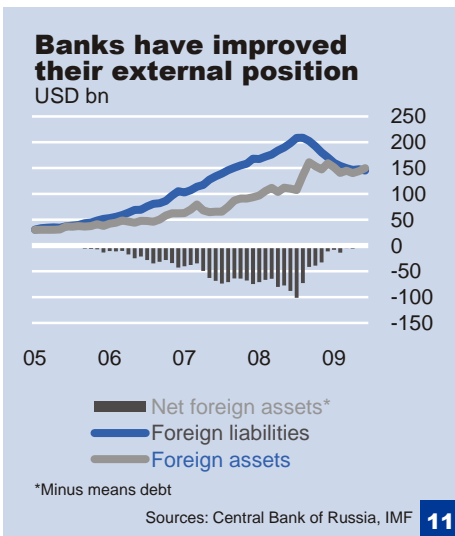
	Private Sector Credit			Credit to Deposits		Net foreign liabilities of banks	
	Av. annual growth	% of GDP		%		% of GDP	
	2002-2007	2002	2007	2002	2007	2002	2007
Kazakhstan	57.1	18.6	58.9	125.3	198.0	-1.9	-21.3
Russia	43.1	17.7	38.0	92.7	119.6	2.5	-3.1
Turkey	37.7	14.5	29.5	49.5	69.7	1.0	-1.8
Hungary	22.0	35.5	63.7	93.2	147.8	-4.6	-12.7
Latvia	49.0	28.8	87.5	123.1	242.4	-7.7	-50.4
Romania	56.1	10.1	35.8	55.3	127.1	0.4	-16.5
Serbia	25.3	18.3	34.0	113.7	98.3	3.1	-8.7
Ukraine	59.0	17.7	58.2	105.7	149.9	0.3	-15.8

Source: IMF

10

Credit growth stopped abruptly

In connection with the external liquidity shock in September 2008, rollover ratios for foreign liabilities of Russian banks declined sharply, and liabilities fell by USD 32 bn in Q4 2008 (chart 11). Due to massive financial support provided by the authorities, the banking



sector managed to finance this outflow without reducing its loan portfolio.⁷ However, the previously high credit growth, which had fuelled the economic boom, came to an abrupt halt. Apart from liquidity provided by the central bank, a total of USD 24 bn equivalent was made available by the government to seven banks, mainly in the form of subordinated loans (“quasi-capital”). Overall, bank deposits remained broadly unchanged in Q4; retail deposits declined in September-October 2008, but recovered quickly thereafter. A shift from RUB to foreign currency deposits remained gradual. All these were major achievements of the stabilisation measures taken by the authorities, including financial support for banks, their essentially unrestricted access to official FX reserves, an increase in the maximum amount covered by Russia’s deposit insurance to USD 28,000 equivalent and the controlled RUB devaluation.

Due to foreign debt repayments and the build-up of foreign assets, banks’ net foreign debt position improved significantly by end-2008. However, the deleveraging continued in 2009: foreign liabilities further declined by USD 21 bn in Q1 and USD 8 bn in Q2. This was mainly financed by drawing down foreign assets. The net effect on banks’ balance sheets was, therefore, limited. Banks’ foreign liabilities fell to USD 145 bn at end-June 2009, USD 63 bn lower than in July 2008. Net foreign liabilities fell by USD 106 bn and foreign assets now exceed liabilities by USD 4.5 bn. The loss of official FX reserves in late 2008 and early 2009 has clearly translated into much improved balance sheets at banks (and other enterprises).

Loan quality has deteriorated

As a result of the recession and more restricted access to finance, official non-performing loan (NPL) ratios have been rising (to 7.6% in July 2009), but loan classification in Russia is not in line with international best practice.⁸ Moody’s estimates that NPLs increased from 4.6% at end-2007 to 11% at end-March 2009 and that an additional 10-15% of loans were restructured to avoid default.⁹ Banks try to restructure problem loans rather than foreclose because of weaknesses in the bankruptcy framework and the judiciary, and government puts pressure on banks to sustain lending even to ailing enterprises; to mitigate risks, the government has provided partial loan guarantees.

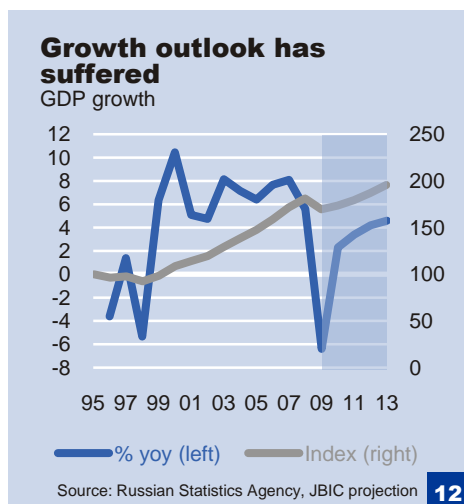
Loan restructurings are apparently mostly simple rollovers of loans for six to twelve months at higher interest rates. The main reasons for this approach are banks’ limited capacity for more thorough efforts, which would take the specific circumstances of borrowers into account, and the expectation that the crisis will be over soon or, if not, loans can be rolled over again. All this has contributed to keeping the overall loan portfolio almost unchanged in 2009 so far. Given that the deposit base has remained essentially unchanged too, there was no pressure on banks to shrink the loan book from this side either.

⁷ In light of high inflation, flat nominal loan growth constituted a strong contraction in real terms. However, in light of the sharp downturn of Russia’s real economy, the credit contraction appeared rather moderate.

⁸ Russian regulation allows classifying only the overdue loan proportion as non-performing. Under International Financial Reporting Standards the entire loan amount must be treated as non-performing.

⁹ Moody’s Global Banking, June 2009. Russian Banks: Major challenges amid the economic downturn (Special Comment).

2. Russia's outlook: Growth to be lower than in 2003-07



Russia's GDP growth forecasts for 2009 and 2010 diverge widely, as the recession has not yet clearly bottomed out, statistics are weak and much depends on oil prices, which are notoriously difficult to anticipate. Uncertainty about banks also plays a role. However, under the assumptions that the implementation of the fiscal stimulus accelerated in H2 2009 and will be followed by moderate fiscal tightening in 2010, bank lending turns positive by end-2009 and international oil prices do not significantly fall again, Russia should continue its recovery in 2010. There are upside and downside risks. First, oil prices could be much higher or lower than expected. The European Central Bank estimates that an oil price change by one percent changes Russia's GDP growth by 0.5 percentage-points the same year (and 0.2 percentage points cumulatively over six years).¹⁰ Second, further delays in implementing the fiscal stimulus could lead to a more protracted recession, aggravating fiscal and banking system problems. However, a more decisive response of the authorities to the remaining banking sector problems would accelerate growth by leveraging bank credit.

There is broad consensus in and outside the country that Russia's long-term growth rates will be significantly below those of recent years, mainly because its two main drivers, rapidly rising commodity prices and strong capital inflows, are unlikely to replicate. Further, in the past, Russia could sustain high growth rates despite relatively low investment due to substantial under-utilisation of capacity. In the long run, however, investment levels have to increase to enhance and modernise production capacity and infrastructure. Nonetheless, Russia's business climate remains a serious impediment for mobilising private investment capital for that purpose. This also relates, to a degree, to investment in the natural resources sector, as inadequate past investment suggests. Even more fundamental growth constraints are unfavourable demographics, which mainly result from deteriorating health and education systems.¹¹ At this juncture, there is still little evidence that the Russian authorities are willing and able to address Russia's business climate and/or other structural growth constraints effectively, despite recent statements by top-level officials that changes are necessary.¹² Russia's long-term growth outlook, therefore, mainly seems to depend on commodity prices. With an assumed oil price of USD 80 per barrel on average in 2011-2013, we expect GDP growth to average 4% over the same period (chart 7). While this is low compared to Russian GDP growth over recent years and expected growth rates in countries like Brazil, China or India, it would not be out of line with Russia's longer-term trends.¹³

¹⁰ R. Beck, A. Kamps and E. Mileva (2007). Long-Term Growth Prospects of the Russian Economy. European Central Bank. Occasional Paper No 58.

¹¹ See, for instance, Lindner, R. (2008). Russlands defekte Demographie. German Institute for International and Security Affairs. SWP-Studie S11.

¹² The need for change was for instance highlighted in President Medvedev's address to the nation on November 12, 2009.

¹³ Jaeger, Markus (2009). Brazil 2020: Economic & political scenarios – update. Current Issues. Deutsche Bank Research. Frankfurt am Main.

There are upside risks

The risk to this forecast seems to be on the upside. First, commodity prices could be higher than assumed. Most analyses of the oil market before the crisis saw the factors behind the oil-price surge as mostly permanent in nature: limited supply combined with strong demand growth in emerging markets like China and India. This may still turn out to be true. Second, Russia's oil and gas production could grow significantly, although this requires substantial investment. Given Russia's reserves, annual oil production could ultimately reach a plateau of 540-600 million tons (compared to 488 million in 2008) according to government estimates. Gas production could plateau at 800-900 billion cubic metres (compared to 664 billion in 2008) according to independent estimates.¹⁴ Third, the overall failure of past efforts to diversify Russia's economy and address other growth constraints would seem so obvious that policy changes cannot be ruled out, particularly if growth rates do not exceed 4%. This may be too low to be politically acceptable for the Russian leadership, given its ambitions.¹⁵ Russia does have enterprises that are competitive without government support, including about 20,000 medium-sized enterprises. With an improved business climate, these companies – which are frequently strong on innovation – could become the basis for successful diversification and non-oil growth.

Russia has competitive enterprises

Switch to inflation targeting still some way off

Inflation may fall into the single digits by 2010, but it is uncertain whether it will stay there for long. Recent official statements suggest that fighting inflation is a priority, but so clearly is economic growth. It is doubtful whether Russia's leadership would support tight monetary policies, which may be required for some time to lower inflationary expectations, if that weakens economic growth over a longer period. Further, given that Russia is a commodity-based economy, its exchange-rate-oriented monetary regime implies that monetary growth will remain driven by commodity prices. There are official plans to switch to an inflation-targeting framework and float the RUB, but this will not happen anytime soon: technical preparations are only at an initial stage¹⁶, central bank independence is not strong enough, and political support seems rather ambiguous. Pursuing exchange rate targets has a long tradition in Russia and enjoys broad support. It seems, therefore, likely that the central bank will continue to pursue exchange rate targets and, simultaneously, aim to lower inflation. This will remain a challenge, particularly in the presence of heavy capital flows. The interest rate consistent with achieving (informal) inflation targets will frequently not be consistent with the rate that would keep the exchange rate on track. In case of doubt, exchange rate targets may prevail.¹⁷

¹⁴ Goetz, Roland (2007). Schätzung des mittelfristigen Produktions- und Exportpotentials von Erdgasregionen. German Institute for International and Security Affairs. Discussion Paper FG 5 2007.

¹⁵ The government's economic programme through 2020 calls for average annual real GDP growth of more than 6%.

¹⁶ Technically, much remains to be done to improve the monetary transmission mechanism between interest rates, monetary aggregates and real output; capturing inflationary expectations through surveys; and developing a persuasive concept and procedures for communication.

¹⁷ A country cannot have more than two out of these three items: free capital flows, a fixed exchange rate and an independent monetary policy. This is the "impossible trinity" problem.

Balance of payment surpluses likely

The increasing oil prices of our baseline scenario should translate into upward pressure on the RUB and, as the central bank will offer some resistance, into monetary growth and upward pressure on prices. The resulting real appreciation of the RUB will tend to increase imports. This, together with our oil price assumptions, make us believe that current account surpluses will fluctuate around USD 40 - 60 bn or 4% of GDP over the coming years. There is a risk that domestic demand further erodes Russia's export potential, particularly in the area of gas.¹⁸ However, we assume that export volumes will remain stable due to structural reforms that increase energy efficiency and/or production. Higher-than-expected oil prices would increase the current account surpluses. However, they would also put upwards pressure on the RUB and, thereby, leverage imports. This mechanism works as a built-in buffer.

Private-sector debt levels are still high in USD terms and rising as a percentage of GDP. Further deleveraging seems, therefore, plausible for the short term. Public-sector external debt will almost certainly increase from 2010 onwards, given the need to finance sizeable budget deficits.

Fiscal sustainability issues fade with higher oil prices

Larger sovereign issuance expected

The planned budget deficits in 2009-2010 could be fully financed by selling assets of the sovereign wealth funds, which would, however, then be depleted by end-2010. This would send a negative signal. The government will, therefore, increasingly mobilise resources by issuing securities in H2 2009 domestically, from 2010 onwards also internationally. Given the low level of gross public debt and negative net debt, there is significant scope for borrowing.

The oil price needed to balance the budget is estimated at USD 85 per barrel, given the current structure of revenues and expenditure.¹⁹ It seems rather likely that the oil price will approach and pass this threshold again in the long term. This implies there will be no major fiscal sustainability problems. However, if our oil price assumption is wrong, which is entirely possible, and oil prices remain substantially lower, the government should take corrective measures to lower the threshold and, thereby, bring the deficit back to a sustainable level. While this may be a challenge, given fiscal commitments, we believe the government would at least make serious efforts to keep the non-oil deficit under control. Its own pre-crisis estimate for a maximum non-oil deficit consistent with monetary stability was 4.5% of GDP. Under an upside scenario, with higher oil prices, we believe the government would be more successful than in the past in sterilising balance-of-payment inflows by fiscal means, i.e. saving windfall gains, to prevent strong upward pressure on inflation and the exchange rate.

Banking sector as key remaining issue

The Russian authorities have created a financial support mechanism that has addressed liquidity problems in the banking system. However, it has not yet created credit growth. The main remaining concern is loan quality. There is broad consensus that the

¹⁸ Over the past decade, strongly increasing oil production overcompensated rising domestic consumption, but this was not the case in the gas sector, where domestic demand has been increasing rapidly.

¹⁹ The government's estimate of the oil price needed to balance the budget is USD 79 per barrel, but this relates to the price of European oil (Urals), which is about USD 5 lower than the international average.

Asset quality in the spotlight

share of impaired loans, i.e. NPLs and loans that have been restructured before entering the NPL category, will further increase. However, views about the ultimate peak level diverge widely. This is understandable given varying assumptions on the length of the recession, government policies, NPL recovery ratios etc. Baseline scenarios for impaired loans range from the low double digits to 40% of total loans.²⁰ Banks have remaining earning capacity to absorb some but not all losses. They will, as such, need fresh capital to stay sufficiently capitalised. Standard & Poor's estimates that banks will need at least USD 40 bn (equivalent to 2.4% of 2008 GDP or 31% of end-2008 banking sector capital) over 2009-2011. Key assumptions are that cumulative losses will amount to 14% of overall loans, half of which banks can absorb with retained earnings.²¹

There are few doubts that the government would be willing and able to provide capital injections of this magnitude, although this would exceed the USD 16 bn equivalent reserved for that purpose in the revised 2009 budget.²² The authorities have proven strong commitment to banking sector stability, state-ownership in the sector is high, fiscal buffers exist, and loan loss recognition can be rolled out as needed due to weak regulation and disclosure. However, even in the best-case scenario, government support does not extend to all banks: There will be failures, particularly of smaller banks. While this is in line with the official objective to move ahead with a long-overdue consolidation of the banking sector, control could be lost if commodity prices were lower and/or the recession deeper than expected, as this would aggravate loan quality problems and test the Government's ability and willingness to provide larger capital support.

Credit growth unlikely to pick up sharply in the near term

Further, credit growth will remain low for the time being, given the drain on capital from loan losses. The main reason why we expect credit to grow at all is increasing government pressure on banks to accelerate lending. In July 2009, the government announced that further government capital injections in individual banks would be subject to banks' compliance with lending targets.

The competitiveness of the banking system will likely remain impaired for a long time by high state-ownership, high concentration, and too many small banks. Due to anti-crisis measures, state-ownership in the system is further increasing. An exit strategy is not clearly visible. There is even the risk that the authorities learn from the crisis, that it is easier to stabilise the economy during turmoil with state-owned banks. With regard to consolidation, its pace will likely be too slow to substantially reduce the number of banks over the forecast period: With about 50 bank exits per year, which would be above the current trend, the total number of banks would still be around 850 in 2013.

²⁰ See e.g. Deuber, Gunter and Marion Mühlberger (2009). All about asset quality. Credit Monitor Eastern Europe. Deutsche Bank Research. Frankfurt am Main.

²¹ Standard & Poor's (June 2009). High credit losses likely to trigger recapitalization of Russian banks (Ratings Direct).

²² The government also plans to issue long-term bonds of USD 9-10 billion equivalent in 2009 and 2010, which would be exchanged with banks in return for preferred shares, counting as capital. State-owned banks may be recapitalised separately. Banks with severe capital shortfalls may also be dealt with separately under the bank resolution framework by the Deposit Insurance Agency, which has undisbursed funds available from an initial USD 7 billion equivalent budget allocation in early 2009.

Conclusion

Russia rises and falls with oil prices, which have a huge impact on the real, external, fiscal and monetary developments. It is open whether Russia will be able to reduce its vulnerability to oil price fluctuations by generating non-oil growth. Russia's unfavourable business climate remains a serious impediment for non-commodity and commodity sector development alike. Nevertheless, even if Russia is not able to develop a healthier model for sustained catch-up growth based on investment, innovation and human capital accumulation, and continues to rely on commodity exports, this would still be a reasonable basis for economic growth, provided commodity prices remain sufficiently high and Russia's natural resources are skillfully managed.

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