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Economics Group

WELLS FARGO SECURITIES

Special Commentary

Eugenio J. Alemán, Senior Economist
eugenio.j.aleman@wellsfargo.com • (704) 410-3273

Russian Economy Struggles To Grow

The Russian economy has joined the ranks of other emerging market economies affected by the slowdown in global economic activity, a slowdown partially spearheaded by the Chinese government's decision to reposition the country's economic prospects to depend more on the domestic market rather than on the global market. For many years, the larger emerging market economies, coined within the term BRIC, were the investment community's darling, as growth in those countries outpaced growth in the developed world. However, for more than a year now the prospects of many of these countries have been clouded by what seems to be a shift in the growth paradigm chosen by Chinese authorities for the future. The Russian economy has also taken a hit from that paradigm shift.

Russian economic growth during the last 13 years has been high, at 5.3 percent on average if we take into account that the economy dropped 7.8 percent in 2009 due to the effects of the 2008-2009 global crisis. If we drop 2009 from the calculation, the economy grew at a healthier 6.4 percent during the 12 years excluding 2009. If we take only the ten years before the 2009 recession, growth was even stronger, at 6.9 percent. However, the growth path the economy has taken after the 2009 recession is all but impressive. Normally, economies that go about a severe contraction recover strongly coming out of that contraction. However, the Russian economy—this has also been true for other emerging and developed market economies—has not been able to replicate the 5.3 percent growth rate mentioned previously. Growth was only 4.5 percent in 2010 coming out of the recession, 4.3 percent in 2011 and 3.4 percent in 2012, a clearly weakening trend. If this weakness was not enough, our current expectation for this year is close to 2 percent and this is only assuming that the improvement trend we have seen from the global economy remains in place from today until the end of the year.

A Closer Look at the Economy: The Supply Side

After the advance release of GDP for the second quarter of the year several weeks ago that showed a very weak economy -- the economy posted a growth rate of only 1.2 percent compared to the second quarter of 2012 -- the minister of finance went further into lowering expectations for the prospects of the economy for 2013 saying that they now expect growth of only 1.8 percent. This was a major revision for the growth prospects of the Russian economy this year and underscores the relatively sharp weakening of the Russian economy during the last several quarters.

The Russian economy was weak across the board in the second quarter of the year.

Looking at the economy from the supply side, which is the only data on the economy available so far, the Russian economy was weak across the board in the second quarter of the year with manufacturing output dropping 1.2 percent year over year while mining was up 1.0 percent after dropping 4.9 percent during the first quarter, all compared to the same quarter a year earlier. Furthermore, almost all sectors linked to the domestic economy were weak during the quarter, with construction activity plunging 3.9 percent after barely growing by 0.4 percent in the first quarter. Demand results for the second quarter are not in yet but we will not be surprised if personal consumption expenditures and investment come in very weak while government expenditures come in relatively stronger than in the past several quarters.

Figure 1

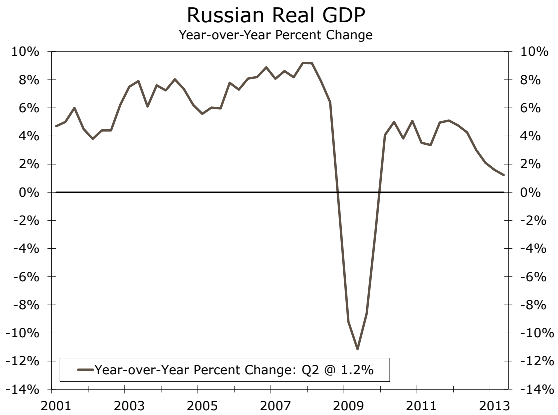


Figure 2

Source: IHS Global Insight and Wells Fargo Securities, LLC

Looking at the same data on a seasonally adjusted basis also tells a very weak story regarding the current state of the Russian economy. The economy posted its second consecutive negative quarter on a seasonally adjusted basis, down 0.26 percent after a very similar performance during the first quarter, down 0.25 percent. Thus, the Russian economy experienced a technical recession during the first half of the year. One of the sectors that worsened considerably in the second quarter was manufacturing production, which dropped 1.2 percent in the quarter compared to the first quarter of the year—the same percentage drop recorded for the year-over-year number—perhaps as it felt the effects of the global downturn.

Weakness in the construction sector is also putting downward pressure on gross fixed investment.

But from the data, we can also see that the sectors linked to the domestic economy were the most affected ones during the second quarter of the year. This was especially true for the construction sector, a sector that was already weak during 2012 as it grew only 2.0 percent during the year. Construction output dropped 0.89 percent in the first quarter and 1.37 percent in the second quarter of 2013, both numbers on a seasonally adjusted basis and with respect to the previous quarter. This weakness in the construction sector is also putting downward pressure on gross fixed investment, which means that the demand side numbers likely will reflect this weakness when they are released later in the year.

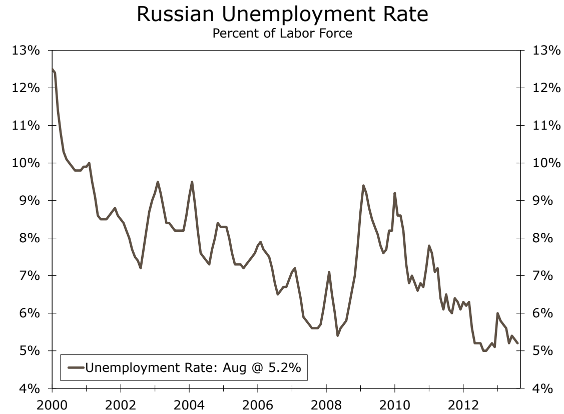
Gross fixed investment grew 6.0 percent in 2012 but it experienced a very strong drop-off in the last quarter of the year when it only posted a 1.4 percent year-over-year growth rate. The prospects for 2013 are not much better as gross fixed investment grew only 0.1 percent in the first quarter and we do not expect it to have recovered during the second quarter, especially looking at the weak performance of the construction sector during the first half of the year. Without an improvement in gross fixed investment it will be very difficult for the Russian economy to grow strongly during the next several quarters. Therefore, growth will probably have to rely on private consumption, government consumption and exports. While exports are looking a bit more promising as the world economy recovers, some strength in private domestic consumption will probably not be enough to take economic growth higher in the coming quarters.

Short-Term Indicators Also Look Unpromising

If quarterly data do not look promising, monthly data on the Russian economy do not show any signs of improvement either. Case in point is industrial production, which was up by just 0.1 percent in August compared to the same month a year earlier after dropping 0.7 percent in the previous month. Activity in the industrial sector has been very weak for almost the entire year even though we saw some up-tick at the beginning of 2013. However, the third quarter of the year has started on a very weak note, which does not bode well for third quarter GDP to be released at the end of this year. Furthermore, our hopes for a recovery in economic activity during the rest of the year depend on a much stronger recovery in global economic growth than what we are anticipating today. This is probably why the Russian minister of finance was so pessimistic several weeks ago when he reduced his growth forecast for this year as we mentioned at the beginning of the report.

Figure 3

Figure 4



Source: IHS Global Insight and Wells Fargo Securities, LLC

Retail sales and the rate of unemployment point to some sort of stabilization of growth going forward.

On the positive side, the Russian economy, while still weak, seems to have stopped falling as can be appreciated by looking at real retail sales as well as the rate of unemployment. Both of these indicators are pointing, if not to a recovery in economic activity, at least to some sort of stabilization of growth going forward (see Figure 5). Furthermore, Figure 5 also shows a very close relationship between Russian real retail sales and real wages growth. Because real wages have recovered somewhat in the second quarter of the year, we expect this to continue to keep domestic consumption at least relatively stable and supportive in the coming quarters.

Figure 5

Figure 6

Source: IHS Global Insight and Wells Fargo Securities, LLC

One of the biggest risks for domestic consumption today is a further depreciation of the ruble (see Figure 6 above) as well as U.S. monetary policy tightening, with its consequent increase in interest rates. Higher global interest rates tend to shift capital flows from emerging markets to developed economies. We have already seen this happening across the world as emerging market currencies have weakened considerably during the last several months, a signal that capital has started to make an about-face. While a stronger depreciation of the currency is good for Russia's export sector, it is not good news for domestic consumption, which has been one of the strongest growth sectors in the country. On the other hand, the good news is that Russian consumer inflation has been slowing down lately, so for now the central bank should not be very concerned. However, if the ruble continues to depreciate then the central bank will probably need to start considering tightening monetary policy, and this has the potential of further impacting any recovery in economic activity going forward. Thus, the policy choices for Russian policymakers are not great in this world economic environment.

Conclusion

As we said before, higher economic growth coming from the rest of the world will be positive for Russian economic growth. The Russian economy continues to be highly dependent on commodity prices and higher growth coming from the global economy could help growth prospects. Stronger growth in China and in the rest of the emerging markets will add to this growth. However, stronger growth in the rest of the emerging markets is not a sure thing and is not part of our current assumptions. Thus, under the current worldwide economic environment Russia's economy is expected to remain weak for the foreseeable future.

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Anika R. Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Sarah Watt	Economist	(704) 410-3282	sarah.watt@wellsfargo.com
Michael T. Wolf	Economist	(704) 410-3286	michael.t.wolf@wellsfargo.com
Sara Silverman	Economic Analyst	(704) 410-3281	sara.silverman@wellsfargo.com
Zachary Griffiths	Economic Analyst	(704) 410-3284	zachary.griffiths@wellsfargo.com
Mackenzie Miller	Economic Analyst	(704) 410-3358	mackenzie.miller@wellsfargo.com
Blaire Zachary	Economic Analyst	(704) 410-3359	blaire.a.zachary@wellsfargo.com
Peg Gavin	Executive Assistant	(704) 410-3279	peg.gavin@wellsfargo.com
Cyndi Burris	Senior Admin. Assistant	(704) 410-3272	cyndi.burris@wellsfargo.com

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