

ECONOMICS: EASTERN EUROPE, MIDDLE EAST AND AFRICA PERSPECTIVES—JANUARY 22, 2010

Consumption Should Underpin Russia's Recovery

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Russia is experiencing its first “normal” economic cycle since the early 1990s. As a result, we expect the drivers of the economic recovery to shift from export demand and a turn in the inventory cycle to a sustained rebound in private consumption. Evidence of a recovery in consumption is already apparent.

The rebound in Russia’s consumption outlook this year is the result of various interlinked factors: a rise in oil prices and the resumption of capital inflows; a turn in the inventory and global trade cycle; the lagged impact of stimulative fiscal and monetary policies; and improvements in corporate productivity and profits. Before we turn to the outlook for consumption, however, it is helpful to evaluate the recent downturn.

Many observers argue that the sharp contraction in private consumption last year implies that it will take years to recover. They note that Russia’s economic contraction of -8.9% of GDP was the sharpest decline among all the major emerging market economies. And they also point out that final domestic demand contracted sharply in addition to a massive inventory liquidation cycle, with real private consumption falling by an estimated -5% and real fixed investment declining by -14%. All told, Russia’s economy contracted by a total of -11.2%, which is greater than the -9.8% contrac-

tion that occurred in March to December 1998 during the country’s financial crisis.

However, the magnitude of Russia’s contraction this time is misleading. Russia’s economy shrank for three consecutive quarters before growing again in the third quarter of 2009, which is the same length of recession as during the 1998 crisis and many other emerging market downturns. But, unusually, the bulk of the decline was concentrated in the first quarter of 2009, when growth contracted by -9.0% quarter over quarter, seasonally adjusted. The other quarters of contraction—the fourth quarter of 2008 (a fall of -1.8%) and the second quarter of 2009 (-0.5%)—were relatively shallow.

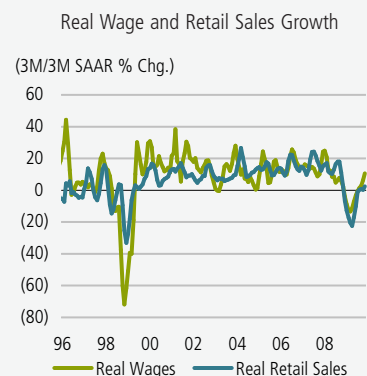
The concentrated nature of the contraction is explained by several Russia-specific reasons. First, the credit boom of 2003–2008 had been excessive, exposing Russia to a sudden pullback in new lending. While helpful, this explanation alone is insufficient. Second, Russia had a greater reliance on foreign borrowing than

Display 1
Strong Corporate Profits Support Wage Growth



Source: Haver Analytics, Rosstat and AllianceBernstein

Display 2
Wage Rebound Supports Consumption



Source: Haver Analytics, Rosstat and AllianceBernstein

many other emerging market economies, since high inflation and negative real interest rates reduced national savings and banks' willingness to lend long term. This reliance exposed Russia to the sudden pullback in global capital flows.

Third, widespread foreign currency mismatches in the corporate and household sectors exposed the private sector to a currency depreciation. The central bank's policy of selling foreign currency reserves to engineer a gradual depreciation in the ruble gave the private sector time and foreign currency funding to reduce its mismatch, therefore avoiding greater debt defaults than would otherwise have been the case. But a negative, unforeseen result of this policy was a widespread cessation in economic activity, as economic actors temporarily shifted funds into foreign currency rather than conduct ruble transactions. This issue was quickly remedied after the central bank stabilized the exchange rate. Arguably, the greater scale of debt defaults from a sudden currency depreciation would have extended the recession, but also made it more shallow in one specific quarter.

Therefore, the size of Russia's contraction for calendar year 2009 does not indicate deeper fundamental problems. Russia is undergoing a substantial banking sector adjustment and an unwinding of rapid credit growth. But overall the country is experiencing its first "normal" cyclical downturn, and as a result we expect a rather more "normal" cyclical recovery.

As we argued extensively last year, the recovery in production has been driven a number of factors: higher oil prices; greater access to foreign capital; rising export demand; a turn in the inventory cycle as production fell below final domestic and external demand; and the lagged effect of fiscal and monetary

stimulus. Industrial production is now growing at an annualized pace of 11% (3m/3m SAAR) in November from a contraction of -44% in January 2009.

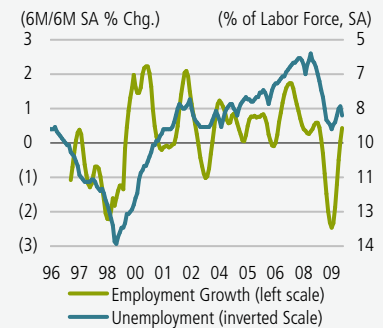
As in more typical cycles, this increase in production eventually stimulates greater consumption as increases in firm profitability is increasingly passed on to workers through higher wages (**Display 1**). A recovery in wage growth is already well advanced (**Display 2**). Firms have also started hiring again, thereby further boosting income, even though the unemployment rate remains high (**Display 3**). We have seen analyses showing that productivity growth in the manufacturing sector has risen by 20% year over year, but have not yet been able to obtain the underlying data to confirm this. If confirmed, this productivity boost would be consistent with higher corporate profits and wages. Finally, higher wages and salary income have helped drive the rebound in retail sales, which started growing again in the last few months (**Display 4**). Retail sales are strongly correlated with household consumption in the national accounts.

Overall, we are forecasting household consumption to rise by only 2.8% this year, as compared with an average of 7.9% between 2000 and 2008, and a forecast rise in GDP of 5.4%. The reason we are forecasting a slower pace of consumption is that consumer credit growth is likely to rebound more slowly than incomes, given the pattern of bank lending in other emerging market downturns. And we expect the household savings rate to continue to rise modestly this year, meaning a slightly smaller share of rising private incomes will be spent.

However, our analysis suggests that there is a risk that we are understating the magnitude of the consumption recovery

Display 3
Employment Is Also Recovering

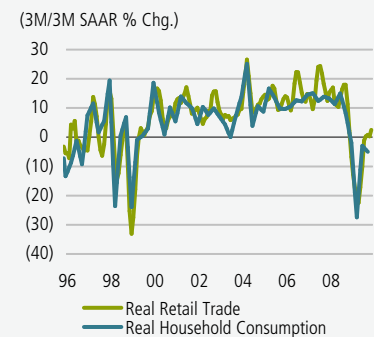
Employment Growth and Unemployment Rate



Source: Haver Analytics, Rosstat and AllianceBernstein

Display 4
Consumption Has Started to Recover

Real Retail Trade and Consumption Growth



Source: Haver Analytics, Rosstat and AllianceBernstein

this year. Policy stimulus is likely to remain accommodative, with firms continuing to ramp up production. The rebound in the labor markets has been swift and large. The credit impulse, which is the change in the rate of credit growth and is the credit measure most closely correlated with GDP growth, is likely to turn seriously positive. And, historically, real consumption only contracted for two quarters following the 1998 crisis, whereas it has already contracted for four quarters.

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