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Russia: Economic Report: July 2013

British Embassy Moscow

July 2013

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Russia Economic Report: July 2013

President Putin uses the St Petersburg International Economic Forum to call for improvements to labour productivity, investment and innovation, and announces a partial relaxation of Gazprom's gas exportation monopoly for LNG. Also at the Forum, Gazprom reveals plans to build an LNG plant on the Baltic coast and Rosneft signs one of the largest energy supply deals in history with China National Petroleum Corporation. Inflation continues to rise as new Governor Elvira Nabiullina takes over at the Central Bank. Putin appoints a new Chief Economic Aide and Minister of Economic Development.

Overview and outlook

Russia's economy has slowed after three years of robust growth. Inflation has risen, but unemployment remains low and the budget is close to balance. The main downside risk is from adverse developments in the world economy, especially if accompanied by a sustained fall in world commodity prices which would undermine Russia's export and budget revenues and financial stability. In the medium term, economic and institutional reforms are needed if Russia's economy is to achieve its full potential and reduce its vulnerability to changing commodity prices. These reforms include modernising and diversifying the economy; improving investment, innovation and the business environment; reducing the role of the state; and re-orienting public spending towards healthcare, education and infrastructure.

Economic developments

- ▶ The State Statistics agency confirmed that **GDP** grew by 1.6% year-on-year in Q1 2013. A detailed breakdown shows that growth in the consumer sector remained relatively strong, with the financial services sector up 12.3% year-on-year and the real estate sector up 7.0%. However, in comparison, the construction and mining sectors saw negative year-on-year growth in Q1.
- ▶ **Inflation** continued to rise, reaching 7.4% in May. In his last Monetary Policy Committee meeting, outgoing Central Bank Governor Sergei Ignatiev left the key policy rate unchanged but cut some longer-term rates by 25bp. Many analysts predict some easing of interest rates in the coming months under new Governor Elvira Nabiullina. **Unemployment** fell to 5.2% in May, reaching a historic low it last hit in September last year.

- ▶ The **oil price** and the **Russian stock markets** remained relatively stable during June. The **rouble** continued to fall against the dollar, reaching around 33 roubles/\$.

Policy issues

- ▶ The annual **St Petersburg International Economic Forum** was held on 20-22 June. Discussion at this year's Forum focused on the slowdown of the Russian economy. In the plenary session, President Putin acknowledged that the recent period of rapid commodity price growth was over, and that Russia now needed to increase levels of labour productivity, investment and innovation in order to meet its growth aspirations. He said that progress in each of these areas required efficiency savings, improved levels of human capital, and a "genuinely competitive" environment for doing business. Chancellor Merkel also spoke in the Forum's plenary session.
- ▶ President Putin used the Forum to make several **economic policy announcements**. He announced that future tariff rises for infrastructure monopolies would be limited to the level of inflation in the previous year; that the Duma would urgently introduce a limited amnesty for those convicted of certain economic crimes; that the Supreme Court and the Higher Arbitration Court would be merged; and that the National Welfare Fund would be used support investment in three projects: a high-speed train link between Moscow and Kazan, a new outer Moscow ring road, and significant improvements to the capacity of the Trans-Siberian Railway
- ▶ Elvira Nabiullina began work as the **new Central Bank Governor** on 24 June. Russian economists and officials continue to debate the correct monetary policy response to the recent slowdown. At an event at the St Petersburg International Economic Forum, Nabiullina said that it would be 'dangerous' to interfere in exchange rate policy now that Russia had built up the confidence of businesses. Instead, she said that the Central Bank should focus on maintaining predictable exchange rate and monetary policy. She also said that Russia needed to bring down the cost of bank operations, reduce banking regulation, and create credit history bureaus to encourage greater lending within the economy.
- ▶ President Putin appointed Andrey Belousov to replace Nabiullina as his **Chief Presidential Aide for economic issues**. Belousov had previously been Minister of Economic Development since Putin's inauguration as President in 2012. As the Russian economy has slowed this year, Belousov has called for the government to abandon its fiscal rule, suggested that the reserve funds should be used to boost investment in infrastructure, and argued that monetary policy should be loosened to lower interest rates to boost demand. At the St Petersburg Forum, he also advocated that Russia should take an approach like Japan or China to depreciate the rouble to protect the economy from imports and stimulate export demand.
- ▶ Completing a 'troika' of reshuffles, the President appointed Alexey Ulyukaev to replace Andrey Belousov as **Minister of Economic Development**. Ulyukaev had been First Deputy Chairmen of the Central Bank, and was considered a likely successor as Central Bank Governor before Nabiullina's nomination was announced in March. Ulyukaev has repeatedly argued that Russia should focus on undertaking

structural reforms to increase investment activity in the economy to overcome the recent slowdown.

- ▶ On 27 June, the State Property Agency announced changes to the **Russian Government's privatisation schedule** for 2014-16. Forecast revenue in 2014 was almost halved to 180 billion roubles (approximately \$5.5 billion). Olga Dergunova, head of the State Property Agency, said that the decision had been taken because of the current state of the financial markets, and also suggested that stakes in state-controlled companies could be transferred to the government pension or welfare funds as an alternative to outright privatisation.

Financial sector

- ▶ Central Bank data suggested that **fictitious import contracts** with entities from Customs Union member states Belarus and Kazakhstan could have accounted for 40% of Russia's net capital outflow last year. Net capital outflow from Russia in 2012 was \$56.8 billion. Outgoing Central Bank Governor Sergei Ignatyev repeated his plea for the authorities to investigate these claims as fully as possible.

Energy sector

- ▶ On 21 June, President Putin announced that there would be a **partial relaxation of the gas export monopoly** enjoyed by Gazprom since 2006, offering to "lower restrictions gradually" on **LNG exports**. This announcement had been under discussion for a long time and analysts have suggested that the decision represents a recognition that Gazprom has not responded sufficiently nimbly to rapid changes in the global gas market. Following the announcement, contracts were signed at the St Petersburg Forum to allow the China National Petroleum Corporation to take a 20% stake in Novatek's Yamal LNG project, and for Rosneft to sign supply contracts from their Sakhalin 1 concession.
- ▶ Separately, **Gazprom announced tentative plans for an LNG plant to be built on the Baltic coast**. This facility would take its supply directly from the Unified Gas System of Russia, and – if built – would provide much greater destination flexibility than Gazprom's traditional pipeline routes.
- ▶ On 10 June, the annual **UK-Russia Energy Dialogue** meeting took place in London. UK Secretary of State Ed Davey and Minister of State for Business and Energy Michael Fallon met with Russian Deputy Prime Minister Dvorkovich and Deputy Energy Minister Kirill Molodtsov. Businesses were well represented on both sides, with senior executives including BP CEO Bob Dudley and Rosneft President Igor Sechin in attendance. The agenda covered a broad spread of energy and climate related issues. The communiqué containing the conclusions can be accessed through the following link: <https://www.gov.uk/government/news/uk-russia-energy-dialogue-communique>.
- ▶ **Rosneft signed one of the largest energy supply deals in history with CNPC**, agreeing a 25-year oil supply contract worth an estimated \$270 billion. Full details of the deal were not released, but analysts suggest that the contract involves an

upfront \$60-70 billion payment to Rosneft. This would drastically reduce the balance sheet pressure it has experienced following its \$55 billion purchase of TNK-BP earlier this year. Following the announcement, the Russian media reported that Bashneft, a privately-owned Russian oil producer, could become another takeover target for Rosneft in the future.

Business and trade

- ▶ President Putin announced an **amnesty for businessmen jailed for economic crimes** to “restore justice” and strengthen “entrepreneurial initiative”. Full details are expected to become clearer as the Bill passes through the State Duma, but the amnesty is expected to apply to people convicted of no more than one crime, for which the sentence was one year or less of detention, and who have already paid damages to their victims. Estimates of the number of people who will be affected range from 5,000 up to 100,000. The amnesty was initially proposed by the Entrepreneurs’ Ombudsman, Boris Titov, in May, but was tightened slightly following some criticism from President Putin.
- ▶ The State Duma swiftly adopted a new law on **protection of intellectual rights on the internet**. The new bill would make it possible to block websites that provide copyright video content unlawfully without requiring a formal court process. The Federation Council will now consider the bill before it is passed to President Putin for approval. It is due to come into force on 1 August. Internet companies have expressed concern that the Bill is being sped through legislative procedures with no time for consultation with the industry, and that some of the requirements being introduced are technically unfeasible.

International issues

- ▶ On 4 June President Putin met President Van Rompuy and President Barroso in Ekaterinburg for the twice yearly **EU-Russia summit**. Both sides welcomed further cooperation, and reaffirmed their commitment to restart negotiations towards a new agreement which would replace the current Partnership and Co-operation Agreement.
- ▶ President Putin attended the **G8 Summit at Lough Erne** on 17-18 June, where trade, taxation and transparency were central elements of the UK Presidency’s agenda. Putin told the media that Russia would introduce new legislation on beneficial ownership of companies, combat the use of offshore jurisdictions, and promote mutual exchange of information between national tax authorities. Putin confirmed that Russia would host the next G8 Summit in Sochi in June 2014.

Calendar of Events

June's main events

| | |
|-------|---|
| 3-4 | EU-Russia Summit in Yekaterinburg |
| 10 | UK-Russia Ministerial Energy Dialogue in London |
| 17-18 | G8 Summit at Lough Erne |
| 20-21 | St Petersburg International Economic Forum |
| 24 | New Central Bank Governor started work |

July's forward look

| | |
|-------|--|
| 1 | Russia takes up Presidency of the Financial Action Task Force (FATF) |
| 6-17 | World Student Games in Kazan |
| 18-19 | G20 Labour Ministers meeting in Moscow |
| 19-20 | G20 Finance Ministers and Central Bank Governors meeting in Moscow |

Key Economic Indicators

| Indicator | | Latest | A year earlier |
|--|-----------|--------|----------------|
| Real GDP (% annual change) | Q1 | 1.6% | 4.8% |
| Industrial production (% annual change) | 3m to May | 1.2% | 2.3% |
| Retail sales volume (% annual change) | 3m to May | 3.8% | 6.6% |
| Unemployment (% of workforce) | May | 5.2% | 5.4% |
| Consumer prices (% annual change) | May | 7.4% | 3.6% |
| Budget balance (% of GDP) | 2012 | 0.0% | 0.8% |
| Government debt (% of GDP) | 2012 | 8.4% | 9.6% |
| Policy interest rate (%) | 30-Jun | 8.25% | 8.0% |
| Current account balance (% of GDP) | 2012 | +4.8% | +5.5% |
| International reserves (\$ bn) | 01-Jun | 518.4 | 510.4 |
| Exchange rate (Rub/\$) | 30-Jun | 32.84 | 32.42 |
| Brent oil price (\$/bbl) | 30-Jun | 102.63 | 95.51 |

Sources: Rosstat, Ministry of Economy, Central Bank of Russia, Bloomberg, Trading Economics