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Confidence Returning, Growth Accelerating

By The Moscow Times

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Earlier this year, a team from Royal Bank of Scotland came to Moscow to the do the rounds in one of their regular "look-see" trips. Timothy Ash, head of the bank's emerging market research team, was surprised by how pessimistic Russian businesspeople were about the country's prospects.

"In terms of overall impressions from the trip, we were actually taken aback by the generally downbeat views of locals on the economy. While accepting that high oil prices would provide a short-term boost to the economy, there was concern that this would likely just discourage policymakers from addressing deeper-seated structural weaknesses revealed through the crisis over the past three years," Ash wrote in his regular notes, which appeared March 16 on Business New Europe's Russia Daily List.

It is a case of the grass being greener on the other side of the fence. From London, where Ash sits, Russia couldn't look better. Gross domestic product growth is clearly going to be on the order of 4.5 percent this year. The government's budget deficit will be about 1 percent this year — way less than the 4 percent the state was forecasting at the start of the year — and it will disappear next year, rather than in 2015, which was the official plan. The Central Bank's hard currency reserves, which fell from $600 billion to $340 billion, are back to about $540 billion and climbing. There will even be money left over in the Reserve Fund, the cash cushion the state keeps back from oil revenues — which was also expected to run dry this year.

All of this looks so much better than what is happening in Western Europe now. Greece looks like it will almost certainly default on its debt this year. Ireland is in better shape, but the austerity measures the government has had to impose — the Greeks have fluffed them — are so painful that some are expecting the Celtic Tiger's gains over the last two decades to be undone. Certainly the Irish people are having an extremely miserable time.

Russia has none of these problems, but that doesn't matter. Residents of Ostozhenka, Moscow's most expensive residential address, aren't comparing themselves with Brits or the Irish, but with the boom in 2007. Everyone is still a bit shell-shocked by the unexpected 7 percent slump in GDP. All said and done, Russia's crisis was not worse than Western Europe's in terms of fundamental damage done — amazingly little damage was done, except to bottom lines in 2008 and 2009 — but it was a lot more dramatic.

Maybe that is the difference between emerging markets and developed ones: In emerging economies, the falls are faster and further, but the bounce-back is fast and quick, because they are so crude. Western economies don't see 14 percent turnarounds in GDP growth from black to red in the space of a few months, but if you put some sand into the mechanism, their 15 percent falls do a lot more damage and are a lot harder to fix.

The difference is key. The West has deep and complicated structural problems that I don't see them fixing for at least a decade — though it could easily get worse before it gets better — but for Russia, it's simply a question of regaining confidence. Everything that was there in the 2004-07 boom is still there.

All that is missing is shoppers' confidence in the future, which would allow them to go shopping again and start the virtuous cycle of spending-growth-investment-profit-wage hikes turning again.

Analysts are chewing over all the numbers carefully and on the whole seem unimpressed or, at best, cautiously optimistic. UralSib summed up the mood in a short note, entitled "Economy performs well, but statistics are contradictory."

You can point to both positives and negatives at the moment. Inflation is one worry. The obvious return of capital flight is another — $20 billion left Russia in the last quarter of 2010 followed by another $20 billion in the first quarter of this year. On the plus side, investment finally turned positive for the first time in two years in April, and foreign direct investment was up to $44.3 billion in the first quarter, though it is still down from its $80 billion peak in 2008.

But I am going to nail my flag to the mast and say the only indicator you need to look at is retail sales. Half of Russia's economy is now driven by services and consumption, while oil and gas only account for about 14 percent. Look at the basics: Because wages continued to rise throughout the crisis, Russians have more money in their pockets than ever. Because credit is underdeveloped, everyone can borrow heavily if they want. And despite the previous boom, spending only really took off in about 2006, meaning that there is still massive, pent-up demand for virtually everything on a shelf.

Once the spending starts again in earnest, problems like inflation will diminish as competition soaks up the extra money in the system, and the Central Bank can raise rates to slow growth. All the other soggy numbers like industrial production or struggling sectors like construction will spring back to life. The main problem will be preventing the economy from overheating.

The reason why retail sales are the key is because their effect multiplies as you go up the economic food chain. A small percentage increase in spending turns into 10 percent more store turnover, 20 percent increases in manufacturing, 50 percent to 60 percent increases in bank capital, which feeds investment and growth, increasing wages and spending.

Real disposable incomes were up 5 percent in the first four months of this year. Retail sales growth accelerated to 5.6 percent year on year in April up from 4.8 percent in March. Demand for retail loans is increasing fast. Dmitry Semkov, head of Alfa Bank's department for cash loan development, estimated that current demand for no-purpose loans is 25 percent higher than it was before the crisis.

The trouble is that this is where the next wave gets stuck because the banks are still not willing to lend. As RBS's Ash noticed, they are not confident about the future. Retail lending was only up 2.8 percent in April.

So we are not quiet there yet. But we are close. All these results bode well for the fall, and they don't include the massive amount of investment that is starting to go into infrastructure: Just the road fund will get some $200 billion over the next five years, and railways will get at least $60 billion to 2018, according to the government.

There is nothing like big state orders and lots of new jobs to really cheer a Russian businessman up. I agree with Prime Minister Vladimir Putin, who told the Duma last week: "By the start of 2012, we should have completely compensated for the crisis drop. We've said we will achieve this somewhere in the middle of 2012. There are grounds for supposing that economic volume will return to pre-crisis levels by the end of this year or by the beginning of 2012."

The views expressed in opinion pieces do not necessarily reflect the position of The Moscow Times.

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