

High Crude Oil Price Invigorates the Russian Economy—But, Drilling May Slow

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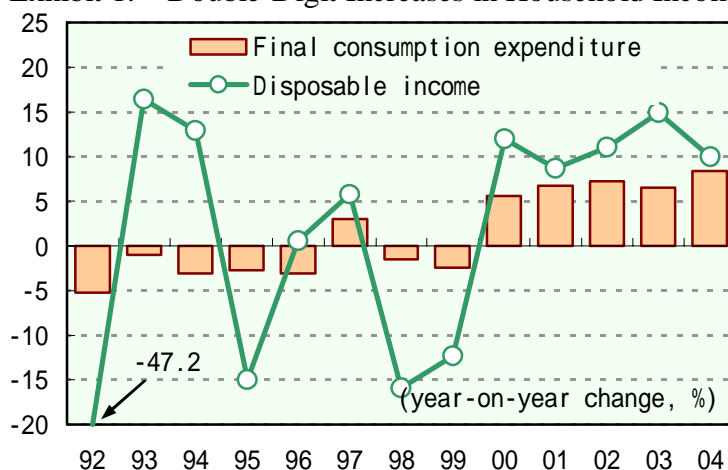
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The BRICs (Brazil, Russia, India and China) are attracting attention as countries with giant markets. However, Russia is the only country among them that can be called a big oil power. In fact, Russia's high economic growth since 1999 has been largely supported by its expanding oil exports. This writer will study the future of the Russian economy, which has recently been referred to as "petro-capitalism," from three angles.

Astounding Spending Sprees of Russian Tourists

First, it should be noted that along with oil exports, the expansion of domestic demand, centering on personal consumption, has been a major factor in Russia's growth. Today, the rate of increase in consumption spending in Russia is one of the highest in the world. This is because the increase in oil exports is directly and indirectly boosting income and enriching families (Exhibit 1).

Exhibit 1. Double-Digit Increases in Household Income



Source: The Russian Statistical Commission.

In the 1990s, the so-called "New Russians," the super-rich, emerged and increased their spending. However, these people accounted for only 5 to 10 percent of

the population. Spending by the rest of the population either stagnated or declined. In contrast, since 2000, a middle class has emerged and consumption has increased in a large number of households.

This new phenomenon has demonstrated the fact that once they have even a little money for extra spending, Russians become very aggressive consumers. In terms of clothing, food, housing and leisure activities, they are not satisfied with the average consumption levels seen in Europe or Japan. They want a more fulfilling level of consumption.

One example, which has been attracting attention, is that the average spending by Russians who holiday in the world's resorts (and who are by no means limited to the wealthy few) is visibly higher than that of tourists from Europe, the United States or Japan. Recently, Indonesia and Morocco have approved de facto visa waivers for Russians, in order to attract tourists from Russia. It is safe to say that Russia has begun to transform itself into a "big consumption power." While the domestic market of Russia has been expanding steadily, Russia is growing in importance as the destination of exports and investment for the world's enterprises.

Increased Capital Inflow from Overseas

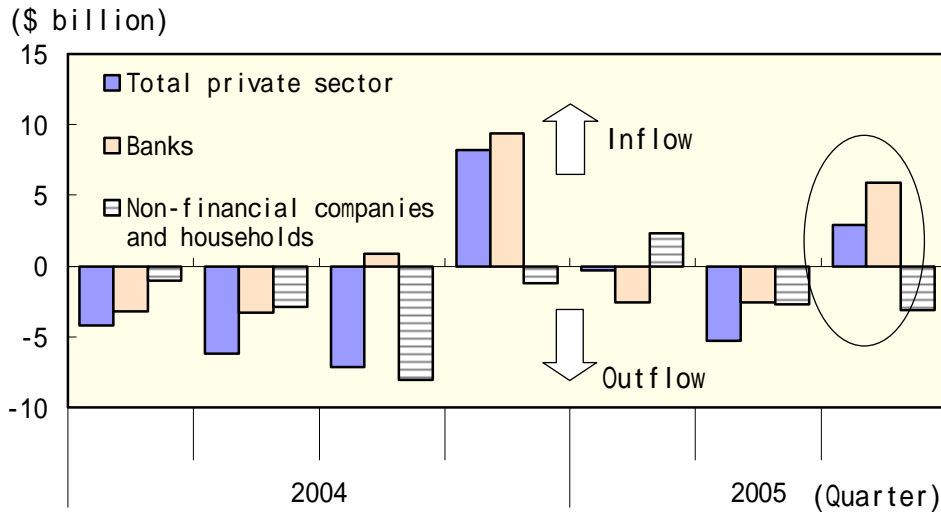
Second, it is to be emphasized that there is a boom in the Russian capital market and that capital inflow from overseas has been on the rise. This is also largely due to the strong performance of the oil sector. Although the average stock price index remained unchanged last year due to the arrest of the owner-manager of Yukos, a major oil company, it surged 52 percent during the first seven months of this year. There are concerns about the emergence of a bubble, but the rise did indeed reflect the recovery of performance in oil, metals and other natural resources-related companies.

For a long time, capital outflows from Russia, due to the poor domestic business environment, attracted attention. Recently, however, the capital balance has shifted to a net inflow (with the inflow exceeding the outflow) as shown in Exhibit 2. The balance of payments statistics show that in 2004, the private sector recorded a net capital outflow of 9.3 billion dollars, but the balance in the fourth quarter was a net inflow. This year, the balance was a net outflow during the first half, but in the third quarter, there was a net capital inflow of 2.9 billion dollars. Moreover, net inflow is expected to continue from now on. At present, Russian private enterprises and banks are able to raise low-cost funds overseas without difficulty. This is also a factor in the current economic growth. Although there is a risk that excessive capital inflows could bring on a financial crisis as they did at the end of the 1990s, so far there have been no signs of such a development. Most funds coming into Russia are directed to the sectors that are directly related to expanding personal consumption, such as retailing.

Foreign direct investment in Russia has also been on the rise. The oil-related sectors are attracting the largest amount of investment, but as Japan's Toyota Motor's decision to start production of automobiles near St. Petersburg demonstrates, the manufacturing sector is also growing as an important area of investment. Major

manufacturers in Europe, the United States and Japan are intensifying their moves to build local production centers in order to cultivate the Russian market.

Exhibit 2. Net Inflow of Private Funds
(Trends in Capital Account Balance)



Sources: International Balance of Payments Statistics, Russia, and Izvestia (October 7, 2005).

A Massive Amount of Oil Money Remains Dormant in the Government Account

The oil industry is the principal source of tax revenues, and it is allowing the government to maintain a large surplus in its fiscal balance. However, Russia’s oil strategy and the system of management of the oil industry are fraught with problems. Unless such problems are solved, the above-mentioned positive effects will not only diminish but the growth of the oil sector itself may well decelerate.

The first cause for concern is the deceleration of the expansion of oil drilling in Russia. The rate of increase is forecast to decline from 8.9 percent in 2004 to approximately 2 percent in 2005. During the first half of this year, oil exports in terms of volume also declined. One of the reasons for this is the high export tax, by means of which the government is intentionally restricting the export of crude oil, in order to promote domestic oil refining. In addition, when an oil company’s profits exceed the standard level set by the government, the “excess profits” are expropriated to the government’s stabilization funds. It is likely that this rule is weakening incentives for the expansion of oil drilling.

There is another serious problem. While the stabilization funds are swelling all the time, they are used exclusively for advance repayments of external debts. The rest remains dormant in the government’s account at the central bank. Hence, earnings from oil exports (oil money) are not being used to support economic activities in other sectors or to develop infrastructure that would benefit people’s lives. The Ministry of Finance and economic advisors to the President maintain that these measures are

necessary to maintain sound government finance, curb inflation and assure the stability of the macro economy. However, there is doubt as to the appropriateness of being held hostage to these principles and freezing massive amounts of funds, which otherwise could be used for economic development and for the improvement of people's lives. This point is becoming a hot topic of discussion, and the outlook for the Russian economy hinges greatly upon its outcome.