Peter Havlik

Russian Federation:
Instability ahead?

The Russian GDP grew by more than 4% in 2011 thanks to a robust recovery of fixed investment, construction and consumer expenditures. The contribution of net exports to GDP growth was sharply negative (despite a sizeable nominal increase in trade and current account surplus). wiiw reckons with unspectacular GDP growth during 2012-2014, assuming no abrupt policy changes or external shocks. Export revenues will grow rather slowly owing to stagnating volumes of exported oil and gas; import volumes are expected to grow at a faster rate as household consumption and investment will gradually pick up, both fuelled by the ongoing real currency appreciation. In the medium and long run, reforms and investments (including FDI) may be stimulated by WTO membership, while the attempted modernisation drive will hardly succeed any time soon. With some luck the annual CPI inflation may gradually drop to 5% and the budget deficit will remain balanced.

The Russian economy grew by more than 4% in 2011, a bit faster than expected earlier, largely thanks to the acceleration of growth towards the end of that year. The better than expected GDP growth resulted from a robust recovery of fixed investment, construction (housing in particular) and also growing consumer expenditures. The contribution of net exports to GDP growth was sharply negative because of widely diverging volumes of exports and imports (see below). On the supply side, the strong upturn of agricultural output (+22%) – after a dismal grain harvest due to severe drought in 2010 – contributed not only to the growth of GDP, but also to the reduction of consumer price inflation in the final months of 2011. Given the strong recovery of oil prices and the related surge in export revenues (USD-based oil prices increased by 40% in 2011 compared to the previous year; export revenues were up by more than 20% in EUR terms), the trade balance and current account surpluses rose as well (the latter reached 5.4% of GDP in 2011). Growing export proceeds helped to increase government revenues and, despite some increase in nominal expenditures, to achieve a balance, perhaps even a small surplus, in the state budget.

Together with slightly expanding employment (and the related drop in unemployment), all these positive economic developments should have influenced the outcome of the

December parliamentary elections in favour of the ruling party United Russia. The more surprising were the announced results, with United Russia reportedly receiving less than 50% of the votes, and the Communist Party collecting many protest votes. Surprising have also been the mass post-election protests after the official voting results were confronted with numerous evidence of cheating. The reports about voting count falsification have been widely circulated and commented on in the mass media and on the Internet. The obviously falsified election results added to the widespread popular disillusionment, especially among the middle class intelligentsia in Moscow and St. Petersburg. Disillusionment escalated after the previous announcement of the switch in the Medvedev-Putin ruling tandem after the next presidential election. The subsequent popular protests, in parallel with organized pro-regime supporters, abruptly changed the political landscape in Russia: the perceived stability and apathy was suddenly over and the victory of Vladmir Putin in the presidential elections on 4 March 2012 does not guarantee stability either.

Moderate economic growth notwithstanding, inflation has calmed down towards the end of 2011, in part thanks to the absence of food price hikes following last year's favourable harvest. Another factor mitigating inflationary pressures has been the nominal rouble appreciation – a by-product of surging export revenues and related foreign exchange inflows. In real terms (deflated with the producer price index), the rouble appreciated by nearly 50% against the euro between January 2009 and January 2012.[1] Nevertheless, the volatility of the rouble exchange rate has been considerable: after a short-lived but sharp nominal and real depreciation during the peak of the crisis at the turn of 2008/2009, the real appreciation of the rouble soon resumed and has been one of the factors behind surging imports (in nominal euro terms, both exports and imports grew by about 23% in 2011). However, the volume of exports de facto stagnated (oil and gas exports even declined) whereas the import volume expanded by an estimated more than 20%. That notwithstanding, foreign exchange reserves are being replenished (they exceeded USD 500 billion in early 2012), although capital flight accelerated again, most likely due to political uncertainties before the presidential elections in March 2012. The outflow of capital from Russia exceeded USD 85 billion in 2011; even net FDI was most likely again negative – already for the third consecutive year.

The banking sector has been slowly consolidating yet the liquidity crisis has not yet been completely overcome. The share of non-performing loans is gradually declining (to 4.2%

[1] Indeed, producer price inflation is hovering close to 20% as a consequence of rising energy prices. The CPI-deflated real rouble exchange rate appreciated by about 16% in the same period.

of total credits as of December 2011). However, at least one third of troubled credits have been restructured and their maturity extended. Last but not least, the market for housing mortgages is recovering as well, supporting rising construction activity: the volume of outstanding housing mortgages reached RUR 613 billion in November 2011 – nearly twice as much as in November 2010 (yet still nearly 20% less than before the 2008 crisis).

As mentioned repeatedly in our previous assessments, the recent years – either before or after the crisis – have not been used for launching economic restructuring and institutional reforms which would bring about the badly needed improvements of the business climate. Russia is as dependent on exports of commodities as ever: oil and gas account for about two thirds of export revenues. Restructuring, modernization and the ‘innovation development’ preached by the authorities already for a number of years have so far been just empty slogans. The long-term strategic target of economic diversification and modernization remains high on the agenda and is being pursued, mostly verbally, by both current President Medvedev and (likely) future President Putin. Modernization prospects suffered another blow after President Medvedev’s announcement in September that Vladimir Putin should stand for the next presidential elections in March 2012. The long-lasting anxiety whether either Mr. Putin or Mr. Medvedev will be the next president was thus finally resolved; the tandem will probably switch positions as Mr. Medvedev should succeed Mr. Putin as the next Prime Minister. Paradoxically, this news created some disappointment in both Russia and abroad.[2] Disappointments with this uninspiring switch in the ruling tandem result not least from a growing scepticism regarding modernization and fears that Russia will turn back- and inward in the coming years. As the modernization will likely stall, a rising number of people will give up initiative for resignation (according to polls, emigration is being considered by an ever growing number of young and educated Russians). The above-mentioned rigging of the December 2011 parliamentary elections, the stubborn reaction of the authorities and the related widespread popular protests have all increased the forthcoming political risks.

Despite Mr. Putin’s convincing victory already in the first election round on 4 March 2012, his authority and the room for manoeuvre will be far more constrained than previously considered. In particular, his relatively low support in Moscow (he received less than 50% there) will require policy adjustments in order to accommodate (hopefully not to suppress) protests of disappointed middle class inteligentsia. There have been a lot of other worrying signals as well. Besides growing nationalism (common to many opposition

[2] See, for instance, *The Financial Times*, 29 September 2011, p. 9.

figures such as the leading anti-corruption blogger Alexei Navalny and others), the openly expressed praise for the Soviet past (in particular for the Brezhnev era) by both Messrs. Putin and Medvedev do not bode well for modernization and forward-looking policies either – despite official claims to the contrary. These and other disturbing signals (such as the public clash and the dismissal of Deputy Prime Minister and Finance Minister Alexei Kudrin in November 2011, Russia's vetoing the UN resolutions on Iran and Syria) foster the views that instead of 'forwards' (Medvedev's slogan 'Russia Forward') the forthcoming years of Putin's presidency will lead Russia backwards, or at least to social and economic stagnation.

The elements of Putin's intended economic programme and future policies have been made public recently. In his first programmatic declaration (from October 2011), Mr. Putin announced the priority of Euroasian (EurAz) integration of the post-Soviet space.[3] A certain progress in this direction, at least on paper, was made in October 2011 in St. Petersburg when eight CIS republics (including Ukraine) announced the establishment of a free trade area (energy and metals will at first be excluded). Another of Putin's recent articles praised the stability achieved under his rule as well as his own leadership qualities.[4] Last but not least, the economic programme of his next presidency was made public in a lengthy article published under the heading 'We Need a New Economy' at the end of January 2012.[5] Apart from stressing again 'stability', as well as repeating the necessity to overcome the 'raw materials character' of the economy via modernization and diversification while rejecting protectionism, the suggested economic reform blueprint represents a somewhat confusing mix of industrial policy measures, the rejection of 'state capitalism' (despite praising the experiences of China and – presumably South – Korea), the support of further privatizations and foreign direct investments.[6] The latter should be attracted inter alia by an expansion of the 'internal market' – not least thanks to the above-mentioned re-integration of the post-Soviet space.

The business climate remains 'unsatisfactory' in Putin's view, despite efforts undertaken during the past couple of years by President Medvedev – an indirect criticism of the latter while avoiding to admit own responsibilities as Prime Minister. Possibly reacting to the

[3] The Customs Union of Belarus, Kazakhstan and Russia was launched already in 2010. Later on, this will be expanded by Kyrgyzstan and Tajikistan, with the ultimate Russian aim to get Ukraine eventually on board as well. The Customs Union was upgraded to a Common Economic Space starting from January 2012.

[4] See *Izvestiya*, 16 January 2012.

[5] See *Vedomosti*, 30 January 2012.

[6] Including selling minority stakes in the natural gas monopoly Gazprom – see *Vedomosti*, 7 February 2012.

widespread criticism of United Russia as the ‘party of crooks and thieves’, Mr. Putin also complained in unusually harsh words the lack of transparency, failures of the state apparatus – including customs and tax officials, the legal and court systems – mentioning even ‘systemic corruption’ and demanding the elimination of all remnants of the Soviet legislation from the business legal codex which may hinder entrepreneurship. Within the next couple of years, Mr. Putin aims at the improvement of Russia’s ranking in the World Bank Doing Business indicator (currently 120 out of 183), to reach at least the current rank of Kazakhstan (47).[7] Last but not least, the state’s role in the economy should be reduced and competition fostered while maintaining macroeconomic stability. Taken together, all these and other outlined measures should contribute to economic diversification, productivity increases and the development of high-tech industries. In all these areas, including job creation, SMEs should play crucial role.

Pre-election rhetoric notwithstanding, any significant breakthrough is unlikely in the near future. Rather, uncertainties have increased as Mr. Putin’s future presidency will be much weaker than previous ones (comparisons with Yeltsin’s second term are being made). External risks have also increased: a more pronounced recession in Europe and a slowdown in the global economy may result in lower oil prices. On the other hand, the escalation of conflicts in the Middle East would go in the other direction and lead to price increases. In view of all these recent developments, the wiiw baseline forecast scenario reckons with oil prices staying at around USD 100 per barrel in 2012 and thereafter (largely in view of the currently sluggish demand in the West and a projected subsequent mild recovery). The ‘horror scenario’, with oil prices falling below USD 70 per bbl with severe consequences for Russian export and state budget revenues, is highly unlikely.

The unimpressive or diminishing drive for reforms and restructuring in Russia, together with the prospect of a weaker next presidency by Putin, may well get reflected in the continuation of capital flight and a poor climate for investments. In the medium term, a certain modernization drive could come from WTO membership: the final obstacle for Russia’s WTO accession – after 18 years of negotiations – was removed when Georgia gave up its veto to Russia’s membership and the accession protocol was signed in December 2011.[8] In the baseline scenario, wiiw reckons with unspectacular GDP growth during 2012-2014, most likely around 4% per year. This scenario assumes no abrupt policy changes or external shocks and is charged with substantial downside risks. In

[7] We note that Belarus ranks 69th and Georgia 16th in the same World Bank ranking.

[8] After ratification, Russia will become a fully-fledged WTO member in 2012 – see *CASE Network E-briefs*, No. 01/2012, January 2012.

particular, a recession in Europe would have severe consequences for Russia, largely via falling export (and fiscal) revenues.[9] In the baseline scenario, export revenues will grow rather slowly (if at all) owing to stagnating volumes of exported oil and gas in the forecasting period (and there will be not much else to export since the progress in export diversification will be limited). Simultaneously, import volumes are expected to grow at a faster rate as household consumption and investment will gradually pick up, both fuelled by the ongoing real currency appreciation. In the medium and long run, economic reforms and investments (including FDI) may be stimulated by WTO membership. This (relatively optimistic) scenario implies an ongoing negative contribution of real net exports to GDP growth in the coming years and, in nominal terms, gradual reductions of the trade and current account surpluses. With some luck the annual CPI inflation will gradually drop to 5% and the budget deficit will remain balanced.

The relatively high oil prices (more than USD 100 per bbl) are a double-edged sword: on the one hand, export revenues (and taxes) fill government coffers enabling the state to finance various spending programmes which range from rising pensions, infrastructure investments and military expenditure. The Russian economy’s growing vulnerability concerning commodity prices is certainly risky – as demonstrated during the 2008/2009 crisis. Besides, high revenues from commodity exports put off the pressure to diversify and modernize the economy, stimulate currency appreciation and impede the competitiveness of non-commodity exports (Dutch Disease syndrome). Therefore, a new collapse of world market energy prices (which appears rather unlikely at the moment) would result in major troubles for the Russian economy: a sharp fall in economic growth with a simultaneous increase in the fiscal deficit, both adversely affecting all components of GDP. The shrinking of the labour force due to demographic factors, emerging skill shortages made more severe through outward migration (mostly to the West) and the demand for unskilled workers being usually met by migrants (mostly from former Soviet republics) represent another major challenge constraining the future economic growth in Russia.

9 Some analysts are fairly upbeat claiming that nowadays Russia is much better prepared to face the challenges which would stem from a crisis in Europe – see, for example, the analysis of the Gaidar Institute published in *Vedomosti*, 19 October 2011.

Table RU

Russia: Selected Economic Indicators

	2006	2007	2008	2009	2010	2011 [1]	2012	2013	2014
								Forecast	
Population, th pers., average [2]	142487	142115	141956	141902	142938	142500	142000	141500	141000
Gross domestic product, RUB bn, nom. [3]	26917.2	33247.5	41276.8	38808.7	45166.0	54369.1	61800	68800	76700
annual change in % (real) [3]	8.2	8.5	5.2	-7.8	4.3	4.3	4.2	4.1	4.3
GDP/capita (EUR at exchange rate)	5500	6700	8000	6200	7800	9300	.	.	.
GDP/capita (EUR at PPP - wiiw)	11100	12500	13100	11900	12600	13400	.	.	.
Consumption of households, RUB bn, nom. [3]	12974.7	16031.7	19966.9	20985.9	23475.9	27221.1	.	.	.
annual change in % (real) [3]	12.2	14.3	10.6	-5.1	5.1	6.4	5.5	5	5
Gross fixed capital form., RUB bn, nom. [3]	4980.6	6980.4	9200.8	8535.7	9829.2	11398.0			.
annual change in % (real) [3]	18.0	21.0	10.6	-14.4	5.8	6.0	6	6	5
Gross industrial production [4]									
annual change in % (real)	6.3	6.3	2.1	-9.3	8.2	4.7	6	5	6
Gross agricultural production									
annual change in % (real)	3.6	3.4	10.8	1.4	-11.3	22.1	.	.	.
Construction output									
annual change in % (real)	18.1	18.2	12.8	-13.2	3.5	5.1	6	5	6
Employed persons - LFS, th, average	68855.0	70570.5	70965.1	69284.9	69804.0	70732.0	70500	70000	70000
annual change in %	1.0	2.5	0.6	-2.4	0.7	1.3	-0.3	-0.7	0.0
Unemployed persons - LFS, th, average	5312.0	4589.0	4791.5	6372.8	5636.0	5020.0	5000	5000	5000.0
Unemployment rate - LFS, in %, average	7.2	6.1	6.3	8.4	7.5	6.6	6.6	6.7	6.7
Unemployment rate, reg., in %, end of period	2.3	2.0	2.0	2.9	2.1	1.7	.	.	.
Average gross monthly wages, RUB	10633.9	13593.4	17290.1	18637.5	20952.0	23532.0	.	.	.
annual change in % (real, gross)	13.3	17.0	11.0	-3.0	5.2	3.5	.	.	.
Consumer prices, % p.a.	9.8	9.1	14.1	11.8	6.9	8.5	5	6	5
Producer prices in industry, % p.a. [5]	12.4	14.1	21.4	-7.2	12.2	19.0	15	10	7
General governm.budget, nat.def., % GDP									
Revenues	39.5	40.2	38.8	35.1	35.7	35.5	.	.	.
Expenditures	31.1	34.2	33.9	41.1	39.2	33.1	.	.	.
Deficit (-) / surplus (+), % GDP	8.4	6.0	4.9	-6.3	-3.5	2.5	0	0	0
Public debt, nat.def., in % of GDP [6]	8.6	6.7	5.7	8.3	8.6	9.2	8	7	7
Central bank policy rate, % p.a., end of period [7]	11.00	10.00	13.00	8.75	7.75	8.00	.	.	.
Current account, EUR mn [8]	75474	56818	70642	34961	53236	72603	60000	50000	40000
Current account in % of GDP	9.6	6.0	6.2	4.0	4.8	5.5	4.0	3.1	2.2
Exports of goods, BOP, EUR mn [8]	241960	258930	321792	218221	303421	372000	410000	445000	480000
annual growth rate in %	23.7	7.0	24.3	-32.2	39.0	22.6	10	9	8
Imports of goods, BOP, EUR mn [8]	130948	163282	199148	137960	188483	231000	280000	320000	360000
annual growth rate in %	30.2	24.7	22.0	-30.7	36.6	22.6	21	14	13
Exports of services, BOP, EUR mn [8]	24791	28681	34921	29918	34190	39200	45000	49000	53000
annual growth rate in %	23.8	15.7	21.8	-14.3	14.3	14.7	15	9	8
Imports of services, BOP, EUR mn [8]	35643	42481	51495	44185	56326	65700	80000	95000	100000
annual growth rate in %	14.7	19.2	21.2	-14.2	27.5	16.6	22	19	5
FDI inflow, EUR mn [8]	23675	40237	51177	26254	32802	35000	45000	50000	55000
FDI outflow, EUR mn [8]	18454	33547	37934	31407	39800	50000	45000	40000	35000
Gross reserves of CB, excl. gold, EUR mn	224305	318840	291916	290432	335191	350786	.	.	.
Gross external debt, EUR mn	237669	316903	340688	325697	369458	416460	.	.	.
Gross external debt in % of GDP	30.1	33.4	30.1	37.0	33.0	31.3	.	.	.
Exchange rate RUB/EUR, average	34.11	35.01	36.43	44.14	40.30	40.87	41	42	43
Purchasing power parity RUB/EUR, wiiw [9]	16.95	18.79	22.13	22.91	25.02	28.42	.	.	.

1) Preliminary and wiiw estimates. - 2) Resident population. From 2010 according to census October 2010. - 3) FISIM reallocated to industries, real growth rates based on previous year prices etc. - 4) Excluding small enterprices. - 5) Domestic output prices. - 6) wiiw estimate. - 7) Refinancing rate of Central Bank. - 8) Converted from USD with the average exchange rate. - 9) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.