RUSSIAN FEDERATION: Stuck in transition!

PETER HAVLIK

Russian economic growth came to a near standstill in 2013. The country is 'stuck in transition'. With traditional growth drivers exhausted, there is little prospect for a renewal of growth without a new decisive reform push. GDP growth forecasts were revised downwards accordingly. The wiiw baseline scenario assumes a continuation of the negative contribution of real net exports to GDP growth and, in nominal terms, reductions of the trade and current account surpluses. We expect a revival of investment and an ongoing modest expansion of household consumption. Inflation and unemployment will gradually diminish.

Russian economic growth has been slowing down since its brief post-crisis recovery in 2010; it came to a near standstill in 2013. GDP growth was fuelled only by higher consumer spending and retail trade which both grew by a still respectable 4-5%. On the other hand, the collapse of investment growth, particularly in the case of state-owned corporations, has been the main factor behind last year's GDP growth slowdown (another factor being the declining export surplus). In this situation it is not surprising that the calls for a 'new growth model' have intensified – in particular given prospects for another fall in export revenues and diminishing current account surpluses. The broadly acknowledged key obstacle to private investments – the poor investment climate – underlines the urgency to markedly improve the institutional, administrative and infrastructure prerequisites for doing business in Russia.[1] Russia thus appears to be a textbook example of a country 'stuck in transition': without a decisive new reform push and marked improvement in economic institutions there is little prospect for a renewal of growth and economic convergence as the previous growth drivers – rising energy prices and better capacity utilisation – have already been exhausted.[2]

Worse than previously expected was the performance of key sectors of the Russian economy (industry, construction and goods transport) whereas grain harvests and some market services (especially finance and real estate) recorded higher growth in the course of the year 2013. Taken together, a rather lacklustre performance required another downward revision of growth forecasts: after meagre GDP growth in 2013 (1.3%), the expected recovery will be unspectacular and GDP growth will be close to 2%

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[1] The latest (2014) Doing Business ranking by the World Bank moves Russia (only Moscow is covered) to the 92nd place among the more than 180 surveyed countries (after rank 111 in 2013 – see http://www.doingbusiness.org/data/exploreeconomies/russia).

[2] Economic convergence as well as the role of economic and political institutions and structural reforms in growth have been analysed in detail in the latest EBRD Transition Report 2013, titled 'Stuck in Transition?' (http://www.tr.ebrd.com).

in both 2014 and 2015 according to the latest wiiw assessment. As in the recent past, growth will be driven mainly by household consumption. The contribution of net exports to GDP growth which has been negative already for nearly a decade (except in the crisis year 2009) will remain a drag because import volumes will continue to grow faster than those of exports. Trade and especially current account surpluses shrank markedly in 2013 (the latter is estimated at just 1.6% of GDP in 2013). Given the expected stagnation of export revenues (as energy prices are unlikely to increase) and rising import outlays, the current account surplus will further diminish and may soon even turn into a deficit.

On the more optimistic side, investments should push up growth in the years to come – provided at least some reforms are implemented. Indeed, the share of investment in GDP is envisaged to increase from the current rate of about 22% to 27% by the year 2018 in one of the recent government economic programmes. With this target in mind, a further substantial improvement in the investment climate is required. In order to foster this improvement, new privatisation plans and public-private partnership schemes have been announced. Unfortunately (as mentioned repeatedly in our previous assessments), the recent years have not been used for launching economic restructuring and institutional reforms which would bring about the badly needed improvements in the business and investment climate. Energy still accounts for two thirds of export revenues, and the expected diversification and modernisation effects resulting inter alia from Russia's accession to WTO in August 2012 are yet to materialise. After the lavish spending on the Sochi Olympic facilities (total costs were estimated at nearly EUR 40 billion, close to 10% of overall annual gross investments), no new investment project of a similar scale is in the pipeline.

Foreign exchange reserves have recently dropped below about USD 500 billion as of end-January 2014 (a drop by more than USD 30 billion within one year). Russian capital is round-tripping via offshore destinations back home: out of nearly USD 500 billion of FDI stocks accumulated until the end of 2012, among the top investors were Cyprus (USD 150 billion), the Netherlands (USD 60 billion), the Virgin Islands (USD 50 billion), Luxembourg, Bermuda and the Bahamas (USD 30 billion each). These top six 'foreign' investors accounted for 70% of all accumulated FDI in Russia. Sizeable net FDI inflows (nearly USD 100 billion) are reported by the CBR for 2013 as well; these inflows are probably somehow linked to the Cypriot financial crisis. The consolidation of the banking sector continues, with credits to both households (including housing mortgages) and enterprises modestly growing, and interest rates and the share of non-performing loans falling. The recent depreciation of the rouble will have little effect on exports (owing to supply constraints and structural effects) yet it may help to contain the growth of imports while slowing down disinflation.

Weakened economic growth notwithstanding, the labour market remains tight with employment growth nearly flat and unemployment slightly declining (the LFS rate of unemployment was 5.5% in 2013). Sectoral and regional labour market shortages persist (e.g. in retail trade and construction), especially in big cities such as Moscow and St. Petersburg. The shadow side of the tight labour market – exploitation of migrant (both legal and illegal) workers and the related social, political and nationalist tensions and even racist conflicts – is posing new challenges to the authorities and to social cohesion (according to some estimates there are more than 10 million migrant workers in Russia, the majority of them coming from former Soviet republics).

Lacking progress in the diversification and modernisation of the economy, growing public apathy and widespread corruption, together with the recent slowdown in economic growth and dismal prospects, are all mutually interlinked features of Russia's current development problems.[3] These came to the fore upon Putin's return to the presidency after the tandem 'reshuffle' nearly two years ago, accompanied by more assertive domestic and external policies. A strange coalition between the Orthodox Church and the political leadership which is gambling on the support from conservative parts of the Russian society raises uneasy feelings among the liberal opposition, yet it is popular with the nationalists and populists. On the external front, Russian relations with the United States and the EU further worsened (Syria, Russian ban of USAID and other restrictions on foreign-supported NGOs, etc.). The ongoing tug-of-war over Ukraine represents the current peak in the dangerously escalating conflict between Russia and the West.[4]

In the field of economic policy, there have also been clear signs that voices advocating more anti-liberal approaches start to gain the upper hand recently – at least at the level of ongoing discussions (the eventual implementation may face a similar fate as the previously attempted modernisation efforts). An alternative economic reform strategy aimed at 'achieving sustainable growth in a period of global instability' calls for more 'interventionist' economic and industrial policies and an increased role of the state in supporting investment activity. Other elements of the monetary policy include targeting a 'stable real exchange rate' and the introduction of capital flow controls. In order to stimulate innovation activities, various tax incentives and preferential depreciation schemes should be used; external financing is to be gradually cut.

In the current baseline scenario, wiiw has once more revised its GDP growth forecasts downwards (below 2% in 2014 and less than 3% in 2015-2016). This scenario assumes no abrupt policy changes or external shocks and is charged with substantial downside risks. In particular, a delayed recovery (not to speak of recession) in Europe would have serious consequences, largely via falling export (and fiscal) revenues. In the baseline scenario, export revenues grow slowly due to stagnating volumes of exported oil and gas, while there will be not much else to export since progress in export diversification is limited. Simultaneously, import volumes are expected to grow at a faster rate as investment will gradually pick up. In the medium and long run, economic reforms and investment (including FDI) may also be stimulated by WTO membership-induced reform efforts. In summary, we reckon with a relatively unspectacular GDP growth of less than 3% per year in the medium run. This implies a continuation of the negative contribution of real net exports to GDP growth and, in nominal terms, gradual reductions of the trade and current account surpluses. With the traditional growth drivers – rising energy revenues and idle production capacity – already exhausted, there is little prospect for a renewal of growth without a new decisive reform push. We expect a revival of investment and an ongoing modest expansion of household consumption. Simultaneously, the annual CPI inflation will gradually decline to 5% p.a., the budget will remain balanced and the rate of unemployment will settle below 5%.

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[3] A recent opinion survey found that one third of Russians think the country is already in a crisis, another third of respondents see the danger of crisis – see http://www.gazeta.ru/business/2014/02/05/5883233.shtml.

[4] For more background information see http://wiiw.ac.at/vilnius-eastern-partnership-summit-a-milestone-in-eu-russia-relations--not-just-for-ukraine-p-3075.html and http://www.nytimes.com/2014/02/04/opinion/dont-let-putin-grab-ukraine.html?_r=0. Without ignoring serious problems of recent Russian political and societal developments, it has to be added for the sake of completeness that Western media reports on the situation in Russia (e.g. related to the Sochi Olympic Games) are rather selective and frequently even biased.

Table 1 / Russia: Selected Economic Indicators

	2009	2010	2011	2012	2013 1)	2014	2015 Forecast	2016
Population, th pers., average 2)	142797	142861	142961	143202	143000	142500	142000	142000
Gross domestic product, RUB bn, nom.	38807	46309	55644	61811	66689	70000	74800	80500
annual change in % (real)	-7.8	4.5	4.3	3.4	1.3	1.6	2.3	3.0
GDP/capita (EUR at exchange rate)	6200	8000	9500	10800	11000	.	.	.
GDP/capita (EUR at PPP)	14600	15700	17200	18100	18600	.	.	.
Consumption of households, RUB bn, nom.	20986	23618	27193	30823	34452	.	.	.
annual change in % (real)	-5.1	5.5	6.8	7.9	4.7	3.5	4.0	4.0
Gross fixed capital form., RUB bn, nom.	8536	10014	11951	13604	14316	.	.	.
annual change in % (real)	-14.5	5.9	9.1	6.4	-0.3	1.0	3.0	5.0
Gross industrial production 3)								
annual change in % (real)	-9.3	8.2	4.7	2.6	0.3	3.0	4.0	5.0
Gross agricultural production								
annual change in % (real)	1.4	-11.3	23.0	-4.7	6.2	.	.	.
Construction output								
annual change in % (real)	-13.2	5.0	5.1	2.4	-1.5	2.0	4.0	5.0
Employed persons, LFS, th, average 2)	69410.5	69933.7	70856.6	71545.4	71391.3	71000	71000	71000
annual change in % 2)	-2.2	0.8	1.3	1.0	-0.2	-0.5	0.0	0.0
Unemployed persons, LFS, th, average 2)	6284.0	5544.0	4922.3	4130.8	4137.5	4200	4100	4060
Unemployment rate, LFS, in %, average 2)	8.3	7.3	6.5	5.5	5.5	5.5	5.5	5.4
Reg. unemployment rate, in %, end of period	2.9	2.1	1.7	1.4	1.2	.	.	.
Average monthly gross wages, RUB	18637.5	20952.2	23369.2	26629.0	29940.0	.	.	.
annual change in % (real, gross)	-3.5	5.2	2.8	8.4	5.2	.	.	.
Consumer prices, % p.a.	11.8	6.9	8.5	5.1	6.8	6.0	5.0	5.0
Producer prices in industry, % p.a. 4)	-7.2	12.2	19.0	6.8	3.4	3.0	3.0	3.0
General governm.budget, nat.def., % of GDP								
Revenues	35.0	34.6	37.5	37.4	36.1	.	.	.
Expenditures	41.4	38.0	35.9	36.9	37.4	.	.	.
Deficit (-) / surplus (+)	-6.3	-3.4	1.6	0.4	-1.3	-1.0	-1.0	-1.0
Public debt, nat.def., % of GDP 5)	8.3	8.4	9.0	10.0	10.5	11.0	12.0	12.0
Central bank policy rate, % p.a., end of period 6)	8.75	7.75	8.00	8.25	5.50	.	.	.
Current account, EUR mn 7)	36169	50853	69855	56022	24855	20000	15000	15000
Current account, % of GDP 7)	4.1	4.4	5.1	3.6	1.6	1.3	0.9	0.9
Exports of goods, BOP, EUR mn 7)	213321	296041	370131	410744	392650	410000	420000	440000
annual change in %	-32.9	38.8	25.0	11.0	-4.4	4.4	2.4	4.8
Imports of goods, BOP, EUR mn 7)	132035	185221	228764	261154	259182	280000	300000	320000
annual change in %	-32.9	40.3	23.5	14.2	-0.8	8.0	7.1	6.7
Exports of services, BOP, EUR mn 7)	32876	37062	41680	48495	52619	56000	60000	65000
annual change in %	-15.6	12.7	12.5	16.4	8.5	6.4	7.1	8.3
Imports of services, BOP, EUR mn 7)	45511	56753	65706	84658	97109	105000	120000	130000
annual change in %	-13.9	24.7	15.8	28.8	14.7	8.1	14.3	8.3
FDI inflow, EUR mn 7)	26262	32545	39557	39353	45000	50000	60000	.
FDI outflow, EUR mn 7)	31070	39668	48008	37980	40000	50000	60000	.
Gross reserves of CB, excl. gold, EUR mn	290380	335251	350786	367323	341787	.	.	.
Gross external debt, EUR mn 8)	325639	369524	416406	480451	532797	.	.	.
Gross external debt, % of GDP	37.0	32.1	30.6	31.0	33.8	.	.	.
Average exchange rate RUB/EUR	44.1	40.3	40.9	39.9	42.3	45	46	47
Purchasing power parity RUB/EUR 9)	18.6	20.6	22.6	23.9	25.1	.	.	.

1) Preliminary and wiiw estimates. - 2) According to census October 2010. - 3) Excluding small enterprises.- 4) Domestic output prices. - 5) wiiw estimate. - 6) Refinancing rate of Central Bank. From September 2013 one-week repo rate. - 7) Converted from USD with the average exchange rate. BOP 6th edition. - 8) From 2011 according to BOP 6th edition. - 9) wiiw estimates based on the 2011 International Comparison Project benchmark.

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