ANALYSIS

The Current State of the Russian Economy

By Philip Hanson, London

Abstract

Russian economic growth had slowed to a crawl before the Ukraine crisis. The reasons for this are assessed from both the demand side and the production capability side. Radical reforms to improve business confidence are needed but are unlikely to be undertaken. The Ukraine crisis and foreign sanctions make near-term prospects worse than they already were. In the medium term some restoration of growth is possible, but only to rates below the global average.

Introduction

In assessing the present state of the Russian economy, it is worth taking a step back from the question of sanctions and their impact. Why had Russia experienced a marked economic slowdown before the Ukraine crisis? What are the medium-term prospects? Answering the second of these questions has to involve some speculation about sanctions and their consequences. The first question however is important in its own right. If peace and goodwill were soon to break out over Ukraine—which, sadly, they will not—Russia would still face fundamental economic problems.

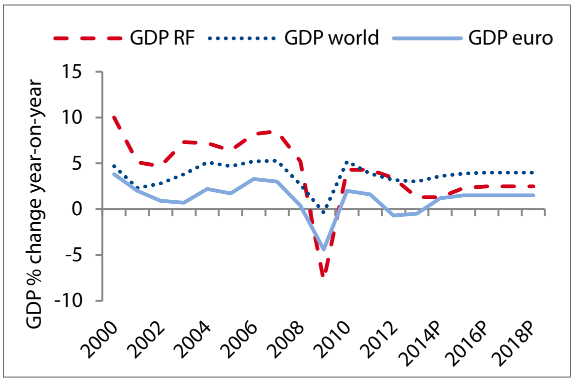
The Pattern of Russian Growth From 2000

Between the Russian financial crisis of 1998 and the global crisis a decade later, the Russian economy boomed. In 1999–2008 GDP growth averaged 6.9% per annum. This was made possible by a rapid growth in oil prices, fuelling a massive increase in household, state and corporate incomes and spending. Real incomes could and did grow even faster than production because the purchasing power of Russian exports over Russian imports was rising.

After a remarkably steep fall in 2008–09, Russian economic activity recovered in 2010–11, but without recapturing its former dynamism. It then slowed to a crawl in 2012–14: GDP rose 1.3% in 2013 and, on preliminary estimates, 0.8% year-on-year (yoy) in the first quarter of this year. Talk of stagnation became commonplace in the Russian media. There were fears of a new recession.

Figure 1 shows how this story looks in comparison with global GDP and that of the globe's sick man: the Eurozone. During its inter-crisis boom, Russia comfortably outperforms the world as a whole, increasing its share of world output; it fares unusually badly in 2009; then approximates global-average rates of recovery in 2010–12, and drops below the global rate of growth in 2013. So far, it continues to do better than the Eurozone, though not as well as some individual European countries, such as Germany. The 'extra slowdown' from 2012 is something of a puzzle.

Figure 1: Growth of GDP in Russia, the Eurozone and the World, 2000–13 actual and 2014–18 projected (year-on-year change, %)



Sources: Russia actual, Rosstat; all other data, IMF World Economic Outlook database, April 2014.

The figures for 2014–18 are IMF World Economic Outlook projections. Like other medium-term projections, they are not necessarily reliable guides to the future. Indeed, the IMF has already revised its Russia projection for this year down to 0.2%. However, a number of Russian forecasters, both official and independent, concur with the IMF in seeing Russian growth stuck for the foreseeable future below that of the global economy as a whole: no longer an emerging, but a submerging, economy.

For a geopolitically ambitious leadership, this is bad news. For any country with a large productivity gap behind the developed world, it is profoundly disappointing (Russian GDP per employed person is around two-fifths of the German level). The IMF sees the Russian economy doing somewhat better than a feebly recovering Eurozone over the next few years, but not markedly better. Catching up with the West, that perennial Russian objective, looks to be postponed yet again.

Many commentators say that the 'growth model' of Russia's boom years no longer works. But what does this mean? And, insofar as it is a helpful way of looking at the global slowdown after 2009, can it account for what might be called the extra slowdown from mid-2012? These questions can be considered from the demand side: what have been the changing patterns of demand for Russian output? They can also be considered from the supply side: what have been the changes in inputs (labour and capital) and in productivity, setting the limits to potential output?

The two 'sides' are not sealed off from one another. If investment demand drops for any length of time, it will tend to lower the subsequent growth rate of capital inputs on the supply side. But as a rough approximation for the short-to-medium term, we can see demand variations as producing fluctuations around evolving levels of production capacity determined by factor inputs and productivity.

Why the 'Extra Slowdown' From 2012? The Demand Side

On the demand side, one element stands out: for most of 2000–2008 the oil price was rising, the inflow of petrodollars was growing and delivering a rapid increase in prosperity. After oil prices recovered, they fluctuated around a historically high (nominal) level but did not resume an upward trend. Therefore income growth slowed after the immediate crisis of 2008–09—whether household income, government revenue or corporate profits. Consequently aggregate demand growth also slowed. That is enough to account, in very broad terms, for the slower rate of GDP growth, a bit above 4%, in 2010 and 2011. But why the further slowdown in 2012–14? It was not to do with any significant fall in the oil price.

Household consumption, at just over half of GDP and growing particularly fast during the boom, is a large part of the story. In 2000–13 average real wages grew more than four-fold and, in the first quarter of this year, the volume of retail sales was still rising, albeit at only 3.5% yoy. However, the rate of growth of household consumption in real terms has slowed sharply: it was an astronomic 11.5% a year between 2002 and 2008, 7.3% from 2010 to 2012, and 4.7% in 2013.

In addition, fixed investment growth slowed after the boom and in 2013 stalled; in fact it fell marginally. Government current spending was almost unchanged between 2012 and 2013. Net exports rose, but there was, as in the abrupt collapse of 2008–09, an especially large cut in inventories (stocks of both finished and unfinished goods).

The World Bank has described this whole deterioration (from mid-2012) as the result of a 'crisis of confidence'. We shall consider just what this means after the next section.

The Slowdown: the Supply Side

Another way of looking at the slowdown is to ask what has been happening to those factors that determine the economy's output capacity: its labour inputs, its capital inputs and the productivity of labour and capital combined. This 'productivity' measure is a residual—a black box containing all sorts of otherwise unaccounted-for influences. These include changes in the allocation of resources between different lines of production, as well as technological progress in the sense of the introduction of new production processes.

Probably the best recent 'sources of growth' analysis for Russia is by Entov and Lugovoy (see Table 1). In measuring the sources of growth, they adjust labour inputs for changes in hours worked and in labour 'quality' (proxied by education); and they adjust capital inputs for changes in capacity utilization. A rough summary of their measurements for the boom period and their lowest (of three) projections for 2011–20 is provided in Table 1.

Table 1. Russian GDP growth by source: a supply-side view, 1999–2008 estimated and a 'low' projection for 2011–20 (% per annum changes)

	1999–2008 estimated	2011–20 'low' projection
GDP	6.9	2.3
Capital inputs	2.1	2.5
of which, capacity utilization	1.4	1.0
Labour inputs*	0.9	-0.9
Total factor productivity	3.7	0.7

*Note: * adjusted for changes in skills and hours worked. Source: Derived from Revold Entov and Oleg Lugovoy, 'Growth Trends in Russia after 1998' in Michael Alexeev and Shlomo Weber (eds),* The Oxford Handbook of the Russian Economy, *Oxford: OUP, 2013,p p. 132–61.*

Three things stand out: the extent to which the growth of the recent past was a recovery process; the importance in the boom period of 'productivity' growth, and the importance for the medium-term future of the decline in the labour force.

What we see throughout is a low growth of capital stock, with much of the increase in capital inputs during the boom coming from increased utilization of capacity rather than increases in that capacity. Similarly, part of the boom-period growth in employment corresponds to a reduction in unemployment. These recovery processes are interrupted by the 2008–09 crisis, but the further recovery from that experience is, it seems, soon completed. Entov and Lugovoy's assumption that capacity utilization will continue to increase in future rests on producers continuing to scrap obsolete equipment.

Employment, even allowing for official measures of net immigration, is expected to fall at close to 1%

a year to 2020, as the number of young labour-force entrants plunges. That has already begun to happen over the past year. This, other things being equal, necessarily slows growth.

That makes the development of the total factor productivity measure critical for future growth. Part, perhaps a large part, of its high contribution in the boom years is due to the reallocation of resources, and particularly the rise of new lines of economic activity, from banking to travel agencies to internet companies, at the expense of inefficient Soviet-era heavy industry. It is a reasonable speculation that much of that reshuffling of resources has happened by now. Therefore this source of 'productivity' change will in the future be weaker.

In sum, supply-side analysis provides some understanding of the post-2009 slowdown, and offers a plausible story about slower future growth. It does not account for the extra slowdown from 2012. Even the Entov-Lugovoy 'low' projection for growth in 2011–20 is a percentage point above the outcome for 2013 and will probably be even further above the outcome for this year. Demand must be critical for the more recent slowdown, and that brings us back to the 'crisis of confidence' and to politics.

A Crisis of Confidence in 2012–14?

Last year's decline, albeit marginal, in fixed investment was in part the result of some major state investment projects, including the Sochi Winter Olympics, having come to an end and not being followed up—in the name of fiscal prudence—by others. It was also in part the result of a dearth of private investment. To some extent, the latter may be dependent on the former. However, there was also evidence that a great many recent private-sector projects had not shown a return above their comparatively high financing costs. Businesspeople have been complaining of high labour costs and low profits, and therefore little incentive to invest. They also think, according to a survey sponsored by the Russian Union of Industrialists and Entrepreneurs, that the business environment has recently got worse.

The wider population, meanwhile, continues to take a dim view of the way the country is run. Asked in March whether 'thieving and corruption in the leadership of the country' was greater or less than 10–12 years ago, 33% of respondents to a Levada Center poll said 'greater' and only 10% said 'less' (48% opted for 'about the same' and the remaining 9% wisely found it hard to say).

So far as household consumption is concerned, growth has continued, but at a slower pace. Wages continue to rise, particularly in the public sector. Putin's May 2012 pledges to raise public-sector pay have put regional budgets under acute pressure but have not been postponed. Despite the drastic weakening of economic performance, unemployment remains at a historically low level—in part because of reduced labour supply. Yet there have been downward pressures on consumption all the same. Household debt, including credit-card debt, is modest by British standards (debt service is about 20% of household income), but it is still worrying because unsecured borrowing has risen fast and non-performing loans with it. The banks are tightening borrowing requirements.

The budget and inflation continue to trouble policymakers. By Western standards, Russian public debt and fiscal balances look very healthy: debt at around 12% of GDP and the consolidated budget (national plus regional plus local budgets) running a deficit last year of only 1.3% of GDP. However, the budget depends heavily (about half of federal budget revenue in recent years) on oil and gas, so uncertainties about both the future oil price and Russia's current ability to borrow make a strong case for continuing prudence, just when fear of recession prompts talk of a new stimulus package. Meanwhile the policy of passing spending obligations down to sub-national budgets that lack the revenue to support them can only end in the federal budget having to bail out the regions.

In late April consumer price inflation was at an annual rate of 7%, well above the target for the year of 5–6%. If the spending lobby gets its way and the National Prosperity Fund is raided to prop up public spending, that inflation rate is unlikely to come down. In sum, both households and businesspeople have recently had every reason to lack confidence.

Reforms, and Why They Don't Happen

The conventional wisdom among Russian liberal economists is that a radical improvement in the business environment is needed. This, in most versions, would include a strengthening of the independence of courts and hence of the protection of property rights, as well as a reduced economic role for the state. Stronger property rights would encourage more investment and innovation, contributing to the growth of both capital inputs and factor productivity. If the state could no longer be corruptly used by incumbent firms to support asset-grabbing and the suppression of market entrants, competition would be strengthened, bringing further gains.

The political elite, many of whom understand the case for such reforms, are unlikely to implement them because their own material privileges could, in a more open society, be threatened. Now, in May 2014, they are less likely to implement radical reforms at a time when, at odds with the West, the leadership is disposed to ramp up social controls.

Even before the Ukraine crisis, however, policy on the judiciary seemed if anything to be going in an illiberal direction. The merging of the High Commercial Court with the general-jurisdiction Supreme Court is widely seen as a step backwards from transparency and judicial effectiveness.

Ukraine, Sanctions and Prospects

The economy, then, was in poor shape before Putin's response to the ousting of Yanukovich. The rouble was already depreciating, initially in line with the currencies of other emerging economies. Rouble depreciation helps towards balancing the federal budget, as export dollars generate more rouble tax revenue. But it worsens inflation and, according to the Centre for Macroeconomic Analysis and Short-term Forecasting (TsMAKP), does more harm than good to the business sector: rouble gains from export revenues, TsMAKP estimates, are outweighed by the higher rouble cost of imported components and equipment and of foreign debt service.

The net outflow of private capital was over $50bn in the first quarter of this year alone. That threatens an annual outflow—absent an improbably rapid resolution of international tension—of over 5% of GDP, and correspondingly depressed domestic investment.

Already, Western sanctions, though officially limited in scope, have tended to deter banks from lending to Russian banks and non-bank companies. They have probably contributed to Standard & Poor's late-April downgrade of its rating of Russian sovereign foreign-currency debt to BBB-, or one notch above junk-bond status. There is brave talk by Russian officials of making the country financially self-sufficient, but this is not promising. The limitations of Russia's domestic financial markets are considerable. The reduced availability of foreign credit is already damaging Russian economic prospects.

The World Bank's 'high risk scenario' for this year has Russian investment falling by a tenth and GDP by 1.8%. That now looks entirely possible. Later on some recovery towards the IMF's projected 2.5% annual GDP growth rate is plausible.

However, to get back to that rate of improvement two things have to happen. First, there has to be at least some return to a working commercial relationship with the outside world. Second, the 'crisis of confidence' within Russia, pre-dating the Ukraine events and already slowing the economy to a crawl, has to be resolved. Both could take time. Radical reform could stimulate investment and innovation. It might in time restore Russian growth beyond 2.5% to world-average levels or above. Right now, however, radical reform looks to be a remote prospect. Meanwhile a sharp recession in the near term cannot be ruled out.

About the Author
Philip Hanson is Associate Fellow, Russia and Eurasia Programme, at the Royal Institute of International Affairs in London.