Analysis

Economic Growth Remains Surprisingly High

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Abstract

Russia's economic growth remained surprisingly high in 2007. The strong performance seems to be due both to unexpectedly high global energy prices and structural change continuing in the domestic economy. A new feature was fast growth in investments. This increase may imply that Russia is entering a phase of investment-led growth. On the other hand, there are evident signs of overheating, and higher inflation towards the end of the year has given rise to worries. The macroeconomic framework of the economy in undergoing change, and it remains open how policies will react to that. Growth will presumably remain robust for a number of years to come.

Growth Drivers: Oil Prices, Middle Class

In 2007 Russian economic growth was again unexpectedly fast; according to current information the economy grew at a rate of 8.1 percent. Most forecasts had been somewhere above 6 percent.

There seem to be two prime reasons for such a forecasting error. First, the price of oil – and also of some other major Russian exportables – was higher than expected. While the forecasts were based on an expected price of $50–70, the actual price at the end of the year was close to $100. It should be remembered, however, that the average annual price was not all that far from the expected, and growth was strong already during the first half of the year, before the price peak. Also the dollar, which remains the key contract currency for Russian exports, has weakened vis-à-vis the euro, which is the major currency in Russian import contracts. Therefore, Russia was not in a position to gain fully from stronger crude price. Opinions differ on the future price of crude oil. Many have raised their expectation to the level of $85, while others remain true to the traditional $50–70 forecast. Nevertheless, there seems to be a strong consensus on two matters. A collapse in the crude price is not in the cards. We remain in a high-energy world for at least years to come. On the other hand, there is little reason to believe in another period of wildly surging energy prices. A future with stable energy prices suits Russia fine. Assuming that will in fact be the case, Russian growth forecasts are again at the 6 percent level. At the same time, there likely will be less inflationary pressure, and consequently annual price increases could be closer to five percent than ten percent.

There has been less discussion of the second cause for the forecasting error. In our minds, we all too easily equate Russia with oil and gas. Doing that, we tend to lose sight of the most essential fact, the deep structural change that Russia has been undergoing, and which continues in the actual production structure of the country. The modern services that were quite alien to the Soviet Union have only emerged in Russia during the last couple of decades. The scope extends from banks, shops and cafes to travel bureaus and service stations. This shift has a self-strengthening character. The Russian new middle class is not very large, and its relative size has hardly been growing. But the middle class consumes those very commodities, whose production and sale give it jobs. The new middle class is both the producer and the consumer of the ongoing structural change. This dynamic therefore has a very strong self-supporting character and is the major source of Russia's future economic growth.

Many Soviet subjects have thus become consumers. Increased incomes have created totally new possibilities of choice. These new consumers are increasingly being satisfied through the global markets, which can always offer many more brands, better quality and greater variety than even the biggest of domestic markets. This is also true of investment goods. That is why Russian imports are growing so fast, recently at 25–30 percent in euro terms.

Three Positive Changes: Current Accounts Surplus

The Russian economy has benefited from three positive changes over the last eight years: a current accounts surplus, increased investment, and a balanced budget. The real appreciation of the ruble, which has so far been an undervalued currency, boosts purchasing power in terms of foreign currencies. But there is a downside to this development. Real exchange rate appreciation spells problems for domestic price competitiveness, even while there are ample possibilities for enhancing productivity. There are few, if any, visible signs of a diversification of export structure. What we know is that Russia's current surplus, which currently is very large, will shrink and perhaps even disappear in a few years.

The shrinking surplus will change the framework for economic development and policies. As less currency flows into the country through the current account, inflationary pressure and the weakening of price competitiveness will ease. Economic policies will face fewer challenges in these respects. Of course, growth in foreign exchange reserves and other funds will slow down.

Obviously, the real exchange rate is a key matter for price competitiveness. Still its role is over-emphasized in Russian debates. One has to remember that no country, having even partially liberalised its trade and payments, is in a position to freely choose its real exchange rate, which translates into its price competitiveness. As the ruble has been much undervalued, its appreciation is inevitable. And this is not only a negative development. At the same time, as the production costs of domestic producers increase, as measured in foreign currency, the purchasing power of households and producers, also measured in foreign exchange, strengthens. The actual competitiveness problem of Russian produce is usually not in the price, but in quality, reliability, choice and marketing. The fact that imports swell in step with purchasing power means that products and services of higher quality than that available before enter the Russian market. That is a bitter pill for uncompetitive domestic producers, but a boon for Russian consumers of goods and services.

Increased Investment

Domestic consumption has risen at double digit rates for years now. Clearly, consumption is greatest in the metropolitan cities, but its growth is fastest in such traditional industrial regions as the Urals and the Volga basin. The most positive piece of news last year was that investment is joining consumption as a pillar of growth. It increased approximately 20 percent. Russia may well be entering an investment-based boom. This increase is excellent news, particularly for those who produce the investment goods that Russia will need. True enough, the volume of investment is not sufficient and it is excessively concentrated in a few branches of the economy, but still the investment growth has been welcome.

Balanced Budgets

A third major change is also visible. Russia has used its booming export revenue in a wise manner: it has paid foreign public debt, facilitated the monetization of the economy, accumulated funds, and increased public sector wages. The time has come, so it is perceived, to increase public investment in activities ranging from infrastructure through health care and education to innovation. How well the money will be spent remains to be seen. In any case, pressure for expenditure is strong. At the same time, revenue will grow at a more modest pace. Current taxation of the resource sector will need loosening. The budget surplus will disappear. These factors imply that politics will make a comeback in Russia through the necessity of prioritizing competing goals in fiscal policy. The current balance of interests inside the power elites can no longer be maintained by allocating increased resources to everybody.

In past years, planners sought to balance the federal budget at an oil price of just over $30. In 2008 this breakeven level is almost $60. The budget will balance and even reach a surplus, but the results will be much less than was typically achieved recently. The only reason why a permanent surplus in the budget of an emerging economy would be justified is to use it to limit aggregate demand, thus trying to prevent overheating and spiraling inflation. Such a policy would be fully justified in the case of Russia, but then there is also no denying the need for increased expenditure. There is a political side involved as well. How long might it be possible to convince consumers of a need to accumulate surpluses, which would be used to finance the US double deficits through sovereign debt paper markets?

Beginning a New Era of Inflation

Though the change is a gradual one, these three factors – current account surpluses, greater investment, and a balanced budget – will economically separate the past eight years from the ones ahead. Though they have no immediate connection with ongoing political change, future economic historians will note that one era has now ended and another is approaching.

The key issue of debate in 2007 was inflation. Although planners had set the goal of 8.5 percent, the final result was 11.9 percent. The trend of declining inflation, evident since 1999 almost without deviation, has been broken. If the higher inflation persists, both businesses and households might change their expectations. The population consistently tells pollsters that inflation is the biggest economic risk they perceive. The bitter experiences of the 1990s are still alive in the popular memory. The nervousness of the decision-makers is easy to understand, remembering that a political transition with the potential for major instability is underway at the same time.

Putting in place an effective policy to reduce inflation is hampered by the fact that there are different views on the causes of higher inflation. Some argue that higher international food prices are to blame. Russia currently imports close to a third of its foodstuffs. Still, the price reaction in Russia would seem to be more than in most countries, perhaps excluding China. That, on the other hand, hints at the impact of domestic incomes growing faster than agrarian production. Another view lays the blame on export revenue, which has been growing faster than expected. As public expenditure has been allowed to increase following revenue, the economy has been stimulated at exactly the wrong time, seen from the business cycle angle. This view is also not difficult to defend. Finally, a third viewpoint refers to a more general kind of overheating in the economy. Qualified labor is in very high demand, especially in the biggest cities. Wages are drifting upward. The same is also true of electricity and gas, not all of which is sold at the fixed centralized tariffs. Freer energy prices may be very high. Construction costs have spiraled. The existence of different, but credible, explanations for higher inflation hinders the formation of a consistent policy response. So far, policies have tended towards temporary solutions, which typically worsen rather than remedy the situation. Price controls, labeled as voluntary, are the prime example of this.

Increased Domestic Energy Prices

On a more positive note, it is worth underlining that the current inflation worries did not in the end lead to abandoning the November 2006 plan for increasing domestic tariffs for natural gas. The aim is to reach a net-back situation in 2011. Gas tariffs paid by industrial users should then equal those paid by European importers, minus export tariffs and transit costs. There are many reasons why domestic gas prices should be increased steeply. Even today, Russia is only able to fulfill its export commitments by importing increased volumes of gas from Central Asia, in particular Turkmenistan. At the same time, Turkmenistan also has other commitments, and doubts linger about its ability to increase production as needed. Russian production only increases slowly, and it is probable that the exploitation of Yamal and Shtokman, as well as the use of the Nordstream pipeline, will be at least postponed. Improved domestic energy efficiency, therefore, becomes a key issue, also for the energy supplies of the rest of Europe. Higher prices are the best incentive available. At the same time, Gazprom and other gas producers would also have an improved cash inflow, which they badly need to be able to finance the massive investment needed in the future.

It should be noted that the current plan for tariff increases only concerns industrial users. Household use of energy would remain very cheap. The plan also only concerns the centralized tariffs. An increasing share of gas will be sold at other prices that may be much higher. Furthermore, this year's hike of 25 percent does not even cover past increases in extractive industry production costs. Finally, the above-mentioned net-back would only be reached in 2011 if the international gas prices would then be notably lower than what is now expected. Domestic prices should increase much faster than now planned, if production for the domestic markets is to be profitable and gas markets are liberalized. But then, raising prices so quickly would have an impact on domestic inflation.

Monetary Policy

Monetary policy has for years been based on a conceptually problematic use of twin goals: containing inflation and maintaining an (almost) stable exchange rate vis-a-vis a basket of currencies consisting of euros and dollars. It would have been possible to reach lower inflation by allowing ruble nominal exchange rate appreciation. But, as Russia has a tradition of a dual-currency economy, using both rubles and dollars, a stable nominal exchange rate has been good for anchoring economic expectations. It remains to be seen if a more flexible nominal exchange rate will be allowed.

This issue is important not only concerning inflation but also concerning capital flows. As noted above, there are good grounds to believe that the net capital inflow through the current account will drop, if not disappear. What then happens to the capital account? The officials naturally hope that Russia will become a major recipient of long-term and stable capital flows, like foreign direct investment (FDI). FDI would bring modern technologies, know-how, management skills, famous brands and, hopefully, produce to be exported. In 2007 FDI into Russia increased greatly, to 3.7 percent of GDP. The pessimists point out that this increase was exceptional, due to three large-scale ownership arrangements. Ongoing discussion about the so-called strategic sectors, where foreign ownership would be strictly limited, contributes to political uncertainty, reducing likely FDI flows in the future. In addition, quickly rising production costs and further ruble real appreciation will make Russia a more improbable platform for exports. Ruble real appreciation will basically come to an end in a few years, if the current account is balanced. The price competitiveness worries of Russian producers will ease, and import growth will slow down.

Russian Competitiveness?

Russia will never be able to compete with the Asian economies on the strength of low costs. True, labor is better educated than in other emerging economies, and according to much experience, good incentives lead to good performance. Qualified labor is, especially in the bigger cities, in low supply, and wages are increasing fast. This situation will further deteriorate in coming years, as the number of 18-year old cohorts will decline in size to just about half of what they have been in recent years. Immigration could, in principle, compensate for the ongoing relatively slow decline in population were that alternative not marred by social and political problems. Even in principle, however, using immigration to compensate for the change in population age-structure and the decline in the numbers of young cohorts would be very difficult.

According to the largest study on the topic conducted in Russia, just 10–45% of companies across a variety of industrial sectors are competitive. More often than not, competitiveness is based on cost advantages, which will largely disappear. Typically, even the capital stock was inherited during the privatization stage, fundamentally at almost no cost. Future competitiveness requires sizable and costly investments. Making those investments will further increase production costs.

If Russia does not belong to low-cost Asia, is it part of high-technology Europe? Clearly, this is no petrostate. After all, it inherited a major research and development capacity, as well as a large industrial base, from the Soviet Union. There are instances of spear-heading global excellence. It would be a wonder if no competitive high value-added commodities could be produced on this basis. But so far, at least, measured by international patent filings, Russian R&D output is modest. In 2007, Russians submitted such filings on a scale that was one fourth that of Finland and one seventh that of Sweden. The distance from Germany and Japan, not to mention the United States, was simply huge. And there has been no growth in filings. Actually, after years of stagnation, the number or Russian filings declined by a fourth in 2007. Among the BRIC's, Russia compares in this respect with Brazil and India, not with China, which continuously had a major surge in filings.

In 2007, Sukhoi, the aviation manufacturer, introduced a short-haul passenger jet developed together with Boeing and other partners. It primarily challenges Brazilian and Canadian competitors. The competitiveness of this airplane, which should become the first new Russian high-tech export product, still remains unknown. But as one plane is expected to be priced at about $30 million, large amounts of them must be sold to make a noticeable mark in Russian export statistics.

Another example concerns the automotive industry. Most international brands have established assembly plants in Russia or are about to do so. For some of them, Russia is already the largest European market. As a result, most cars sold in Russia are either imported or assembled from foreign-made components. Altogether, Russia may well become the biggest European car market in a couple of years. But, at least for the time being, all foreign assembly plants – most of them in St. Petersburg or nearby – only produce for the Russian market. They are struggling to find qualified workers and Russian subcontractors. The industrial conflicts at the Ford plant in recent months may be a harbinger of things to come, not least because of the hefty wage rises reportedly gained there.

The aviation and automotive industries are important examples not least because they are a major part of the industrial backbone left by the Soviet Union. They had a key role both in military and civilian industries. Quite often also larger cities – with population ranging from 0.5 – 1 million inhabitants – are highly dependent on the jobs they provide.

So, Russia will not be a low-cost producing platform. Officials would like to see it as a high-tech producer. True enough, the research and development share of GDP is about 1.5 percent, not low for a country at this income level. It basically equals the share in China. The problem is that most of the financing comes from state sources, and much of it is used for military purposes. That is needed, if Russia wants to have a functioning military industry in the future. But this is not the way to produce a large number of marketable commodities.

Russian companies usually have no or almost no research and development effort. In addition, they are often inflexible, hierarchic, closed and unfocused. Betting on the so-called national champions hardly supports innovation. But there is an even deeper problem. How many Russian companies in fact should aim at innovation-based development? They are, after all, in most cases so far from the global technology frontier that imitation would still be the best way to enhance productivity. The various institutions that the state aims to develop – from top down – to support innovation, may under the circumstances be left without sufficient social demand. What is good for an economy at the global frontier, is not necessarily good for an economy in catching up.

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