EMERGING MARKETS

RUSSIA: Wild is the wind

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Russia's economy is perennially beholden to the whims of oil prices – and experts warn not enough is being done to change that

Policymakers in the eurozone have reason to look at Russia's macroeconomic figures with envy: economic growth, even though slowing lately, is still robust while its ratio of debt to gross domestic product is below 10%; inflation seems to be under control, albeit edging up a bit, while unemployment is hovering around the lowest level in the past 10 years.

Confidence in the country increased so that when Russia's economy slowed in the middle of the year, it failed to produce any of the market tremors that might have been expected in the past. There remains a widespread understanding that the economy has recovered well from the effects of the global financial crisis that started in 2007.

But the same risk is still there: Russia's heavy dependence on exports of oil and other natural resources. The collapse in oil prices, more than the western banking crisis, precipitated the fall in economic activity in 2009. This year talk has intensified about the risks of another sharp fall in prices for crude if the global economic slowdown accelerates.

The problems are typical of resource-dependent countries, which are subject to the phenomenon of 'Dutch disease' – where dominant exports force up exchange rates and crowd out other parts of the economy.

"It might not be a big problem if a significant share of the high profits from these sales went towards the modernization of the economy, and was directed by the government to the revival of the 'real economy'," Alexey Gromyko, deputy director of research for the Institute of Europe, says.

According to Julian Cooper, a professor of Russian Economic Studies at Birmingham University in the UK, the most worrying aspect of oil dependence lies in its indirect effect on the government's budget, but more direct impacts on the balance of payments and the structure of GDP also matter. Over 40% of budget revenues derive from foreign trade, headed by duties on oil exports, he says.

The budget is also put under strain by president Vladimir Putin's election pledges this year. He promised to spend a further Rb5 trillion ($170 billion) to Rb10 trillion on pay rises for federal employees – the equivalent of about 1% of GDP – and to launch an expensive defence modernization programme.

On the plus side, the budget is more resilient to external shocks after this year's abandonment of an exchange rate-targeting policy for the rouble, says Evgeny Gavrilenkov, chief economist of Troika Dialogue in Moscow. If international oil prices fall, the exchange rate will do so too, helping to maintain revenues in rouble terms.

"Russia's dependence on the oil price is no worse than western countries' dependence on printing money," he says.

SLOW DIVERSIFICATION

The Russian economy is gradually diversifying, but economists differ over the extent and significance of the trend. According to some, manufacturing is on the way to replacing oil as the main driver of the economy.

Others are less convinced. Andrei Yakovlev, vice-rector of Moscow's Higher School of Economics (HSE), says the government has refocused to become more business-oriented since the crisis. It is looking for models to emulate the success in industrial development of countries such as South Korea in the 1970s. "I would stress the huge opportunities and new understanding by the Russian government," he says.

Gavrilenkov calls the process "spontaneous diversification" and warns that it is advancing slowly. 'Organic' development has been seen in faster growth recently in the manufacturing, services and construction sectors, rather than in raw materials extraction.

Rising real incomes, credit expansion and drawing down of personal savings have boosted consumer demand. Household expenditure was up 11% in the first five months of this year, compared with the same period in 2011.

However, a large part of this expenditure goes on imports, Cooper says. More cars are now produced in Russia, but he sees little other real evidence of diversification.

Domestic and foreign resources must be mobilized to get to the next step of the process.

"The modernization of the Russian economy is impossible without attracting significant investment from within Russia and from abroad," says Gromyko. And, he adds, the obstacle to investment "lies in well-known problems, in the first place corruption and the inadequate development of the judicial system."

Russia's image in the eyes of foreign investors is slowly improving, but many are still wary of putting their money in a country perceived as uncertain.

After a buoyant first half, economic growth fell to 2.6% year-on-year in July from 3.8% in June. This disappointing news produced barely a ripple on the financial markets, partly signalling increasing investor confidence.

When announcing the figures, Andrei Klepach, deputy minister for economic development, predicted an acceleration of GDP growth in the fourth quarter due to higher investment. He raised the government's growth forecast for 2012 from 3.4% to 3.5%.

However, that is lower than the 4.3% achieved in each of the last two years. And, despite the lack of market reaction, many analysts have doubts about the prospects for the Russian economy.

STRUCTURAL CHANGES

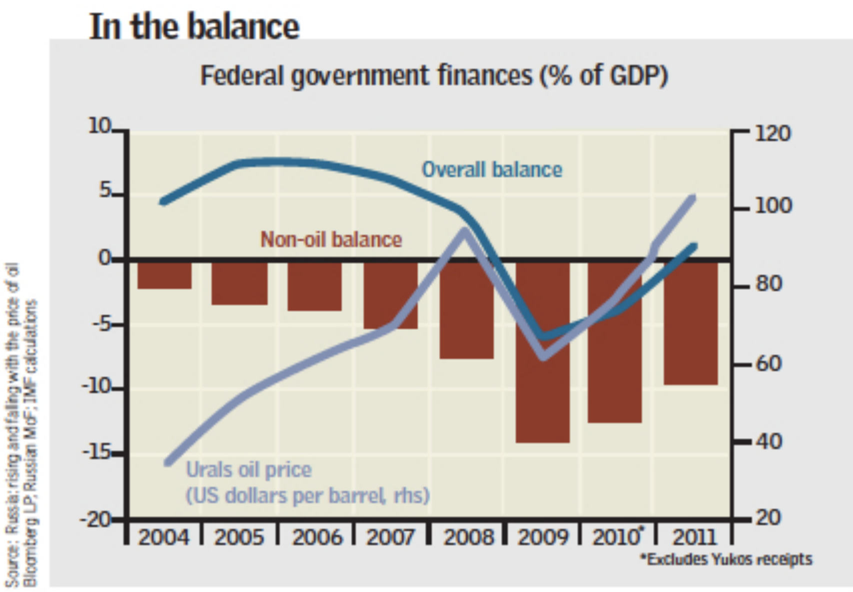
The rapid growth of the last decade was always fragile because it was thinly based and relied on external demand for oil and other commodities. Structural change to match the most advanced economies was limited.

"It is clear that without real structural reforms of the Russian economy... it will still remain extremely vulnerable in the event of a sharp fall in prices of raw materials, oil and gas in the first place," Gromyko says.

However, other economic indicators suggest macroeconomic management since 2009 has been effective.

The government has turned the budget round from a deficit of 6.3% of GDP in 2009 to a projected 0.6% surplus in 2012, according to ministry of finance data cited by the IMF.

At the end of 2011 gross government debt stood at just 9.6% of GDP. The IMF projects it to slip further this year to 8.4%. Unemployment has fallen to 5.4% compared with average rates of around 8% since 1999.



But Klepach warns that inflation is rising. He raised the year-end inflation forecast to 7%, due mainly to increasing prices of food. The figure stood at 5.8% in August.

A nagging fear survives in some observers' minds that things can still go very wrong. After all, in the global crisis the country suffered the sharpest yearly fall in output of any G20 country, with a 7.8% decline in GDP in 2009.

Continuing lack of confidence among Russia's capitalists is shown by the persistently high level of capital flight. Klepach predicts it would reach "$50 billion or even more" in 2012.

Nevertheless, "the Russian elite learnt something, especially from the crisis of 2008," says Yakovlev. "It was a cold shower – but without catastrophic consequences."

Julian Cooper agrees. Recognition of the need for adaptation has been general across the elite, in response to the crisis of 2008–09, he says.

However, there is less agreement among economists about the forms of adaptation required and whether – and how – they can be achieved.

TARGET SETTING

Before the presidential election in March, Vladimir Putin announced an ambitious aim of reaching the top 20 countries in the World Bank's 'Ease of Doing Business' index. Presently, Russia is ranked 120th.

The government is working on improving performance on index components such as construction permits, where Russia is ranked 178th out of 183 countries. It also appointed a business ombudsman supported by a Commission for Entrepreneurs' Rights, and set up an Agency for Strategic Initiatives to improve communications with business.

The government is trying to refocus its activity away from oligarchs towards medium-sized businesses, says Yakovlev, who directs the HSE's Institute for Industrial and Market Studies. However, he reckons these changes would remain mere rhetoric "if the government does not provide some conclusions for conflicts of interest".

One tempting line for modernization is to promote a 'knowledge-based economy' relying on Russia's high standards of education and scientific capabilities. But some analysts, among them both Gromyko and Cooper, are sceptical of its chances of success.

Russia suffers from a debilitating brain drain as educated and talented young people continue to move to more attractive jobs abroad. The recent tightening of political control is only likely to exacerbate this process.

“The Russian economy could be raised to a qualitatively new level only on the basis of sectors like light industry, processing industries, engineering and the food industry,” says Gromyko.

Cooper says the state invested large sums in nanotechnology but found little demand for its products. Some regional projects have shown signs of success, such as the Titanium Valley project in the Urals and a hi-tech software centre in Kazan, capital of the Republic of Tatarstan, based on private investment.

Projects of this sort might kick-start development, he adds, but at the federal level they are hampered by political leaders’ belief that everything has to start from the top.

Internationally, Russia plays an active part in the Brics (Brazil, Russia, India, China and South Africa) grouping and is fostering the Eurasian Economic Community, a customs union which also involves Belarus, Kazakhstan, Kyrgyzstan and Tajikistan. The government has worked with China on proposed global reforms to reduce the role of the dollar as the only major international currency.

On its Pacific coastline it sees opportunities to develop trade with the buoyant economies of East Asia, with which Russia’s economic structure is in many ways complementary, as the country can provide the resources the Asian economies need while they can supply the know-how for migrating towards a more diversified export strategy. There is a new Ministry for Development of the Far East and Siberia, and in early September the annual Asia-Pacific Economic Cooperation (APEC) leaders’ meeting was held in Vladivostok, on Russia’s far east coast.

But observers say any hopes of radical reorientation towards the East are hampered by the country’s vast size and demanding climate, its inadequate communications and the outdated infrastructure of the far east in particular.

One important change has, however, taken place: on August 22 Russia finally joined the World Trade Organization (WTO) as its 156th member.

The consensus of analyst and investor opinions is that this will have a limited immediate impact on the economy, after many long years of negotiations. On the Russian side it will not lead to much reduction in import tariffs.

However, “this long time period provided an opportunity for Russian companies to make the necessary preparations,” says Yakovlev.

WTO membership could help to encourage inward investment and will permit access to Russia for foreign banks. But Cooper says it will do little for much-needed reforms of Russia’s own banks.

The most important consequence of membership might lie in restrictions on export taxes, which would further limit the room for manoeuvre in budgetary policy, he says.

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