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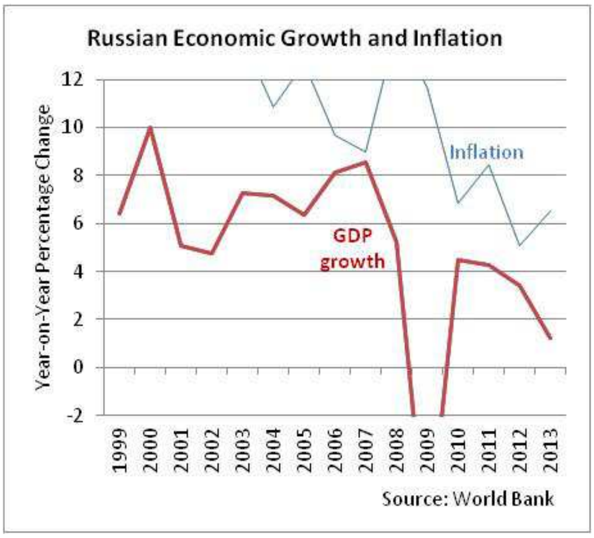
Can Russia Revive its Economy?

Despite Russia's abundant energy resources, the country's economic engine is low on fuel. Growth averaged 7% a year in Vladimir Putin's first terms as president in 2000-2008. But expansion slowed to 3.4% in 2012, when he returned to the post, and 1.2% in 2013. Analysts see no hope for a new surge until economic policies change. Reforms are on the agenda, ***Economy Minister Alexey Ulyukaev*** *said recently at a conference at the* ***Institut Français des Relations Internationales (Ifri)*** *in Paris attended by students of* ***BMI partner school HEC Paris****. We review Russia's economic environment and Ulyukaev's remarks to offer tips on tracking the changes.*



New model needed: Past "high growth on the back of rising oil prices and utilization of spare capacity cannot be replicated" in Russia, the IMF said in Oct. While energy prices remain high, demand for Russian oil and gas in key markets like the EU and China has fallen. And there's little slack left in the country's shrinking labour market, outdated factories or underdeveloped transportation systems. While domestic demand remained strong last year, production was weak. With unemployment near historic lows, capacity utilisation at record highs and rail shipments often delayed, Russian firms struggled to meet demand and imports rose along with prices.

Obstacles to growth are thus mainly on the supply side – a problem you can't solve by stimulating demand via fiscal or monetary policy. According to the IMF, better economic performance in Russia "is clearly possible" in the medium term, "but that would require a new growth model" based on increasing capacity through investment (with diversification away from energy exports) as well as infrastructure projects and reforms to improve productivity.

One thing that's steadily grown in Putin's Russia is the government's economic footprint. The state controls all key energy and transportation firms and 60% of banking assets. Rostec, a state group set up in 2007, employs 900,000 people in 663 technology companies. Meanwhile, productivity in the public sector is low and declining amid poor governance, red tape and corruption. "Russia's labour productivity remains one of the lowest amongst industrialised nations," the EBRD reports, adding that energy intensity in Russia is 2.5 times the world average. Production costs in Russia have doubled since 2000, according to Ulyukaev. Fixed investment, which Russia needs in order to regain competitiveness, is just 21% of GDP and shrinking. That compares with 46% in China and 35% in India.

Policy plans: Ulyukayev, 58, "has not ceased to revise [growth] estimates downwards since taking office last June" as Economy Minister, according to the French institute Ifri, which hosted him at the Paris conference in November. After 9 years as head of monetary policy at the Russian central bank, he seems to have brought a new sense of realism to the government. Slowly, President Putin's calls for demand stimulus are giving way to acknowledgement of the need to bolster the supply side of the economy. As Ifri reports, the minister stressed three new policy priorities which he hopes can help get growth back to 3.0-3.5% by 2016

First is promoting investment. That means improving the business climate to attract foreign investors and keep domestic capital at home. “We seek to facilitate customs procedures, simplify tax administration, registration, connection to energy networks, construction permits, etc.,” Ulyukayev said. The government‘s goal is to rise in the World Bank's 'Ease of Doing Business' rankings to 20th place by 2018, from 120th in 2012. Russia already rose significantly in the 2014 ranking, to 92nd place. To help diversify the economy, investment incentives are planned to boost manufacturing and especially the aerospace, pharmaceutical, petrochemical and agriculture industries.

Second, Russia seeks to develop transport and energy infrastructure through public-private partnerships. Ulyukayev said large foreign investors will be crucial for the PPP projects.

The third priority is efficiency, including cost cuts and productivity gains. State-owned enterprises are asked to cut costs by 10% by 2016. The government’s limiting gas, power and rail tariffs in 2014 as a way to force monopolists to seek efficiency gains. (Ifri notes that the tariff freeze might be counterproductive if it leads utilities to scale back planned investments.) Another objective is to modernise the energy sector.

Numbers to watch: There are several signs to watch for which could indicate that policy changes are working and Russia's longer-term economic prospects are improving, according to a Feb. note to investors by Capital Economics. One would be renewed growth of the working age population, which has been shrinking since 2007. Another would be a pickup in monthly investment figures. Fixed investment growth, near zero or negative since mid 2013, fell 7% y/y in Jan. Other positive signs would be increased government spending on public infrastructure, a revival of manufacturing growth, an increase in the registration of new companies and steps to reduce the dominance of state companies. Stronger anti-corruption measures would be icing on the cake.

Selected Facts About the Russian Economy

- The public-sector share of Russia's GDP, which shrank to 30% in the 1990s, now is back above 50% (EBRD)
- Rosneft‘s 2012 net income per employee was $70,815 vs. $620,026 at U.S. competitor Exxon Mobile (Bloomberg)
- $421b of private capital left Russia in 2008-2013
- 90% of companies in Russia say they can‘t find enough high-skilled professionals (Capital Economics)
- Half of Russia‘s budget revenue is from energy exports
- Transparency International‘s 2013 Corruption Perceptions Index ranks Russia 127th among 175 countries

The immediate economic outlook in Russia is uncertain. Russia's central bank is forecasting 1.5-1.8% expansion this year, while the government still hopes for as much as 2.5%. Economists surveyed by Bloomberg in January on average saw a 33% chance of recession this year, while Capital Economics said its model predicts 0.5% growth in 2014 based on data available as of mid-Feb. “While the growing acknowledgement of the need for reform is good news, we remain sceptical that a major shift in policy is on the cards, at least in the very near term,” Capital Economics concluded.

By Bryan Bradley, BMI, based on:

- Thomas Gomart and Tatiana Kastoueva-Jean, “Russia: A Challenged Growth Model”, HEC Hommes et Commerce, January-February 2014, p. 114-115.

- Neil Shearing et al. “How and why Russia needs reform.” Capital Economics, Feb. 12, 2014.

- International Monetary Fund. Russian Federation: Article IV Consultation. October 2013.

- EBRD, OECD, World Bank, Transparency International, Bank of Russia and newswire reports.