Russia's Constrained Economy

How the Kremlin Can Spur Growth

Sergei Guriev

In recent years, many discussions of the Russian economy have opened with an old joke. In the mid-1990s, John Major, the British prime minister, asked Russian President Boris Yeltsin to characterize Russia's economy in one word. "Good," Yeltsin said. Major, seeking more detail, asked him to elaborate in two words. Yeltsin replied: "Not good."

The joke was prescient. Over the past 25 years, Russia's economy has alternated between "good" and "not good." In the 1990s, Russia's GDP declined by some 40 percent, and in 1998, Russia suffered a major financial meltdown. Then, from 1999 to 2008, Russia's GDP grew by roughly seven percent per year on average, almost doubling in nine years. In the past few years, however, Russia's economy has taken a decisive turn for the worse.

In early 2013, Russian Prime Minister Dmitry Medvedev sought to push beyond official projections of four percent annual GDP growth. Yet by later that year, the Russian Ministry of Economic Development had revised Russia's growth forecast downward to between two and three percent. Now, even projections of two percent growth are considered optimistic. In 2015, Russian GDP actually shrank by close to four percent, and the International Monetary Fund's January 2016 *World Economic Outlook Update* projected a further one percent decline in 2016. Meanwhile, in 2015, inflation reached 13 percent, real wages (adjusted for inflation) fell by 9.5 percent, and real incomes dropped by four percent. The ruble's exchange rate with the dollar is now roughly half of what it was just two years ago, and RTS, Russia's primary dollar-denominated stock market index, has fallen to just over one-quarter of its 2008 peak.

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Russia may not be doing as badly as it was in the 1990s, but it is certainly doing worse than at any time since then. Even the fall of Russia's GDP in the aftermath of the 2008 global financial crisis was short lived: the Russian economy contracted in 2009 but began growing again just one year later. Today, a confluence of factors—corruption, low oil and gas prices, and Western sanctions—is keeping Russia's economy from returning to fast growth.

Moscow has the power to reverse much of the damage—by stopping the violence in Ukraine, for example, or pursuing pro-growth, pro-market policies. Yet the government has chosen not to act, and President Vladimir Putin has failed to deliver on early promises he made to reform Russia's economy. In Moscow, few seem willing to change the status quo, and it is ordinary Russians who keep paying the price.

"NOT GOOD"

Russia's economy faces three major obstacles. First, it suffers from a number of deep-seated problems, including endemic corruption, a weak rule of law, overregulation, and the dominance of state-owned and politically connected businesses and monopolies. The simplest way to understand the impact of these flaws is to look at investment flows. In the past few years, Russia has experienced substantial capital flight, as Russian and international investors have flocked to safer investment destinations. Since 2011, Russia has been losing four to eight percent of GDP annually in capital outflow—a significant amount given that total capital investment in Russia makes up 20 percent of GDP. Investors, fed up with Russia's poor protection of property rights and unpredictable judicial system, have moved their money elsewhere.

Second, the economy has taken a serious hit from the collapse in oil prices. From 2014 to 2016, global oil prices plummeted from $100 a barrel to about $30 a barrel. It is hard to overstate the damage that this plunge has wreaked on the Russian economy. Russia is not quite an oil economy: compared with, say, Saudi Arabia, where oil rents account for nearly 45 percent of GDP, Russia maintains a relatively diversified economy, with oil rents accounting for around 15 percent of GDP, according to the World Bank. But Russia does qualify as a petrostate, since about half its budget revenues come directly from taxes on oil and gas. In the past two years, those revenues have sunk from more than seven trillion rubles in 2014 (about $200 billion at that year's exchange rate) to an estimated six trillion rubles in 2016 (about $80 billion at the current exchange rate). The decline in oil prices has also caused asset prices, including oil company stocks and government bonds, to drop. Various estimates suggest that each ten percent dip in oil prices results in a roughly one-percentage-point decline in Russian GDP. The decrease in oil prices in 2015 thus reduced expectations for Russian GDP by five to six percent; 2016 may see a further dive.

Third, Western sanctions imposed after the annexation of Crimea have isolated Russia from global markets, and Russia's countersanctions, the country's retaliatory embargo on Western agricultural imports and fish, have only compounded the problem. By cutting Russia off from global financial markets, the sanctions have magnified the effect of falling oil prices. Were Russia financially integrated into the global economy, it could have borrowed from Western banks to mitigate the oil-price shock. Instead, Russia's inability to borrow has led to a dramatic depreciation of the ruble and a fall in real incomes and wages. Without access to credit, Russia has had to rely on its Reserve Fund, one of the country's two sovereign wealth funds. But as of January 2016, there was only 4.6 percent of GDP left in the fund, barely a third of what it held just seven years ago. There is another 6.6 percent of GDP in Russia's National Wealth Fund, which supports the country's pension system, but much of that money has already been committed to various investment projects, including some that provide financial support to companies targeted by Western sanctions.

If Russia's budget deficit remains at its current projected level of approximately three percent of GDP, the Reserve Fund will last until mid-2017. The problem is that the current budget assumes the price of oil will soon return to around $50 a barrel. If it stays at near $30 per barrel, as seems quite likely, the budget deficit will likely double, and the Reserve Fund will run out before the end of 2016. To stave off this possibility, Moscow will need to either cut spending or increase taxes. But the current budget is already the result of significant cuts: government spending in 2016 will be roughly eight percent lower in real terms than it was in 2015, which was already six percent lower than the government had forecast when it was putting together the budget projections in mid-2014, when oil prices were $100 a barrel. Moscow's cuts in government procurement, educational and health-care expenditures, and investment programs will put downward pressure on wages and employment and worsen the living standards of ordinary Russians.

DOWN BUT NOT OUT

It is not too late for Russia to reverse course. One option is for the government to continue implementing austerity policies by embracing further budget cuts. Yet the Russian people, tired of tightening their belts, may not support such measures for much longer.

Alternatively, Russia could focus its energies on persuading the West to lift the sanctions by de-escalating the conflict in Ukraine. If Russia could be reintegrated into global markets, Moscow could finance its deficit through external loans, eliminating the risk of bankruptcy. Because Russia's sovereign debt is still very low, at just roughly 14 percent of GDP, it would have little trouble selling bonds to close its budget gap.

But Russia will not be able to grow its economy in the long run without deeper structural reforms. These include privatizing state-owned companies, loosening regulations, fighting corruption, and improving the judicial system and law enforcement. Among Russian leaders, there is a broad consensus that such reforms are necessary for growth. In fact, in 2012, on the first day of his third presidential term, Putin signed Presidential Decree no. 596, "On Long-Term National Economic Policy," which detailed several pro-market reforms to be undertaken during his presidency. These included privatizing many government assets before 2016. Yet four years later, almost none of them have been implemented.

As a result, Russia's economy has not grown. The decree foresaw the creation of 25 million new jobs, annual labor productivity growth of six percent, an increase in the investment-to-GDP ratio from 24 percent of GDP in 2012 to 25 percent in 2018, and 30 percent growth in the share of high-technology industries in GDP by 2018. There has been no significant growth in any of these indicators. In fact, the investment-to-GDP ratio has actually declined, and labor productivity has stagnated.

Putin's record on reform is not completely negative, however. One place he has enjoyed success is in his attempt to improve Russia's business climate. In 2012, the World Bank ranked Russia 120th in the world on its annual Ease of Doing Business Index, which looks at metrics such as how easy it is to start a business and secure construction permits. Putin aimed to move Russia into the top 50 by 2015 and into the top 20 by 2018. In the fall of 2015, the World Bank ranked Russia 51st, which can fairly be counted as a victory, even

Money for nothing: at a market in Stavropol, southern Russia, January 2016

EDUARD KORNIYENKO / REUTERS

if Russia's rise in the ranking owed largely to a change in the index's methodology.

But it is unlikely that the country will be able to move from 51st place to a position in the top 20 in the next two years, as Putin pledged. And given the mounting capital flight from Russia, the metric may no longer be as relevant. Investors, it appears, care more about the geopolitical risk of investing in a country than about the ease of registering a company, connecting to the electrical grid, or getting a construction permit there. Still, Russia's rise in the ranking demonstrates that Moscow can enact and implement reforms designed by technocrats with limited political interference.

Another successful reform has been Russia's adoption of a floating exchange rate. In 2015 and early 2016, Russia's central bank wisely chose not to intervene in the currency market. As oil prices fell, the central bank allowed the ruble to depreciate, helping the economy regain international competitiveness. This stood in stark contrast to 2008–9, when the central bank actively defended the ruble in reaction to the global financial crisis by spending $200 billion of reserves. It was clear that the official ruble exchange rate was unsustainable, so banks stopped lending in rubles and instead bought and hoarded dollars. By the time the central bank allowed the ruble to fall, its credibility had been so undermined that it had to raise interest rates dramatically to provide a floor for the currency, aggravating the recession.

These two success stories aside, however, Moscow has largely forgotten its promises of privatization and pro-growth reform. Global energy prices remain beyond Moscow's direct control, of course, and there are limits to what a petrostate, such as Russia, can do when confronted with an oil and gas price slump. But it is within Putin's power to eliminate the other two obstacles facing Russia's economy by ending the conflict in Ukraine and pursuing structural reforms. The president, however, has preferred inaction. The government's major stakeholders—state-owned companies and politically connected businesses—benefit from the status quo. This is why there were no reforms when oil prices were high. Now, given the current economic climate, the reforms are even less likely to happen.

CAUSE FOR OPTIMISM

Yet even if the current state of the Russian economy is "not good," its long-term outlook is brighter. It will not be easy for Russia to implement structural reforms, reintegrate into the global economy, and build modern political and economic institutions. But if Russian leaders are willing to reform, Russia should be able to catch up to wealthier countries. Russia still has a large domestic market and a highly educated work force. Russia also benefits from a rich store of natural resources beyond oil and gas, including arable land. And although Russia's population is stagnating and aging, younger immigrants from neighboring countries could help offset those trends. In fact, forecasters predict that Russia's population will actually increase by 2030, owing largely to immigration from neighboring countries.

In 2005, the economists Ricardo Hausmann, Dani Rodrik, and Andrés Velasco proposed evaluating countries' development potential through "growth diagnostics," which involves determining the key factors that prevent a given country from developing. If their analytical model were applied to Russia, it would be clear that the country is constrained by its outdated political and economic institutions. Russia has many of the crucial ingredients for success, including savings and human capital, but to encourage long-lasting growth, it needs to enhance the protection of property rights, strengthen the rule of law, encourage competition, fight corruption, and integrate into the global economy. Other countries have enacted such reforms; there is no good reason for Russia not to join them.

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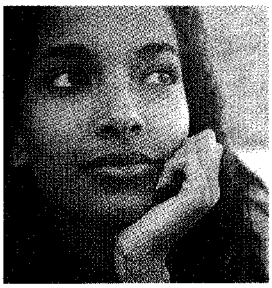

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