

Russia: Prospects for Growth and Convergence

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Russia dramatically transitioned over the last quarter century from a centralized planning economy to the one of the world's biggest developing economies, a member of the G-20 and one of the five BRICS economies. In that time GDP per capita in Russia more than doubled.¹ Russia's high economic growth, especially in the early 2000s, was fueled by sustained oil price growth and a global investment boom. This changed with the advent of the 2008-2009 global financial crisis as real GDP in Russia fell by 7.8 percent. Russia went through the crisis without increasing public debt and kept the government budget nearly balanced. In the aftermath of the crisis, the price of oil recovered, holding steady at around \$100 per barrel (bbl) since 2011, the financial sector suffered minor losses (some second-order commercial banks failed in 2009, but those cases did not have serious implications) and inflation went down to the one-digit range for the first time since market reforms began. On the other hand, income inequality in Russia, as in many other developing economies, remains high and the Gini coefficient currently stands at 0.42. After the second half of 2012 the economy's growth rate slowed considerably and now tends to be close to zero, and experts forecast low growth and the possibility of stagnation.

Oil Prices and the Commodity Economy

In recent times, Russia has been considered a commodity-based economy as its welfare has mainly depended on the extraction and export of hydrocarbons. The country has one of the biggest oil and natural gas endowments in the world, dominates the European crude oil and natural gas markets and extensively exports oil and gas to China and South-

east Asia. Oil and gas account for two-thirds of exports, and taxes from those industries provide more than 50 percent of federal budget revenues. But the world is changing, traditional assumptions are not still valid and the oil and gas sector is no longer a key driver of Russian economic growth.

The oil and gas sector was historically important in Russia, but the Russian economy has become much more diverse, making the effects of oil prices less acute. According to the Gaidar Institute estimates of the oil and gas sector peaked in 2005 at 25 percent of GDP. Since then, this figure has progressively contracted and now the industry accounts for at most 21 percent of GDP. In fact, the level of oil extraction has remained virtually constant since 2005 producing around 500 million tons a year, meaning the industry's real output has not grown at all in 10 years. Our estimates predict that this trend will continue through 2020, where the share of oil and gas will fall to 18-18.5 percent of GDP.

Oil and natural gas are not the only commodities exported by Russia. Metals (various non-ferrous metals and steel) are a close second amounting to 20 percent of Russia's exports. While a projection of the broad metallurgy industry input to GDP was not conducted here, this industry is very important for the Russian economy in terms of employment and impact on particular regions of the country. Agriculture is also an important industry that has great export potential but is tied to natural resource constraints. Russia has the largest reserves of unused rural land and a lot of capacity to increase productivity of land currently in use (for example, the average wheat yield per hectare in Russia is currently 2.5-3 times lower than in Canadian or European regions with similar climate conditions).

Though the country's role as major global player in the natural resources markets (energy, metals, food and other commodities) remains important and can become even stronger, the burden of a resource-based economy over the medium term pushes the country towards rather low rates of economic growth. However, we are convinced that the resource sector cannot become a leading growth factor as it was in Middle East or some African countries. Maintaining such a strategy inevitably leads to very low growth rates and a preservation of the distance between Russia and advanced economies.

The current decline in oil prices also presents risks for budget policy. The acting budget rule is based on the 10-year average oil price (Urals) as a benchmark. For 2015 the benchmark oil price is \$96 bbl, however the budget is actually balanced at the price of \$100-\$105 bbl. Thus, if oil prices go down to \$80 or \$75 bbl, the budget deficit rises to 3-4 percent of GDP. The reserve fund, accumulated during the period of high oil prices, is now 4.5 percent of GDP, so it can only protect the budget from a drop in oil prices for one year. Should oil prices remain low, the Russian government will need to tighten its policy and consolidate the budget with lower levels of public expenditure.

Limits to Growth Potential

Many politicians and investors were accustomed to high growth rates in Russia in the 2000s (recall Goldman Sachs's forecast on growth in BRIC economies²). Since then the domestic public and political discourse has not changed, centering on the expectation of at least 5 percent annual economic growth. In our view, such growth rates are not feasible for Russia in the medium term for four key reasons.

First, in the 2000s economic growth in Russia was *inter alia* determined by a recovery after the geopolitical transformation of the region. In the 1990s Russia experienced a major slowdown (which was also observed in all CEE and former USSR countries) and a four-fold devaluation of the Russian

ruble in 1998. While these factors positioned Russia to have a high potential for growth, each were unique and non-repeatable.

Second, the economy has now approached its production potential frontier. Evidence for this includes Russia's extremely low unemployment rate (unemployment in Russia is currently lower than it was at the peak of economic boom in 2007-2008) and the increasing growth of labor costs along with virtually constant labor productivity. Due to political and social reasons, no necessary structural reforms have been carried out until now. The capital utilization ratio is rather low (60-70 percent), which is either related to the presence of technologically or physically outdated capacities or to the impossibility of using this capital without a qualified labor force.

Third, the demographic trends in Russia are extremely bad for economic development. The labor force will lose several hundreds of thousands of people annually for years to come. Such a situation is unique—there are very few historical examples of economic development and growth given the presence of a permanently shrinking labor force. To increase the labor force, policymakers often consider increasing the retirement age and liberalizing migration procedures. This can only solve part of the problem; some retirees are already involved in production and there are not enough possible migrants who can address the economy's demand.

Fourth, Russia is in a middle-income trap now. International research shows that many countries face a slowdown in growth rates entering the GDP per capita interval of \$15,000-\$30,000.³ The reason is that breaking the middle-income threshold requires a transition to a different economic model: cheap production and commodity exports can drive growth in low-income countries, but the economies of high-income countries are based on the production of technology-intensive goods, big international companies and a developed financial sector. The situation in Russia is aggravated by stagnation in the commodity sector where

production costs are very high and there is no suitable institutional environment for establishing a modern non-commodity economy.

The productive capacity of the Russian economy, even in a favorable global economic climate with restored investor trust in emerging markets, cannot grow faster than 3-3.5 percent annually. Nonetheless such growth rates are above the average in advanced industrial economies. Institutional reforms and improving the business climate can further improve the potential speed of economic growth. As Russia moves to higher growth, it should address the challenges which are inherent to advanced economies. Under tough demographic constraints on the labor force, the problem of speeding up economic growth is directly related to a deeper automatization and technological modernization in all industries, including in services, and a transition to a model of jobless growth by increasing total factor productivity within the economy.

The ongoing 'war of sanctions' is another factor preventing total factor productivity growth. Aside from the direct effect of a ban on transferring capital and technologies to Russia, we see now that domestic firms do not consider sanctions to be a long-term factor, and the business environment remains unfriendly. That's why, in my opinion, we will not see any significant import substitution, but merely a shift in foreign trade towards countries not applying sanctions. I do not consider the Iranian scenario of sanctions plausible, so Russia will continue exporting energy and natural resources, and the current structure of the economy will be preserved.

Consumer Demand

Domestic consumer demand is another avenue to stimulate economic growth, but it is sluggish in Russia. Despite the relatively weak financial sector in Russia (total bank assets are only around 60 percent of GDP) the population is surprisingly heavily indebted. Though the total amount of outstanding loans to individuals amounts to as much as one-

sixth of GDP, the population spends the same proportion of its disposable income to serve and repay loans as the U.S. population. This is entirely due to certain characteristics of the loans issued in Russia. The loans have a short maturity, there is a low share of mortgage loans and loans have very high nominal interest rates. Therefore, a further development of consumer demand driven by bank credit is not economically reasonable and bears evident risks for the financial sector.

An expansion of consumer demand based on labor income is also unlikely. Although wages kept growing and employee incomes increased, people's expectations do not favor consumer-oriented behavior. The inability of the economy to grow further increases labor costs. The demanded industrial restructuring induces releasing workers and shifts in the labor force are evident. With these shifts workers tend to be cautious regarding their future incomes and prefer saving, not spending. Pension reform inconsistencies have forced more and more people to care about pension provisions by themselves, thus also stimulating saving, not spending. Currently savings are restrained partly by rather high and volatile inflation rates, but as inflation subsides and becomes more predictable (the Russian Central Bank has evident achievements on its way to bringing inflation down and shifting to an inflation-targeting regime), the motivation to save will be much stronger.

On the whole, the Russian population seems to be a rather a stingy saver paying its debts, not a rash consumer. This is a fundamental shift in a typical Russian individual's behavior compared to the 2000s and we need more time to understand what it means for policymakers and all other parties in the Russian economy. In the medium term, the current high income inequality is a negative factor for economic growth in Russia. On the one hand, the most well-off part of the Russian population has a lot of savings and there is a clear trend of saving outside the state pension system. These factors provide good preconditions for accumulating capital within the country and financing domestic investments. However, high institutional and market

risks push a great part of the savings out of Russia even though the expected return is lower. On the other hand, most of the population has a low income and can afford only modest consumption or has a high debt-to-income ratio. Though the total amount of outstanding consumer debt is only 16 percent of GDP (as of January 1, 2014), the Russian population paid banks around 12 percent of total disposable income (more than the U.S. population with a 90 percent debt-to-GDP ratio) because of very high effective interest rates and short maturity of consumer loans in 2013. Thus, we expect that during the next several years people will pay off their debts rather than use banks loans to increase consumption. Otherwise it would heighten the risk of a large-scale crisis in the consumer loan market.

Global Context

Changes in commodity prices, limits to potential growth and consumer demand issues all point to a low probability of fast and stable growth in the Russian economy in medium term. Does this mean that the economy is doomed and Russia will plummet in the list of top economies? Our answer: No. In fact, all the arguments are valid if we assume conservation of institutional environment, business and investment climate. But if the institutional reforms take off, the country can quickly eliminate many constraints to development and achieve more stable economic growth. Much needed reforms include loosening the administrative barriers for establishing new business and entering new markets, fighting corruption and pressure against business from the side of different public bodies, better property rights protection and reforming the natural resource monopolies. Still, it is hard to envisage realistic preconditions for high growth rates in Russia as existed in the 2000s, even if all the negative consequences of the crisis are set aside. We estimate the most probable range of economic growth rates for Russia will be between 2 percent to 4 percent on average annually until 2020.

But the Russian economy will grow faster in dollar terms (both in current and PPP) due to the Balassa-Samuelsson effect and an increase in labor productivity and in total factor productivity. The Russian ruble has appreciated since 1999 and many Russian economists say it is overvalued now, but according to the World Bank estimates in 2013 the nominal ruble/dollar exchange rate was approximately 39 percent below the PPP exchange rate.

So, we think that Russia could stay on the convergence path and in 2020 it could enter the top-five economies in the world (in PPP terms), and move up from 44-60 rank (in 2013) to 28-40 rank by GDP per capita (in PPP dollars, by different methods used by the IMF, the World Bank and the CIA). At the same time, we do not expect substantial changes in the domestic labor market: jobless growth for Russia means growth along with a shrinking labor force, not growth along with high unemployment. We also forecast a rather high, sustained level of income inequality, though this factor pushes the expected rates of economic growth down.

Endnotes

1. According to the Penn World Tables GDP per capita in PPP terms grew from \$7779 in 1990 to \$24,120 in 2013
2. Dreaming With BRICs: The Path to 2050. Goldman Sachs Global Economics Paper, No. 99, 2003.
3. See, e.g., Im, Fernando Gabriel; Rosenblatt, David. 2013. Middle-income traps : a conceptual and empirical survey. Policy Research working paper ; no. WPS 6594. Washington, DC: World Bank.