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Russia's Economy: Outlook

By Christopher Weafer (Macro-Advisory LLC, Moscow)

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Most world economies will report a strong and broadly based rebound this year. This is because of the base effect from last year's lockdowns and global trade collapse. Russia is no exception. The contraction in GDP was a modest 3.0 percent in 2020, and the recovery this year is expected to be in the range 3.5 to 4.0 percent. But then growth is likely to slip back into the 2–3 percent range, and it will be difficult, or will take many years, to pull the economy into the higher 3.5–4.5 percent growth range required to achieve the ambitious targets for economic and social changes set out by President Putin.

The reason for the relatively small decline last year and the equally small prospects for recovery is the structure of the economy: it is too heavily laden with state-controlled enterprises and extractive industries, especially hydrocarbons, and has far too small a share in SMEs and far too few mechanisms to support entrepreneurs. SMEs account for approximately 25 percent of economic activity in Russia, while in other faster-growing developing economies the percentage is three times higher.

Part of the problem lies in the fact that Russia never materially changed the structure of the economy it inherited from the Soviet Union. The 1990s was a decade of lawlessness, the emergence of oligarchs and very ineffective government. People were impoverished and somewhere close to \$500 billion was removed from the country. The picture changed dramatically from 2000 as Putin's administration brought in law and order and forced the oil and gas sector to refocus on export growth. The country is estimated to have earned close to \$3 trillion from exported hydrocarbons over the period 2000 to 2012.

This revenue sustained one of the most extraordinary economic booms in the history of developing economies, but it left the economy excessively vulnerable to fluctuations in hydrocarbons markets, a vulnerability compounded by meagre investment in new industries. There was indeed significant discussion about using the wealth generated to transform the economy and to create future sources of growth, but decision makers always thought they had plenty of time and there was no need for urgent action.

That changed after 2014, when Russia was hit with a combination of sanctions and yet another oil price collapse. Yet the contraction in headline activity in 2015 and 2016 was much smaller than many predicted. One of the reasons for this was because that crisis, which was partly economic and partly political, finally shook

government complacency. It is often said that "Russia does the right thing only when there is no other choice". That was the situation in early 2015.

The actions initiated since then, although hardly revolutionary, today better position Russia to finally start the process of changing the drivers of future growth and achieving the long-talked-about economic diversification. One should always be wary of saying "it's different this time", but there are observable differences to support pragmatic optimism, though progress is slow.

One of those changes was the reduction of the federal budget's vulnerability to volatile hydrocarbon tax receipts and to remove any "excess" receipts from day-to-day spending. This is the so-called "Fiscal Rule" or "Budget Rule". It sets the budget oil price target at \$44 per barrel and, pre-Covid, set a target of having the budget break even at this level by 2022. It was on track as of 2019, when the budget broke even at \$50 per barrel, down from the \$115 per barrel required in 2013. This year the budget will balance somewhere in the \$50s per barrel (depends on the ruble exchange rate) and, because of the higher average year-to-date, it returned to a surplus in March of this year.

The second major change was the rapid devaluation of the ruble. This was not supported by President Putin, as he considered it might lead to a banking crisis. But by early 2015, the choice was to devalue or risk going broke. Within six months, Putin was convinced of the benefits of a weak ruble in terms of budget management, import substitution and export growth in such sectors as agriculture and food. The devaluation has undoubtedly been very painful for people and industries dependent on imports. But that pain is now absorbed by the broader economy and the benefits in terms of a much more competitive industrial and export base are showing positive results. For instance, Russia has been the world's largest grain exporter for several years since.

The third factor was the adoption of the National Projects programme. This was originally a five-year, \$400 billion spending programme aimed at boosting transport and communications infrastructure, technology, training, and productivity schemes, and improving social infrastructure. This differed from Soviet-era five-year plans in that it was transparently debated over several years, funding was identified, and responsibility for each of its aspects was assigned to newly appointed Deputy Prime Ministers. The newly revamped and strengthened Audit Chamber had a role in overseeing spending and efficiency.

The disruption due to Covid-19 has forced a rethink, and the programme has now been relaunched as a more realistic 8-year programme and with adjusted priorities.

The Fiscal Rule also makes the National Projects, as well as other measures announced aimed at encouraging investment and economic diversification, more achievable. The diversion of hydrocarbon surpluses means that Russia's National Fund is worth almost \$180 billion today. Total national debt is at a still-modest 18 percent of GDP, having jumped from under 13 percent at the start of the pandemic in early 2020. In other words, the government can now afford to fund this better-structured and more transparent recovery and growth programme.

About the Author

Christopher Weafer is Chief Executive of Macro-Advisory LLC, a Eurasia-based strategic advisory consultancy. He has worked as an economist and market strategist in emerging markets for over forty years, and been based in Moscow for the past twenty-three. He has regularly been voted the best market strategist and forecaster in Russia and for the Eurasia region.

Challenges certainly lie ahead. The legacy of Russia's poor behavior with investors, the most recent example of which being the Barings Vostok case, and the continuing sanctions threat means that private sector investors will be reluctant to participate too quickly. These investors will be needed in the coming years if the programme to pull the economy out of a low-growth environment is to succeed; the state will not be able to do it on its own. Three oil price shocks since 1998, pressure from Western sanctions and a slowly changing and more demanding population means that the government has no choice. It is now embarked on an irreversible course, as the consequences for social and political stability of doing otherwise are worse.

The Covid-19 Pandemic Offers a Glimpse into Russia's Economic Future

By Janis Kluge (German Institute for International and Security Affairs—SWP, Berlin)

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Russia's economy survived the Covid-19 crisis with a relatively mild GDP contraction of 3.1 percent. Under the exceptional circumstances of the pandemic, having a less complex and less internationally integrated economy turned out to be an advantage. A relatively short-lived Covid-19 lockdown helped as well, but with excess mortalities during the pandemic rising above 400,000 in Russia, it is becoming increasingly clear that the more vulnerable parts of Russia's population paid an immense price for keeping businesses open.

The unspectacular GDP statistic may not suggest it, but the Covid-19 pandemic has offered a glimpse into Russia's economic future. First and foremost, recent developments on international energy markets and the trajectory of climate policies around the world are spelling the definite end of the era of limitless oil and gas rents. Although Russia will continue to export hydrocarbons for many years, stagnating and eventually falling demand will result in lower long-term average prices. Heightening the pressure on margins and tax revenues, prospective new oil projects such as Rosneft's Vostok Oil in the Arctic are more expensive to develop, and stricter sustainability requirements on international capital markets make financing these projects costlier.

While some Western observers fear that the Russian economy will fall into deeper isolation as the role of hydrocarbon trading diminishes, the opposite is likely to happen. The government's ongoing attempts to achieve economic sovereignty through import substitution and trade barriers is costly. Today, Russia's economic model is based on the redistribution of oil and gas rents to uncompetitive domestic industries, both through government subsidies and cheap domestic energy prices. Once hydrocarbon revenues dry up, it will become more difficult for Russia to finance its isolationist policies. Integration into international value chains will also become more attractive and economically feasible as the symptoms of Russia's "Dutch disease" subside.

The Covid-19 pandemic has also given a boost to Russia's digital economy. The rise of sectors such as IT and communications, but also financial services, runs against the government's intentions of making the economy sanction-proof. Many of Russia's promising growth stories are deeply integrated with Western capital markets and technologies, and are even more prone to sanctions than the country's traditional industries. In 2019, the US and EU accounted for almost 80 percent of Russia's trade in telecommunications, computer and information services, while China accounted for