Russia's economic agenda to 2020

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In the autumn of 2009, 18 months after his inauguration, Russian President Dmitry Medvedev put forward a thesis about the need for the modernization of Russia. The word 'modernization' may best encapsulate what Russia needs to do to address all the problems it faces today and will face for the next decade. This huge country needs to escape from its semi-archaic state, in which elements of the nineteenth, twentieth and twenty-first centuries are curiously intertwined. Russia needs to become a country moving confidently along with the flow of global evolution. The basic danger is that it may lag behind other countries, get stuck in a bog of obsolete values and find itself on the periphery of the modern world.

Though the next presidential election in Russia is scheduled for the beginning of March 2012, its outcome is already clear to everyone: Vladimir Putin will return to the Kremlin. The only question is whether he will stay there for six or twelve years—or maybe even longer. In contrast to his first arrival in the Kremlin in 1999, when he inherited a dynamic economy on the rise after the difficult transition years of the 1990s and public finances that had stabilized after the crisis of 1998, this time around Vladimir Putin will see a very different picture. The economy has lost its momentum and is approaching stagnation. The oil and gas revenues that for several years guaranteed macroeconomic stability now appear insufficient as oil prices stop rising. Moreover, new macro shocks are visible on the horizon. The budget is still balanced, but if all the decisions on expenditure that have been made are implemented, future imbalances will inevitably result. The country's population is gradually ageing, and in the decades ahead Russia will face a sharp decline in its labour force. A dominant culture of bureaucracy and corruption, and a lack of independent judicial protection for property rights, have deterred foreign direct investment, exacerbating the country's technological backwardness.

There are solutions to these problems. Many countries have faced them and have found ways and means to overcome them. But history provides no guarantee that Russia during Vladimir Putin's next presidential term can find adequate answers to the challenges it faces. The new/old Russian President cannot point to a reassuring track record in economic policy. His team is stagnating: it has not attracted newcomers for a long time, and existing essential staff, it seems, have exhausted their mental potential and political will to undertake reforms. All politicians know that the initiation of any reform (unless the situation is so severe that the necessity

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of change is recognized by the whole of society) leads to a decline in popularity that in democratic countries may result in electoral defeat, and in authoritarian countries may undermine the stability of power structures. Thus Putin's desire (and the desire of those closest to him) to keep power in their own hands indefinitely is the main obstacle to any reform measures in Russia, to any rational decisions in the field of economic policy, and to real modernization of the country.

This article considers the role of Russia in the world economy and its slow recovery from the deep recession of 2008–2009. It examines the economic challenges facing the country over Putin's next presidential term, with particular focus on demographics, dependence on the oil price, and the impact of that dependence on monetary policy, the budget and the balance of payments.

Russia in the globalized world

Over the past 15 years 'globalization' has changed from a rather obscure term into the main characteristic of the modern world economy. Today, a business may have its headquarters in one part of the globe and its production dispersed across many other countries. For the modern business, state frontiers are no obstacle to operations: it has become common practice to rely on foreign partners, suppliers and consumers.

In order to be competitive in this situation, national economies have to be open to the rest of the world, their borders porous to the movement of labour, goods and capital. Today, no country in the world can afford to attempt to produce everything its economy needs and to be a leader in all technologies. On the contrary, in this modern world sustainable growth can be guaranteed only by active participation in the international division of labour, concentration of efforts on new and emerging sectors, and a wide use of the best practices and knowledge accumulated in other countries. In such conditions, competition between countries for the available investment capital, as well as for their standing in the global economy, grows ever more acute. Any country that closes the economy in an attempt to develop only on the basis of its own efforts is bound to be overtaken by others.

Successful economic reform in China led to the appearance of a huge, fast-growing economy, which today already is the second largest in the world and in just another 15 years may displace the United States to become the biggest economy on the planet. Following China, India too is gradually 'waking up'. It is beyond doubt that the development of the world economy in the first half of the twenty-first century will be to a great extent determined by these two countries, which together are home to 40 per cent of the world's population. Nor should one overlook the other fast-growing economies of Asia and Latin America, which will play increasingly important roles in global processes. For readily understandable reasons—low starting base, transformation from rural to urban society—economic growth in these countries will be conspicuously higher than in the developed ones, which will lead to a redistribution of the balance of economic forces in the world. Countries' respective positions in the world will

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be determined by the scale of their economic development and the degree of their participation in the international division of labour. Today, it is possible to be a 'superpower' by virtue of possessing a nuclear arsenal and a seat on the UN Security Council; within the current generation, this situation will change.

Fast-growing economies are already using their unique advantages—above all, the size, quality and relatively low cost of their labour forces—to become 'world factories', taking jobs away from the developed countries. The latter, in turn, are starting to face the problem of how to respond to this trend. Innovation and technological sectors are very important, but they cannot (yet) provide mass employment: the economies of the developed countries also need traditional jobs. One of the most obvious responses to the challenge is to aim at creating top-quality products or to make the transition from selling equipment and technologies to selling a complex combination of both goods and the services for their support and maintenance.

Russia at present competes neither with the developing nor with the developed countries, lacking both the labour resources and the technological skills. How to overcome these inadequacies is the most important challenge facing Russia today, and one to which the nation has to find its own distinct answer.

Slow recovery

Russia was plunged into deep recession as a result of the global financial crisis that began in 2008, the economy suffering an annualized quarterly decline of 15 per cent in the fourth quarter of 2008 and 20 per cent in the first quarter of 2009 before stabilizing in the middle of the second quarter. The economic recovery that followed was neither as stable nor as impressive as growth in the previous decade had been. At its nadir in spring 2009, Russian GDP was back to the level of late 2006 and early 2007; by the beginning of 2012 the Russian economy is back to its pre-crisis peak. What that means is not only that the economy has lost five years of growth; more importantly, it is now growing much more slowly than before the crisis. In summer 2008 the IMF estimated the potential annual growth rate of the Russian economy at 5.5–6 per cent. With those rates not yet attained, it seems that the crisis in Russia is far from over.[1]

Many Russian experts and even some of the country's political leaders recognize that the Russian economy has lost its momentum and that it is very difficult to determine which sectors may become new drivers of economic growth. It is clear that those models of economic growth which functioned in Russia in the decade between 1998 and the crisis of 2008 have gone for good. Russia today cannot hope to relaunch the mechanisms and sources of growth which moved its economy forward in those years.

In that decade the Russian economy grew fast and constantly, with GDP increasing by 94 per cent, that is, almost 6.9 per cent a year. Had there been

[1] IMF Country Report No. 08/309, Russian Federation: 2008 Article IV consultation—staff report; staff statement; and public information notice on the Executive Board discussion (Washington DC: International Monetary Fund, 2008), http://www.imf.org/external/pubs/ft/scr/2008/cr08309.pdf, accessed 16 Jan. 2012.

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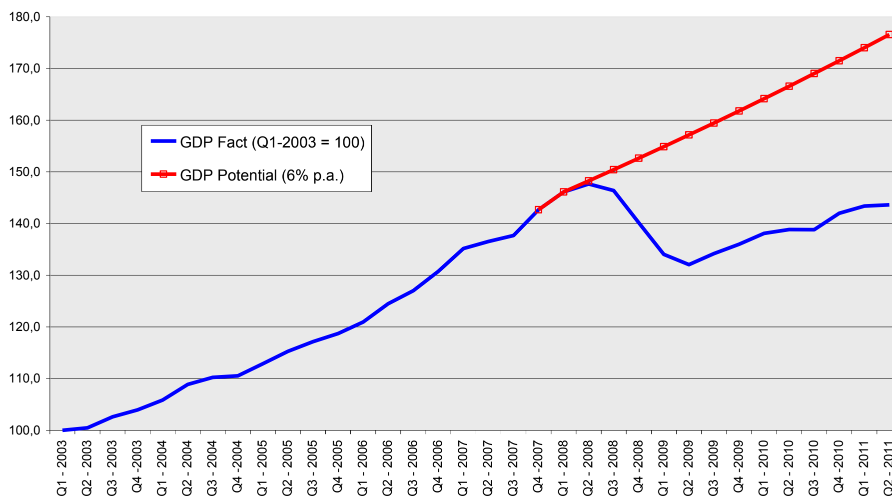
Figure 1: Crisis in Russia



another 10–15 years of such growth, the world would have witnessed a 'Russian economic miracle': history provides very few instances (only 13) of the economy of a single country growing at 7 per cent or more a year for 25 years in succession.[2]

Even at first glance, however, it is clear that Russia's economic growth over those years was not homogeneous. The gap between the minimum and maximum rates of growth (annualized quarter to quarter, seasonally adjusted) was about 10 per cent, between 2.5 per cent in the fourth quarter of 2004 and 12.3 per cent in the fourth quarter of 2007. These figures force us to assume that this period was internally homogeneous and that during this decade the growth of the Russian economy was not determined by different factors at different times.

Analysis makes it possible to identify three separate stages within that decade of growth—1999–2000, 2001–2004 and 2005–2008—which differ from one another with respect to the sources and engines of growth in the Russian economy. Of course, any periodization of this kind cannot be rigid: the impact of any given factor very seldom starts or ends overnight, and the factors ascribed to different periods are often acting in parallel. Nevertheless, it is possible to single out those whose impact, over a given period, is particularly strong.

The first stage, 1999–2000, was a classic period of post-transformational growth, such as all East European countries experienced at the end of the recession connected with the transition from the command economy to the market. In Russia the period of transformational decline lasted for around six years, until 1996; only in 1997 did the economy begin to expand again, registering 1 per cent growth. Then came the crisis of 1998, which on the one hand delivered a sledgehammer blow to the entire economy, especially to the financial system, and on the other hand, through the sharp devaluation of the rouble, conspicuously raised

[2] Commission on Growth and Development, *The growth report: strategies for sustained growth and inclusive development* (Washington DC, 2008), http://cgd.s3.amazonaws.com/GrowthReportComplete.pdf, accessed 27 Dec. 2011.

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the competitiveness of many Russian goods on both the domestic and the international markets.

It is no coincidence that it was those sectors of industry that were oriented towards domestic consumer demand and/or towards import substitution (food, beverages and tobacco), or whose costs in dollar terms fell (chemicals and metals), that demonstrated the highest growth during this period. Russian statistics do not make it possible to separate out reliably the respective contribution of each of these industries to GDP growth, but we can confidently say that together they were responsible for about half of all growth in industrial production in 1999–2000, and industry during those years provided 45–50 per cent of GDP growth.

It is not possible to say that the impact of this factor has ceased, or that the stage of economic growth connected with it ended at a certain moment. Indeed, it is still at work today: the food industry has been steadily providing about 0.7–0.8 per cent, and metallurgy about 0.6–1 per cent, of annual growth in overall industrial production (with the exception of the crisis period from 2008 to 2009). But as early as 2001 it was obvious that its significance had started to decline, as the industries that had revived during devaluation ceased to be the main engines of growth. This was reflected in the decline of economic growth rates from 6 per cent and 10 per cent in 1999 and 2000 to 4.5 per cent and 5 per cent in 2001 and 2002. The rates of growth of industrial production declined even more, from 8.7 per cent and 8.9 per cent in 1999 and 2000 to 2.9 per cent and 3.1 per cent in 2001 and 2002.

However, from 2000 a new factor of growth, which can be called the 'fruits of privatization', started to manifest itself. By that time the period of initial redistribution of Soviet assets was over, and private owners had survived the phase of political and economic upheaval. The fundamentals of the new economic system had not yet been challenged, and business could feel confident that its ownership and interests were not threatened. On this basis owners, who had obtained assets in the mid-1990s, started to invest in their companies, which soon resulted in increased productivity and an improvement in the quality of management of privatized enterprises. Most of these enterprises were concentrated in the extraction of raw materials for export, which at the beginning of the 2000s provided no less than 30 per cent of growth of the gross value added in the Russian economy. Oil extraction grew by 50 per cent between 2000 and 2005.[3] The growth of production of coal, iron ore, steel, aluminium and copper grew by 17–22 per cent between 1999 and 2005, and the production of 'Norilsk nickel' grew by 35 per cent from 2000 to 2007. At this point it should be made clear that a much more important driver of economic growth was not the extraction of raw materials as such, but the additional domestic demand generated by those sectors. It was no coincidence that the processing industry in the period was growing at an annual rate of 5–6 per cent over the years 2003–2007.

In contrast to the first stage, it is possible to identify a particular moment when the dominating influence of this factor on the economic process in Russia ceased.

[3] Gas extraction (95% of which was concentrated in state-run Gazprom) during this period grew by less than 10%.

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This was marked by the Yukos case. The arrest and subsequent conviction of Platon Lebedev and Mikhail Khodorkovsky, the forced bankruptcy of the Yukos oil company for non-evident reasons and the subsequent nationalization of its assets destroyed the confidence of business in political structures on which long-term forecasting and development were based. The political lynching of the owners of Yukos and the liquidation of the company itself opened the way for similar actions across the country. Businessmen ceased to be able to defend their interests in the courts, and this led to a sharp contraction of investment and business horizons. From 2005 the contribution of the raw materials sector to economic growth began to fall steadily, even though at precisely this time prices for raw materials started to grow rapidly.[4] The share of this sector dropped both in the total volume of gross value added (from 23–24 per cent in 2004–2005 to less than 20 per cent in 2009) and in the increment of gross value added (from 20–30 per cent up to 2004 to 3–6 per cent in 2006–2007 and to negative values in 2008–2009).

Fortunately for the Russian economy, the international capital markets became very active during this time. International investors finally forgot their losses during the crisis of 1998, and the Russian budget became enormously strong on the basis of rising oil prices, which led to a rapid increase of the sovereign debt rating. Between 1 January 2005 and 30 June 2008 Russian corporate foreign debt (financial and real combined) grew by $400 billion, that is, by about $115 billion annually. Even assuming that half of this increment was spent on financing mergers and acquisitions, it turns out that the Russian economy was receiving about $55–60 billion a year to finance its current growth (4.3 per cent GDP on average during 2005–2008).

As in many other countries, foreign financing in Russia was directed mainly towards the non-tradable sectors—construction, trade, finance and market services (excluding transport and communications). Those sectors became the main driving force of growth at this stage, providing up to 80–90 per cent of the increment to GDP in 2005–2007 and more than 100 per cent in 2008. These sectors accordingly registered a conspicuous increase in share of gross value added—from less than 44 per cent in 2003–2004 to more than 54.5 per cent in 2008. However, from the middle of 2008, as the world financial crisis gathered pace, access to financial markets for Russian banks and companies was reduced; moreover, earlier borrowing was called in, resulting in the credit contraction that became a serious brake on growth.

Since recovering from the crisis, the Russian economy provides no evidence of new mechanisms of growth having come into effect. As traditionally happens after

[4] To a certain extent the contribution of the raw materials sector (mainly oil) fell because of changes in the tax regime. From August 2004 the combination of the export duty for oil and refineries and the natural resource tax channelled 80% of the increase in oil price to the federal budget, while the tax on profits channelled another 5% of the price increase to federal and regional budgets. As a result, oil companies received only 15% of the price increase. I would therefore argue that the direct impact of growing oil prices on the economy was equal to just 15% of the increase in oil price, taking into account the fact that the federal budget has accumulated the bulk of the proceeds from oil taxes into (initially) the Stabilization Fund and (later) the Reserve Fund and National Welfare Fund. Rising oil prices were of course a very important psychological factor influencing Russian businesses, international lenders and rating agencies alike.

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a recession, the statistically dominating factor of growth in the Russian economy is the rebuilding of inventories, which accounts for all the increase in GDP over the past two years. But it is obvious that this factor cannot last for ever. The second strongest factor in economic growth in Russia since the crisis is a rapid expansion in imports. Though the growth of imports itself leads to a reduction of net exports, thus reducing GDP growth, heavy taxation on the import of goods into Russia (through VAT and customs duties) has resulted in a growth in 'net taxes',[5] which has contributed more than 1 percentage point (on an annual basis) of the increase in GDP during the last eight quarters. If profits of the trade sector from the sale of imported goods are added, the overall contribution of import growth to Russian GDP may reach 1.2–1.4 per cent. At the same time, the slow but steady decline in internal demand for domestically produced goods and services is an indicator that the Russian economy is in serious trouble.

To date, the Russian authorities have refused to discuss the problem of decelerating economic growth, either resorting to the polemical assertion that 4 per cent growth is above that in developed countries or simply asserting confidently (with no supporting arguments) that in the near future the Russian economy's annual growth rate may increase to 6–7 per cent. If economic growth in Russia continues to slow down, that has the potential to create huge social problems in the country. On the one hand, the budget will be short of resources to finance commitments; on the other, Putin's popularity may decline. So far he has been lucky: during his first eight years Russia experienced unprecedented growth, which, together with skyrocketing oil prices, resulted in rapid increases in households' incomes and consumption. In the years to come, slowing economic growth will be the main challenge for the next Russian president. And although on the face of it the rate of growth is an economic problem, for Russia it is above all a political problem.

The economy cannot grow without investment, and catch-up growth demands investment at a higher level. It is considered that in developing economies investment should make up 25–30 per cent of GDP, yet in Russia the level is no higher than 21–22 per cent. The necessary increase in the rate of investment is impossible in Russia without radical improvements to the investment climate—Russia has been low and often falling in recent years in all international rankings and comparisons—and that requires political reform.[6] Active opening of the economy and a greater effort to attract foreign investment are also needed. Thus, political transformation based on democratic freedom and real political competition must be high on the agenda of Russia between now and 2020 as a basic pillar to support stronger economic recovery. As yet, however, there is no sign of any readiness or willingness on Putin's part to move in this direction. Indeed, the electoral campaign of 2011–12 has clearly demonstrated the opposite.

[5] Export duties on natural resources are also a part of net taxes.

[6] Independence of the courts, law enforcement, protection of property rights, and measures to combat corruption and racketeering are all elements of an investment climate, but cannot be supported within the limits of the existing political regime.

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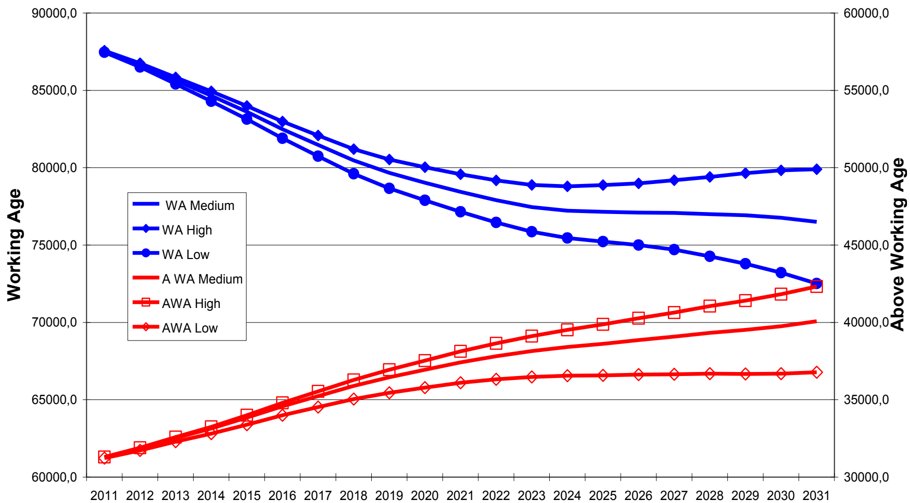
The demographic trap

Many Russian and international experts have indicated in the past decade that the period 2015–25 will be critical for Russian demography, as Russia faces a sharp decline in its population and labour force that will pose grave challenges to its economy and society.

The Russian demographic situation in the coming decades will be influenced by a set of disparate trends, some of which are global while others are exclusively domestic. Among global trends are the general decrease in the birth rate (currently 1.6–1.7 children per family in Russia) and increase in life expectancy. Among domestic trends are a high level of infant mortality, strong influence of the 'military wave',[7] significant emigration and increasing levels of alcohol consumption in many regions of Russia.

During the past 20 years, a steady population decline in Russia has been partially redressed by the inflow of immigrant workers, mainly from Commonwealth of Independent States (CIS) countries. However, though this influx provides the national economy with additional labour, it does not constitute an adequate response to the long-term demographic challenge.

Figure 2: Demographic forecast for Russia ('000)



It is a well-known fact that the Russian population will be declining slowly during the decades ahead, while the working-age population will be declining much faster. There are differences between the Russian official statistical forecast by Rosstat, the UN forecast and the US Bureau of Census estimates; but all three agree on the trend, namely that during the next 20 years the Russian economy may lose 15–20 per cent of its labour force. This means not only that the demographic factor will 'swallow up' about 1 per cent of annual economic growth, but also

[7] Owing to the effects of the Second World War the number of people born in 1941–1948 in the USSR (and Russia) was several times lower than in previous and subsequent years. This is very visible in Russian demographics every 25 years (the length of a generation).

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that many sectors of the economy and many regions of Russia will face a serious shortage of labour.

As with many issues in Russia, the obvious solution to this problem—an active immigration policy—itself poses a political problem. In order to preserve a numerically stable labour force, the Russian economy needs a net annual inflow of 500,000 workers between 2012 and 2025. First, it is not clear whether a labour influx on such a scale is even possible—the Central Asian countries, the usual labour exporters to Russia, can hardly provide such numbers. Second, most labour migrants to Russia do not want to live there permanently, preferring that their families remain in their own countries. These immigrants are usually low-skilled and do not want to invest their time in education; nor, to be honest, has the Russian education system to date provided any opportunity for them to become better educated. In addition, immigration flows bring with them well-known difficulties of a psychological, political and cultural nature. In the recent past the authorities have been reluctant to support this process, giving impetus to nationalistic rhetoric and political movements.

The second element of the demographic trap in Russia is population ageing, and the inevitable growth of the pension burden on the economic system. Although the pension system in Russia has been modified several times over the past 20 years, it remains essentially, with minor changes, the Soviet system based on the generational solidarity principle. The Russian authorities have been unable to launch an individually funded component, so that pensions are entirely reliant on tax-based revenues. Today the Russian pension system may be briefly described as one in which:

- pension expenditure as share of GDP is equal to that in the OECD developed countries and significantly above the average for the emerging economies;
- the payroll tax exceeds the average OECD level and may be increased further;
- the level of pension payments (measured by the replacement coefficient) remains between a third and a half of the OECD average (36 per cent compared to 56 per cent);
- pensionable age remains lower than in OECD countries (55 for women and 60 for men).

Currently, overall pension expenditures make up about 9 per cent of GDP (up from 5.1 per cent in 2007): only 70 per cent of this amount is generated by the payroll tax and the rest is funded by the federal budget. The stability of the Russian pension system is based entirely on a fairly comfortable ratio of pensioners to employed (33 per cent), and is therefore under threat from the expected deterioration of this demographic ratio. According to Rosstat's 2010 forecast, by 2030 the pension-age population will have increased by 9 million, while the working-age population will have decreased by 11 million. As a result of these changes the 'pensioners to employed' ratio will increase to 45 per cent by 2020 and to 52 per cent by 2030.[8]

[8] 'Projected population level of the Russian Federation to 2030' (Moscow: Rosstat, 2010); http://fsgs.ru/wps/wcm/connect/rosstat/rosstatsite/main/publishing/catalog/statisticJournals/doc_1140095525812 (in Russian), accessed 27 Dec. 2011.

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So significant a change in this ratio means that the government will be unable (even assuming that other things remain equal) to preserve the current relationship between average pension and average salary. According to Gurvich, in order to keep the current replacement coefficient it will be necessary to increase the transfer from the federal budget by 1 per cent of GDP every five years, or annually to increase the rate of the payroll tax by 1 per cent every year.[9] The only alternative—to allow a rapid decline in the replacement coefficient—is hardly likely to be acceptable to Vladimir Putin, who depends heavily on pensioners for his electoral support base. Thus the problems of the Russian pension system will soon become not simply a fiscal but a macroeconomic and systemic problem.

This outlook will compel the Russian authorities to carry out radical reform of the pension system, which will affect many strata of society. What has to be arrived at is a combination of an increase in the pension age, a cancellation of privileges and an increase in the contribution from payroll tax—each of which is extremely sensitive from a social and political point of view. It should be recalled that only once during his 11-year rule has Vladimir Putin faced protest from the Russian population on a massive scale, and that this was when, at the beginning of 2005, pensioners all over the country came out on to the streets after the launch of a poorly prepared programme of monetization of social benefits. That is why Vladimir Putin and his government have refused even to mention this problem during the two years preceding the most recent parliamentary elections.

Pension reform needs to be not only presented adequately to the population, but also carefully prepared. Serious doubts exist over the likelihood of this: during the past ten years the Russian government has made three major additions to the rules of the pension system, each time committing serious errors which made further changes inevitable. Constant changes of the rules of the pension system obviously reduce citizens' level of trust in the promises of the state, and do not stimulate the development of voluntary forms of pension insurance. Yet from the point of view of long-term economic prospects, pension savings are one of the main domestic sources of finance for economic development.

Dependence on the oil price

Russia's dependence on the price of oil poses another significant medium-term risk. Today, two-thirds of Russia's exports and almost half of its federal revenues are tied to the oil price. Sales and purchases of foreign exchange represent the single instrument used by the Russian Central Bank (CBR) to manage the money supply (except in times of crisis). Given current spending and investment trends, Russia's budget and balance of payments will stay balanced only if the oil price continues to rise.

The economic history of the USSR and Russia over the past 40 years demonstrates clearly the real dependence of the country's economic dynamics on the level of oil prices. Certainly, it will not be possible to overcome this dependence within

[9] E. Gurvich, 'Principles of the new pension system', *Voprosy Ekonomiki*, no. 4, 2011 (in Russian).

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a year, or even within three or ten years. But in any analysis of the economic possibilities and challenges facing Russia, and in the consideration of different scenarios for the country's future prospects, it is essential to pay serious attention to the limitations arising from this dependence and the complications to which they in turn give rise.

The oil price and monetary policy

Almost 20 years have passed since Russia cast off the Soviet economic model. In that time its central bank, like all central banks, has tried to keep inflation under control; but it has done so with much less success than its counterparts in Eastern Europe. The CBR has brought the rate of inflation below 10 per cent—unacceptably high for any modern economy—just twice in those 20 years; and even today inflation is over 7 per cent, despite the depressed economy. Part of the explanation for this poor record lies in the specific type of monetary regime employed in Russia, which may be described—contradictory as it sounds—as a currency board with a floating rouble exchange rate.

Following Russia's severe financial crisis in 1998 the government debt market was essentially frozen, and surviving banks lacked assets to offer as collateral against the CBR's loans. That left the central bank with one option to manage liquidity: sales and purchases of foreign currency. Moreover, when the crisis ended, the CBR needed to rebuild its foreign exchange reserves. As a result, from 2000 until the onset of the global financial crisis in 2008, Russia chose a modified currency board approach to monetary policy: its currency was pegged to a basket—currently 55 per cent dollar, 45 per cent euro—and more than 90 per cent of changes in the money supply came from the CBR's sales and purchases of foreign currency.

The currency board approach is widely used, and has often helped countries to implement macroeconomic stabilization programmes in circumstances where national monetary authorities have lacked credibility. But its success relies in significant part on making the currency board official, and this is a step Russia refused to take, given that the CBR could not decide whether it should focus on controlling the exchange rate or controlling inflation. Also, the currency board policy has drawbacks under certain economic conditions—all of which prevailed in Russia. Currency boards do not function well in countries that depend on a single, volatile commodity export (more than 65 per cent of Russia's exports are directly linked to oil prices). Nor does the policy work well for countries that receive big capital inflows (as Russia does from time to time) or those experiencing sudden negative external shocks (as Russia did during the 2008 financial crisis). Under these circumstances, strict application of the currency board's rules often causes the money supply to spin out of control, rapidly pushing up inflation and overheating the economy when shocks are positive, or forcing deflation to the point at which the country abandons its currency board and devalues its currency when the shocks are negative.

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The dependence of Russian monetary policy on oil-related exports is particularly problematic. Any movement in the oil price has an impact on the current account. And, with many foreign investors believing that a rise in the oil price means an improvement in Russia's economy and vice versa, rising oil prices attract speculative capital, while falling prices push capital out. Given the lack of a clearly established fixed exchange rate regime, big inflows leave monetary authorities with a difficult choice between rapidly strengthening the currency and adopting a controlled exchange rate regime along with extra measures—often stringent—to fight inflation, such as increased deposit interest rates or reserve requirements.

During the pre-crisis period (2004–2007), the CBR took a middle path, combining gradual appreciation of the currency with efforts to control excess liquidity and inflation. This was not an easy task, as oil prices were rising by 30–50 per cent a year, boosting the current account. And, as is often the case, this middle path failed to achieve either the inflation or the exchange rate target. In 2004 the Ministry of Finance started to help the Central Bank to control money supply by absorbing part of the extra oil revenues in its reserve funds. It was relatively successful in neutralizing the increase of the money supply resulting from growing export earnings as the current account balance stayed between $118 billion and $130 billion in 2004–2007. Nevertheless, against a background of improved credit ratings, relatively high nominal interest rates and the CBR's policy of steady nominal appreciation of the exchange rate, the inflow of foreign capital skyrocketed from $2 billion in 2005 to $81 billion in 2007. Meanwhile, commercial banks' demand for CBR credit was negligible; indeed, many deposited substantial funds in CBR accounts or purchased CBR bonds. As a result, the CBR lost control of the money supply and prices rose by more than 10 per cent a year, forcing the CBR and commercial banks to keep nominal interest rates much higher than those in other countries. This made investing in Russian debt instruments all the more attractive, and outside investors also obtained informal guarantees from the CBR that the rouble would continue to strengthen if oil prices kept rising, which pushed the rouble even higher.

The CBR's lack of a clear objective, the banking system's high exposure to foreign exchange risk and the economy's emerging signs of overheating made the CBR's policy decisions more difficult during the global financial crisis and increased the scale of resources needed to deal with its effects on the banking system. In order to avoid Russia experiencing a liquidity crunch, the authorities decided to pump extra liquidity into the banking system, lowering reserve requirements and placing new deposits (later replaced by CBR credits without collateral) through the Ministry of Finance.

At the same time, demand for foreign currency surged relative to supply—not only because of a usual seasonal rise in September, but also because of falling export earnings (with raw materials prices falling) and the problems of the global financial market, which made it impossible for banks and companies to refinance external borrowing. The CBR responded by holding the exchange rate stable

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against its bi-currency basket in September and October 2008, implying a depreciation against the dollar as the euro weakened.

As the CBR gave the Russian banking system almost unlimited access to its credit, with substantially longer terms, banks were encouraged to use almost all of their rouble funds to buy foreign currency, rapidly depleting the CBR's currency reserves. With oil prices falling in the autumn of 2008, the CBR had to make a further decision about the rouble exchange rate by November. This time, the choice was between stabilizing the rouble by continuing to spend foreign currency reserves or agreeing to its devaluation—a choice made harder by the obvious negative social and political impact devaluation could have. The resulting uncertainty accentuated expectations of devaluation, which in turn drove up demand for foreign currency. In the end, the monetary authorities let the rouble go into what was essentially free fall at the start of January 2009. It stabilized in early February, as soon as the CBR stopped providing the banking system with new liquidity.

The CBR's work was made easier with the renewed upward movement of world oil prices from spring 2009; but that has also reignited debate about the future of Russian monetary policy. The CBR has declared its desire to move towards inflation targeting, which requires a free-floating exchange rate. But letting the rouble float may deprive the monetary authorities of control over the money supply, which will be predominantly dependent on the oil price and capital flows.[10] Moreover, volatile oil prices will lead to a volatile current account balance, and almost any fluctuation in oil prices will affect the exchange rate. Given that Russia's economy already depends on the price of oil in respect of its budgetary revenues, increasing this dependence further would hardly help the economy.

Ideally, the CBR should find a way to anchor its policy in controlling the money supply, for an anchor is necessary in order to control inflation. And, regardless of the ways and means it chooses, the CBR must make its principles clear. Otherwise, economic actors will continue to overshoot expectations or speculate—precisely the two behaviours that limit the CBR's ability to fight inflation.

The oil price and the balance of payments

It is a well-known fact that Russia is a supplier of raw materials to the world economy. More than 85 per cent of Russian exports are either raw materials or primary commodities. The export of hydrocarbons is the basic foundation of Russian foreign trade. Its share in Russian export revenue grew steadily from 50 per cent in 2000 to 67 per cent in the first half of 2008. During 2010–2011 the share of hydrocarbons in Russian exports has fluctuated between 63.5 and 65 per cent. On the basis of these figures, Russia could be described as a de facto monocultural economy. But Russia cannot increase the role of hydrocarbon exports—its ratio

[10] Of course, the extra inflow of oil revenues could be absorbed by the budgetary Reserve Fund, as happened in 2004–2008. But since then the expenditures of the federal budget have increased significantly and all oil revenues at the current price are used for current needs.

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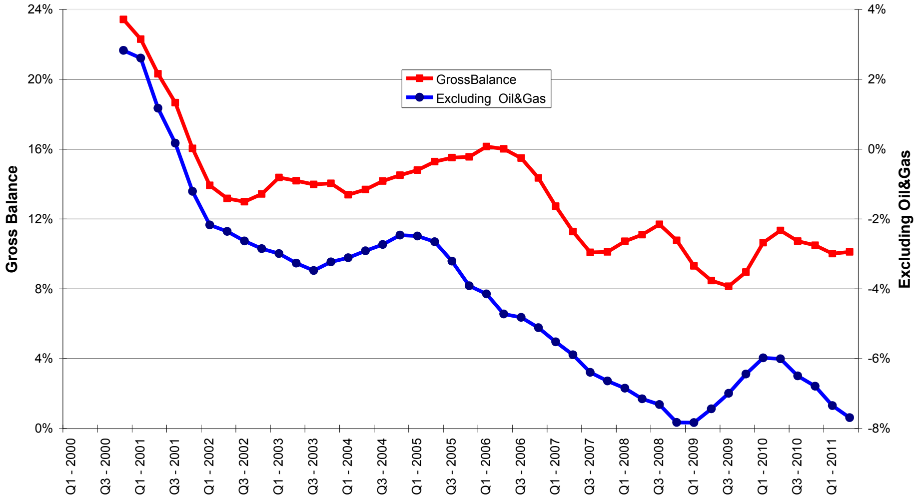
Figure 3: Russian trade balance
(% of GDP, 4-quarters average)



to GDP has remained fairly stable over the past eleven years, fluctuating between 17 and 19 per cent. Over the same period, the ratio of all other exports (excluding hydrocarbons) to GDP has declined rapidly, from 20 per cent in 2000 to below 10 per cent in 2008–2011.

In parallel, the Russian economy has become a more and more active importer, its ratio of imports to GDP steady at about 17–18 per cent since 2000. Whereas after the crisis of 1998 it took five years for imports to regain their pre-crisis level, after the crisis of 2008 it took only one and a half years, falling to 15 per cent in mid-2009 but recovering by autumn 2010. Today, the Russian economy depends critically on imports in all sectors, from foodstuffs and medicines to cars, machinery and military equipment.[11]

As a result of those trends, the Russian trade balance remains positive but declining (23 per cent of GDP in 2000 but 10 per cent of GDP in 2010–11); excluding exports of hydrocarbons it is negative and steady (growing to 7.5–8 per cent of GDP in 2010–11). Such a situation may be sustained as long as oil prices are constantly rising; as soon as oil prices stabilize, let alone fall, the current account surplus of the Russian balance of payments starts to shrink quickly. Recent Russian economic history demonstrates clearly that, as soon as the current account surplus drops below 1 per cent of GDP, a severe financial crisis and rouble devaluation are all but inevitable. With the oil price at its current level, and fairly modest import growth (20–25 per cent year on year) Russia may have just five to six quarters before this occurs again. If the oil price were to fall by another $10–20 per barrel the outlook would be even worse. But what is more important is that this balance of payments instability may become permanent, creating extra volatility in the rouble exchange rate.

[11] In 2011 Russia became an importer of armaments for the first time in its history. Up to that time all Russian and Soviet policymakers emphasized reliance on national weapons only.

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The oil price and the budget

After the most serious crisis in the public finances, which ended with the default of 1998, the first years of the new century were marked by real progress in Russian budgetary policy. Federal budgetary revenues rose by a multiple of 3.4 in real terms from 1999 to 2007, revenues of the consolidated budgetary system by 2.5.[12] Federal budget spending grew in real terms almost fourfold, while consolidated budget spending has grown by a factor of 2.7. Until 2009 the budget remained in surplus. At this time Russia had reduced its public debt from more than 100 per cent of GDP at the end of 1999 to 8 per cent of GDP by the end of 2009. Moreover, from 2003 to 2008 the Russian budget could save essential funds from hydrocarbon export revenues, initially in the Stabilization Fund and then in the Reserve Fund and National Welfare Fund.

Still, one can hardly attribute this budgetary strength entirely to the economic policy of the Russian authorities. The main source of budgetary revenues was, of course, proceeds from hydrocarbon exports, thanks to a rise in prices on world markets. The value of oil and gas exports in 2008 ($310 billion) was ten times the level of 1999 ($31 billion), and taxation of export revenues in Russia has been arranged in such a way that additional proceeds from any marginal increase in the oil price (no less than 85 per cent above $25 per barrel; according to some experts, up to 90–92 per cent above that level) goes to the federal (mainly) and regional budgets.

Besides their direct influence on budgetary incomes, oil proceeds have exercised a substantial indirect effect on economic growth. Thus, even if no more than 1.5–2 per cent (out of 7 per cent average annual growth in 2000–2008) of overall expansion could be attributed directly to growth in the oil and gas industry, another 3–4 percentage points derive from its indirect effects, in the form of an influx of external finance resulting in a rapid expansion of internal demand.

It is not easy for any government to resist the temptation of increasing expenditure when budgetary revenues grow quickly, and the Russian authorities were no exception. But whereas in 2004–2006 they were able to increase budgetary expenditure modestly (by 23–25 per cent annually), in 2007–2008, with the new electoral campaign looming, budgetary policy was loosened, and expenditures grew by 33–34 per cent. This expansion took the form of additional social expenditures (including increases in pensions), extra funds directed towards several so-called projects of national priority, and new politically influenced investment programmes. As a result, the surplus in the federal budget was reduced even though export revenues had grown significantly. Moreover, most of the new expenditure consisted not of one-off projects but of extended commitments, thus increasing the long-term budgetary burden on the economy.

The crisis of 2008 has shown the real dependence of Russia's public finances on the international situation. The federal budget absorbed the biggest share of the

[12] Revenues of the consolidated budgetary system comprise federal plus subnational budgets plus ex-budgetary funds (pension, social security and medical security).

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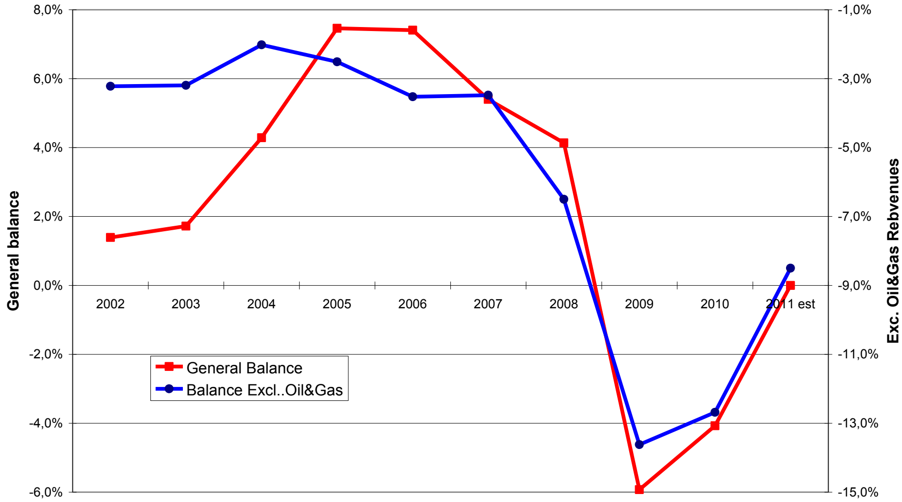
Figure 4: Russian federal budget balance
(% of GDP)



decline in revenues—a fall of 23 per cent in real terms. According to the Gaidar Institute, the fall in budgetary revenues consequent on declining hydrocarbon exports was equivalent to 4.9 per cent of GDP. Alongside this, the new fiscal stimulus plan adopted to counteract the crisis shifted the federal budget from surplus (4.1 per cent of GDP in 2008) into significant deficit (5.9 per cent of GDP in 2009).

This shift in the budgetary balance, common to many countries in times of recession, was temporary, and as oil prices started to recover the Russian budget began to move towards equilibrium. At the same time, the quality of Russia's post-crisis budgetary policy sharply deteriorated: on the one hand, the government has cancelled the practice of accumulating part of the proceeds from oil exports for future generations; on the other hand, new decisions on increased budgetary expenditures (for example, in pensions, and in military and national security funding[13]) have been announced that threaten the long-term equilibrium of the budget.

Sluggish economic recovery after the crisis and rapid escalation of budgetary expenditures have increased the dependence of the federal budget on windfall oil revenues, compared to the pre-crisis period. Revenues derived from oil and gas account for over 45 per cent of total federal revenues, and the federal budget deficit excluding those revenues, although it declined to 8.5 per cent of GDP in 2011 from 12.5 per cent of GDP in 2009, remains well above the pre-crisis level (2.5–3.5 per cent of GDP). In the medium term Russia will face an inevitable reduction in the revenues from hydrocarbon exports, as oil companies will need to invest much more than they are doing today in order to keep the production levels stable and yet the current taxation system starves them of adequate funds to do so.

[13] Military and national security expenditure is projected to grow from 5.5% of GDP in 2011 to 6.7% of GDP in 2014, and will grow further if the new armaments programme is implemented as announced.

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Many experts agree that Russia has gone some way towards radical change in the principles and level of taxation of the oil and gas sector that will lead to a fall in budgetary incomes. Discussions between the government and the companies have been actively conducted for many months, but while it is still impossible to predict the outcome with confidence, one thing is clear: budgetary incomes will be reduced, either because of a decrease in the tax burden (that will allow the oil production level to stabilize) or because of a slump in production if the solution is postponed.

One more problem for the Russian budgetary system is insufficient financing of infrastructure and investment in human capital. Compared to the OECD average, Russia spends less on education (by 1.5–2 per cent of GDP), on public health care (by 3–4 per cent of GDP), on environmental issues (by 0.5–1 per cent of GDP) and on infrastructure development (by 2–3 per cent of GDP). Moreover, recently adopted budgetary policy envisages further reduction of such expenditures, without which it will be impossible to combine the 'zero deficit' principle[14] for the federal budget with the planned increases in pensions and military expenditures.

The Economic Expert Group and the Gaidar Institute estimate that with oil prices growing by 2 per cent annually in real terms the federal budget deficit could rise to 10 per cent of GDP by 2025 if today's tax burden and economic growth rate are sustained and the government finances all programmes planned for the next five to seven years. Of course, the budget's future problems do not require immediate action by the Russian authorities. Nevertheless, the trends identified will inevitably lead to growing macroeconomic instability during the next presidential term of Vladimir Putin. There are no easy solutions for him: neither tax increases nor expenditure cuts would be pleasant. But if he does neither he will destroy the macroeconomic balance that has been the hallmark of the past decade in Russia.

Conclusion

Sadly, the first decade of the twenty-first century seems to have been lost so far as the Russian economy is concerned. Certainly, Vladimir Putin's first two presidential terms were marked by a period of fast economic growth unprecedented within the previous 50 years, accompanied by a sharp increase in the population's standard of living. It is true to say that Russian households have never lived as well as they do today. But all this well-being derived entirely from external factors—a rise in oil prices and foreign loans—both of which dried up as the global crisis hit Russia in 2008. At the same time, during these years Russia has become ever more dependent on the revenues from hydrocarbon exports—a dependence that is, moreover, fraught with serious risks in the near future. The windfall funds were

[14] The crisis of 1998 has had so strong an influence on the Russian political elite that many consider it unacceptable even to admit to a budget deficit. Among them is the former Minister of Finance Alexey Kudrin, who exerted a critical influence on the formation of principles of budgetary policy.

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not used to implement urgently needed structural reforms, and those reforms have once again been postponed. Corruption and racketeering by government officials have sharply increased, nepotism and crony capitalism have become the norm, while protection of property rights has been reduced and the indirect participation of the state in many sectors of the economy has grown. All this makes the Russian economy more and more primitive, less and less able to give anything to the rest of the world but raw materials.

Investment to the tune of billions of roubles is necessary to modernize the country in all sectors from public health services and education to the oil and gas industries. However, over the last ten years the investment climate in Russia has deteriorated considerably compared to other countries. This has made the economy unattractive and uncompetitive.

In May 2012 Vladimir Putin will in all probability return to a presidential armchair in the Kremlin. This time around he is going to face serious challenges that may threaten not only his personal authority but also the stability of the Russian economy and state. Unlike before, he cannot count on sound macroeconomic fundamentals—on the contrary, he will need to look for solutions in areas that earlier created no problems for him. Russia needs to make the right decisions to confront tough economic challenges, and in many cases those decisions will be connected with political reform. To date, however, Vladimir Putin has expressed no desire to carry out such reform.

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