THE SYSTEMIC ROOTS OF RUSSIA’S RECESSION

MAREK DABROWSKI

Highlights

• The Russian economy grew rapidly between 2000 and 2007, but growth decelerated after the 2008-09 global financial crisis, and since mid-2014 Russia has moved into recession. A number of short-term factors have caused recession: lower oil prices, the conflict with Ukraine, European Union and United States sanctions against Russia and Russian counter-sanctions. However Russia’s negative output trends have deeper structural and institutional roots. They can be tracked back about a decade to when previous market-reform policies started to be reversed in favour of dirigisme, leading to further deterioration of the business and investment climate.

• Russia must address its short-term problems, but in the medium-to-long term it must deal with its fundamental structural and institutional disadvantages: oil and commodity dependence and an unfriendly business and investment climate underpinned by poor governance. Compared to many other commodity producers, Russia is better placed to diversify its economy, mostly due to its excellent human capital. Ruble depreciation makes this task easier.

Marek Dabrowski (marek.dabrowski@bruegel.org) is a Non-Resident Scholar at Bruegel, Professor at the Higher School of Economics, Moscow and Fellow at CASE – Centre for Social and Economic Research, Warsaw. The author would like to thank Uuriintuya Batsaikhan for excellent research assistance, and Guntram Wolff, Sergei Aleksashenko, Sergei Guriev and Daniel Gros for their valuable comments. Opinions expressed are the author’s alone.
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1. FROM GROWTH SLOWDOWN TO GDP DECLINE

Recession in Russia has become a fact. Seasonally adjusted quarterly GDP peaked in the second quarter of 2014 and then started declining. In the third and fourth quarters of 2014, the pace of decline was very slow (Figure 1) and therefore growth for 2014 overall remained positive (+0.6 percent, Figure 2).

However, the first half of 2015 brought an acceleration of the negative trend. Real GDP declined by 2.2 percent in Q1 2015 and by 4.6 percent in Q2 2015, compared to the respective quarters of 2014.

Recession was no surprise. Figure 2 shows that after the global financial crisis of 2008-09 Russian growth did not resume its pre-crisis pattern. From 2010-12 growth was muted but reasonable, with annual GDP growth of 5.4 percent, 4.3 percent and 3.4 percent respectively (although from a low level in 2009). However, already in 2013 – well before the conflict with Ukraine and resulting international sanctions, and the oil-price decline – there was economic stagnation.

To understand the causes of the trend of declining growth, we must look at the history of the Russian transition and its partial reversal.

2. THE FIRST TURNING POINT: THE YUKOS CRACKDOWN

Russia was never a star reformer. Its economic transition in the 1990s was long and painful (see Figure 2) because of the complicated legacy of the Soviet system [structural distortions, macroeco-
nomic imbalances and the absence of market institutions) and because of insufficient political support for radical, market-oriented reforms (Dabrowski et al., 2004). Nevertheless, at the beginning of the new millennium, those reforms started to bear fruit. In 1999, the Russian economy entered a phase of post-transition growth recovery, which accelerated in the subsequent years on the back of increasing oil prices.

Furthermore, the first years of Vladimir Putin’s presidency (2000-03) brought completion of many overdue reforms, such as land reform, simplification of the tax system (the flat 13 percent personal income tax rate), elimination of fiscal imbalances, continuing privatisation, limited opening to foreign investors, deregulation and adoption of several pieces of market-oriented legislation. At that time, Russia could be considered a country that completed its basic transition agenda and managed to build a market economy based on private ownership, even if several distortions and imperfections continued to exist.

The turning point came in 2003 with politically motivated crackdown on the largest Russian private company, Yukos (its assets were subsequently taken over by the state-owned Rosneft). As result, the private sector share of GDP decreased from 70 to 65 percent between 2004 and 2005. In the following years, this trend of state takeover continued, especially in the oil and gas industry. For example, in 2005 Gazprom acquired the private oil company Sibneft, which was transformed into Gazprom’s daughter company Gazprom Neft. The activities of foreign oil and gas firms were marginalised. The best-known case was the downsizing of the shares held by Shell, Mitsubishi and Mitsui in the Sakhalin-2 project in favour of Gazprom (Sprenger, 2010).

While the Yukos takeover did not stop investment and growth immediately, it initiated Russia’s gradual departure from market-oriented reforms towards the building of a sort of hybrid system that is heavily controlled and dominated by the state bureaucracy and the ruling elite. The tighter political and administrative grip on the economy was preceded by a revival of political authoritarianism. This included a clamp-down on free media, political control of the judicial system, the increasingly oppressive behaviour of various law-enforcement and security agencies, the increasing control of federal entities by the federal government, the gradual departure from free and competitive elections and a party system and the elimination of other institutional checks and balances (Figure 3). Increasing government interference in business activity was part of a broader process of building the so-called power vertical – the mechanism of hierarchical control extending down from federal authorities to regions, municipalities, enterprises, media and civil society organisations.

**3 THE SECOND TURNING POINT: GLOBAL FINANCIAL CRISIS**

The negative effects of recentralisation in Russia became fully visible in 2008-09 when the global financial crisis hit. Several emerging-market economies, especially in Europe, suffered from capital outflows, suddenly cutting off their external financing, bursting credit and real-estate bubbles, reducing demand for their exports and resulting in falling remittances. However, the magnitude of crisis-related shock in Russia was particularly large. It resulted from, among others...
things, massive external over-borrowing of large enterprises and banks, both private and state owned, prior to the crisis, declining oil prices and massive net capital outflow (Figure 4) when global liquidity dried up (partly because of the inability to roll over previous debt).

In 2009, the Russian economy contracted by 7.8 percent (in the second half of 2008 and first quarter of 2009, the cumulative output decline amounted to some 10 percent). The exchange rate depreciated from 23.5 rubles to the dollar at the end of July 2008 to 35.2 rubles to the dollar at end of February 2009, despite massive market interventions by the Central Bank of Russia (CBR). As a result, the CBR’s international reserves decreased from $582 billion at the end of August 2008 to $384 billion at the end of February 2009. In the following year, when oil prices picked up again and global financial markets stabilised, the exchange rate partly recovered and international reserves started to grow again.

As part of its anti-crisis package, the Russian government offered generous bailouts to troubled enterprises and banks, via either their direct nationalisation or through takeovers by those firms that were already state-owned.

Deteriorating fiscal accounts became a natural consequence of generous bailouts. Large increases in pensions and public-sector wages in the crisis year of 2009 additionally increased pressure on the budget. As a result, a general government surplus of 8.4 percent of GDP in 2006 turned into a deficit of 6.3 percent of GDP in 2009 (Figure 5). The federal government’s non-oil deficit increased from less than 5 percent of GDP in 2006 to 13.8 percent of GDP in 2009 (Figure 6). Although oil prices gradually recovered to above $100 per barrel in 2010, and the general government fiscal balance became positive again in 2011-12 (see Figure 5), the Russian budget and the entire economy remained even more dependent on oil prices, compared to the pre-crisis situation.

4 RENATIONALISATION DRIFT

Subsequent waves of renationalisation increased the share of the Russian economy owned by the state, especially in finance, the military-industrial and heavy industry sector, transport, communication and other sectors considered to be ‘strategically important’. As result, more than 80 percent
of shares in the ten largest Russian firms belonged to the state and the three largest state-owned banks accounted for almost 60 percent of total banking assets at the end of 2013 (IMF, 2014, pp30-33).

At the end of 2012, the top twelve state-controlled open joint-stock companies traded on the Moscow Stock Exchange included [percentage of shares belonging directly or indirectly to the state in brackets]: Gazprom (50.1 percent), Rosneft (75.2 percent), Sberbank (50.1 percent), VTB Bank (75.5 percent), the Federal Grid Company of the Unified Energy System (83.2 percent), RusHydro (60.5 percent), Transneft (78.1 percent), Interregional Distribution Grid Companies Holding (63.7 percent), Mosenergo (85.0 percent), Aeroflot (51.2 percent), United Aircraft Corporation (93.4 percent) and RAO Energy System of East (65.6 percent) (OECD, 2013, Table 1, p19).

As well as listed companies, public ownership in Russia includes the so-called unitary enterprises at the federal, regional and municipal levels, and state corporations (Sprenger, 2010). State unitary enterprises include Rosoboronexport (weapon export), Post of Russia and Rosspirtprom (production of alcohol). The group of state corporations includes, among others, Vnesheconombank, Rosnano (nanotechnologies), Rostekhnologii (defence industry) and Rosatom (nuclear energy).

The state-owned enterprises are less efficient, less dynamic, non-transparent, overly politicised and favoured by government in its regulatory and procurement activities. The natural gas monopolist Gazprom might be the best example of the negative consequences of government control. Its gas production in physical volume has stagnated since its formation in the early 1990s, while its business model has remained highly opaque and it often serves Russia’s foreign policy goals rather than a purely business strategy with the aim of maximising profit (see Aslund, 2012).

Several state-owned listed companies were to be privatised, fully or partly, according to the 2012-13 privatisation plan (IMF, 2014, p30). However, the subsequent privatisation plan for 2014-16 set less ambitious targets. And even those limited plans are not implemented in practice.

5 POOR BUSINESS AND INVESTMENT CLIMATE

As result of incomplete economic reforms in the 1990s and then their partial reversal, Russia is not a friendly country for business, domestic or foreign. This is confirmed by several international rankings. In the Transparency International Corruption Perception Index of 2014, Russia is ranked 136 out of 175 countries. The 2014 Heritage Foundation Index of Economic Freedom places Russia at 140 among 178 countries. With a score of 51.9 in the Heritage Foundation ranking, Russia belongs to the category of ‘mostly unfree’ economies. For several years, these poor scores have remained either unchanged or have even deteriorated.

The World Bank Doing Business survey offers a more nuanced picture. In 2013-14, Russia recorded certain progress in its scores and ranking (moving up to 62 out of 189 countries surveyed), mostly on account of improvements in contract enforcement, property registration and business start-up [simplification of registration procedures]. However, according to the same survey, Russian enterprises continue to face serious obstacles in ‘Dealing with construction permits’ (ranked 156), ‘Trading across borders’ (ranked 155), ‘Getting electricity’ (ranked 143) and ‘Protecting minority investors’ (ranked 100).

Similarly the 2014-15 Global Competitiveness Index [GCI] from the World Economic Forum puts Russia in the middle of the summary ranking (ranked 53 out of 144 countries with a score of 4.4 out of maximum ?), with some improvement over the last four years. Nevertheless, Russia fares badly under the first GCI pillar ‘Institutions’, especially in relation to property rights, intellectual property protection, diversion of public funds, irregular payments and bribes, judicial independence, the burden of government regulation, the efficiency of the legal framework in settling disputes, business costs of terrorism, organised crime, reliability of police services, strength of auditing and reporting standards, and protection of minority shareholders. There are also serious problems with the efficiency of goods markets, ie competition [the GCI’s sixth pillar] and quality of infrastructure, especially roads (second pillar).

2. Partly it can be attributed to changes in the Doing Business survey methodology.
Given this evidence of poor governance and business climate, it is hardly surprising that Russia is a net capital exporter (see Figure 7), ie a substantial part of its gross domestic savings is not invested within the country but is rather invested abroad (including official reserves). Incidentally, this shows that a current account surplus does not always reflect healthy economic policy and a friendly business environment.

When we look into Russia’s investment data (Figure 8), it becomes clear that: i) the post-2008-09 investment growth was slower than growth in the pre-crisis period, and ii) its stagnation (in 2013) and decline (in 2014) signalled looming recession.

6 THE ADDITIONAL SHOCKS OF 2014

On top of the systemic roots of the slowdown that has been visible since the 2008-09 global financial crisis, in 2014 the Russian economy was hit by two additional shocks: i) international sanctions in response to the annexation of Crimea and military interference in Donbass (Ukraine), followed by Russian trade counter-sanctions; ii) a sharp decline in the international prices of oil and other commodities. While these factors had different origins (the first resulted from Russia’s geopolitical choices, the second from growth deceleration in emerging-market economies and rebalancing of the global commodity market), both led to an intensification of capital outflows and deep depreciation of the ruble (see Dabrowski, 2015).

Figure 7: Russia, total investment, gross national saving and current account balance, percent of GDP, 2000-14


Figure 8: Investment in fixed capital, real terms, annual percent change, 2000-14


Capital flight demonstrates the vulnerability of the dominant Russian business model: large enterprises prefer to keep their profits and assets abroad (via affiliated business structures) while financing their current activities with foreign borrowing (see Rogov, 2014). Lack of confidence in government and insecurity of property rights are the chief reasons for such practices.

In the particular context of 2014, the massive flight of capital of residents and non-residents reflected a further deterioration of the business climate, which resulted, among other factors, from tighter government controls over the media, the judicial system, civil society and business activity, in addition to new restrictions on foreign investors. The impact was compounded by the nationalist and anti-Western drift in Russia’s domestic and foreign policy. The US and EU sanctions reduced substantially the possibility of external financing for large Russian companies and banks. Russian counter-sanctions targeted food products from the EU and other western countries, and hit consumer markets and import-dependent Russian firms.

An additional blow to imports (see Figure 9) came from the depreciation of the ruble. Overall, depreciation led to a sharp contraction in domestic demand, which turned the previously observed growth deceleration into a recession.

The oil price decline revealed another structural vulnerability of the Russian economy. Although far from being a hydrocarbon monoculture, like the...
Gulf countries, Azerbaijan or Algeria, in 2008-14 oil exports oscillated between shares of 50 and 55 percent of Russia’s total exports, and some 25-28 percent of GDP at current prices. Oil-related revenue accounted for 11.4 percent of GDP and more than half of federal government revenue in 2014. If one adds natural gas (some 13 percent of total exports in 2013), and ferrous and non-ferrous metals, there is a clear picture of deep-reaching commodity dependence in Russia. However, expectations inside Russia that the ruble depreciation can lead to fast growth in non-oil industrial and agricultural output, as happened in 1999, have not so far materialised. A sort of stagnation at the post-recession level looks to be the most plausible scenario.

7 UNCERTAIN PROSPECTS

The macroeconomic data for the first five to seven months of 2015 is not always sufficient to make a firm judgement about the current position of the Russian economy and its near-term prospects. In addition, too little time has passed since the major devaluation shock of December 2014 and January 2015 to be able to confidently assess how the economy will adapt itself to the new macroeconomic environment.

In particular, from the GDP statistics for the first half of 2015, it is hard to predict whether the declining trend has already reached its bottom or if it will continue, and for how long. According to the IMF World Economic Outlook July 2015 update, Russia’s GDP is expected to decrease by 3.4 percent over the entire 2015, and increase by 0.2 percent in 2016. This would be a significant improvement compared to the previous, more pessimistic WEO forecast published in April 2015 (IMF, 2015a), which foresaw a decrease of 3.8 percent in 2015 and 1.1 percent in 2016. The assumption is that the recession should not deepen further.

8 MANAGING THE CRISIS

Stabilisation of external accounts

After the dramatic developments of 2014 and early 2015 (see Dabrowski, 2015), Russia’s balance-of-payments situation has stabilised. While exports in current dollars have contracted (the effect of the drop in oil and other commodity prices), trade and current account balances have remained positive, because of declining imports (Figure 9). It is worth noting that Russia’s exports of crude oil and oil products kept growing in physical volumes during the first five months of 2015, compared to the same period in 2014.

Capital outflows have continued, though at a less dramatic pace than in 2014 (see Table 1). External debt in US dollar terms has declined compared to the beginning of 2014 by almost a quarter (see Table 2), but has increased in ruble terms, because of ruble depreciation. The major part of this decline has come from the Russian banking and commercial sectors, which have reduced their external exposures (partly because of sanctions and the resulting inability to roll over their debts).

Figure 9: Non-oil primary fiscal balance, % of GDP, 1999-2014

Some respite for the balance of payments also came from lower outward remittances. In the first half of 2015, these decreased by approximately half compared to the same period in 2014 as the consequence of recession and ruble depreciation.

Furthermore, introduction of more a flexible exchange-rate regime allowed the CBR to minimise intervention in the domestic foreign-exchange market, which was the major source of official reserve losses in 2014. The most recent sales at the time of writing took place in January 2015. Between May and July 2015, the CBR purchased more than $10 billion. Overall, CBR foreign exchange reserves (without gold) stopped declining and stabilised at a level above $300 billion (Figure 10).

Exchange rate and inflation

After dramatic depreciation between December 2014 and February 2015, the ruble partly recovered, reaching its early November 2014 value in mid-May 2015. Then the depreciation trend returned (Figure 11). In the second half of August 2015, the exchange rate weakened again, returning to its January 2015 level. Its fluctuation resulted partly from short-term changes in oil prices and the situation in Donbass (ie temporary escalation of the conflict in the second half of August 2015). The CBR's purchases of foreign currency (see above) are also likely to have affected the nominal exchange rate.

The depreciation of the ruble has had a pass-through effect on inflation. Russia has never reached a truly low single-digit level of inflation. Its lowest-ever 12-month level was achieved in Q1 2012 (slightly below 4 percent), but since then inflation has picked up. It amounted to 6.1 percent in January 2014 and gradually accelerated to reach a two-digit level in December 2014 (Figure 12). In the first eight months of 2015, it remained between 15 and 17 percent. A decrease in the

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12-month consumer price index will only be possible after March 2016 when the statistical effects of high monthly inflation between December 2014 and February 2015 will be left behind. However, this will be possible only if the exchange rate stops depreciating.

Two-digit inflation means cuts in real wages, salaries and other sources of income for the population. In fact, real income levels already dropped by 1 percent in 2014. Because of budget cuts (see the next section), public wages and salaries, pensions and other social benefits will not be fully indexed against inflation, at least in 2015-16. However, unemployment continues to remain at a low level of between 5 and 6 percent of the active labour force.

**Fiscal challenges**

Without any doubt, the fiscal situation poses the most serious challenge to Russia. At first sight, Russia has no reason to worry. During the oil boom years, it accumulated sizeable reserves in the form of two sovereign wealth funds – the Reserve Fund (RF) and the National Wealth Fund (NWF) (Figures 13-14). Although seriously depleted during the global financial crisis (especially the RF – see Figure 13), the funds were partly rebuilt in 2012-13. Even after spending some of these resources during the current (2014-15) crisis, their size remains substantial – each representing approximately 6 percent of GDP.

At the same time, Russia’s general government gross debt amounted to only 17.8 percent of GDP in 2014 (IMF, 2014b, Table 4, p36), a level much lower than most advanced and emerging-market economies.

However, the US and EU sanctions make it impossible for Russia to borrow on international markets. Therefore, Russia can only rely on its accumulated fiscal reserves and domestic borrowing to finance fiscal deficits. Domestic borrowing will remain limited because of the insufficient depth of the domestic financial market, limited trust in the ruble and fragility of part of the banking sector.

According to the IMF forecast (IMF, 2015b, Table 4, p36), Russia’s general government deficit will amount to 4.8 percent of GDP in 2015, and the federal government deficit will be 3.5 percent of GDP. Practically the entire revenue shortfall will be made up from the oil-related sources: minus 2.9 percentage points of GDP compared to 2014. In addition, general government expenditure will expand by

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7. However, the NWF’s assets are partly illiquid; they have been in various domestic projects.

8. The oil-price decline in dollar terms has been partly compensated for by ruble depreciation.
more than one percentage point of GDP, mainly because of a shrinking denominator (real GDP). Without further fiscal adjustment the RF will become depleted in 2017, and the NWF will suffer the same fate a year or two later. Russia’s Ministry of Finance aims to avoid this and has advocated serious expenditure cuts in the 2016 budget. They might involve, among others options, limited indexation of public wages and salaries, pensions and social benefits; rationalisation of employment in public administration and the public healthcare sector; restricting the list of health services and procedures financed from public sources; cuts to space programmes; and further cuts in public investment projects, including those related to the 2018 football World Cup. Military expenditure will be less affected, though it is likely that it will not increase further in nominal terms.

Apart from short-term expenditure cuts, there are also discussions about increasing the statutory and actual retirement age (one of the lowest in Europe), cutting pension privileges related to individual sectors and professions, and limiting the possibility of combining pensioner status with continuing employment. Economically, these are the right solutions (especially when considering the unfavourable demographics trends), but they face political resistance both inside the government and in the Duma (the lower house of the Russian parliament).

Cutting direct and indirect energy subsidies and returning to privatisation could offer additional support to the budget, but these measures are not currently being debated.

9 HOW RETURN TO ECONOMIC GROWTH?

Even if the Russian economy has already reached its lowest point, a more fundamental question of how to return to sustainable economic growth at reasonable rate remains open.

In the short term, much will depend on oil prices and the political ability to resolve the Ukrainian conflict. Higher oil prices, for example $60-70 per barrel and a relaxation of the sanctions regime could provide Russia's economy and budget with a certain respite and could ease somewhat the largely negative perception of the business climate. In addition, continuation of conservative monetary and fiscal policies can help to prevent new episodes of macroeconomic turbulence of the

Figure 13: Reserve Fund, $ billions, 2008-15


Figure 14: National Wealth Fund, $ billions, 2008-15

sort observed at the end of 2014 and in early 2015 (see Dabrowski, 2015). This would also be important for output stabilisation and potential recovery. In the medium-to-long term however, Russia must address its fundamental structural and institutional disadvantages: the high degree of oil and commodity dependence, and the unfriendly business and investment climate, underpinned by poor governance.

Compared to many other commodity producers, Russia has a greater chance to diversify its economy, mostly because of its excellent human capital. Ruble depreciation makes this task easier. Whether such a diversification will materialise depends, however, on improving the business and investment climate and stopping the authoritarian drift in domestic politics and geopolitical confrontation with the west and Russia’s neighbours.

REFERENCES


