



SKOLKOVO
Moscow School of Management

RUSSIA'S LOST DECADE?

CHALLENGES TO GROWTH RECIPES FOR ACCELERATION



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The Russian economy today is going through a critical stage. The growth model, which catapulted the country into the world's top ten economies' list has been exhausted and most experts believe that Russia is facing a long period of low or no growth. While the world is moving forward, Russia's standing still. Hovering anxiously in one place means its economy is becoming smaller and is further increasing its competitive gap.

The ailing economy is often blamed on the falling oil prices combined with the economic sanctions that were imposed on Russia in 2014. However, the array of challenges that the economy is facing today is much broader than that, and the recession in Russia has deeper roots.

This report represents an attempt to discuss those roots and to summarize economic agenda that the country's leadership will face on the way to restart growth, amid the 2018 presidential elections and regardless of its outcome. This agenda will define economic and fiscal policy over the next 5-10 years, and thus will impact anyone who is doing business or going to invest in the country.

Russia is entering 2017 with a clear understanding that ignoring the economic policy issues is not an option. The intense public debate has revived on what could help Russia come out of the recession. Would it be the budgetary tightening or the increased spending? Market liberalism or state intervention? Encouragement of private initiative or state-backed projects? The proposals maybe contradictory but united in the belief that a 4% annual growth is realistic even in the current economic situation.

The power to overcome the challenge and re-ignite growth lies with the people Russia so desperately needs: entrepreneurs and investors who would not be afraid to work and to do business here. SKOLKOVO business school is here to help you understand the context and the challenges that the economy is facing today, to make better decisions and ultimately to achieve growth, for both your business and Russia.

ANDREI SHARONOV,

President of the Moscow School
of Management SKOLKOVO

Introduction



The 2014 saw the halt in continuous growth of the Russian economy, which had been on the rise practically without any setbacks since 1999. The fifteen years of oil abundance led to a doubling in Russian GDP, Russia's joining the G8 and the WTO, accumulating formidable reserves, as well as to steadily rising of real incomes. This created a sense of prosperity, although fragile. Economic policies were declared a success. Until recently, the latest recession has been described as a temporary slowdown, which will blow over just like the world economic crisis of 2008–2009. The experts have been saying "we have reached the rock bottom of the recession", and the fall is slowing down, but such optimistic forecasts are not supported by data.

We believe that careful exploration of fundamental challenges to the Russian economy is more vital today than focusing on its current state of play. After the 2018 presidential election, the new government will have to carry the same "baggage" and address the same issues, which will impact the quality of life of the people and national security.

As it happened, Russia did not take full advantage of the enormous oil and gas revenues and the favourable global economic environment of the previous two decades. Should Russia want to have another go, it will struggle to do so as the odds are against it: shrinking revenues from oil and gas, economic relationships marred by geopolitical agenda, worsening demographic situation and falling incomes do not leave much room for manoeuvre. While it is unlikely that any major dramatic consequences may occur if the situation remains unchanged by 2018, it is important to take proactive measures to offset potential damages.

This report is not intended to paint a most detailed picture of the Russian economy; neither does it purport to dive deep into academic nuances. Its key task is to give an overview of the major trends impacting the country's economic development prospects. We invite all those interested in this subject to join the discussion which, hopefully, will help us gain an insight into the current situation together and to think of ways to resume growth.

Historical Overview



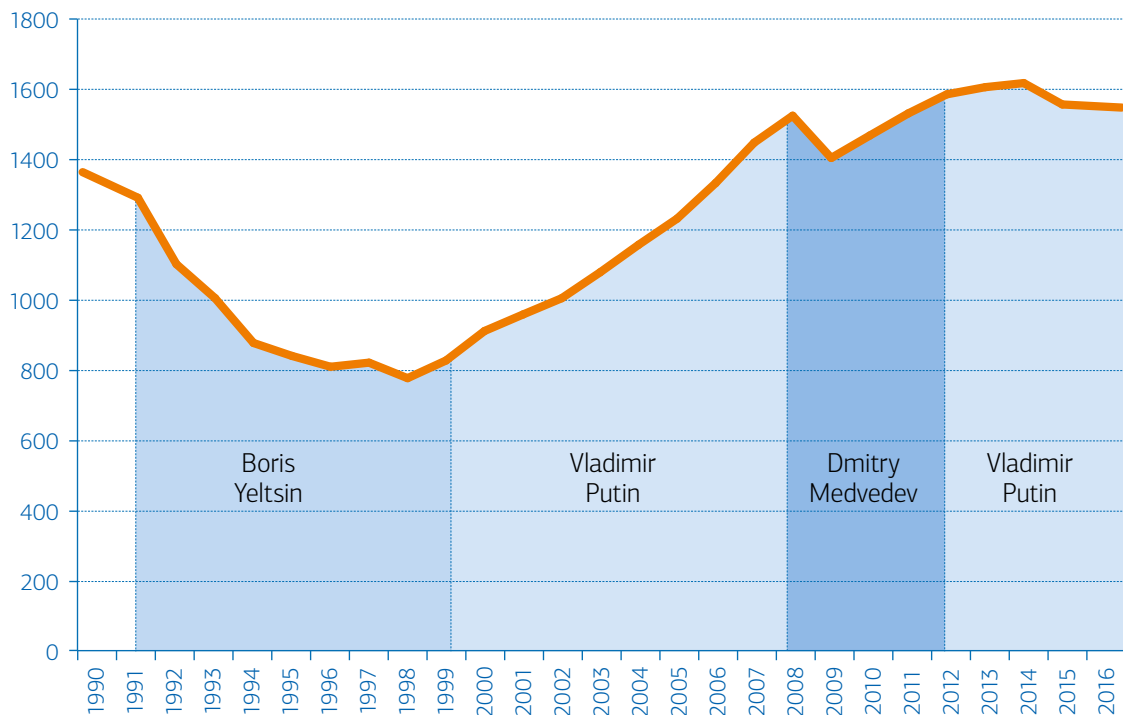
In the twenty-five years since the collapse of the Soviet Union Russia's economy has gone through three very distinct stages. Eight years of decline in 1991–1998 gave way to fifteen years of growth in 1999–2013 (with a short halt in 2009), followed by stagnation in 2014 and recession in 2015–2016. Each of these stages had its dynamics and challenges.

1991–1998:
Transformational Decline
 (Average of 5.5% per Year)

The enormous disparities in the economic development of the Soviet Union and the widening gap between the demand for goods and their real supply led to a rupture

of economic ties, a loss of competitiveness of entire industry sectors, and a prolonged period of economic adaptation to the new rules. Although conditions were dire, they did not prevent the formation of the basic institutions of the market economy: liberalisation of prices, trade and capital. However, the shock therapy, the collapse of the financial system, hyperinflation and factories' closures caused millions of people to lose their jobs and savings, which was followed by a mass of social cataclysms, from worsening crime to the "brain drain" and increased death rate. Hyperinflation wiped out private savings, while companies lacked funds; consequently, there was no capital for development and investment.

Russia's GDP in 1990–2016, US\$ Billion in 2010 Prices



Source: World Bank, Wikipedia

Liberalisation of trade and entrepreneurship, as well as the loss of guaranteed income by a significant number of Russians resulted in a substantial increase in business activity – the majority of successful Russian businesses were founded in the 1990s. Privatisation, launched by the government in 1993–1994 intended to create a class of business owners and stimulate competition. Due to insufficient financial literacy of the population and high pace of liberalization most of people missed their opportunity, and the most valuable assets got consolidated in the hands of the very few large financial and industrial groups, which later became the largest investors in various sectors of the economy.

The first stage ended approximately in 1998, when the state defaulted on its short-term debt. It resulted in a devaluation of the currency and an overall economic crisis.

1999–2012: Recovery and Oil-Powered Growth (Average of 7% per year until 2008)

The Russian economy quickly recovered from the crisis of 1998. As the ruble lost 75% of its value against the dollar, industrial production surged on lower costs and higher demand for cheaper domestic goods. Oil prices started to grow in 1999, and continued to do so almost uninterrupted till 2014. Russia's revenue surged, but oil hijacked the economy, contaminating it with the Dutch disease. A newly created Stabilisation Fund, later divided into Reserve Fund and National Wealth Fund (also referred as National Well-being Fund in English-speaking literature), absorbed some of the oil revenue. This rainy-day fund helped Russia to glide through the crisis of 2008–2009 relatively smoothly.

By the early 2000s the Russia's major industrial and resource assets were in privatized. The new owners started to invest in order to boost the cash flow and the value of their companies. At the same time a set of institutional and fiscal laws (the so-called

Gref Programme) were introduced to ease the tax burden and to improve investment climate. It marked the beginning of a long phase of investment activity and capital inflow, which lasted until 2008. Russia entered the Top 10 of the world economies, joined the G8 and the G20, and contributed R to the BRICS (Brazil, Russia, India, China, South Africa) acronym. It seemed that growth and rising wealth were there to stay.

2013–?: Structural Recession

The Russian economy began to slow down late 2013, and after just six months stagnation manifested itself. Although a tempting thought, the key causes were the drop in oil prices and the economic sanctions, since these events occurred only towards the middle of 2014. The external economic factors only added to the middle-income trap, which Russia was caught in.

Russia ended 2015 with a 3.7% GDP contraction, a halved value of the ruble, a 12.9% inflation and entered in 2016 with a budget deficit of 3%. Domestic consumption decreased for the first time in 13 years, while real income fell to the 2011–2012 level. Anemic growth at best is expected to last till 2019.

Russia's economy is dependent on oil prices and geopolitical risks, none of them we dare to predict. Instead we will look closely at the constraints to growth and the opportunities of recovery.

Optimism Vanishes. Russia's 2014 GDP Growth Outlook Reduction. Consensus Forecast



Sources: Russia's Finance Ministry, Economy Ministry, CBR, IMF, World Bank, OECD, EBRD.



Challenges to Growth



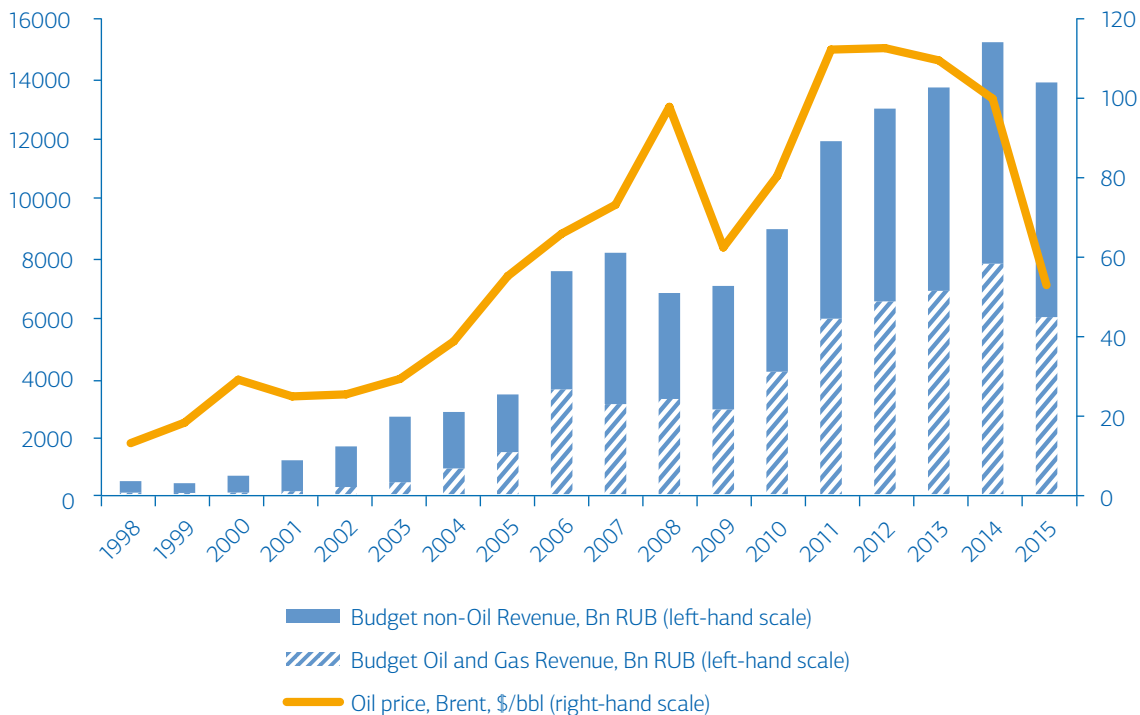
1. Demise of the Oil-Powered Growth

From 1999 to 2012 the average annual price of Brent crude oil increased sixfold between 1999 and 2012, while its production in Russia approximately doubled. There is no denial that the natural resource sector, particularly the oil and gas industry has made a key contribution to the economic development of Russia in the past 15 years. Oil remains the main source of foreign currency, and half of the budget revenue came from energy sales most of the first decade of the century. The share declined somewhat now due to lower oil prices, but as the economy stagnates pushing other revenue down the

government coffers depend even more on the fluctuation of oil prices.

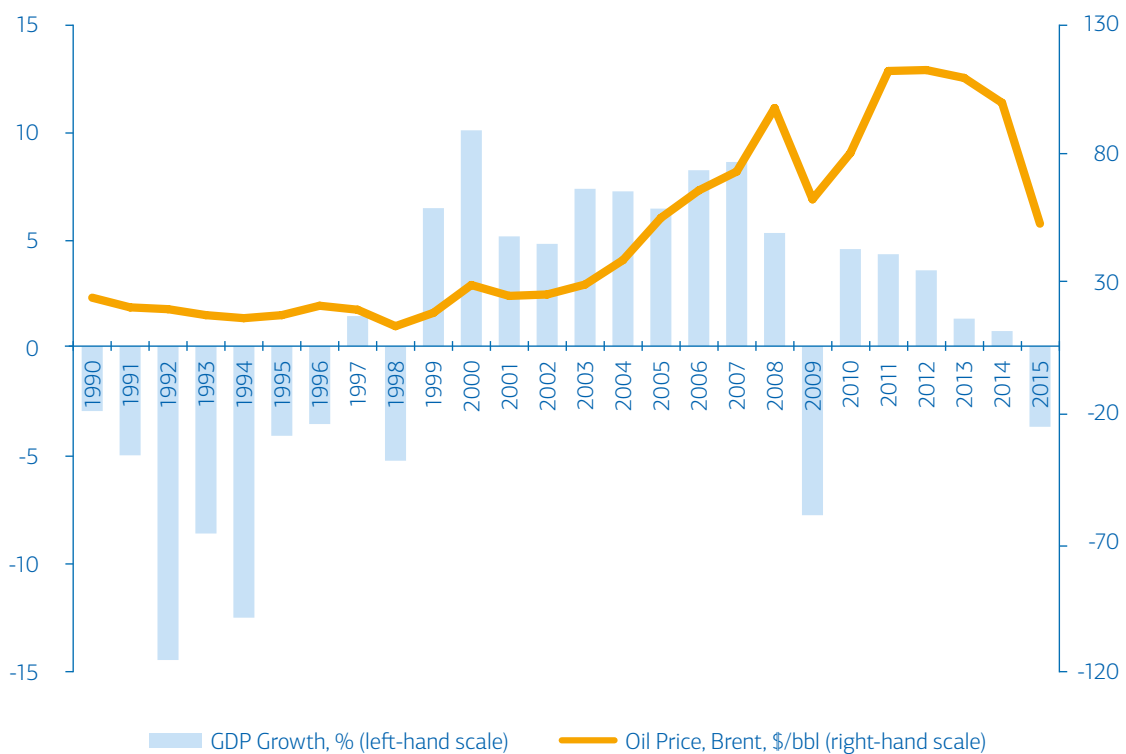
Moreover, a steady flow of oil-generated cash plunged Russia into the Dutch disease, a sharp inflow of foreign currency leading to currency appreciation, making the country's other products less price competitive on the export market. The ruble, supported by the forex proceeds from oil export, cheap credit in the West and the Central Bank's policy of partly managed exchange rate, was overvalued. The real salaries grew much faster than productivity, while commodities exporters and consumer-driven sectors attracted most of capital investment. When oil prices fell, and cheap credit dried out, the party stopped abruptly, leaving an

Russia's budget revenue in 1998-2015 and the oil price



Sources: Ministry of Finance of Russia, U.S. Energy Information Administration

Oil is the King. Russia's GDP growth in 1990-2015 vs. the oil price



Sources: Rosstat, U.S. Energy Information Administration.

aftertaste of inflation, budgetary austerity, devaluation, decline in real incomes, choked lending, the longest recession in almost two decades and no growth engine ready to kick-start the economy.

Russia needs to find new drivers for growth outside the natural resource sectors, but the discussion of diversification has lasted for years. Nevertheless, the country continues to degrade in terms of the economic complexity of the economy – fewer and fewer industries remain competitive in the international market. Considering the available resources, Russia has about 20 years left to find and implement a solution to this problem.

2. Household Consumption Shrinks, Import Flows In

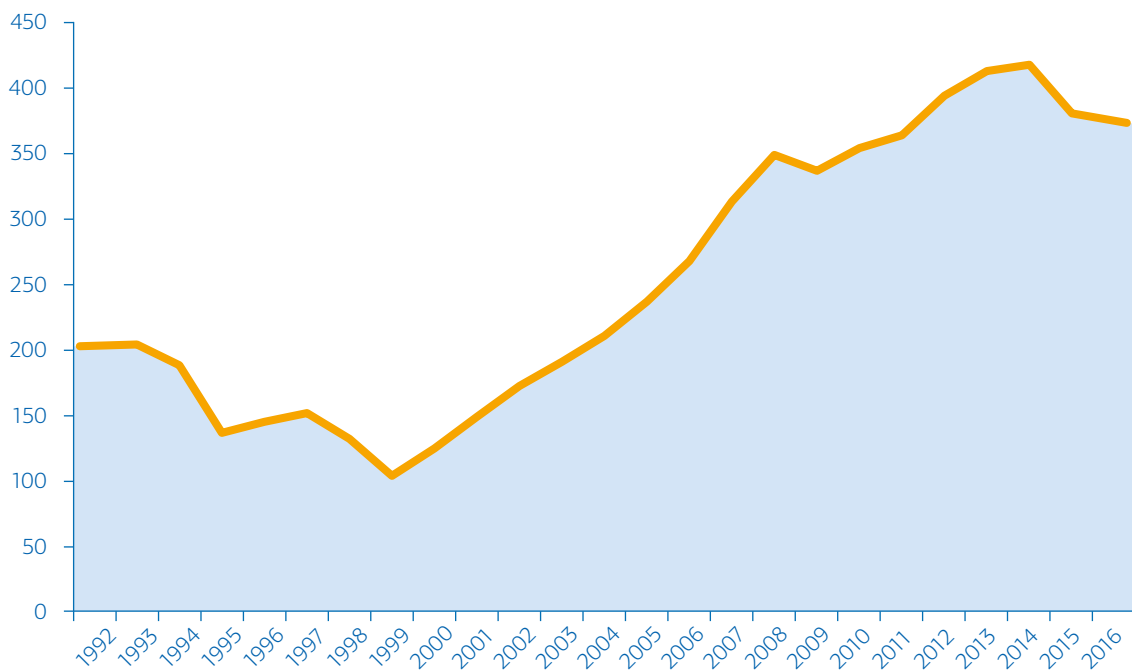
Household consumption fueled growth in many sectors of the economy and contributed significantly to the GDP expansion. It was domestic consumption that allowed the economy to recover after the crisis of 2008–2009. However, in 2015 the situation changed – consumption began to decrease and dropped sharply by 5%, as recession loomed. Today there is no reason to hope of consumer demand to return to growth, as a significant proportion of households is directly or indirectly dependent on the public sector and the shrinking budgetary spending.

Table. Key Drivers of Russia's GDP Growth n 2002–2015

| Indicators | Growth 2002–2008, % (real) | Growth 2008–2014, % (real) | Growth 2014–2015, % (real) |
|----------------------------------|-------------------------------|-------------------------------|-------------------------------|
| GDP | 51% | 6% | -4% |
| Household consumption | 93% | 23% | -5% |
| Public sector consumption | 15% | 4% | 0% |
| Gross savings | 123% | -12% | -4% |
| Export | 54% | 6% | 1% |
| Import | 196% | 13% | 5% |

Sources: Federal State Statistics Service (Rosstat), Russia's Ministry of Economic Development

You Never Had It So Good. Average Real Wages in Russia 1999 = 100



Source: Rosstat.

Household consumption burgeoning between 1999 and 2014 was fueled by a steady rise both of the real wages and real disposable incomes. Russia's average real wages increased fourfold in 15 years after a plunge following the collapse of the Soviet Union. Oil revenues trickled down to the masses, but as prices fell so did the rise of prosperity. Real wages rolled almost five years back, making labour cost in Russia lower than that in China. The decline may well continue. However, as an average Russian is much better off than he was in 1999, the approval rates for President Vladimir Putin remain high - 86% in December 2016. However, the decline in private consumption is an important factor behind the flagging economy. Declining private demand leads to a shrinking domestic market, which in turn discourages business from investing. Only two years ago, in 2014

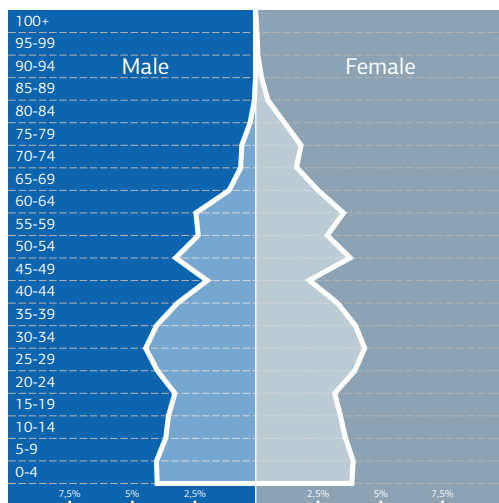
Russia was the largest market in Europe in cars, and consumer companies were flocking to the country. Now the demand has dried up, the car sales are in decline, global retailers are leaving the country and the appetite for new projects in Russia is hardly visible.

3. Longer Lives with Fewer Kids

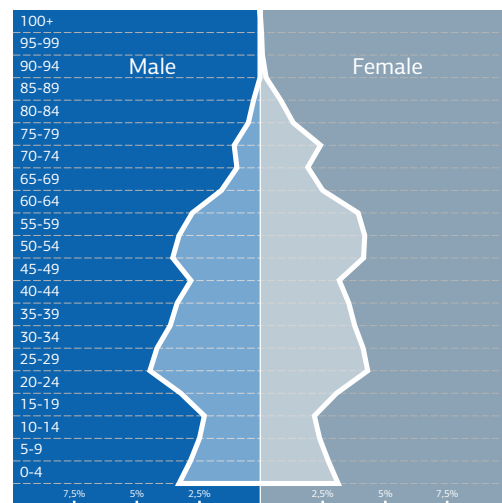
The tribulations of the 20th century had a devastating impact on Russia's population, which now stands at 146.5 million people (including Crimea). It could have reached about 300 million people had it not been for the two World wars, the Civil war, emigration, political repressions and economic upheavals. At the beginning of the 20th century Russia had the potential to become one of the world's three most populous countries by the turn of the 21st century, but the fact is that

Russia's Population Pyramid in 1990 and in 2015

Russian Federation **1990**
population **147568000**



Russian Federation **2015**
population **143456000**



Source: populationpyramid.net; numbers do not include Crimea.

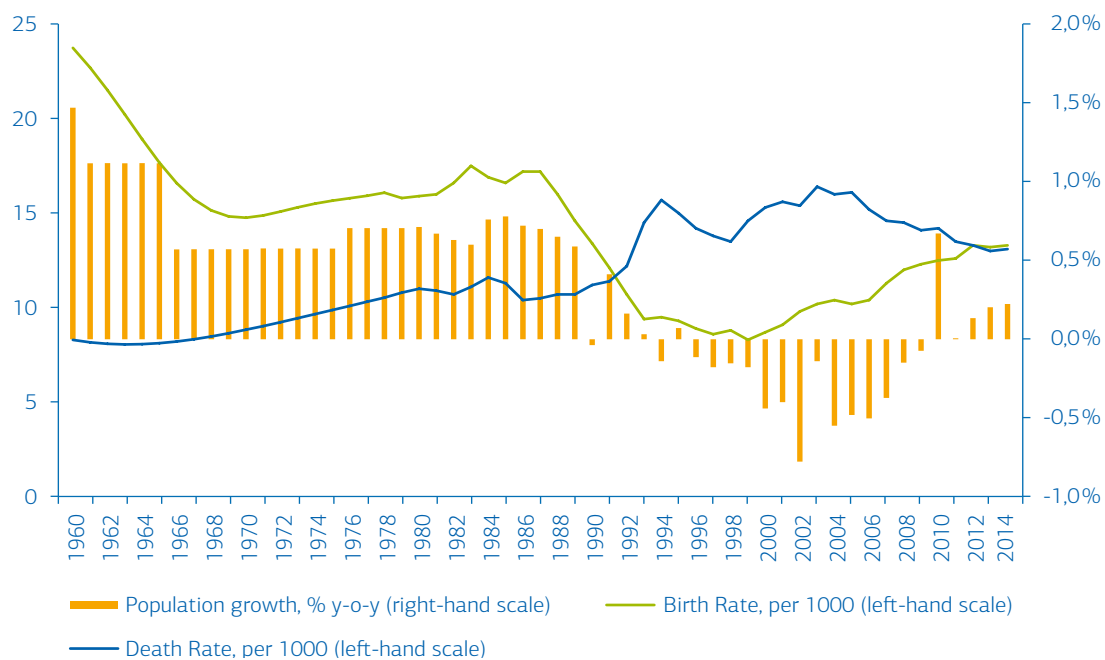
now it only closes the top ten and is expected to be overtaken by countries such as Ethiopia, Philippines, Congo and Mexico by 2050. In terms of demographics Russia is turning into a minor player in the global market.

Russia's population took a steady hit during the 1990s which is often attributed to difficult economic and social conditions after the collapse of the USSR. The trend towards population growth began in 2010. However, it was not so much due to the improved economic situation and the state programmes promoting the birth rate, as to the fact that the generation of people born in the 1980s (the children of the post-war baby boomers) entered the fertile age, causing a surge in the birth rate. It will not create a lasting effect, since the generation born in the 1990s is extremely small in numbers. Therefore, this trend can hardly be called sustainable.

Russia's population is getting older – in 2015 an average Russian was 39.5 years old (36 years in 1995), and this indicator is very close to that of Western Europe (over 40 years). The proportion of the working age population is decreasing, while the ratio of dependents (pensioners and minors) is growing. Thus, in order to maintain growth, the Russian economy has to either increase productivity or attract new labour force (about 4.6 million people, as estimated by Alexei Kudrin, former Minister of Finance of Russia).

The World War II has not only reduced the number of people, but has also distorted the age distribution in the whole population. A generation wiped out by the war casts a shadow on the generation of its children, who in turn are less numerous than those older and younger than they are. The pattern repeats itself over generations, resulting in what is

Key Demographic Indicators of Russia in 1960-2014



Source: Rosstat.

known in demography as a 'Christmas tree-shaped pyramid'. The largest present-day groups of population are people aged 50–65 (those who now possess wealth and power) and people aged 25–40. It is similar to the demographic spread at the turn of the 1980s and 1990s. However, the millennials, those who grew up in the 2000s, did not have to fight for survival but reaped the benefits of prosperity, may not have sufficient skills to successfully restart growth in the times of crisis and uncertainty. Nevertheless, the figures show that the next 5–10 years will see the change of generations and elite, and it can be quite sharp. The question is, what values will this new generation of "thirty-somethings" bring to the country?

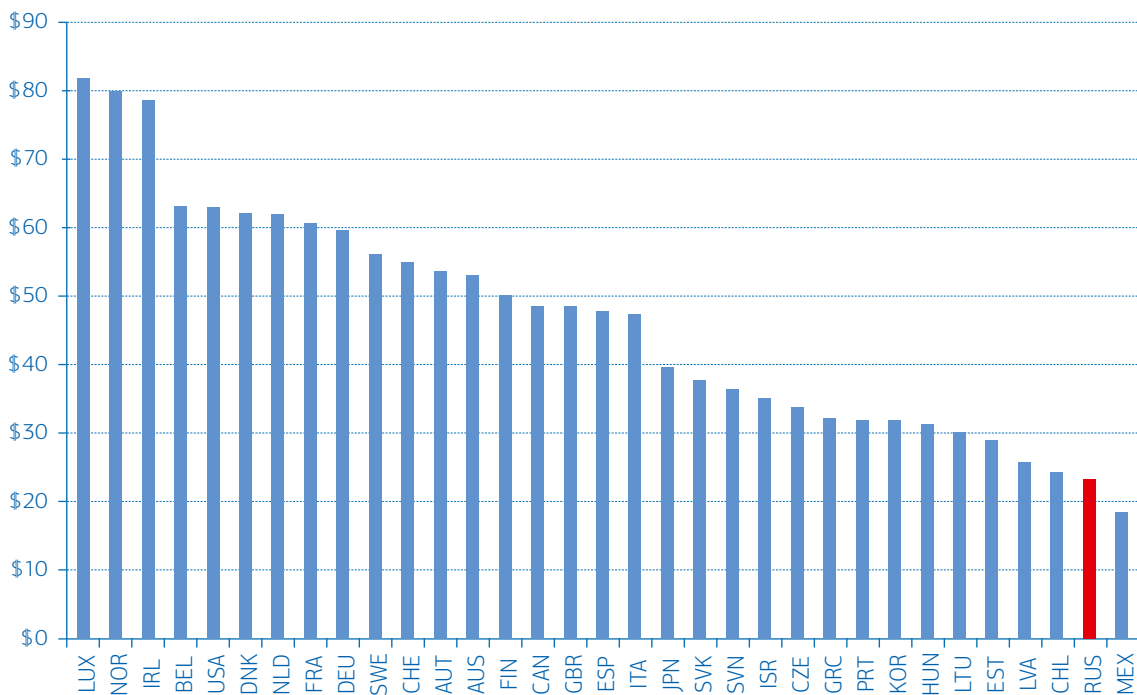
The last but not the least serious challenge is the change in the quality of human

capital due to the migration and "brain drain". According to various estimates, emigration in 2015 was close to the record levels of the 1990s. While Russia's migration is still net positive, it's the quality of migration that matters too. Russia ranks second only to the United States in terms of migrant influx. However those who are leaving are on average better educated and better fit for the needs of a modern economy, than an average immigrant eager to grab low-skilled and low-paid jobs. Would Russia be able to compete for skills and brains and to take advantage of the mass influx of migrants?

4. Low Labour Productivity

Russia has been consistently lagging behind developed countries in terms of labour

Labour Productivity in 2015, Calculated as GDP per Hour Worked



Source: OECD

efficiency. Over the past 25 years the gap has remained practically unchanged: different sources indicate that Russia is 2–3 times less productive than most of the OECD countries. This lag is structural in many ways, due to the geographical and industrial heritage of the USSR. However, taking into account the demographic challenge, a relatively low unemployment (5.6% in 2015), and a high capacity utilisation (64% at the maximum of 65% over the last 20 years--not clear), labour efficiency becomes paramount for growth.

One of the factors that hinders the productivity growth in Russia is the share of the government's ownership in the economy. According to the Federal Antimonopoly Service, in 2015 almost 70% of GDP was directly or indirectly created in the public sector (compared to 35% in 2005). State-owned enterprises are far from being the most efficient market participants. The most successful companies of the last decade in Russia are those operating in sectors with minimum government regulation, such as IT, FMCG, telecommunications, services, and retail trade. It is the same companies that made the greatest success abroad. In contrast, state monopolies have regularly applied for the government's subsidies or subsidised loans. Many experts say that to improve the productivity in Russia we need to eliminate the state monopoly in many sectors, promote competition and actively encourage the development of private initiative.

Increasing productivity does not necessarily mean updating facilities; it may be more effective to revise the structure of the economy to eliminate non-productive entities and to reduce supervisory and controlling pressures. As an example, revising the principles of accounting and personnel administration will eliminate the burden of keeping unnecessary records and reduce

headcount. However, a significant reduction in non-productive jobs may lead to a social tension as it happened in Pikalyovo in 2009¹. Higher social and geographical mobility of the population, better training and re-education, reformed institutions and regional development will help to improve productivity smoothly, without the risks of social tension.

5. Capital Flight and Retrenchment

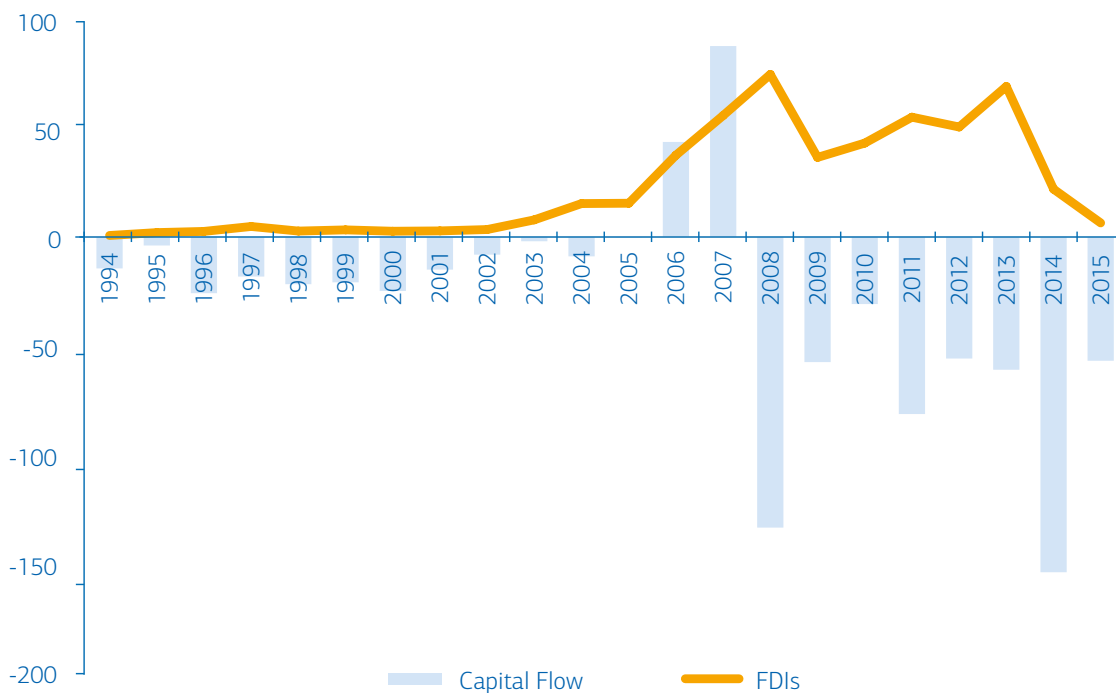
Russian economy bleeds for investment, but investors are not willing to commit to Russia. This applies to international and domestic companies alike, which curtail their investment programmes and prefer to keep their capital abroad.

In the 2000s the growth of the Russian economy was accompanied by capital inflows, primarily in the form of foreign direct investment (FDI). Amounting to US\$ 2.7 billion in 1999, FDI increased to US\$ 74.8 billion in 2008, but by 2015 it declined to US\$ 6.5 billion, to the level of 2003. It must be noted that the bulk of the foreign direct investment comes from offshore jurisdictions (such as Cyprus, the Bahamas, the Bermuda Islands, the British Virgin Islands, etc.), and is de facto not foreign, as Russian companies and high net worth individuals prefer to park their cash abroad. As for the foreign players, they saw the country risks mitigated by high profit margins and growth prospects. As soon as the market began to shrink and the profits fell, the risks outweighed the benefits, and the mood reversed followed by the capital.

The decrease in investment was particularly noticeable from 2013. Mining, metals, resource sectors, production of heavy machinery and other capital-intensive sectors suffered a drop in investment. This in turn resulted in lower output of construction

¹ Pikalyovo is a town 246 km from St. Petersburg, Russia, where a large cement factory is located. Most of the town's population are linked economically to the plant. In 2009 in the midst of the financial crisis, about three hundred inhabitants blocked the highway between St. Petersburg and Vologda to protest late payment of wages. Vladimir Putin, then Prime Minister of Russia, flew to Pikalyovo and, without going through a legal process, ordered Oleg Deripaska, the plant owner, to pay out the wages and debts immediately.

Capital Net Inflow and Outflow and Foreign Direct Investment in Russia in 1994–2015, US\$ billion



Source: Russia's Ministry of Economic Development, World Bank

materials, transportation, and all related sectors, including trade. These sectors have a long investment cycle, and the recent capital frugality will affect the overall economy negatively for years to come. Even when companies resume investing, it will take time until economy gets a boost from it.

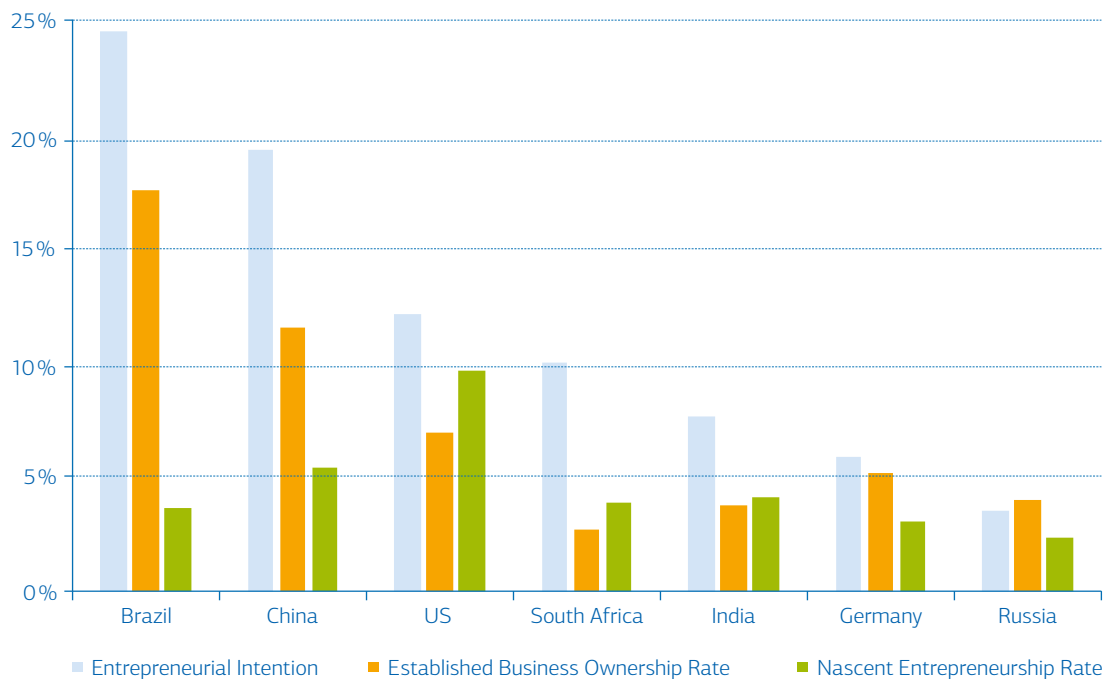
6. SME's Share Is Low, Entrepreneurial Spirit Is Subdued

Small and medium enterprises (SME) are the economic engine in both developed and developing countries. However in Russia they play an exceedingly small role accounting for only between 15 and 20% of the GDP, only 0.5% of the export and employing only a quarter of all the workers. In contrast

to Russia, in the U.S., Germany, and China, where SMEs greatly contribute to the development and diversification of the economy these indicators easily reach 50%. According to the U.S. National Centre for the Middle Market, the growth of medium-sized companies (from US\$ 10 million to US\$ 1 billion in revenues) exceeds that of the overall economy by 4.4% on average. While representing only 3% of all registered enterprises they employ a third of the workforce.

Studies show that entrepreneurial spirit in Russia is traditionally low. Polls show that only between 3 and 5% of the Russians are considering opening their own businesses, and the majority of university graduates dream of a position with one of the large commodities companies instead. At

Entrepreneurial Tendencies in Selected Countries, % of Population Aged 18–64



Source: Entrepreneurship Monitor.

the same time, low unemployment suggests a lack of available human capital, which may be another reason behind a low number of prospective entrepreneurs. Can Russia import them, like many other countries are trying to do?

7. Turning to the East

In 2014, following the imposition of sanctions by the Western countries, Russia adopted the ‘Pivot to the East’ strategy, aiming for the new export markets in Asia and for closer economic ties with China. Two years later the results are not that encouraging: trade turnover between the two countries has dropped by more than a fifth, reflecting lower prices for commodities exported to

China, and lower appetite for import in Russia. Moreover, Russia dropped out of China’s ten most important trading partners. Economic cooperation and business relationships between the two countries isn’t flourishing as expected. The structure of Russia’s trade with China is extremely uneven. Russia has little to offer to its eastern partners apart from commodities, arms, space and nuclear technologies. On the other hand, Russia is hungry for machinery, electronics and consumer goods produced abroad. This imbalance suggests that Russia needs China more than China needs Russia, placing Moscow at the receiving end of the talks.

In addition, Russia was late in entering the Chinese market. Russia came there when many Western companies were already

leaving it, as China started to move from a “workshop of the world” to developing its own home-grown technologies. Twenty years ago, China was a growing market with a seemingly endless source of cheap labour and domestic consumption. Today it's an actively developing innovation player, implementing mega-projects and competing for the global market.

In order to successfully implement the ‘Pivot to the East’ strategy, Russia needs human resources and competencies. Achieving a significant increase in trade turnover with China is an exceedingly difficult task, as Russia’s Far East with its 6.3 million inhabitants gravitates towards its gargantuan neighbour despite cultural differences between the two countries. Moreover, China is much farther from Russia than it seems: distance from Moscow to Shenzhen is equal to distance from Moscow to New York.

To be able to engage Chinese partners Russia needs more than just Chinese speakers. It needs entrepreneurship initiative, competitive products and services to be used either in China or with China. Russia lacks understanding of its Asian neighbour, which makes the task of tending to this demanding customer even more challenging.

8. Economic Sanctions and Counter-Sanctions

In March 2014, the EU, the U.S. and a number of other states introduced the first sanctions against Russia in connection with the situation in the Crimea and eastern Ukraine. At first, these were individual sanctions against specific people and companies that were not significant to the Russian economy as a whole. However, in July 2014, additional sectoral sanctions were imposed that limited foreign financing for leading public banks and oil and gas companies and restricted Russian oil and gas companies’ access to advanced production technologies. In response, Russia imposed an embargo on a wide range of agricultural

products from Western countries in August 2014.

According to experts at the Bank of Russia, the sanctions chipped away 0.5% of Russia's GDP during the first year they were in effect and 0.6% during the second year. Foreign investors shunned Russia, and self-imposed ban on food import fueled a sharp rise in consumer prices inflation.

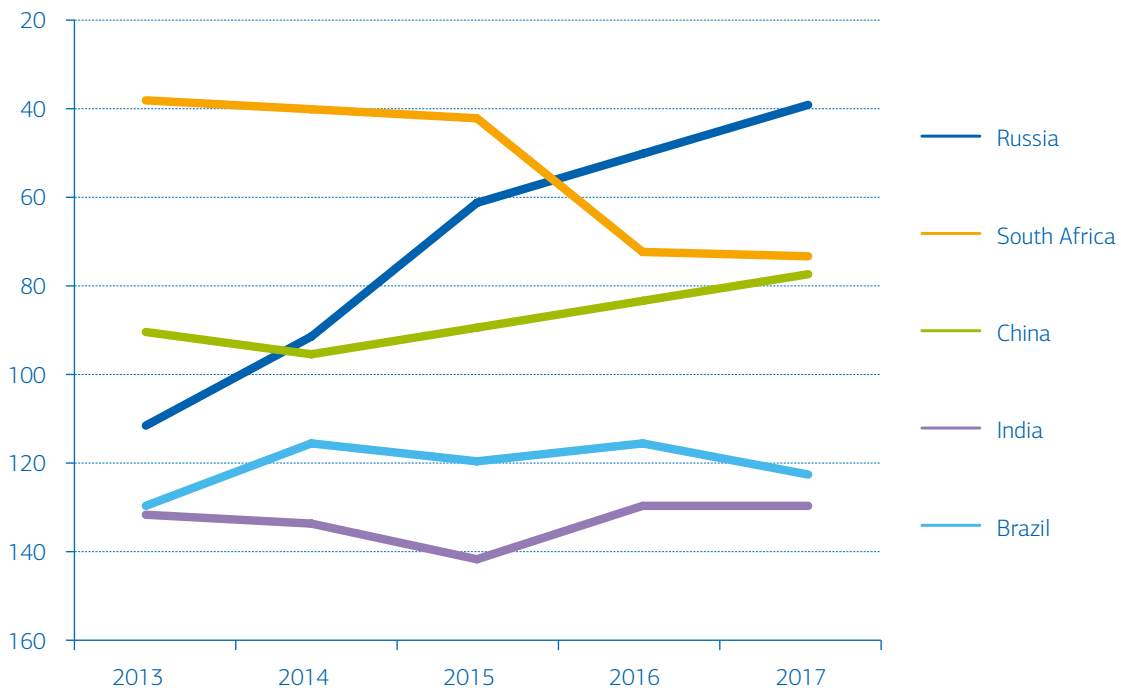
On a brighter side, protected from competition domestic agriculture and food industry burgeoned. While the country’s industrial production fell 3.4% in 2015, these sectors were enjoyed a steady growth. However a limited capacity of the local market will exhaust this surge. Compared to other factors, primarily the drop in oil prices, the sanctions had a limited effect on Russian economy. Nevertheless a lifting of the sanctions may boost investment. However the recent developments in Ukraine and Syria give little ground to hopes that the restrictions would go away anytime soon.

9. Development of Institutions

During the past four years Russia has shown significant progress in improving business environment: from 2013 to 2016 the country has made a spectacular leap in the Doing Business rankings, rising by as much as 72 positions (from 112th to 40th place). It ranks higher than any other BRICS country and almost made it into the world's top 20%. This result seems contradictory because of the widespread assumption of obstacles to business in Russia. At the same time many former Soviet states rank above Russia – Armenia ranks 38th, Belarus 37th, Kazakhstan 35th, and Georgia 16th. Thus, despite significant progress, Russia is still trying to catch up.

The underdeveloped institutions pose a serious risk to the country's growth: in the recent World Competitiveness Report by the World Economic Forum Russia ranks only 97th out of 140 in institutions development, 110th in financial market development, and

Dynamics of BRICS Countries' Positions in the Doing Business Rankings in 2013–2017



Sources: World Bank.

92nd in commodity market effectiveness. If we add to these Russia's 119th 109th position in Transparency International's Global Corruption Perceptions Index, the problem of falling oil prices does not seem so critical. The creation of effective law enforcement and judicial systems will contribute to the development of entrepreneurship and innovation in Russia more than any government development funds, the 2018 FIFA World Cup, and infrastructural megaprojects. It should be noted that those institutions are created in response to the demand for them.



What Does This Mean, and What to Prepare for?



There is no expectation of an economic breakthrough by either the Ministry of Economic Development (as of Q4 2016) or by any of the analytical centres. According to the base case scenario the stagnation or low growth will continue up till 2019 and possibly beyond, if all present conditions remain. This is bad news for Russia as the leading OECD and the emerging markets continue to grow. The time now calls for mobilising all resources in order to run forward, or as a minimum – to remain in the same place and not fall behind.

There are two ways to respond to these challenges. One is to pretend that they do not exist and focus on the maintenance issues. The other is to address the root of the problems. Either way the near future is likely to bring further shrinking of the consumer market and of tax revenues and rising risks for investors, who will continue to experience low returns.

In a short to medium term the government has limited options to plug budget deficit and to preserve economic stability:

- **Increase taxes, both direct and indirect.** In the second half of 2016 a new bill for tax increase was proposed every week, including that for VAT, personal income tax, minerals extraction tax, social security tax, excise tax on petrol, tourist tax, real estate tax, tax on the unemployed, bank deposit tax and even an increase in mandatory third party liability insurance for drivers who have an extensive record of penalties. Only some of the proposals were adopted, but in all the likelihood the government will preserve its appetite for higher taxes.
- **Reduce government spending and the number of welfare recipients.** There is a stable consensus that the retirement age is to be raised: the expectation is that this is definitely going

to happen after 2018. If the tax revenue continues to fall, the government will have to curtail its public spending, which may include revising public healthcare system and cutting the salaries of those employed by the state-financed institutions

- **Devalue currency in order to balance the budget.** Russia sells oil for dollars, but budgets the expenditure in rubles. There is always a temptation to devalue the ruble in order to balance the books. However as the Central Bank maintains its free-floating exchange rate policy, a forced devaluation is not envisaged, while a natural one may happen mostly on the back of plummeting oil prices, which is not the case currently. Provided that oil prices do not plummet, there is no expectation for the large-scale devaluation of the Rouble in short term. However, we expect that in a long-term Rouble will continue to fall.
- **Spend reserves.** By Q4 2016 Russia's gold and forex reserves reached nearly US\$ 600 billion. This includes the Central Bank's own reserves, the Reserve Fund, the National Wealth Fund, as well as the savings of the population and organisations. It comfortably covered the US\$ 240 billion of the budget expenditure and some \$180 billion needed for the import. If tapped into, this reserves will be enough to maintain economic stability up to the year 2018. However, the Finance Ministry is already close to an exhaustion of the Reserve Fund and may uncapped the National Wealth Fund in 2017.
- **Borrow with an increase in public debt.** Russia's current national debt is 18% of its GDP, making it one of the lowest ratios in the world. Russia can

afford to build up debt on condition that it maintains macroeconomic stability. The government is already increasing domestic borrowings, which may triple in 2017.

Despite the variety of economic instruments available, the government is not expected to resort to any steps that could have a direct negative impact on the general population before the presidential election of 2018. Presumably, the country's leadership will make every effort to maintain economic stability since it has all resources and capabilities required for it. This does not eliminate the need for the revision of the economic policy and for the search of new growth drivers. For the time being, it is still possible to plug the budget deficit, but the country will not escape having to address the challenges eventually.



Possible Way Forward: Selection of the Growth Model



Late in 2016 it became apparent that the old model of economic growth was now defunct. Heated debates followed over what steps to take to get the Russian economy out of recession and return to the target growth rate of 4% per year. Two alternative concepts emerged in the public discourse offered by the organisations informally competing for the right to propose its development agenda to the Government and the President:

- **The Centre for Strategic Research (CSR)**, a think tank close to the government headed by Alexei Kudrin, former Russian Minister of Finance (2000–2011), the architect of the current financial and fiscal system, as well as the founder and a former zealous guardian of the rainy-day funds;
- **The Stolypin Club**, an expert forum of prominent economists and former government officials. The most outstanding representatives of the Club are Sergei Glazyev, Economic Adviser to the President; Boris Titov, the leader of the Party of Growth, who is also a Business Ombudsman; as well as Andrei Klepach, Deputy Chairman of the Executive Board at Vnesheconombank, former Deputy Minister for Economic Development.

The CSR adheres to the liberal approach to economic development, with particular emphasis on developing private initiative and improving investment climate, while the Stolypin Club holds on to the principles of interventionism and relies on large-scale public-private partnership development projects. The key positions of both camps are presented in the table below, showing the polarity of opinions. At some point the government might have to choose one over the other, although it might be rather difficult to do.

Despite the differences in approach, both concepts ultimately come down to the issue of the institutional development of the economy and the need to minimise the

risks for investors, be it small and medium-sized businesses, or large corporations. The challenges to Russia's economic growth are much stronger than the response instruments available through the country's financial system. For example, the demographic challenge, the challenges related to the sanctions, or the "Pivot to the East" strategy are practically not taken into account by either of the programmes.

No matter what choice is made, and what direction the financial system is going, the next presidential term in Russia will include the need to solve long-term problems that have led to the structural recession. The EBRD's forecast of a moderate economic growth in 2017 of up to 1.2%, may be over optimistic. Even so, this growth will be below the global average, pushing Russia deeper into the bottom of the global rankings. Russia's nominal GDP per capita has already halved in 2015 from 2013 due to the ruble depreciation, leaving Russia the 66th between Mexico and Suriname. This is disappointing for both the government and the citizens.

Continuous free fall will leave the country's leadership with even fewer reserves and room for manoeuvre. Presumably, we should not expect any serious steps on the part of the government until 2018. The following six years may bring unpopular decisions, provided that the goal is to transform the economy and achieve growth.

Despite all the challenges to the Russian economy, there is probably a reasonable belief that an annual growth of 4% is achievable. The first step to address the task is to set the goal, to believe in it, and to make a sober assessment of the challenges on the way.

Table. Two ways out of recession: summary of the debate between The Centre for Strategic Research and The Stolypin Club

| | Alexei Kudrin (Centre for Strategic Research) | The Stolypin Club |
|------------------------------|---|---|
| Key approach | Structural growth based on private initiative. Limiting state intervention in the economy, including privatisation of inefficient state corporations. | Industrial growth based on large-scale public-private partnership projects. Bringing investment to 30% of the GDP from 18% in 2016. |
| Fiscal policy | A 10% fiscal consolidation, including cuts in defence spending. Limiting budget deficit at 1% of the GDP. | Allowance for budget deficit is up to 5% of the GDP in order to stimulate growth by higher borrowing. Increasing budgetary independence of the regions. |
| Monetary policy | Targeting inflation at 4% which will reduce uncertainty, lower interest rates, and stimulate private investment. | Shifting away from inflation targeting. Aiming at lowering inflation through higher production and demand, better competition, capital restrictions, and stimulated capital investment. |
| Investment | In total, up to RUB 40 trillion. | At least RUB 7.5 trillion (RUB 1.5 trillion per year for 5 years). Maintain the lending rate at the level of 4% to 5%, on the back of the Central Bank's policy easing. |
| Sources of investment | Private investment, accumulated on bank accounts. | Monetary expansion, higher public borrowing up to the debt to the GDP ratio of 30% (from 18% in September 2016). |
| FX rates policy | Free-floating currency. | Managed exchange rate policy to keep the ruble 10% undervalued, restrictions on FX trade to smooth fluctuations. |
| Taxation | Prevention of further increase in taxes. Ideally, a further reduction of taxes to stimulate entrepreneurship and economic activity. | Tax holidays of up to 5 years for new investment projects (income tax, property tax, land tax). Zero VAT for engineering and design work. Regressive social tax for productive jobs. Accelerated depreciation of equipment produced in Russia. Increasing taxation of natural resource sectors. |
| Institutional reforms | Law enforcement and judiciary reforms to improve business climate. Public administration reforms. | Reducing the government's audit pressure, increasing the effectiveness of state regulation, transition to e-government. |
| Pension reform | Raising the retirement age after 2018–2019. | Raising the retirement age by 3–5 years. |





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