ANALYSIS

The Russian Economy: the Impact of Sanctions and Falling Oil Prices, and the Prospects for Future Growth

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Abstract

The imposition of trade and financial sanctions on Russia by the US, the European Union and some other countries as a response to the conflict in Ukraine, and the sharp decline in the price of oil, have focused attention on the performance of the Russian economy and its future prospects. These developments occurred at a time when the economy was already experiencing mounting fears of stagflation or recession. This article explores the factors responsible for the loss of momentum of the Russian economy, the impact of sanctions and lower oil prices, and future growth prospects at a time of considerable geopolitical uncertainty.

Of all the G20 countries, Russia was hit hardest by the global financial-economic crisis. After a robust initial recovery, growth faltered in 2013 at a time when the price of oil was relatively high. The Russian economy was negatively affected by the troubled economic development of most EU economies and some loss of momentum in China, since 2010 Russia's largest country trade partner. But there were also domestic factors. Most importantly, the rate of growth of investment declined. Whereas fixed investment had grown by 10–20 per cent a year before the global crisis, by 2013 the rate had fallen to 0.2 per cent. At the same time, the workforce ceased to grow and then began to decline.

As the leadership acknowledges, the model of growth that achieved impressive results prior to 2008 no longer functions effectively. New drivers of growth are needed. The constraints on growth are structural in character and not easily removed without decisive action. Over the past decade there has been a growth of the role of the state in the economy, not just as an owner of assets, but also as a regulator, at both federal and sub-federal levels. Competition is weak, perhaps not surprising in a natural resource economy dominated by large state companies, with a corresponding low level of innovation.[1] By European standards the small business sector still plays a limited role in the economy and faces many obstacles. Human capital is by and large strong, but its growth is limited by inadequate spending on education and health. Corruption remains a serious problem, though it is difficult to separate its negative impact on growth from other factors. Business-state relations are in need of improvement, and notwithstanding serious efforts by the main business associations and the business ombudsman, Boris Titov, working with the government, much remains to be done.

It is against this background that recent developments must be considered and future prospects assessed. Firstly, there is the issue of the impact of the Ukraine conflict and sanctions, together with the policy response to them. On Russia's action in Ukraine, it is worth noting that economic concerns, in particular implications for the budget and the state of external economic relations, do not appear to have been a major consideration in the government's decision making process. It is the Security Council that has been the principal body for discussion of Ukraine, a purely consultative body, chaired by the President. While finance minister, Anton Siluanov, is a member (but not the economics minister or Central Bank of Russia's governor), he is not one of the core permanent members, and discussion of Ukraine has been at meetings of permanent members only. In the USA, the Treasury Secretary is a full member of the equivalent National Security Council and eligible to attend all its meetings. Inadequate integration of policies for national security and for the country's socio-economic development is one of the central issues that the new law on strategic planning adopted in June seeks to address, but it contains no consideration of the composition of the Security Council.

Secondly, Russia must now counter sanctions imposed by the US, EU and other countries, with efforts to render the Russian economy less vulnerable to external pressure, including a search for new trade partners, especially in Asia, and measures to promote import substitution. The latter has come to the fore as a priority, above all, in the defence industry and high technology sectors in general, but also in others spheres, not least energy, faced with limited access to advanced technologies, including food production and processing, a sector obliged to respond to the retaliatory limits on import imposed by Russia itself on sanctioning nations. In addition, Russia is responding to a ban imposed by Ukraine on deliveries to it of armaments and other military equipment. But replacing imports by domestically produced

1 See Harley Balzer and Jon Askonas, 'Innovation in Russia and China Compared', Russian Analytical Digest, No.155, 23 September 2014, pp. 2–6.

goods will not be easy and could prove to have negative consequences. While there could be short-term output gains, there is a danger that costs will rise and quality decline. Companies are expecting budget support for import substitution activities; the overall cost could prove quite substantial. A programme for replacing Ukrainian defence inputs over the next two years has been approved, with a total cost of almost 40 billion roubles, but another programme to substitute for defence industry inputs currently obtained from the USA and other sanctioning countries is behind schedule, so funding has not been included in the budget for 2015.

In the years preceding Russia's accession to the World Trade Organisation in 2012, the agricultural sector was vocal in questioning the wisdom of joining. Demands for more protection were often voiced after accession. So, when deciding on counter-sanctions it is probably not surprising that a decision was made to end the import of agricultural products and food items from sanctioning countries. This was probably considered a move to promote diversification of the economy. While there may be some short term boost to output of some food items, by its nature agricultural production cannot be increased rapidly and in Russia there are also logistical issues to be addressed. Alternative external suppliers are being found, but this takes time and costs may rise. Already, food prices are increasing, for some items quite rapidly. The price and availability of food is potentially a sensitive issue for the authorities as many still recall the crisis of 1998, and an older generation remember the bare shelves of the last Soviet years. The wisdom of these counter-sanctions has been called into question by former finance minister, Aleksei Kudrin, who thinks that there are better methods of supporting agriculture, with lower social and economic costs, such as aid for the purchase of technology and favourable terms of credit.

Notwithstanding regular acknowledgement at the highest level that diversification of the Russian economy to reduce its dependence on hydrocarbons and resource extraction in general is a top priority, little has been achieved. Over the years, the share of hydrocarbons in the country's exports has in fact steadily grown. Deliveries of crude oil, oil products and natural gas accounted for just over half of all exports by value in 2000, in 2005 the share had increased to 62 per cent, in 2010 to 65 per cent and during the first nine months of 2014 the share rose to over two-thirds.[2] Export duties and various taxes on the oil and gas industries account for half of federal budget revenues. In these circumstances the Russian economy is very vulnerable to fluctuations in world oil prices and this has become evident in recent months as oil prices have declined from over $110 per barrel to $80 or less.

With a troubled economy, the issue of the federal budget, its priorities and dependability of funding, becomes important. Established precautionary policies are under attack. Since the end of the 1990s Russia has had a good record of budget stability. This has been aided by a Stabilisation Fund created in 2004. The Fund was divided into two in January 2008, to form a Reserve Fund intended to cover budget deficits arising from low oil and gas prices, and the National Welfare Fund to support the pension system. In addition, there is the so-called budget rule, which provides some insulation from sharp changes in oil prices.

The Reserve Fund proved of great value during the global financial economic crisis. With reform of the pension system low on the policy agenda, the Welfare Fund has come to be seen as a source of investment, above all for infrastructure, and now up to 60 per cent can be used for this purpose. As sanctions have taken hold, a number of companies near to the state, 'Rosneft' to the fore, have requested large-scale financial assistance from the Fund and there has been pressure to raise the threshold of its use to 90 per cent. By international standards, Russia has large foreign currency reserves (equivalent to over a year's imports), but if account is taken of the reserve funds, plus gold, the total available is little more than $200 bn. (less than six month's imports). Experience of the recent past is cautionary: between July 2008 and January 2009 the Bank of Russia ran down the reserves by over $200 bn in striving to avoid a sharp devaluation of the rouble.

The federal budget for 2015 has been based on an oil price forecast of $100 a barrel, GDP growth of 1.2 per cent, a rate of inflation of 6.7 per cent and an average exchange rate of $37.7 per rouble. By early December, with oil prices falling below $65 per barrel, these assumptions had become highly questionable. It is a budget in which the military has top priority. This stems from a firm determination to implement in full the first five years of the ambitious state armaments programme to 2020. Spending on the armed forces of the defence ministry will account for 21 per cent of total expenditure, 4.2 per cent of GDP, a share not seen since the early 1990s. As a consequence, budget shares of spending on education, health and the economy have already been reduced. This pressure on social and economic spending will now be intensified. Following Putin's state of the nation speech on 4 December, the government was instructed to amend the 2015–17 budget by reducing all spending except that on defence and security by five percent in real terms.

2 Data of Bank of Russia.

Economic forecasts for 2015 and beyond have been progressively cut back. The most sober to date has been that of the Bank of Russia, with hardly any growth expected until at least 2017. The economics ministry always tends to greater optimism, hoping for 1.2 per cent growth in 2015 followed by 2.3 per cent in 2016, and it is this forecast that provides the basis for the budget. However, it plans to issue a revised forecast in December and this is likely to take more account of the lower oil price and the depreciation of the currency. Russians may soon experience what has been a reality for many citizens of the European Union in recent years, falling per capita disposable incomes and living standards under pressure, but in the case of Russia with a higher rate of inflation and, probably, a lower level of unemployment.

Given these far from optimistic prospects for the economy, it is not surprising that some have been arguing for a fundamental change of course, with a move away from the liberal approach to macroeconomic management that has prevailed in Russia hitherto. This is no surprise. Similar demands were voiced at the time of the 1998 crisis, but then they were rejected. The principal advocate of transition to a state-led 'mobilisation' strategy is now Putin's advisor on Eurasian economic integration, Sergei Glaz'ev, an active member of the conservative, nationalist, Izborskii Club, now having some prominence. He advocates a radical change of monetary policy, envisaging a massive injection of credit by the Bank of Russia, but also the adoption of directive planning in the state sector of the economy, strict controls on capital and external economic relations in general, with extensive protection. This, he believes, will secure a rate of investment of up to 40 per cent of GDP and annual rate of growth of 6–8 per cent. It is worth noting that this statist approach has been explicitly rejected by Putin and his economic team.

Perhaps of greater danger to future economic prospects is increasing statisation and moves toward autarky by stealth, i.e. an accumulation of measures, relatively minor in themselves, for greater state intervention and control, leading to a further deterioration of the business climate and a creeping re-emergence of an administered economy. Demands for state financial support and protection are mounting, the predominantly state-owned defence industry, with increasingly centralised leadership, is playing an ever larger role in the economy, and pressure to introduce new taxes is strong, though generally resisted by the authorities. Re-orientation of the economy away from Europe towards Asia will require huge state investment, if perceptions of strained relations with the West persist.

However, there are alternatives. The opportunity for liberal reforms and policies has increased. A weakened economy and depressed living standards must haunt Putin's conjectures about Russia's heritage from his third Presidential term of office. His unprecedented level of popularity spurred by the annexation of Crimea and the reassertion of Russia as a power in the world, gives him the chance to push for more market liberalisation and incentives, with the possibility of blaming external forces for any costs they may entail. While under some pressure, the liberally orientated economic agencies still prevail. The private sector, vital to any economic modernisation, is in urgent need of a boost to its business confidence. These are conditions that could be favourable to the adoption of, and support for, far-reaching reforms. There is a window of opportunity for change; it remains to be seen whether it will be grasped.

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