The Future of Russia's Economic Growth: De-Coupling from Oil

Vladimir Tikhomirov

1. Can Economic Growth Be Sustained?

In June the official estimate of Russian economic growth for 2003 was upgraded for the fifth time since the start of the year. In their statements both Prime Minister Mikhail Kasyanov and President Vladimir Putin were increasingly bullish in their vision of the future growth rates in the economy. Moreover, official statistics for 1Q03 and 5M03 were also showing positive economic growth.

However, despite this generally positive picture, the big issue of whether the Russian GDP growth rate is sustainable in the future remained largely unanswered. President Putin's appeal to the Cabinet to ensure doubling of the GDP by the end of the decade has provoked a lively debate on the prospects of reform in Russia. But neither the Economics Ministry nor the industrial departments of the government were able to present a realistic program of how to achieve this grand objective, at least not at the time of writing.

Russia's economic progress is still inextricably linked to commodities prices, which drive up export revenues and in turn, GDP. Yet commodities prices are notoriously volatile, making GDP forecasts difficult and economic progress difficult to sustain. A more balanced economic structure is key to reducing Russia's dependence on oil prices. Still, despite the cabinet's increasing focus on Russia's economic progress, deep structural reform implementation is far from complete. Resource-based industries continue to dominate the GDP and the share of high value-added industry output remains low.

2. Officials Debate Russia's Growth Prospects

In May and June 2003, President Putin and Prime Minister Kasyanov made public statements, in which they said that they expect the Russian economy to continue to expand this year at a rate of 5-5.5% YoY. The Economics Ministry also followed these expectations when it upgraded its 2003 growth forecast to 5.4% YoY in the May economic outlook report.

Later, in a separate statement, the Economics Ministry backtracked on its words, saying that the new 2003 forecast was just "an estimate," while the official forecast remained unchanged at 4.5% YoY. This statement became yet another move in the ongoing growth debate within the Russian government. Four days prior to this statement and the day after it was made, Prime Minister Mikhail Kasyanov publicly stated that, in his own view, the Russian economy could grow by some 5.5% YoY this year.

Fig. 1. Economic Indicators: Fact & Forecasts (YoY %)

	2001	2002	2003 Official Forecast
GDP	5.0	4.3	4.6
Industrial Output	4.9	3.7	4.3
Agricultural Production	6.8	1.7	1.0
Fixed Investment	8.7	2.6	6.0
Real Disposable Income	8.5	8.8	15.0
CPI	18.6	15.1	12.0

Sources: Goskomstat, Russian Ministry of Economic Development and Trade.

From an economic standpoint, this GDP growth debate is certainly a minor issue, but politically it has become a significant topic, as the President and the Cabinet need good news to curry favor with the electorate. Given the absence of economic reform breakthroughs, growth became the most positive story they can deliver a few months before the elections.

The adamant opposition to the Kasyanov's GDP estimate demonstrated by the Economics Ministry is alarming for two reasons. First, it confirmed our fears that Russia's economic development could become more difficult as the year progresses. Second, the current GDP growth debate shows that Russia's top leaders are less cautious about their estimates and more interested in delivering the news the public wishes to hear.

The growth debate came as a clear indicator that the 2003 election campaign in Russia was already in full swing. However, the way this debate proceeded and the level of importance given to the growth issue by the Russian leadership also came as a warning signal that forthcoming releases of official statistics might be subject to increased scrutiny by top officials and could in the end be less objective than in the past.

3. Current Growth Prospects Linked to Oil

While serious doubts remain about the ability of Russia to double its GDP within just one decade, few would argue that the Russian economy does not have the potential to significantly increase its growth rate over the next few years. Still, whether this potential is used or not will largely depend on the content and speed of future reform.

If no economic restructuring takes place, Russia's future looks bleak. Without economic diversification, growth rates will remain tightly linked to world commodity price fluctuations. Even under the best of circumstances, economic growth is unlikely to exceed the world's average rate of 1-3% after Russia exhausts the growth potential that it accumulated following a decade of economic decline during the 1990s.

It is unlikely that Russia will manage to implement major structural reforms earlier than 2005-2006. Even this view might be too optimistic since during the larger part of 2003 and at least the first half of 2004 one can expect the Russian government to reach very limited progress in the area of reforms as the pre-election race speeds up. In addition, it would take one to one-and-a-half years for the effect of reforms to start boosting the economy's growth rate and/or the population's living standards.

Thus, under an optimistic scenario it would take at least between three to five years before we might start to see the economy in its development moving away from commodity markets.

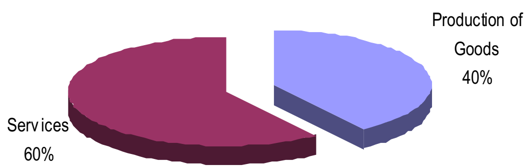
Until that time Russian economic growth would continue to remain linked to fluctuations in commodity prices and foremost that of crude oil.

Oil prices are notorious for being hard to forecast since their dynamics are influenced both by economic and political factors on the international as well as on the country level. Our estimates show that if crude oil prices are to remain at levels of US$24-US$25/bbl (Urals), the Russian GDP is likely to continue to expand at a rate of 4.7-5.2% YoY in 2003 and 4.0-4.5% YoY in 2004. However, if Urals crude oil prices fall to the US$20-US$22/bbl range, Russia's 2003 GDP growth is not likely to exceed 4.6% YoY.

4. The Service Industry Could Become the Main Growth Driver...

Russia's development into a market economy over the past ten years has caused its GDP structure to change drastically. In the late Soviet period, 70-75% of Russia's GDP was dominated by the production of goods. The combined results of contraction in the real sector of the economy in the post-Soviet period and the introduction of market reforms helped to raise the level of services as a percentage of GDP to 60% in 2002, according to official preliminary estimates. However, the development of the service sector is still in a very rudimentary stage.

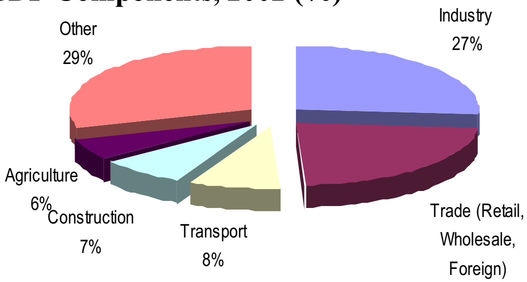
Fig. 2. GDP Composition, 2002 (%)



Source: State Statistics Committee.

The service sector could make up an even higher percentage of Russia's GDP, depending on how estimates account for the scope of the informal economy. What is important to the economy is that goods production is formally no longer its main driver. Thus, Russia has finally left its Soviet legacy behind and moved closer to joining other developed and transition economies where the share of service industries is between 55% and 75%.

Fig. 3. GDP Components, 2002 (%)



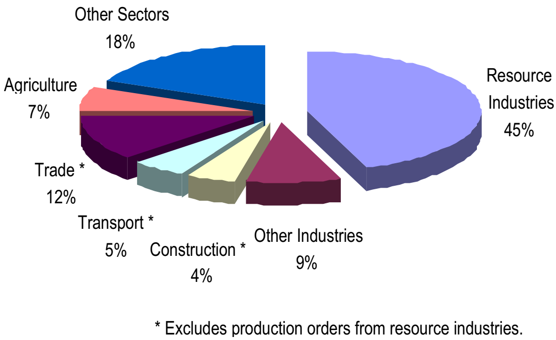
Source: State Statistics Committee.

According to data from the State Statistics Committee, the four main contributing factors to Russia's economy in 2002 were industry (26.5% of GDP), trade (22.7%), transport (8.1%) and construction (7.3%). The last three sectors made up almost two-thirds of the service industry's gross value-added products.

5. ...If It Were Not Still Relying on Commodities

On paper, the changes in GDP composition inspire more optimism than can be justified by the reality. According to our estimates, resource-based industries in broad definition still contribute as much as 45% to Russia's GDP. Official figures show that in 2002 the combined production by oil, gas and refinery industries, metallurgy and timber directly contributed 21.5% of Russia's GDP. We estimate that another 23.5% of GDP was contributed indirectly by the same industries by means of economic activities channeled from the resource sector into other economic spheres, including trade, construction, transportation, as well as through boosting consumer demand.

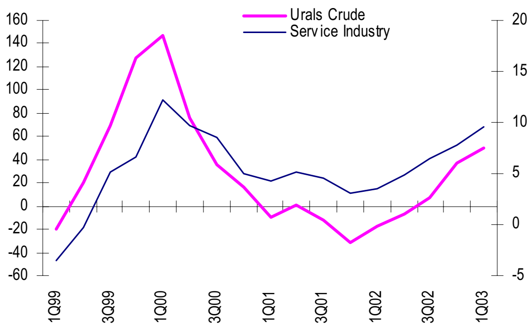
Fig. 4. Share of Resource Industries in GDP (broad definition), 2002 (%)



Source: State Statistics Committee, NIKoil estimates.

We estimate that resource-based industries generated about 47% of the gross volume of wholesale, retail and foreign trade last year. These industries also contributed directly and indirectly through increased incomes, which bolstered consumer demand and funded over 45% of Russia's new construction projects, and accounted for almost 40% of transport turnover.

Fig. 5. Change in Urals Crude Oil Price Vs. Dynamics of Service Industry, YoY %



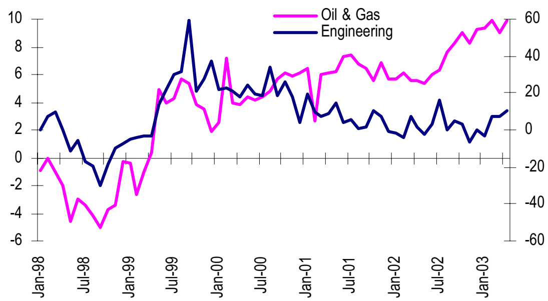
Source: State Statistics Committee, Bloomberg, NIKoil estimates.

So, despite the fact that in formal statistics services formally made up a greater portion of the GDP, the sector's dynamics continue to depend on commodity price fluctuations, especially oil prices. As a result, if crude oil prices are to fall in the future, it is highly likely that the services sector will also begin to shrink, along with the rest of the economy.

6. High Value-added Industry Growth Still Slow

As the latest statistics reveal, the share of value-added products in the overall structure of the Russian economy continues to be disappointingly low, an area which is typically a major GDP contributor in more balanced economies. This is unfortunate, as Russia's engineering sector could utilize the high-tech potential it inherited from the Soviet Union to become the main driver for economic restructuring and diversification.

Fig. 6. Growth Rates in Oil & Gas and Engineering Industries, YoY %



Source: State Statistics Committee.

Given the low contribution production of high value-added products to the GDP, it is no surprise that the government views this industry as one of the most promising factors of growth that is capable of becoming Russia's main economic driver in the future. In June 2003, the cabinet dedicated a special meeting to how to introduce a special development program for the engineering sector. However, the draft program created at the meeting will probably be changed several times before the final draft is adopted later in the year.

So far production dynamics in the engineering sector were quite disappointing. While high growth rates were recorded in 1999-2000, they proved to be unsustainable as a stronger ruble pushed import levels higher in spite of continuing growth in personal incomes. By late 2002, the engineering industry was still showing negative growth dynamics, while imports of manufactured goods were steadily growing accompanied by increased domestic demand and higher personal incomes.

Despite some growth recorded in the manufacturing sector in the first months of 2003, the industry has been unable to take advantage of increased domestic demand, or compete with imported products for several reasons:

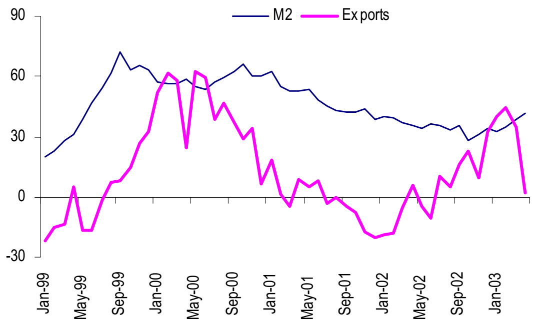
- *Capital.* Limited access to capital markets and the absence of an efficient banking system in Russia hurt the ability of this sector to modernize and compete with imported goods of higher quality;
- *Management*. Most manufacturing enterprises are still run by Soviet-trained directors, who often lack vision, experience and skills required to run a successful company in a market economy;
- *Low Quality*. Russian manufacturing companies are, as a general rule, able to compete in terms of price, but not quality;
- *Lack of Priorities*. 2003 was the first year when economic development has been seen as a priority at the government level. In previous years, there had been no talk of the government's industrial policy or state support to increase the share of value-added goods production as a percentage of GDP.

The engineering sector's current stalemate could have been even more pronounced if production orders from Russia's largest exporters were taken out. For instance, in the first half of 2003 these orders allowed Russia's machine-building industry to overcome the negative growth trend recorded between November 2002 and January 2003.

7. Flush with Liquidity

Money supply dynamics also reveal Russia's high-level of dependence on commodity prices. For the past five years, issues of new money were tightly linked to currency repatriation rules introduced by the cabinet and the CBR soon after the 1998 financial crisis. At that time, in order to stop capital outflows, the government introduced legislation requiring 50% of all foreign currency export revenues be sold on the domestic currency market, most of it to the CBR. This law has played an important role in halting capital flight, building up the country's international reserves and helping the Central bank to reinstate its control over the local currency market.

Fig. 7. Dynamics of M-2 Money Supply and Exports, YoY %

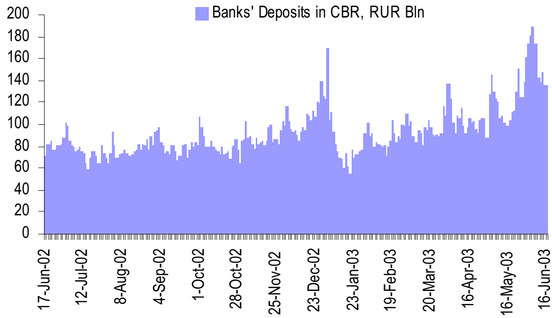


Source: State Statistics Committee, Central bank.

At the time of writing, Russia's *Currency Control and Regulation Law* still stipulated that exporters must repatriate 50% of their non-ruble denominated revenues. However, an amendment recently approved by both chambers of the Russian parliament called for the reduction of this level to 30%.

It needs mentioning that Russia's currency law was extremely effective in restoring a steady inflow of foreign cash to Russia's government coffers in the aftermath of the financial crisis. The currency influx was particularly high when commodity prices were up. But at the same time Russia's lack of an effective banking and financial system meant that the larger part of this cash did not enter the real economy. Instead, the cash greatly increased pressures on the forex market and bank account balances.

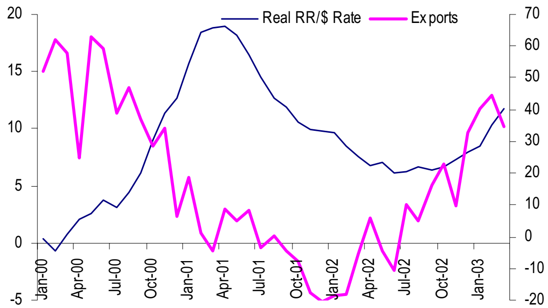
Fig. 8. Banks' Deposits in Corresponding Accounts at CBR, RUR Bln



Source: Central bank.

Between late 2002 and mid-2003, the world economy experienced an unusually long period of high crude oil prices which pushed Russia's foreign currency inflows up to record levels. However, the economy's limited capacity to absorb this additional cash put increased pressures on the ruble causing it to appreciate rapidly. The trend was especially evident in the ruble's exchange rate to the US dollar since the latter is used as the preferred currency of payment for the bulk of Russia's exports.

Fig. 9. Exports and Real RUR/US$ Exchange Rate, YoY %

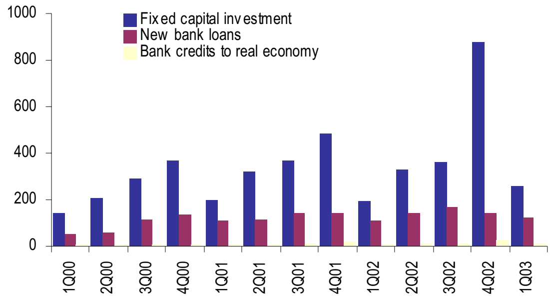


Source: Central bank, State Statistics Committee, NIKoil estimates.

8. Lack of Structural Changes Hampers Growth Prospects

If a stronger banking system had been in place in Russia, the recent unprecedented rise in ruble liquidity should have led to a major increase in economic investment levels and could have become a crucial driver for Russia's general economic growth. However, according to recent data, bank loans to the real sector of the economy in 1Q03 were still running at extremely low levels. At the same time, corporate funds continued to cover over half of the country's economic investment needs.

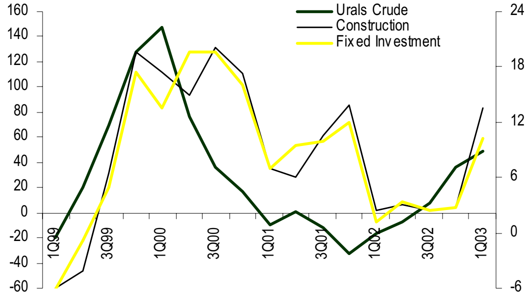
Fig. 10. Fixed Investment, Bank Loans and Bank Credits to the Real Sector, RUR Bln



Source: State Statistics Committee, Central bank.

Although in early 2003 the dynamics of fixed investment in the real economy did improve somewhat, capital inflows to the real economy were still far from sufficient to ensure major structural changes. Most worrying for the economy was that this surge in fixed investment flows and volumes of new construction was still directly linked to upward movement in commodity prices since the end of 2002. This suggested the investment boom could disappear once commodity prices begin to fall, as had already happened in Russia before.

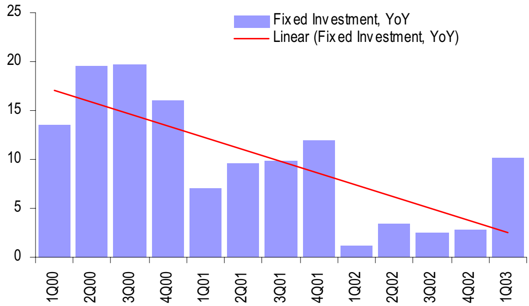
Fig. 11. Urals Crude Prices, Fixed Investment and Construction, YoY %



Source: State Statistics Committee, Bloomberg, NIKoil estimates.

Another disappointing trend of the turnaround in Russia's economic development in early 2003, was that on average investment levels were still below those Russia reached in 1999-2000 and many times lower than the levels recorded in other transition economies during periods of rapid economic growth. In the first quarter of 2003, Russia's investment/GDP ratio was a mere 11.4%, just slightly better than the 11.2% recorded in the same period of 2002. Meanwhile, the investment/GDP ratios of Korea, Japan and China were at least twice as high during their peak growth periods.

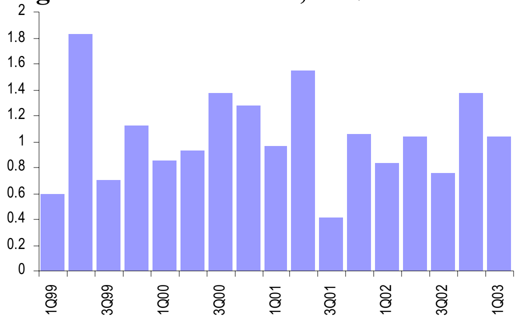
Fig. 12. Change in Fixed Investment, YoY %



Source: State Statistics Committee.

During the past year, the Russian government has grown increasingly bullish about the prospects of foreign investment. Officials pointed to data showing significantly higher gross volumes of foreign investment in 2003. The country's diminishing capital account deficit was also often cited as evidence of an improved investment climate.

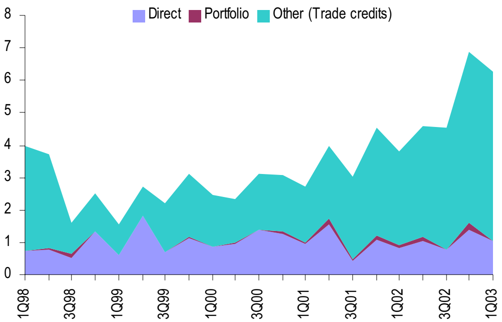
Fig. 13. Foreign Direct Investment, US$ Bln



Source: State Statistics Committee, Central Bank.

However, a detailed analysis of official statistics demonstrates that this growth in gross foreign investment was the result of larger trade credits and company borrowing, while FDI levels remain unchanged. At the same time, during the first quarter of 2003 foreign portfolio investment was actually in decline while foreign direct investment on average did not exceed US$1 billion per quarter. The latter figure was three to four times lower than the FDI levels recorded in more successful transition economies like the Czech Republic, Hungary and China.

Fig. 14. Structure of Foreign Investment, US$ Bln

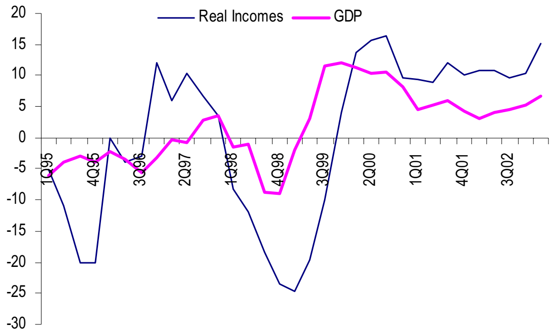


Source: State Statistics Committee, Central bank.

9. Consumer Demand: Has It Really Become a Growth Driver?

Living standards recovered with remarkable speed following the 1998 crisis. It has only taken three-and-a-half years for Russians to reach their pre-crisis income levels. In fact, by mid-2003 the average per capita income was already approaching the same levels as in the even more prosperous late USSR period.

Fig. 15. GDP and Real Incomes, YoY %



Source: State Statistics Committee.

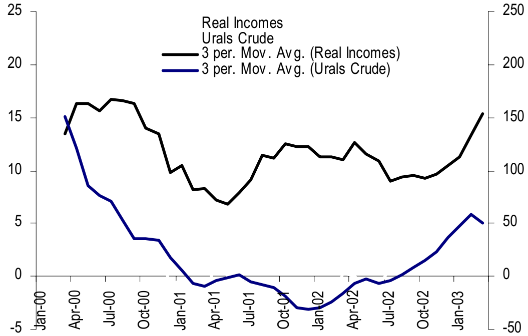
There is little doubt that at some point in time this increased prosperity should eventually create a greater demand on local markets thus boosting Russia's general economic growth. While growing incomes are certainly a positive development, there are two major factors that cause us to doubt that consumer demand would turn into the Russian economy's biggest growth driver, at least in the immediate future:

Factor 1: Spending Exceeds Earnings. Since 2000, real incomes in Russia were growing at a rate significantly higher than that of Russia's GDP. In other words, the country has again slipped into what was previously a traditional development model through spending more than it earns as soon as commodity prices rise. It seems that regardless of who holds power in Russia the country seems attracted to the same development pattern.

For instance, during the 1970s the Soviet Union enjoyed a period of relative prosperity, but this ended in the next decade when crude oil prices fell. The widening gap between high income levels and low productivity of labor became unsustainable when the flow of oil revenues started to dry up. This became one of the main factors that provoked the USSR's economic and political disintegration. In the mid-1990s, after crude oil prices came back to higher levels Russia again returned to the same development model but that abruptly ended in August 1998.

Since late 1999, Urals crude oil prices have been continuously higher than US$20/bbl levels, which again created an illusion that Russia has finally reached an era of prosperity. Blessed with high budget revenues, the government has gone on a spending spree, agreeing to raise state employee salaries but without demanding higher productivity in return. The result has been that since early-2000, the country's main competitive advantage – low labor costs – which Russia gained after the '98 crisis, has been steadily lost. At the same time, the future stability of Russia's budget and fiscal systems became more and more questionable as budgetary planning was becoming heavily dependent on the continuation of the period of high commodity prices.

Fig. 16. Change in Real Incomes and Urals Crude Oil Price, YoY % (3 month averages)

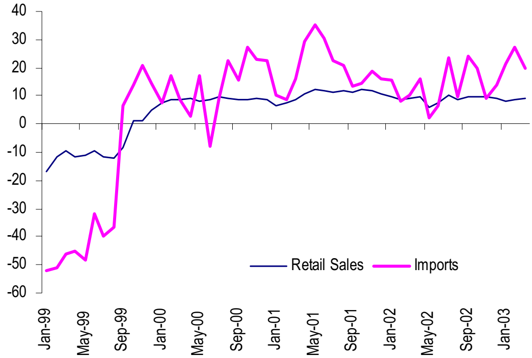


Source: State Statistics Committee, Bloomberg, NIKoil estimates.

Factor 2: The Import Threat. Rapid growth of consumer imports could mitigate the positive effects that increased consumer demand has on the economy. In recent times, real income growth has coincided with a steady appreciation of the ruble against major world currencies. The real ruble exchange rate to the US dollar has been growing since April 2000 and by mid-2003 already reached 80% of its pre-crisis levels. In April 2003, the average per capita income in dollar terms was also 10-15% higher than before the 1998 crisis.

The surge in dollar-denominated incomes was accompanied by a fast growth in the volume of trade credits which helped to push up consumer demand for imports. Since late-1999, the imports have grown at an average rate which was steadily higher than the retail sales growth rate.

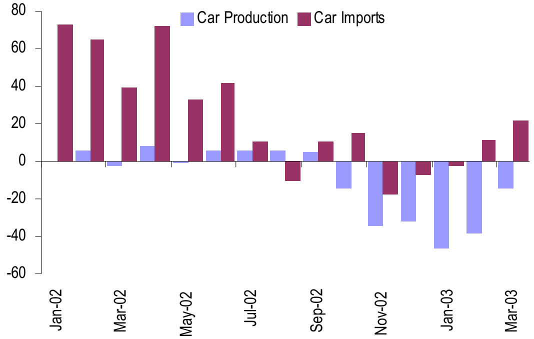
Fig. 17. Dynamics of Imports and Retail Sales, YoY %



Source: State Statistics Committee.

Increased volumes of consumer imports, combined with growing incomes was bad news for many Russian companies which quickly started to lose the competitive edge they earlier had, *i.e.*, low prices. A stronger ruble made imported goods relatively cheaper and drove consumers away from locally produced low-quality goods and toward imported products.

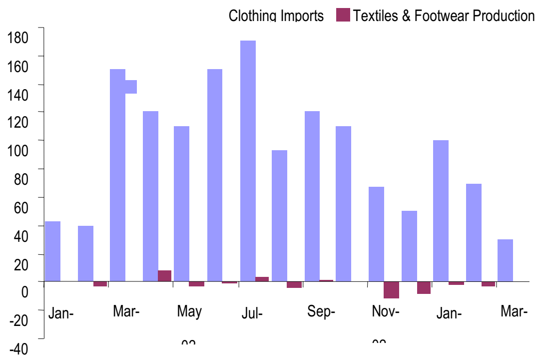
Fig. 18. Russian Car Production and Car Imports, YoY %



Source: State Statistics Committee.

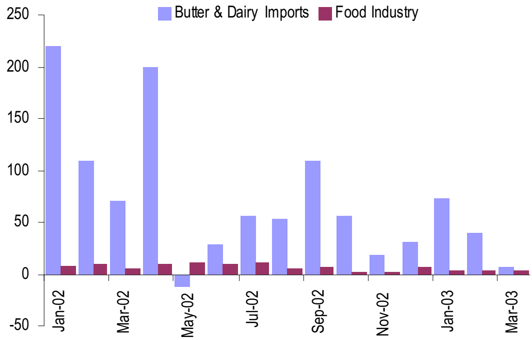
Official statistics from early 2002 onward show an increasingly bleak picture in Russia's manufacturing and consumer industries. The automobile industry was probably hit worst of all, as its output decline was accompanied by a rapid increase in the numbers of imported cars. A similar, though less pronounced, trend could be seen in the textile, clothing and footwear sector, where imports grew at a 50%-150% annual rate, while growth rate in local production fell from zero into negative territory.

Fig. 19. Imports of Clothing Vs. Production of Textiles & Footwear, YoY %



Source: State Statistics Committee.

Fig. 20. Imports of Butter & Dairy Vs. Food Industry Growth Rates, YoY %



Source: State Statistics Committee.

Even the food and beverage industry, generally considered to be one of Russia's most competitive sectors following the direct investment boom it experienced between 1999 and 2001, was coming under increased pressure by 2002-2003. In 2002, the sector's average growth rate was just 6.8% YoY, while in the same year imports of dairy products increased by more than 78% YoY. This trend continued in the first quarter of 2003, as the industry's average growth rate fell further to just 3.8% YoY, while imports grew by more than 40% YoY.

Conclusions

Without diminishing the importance of the many positive changes that Russia has seen in the past four years, this paper nevertheless argues that from the point of view of Russia's economic fundamentals very little has changed. Until now Russia was blessed with high commodity prices that, coupled with an energetic and a more professional leadership, good debt management strategy, and high levels of accumulated international reserves, led many to think that the economy had become fully crisis-resistant. Indeed, the economy now is far more stable than it was just few years ago. But its ability to withstand periods of sharp falls in commodity prices is still very limited.

One of the questions that this paper has attempted to answer is whether economic growth in Russia can be sustained in the future. The answer is that it can, but only at relatively low YoY levels and only if crude oil prices remain above US$20/bbl levels on average. In order to ensure a truly sustainable and high growth rate, Russia needs to significantly lower its economic dependence on commodity prices. It also needs to implement major structural reforms through the introduction of an effective banking system, investment stimulation and nation-wide infrastructure development projects. The current investment/GDP ratio of 11% should be at least doubled if fundamental changes were to be implemented.

The other question is whether in the past few years the Russian economy has been changing fundamentally. The answer to this question is both yes and no. On the positive side, in the last four years Russia's political structures and large areas of legislation and state finances were finally put in order. This has created the necessary framework for continuation of reforms in the future. But at the same time, the most difficult and painful economic reforms are still to come and it is not yet clear how successful these reforms would eventually be. On the negative side, indications are that in the current period of high commodity prices, Russia's government spending has been becoming less and less stringent. As for the on-going debate about growth forecasts and the ways to double Russia's GDP, it is worth noting that any attempt to accurately predict GDP growth in Russia will only ever be as accurate as world crude oil price forecasts, which generally are no more reliable than by 15-20%.