

TRENDS IN THE RUSSIAN ECONOMY

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The end of 2016 seems to be the end of a 'lost decade' for the Russian economy that had to struggle for survival from crisis to crisis during the past ten years. Russia lost half of its Gross Domestic Product (GDP), its industrial production declined by 57 percent, and agricultural production dropped by 45 percent as a result of the ill-conceived market reforms executed during Boris Yeltsin's presidency in the 1990s. The world's second largest industrial country lost some of its vital industrial sectors in those years, turning into a natural resource-dependent economy. The climax to those disastrous reforms came when the once mighty superpower plunged into the worst ever financial crisis in its history, declaring itself a sovereign bankrupt nation in August 1998. The rouble got devalued by 400 percent in a single day. President Yeltsin was forced to change his economic reform course by replacing a neo-liberal government, headed by the Gaidar-Chubais team, by the Primakov-Maslyukov team, a group that believed in market reforms through state regulation. So the ideology that the state has no business in business was finally abandoned in favour of state-regulated economic reforms. The Primakov-Maslyukov government, during its 11 months stay in power, drastically changed the course of the economic reforms by laying the foundation for a state-regulated economy on the basis of indicative planning that provided a new lease of life to the Russian economy.

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Once little-known, Vladimir Putin, after getting elected as president in May 2000, in his first policy statement said that it would take another 20 years for Russia to catch up with Portugal, Europe's poorest country, if Russia grew at the then low rate. He indicated his support for accelerating the economic growth rate.

Yeltsin sacked Primakov's left-of-the-centre government after the latter became a serious contender for the post of president in the upcoming presidential election, paving the way for his hand-picked Prime Minister Vladimir Putin, tipped to succeed him as president in an operation known as 'Operation Successor' in modern Russian history.

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Minister Mikhail Kasyanov who was virtually imposed on the president under the secret deal 'Operation Successor'. Vladimir Putin could not bring any change in the composition of the government that was thrust upon him by Yeltsin and his 'family', which consisted of mostly die-hard neo-liberals. However, the astute Vladimir Putin, manoeuvring between the neo-liberals in his government and close advisers with a Siloviki (secret service) background, somehow managed to continue the course of reform under strict state regulation for which the foundation was laid by Primakov. The Russian economy grew fast significantly under Putin. Economists attributed this to the low base, calling it recovery growth, a result of import substitution in the backdrop of an unprecedented financial crisis, leading to massive devaluation of the rouble. However, the economic growth continued year on year for a long period, convincing the economists that it was not only recovery growth. Putin set an ambitious target of doubling the size of the economy in 10 years. The economy really grew at an average annual rate of 7.5 percent in the subsequent years. This helped the Russian GDP to finally reach the size of 1991, the year when the USSR collapsed, paving the

way for neo-liberal market reforms that dealt a severe blow to the Russian economy in the next almost one decade. The Russian economy became the seventh largest in the world, with a GDP estimated at US\$ 2 trillion, climbing down from 18th position in terms of size of the GDP. The country could manage to collect more than US\$ 500 billion hard currency in its kitty thanks to the high energy prices. Russia got a fast-growing buoyant economy and had huge hard currency reserves as well as resources at its disposal, but it could not take advantage of this for undertaking structural reforms and diversification of the economy, suffering from the Douche disease.

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During the period from 2001-08 the size of the Russian GDP grew by 160 percent, falling short of the GDP doubling target when the global financial crisis hit the Russian economy. Belying Putin's Finance Minister Aleksey Kudrin's prediction that the Russian economy was a safe haven which would not be affected by the global financial crisis, the Russian economy indeed became one of worst- hit in the world, with the GDP declining by almost 7 percent and industrial production by 11 percent in a single year as a result of the global financial crisis as well as low oil prices. Russia took almost three years to recover from the crisis in 2012 and was poised to embark on a positive growth trajectory.

In the meantime, Russia's long-term development strategy, drafted in 2008, covering the period up to 2020, had ambitious targets to increase the size of the middle class from the current 20 percent to 75 percent, increase the average salary to US\$ 30,000 in a month, and attain the level of the developed Western countries by creating an innovation-based economy, faced serious problems in its implementation as a result of the global financial crisis and low oil prices, the life-blood of the Russian economy. The strategy was then virtually buried.

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When, finally, the Russian economy entered a trajectory of steady growth in 2014, it was again hit by unexpected factors, this time by the Western sanctions in the wake of Crimea's reincorporation into Russia. The Russian economy was pushed into a crisis zone during the period from 2014-16 as a result of banning of access to lending by Russian companies from foreign sources, and embargoes on Russian companies. The economy received a severe blow but survived. The Russian government and the population as a whole tightened their belts to confront the international sanctions. The Western countries had calculated that economic hardship resulting from the sanctions would bring angry Russians out onto the streets to wipe out Putin's government, but this boomeranged when thousands of 'people did pour into the streets but to condemn the punitive Western sanctions, supporting Putin's action of reincorporating Crimea into mother Russia. President Putin's popularity catapulted to an unprecedented level. The Russians who saw Western evil designs in the sanctions to punish their country, rallied strongly behind President Putin.

Finally, the year 2017 now brings good news for the Russian economy that looks all set for a steady growth trajectory, overcoming the long drawn out crisis stemming from the widespread international sanctions. The economy looks confident to register positive growth from the current year onwards. The most convincing argument in favour of the crisis having been relegated to the past is the dynamic growth in industry as well as agriculture. According to statistics available from GosStat, the official statistics body of Russia, almost all the branches of the Russian industry have registered confident recovery growth. According to economists, the growth can be a steady trend in the coming years, on the basis of import substitution¹.

1. "Russian Industry Came Out of the Crisis", *Vzglyad*, January 6, 2017, <http://vzglyad.ru/economy/2017/1/6/852039.html>. Accessed on January 7, 2017

The latest micro-economic data provided by GosStat confirms that most of the branches in the Russian industry have come out of the negative growth zone. During the last 11 months of the outgoing year, compared to the same period in 2015, the food industry has registered 2.5 percent growth while the textile industry has grown at a rate of 5 percent, the leather and shoe industry by 6.3 percent, the wood industry by 3.2 percent, the chemical industry by 4.5 percent, rubber and plastic production by 5.9 percent. The most important news definitely is that the machine-building sector – the backbone of the Russian industry that was worst hit by the crisis – has displayed significant growth. The production index of the machine-building industry in the 11 months of 2016 is 103.6 percent compared to the same period in 2015.

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The first month of 2016 when the Russian industry displayed confident growth was November that witnessed the production index at the level of 103.7 percent. According to experts, two factors that facilitated this encouraging trend were the long working days in November and the cold weather that helped in the rise of electricity production. This factor apparently ensured almost 1.1 percent of the industrial growth. Independent experts attribute the fact of recovery growth not to November but to the period from the beginning of 2016 if not from the end of 2015. The average monthly recovery growth rate constitutes 0.2-0.3 percent while the average annual recovery growth rate stood at 2.55-4.5 percent. Rise in business activity, that was a clear indication of recovery growth, which was evident in the positive zone in the entire half of 2016, was not observed in the last five years.

Further indication of recovery growth was the rise in consumption and investment by large and middle-scale enterprises. As a whole, the growth in investment in the entire economy registered 0.9 percent whereas consumption growth stood at 1.9 percent. In a nutshell, the second half of 2016 witnessed a lot of symptoms of growth. The sectors that witnessed dynamic growth

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becoming drivers of GDP growth were agriculture, chemical industry and extraction industry which did not even notice the crisis. 2016 saw recovery growth in most affected sectors of the economy like the machine-building industry. Here recovery growth touched all most all the branches.

The double trouble for the Russian economy comprised the international sanctions in the aftermath of the Crimean reincorporation into Russia as well as the steep decline in oil prices, the main source of income for the Russian budget.

While the sanctions turned out to be a blessing in disguise by stimulating import substitution, the recent upward trend in oil prices in the range of US\$ 50 to 60 has contributed to economic recovery in no small way. Apart from this, the axiom that devaluation of the national currency exerts a favourable impact on the national economy has been proven wrong this time in the case of Russia. Surprisingly, the Russian rouble in the last couple of years, has not only shown resilience but even gained strength against the US dollar. The oil price rise, coupled with strengthening of the rouble has provided a strong boost to economic recovery through cheaper imports. This factor stimulating acceleration of economic recovery needs the adaptation of producers to shocks and new conditions.

Now the issue that agitates the minds of economists is: how long will this growth continue? Most experts agree that this growth trend would continue in 2017 and do not foresee any production decline in any of the sectors. Strong companies that withstood the effects of the shock would be drivers of recovery growth and would discover new avenues for development as a result of those who have been driven out of the market. Enterprises that did not perish, are not sitting idle and managed to learn how to survive in the new conditions. Certain limitations on financial resources helped this process, indicating gradual reduction of key interest rates of the Central Bank. The growth potential of the economy in the sense of market compulsions remained, and it has to be

utilised. The Russian market has the potential for growth but it needs enterprises that would implement a development strategy. Only effective business can implement this strategy. And, presently, this process has started. The situation in most affected enterprises is serious, but it can hope for government support, for example, the automobile sector.

However, there are some experts who believe that the current growth is the effect of the low base. They are of the opinion that such a growth can be accidental in a long drawn out economic crisis, and the possible 3.5 percent decline in oil production would spoil the industrial statistics in the first half of 2017 and that it is early to talk about growth in industrial production. In addition to this, the level of real income of the population is the real indicator of steady growth. In the first 11 months of 2016, the real income of the population has declined to the level of 94.2 percent compared to the same period of 2015. The average monthly salary of the population in this period has grown by 7.7 percent but if you convert that into real income in terms of purchasing capacity, the growth is barely half a percent.

The overall decline in domestic trade volume also indicates the fall in real income. In the first 11 months of 2016, total domestic trade had declined to 94 percent of the level of 2015. The external trade has also indicated a similar trend.

The prospects for income growth in the future are not very clear. Deputy Prime Minister Igor Shubalov's statement that the income of the population is not growing as hoped for, also confirms this conclusion. However, the real income of certain sections of the population is, no doubt, growing, say official statistics. And it is expected that there would be growth in the income of almost all sections of the population in 2017.

Stabilisation of the rouble might have prevented inflation from taking place but it has triggered the arrival of a huge mass of speculative money of the non-residents who are investing their euro and dollar deposits in rubles for higher interest. However, after some time, they might convert this rouble mass into hard currency, receiving exorbitantly high profits. This is a standard recipe for provoking a financial crisis in the country, as has already happened three times, and could take place for the fourth time.

The government has set the objective to take the economy to a trajectory of sustainable growth. The set of necessary structural reforms such as privatisation, liberalisation and competition for accelerating growth is well-known. The government and society do not seem to be ready for such serious changes.

Some economists believe that expectations for an oil price hike and further strengthening of the rouble might not come true. Some Russian economists are of the opinion that the Russian economic model can prove sustainable and successful in case the global economy has to pass through yet another cyclical crisis for one or two years. President Putin, in his state of the nation address, has set the objective of achieving a higher growth rate than the average global growth rate, and this could be easily achieved in the case of the abovementioned global crisis.

Political stability can be used for attracting more foreign investment as there is sort of guarantee in Russia for not changing the rules of the game for the next 6-7 years. It can really help the Russian economy in fulfilling the task of import substitution in a paradoxical manner.

Russia had lost a substantial part of the machine-building industry, particularly production of equipment for different sectors of the economy, during the years of the disastrous neo-liberal reforms. In the meantime, Russian companies started procuring such equipment in the global market, but it was not all that easy to orient it to the domestic producers. That is why it requires more efforts to attract global producers of equipment to invest in Russia, particularly in segments such as heavy machine building, oil equipment, and railway transport. There are not many such companies; some sectors are highly monopolised; that is why companies need concrete concessions. Now the paradoxical situation lies in the fact that Russia is one of major oil extracting countries in the world but it uses imported equipment for oil extraction and transportation. Russia has to develop this sector for the production of oil industry equipment, not only for the domestic market but also for export. Things look much better in agricultural machine-building over the years. Import substitution in this sector has emerged as a fact of life. It is necessary to prevent the return of a situation of imports growing faster than the GDP.

The transport machine-building sector that includes the automobile, aviation and wagon building sectors is the leader in the machine-building industry. The government's anti-crisis measures as a whole helped in achieving positive results for the economy. The state's anti-crisis programme that covered 199 major enterprises in different branches included, first of all, automobile, aviation wagon building and goods transportation, etc. The budget allocation for these sectors amounting to Roubles 300 billion was a major support for their development.

Special attention to these 199 major enterprises is not accidental. These enterprises constitute the backbone of infrastructure which is protected by any government, first and foremost. If the transport system is disrupted, the economy of any country would collapse in no time. Secondly, these enterprises constitute the system formation, on which depends a lot of production in different spheres as well as people. For example, a decline in the aviation industry would lead to a decline of production in many spheres. Thirdly, the social significance of the sector is very important as it employs almost one-fifth of the country's workforce. And its share in GDP constitutes more than 20 percent.

In the meantime, the rouble has become astonishingly a stable currency, hardly reacting to the fluctuations in international oil prices. The rouble has been strengthened by almost 15 percent in a single year; and inflation has reached the single digit figure. Western economists, predicting doomsday for the Russian economy, have been forced to acknowledge its positive dynamism².

According to Moody's forecast, the Russian economy is expected to grow by 1.5 percent to 2 percent as a whole in 2017. The Russian Ministry

International Monetary Fund (IMF) experts also paint a positive picture of the Russian economy, stating that it has succeeded in withstanding the double-shock stemming from the oil price decline and the international sanctions imposed on Russia in the aftermath of the Crimean re-incorporation into it.

2. "Ruble, Oil and Stock Exchange Bring Cheers to Russia", *Vzglyad*, January 3, 2017, <http://vzglyad.ru/economy/2017/1/3/740262.html>. Accessed on January 4, 2017.

of Economic Affairs is careful in forecasting that economic growth would register 1 to 1.15 percent in 2017.

The Development Centre in the Higher School of Economics, a liberal think-tank, conducted a survey about the perspective of the Russian economy among Russian as well as foreign economists, in which 22 leading experts took part, and the consensus prediction was that the GDP decline in 2016 would be 0.7 percent, and economic growth in 2017 would touch 1.4 to 1.9 percent.

Experts draw attention to the fact that size of the GDP has not grown beyond the level of 2008, the pre-crisis year; which prompts them to talk about the 'lost decade.' The size of the Russian GDP in the year 2016 would be more than just 1.5 percent compared to the pre-crisis year of 2008. The Russian GDP growth between the years 2002 to 2008 was 158 percent.

However, all economists agree that the Russian economy would witness steady growth from 2017 onwards, primarily as a result of the import substitution policy.

International Monetary Fund (IMF) experts also paint a positive picture of the Russian economy, stating that it has succeeded in withstanding the double-shock stemming from the oil price decline and the international sanctions imposed on Russia in the aftermath of the Crimean reincorporation into it. They forecast a GDP decline of just 0.5 percent in 2016 and GDP growth of 1.5 percent in 2017, pushing the crisis to the past. The Russian economy has registered positive growth in both November and December of 2016 and the inflation rate is at the level of 5 percent which is likely to further reduce in 2017.

The oil and chemical industries, followed by metallurgy are the leaders, with their production achieving new records. Considering the positive trend in industrial production, experts believe that the industry would grow by 2.5 percent annually in the coming years. Now it is important not to disturb the complete adaption of the economy and its movement to the expansion zone. One thing that is evident is that the monthly 5 percent negative industrial growth of 2015 has become a thing of the past.

One more factor suggesting improvement of the economic situation is the rouble's stability, which has strengthened almost by 15 percent against the US

dollar, compared to the beginning of 2016, making the rouble a very strong currency. Considering the positive showing, international agencies are likely to increase Russia's sovereign rating.

As regards the sectoral growth, Russia's military industrial complex has established itself as the leader in the economic growth sphere, thanks to the serious efforts put in by the state to revamp the sector and increase the state defence order. Labour productivity in the military-industrial complex has grown three times which is a serious record. This kind of growth is explained primarily by the rise in the state defence order. During the period from 2011 to 2015, labour productivity in this sector grew by 1.7 times. In 2016, the military-industrial complex witnessed 15 percent growth.

This has helped Russia to occupy second place in the global arms market, with exports reaching US\$ 14.5 billion in 2015. The total portfolio orders for defence supplies in 2015 reached US\$ 56 billion. The military-industrial complex has displayed 20 percent growth as a whole in 2015, while the radio-electronic sector has registered 32 percent, the ship building industry 18 percent, rocket-space industry 9 percent and aviation industry 6 percent. The expenditure on research and development over the last several years has grown significantly. Here again, import substitution did wonders in the revamping of the industry and guaranting of sovereignty.

Russian President Vladimir Putin, in his address to the nation, has advised the military-industrial complex to move into conversion and diversification of production since the state purchase would most likely diminish starting from 2018.

Reduction in the state purchase would be explained by budgetary constraints and a lack of possibility to increase financing in the future. The state purchase of military hardware that amounted to only Roubles 300 billion in 2007 had reached Roubles 1.5 trillion in 2013 and had touched Roubles 1.8 trillion in 2015 which was less than the figure of 2014.

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Russia has managed through its astute diplomacy to reach an agreement among all the oil-producing nations, including the Organisation of Petroleum Exporting Countries (OPEC) as well as non-OPEC countries for reducing the total global oil production in order to bring stability to global oil prices while indeed increasing its own production.

The exchange rate of one US dollar fell from Roubles 80-85 to Roubles 61, which facilitated the inflation decline, making the rouble one of the strongest currencies in the world³. Here the rise in oil prices from \$30 to \$55 per barrel also came to the rescue of the Russian economy. The increase in oil prices after a long time could be possible because of the agreement to reduce production by the exporter-countries. This is again a victory for Russian diplomacy. There was widespread speculation that the US, being hand-in-glove with some nations of the Middle East, had led to lowering of oil prices as they increased their production in order to punish anti-American countries such as Russia, Iran and Venezuela, heavily dependent on oil exports. However, Russia has managed through its astute diplomacy to reach an agreement among

all the oil-producing nations, including the Organisation of Oil Producing Countries (OPEC) as well as non-OPEC countries for reducing the total global oil production in order to bring stability to global oil prices while indeed increasing its own production. This is, no doubt, a tremendous victory for Russian diplomacy and an indicator of its strong global player status.

In spite of financial constraints, the Russian budget deficit never crossed 3.7 percent of the GDP, which was acceptable in the backdrop of the trade balance in favour of Russia to the tune of US\$ 70 billion. One of the encouraging phenomena in the Russian economy has been the sharp reduction in capital flight which has declined five times in 11 months.

Agriculture has been one sector which brought good news for the economy by growing at an average annual rate of 4 percent. Growth in agricultural production, coupled with growth in the machine-building, light

3. "Rouble was Never so Stable and Strong", *Vzglyad*, January 9, 2017, <http://vzglyad.ru/economy/2017/1/9/852683.html>. Accessed on January 10, 2017

and processing industries, provided a boost to the GDP growth. Industrial production as a whole has grown by 0.9 percent, while certain industrial sectors have registered growth up to 20 percent.

Most economists agree that the import substitution policy has brought success to the ailing Russian economy by reducing imports from 49 percent to 39 percent of consumption. Serious efforts have been made in the pharma, chemical, and light industries, and heavy machine building and transport equipment sectors to increase production through import substitution. Some of the high-tech sectors in the Russian economy have become absolutely competitive in the international market, making Russia the leader in nuclear technology, space and rocket technology, aviation industry, etc.

Agriculture, over the years, has brought a lot of cheer for the Russian economy by maintaining a steady growth and making Russia a leading grain exporter. The grain production that reached 119 million tonnes, has enabled grain to replace oil as the major export item for Russia. Eighty percent of milk and meat products consumption in the country is now met through domestic production. This has helped in strengthening Russia's food security which was in the danger zone when Russia was importing 70 percent of its consumption from abroad during Yeltsin's disastrous reforms of the 1990s.

There are indications that the long-drawn out economic crisis is finally over, laying the foundation for sustainable growth of the Russian economy in the coming years. The government needs to consolidate the gains by further strengthening the import substitution policy and diversifying the economy.

The Western plan to dislodge Putin from the presidency by bringing hundreds of thousands of angry Russians onto the streets in protest against the economic hardships, stemming from the economic crisis, have absolutely

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failed . Rather one can see an upsurge of unprecedented patriotism in the post-Soviet Russia. The people saw through the Western design in the sanctions by the Western countries for penalising Russia for its patriotic act of reincorporating Crimea into Russia. The crisis rather came as a blessing for President Putin's regime. By consolidating political stability and pursuing a policy of import substitution in the backdrop of the Western sanctions and embargoes, Russia looks poised to be solidly on the path of sustainable growth in the coming years.