Global Counsel

Does strong Russian leadership mean a weak economy?

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Summary

The Russian economy, fuelled by high energy prices, boomed during the first decade of this century. But in recent years the limits of the current economic model have become clear as growth has slowed. Many among the Russian elite understand the need to modernise and diversify the economy. Even so, Russia is a serial under-reformer. More recently the Ukraine crisis has seen the economy stall, with capital flowing out, interest rates up and the rouble under pressure. Sanctions are partly to blame, but the bigger problem is political risk and uncertainty. The state has become harder to predict and appears indifferent to the economic consequences of its actions, while the agreements in May to establish a Eurasian Economic Union and export gas to China suggest Russia is pursuing a trade policy based more on geopolitics than commercial logic. Staccato progress on reform and the rise in political risk means the outlook for investors has deteriorated. Strong, centralised leadership, with an apparent insensitivity to the consequences of policy choices may turn out to be a source of weakness, if it continues to exacerbate Russia's economic vulnerabilities.

The Russian economy boomed between 2000 and 2010, with average annual growth above 5 per cent and per capita GDP rising from one third of the OECD average to one half. Since 2011 growth has slowed and is now stalling. Forecasts of Russian growth have been adjusted down quarter by quarter. The IMF expects 1.3% growth this year, the same as last year. Even so, in both 2013 and 2014 that is a 3pp drop from earlier IMF forecasts. It adds up to a big cut in living standards for the average Russian. Many other forecasters are expecting worse. How much worse depends on what happens in Ukraine, what this means for both sanctions and private capital flows, and the damage this does to confidence in the Russian economy.

The serial under-reformer

The boom years were driven by two factors: most obviously high energy prices, but also massive spare capacity in Russian industry, which created the room for expansion. Both sources of growth have been exhausted, according to the IMF. The risks to future energy prices are now more to the downside. With inflation stubbornly above 6% for some time and rising to 7.3% in April, despite low growth, this suggests there is no more spare capacity in the economy. Russia therefore needs a new economic model if income levels are to keep rising. This requires structural reforms to diversify the economy.

The government is not short of advice or strategies, but actions have typically fallen short of what is required. Progress on two of the government's highest profile initiatives – creating a knowledge-based economy and developing Moscow into an international financial centre – has been modest. Russia's most eye-catching success has been moving up 32 places in the World Bank's doing business rankings over three years to 92nd place. That reflects a focus on the most easy-to-influence measures rather than the underlying conditions facing businesses on the ground. Realising the ambition to move into the top 20 is therefore likely to be much harder.
Russia has for some time invested less as a

percentage of GDP than other countries with a similar income level, even though the economy relies on the capital-intensive energy sector and industry. A poor business climate is mostly to blame. Executives at the St. Petersburg International Economic Forum last month highlighted the regulatory burden and barriers facing SMEs as the biggest threats to Russian competitiveness. Product and labour markets also need reforming so that resources are drawn to where they can be most productive. Intellectual property rights need strengthening if Russia is to succeed in fostering knowledge-intensive industries. And corruption remains endemic – worse than in Brazil, China or India, according to Transparency International – despite a high-profile national campaign that has led to the prosecution of hundreds of officials.

The state is part of the problem, as it plays an opaque, overbearing role in the economy. The banking system is a case in point. Between 2000 and 2012 the share of assets held by state-controlled banks jumped from 35% to 58%. All of the big banks are run by the state. This matters because credit will not flow to the most innovative and efficient enterprises, particularly SMEs, if the shadow of the state hangs over those decisions. The government needs to reduce the role of the state, including through privatisations. But just as important, the government must clarify the blurred lines between the state and private enterprise through better governance.

Russia must now pursue structural reforms in a more difficult and complicated external environment. The challenges extend beyond the fallout from Ukraine. Energy markets are changing. US shale production, the delinking of gas and oil prices, and increasing LNG trade, are taking an expanding global supply of gas to the highest bidder, with a transformative impact on Russia's traditional export markets. Geopolitical developments, such as a potential rapprochement between Iran and the west could add to the pressure. On top of this, Europe now appears more serious about reducing its dependence on Russian energy. This month the European Council will consider a new energy security strategy, which is explicitly motivated by 'events on the EU's eastern border'. Yet Russia is more dependent than ever on energy, which accounted for two thirds of exports in 2012. Non-energy exports have fallen as a share of GDP from 20% in 2000, to less than 10% now.

The surge in Russia risk

The Ukraine crisis has shocked an already weak Russian economy, contributing to a 0.5% fall in GDP in the first quarter this year compared with the final quarter last year. Private capital has been flowing out of the country for some time. Net private outflows were $54bn in 2012 and $60bn last year. But in the first quarter of this year alone net private outflows were $51bn. Uncertainty about US monetary policy may have contributed to the exit of private capital last year, but this is now being driven by a rise in 'Russia risk' following the Ukraine crisis. This is partly about sanctions, but also a more general reassessment of political risk. The Russian state has become harder to predict, expresses indifference to the economic consequences of its actions and appears to put geopolitics before economic interests.

Some striking facts stand out when comparing capital flows in the first quarter of this year with the first quarter of last year. According to the Bank of Russia the net flow of Russian FDI overseas dropped from $65bn to $15bn, so Russian firms are being more cautious internationally. But Russian residents are shifting cash abroad at a fast rate, with a $2bn net repatriation of cash in the first quarter of last year turning into a net outflow of $20bn in the first quarter of this year. Over the past year the net flow of foreign FDI into Russia dropped from $37bn to $12bn. Even more worrying for Russian corporates is the sharp fall in the inflow of foreign loan financing from $36bn to $9bn. If this continues then Russian corporates that need to refinance foreign debt may struggle.

$472bn of foreign exchange reserves have provided a buffer and a more flexible exchange rate has also absorbed some pressure. But reserves are now $125bn below their peak in 2008 and fell by $27bn in the first quarter of this year alone. This is one reason why the Bank of Russia has twice had to increase interest rates, from 5.5% at the beginning of March to 7.5% at present, even though the growth outlook is weakening.

Geopolitics before economics

Economic diplomacy has played a part in Russia's response to the current situation and most recently President Putin made progress on two long-standing priorities. On 29 May he agreed a treaty with his Kazakh and Belarusian counterparts that will see the three countries form a Eurasian Economic Union from next year. The agreement sets out a multi-year timetable for establishing a single market spanning energy, finance, and goods and services. This will do little to stimulate the Russian economy: less than 8% of Russian exports went to Belarus and Kazakhstan last year, compared to the 53% that went to the EU. Moreover, it could be bad news for Russian consumers if it makes it more expensive to import high-quality products from the west. It could also make the modernisation or the Russian economy harder to the extent it shields producers from competing head on with western firms. Russia is clearly serious about pushing ahead with the Eurasian Economic Union, even without Ukraine, but the primary motive is most likely political.

President Putin's other achievement came the week before in Shanghai, where he agreed with his Chinese counterpart a 30-year deal for the export of up to 38bn cubic metres of gas a year, reportedly worth $400bn. The agreement came after a fraught all-night negotiation, but was ten years in the making. The fact that the details of the contract are sketchy has been interpreted by some in Russia as a sign that Gazprom has accepted a discount price – thought to be in the region of $325 to $350 per thousand cubic metres – that they would have baulked at pre-Crimea. Russia analysts estimate Gazprom will struggle to break even and carries most of the risk from cost overruns from building the pipeline. Again, the primary motive appears to be political, with President Putin needing to be seen to secure alternative export markets for Russian energy in the face of the threat of further European sanctions.

Putin's meeting with Xi Jinping was their sixth in eighteen months. He is undoubtedly serious about 'looking east'. The announcement that Russia and China will set up a joint rating agency is another manifestation, as is the Russian suggestion that they might join the Chinese UnionPay credit card system for fear that Russian banks may be shut out of the Visa and MasterCard systems by the US. However, Moscow and Beijing will find it difficult to build a genuine strategic partnership. China puts huge emphasis on predictability and stability, and those are two things that Moscow has demonstrated through its recent actions that it cannot reliably provide.

Speaking truth to power

The chronic failure to follow through with reform and the rise in political risk means the outlook for existing and potential investors in Russia has deteriorated. The record on reform will not improve until the Russian government works out how to create the conditions required on the ground for real change to occur. Political risk will only subside once the Kremlin becomes more attentive to the economic consequences of its policy choices. Both may require a different style of leadership – one that actively listens, is open to feedback, and willing to adapt policy in response. The Russian style of government, with an emphasis on strong leadership and a concentration of power at the centre, may inhibit this. It contrasts with the Chinese system, which involves a wider dispersal of power, encourages adaptive reforms through experimentation, and sees policy ideas tested more thoroughly through internal debate. The Russian style of government could therefore turn out to be a source of weakness. If that is to change then Russian business may need to be more willing to speak truth to power.

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