Wilfried
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The Russian Economy IN FOCUS

Recovery Is Further Away than Some Might Think

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Vladimir
Milov

Executive summary

This working paper looks at recent trends in the Russian economy after more than two years of recession. It analyses the fundamental reasons for the current economic crisis and argues against some of the mainstream views on 'the end of the recession' and the role of Western financial sanctions. The paper follows up the author's publication on the same topic which was published by the Wilfried Martens Centre for European Studies in December 2015.

Keywords Russia – Economy – Crisis – Domestic demand – Import substitution – Real wages – Sanctions

Introduction

In December 2015, I wrote a working paper titled *Russia's Downfall: The Worst Economic Crisis Since the Collapse of the USSR*. In it, I suggested that the Russian economic crisis was deeper than anticipated and predicted a grim outlook for the Russian economic future.

Here is an excerpt:

> [G]iven all of the above, it is really quite hard to imagine that the Russian economy is beginning to grow again. Proponents of the idea would do well to provide serious explanations of how the above challenges will be addressed—until a convincing explanation is provided, it does not make sense to discuss any of the optimistic forecasts.

Optimists are simply hoping for the beginning of the 'low base effect', but as explained above, there are serious factors at work which will most probably drag the economy further down in a spiral effect—the destroyed domestic demand will force manufacturers to lay off people and reduce wages, causing further shocks to domestic demand; investors will be increasingly cautious due to the continued weakening of demand; and so on.[1]

At the time this contrasted with both the mainstream view and official forecasts by the Russian government. The forecast for 2016 published by the Russian Ministry of Economic Development in October 2015 had envisaged GDP growing by 0.9%.[2] In December 2015, former Economic Minister Alexey Ulyukayev publicly confirmed the Ministry's position that 2016 would be GDP-positive.[3] An updated official Ministry forecast published at the end of December 2015 predicted a 0.7% growth in GDP in 2016 in the 'base case' scenario.[4]

In mid-January 2016, however, the Ministry of Economic Development recognised that the situation was not as optimistic, and sharply revised its forecast downwards, from 0.7% GDP growth to a contraction of 0.8%.[5]

This paper provides a brief annual update as to what happened to the Russian economy in 2016, and offers some conclusions about future developments and the impact of Western sanctions against Russia.

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1 V. Milov, *Russia's Downfall: The Worst Economic Crisis Since the Collapse of the USSR*, Wilfried Martens Centre for European Studies (Brussels, 2015), 10, accessed at http://www.martenscentre.eu/publications/russias-downfall-worst-economic-crisis-collapse-ussr on 24 January 2017.

2 T. Zykova 'Минэкономразвития понизило прогноз цены на нефть до 38 долларов' [Ministry of Economic Development Has Lowered Oil Price Forecast to $38], *Rossiyskaya Gazeta,* 10 September 2015, accessed at https://rg.ru/2015/09/10/prognoz-site.html on 24 January 2017.

3 *RIA Novosti*, 'Улюкаев видит предпосылки для слабого роста экономики РФ в 2016 году' [Ulyukayev Sees Conditions for Weak Economic Growth in Russia in 2016], 7 December 2015, accessed at https://ria.ru/economy/20151207/1337822507.html on 24 January 2017.

4 Russia, Ministry of Economic Development of the Russian Federation, Прогноз социально-экономического развития Российской Федерации на 2016 год и на плановый период 2017–2018 годов' [Forecast of Socio-Economic Development of the Russian Federation for 2016 and for the Planned Period of 2017–2018], accessed at http://economy.gov.ru/wps/wcm/connect/fb93efc7-d9ad-4f63-8d51-f0958ae58d3e/1.pdf?MOD=AJPERES&CACHEID=fb93efc7-d9ad-4f63-8d51-f0958ae58d3e on 24 January 2017.

5 *Forbes Russia,* 'Минэкономразвития ухудшило прогноз роста экономики в 2016 году' [Ministry of Economic Development Has Worsened Economic Growth Forecast for 2016], 15 January 2016, accessed at http://www.forbes.ru/news/310327-minekonomrazvitiya-ukhudshilo-prognoz-sotsialno-ekonomicheskogo-razvitiya-rossii-v-2016 on 24 January 2017.

Declining consumer purchasing power: still a key problem

The Russian authorities continue to underestimate the importance of a key factor that is dragging the Russian economy down: shrinking domestic demand. In part this can be explained by the traditional school of thought of Russian mainstream economists, who overwhelmingly focus on supply-side economics and pay less attention to the fact that the current crisis is, in fact, demand-driven. The nature of the current downward spiral in the Russian economy can be simply explained:

1. Falling oil prices and an international credit blockade caused by Western financial sanctions have led to the devaluation of the national currency. (I would argue that the latter is more influential here than the former, but this is discussed separately below.)

2. The Russian consumer market is highly dependent on imports, which has led to the shrinking of domestic demand, along with currency devaluation.

3. The 'import substitution' policy has failed because of the low competitiveness of the Russian economy and the inability of domestic manufacturers of consumer goods to offer viable alternatives.

4. At some point either another shock to the rouble will reduce domestic demand even further, or, with the rouble being relatively stable (as it more or less was during 2016), imports will start to pick up (as is happening right now).

5. The vicious circle continues.

In Russia's Ministry of Economic Development official December 2015 forecast, domestic retail sales were expected to grow by 0.4% in 2016 in the 'base' scenario and by 0.8% in the 'target' scenario; only the 'conservative' scenario envisaged a contraction of 2.7% in 2016.[6] In reality

[6] Russia, Ministry of Economic Development, 'Прогноз социально-экономического развития Российской Федерации на 2016 год и на плановый период 2017–2018 годов' [Forecast of Socio-Economic Development of the Russian Federation for 2016 and for the Planned Period of 2017–2018.

the economy contracted by 5.2% in 2016,[7] beating even the conservative forecast, which was based on an average Urals price of $40/bbl (the actual average Urals price in 2016 was $41.90/bbl, sometimes even a bit higher, which offers another hint that it is not the oil price that is the main factor dragging the Russian economy down). In the middle of the year there was slight optimism when retail sales started to grow on a month-by-month basis, but this also happened in mid-2015 and did not ultimately make any difference to overall growth. In 2015, the total contraction of retail sales was 10% year-on-year, despite some occasional month-to-month positives. In 2016, as noted above, sales contracted by 5.2%.

Table 1 Key consumer purchasing power indicators in Russia in 2016 (year-on-year)

	Jan 2016	Feb 2016	Mar 2016	Apr 2016	May 2016	Jun 2016	Jul 2016	Aug 2016	Sept 2016	Oct 2016	Nov 2016	Dec 2016
Retail sales (%)	-6.4	-4.7	-6.2	-5.1	-6.4	-6.2	-5.2	-5.1	-3.6	-4.4	-4.1	-5.9
Real personal incomes (%)	-5.7	-4.3	-1.3	-7.0	-6.0	-4.5	-7.0	-8.2	-1.5	-5.9	-5.6	-6.1
Real wages (%)	-3.6	+0.6	+1.5	-1.1	+1.0	+1.1	-1.3	+2.7	+1.9	+0.4	+1.7	+2.4

Source: Rosstat, 'Информация о социально-экономическом положении России - 2016 г.' [Information on Socio-Economic Conditions of the Russian Federation—2016].

As can be seen from the table above, real wages moving into positive territory were not able to offset the overall decline in real incomes. In part, this can be explained by the lack of proper pension and wage indexation in the budget system—for instance, the nominal wage growth in health care (6%) and education (4%) during 11 months of 2016 was the lowest in all sectors of the economy—compared to 8.9% nominal wage growth in the extractive and manufacturing industries. Real pensions had contracted by 3.5% after 11 months of 2016. It should also be said that the wage growth in the manufacturing industries was partly due to the effect of the 'false start' approach, with these industries be-

[7] Rosstat, 'Информация о социально-экономическом положении России - 2016 г.' [Information on Socio-Economic Conditions of the Russian Federation—2016], accessed at http://www.gks.ru/bgd/free/B16_00/Main.htm on 24 January 2017.

ing more optimistic about the recovery than the real economic situation suggested, and overproducing (see below).

Import substitution: not truly working

The key hope of the Russian economic optimists was that the decline in consumer purchasing power, combined with Moscow's anti-Western food import embargo, would trigger certain import substitutions, allowing domestic consumer-oriented businesses to thrive despite sharply falling domestic demand. It would be fair to say that, to some extent, this took place. The agricultural sector grew by 4.8% year-on-year during 2016, meat production by 12.2%, poultry by 2.8%, textiles by 19.3% and so on.[8] However, the key factor appears to be competitiveness: over the months, these growth figures clearly shrank, whereas the volume of imports bottomed out and began to grow again in the third quarter of 2016. While in 2015, the total contraction of imports on a year-on-year basis was a striking 37.3%, during 2016 as a whole it was just 1.9%, whereas in the period September–December 2016 it was 6%–8% growth of imports (all year-on-year).

Table 2 Dynamics of Russian imports, quarterly

	Q3 2014	Q4 2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Oct 2016	Nov 2016
% change, year-on-year	-7.8	-20.0	-38.4	-40.9	-38.1	-31.6	-14.5	-4.3	+5.5	+8.2	+6.4

Sources: Rosstat, 'Информация о социально-экономическом положении России - 2016 г.' [Information on Socio-Economic Conditions of the Russian Federation—2016].

Essentially, what this means is that the Russian economy reached a kind of saturation point in terms of consuming domestic goods, and switched to imports as soon as the Russian currency rate became more stable. The import substitution policy has apparently reached its limits; imports, so far, have outlasted the past couple of years of heavily forced import substitution efforts and have started to pick up. While imports of

[8] Rosstat, 'О промышленном производстве в 2016 году' [On Industrial Output in 2016], accessed at http://www.gks.ru/bgd/free/B04_03/IssWWW.exe/Stg/d01/7.htm on 24 January 2017.

meat and poultry fell the most during 11 months of 2016 (by 30% and 25% respectively, corresponding to the equivalent growth in domestic production), major items such as clothing and medicines essentially stayed flat year-on-year (increasing slightly by 1%–2%), and imports of milk and dairy products substantially increased (by over 18%). However, the key issue was the growth in the importation of machines and equipment during 11 months of 2016—up by 4.3%. This is the key item as it represents almost half of total Russian imports.

Some of the economists who focus on the supply side were more optimistic about the Russian economy because they took the more or less positive numbers in the manufacturing industries in 2016 at face value as signalling the 'end of the recession'. In fact, however, this was no more than a false start, essentially overproduction due to optimism. While the manufacturing industries first entered positive territory in quarter two of 2016 and returned to growth in November and December (although November's and December's 2.5%–2.6% growth appears to be a result of Rosstat's reclassifications, which have not yet been properly explained), this clearly does not correspond to domestic demand dynamics. Car makers offer a visible illustration of how overproduction works: whereas the decline in car demand during 2016 totalled 11%,[9] car production only contracted by 7.4%.[10] Thus there was clearly an oversupply in the domestic car market which did not take into account the real market situation—in December, many car dealers were forced to sell their stock at below profitable prices just to clear the showrooms.[11]

Thus it is important to understand what is driving the current Russian economic crisis: a contraction in demand on the back of the 2014–15 rouble collapse, which continues to have a major impact as the economy is still very dependent on imports, and the breakdown of import substitution.

[9] *Gazeta.ru,* 'Продажи автомобилей в России снизились на 11% в 2016 году' [Car Sales in Russia Contracted by 11% in 2016], 12 January 2017, accessed at https://www.gazeta.ru/auto/news/2017/01/12/n_9551459.shtml on 24 January 2017.

[10] Rosstat, 'О промышленном производстве в 2016 году' [On Industrial Output in 2016], accessed at http://www.gks.ru/bgd/free/B04_03/IssWWW.exe/Stg/d01/7.htm on 24 January 2017.

[11] I. Skrynnik and A. Ivanova, 'Автодилеры будут зарабатывать все меньше и меньше' [Car Dealers Will Make Fewer and Fewer Profits], *Vedomosti,* 21 December 2016, accessed at http://www.vedomosti.ru/auto/characters/2016/12/21/670664-avtodileri-zarabativat on 25 January 2017.

Dependency on foreign credit: still a key issue

The importance of the Russian economy's dependency on cheap foreign credit is still strikingly under-appreciated, much as it has been since the beginning of the Ukraine crisis and the subsequent rift with the West. Conventional wisdom is that the Russian economy has been hurt mostly by the falling oil prices, and that Western financial sanctions have had only a limited impact.

In reality, however, the impact of Western financial sanctions has been enormous, and has been seriously underestimated by most analysts. It is true that falling commodity prices have deprived the Russian economy of much of the liquidity inflow that it enjoyed during the days of hundred-dollar oil. But in reality, the effect from this has not been so disastrous. Yes, in 2015 total exports declined to $342 billion from $498 billion in 2014, and further to an estimated $275 billion in 2016. This means that, in 2015–16, Russia lost about $380 billion in export revenues compared to the 'comfortable' annual level of 2014.

However, other factors need to be taken into consideration:

- Imports have shrunk dramatically. They fell from $308 billion in 2014 to $194 billion in 2015. The imports in 2016 are expected to be similar to those in 2015 (the end figure is not yet published for the entire year). This means that import payments for 2015–16 are cumulatively down $228 compared to the benchmark level in 2014.

- Injections of liquidity into the economy from the Reserve fund from the peak amount available in October 2014 (around $90 billion) to January 2017 (when just over $16 billion of liquidity was available) totalled about $74 billion.

Thus in reality, liquidity loss from the collapse of commodity prices was not that substantial, if the offset from falling imports and Reserve fund cash injections is considered—less than $80 billion in two years (2015–16).

Much more impressive was the credit crunch experienced due to the international credit blockade which occurred after Western financial sanctions were introduced. Before mid-2014 Russian companies and banks were borrowing quite heavily: total corporate and banking sector foreign debt had jumped from around $400 billion in mid-2009 to a record $660 billion in July 2014. This inflow of international corporate loans was a key factor driving the recovery from the 2008–9 financial crisis. Most of these loans came from Western financial markets.

However, Western sanctions have effectively blocked the ability to borrow from the West for Russian companies and banks. The biggest borrowers appear on the financial sanctions lists, and even those that do not have still started to feel the effects of major caution from Western financial institutions, due to an overall reconsideration of the political risks of lending to Russia. As a result, the total Russian corporate foreign debt portfolio had shrunk from $660 billion at its peak in July 2014 to $467 billion in October 2014, a reduction of about $200 billion. Such an impressive credit crunch was a key factor behind Russia's economic decline in 2015–16, arguably surpassing the loss of liquidity from collapsing commodity prices in its significance.

Western sanctions have played a direct role here. Essentially, alongside oil prices, they have greatly influenced the negative dynamics of the rouble exchange rate, and this factor will be in play for a long time.

The foreign credit crunch is also a very important part of the explanation as to why money so expensive and credit costs are sky high (the average loan interest rate for enterprises is about 13% and about 15% for small businesses, while consumer price inflation was estimated to be as low as 5.4% in 2016).

Investments have also been hurt by the lack of foreign financing. According to Rosstat,[12] the share of foreign-financed fixed investment fell from 3.4% in 2014 to 2.6% in the first half of 2016. Aside from this, sanctions have created a pessimistic mood among investors, causing fixed investment in 2016 to continue to fall, contrary to the expectations of the authorities: in December 2015 the Ministry of Economic Development forecast fixed investment to grow by 3.1% in the target scenario and to contract by 1.6% in the base case scenario, whereas after nine months of 2016 (Rosstat now only publishes quarterly data on invest-

12 *Rosstat,* 'Инвестиции в нефинансовые активы' [Investments in Non-Financial Assets], accessed at http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/enterprise/investment/nonfinancial/ on 24 January 2017.

ments) the actual contraction of fixed investment was 2.3% year-on-year, worse than the base case scenario expectations. Once again, declining investments were not the main factor driving the negative dynamics of the Russian economy—domestic demand was—but this has also contributed to the grim picture overall.

What now?

Although the worst dynamics for the Russian economy are probably over and major indicators may be evening out in the near future, there is still no visible driver for growth. As Russian Central Bank Chair Elvira Nabiullina has recently rightly said, 'The economy is groping for a new model of development, and recovery may be stretched over a lengthy period'.[13] None of the factors listed below, which could act as key drivers of growth, is a viable option for Russia:

- Even if Western sanctions are eased somehow, Western capital inflow is hardly likely to return to pre-crisis levels. This is due to the new level of political risk when lending to Russia and the widely recognised weak prospects for the Russian economy.

- The oil price is unlikely to return to near $100 per barrel.

Structural reforms and the de-monopolisation of the Russian economy are not in sight. On the contrary, the state sector is officially responsible for more than 70% of GDP,[14] which means that there is no reason to expect a boost in productivity in the coming years.

- State investments are not delivering growth. Total fixed investment by the state and the biggest state companies combined reached a record 6%–7% of GDP in 2013–16. At the same time, however, growth was only 1.3% in 2013 and 0.6% in 2014, with GDP declining in 2015–16.

[13] Y. Kalyukov, 'Набиуллина рассказала о смене модели развития экономики России' [Nabiullina Talks About Changing Model of Russia's Economic Development], *RBC,* 14 November 2016, accessed at http://www.rbc.ru/economics/14/11/2016/5829b9229a7947388373a8f3 on 24 January 2017.

[14] Y. Mereminskaya, 'Государство и госкомпании контролируют 70% российской экономики' [State and State Companies Control 70% of the Russian Economy], *Vedomosti,* 29 September 2016, accessed at http://www.vedomosti.ru/economics/articles/2016/09/29/658959-goskompanii-kontroliruyut-ekonomiki on 24 January 2017.

At the same time, further shocks can be expected:

• Further shocks to the rouble are highly possible—due to both external factors (possible US Federal Reserve rate increases) and internal ones. The latter include current account surplus balances hovering around zero[15] and still high levels of foreign corporate debt, which could create moments of occasional foreign currency deficits to meet certain payments. With a high dependency on consumer imports, future shocks to the rouble will inevitably result in a further decline in consumer purchasing power in Russia. The federal budget for 2017–19 adopted by the new State Duma in December 2016 essentially envisages the freezing of spending and even some spending cuts. This means that wages and pensions in the budget system will not be adjusted for inflation—this will further hurt domestic consumer purchasing power.

As already mentioned, the phenomenon of overproduction in the Russian manufacturing industries continues to be a problem. At present, manufacturers are trying to compensate for their losses by utilising state financial aid, as in the case of Russia's biggest car maker, Avtovaz[16]. But state reserves are being eroded quickly, and this aid option is disappearing. In addition, the oil glut in the international markets could persist, meaning that 2017 will bring a further decline in revenues and a more rapid erosion of state reserve funds.

The oil price factor may be of importance here, some would say. But only to a degree: although the federal budget for 2017–19 was adopted based on a justifiably conservative oil price forecast of $40 per barrel, there is a wide consensus that significant growth cannot be achieved if prices do not return to the level of $100 per barrel, which does not seem to be a likely scenario given how sharply US oil output began to rebound after oil reached about $50 per barrel.[17] Thus, if the oil price jumps from $40 per barrel to $50 or slightly over, the only thing it can influence is the rate of depletion of the state's remaining financial reserves; it surely cannot offer a source of meaningful growth.

[15] O. Kuvshinova, 'Текущий счет в 2016 году сократился до 18-летнего минимума: угроза рублю' [Current Foreign Currency Account has Reduced to 18-Year Minimum: A Threat to the Rouble], *Vedomosti,* 18 January 2017, accessed at http://www.vedomosti.ru/economics/articles/2017/01/18/673430-tekuschii-schet-sokratilsya on 24 January 2017.

[16] *Autovesti,* 'УБЫТКИ "АВТОВАЗА" ВЫРОСЛИ ВДВОЕ' [Avtovaz Losses Have Doubled], 31 October 2016, accessed at http://auto.vesti.ru/news/show/news_id/663935/ on 24 January 2017.

[17] M. Zborowski, 'BHI: US Rig Count Records Largest Increase Since 2011, *Oil & Gas Journal,* 21 January 2017, accessed at http://www.ogj.com/articles/2017/01/bhi-us-rig-count-records-largest-increase-since-2011.html on 31 January 2017.

In parallel to this, Vladimir Putin very much hopes that Western financial sanctions will be lifted in 2017, thanks to the election of new leaders in the US, France and possibly Germany. Russian leaders hope that this will allow a return to pre-2014 international corporate borrowing levels and essentially put the recent sordid economic past behind them.

It is important for Western decision-makers not to buy the Putin-friendly superficial rhetoric that 'sanctions are not working' and to realise the true impact that the Western financial sanctions are having on the Russian economy.

About the author

Vladimir Milov is the founding chair of the Democratic Choice Party in Russia, and director of the Moscow-based independent Institute of Energy Policy. He is the former deputy minister of energy of Russia.

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Wilfried Martens Centre for European Studies
Rue du Commerce 20
Brussels, BE 1000

For more information please visit: www.martenscentre.eu

Editors: Eoin Drea, Senior Research Officer, Martens Centre; Loredana Teodorescu, Visiting Fellow
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