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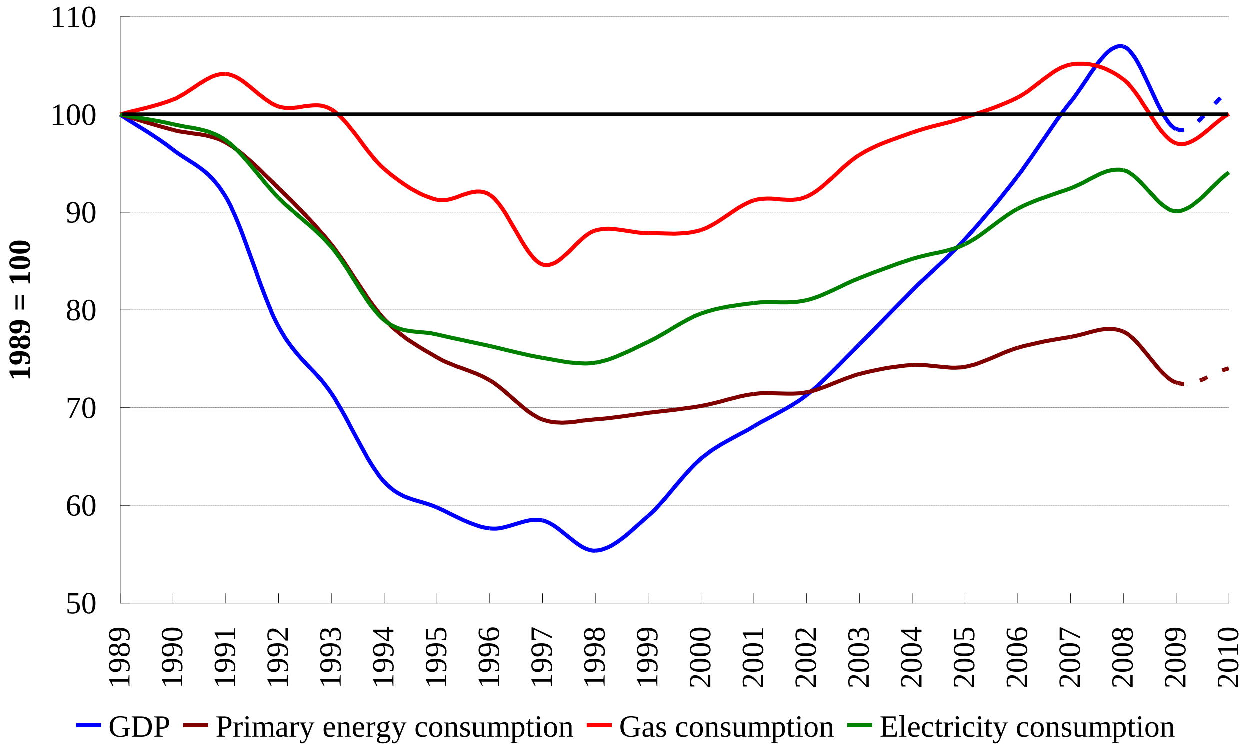
Russian Economy: Now and Future (challenges of WTO)

Russians now are two decades past the Soviet Union. Russia, in the previous period of its history, has experienced the "triple transition:" from the Soviet state to the regular republic without ideology and with all democratic processes; from a planned economy to private property and the market; and from a republic within another huge country toward an independent state (with 80% of the territory of the Soviet Union). Russians under 40 years of age never experienced a planned economy and they did not live (since the school) in the Soviet society.

Russian society has not fully overcome the difficult transition crisis. Current problems it is facing today are rooted not only in its Soviet past, but also in the nature of its transition period. The transition has resulted in an irreversible departure from the Soviet experiment of the twentieth century and in the formation of a new Russian capitalism. The latter is marked by profound inequality and broad diversification of the interests of various social groups, regions, and types and groups of businesses. Actually (unlike CEE countries) Russia moved from quasi-egalitarian society to Latin America's social structure (close to Argentina). Therefore, the nation as a whole should be modernized by revamping its civil society, the economy and the state.

Transitional economic crisis was terrible of decline by 43% GDP – alike the American Great Depression of 1930-s. And the key factor for a background – Russian GDP in 2008 and 2011 are very close to GDP of 1989 (see graph 1).

Graph 1. Transition dynamics.



As a result of the crisis and some technological improvements the CO2 emission from Russian economy has declined since 1990 by 35% - more than the most of countries. Probably about two millions of educated Russians are living outside the country as mostly "international middle class". But we need more middle class at home – only 20-30% of the households (from country of 145 million people) may be considered as relatively well-off and close to the European middle class. That's them who are on the beaches all around Barcelona and in the Museum of Amazing Antonio Gaudi in Reus.

Any way Russia retains well educated population, huge natural resources, and good nature (people are still kayaking camping on rivers near Moscow). The long-term prospects for economic growth in the country remain generally favorable, which makes it possible to set new, more ambitious tasks.

After Vladimir Putin's reelection in March Russia has a supposedly stable period of development for six years ahead of us. Some new strategy of turning to innovations and modernization was discussed for the last few years. Debates go between more comprehensive approach of liberals for modernization of the state and society along with the economy and technocrats. But at the moment the modernization is defined by the authorities more in a technocratic style, or by terminology of recent years: investments, infrastructure, innovations, sometimes "institutions" are also mentioned. Russian "new old" President recently promised the drastic improvement of investment climate in Russia in few years. It may help modernization – Russian economy brings higher profit rates and needs a lot of capital, while actually exporting a lot of direct capital. National saving rate typically are much about the capital formation rate in GDP (which is about 21%). Euphoria of high oil price and income is receding and the prospect of 4% long-term GDP growth rate look optimistic but far from Chinese level. Main indexes of Russian economic situation look pretty stable by current EU environment. But actually Russian economists are dissatisfied by the character of growth, excessive resource dependence, and low tempo of innovations. General view is that we do not use human capital of the country in an efficient way.

Table 1 - Main Economic Indicators, 2005-2012

Index	Measure	2005	2006	2007	2008	2009	2010	2011	*2012 (est)*
GDP growth, constant prices	%	6.4	8.2	8.5	5.2	-7.8	4.3	4.3	*4.0*
GDP, current prices	Billions, U.S. dollars	763	990	1 300	1 660	1 222	1 487	1 850	*2 021*
GDP, current prices	trln, rubles	21,6	26,9	33,9	41,2	38,8	45,1	54,3	*59,7*
CPI	End of period, %	10.9	9.0	11.9	13.3	8.8	8.8	6.1	*6.2*
Unemployment	%	7.6	7.2	6.1	6.4	8.4	7.5	6.5	*6.0*
Deficit/Profit of Budget	% of GDP	-8.2	-8.3	-6.6	-4.9	6.3	3.5	-1.6	*-0.6*
Government	% of GDP	14.2	9.0	8.5	7.8	11.0	11.7	9.6	*8.3*

Debt									
Balance of Trade	Billions, U.S. dollars	118.4	139.3	130.9	179.7	111.6	152.0	198.2	*203.4*
Oil price:									
Brent	Dollars per barrel	52.6	70.3	70.6	122.6	67.6	71.5	115.1	*98.7*
Urals	Dollars per barrel	49.7	64.0	68.7	117.6	67.2	71.2	112.8	*96.9*
RUR/EUR	Average	34.7	34.4	34.8	36.7	43.9	38.0	40.3	40.8*

Source – IMF, Thomson Reuters Datastream, Central Bank of Russia
* May, 2012

***Energ**y*

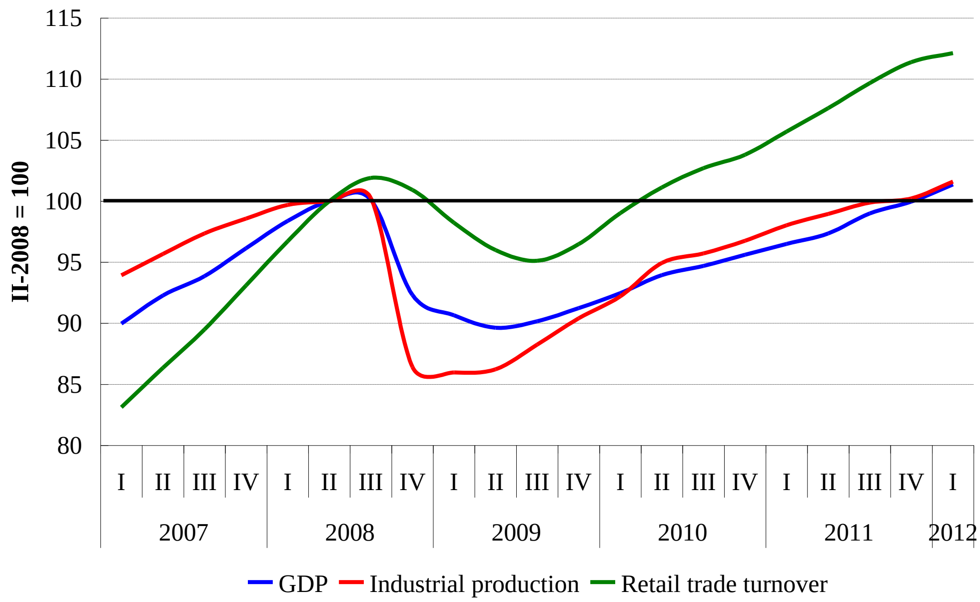
To the great extent Russian budget – like of Saudi Arabia – heavily depends of the oil price. Since 2005 the most of oil countries greatly increased their budget expenditures – mostly for social and defense objectives. Russian energy sector is much bigger than normally recognized, and it was built by Soviets for geopolitical reasons, not commerce. Current reproduction cost of Russian Energy Infrastructure is beyond any measure. Russia invests 4-4.5% of its GDP in Energy Sector annually – about four times more than global average. With 2.3% share in World Population and GDP Russia produces 9.6% of Global Primary Energy, and exports 4.3-4.5% p.p. of it. Financing comes predominantly from Russian private and state companies with some foreign participation mostly through the joint venture system and credits (from China). Actually Russian net export of Energy is close to sum of net energy import of Germany and China together, if we are looking into global energy balance. Russian exports accounts for: 2/3 of produced Oil (of 500 mln t a year), 1/3 of Coal (of 300 mln t), and 1/3 of Gas (of 600 bcm). Plus we must account for energy intensive goods like Aluminum, Fertilizers. Russia is the Global supplier with domestic agenda – Modernization in both Energy and non Energy sectors. SO, it depends seriously on export revenues for the budget and investments. Favorable conditions on the global market over the past quarters made it possible for oil companies to increase capital investment by more than 40% in Q1-2012, to a 20-year record high. However, Russian oil companies are still facing the problem of expanding production. Russia is running out of unexplored resources and the sole source for further oil production is the continental shelf, where development is booming right now after several years of inactivity. Russian oil majors Rosneft and Gazprom, which have exclusive rights to explore the shelf, signed a package of cooperation agreements in April 2012 to explore oil and gas deposits in the Black Sea and the Arctic.

Crisis and after

Russian economy was growing by 7% annually in 2001-2007 – prior to the crisis, but declined in 2009 by 7.8%. Important features of the Russian crisis are, just counting: concentration of troubles mostly in industrial regions; devaluation of ruble in the beginning of 2009 by 15%; securing deposits was up from $10 to $23 thousand per person per bank; supplying some credits to troubled enterprises. Unemployment went up (see Tabl. 1), but no defaults on bank deposits of households happened. Government intervention was rather costly but had a clear objective to reduce social dissatisfaction to a minimum – which succeeded on the side of numerous pensioners and support of poor regions. Since that time the situation was improving on the many parameters but nobody is foreseeing the return to previous fast growth.

GRAPH 2.

GDP, industrial production and retail trade turnover, II-2008 = 100, 2007-2012



Source: FSSS,

The Russian economy grew 4.3% in 2011, more than official forecasts of 4.1%. Favorable foreign trends contributed to this relatively high rate of growth; the average price of Urals crude was close to $110 per barrel in 2011, up 40% from the previous year. In addition, a revival in lending (all market segments posted growth) and more federal spending also contributed to the economic rebound. As a result, the Russian economy had reached its pre-crisis levels by the middle of 2011 (see graph 2). But once the influence of the agricultural sector is factored out, economic growth was a mere 3.9% in 2011, compared to 4.8% in 2010. Most competitive production (above all the export sector and the food industry) has reached pre-crisis levels of capacity and demand has fallen, which has also contributed to the slowdown in the non-agricultural sector. Real disposable income rose a mere 0.8% year-on-year – a ten-year low – in 2011, mainly due to a growth in federal salaries and an increase in social payments. Higher demand (household spending for the end consumer rose 6.4% in 2011) is supported by an increase in consumer lending, and the revival of the mortgage market and the car market (these markets had neared pre-crisis levels by the end of 2011). However, such a model will not likely remain in the mid-term, especially as conditions worsen on financial markets.

Russian economists and officials are closely watching the second wave of reception in the EU – actually industrial stagnation since the Fall of 2011, worsening budget and aggravation of sovereign debt problems. TV and news papers “entertain” the defenseless public mind by thriller stories of Greece leaving euro zone and the negative impact on Russian economy. Russian Central bank has by the start of June $510 billions in reserves, with low debt and low budget deficit. Russian authorities are much more worrying of growth in the medium term and modernization that immediate impact of the European “debt unrest”.

In 2012 economic recovery continues. General trends show some improvement but far from boom. Economic Development Ministry forecasts show an increase in fixed capital investment, which should support economic trends in 2012. However, the analysis of the investment plans of the 40 largest companies (35-40% of all investments) show that these companies are not planning on increasing investment in real terms in 2012.

Russians started to rely more on credit like they did before the financial crisis. In 2011, the credit portfolio for individuals grew by almost 1.5 trillion rubles (+36% y-o-y) in one year to exceed 5.5 trillion rubles. The number of both short-term and mid-term personal loans increased. Mortgage loans only accounted for around 300 billion rubles of the growth in the loan portfolio, while consumer loans accounted for the rest (car loans, loans for other consumer goals, etc). Providing personal loans is extremely favorable for banks, since the average interest rate on a short-term loan is currently around 25%. The slowdown in the growth of individual deposits has been partially offset by deposits in the corporate sector and also by the Finance Ministry, which has placed budget resources in commercial bank accounts.

Inflation is low by historical standards. Prices inched up only 2.2% in the first five months of 2012, which was a new record low. Service prices rose 0.9% in the first four months of 2012. Delaying price hikes has disrupted the traditional seasonal factor in inflation figures; when prices usually jump in January and inflation falls in July and August when most foodstuffs are cheaper. An additional factor is uncertainty over just what the effect of the regulated price hikes will be. Due to the changeover to new principles of regulating tariffs, even the Economic Development Ministry cannot predict the new prices, especially the cost of housing and utilities. One may assume that the tariff factor will lead to growth in prices since July; and some price growth will come as be a result of higher service prices and increased excises on tobacco and alcohol.

One reason that has limited the appetites of natural monopolies concerning price hikes were Govt. policies. At the end of March, Prime Minister Vladimir Putin announced that gas prices would increase 7.1% for industrial customers and 10.4% for individual customers in 2012. Russian gas giant Gazprom had wanted an additional hike in gas prices by 26.3% in Q4 2012, but this will not happen. The Federal Tariff Service (FST) has recommended abolishing RAB-regulations for a number of MRSK Holding subsidiaries and reinstating long-term regulated prices. All of these factors show that the government is ready to gradually conduct a more active policy aimed at lowering price growth for regulated tariffs, thus helping fight inflation.

Starting in Q3 2011, real rates have returned to the positive zone. Moreover, low inflation since January 2012 has meant that real interest rates are currently at record highs – around 5-6%. The last time Russia posted such rates was during an economic slump at the end of 2008 and 2009. Inflation has declined in the past few months, yet nominal rates have not, fueling dissatisfaction from both issuers and bankers alike. Heads of a number of large Russian banks, such as Sberbank and VTB, have issued regular statements since the beginning of the year calling for an expanded Central Bank role in providing long-term financing to banks[1]. In the worse case, as top bankers argued, the banking sector will fall into stagnation and interest rates will remain high. The Central Bank has still not made any decisive concessions to banks.

Lower interest rates and easier access to foreign financing will cause nominative interest rates to fall. Higher inflation will trigger a drop in real interest rates in the economy. However, positive real rates will remain for the next few years and become a new reality for the financial sector.

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[1] For a more detailed account, see an interview with Andrei Kostin, VTB chief executive, in the *Financial Times* (22 Feb 2012) http://www.ft.com/intl/cms/s/0/e869d724-5d5d-11e1-869d-00144feabdc0.html

There was more evidence of the Russian economy’s dependence on global trends in May 2012, when falling oil prices initially fueled a drop on the stock market, and, subsequently, caused a sharp plunge in the ruble. Despite some panic on the market, the Central Bank has so far been consistent in its FX interventions policy. The Central Bank only started its first intervention on May 30, when it placed a mere $70 million/day. On June, 1 FX interventions increased to $140 mln/day. Increased activity of CBR will help to calm the markets; the basket (euro&dollar) will fall to 35-36 rubles. Picture of Russian recovery is not rosy but not promising major troubles, excluding the case of strong negative second wave of recession in the OECD countries or the fall of oil prices well below $100 per barrel. The rest of scenarios is normally favorable enough to go on with growth.

WTO

By the end of 2011 Russia had finally completed the long process of accession to the World Trade Organization (WTO). This process lasted for 18 years for various reasons, esp. due to the continuous changes in Russian trade-related legislation and difficult bargaining with a large number of participants. And external obstacles for the completion of the accession were considered in Moscow so tiring, that “WTO – fatigue” was a common definition for status of the process for last few years. Companies and enterprises have forgotten about the coming change in the environment since main parameters of the accession had been agreed back in 2006. Russia has to complete the internal ratification procedure, then to notify the WTO about it, and in 30 days Russia is supposed to have the full rights of WTO membership.

The average Russian import tariff should be reduced from current 10% (as at the end of 2011) to 7.8%. Tariff rates will be reduced gradually, and the transitional period will end in 2013-2020 for various commodity groups. The fluctuations of the ruble rate to euro and dollar may affect Russian foreign trade much more than

2.2 p.p. of tariffs on the average. Any strengthening of Russian ruble against US dollar is equivalent to reducing the effective rate of import duty by the same amount (adjusted by the share of dollar settlements in Russian foreign trade). Ruble fluctuations were quite perceptible over the past few years: for example, during the first quarter of 2009 ruble fell by more than 15%, and quarterly fluctuations in 2011 were: +8%, +4.3%, -4%, and -6% respectively. And right now in early June ruble was devalued by the market by 10-15%. Reduced import tariffs as a result of WTO accession will have limited impact for the most of Russian industries and for the most of countries importing to Russia.

Much more significant consequence of Russia's entering the WTO will be higher level of transparency and stability in terms of access to the Russian market. The inevitable gradual changes in the institutional environment and the effect of reputational factor may help to increase the attractiveness of Russia as a member of the WTO for foreign investors. All these effects are difficult to evaluate quantitatively, and their impact will be effective only in combination with other measures aimed to the development of civil and state institutions in Russia, but in any case they will definitely be a positive factor for Russia.

The sectoral impact of WTO accession for most of Russian industries (and services sectors) can not be predicted accurately, while normally people believe on the some serious impact on car trade, agriculture and metals. Banking sector is protected by requirement to register foreign own but Russian legal entity under the super vision the Central Bank of Russia. The majority of Russian enterprises are only now beginning to realize the WTO rules of the game is something inevitable for adaptation. Some trade associations publicly pretested the Duma's ratification, but surely in vain.

There have been some serious changes in the Russian trade regime – first of all, new strategy of automotive industry development with the help of an assembly on Russian territory regime. Such changes affected an important article of Russian import of cars, which represents about a quarter of Russian equipment import. It was also a question of growing difficulty to involve sanitary issues in trade relations. The most important direct consequences of WTO accession for Russia will be the access to the WTO Dispute Settlement Body (DSB), where it is possible to resolve all contentious trade-related disputes fairly and quickly. It is already clear that with the help of DSB mechanism Russia can seek to improve access to some foreign markets – primarily by filing cases against anti-dumping restrictions for Russian export (e.g. to the production of metallurgical and chemical industries). On the other hand, WTO countries will try to qualify as non-compatible with WTO rules some regulations of foreigners’ access to Russian market.

The most interesting development with Russian participation may occur in the energy sector, which is only partially covered by the provisions of the WTO agreements. All sides now probably are looking now into WTO rules concerning energy relations to other sources of regulations. And Russian companies may look into options with relation to the EU Third Energy Package – concerning market access restrictions for companies from outside the EU. Now it’s time for Russia and all other WTO members to leave in the past the negotiation time and move to the “win-win” strategy. WTO accession will not have immediate visible impact on Russian economy, but experts trust general economic rules and hope that more competition would bring more efficiency for Russian economy.