

RUSSIA: A bigger picture

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In a contest for best macroeconomic management, Russia could lay claim to be the world's star performer. But it will have to make some changes



Russian economic growth slowed from 2011's 4.3% to 3.4% in 2012 and is projected at nearly similar levels in coming years by the International Monetary Fund. Inflation fell last year to its lowest for many years at 5.1%, and is expected to stabilize around 6%, while unemployment could decline further than its present 6%. Government accounts are roughly in balance, while foreign exchange reserves including gold were

a healthy \$526 billion in February. Public debt in 2012 is estimated at just 11% of GDP – “good by any standard”, Ivan Tchakarov, chief economist of Moscow's Renaissance Capital, says.

Julian Cooper, professor of Russian economic studies at Birmingham University, argues that Vladimir Putin's orthodox policies have largely brought good macroeconomic management to his country. However, trade is strong because of resource exports. The 2012 current account was \$81 billion in surplus, or 4% of GDP, but this source of strength is in decline. The surplus has fallen steadily from 11.1% of GDP, and the IMF forecasts no more than 1.6% in 2014.

Since last year, Russia has faced a new shock in falling gas prices, which has begun to bite into its economy. Forced to renegotiate some export prices, state-owned giant Gazprom is no longer the international force it was. And as oil and gas surpluses decline, many say that being a regional – rather than global – power could be the height of Russia's ambitions.

Despite these alarm signals, dependence on oil and gas has actually increased, says Tchakarov. Energy's contribution to federal revenue has grown from one-quarter in 2000 to one-half now; but if the oil price required to balance the country's books was \$18 a barrel then, now it is \$100.

But, while richer countries struggle with high debts and stagnant output, Russia's impressive macroeconomic performance has failed to stimulate either domestic or foreign investors. Foreign investors say they are not rewarded properly, being forced into minority shareholdings and facing pervasive corruption. Both domestic and foreign capital has flowed out since 2009.

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“nationalize” the elite, says Andrei

Yakovlev, vice-rector

School of Economic



unlikely to succeed since domestic stimuli for investment are required.

WHY THE PARADOX?

Russia’s problems are long-term issues of economic structure and social development, Yakovlev says. And while the government is trying to restrain expenditure and introduce a revenue stabilization fund, “it’s at a purely fiscal level”, Tchakarov adds.

For the development of manufacturing, nothing is happening, he explains. Manufacturing strength lies in small pockets, some of them – like nuclear turbines – preserving competitive advantage from Soviet times. Many businesses praised by foreigners also go back to that time, like Sberbank, the largest bank.

Yakovlev says Putin’s confident form of state capitalism, modelled on South Korea, has run its course, and the leadership has not found a strategy to replace it. The government wants to move towards China’s model of competition between autonomous regions, but the centralized bureaucratic machine it created after 2000 stands in the way.

Oil and gas remain Russia’s big comparative advantages, and this offers the elite no immediate reason to change, Tchakarov says. However, the crisis showed that Russia cannot rely on them indefinitely. In Yakovlev’s view, this was emphasized during protests after the 2012 presidential election.

International pressures might finally push Russia towards diversification, according to Cooper. Russia has interests and influence in the former Soviet space, as well as cultural and economic links.

The Eurasian Customs Union (ECU) of Russia, Belarus and Kazakhstan has developed rapidly since it started in 2010, with a “single economic space” inaugurated under World Trade Organization rules in 2012. Cooper says this is remarkable since Kazakhstan and Belarus have yet to join the WTO. An Economic Union is planned for 2015 with Kyrgyzstan and Tajikistan as further members.

The project could work if it sticks to the economy, but not if Russia tries to make it more political and strategic, Cooper says. The Union follows the EU’s 50-year experience closely, and any expansion will be cautious. Kyrgyzstan is being “put through the hoops” while its border controls with China are examined.

Russia’s long-term plan is seen in the desire of Viktor Khristenko, chairman of the Eurasian Economic Commission, for an eventual free-trade area with the EU. This may be “not entirely unrealistic” three to five years ahead, Cooper says. As much as 84% of Russia’s exports and 86% of its imports are with countries outside the Commonwealth of Independent States, central bank statistics show. But for Yakovlev, Moscow’s emphasis on the region betrays a recognition that Russia’s economic potential is not global.

The ECU’s asymmetric domination by Russia makes it different from the EU, Cooper says. Nevertheless, both Kazakhstan and Belarus are happy to gain entry into bigger Russian markets. Russian companies meanwhile can use Kazakhstan as a springboard into China, Yakovlev says. Smaller southern countries hold less attraction, but they all need strength and resolution if they are to move far outside Moscow’s orbit. Georgia’s troubles stand in contrast to Azerbaijan’s freedom of manoeuvre as an oil exporter.

The big prize for Russia remains Ukraine. The first “Russian” state was in Kiev, and with 46 million people it is by far the largest former Soviet republic outside Russia. Russian pride is still smarting from its neighbour’s 90% vote for independence in 1991, but since then Kiev has been equivocal on ties with Moscow despite serious economic failures. Kiev’s divided elite tries to play on contradictions between Russia and the EU, Yakovlev says.

“East or West is the big question at the moment,” says Andrew Wilson, reader in Ukrainian studies at the University College London School of Slavonic and East European Studies. “The elite wants Europe, but it does not want full membership and all that implies.”

It faces an immediate deadline in May 2013, set by Brussels for improving the judicial and electoral systems as a requirement for an Association Agreement with the EU, to be signed in November.

REGIONAL AMBITION

Most Ukrainian exports to Russia are light manufactured products, which are uncompetitive on European markets; Ukraine would have to move up the value chain to operate in Europe, Wilson says. Meanwhile, the western share of its bank assets has halved to 20% since the 2008 crisis, with Russia filling the gap. But imports from Russia are in sharp decline.

However, not only Moscow is wooing the Ukrainians. Both Astana and Minsk are speaking to Kiev without Russia's involvement, while President Nursultan Nazarbaev of Kazakhstan wants Turkey in the ECU project too. Russia could then be outvoted, Cooper explains.

Nevertheless, "it's clearer what the Eurasian Union offers to Russia than what it offers to Ukraine," Wilson says. "The current guys in power don't think close ties with Russia are a state interest."

Russia holds a strong position in the Ukrainian economy, with growing equity holdings and vertical integration in oil refining. But even pro-Russian elements think Moscow is pressing too hard, for example on ownership of the gas pipeline that runs across Ukrainian territory, Wilson says. Kiev is serious about energy security, seeing long-term interest in the country's rich shale gas reserves. Cheap Russian energy would be good in the short term but not in the long term.

What can regional integration offer Russia itself, beyond memories of past times and a further outlet for oil and gas exports? On the face of it, the match looks unlikely given the similar profiles, especially between resource-rich Russia and Kazakhstan. However, it could help to transform manufacturing, Cooper argues. The countries might develop stronger industrial bases when they do not face the full force of global competition.

Tchakarov points out that while Russia moved up from 120th to 112th place in the World Bank's 2012 ranking for ease of doing business, Kazakhstan was 49th and Belarus 58th. Putin's goal of 50th place for Russia in 2015 is "very ambitious" but a positive step. "If we go to 60 or 70 I think it will be an amazing achievement", he says. He notes that Astana and Minsk moved up the rankings under authoritarian systems, and some investors see that positively.

At present, Russia's medium-sized companies can operate successfully at home but not abroad, says Yakovlev. Even at home it is recognized that they can lose if they play by the rules. They still fear confiscation, following the absorption since 2003 by Rosneft, a state-owned oil company, of Mikhail Khodorkovsky's rival company, Yukos.

Tchakarov says this inhibits new businesses as much as existing ones. The Global Entrepreneurship Monitor recently reported that only 2% of Russian adults intended to set up as entrepreneurs in the next three years – the least in all 67 countries it surveyed. The figures were 20% in China and 22% in Latvia.

But the ECU is not the limit of Russia's regional ambitions: it has interests to the west, where it is now pursuing economic integration and investment rather than using political pressure, Yakovlev says. Latvia, Lithuania and former Comecon partners such as Hungary are in the frame.

Another priority is Russia's Far East zone. Cooper says it offers "tremendous potential" as Russia builds ties with China, taking advantage of economic complementarities, with Russia strong in energy and raw materials, and China in manufacturing.

Besides trade, it would involve investment "in a controlled way" from China, South Korea and Japan, including mineral and forestry concessions and access to the Arctic. The Asian side of Russia is in a good position to trade with the West of the United States and Canada.

But in Moscow so far this is only talk. There have been tentative steps to strengthen transport links, but an obstacle lies in the depopulation of the region since the 1990s.

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