

The Russian Economy in the Year 2005.

by

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1. Introduction

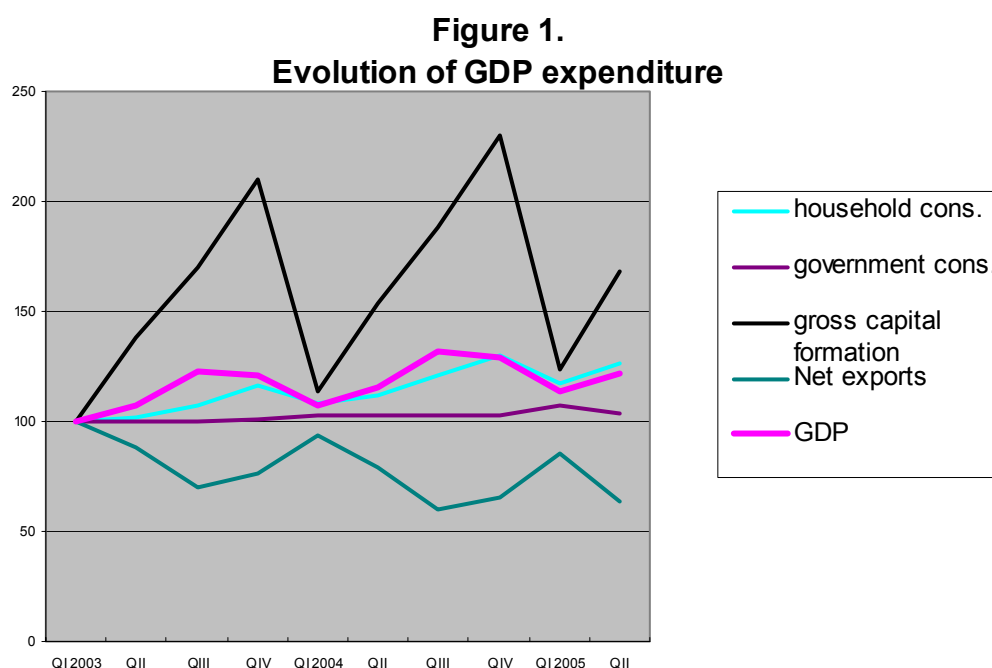
Since the Yukos affair and the Khodorkovsky trial, the Russian and foreign press have been reporting many contradictory signals about the health of the Russian economy and its future. One has observed a fall in real GDP (measured at constant prices) in the second half of 2004. The Ruble has been appreciating quite strongly as oil prices have been increasing steadily. The specter of a Dutch disease in Russia has appeared feeding all sorts of alarming articles and reports. Increases in capital flight have been observed the same year. Has the Russian economy lost its momentum with the crackdown on Yukos? Is it headed for a plunge that could have major effects on the 2008 elections?

In this paper, I ask four questions and propose tentative answers based on data from the Russian economy. First, has the Russian economy really been slowing down recently and has the slowdown of late 2004 been confirmed in 2005? Second, is Russia facing a Dutch disease problem? Third, what is the investment climate after Yukos? Fourth, what are the long term prospects of the economy?

The answer to the first three questions is easier than the answer to the last one. I find that there are no signs of slowdown in the Russian economy. It is continuing to grow at a very healthy pace. I find it premature to speak of a Dutch disease in Russia. The real appreciation of the Ruble is very real but there is so far not much solid evidence for symptoms of a Dutch disease. While the investment climate is clearly far from perfect, the response of both foreign and domestic investors indicates that the positive factors outweigh the negative factors for now. Alarmist views on the current state of the Russian economy are in my view misguided, reflecting a very volatile investor opinion. It would however also be quite premature to speak of an economic miracle of the kind that China has been experiencing in the last twenty years. The economic fundamentals for the long run prospect of the Russian economy are not as rosy as the short term prospects which reflect mostly a solid rebound after the very long decline of the nineties.

2. Has the Russian economy been slowing down?

To answer this question, let us look at the evolution of real GDP. Figure 1 shows the evolution of an index of Russia's GDP and major categories of aggregate demand between the first quarter of 2003 and the second quarter of 2005, as reported by Russia's Finance Ministry. The data are measured in constant 2003 prices so as to eliminate the effect of inflation. An index of 100 is taken for the first quarter of 2003 so as to picture the dynamics of these variables since 2003.

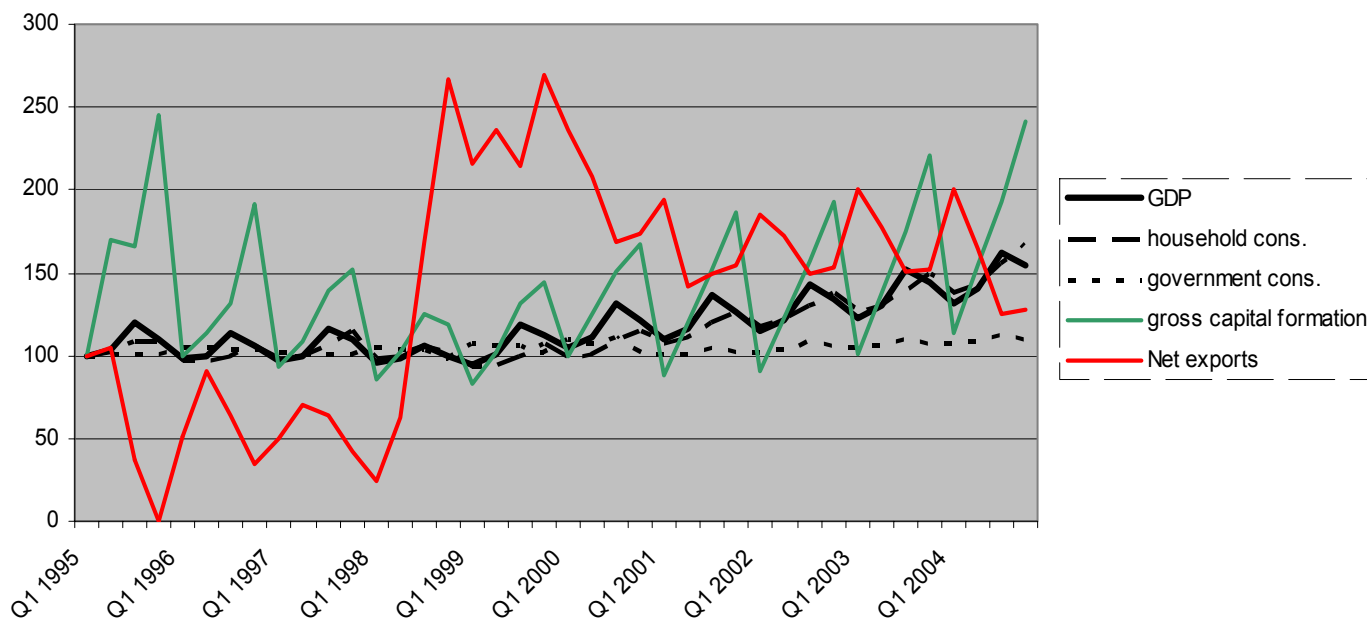


Source: Russian Ministry of Finance

As one can see, GDP has indeed been declining in the last quarter of 2004 and the first quarter of 2005. However, this was after a particularly strong third quarter in 2004. The economy has been picking up later in 2005 with a rebound in the second quarter. As one sees, the path of GDP is closely associated to the path of private consumption and one can argue that private consumption demand has been the leading factor in the recent dynamics of aggregate demand in the Russian economy. Government consumption is quite flat and has hardly been growing at all since 2003, reflecting the fiscal discipline

established under Putin. Investment is very volatile but has also been picking up in the second quarter of 2005. Net exports have been clearly declining in the last two years. This is not due to a decline in export growth but rather to a very strong growth in imports, reflecting the real appreciation of the Ruble and the growth in incomes in the domestic economy. Exports have grown at about the same pace as GDP. To summarize, there is not really a sign of a slowdown in the Russian economy in the short run.

Figure 2.
GDP evolution since 1995

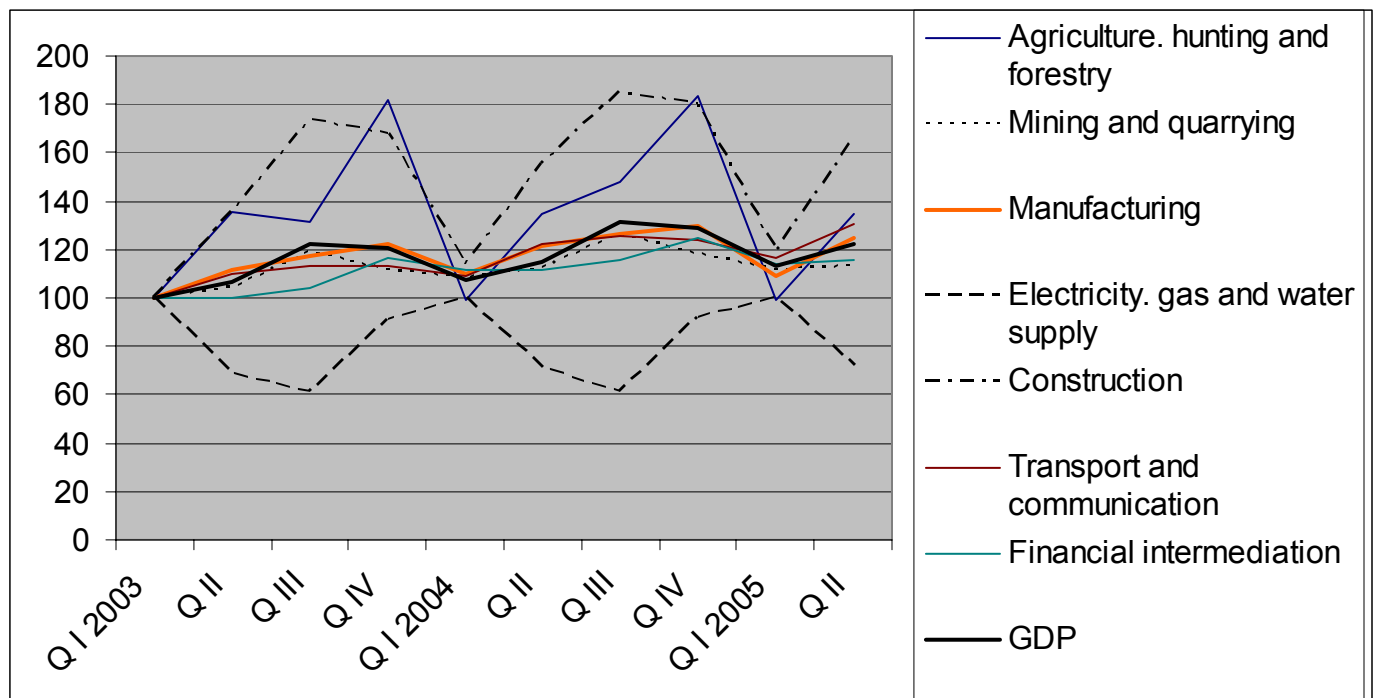


Source: Russian Ministry of Finance

This is even clearer if we look at the evolution of the economy between 1995 and 2004, as shown in figure 2. Data are also measured in constant prices with an index level of 100 in the first quarter of 1995. One sees clearly the break associated to the 1998 crisis. GDP has been on a growing path ever since albeit with seasonal fluctuations. Household consumption has been growing steadily. Government consumption is flat. Investment has also been growing but in an increasingly volatile way. Finally, net exports have been booming after the strong devaluation of the Ruble in 1998 and have been declining since then. They however remained substantially higher at the end of 2004 compared to before the 1998 devaluation.

There is no question that the growth since the crisis has been strongly fueled by the increases in oil prices which have generated a large windfall income for the Russian economy and have had an effect on Russia's trade balance and its fiscal surplus. It would be however wrong to state that the growth in the Russian economy in the last seven years reflects nothing else than the boom in oil prices. There has been a substantial increase in incomes which has generated a strong growth in consumption leading to further growth in income and consumption.

Figure 3. GDP by sector.



Source: Russian Ministry of Finance

An inspection of the dynamics of GDP by sector (again measured in 2003 prices) confirms our diagnostic. The dynamics of GDP growth follows that of manufacturing, transport and communication, mining and quarrying and financial intermediation. Agriculture is very volatile as is electricity, gas and water supply and the construction

sector. Note that the latter has been growing very strongly in the second quarter of 2005, a strong indication if any, that the Russian economy is not in a recession.

To summarize, while the Russian economy has been experiencing some volatility, we do not see tangible signs of a slowdown in the Russian economy. The end of 2005 looks much better than the end of 2004.

3. Is Russia facing a Dutch disease problem ?

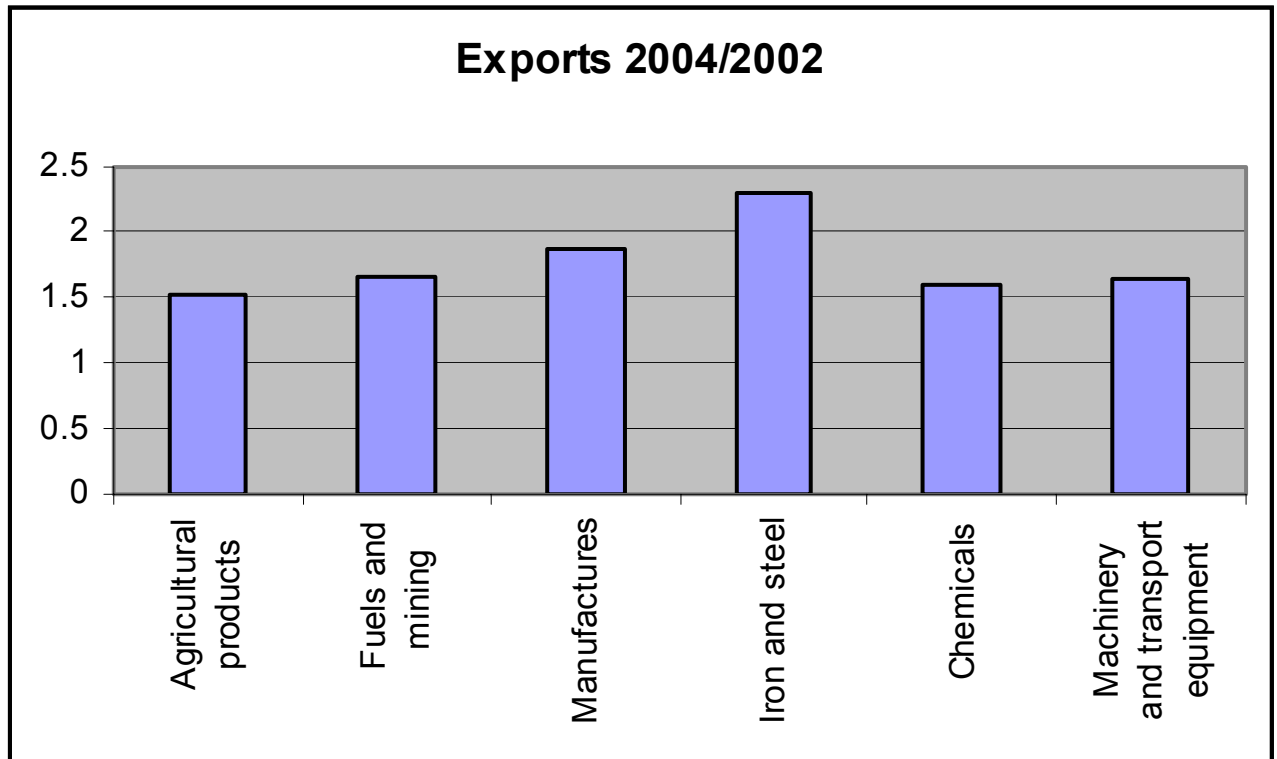
The notion of Dutch disease refers to the experience of the Dutch economy when natural gas was discovered in that country. The export of natural gas led to an appreciation of the Dutch currency which made its other exports less competitive on the world market. Since then, one usually mentions that a country suffers from a Dutch disease when real appreciation due to the export of a natural resource leads to a loss of competitiveness for other exporting sectors (see .e.g Krugman, 1987)

Being endowed with natural resources used to be seen as an economic advantage in the past. It is increasingly seen as a liability and a literature has developed on the “natural resource curse” giving evidence suggestive that the presence of natural resources in an economy enhance rent-seeking activities relative to productive activities and are detrimental to a country’s institutional development which in turn is important for growth (see e.g. Sachs and Warner, 1995). However, natural resources are not a fatality. In the recent past, Norway and the UK for example have strongly benefited from their offshore oil reserves.

Are there signs of a Dutch disease in Russia ? There have been clear signs of real appreciation of the Ruble. The Ruble appreciated by 7.3% in the first nine months of 2005 while wages increased by 8.7% (World Bank 2005). The World Bank also mentions a slowdown of certain categories of exports in 2005, the most important being machines, equipment and transport. However, it is difficult to draw firm conclusions on slowdown of export growth. There is high volatility of export dynamics in particular sectors and a decline after a particularly strong growth is not necessarily an indicator of a serious

slowdown. Figure 4 plots the ratio of 2004 to 2002 exports in major export categories that are relevant for Russia. The data are from the WTO and are measured in US dollars.

Figure 4

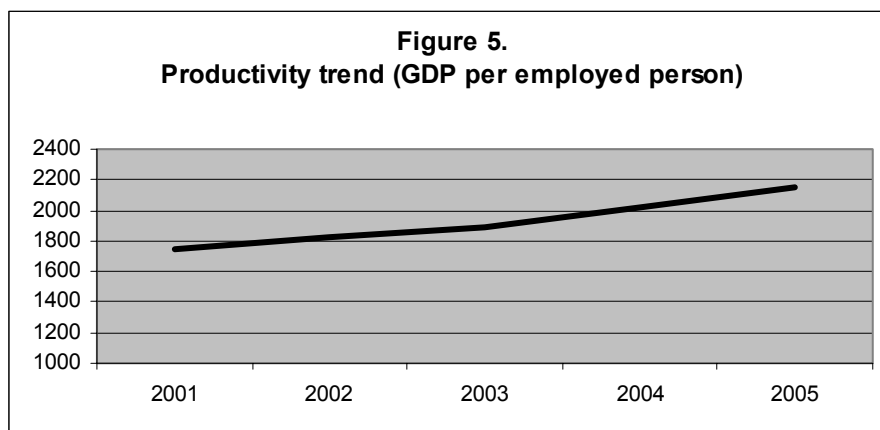


Source: World Trade Organization.

As one can see, exports of all categories have been growing strongly between 2002 and 2004. Despite the increase in oil prices, exports of fuels and mining have not been the largest growing category. Exports of iron and steel and manufactured exports have been growing more strongly than fuels and mining. These export data are clearly not suggestive of Dutch disease symptoms. It thus seems premature to conclude that the Russian economy is experiencing a Dutch disease.

There are various reasons for why it is useful not to exaggerate the danger of a Dutch disease in Russia. First of all, Russia is a very large economy. Exports are only roughly one third of GDP. The effects of an excessive real appreciation are thus less likely to be important than for a small economy like the Netherlands. Second, a real appreciation of the exchange rate is not necessarily a symptom of bad economic health. On the contrary,

real appreciation should be a naturally observed phenomenon in growing economies that are catching up on the more advanced economies. This is usually called the Balassa-Samuelson effect (Balassa, 1964, Samuelson, 1964) and reflects increases in living standards following productivity increases. The Balassa-Samuelson effect works like this. Every economy has a tradable and a non tradable sector. The tradable sector is subject to strong competition on world markets. Suppose that there is a strong productivity growth in the tradable sector. This will generally lead to a corresponding wage growth. However, wage differentials between the tradable and the non-tradable sector will create upward pressure on wages in the latter which will be translated in higher prices since the non-tradable sector is not subject to international competition. As a result, productivity growth in the exporting sector will lead to higher wages in the whole economy and to higher prices in the non tradable sector. This price increase reflects the diffusion of the rents from the productivity gains in the exporting sector to the rest of the economy. This is why a hairdresser in California is richer than a hairdresser in Turkey. Real appreciation associated to the Balassa-Samuelson effect is thus a reflection of an increase in living standards in a growing economy and should not be feared. Nor should it necessarily be fought by too tight monetary policy as it would lead to excessive demand contraction. In the case of the Russian economy, productivity growth has been quite strong in recent years as can be seen in figure 5 which lists annual GDP over the number of employed people. Productivity has been growing on average at over 5% a year since 2000 and it shows no signs of slowing down so far.



Source: Russian Finance Ministry

4. What is the investment climate after Yukos?

Since the expropriation of Yukos, one sees a clear strategy of takeover of the energy sector by the state. This is confirmed by the purchase of Sibneft by Gazprom. This strategy, as well as the whole Yukos case, has generated fears that the government may want to further expropriate private sector firms. There are many other signs of deterioration of the business climate. All observers agree that corruption is increasing in Russia. Bribes to local officials have grown much faster than oil prices, increasing tenfold in some cases (Gurieva, 2005). There has been social unrest surrounding reform plans of social spending. The failure to influence the Ukrainian election outcome was seen as a clear sign of weakness of the Putin presidency. The World Economic Forum's 2005 report has downgraded Russia's competitive ranking from number 70 to number 75 (out of 117 countries). It has been downgraded significantly on many important dimensions: from number 88 to 108 on protection of property rights, from number 84 to 102 on judicial independence, from number 85 to 106 on favoritism in decisions of government officials. However, these data should be taken with a grain of salt and reflect subjective expert judgments.

There are however also signs that point to an improvement of the investment climate in Russia. The unemployment rate has been declining from 8.1% to 7.1% (World Bank, 2005) and there has been a substantial reduction in poverty rates (Gurieva, 2005). Most signals in the economy are good. The fiscal surplus is quite strong and a Stabilization Fund has been established to buffer government revenues from variations in oil prices. Interest rates remain low (around 10%), too low maybe. The government has given explicit assurances of continued commitment to reform and protection of investors. This includes a reduction in the number of years privatization deals can be contested, an amnesty for the repatriation of private capital and improvements in the operation of tax administration to protect private business. Previous reforms are continuing to have positive effects: the tax cuts and introduction of the flat tax, the deregulation of small private enterprises, the land code and other measures introduced since Putin came to power. The improvement of the climate for

small businesses and the expansion of entrepreneurship contribute to the development of a middle class which seems at last to be slowly emerging. Municipality reform entails important positive potential. The creation of new small municipalities endowed with budgetary means contains much potential for the development of civil society and grassroots democracy. It is however much too soon to tell what effects it will have. Interestingly, attitudes towards entrepreneurs and entrepreneurship are changing significantly in a positive direction. According to the results of a survey conducted by the ROMIR Monitoring and the Institute of Public Projects, a dominantly positive attitude towards small and medium-sized business can be found in all social groups: 93.5% of managers, 92.4% of students, 80% of non-qualified workers and unemployed people and even 62% of pensioners approve of businessmen. The attitude towards big businessmen and company owners is not as positive but is mainly positive among all groups except among pensioners (42% approval only). (Novosti, March 3 2005). The desire to start a business is expanding. Most representatives of all social categories, including 39% of pensioners, would like their children to start a business. This cultural shift carries much potential for the future. Finally, if the World Economic Forum is very critical of Russia, its rating has been upgraded by Moody's and Fitch.

While the signals on the investment climate are mixed, in practice it seems that the positive factors are dominating. Foreign direct investment has been increasing and reached 11.9 billion dollars in 2004. This is more than India has received in the same year and roughly one fifth of the foreign direct investment China has received, which is rather impressive given the strength of the Chinese economy. Capital flight has been down significantly in 2005. It reached 12 billion dollars for the first nine months of 2005 compared to 23.3 billion for the same period in 2004, a 50% reduction.

5. What are the long term prospects for the Russian economy?

In the short run, the Russian economy continues to grow at a very healthy pace and nothing indicates this trend is likely to be reversed in the short run. However,

these recent developments should be put into perspective against the longer run prospects for the Russian economy.

The long term picture is less rosy. The Russian economy has been growing strongly for 7 years but this is after more than 7 years of strong decline. The bear is still licking its wounds. The Shleifer-Treisman (2004) diagnosis that Russia is finally a “normal economy” is no consolation for those who deplore that Russia has lost its superpower status and has an income per capita that is slightly below that of Brazil! The institutional base remains very weak and shows no signs of improving drastically in the foreseeable future. Corruption is omnipresent and on the increase. The cuts in education expenditures in the nineties are taking their toll and the deterioration in the quality of human capital will have negative effects in the long run. The radical decline in life expectancy has not been reversed and male life expectancy stands at an all time low of 58.9 years, putting Russia in the same league as Honduras and Tadjikistan. Other demographic trends are not very favorable either. The Russian population is ageing and shrinking. It is supposed to decline by 25 million people in the next 45 years. Low birth rates in the last decades are responsible for this. As a result, the average age is increasing and the working age population is structurally declining. In order to reverse these demographic trends, Russia would have to attract millions of immigrants from Central Asia. This is a huge challenge given the tensions in that region and the rise of Islamic fundamentalism.

Putting all these factors together does not augur well for the long run prospects of the Russian economy. Some of these factors may change for the better but it would take a host of extraordinary coincidences to deliver better prospects for institutions, labor supply, human capital and capital accumulation all together. Russia is not very likely to be one of the most dynamic economies in the twentieth century. By the same token, it is unlikely to recover the world power status it enjoyed in the twentieth century at the time of the Soviet Union.

6. Conclusion.

The Russian economy is continuing to enjoy a healthy growth rate despite the real appreciation of the Ruble and despite the uncertainty created by the crackdown on Yukos and the Khodokorsky trial. While rising oil prices have played an important role in the growth of the Russian economy in the last few years, domestic demand (private consumption and investment) has been quite strong. The diagnosis of a Dutch disease in Russia seems to be premature given the continued health of categories of exports other than oil and gas. The investment climate seems, for now at least, dominantly positive. Capital outflow has declined and foreign direct investment in Russia has increased. In the longer run however, Russia remains a weakened economy facing major uncertainties but with some signs of stabilization and steps in the right direction

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