# Fear of the Future: Russia in the Global Economy in the Next Few Years

Philip Hanson

The Russian economy, though so far in better shape than Europe, is facing the possibility of very slow growth in the near future. Its tendency to volatility was demonstrated in 2008-09, when Russian GDP fell more than that of any other large country. Looking at that experience and at current concerns, it seems that Russia has both demand-side (slow world growth, uncertain future oil prices) and supply-side (falling labour force) problems. The continuing failure to provide secure property rights for business probably compounds these difficulties.

***Keywords:*** Russia, oil, demography, rule of law

The Russian economy seems to be faltering in the face of renewed doubts about global prospects. If the recent past is any guide, there are reasons to be concerned. This is the case even though Russia is still experiencing growth at a rate that Europeans can only dream of.

Russia was hit hard by the global crisis of 2008 and 2009. Between those two years, its GDP fell by 7.8 percent. This was the steepest decline experienced by any G-20 nation. Other so-called 'BRIC' countries experienced a slowdown rather than a decline. Other oil exporters, with the exception of Kuwait, suffered far less than Russia. The depth of Russia's dip suggests an unusual sensitivity to outside events.

This article offers an assessment of Russia's medium-term prospects and of its sensitivity to external difficulties.

The questions to be addressed are whether the Russian economy is performing as an emerging economy is expected to do – growing faster than the world as a whole while transforming its economic structure; what the supply-side constraints on its growth currently are, and how far its performance is constrained on the demand side by patchy global recovery from a 'balance sheet recession', and especially by Russia's close ties with Europe.

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The aim is to review both demand-side and supply-side constraints on growth. On the demand side, a look will be taken at the sources of uncertainty, especially with respect to export demand and the degree of confidence in business-state relations. On the supply side, the sources of growth will be considered, drawing to some extent on recent work by Kuboniwa, but employing the approach loosely and in orders of magnitude only.

The article begins with a brief section on the background of Russia's apparent hyper-sensitivity to global recession in 2008-09. Next it will address the questions just listed, and then draw some conclusions – political as well as economic.

## The background: Russia in the crisis of 2008-09

The Russian authorities were in some respects well prepared for the global financial crisis. Their external sovereign debt was minimal: about 2 percent of GDP. They had a budget surplus in 2008 and a stabilisation fund in excess of 10 percent of GDP.[1] These defences eased the country's adaptation to the global crisis. There was a total fiscal swing from the 2008 surplus to the 2009 deficit of 10 percent of GDP (considering only the federal budget). Within that 10 percent change the authorities provided a discretionary fiscal stimulus of about 3 percent of GDP.[2] Yet the country came out of the immediate crisis still carrying only minuscule public debt. This was made possible by the drawing-down of the Reserve Fund.

The events of 2008-09 suggested that Russia, though capable of rebounding, was unusually sensitive to external developments. Table 1 puts the Russian downturn in international perspective.

This was a crisis whose chief focus was on the developed world. Most emerging economies and most oil exporters, though affected, suffered less.[3] Russia's sharp fall in output cannot be accounted for simply by its being an oil exporter: there was no such marked and general deterioration across oil-exporting nations.

So what else was going on? In the next four paragraphs a conjecture will be offered that fits the known facts and may provide some guidance to the future, but which remains no more than a conjecture.

We start with a little-discussed and usually small number: the amount invested in inventories, or stocks of goods. One striking feature of the Russian downturn of 2009 was the exceptional role played in it by a steep fall in inventories.

[1]Data from Central Bank of Russia (http://www.cbr.ru) and Bank of Finland (http://www.suomenpankki.fi/).

[2]'Discretionary' here means deliberately adopted as a matter of policy; not happening simply as an 'automatic stabiliser' effect of the reduction in revenue and increase in spending, e.g., on unemployment benefit, that is generated by recession. As discretionary stimulus packages go, the Russian one was large. It has been criticised for propping up politically favoured businesses that did not have longer-term viability. Whatever the truth of that criticism, the point here is that it was managed without lasting fiscal damage.

[3]The picture among oil exporters was admittedly quite diverse. The GDP of the United Arab Emirates fell by 4.8 percent, while Iran grew by 4 percent and Qatar by 12 percent. Kuwait's GDP is recorded as falling by exactly the same percentage as Russia's: 7.8. Source as for Table 1.

**Table 1.** Change year-on-year in GDP in 2009: world, select regions and select large countries (%)

| | |
|---|---|
| World | -2.2 |
| G-8 excluding Russia | -3.8 |
| Middle East & North Africa | 2.6 |
| Russia | -7.8 |
| Brazil | -0.3 |
| China | 9.2 |
| India | 5.9 |
| Kazakhstan | 1.2 |

*Source*: IMF World Economic Outlook database of October 2012.

Year-to-year changes in inventories, in most countries in most years, contribute only marginally to the annual change in GDP; they are a minor component of gross investment, the predominant part of which is gross fixed investment. In Russia in 2009, the year-on-year (yoy) cut in inventories contributed -4.7 percentage points to the net change in real GDP – the largest single component of that change. This number is no longer accessible on the Rosstat website, but the available current-price series shows the value of annual inventory change as +3.2 percent of GDP in 2008 and -3.0 percent in 2009.[4] Evidently the fall in the value of oil inventories played a part in this, but the importance of this should not be exaggerated: nevertheless, there is no similar phenomenon to be observed across other oil-exporting nations.

One possible explanation is that Russian big business, alarmed by the falling oil price, moved funds out of Russia so rapidly that they cut into working capital to the point of decimating stocks of goods. This explanation was suggested at the time by Nikita Krichevskii. He used the published accounts of a number of large companies to provide support – albeit only illustrative – for this interpretation.[5]

Two circumstances are relevant here. First, most large private Russian companies are closely held through offshore holding companies. Second, many of the managers of state-run companies have their own offshore holdings, into which they siphon funds from state companies. Thus there are financial channels that make such a movement of funds possible.

Why panic in this way? Perhaps because of insecure property rights in Russia and the influence, in an emergency, of particular uncertainty about what the state might do. There is no guarantee that such alarms would necessarily be repeated

[4]As reported by Rosstat at the time. See current-price GDP by end-use data at http://www.gks.ru/free_doc/new_site/vvp/tab24.xls. For more discussion, see O. Kuvshinova, "Spad pro zapas", *Vedomosti*, 2 October 2009; and Hanson, "Russia: Crisis, Exit and…Reform", 458-9.

[5]N. Krichevskii, "Postpikalevskaya Rossiya: novaya politiko-ekonomicheskaya real'nost'", August 2009, http://www.krichevsky.ru (last accessed 27 March 2013), summarized in an article by V. Inozemtsev and N. Krichevskii, "Postpikalevskaya Rossiya: razoblachenie oligarkhov", *Izvestiya*, 21 August 2009.

in similar circumstances. Still, if confidence in property rights has not been strengthened more recently, one might expect a repeat performance.

The sequence of events just posited is, to repeat, only a matter of conjecture. It may be, as some have suggested, that the extraordinary fall in inventories reflected merely the lack of Russian business experience in efficient stock management. But the scenario suggested here provides a possible clue to what is happening now.

## Recent performance and medium-term prospects

Russia's economic recovery began in late 2009 and has been more clearly established than that of the developed West or Japan. On the other hand, there has been no return to the GDP growth of the boom years. That averaged 7 percent from 1999 through 2007. Post-2009 growth has been around 4 percent per annum with a very recent tendency to slow down further, as Table 2 illustrates.

Year-on-year changes in the volume of retail sales are shown alongside changes in GDP. Household consumption has been the main driver of Russian growth on the demand side in the 21st century. In most of those thirteen years (counting the year 2000), oil prices have risen, strengthening Russia's terms of trade. In other words, for much of this time the purchasing power of a barrel of Russian oil was rising. This allowed aggregate real domestic spending to grow faster than GDP. The largest component of that spending was household consumption. Figure 1 illustrates the consistent excess of consumption growth over GDP growth. This was sustainable, other things being equal, so long as the real oil price (the price of oil relative to everything else) continued to rise.

Imports tended to grow faster in volume than exports, but the (mostly) rising price of oil allowed Russia to maintain a positive balance of trade and a positive balance of payments on current account. With the Central Bank of Russia (CBR) operating to keep the nominal rouble exchange rates against the US dollar and the euro stable,

**Table 2.** Russia: GDP and retail sales growth, 2009-13, % year-on-year.

| | GDP | Retail sales |
|---|---|---|
| 2009 | -7.8 | -5.1 |
| 2010 | 4.3 | 6.4 |
| 2011 | 4.3 | 7 |
| 2012 | 3.4 | 5.9 |
| 2012-I | 4.9 | 7.6 |
| 2012-II | 4 | 7 |
| 2012-III | 2.9 | 4.8 |
| 2012-IV | 2.3 | 4.5 |
| 2013 Jan | | 4.2 |
| Feb | | 3.0 |
| March | | 4.4 |

*Source:* Rosstat (www.gks.ru)

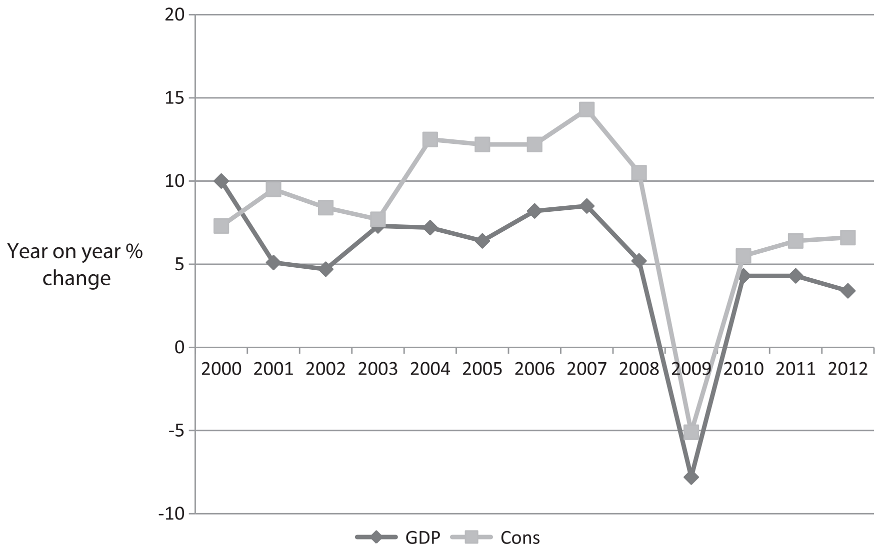


FIGURE 1. Russia: consumption outpacing GDP, 2000-12 (% annual changes)
*Source:* Rosstat.

while inflation in Russia was above US and Eurozone levels, the real effective exchange rate of the rouble tended to strengthen, augmenting domestic purchasing power over imports. All of this has contributed to a buoyant growth of retail sales.

There are two salient features that Table 2 illustrates: post-crisis growth has been significantly slower than that of the pre-crisis boom years, and this post-crisis growth has itself been slowing down. The reasons for the first of these developments will be discussed in the next section. For the moment, the longer-term slowdown is taken as given, and the focus is on the most recent signs of further deceleration.

In the second half of 2012, Russian GDP growth slowed to well below 4 percent per annum. This slowdown extended into early 2013 and has been accompanied by a deterioration in several leading indicators: for example, rail freight loadings and car sales. Meanwhile President Vladimir Putin has been calling on his government team to come up with policies that would push the trend rate of growth to 5-6 percent per annum. They have until the autumn to do this, but few onlookers expect success in this exercise. To complicate matters, there is open disagreement within the leadership over major policies such as pension reform and privatisation.[6]

[6]For example, K. Dokukina and O. Gavshina, "Dvorkovich prizyvaet ne slushat' Sechina", *Vedomosti*, 24 August 2012 (on the privatisation of the energy sector); J. Rogoza, "Disputes within the Russian Ruling Elite are Gathering Force", http://www.osw.waw.pl/en/publikasje/osw-commentary/2012-09-27.

Leading indicators are not encouraging. Sales of cars and light commercial vehicles were up last year as a whole, compared with 2011, but the December figure was at about the same level as December 2011. Car sales bounced back in January 2013 but were only 2 percent up yoy in February. Over the year as a whole, they were not expected to grow significantly. Rail freight loadings (in tons) were up by a modest 2.4 percent in the year as a whole, but down by 3.7 percent yoy in December. In January the slide in rail freight continued: down 7.3 percent in 'turnover' (ton-kilometres). With industrial-sector growth slipping (yoy) from 4.0 percent in the first quarter to 1.7 percent in the fourth and then going negative in January this year, the deterioration in freight transport indicators looks understandable. Spending on fixed investment grew by only 1.1 percent yoy in January, while machine-building output (excluding cars) fell.[7]

Why has this deterioration occurred? The oil price usually explains a great deal, but it did not alter significantly. Nor did the exchange rate.

The Gaidar Institute's industrial surveys, however, report a sharp deterioration in business confidence in late 2012.[8] Manufacturers' sales were tending to fall, as both consumer demand and investment slowed. Investment was perhaps dampened by worries over political instability or an impending 'second wave' of global recession, or both; the net outflow of private capital rose in the fourth quarter.[9] One possibility is that inflation is eroding the competitiveness of domestic producers against imports – which rose strongly in 2012. The consumer price index rose 6.6 percent in 2012, and has not slowed in early 2013, though it may do so later.

One possible influence is increased political uncertainty. There was a surge of unrest in late 2011 and early 2012. It was set off initially by the announcement that Putin would be returning to the presidency, swapping jobs with Dmitry Medvedev. This manoeuvre was not necessarily unwelcome or unexpected, but the leaders made the mistake of presenting it as a *fait accompli*, about which no prior public consultation was deemed appropriate.

The 'management' of results in the elections that followed, especially in the parliamentary elections of December 2011, further soured the mood of many. The authorities seemed to re-establish control later in 2012, numbers of public protesters fell away, and no serious rival to Putin is on the horizon. However, Putin's leadership no longer seems as inevitable as it used to, and his personal popularity, though still high, has tended to decline.

There is also the question of credit terms. Tightening consumer credit will be an additional adverse influence this year. Retail credit growth, partly on credit cards, was of the order of 39 percent in 2012. Concerns were being expressed about this

[7] New car and light goods vehicle sales reported in *Vedomosti*, 11 March 2013; rail data from Rosstat and from Russian Railways (http://www.rzd.ru).

[8] http://www.iep.ru/en/rossiiskaya-promyshlennost-v-yanvare-2013-g.html.

[9] http://cbr.ru/statistics/print.aspx?file=credit_statistics/capital_new.htm&pid=svs&sid=itm_18710.

towards the end of 2012, but most of the tightening has been rather late in 2012 and in 2013. The Central Bank of Russia has been raising reserve requirements; the rapid rise of unsecured retail loans in 2012 will force banks to be more cautious in future in order to maintain asset quality. Sberbank in early February (2013) raised the rates of interest it charges on consumer loans by 3-5 percent. The CBR expects consumer lending in 2013 to slow – not to a halt, by any means, but to 25-30 percent, a marked deceleration.[10]

All in all, there is more uncertainty around than there was as recently as mid-2011. Whatever the exact reasons for it, the drop in business confidence seems to be crucial to the new slowdown.

Even if the late-2012 slump in growth gets no worse during 2013, the medium-term prospects are modest. That is to say, they are modest by comparison either with the pre-crisis boom or with Putin's stated aim of 5-6 percent annual growth in GDP. The Russian economy is not expected to perform in the manner that has come to be associated with large emerging economies. In particular, it is not expected to grow faster than global output over the next two-three years.

True, Russia's projected growth is, predictably, above that of the euro area. But so is growth for most of the world. An emerging economy might be expected to be emerging more clearly than this. Russia, it has to be said, is not alone among large 'emerging' economies in this. Of the original so-called BRIC countries, Brazil's projected growth over this period is also close to the global average. Only China and India, the two poorer members of the quartet, are fancied to perform substantially better than this in the next few years.[11]

Recent projections are cautious. The Bank of Finland Institute for Transition (BOFIT) projects 3.4 percent annual GDP growth for Russia in both 2013 and 2014 and 3.0 percent in 2015, while the World Bank projects 3.3 percent for 2013 and Alfa Bank 2.8 percent.[12] In April, Russia's Ministry of Economic Development revised its projection for GDP in 2013 down to 2.4 percent, and the minister warned of the possibility of recession.[13]

The immediate short-term prospects, however, are less important than those for the medium term: five years or so. Here both supply-side and demand-side constraints on Russian growth play a part. They will be reviewed in the next two sections.

[10]East Office of Finnish Industries, *Quarterly Review*, 8 March 2013, 15.

[11]The projections here are in constant domestic currency prices. The original Goldman Sachs contention about the BRICs (their acronym) was that in dollar terms at current exchange rates, the weight of the four countries in the global economy would be likely to grow substantially in the long term, in part because their currencies would strengthen. This argument is not undermined by modest real-term growth for some of them. Nor does the observation that Russia and Brazil are slowing down at present necessarily support the controversial hypothesis of a 'middle income trap' for emerging economies.

[12]*BOFIT Weekly*, 15 March 2013; World Bank as reported by O. Kuvshinova in *Vedomosti*, 26 February 2013; Alfa Bank, *Russia Economic Monitor*, 4 March 2013.

[13]O. Kuvshinova and M. Tovkaylo, "Minekonomrazvitiya pugaet retsessiei", *Vedomosti*, 15 April 2013.

**Labour shortages, capacity shortages and the need to change the business environment**

On the supply side, the reasons for slower growth after 2009 are not hard to find. To begin with, there is a labour shortage and, worse still, a shrinking workforce – influences which did not apply during the pre-crisis boom. And the effects of a changing demographic situation are compounded by the tightening of credit globally that has followed a 'balance-sheet recession': in other words, foreign lenders, having over-extended credit in the run-up to the 2008-09 crisis, are still trying to reduce their exposure to most would-be borrowers.

This credit constraint is not a problem for the Russian state; as noted above, the Russian government and central bank have very little debt to begin with and would qualify as sound credit risks, at least for moderate increases in borrowing, as and when they seek to borrow. But for Russian banks and companies, including state-controlled companies, foreign borrowing has been a major source of finance. Long-term finance is difficult to find from domestic sources in Russia; foreign lenders have shied away from riskier markets, and many (not all) Russian companies have lost the easy access to finance that they enjoyed before mid-2008.

The problem of a declining workforce has only just begun to make itself felt. It was common knowledge that Russia's total population was declining until recently (it has plateaued in the past couple of years), but the age structure of the population was such that this was compatible with a slowly growing population of working age (up to 55 for women and 60 for men, but many pensioners work).

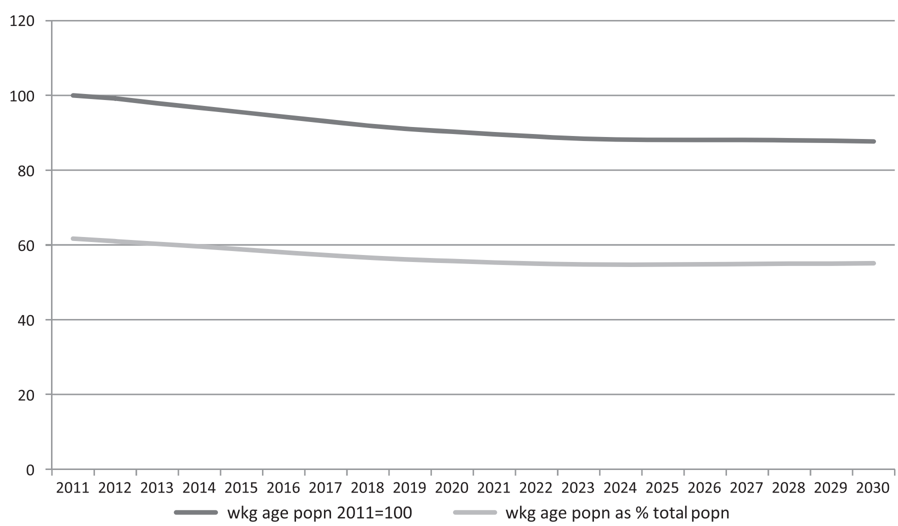


Figure 2. Russia 2011-30: projected working-age population (2011-100) and working-age population as a share of total population (%).
*Source*: Rosstat. This is the medium variant projection of three; it includes projected net immigration.

Figure 2 illustrates the demographic problem. In the period up to 2020 the decline is about 1 percent per annum. The number of young entrants to the labour force falls precipitously, and is only partly offset by net immigration.

It does not follow that the economically active population (those employed or seeking employment) will necessarily fall *pari passu* with the population of working age, but the effective workforce is almost certainly going to fall over the next few years by at least 0.5 percent per annum. Acute labour shortages are already being experienced. In December 2012, the unemployment rate was at a post-Soviet low of 5.3 percent. Labour shortages in general and skill shortages in particular are especially severe in precisely the most prosperous and economically dynamic regions. In other words, a good deal of what unemployment there is, is in the wrong places.

Net immigration, it should be stressed, is included within the projection of working-age population in Figure 2. Immigration into Russia is predominantly from other CIS countries; some of it is illegal; much of it is low-skilled. As skill shortages worsen, this immigration provides at best a partial easing of the labour market. Moreover, immigrants, whether legal or illegal, from the Transcaucasus and Central Asia are unpopular with many nationalistically-inclined Russians, so they represent a political problem.

What does this, together with the changed international lending environment, mean for Russia's economic growth prospects in the medium term? In considering this, doubts about global demand and oil prices must be put to one side to focus simply on what constraints there may be on Russian productive capacity.

If labour inputs are going down over time and there is little or no margin of unemployment to be drawn upon, what can maintain or increase output? Increases in capital, major natural resource discoveries and increases in productivity just about exhaust the options. Productivity could be boosted by a more efficient allocation of resources between different lines of production or by the introduction of improved technologies or skills, or some combination of these. In Russia during the pre-crisis boom, the employed workforce was growing by about 1 percent per annum, the capital stock by 3 percent per annum and overall productivity by several percentage points – the last of these due in part to the shift of labour and capital from less to more productive lines of business.[14]

To preserve the earlier rate of growth in the face of a declining labour force, Russia would need to do one or more of the following: raise the rate of investment so as to increase the growth rate of the capital stock; accelerate the rate of structural change in the economy; accelerate the application of more advanced skills and technologies; or make major new natural resource discoveries. None of these look likely.

[14]For an extended, technical analysis, see Kuboniwa, "Russian Growth", 39-53.

Investment in fixed assets has been around 20-22 percent of GDP for some time. That is a modest level for an emerging economy. It is probably constrained by the lack of secure property rights and the associated uncertainty about what a predatory state might do to one's investment. Fundamental reform is probably a prerequisite for more rapid growth of investment and therefore of capital stock, unless the state itself steps in and does the investing. That would not be a promising option in most countries, and certainly not in Russia, where public projects mostly turn out to be grandiose schemes for looting.

More rapid structural change and more rapid application of new skills are impeded by the drop in the numbers of young labour force entrants. The young are, after all, the most mobile component of the workforce and the best able to learn new skills.

As new oil and gas extraction, replacing depleted fields, shifts into the Arctic shelf and East Siberia, there certainly should be new natural resource developments. But they will be more costly than the older fields. Thus, Russia faces a reduction in its hydrocarbon rents.[15] Together with the partial drying-up of foreign credit, this limits the possibilities of improvement through a higher tempo of investment, even if the business environment improves somewhat.

Really radical reforms might open the way back to faster growth nonetheless, but they will not come about rapidly or painlessly. The question of reform will be taken up again in the concluding section.

## Demand-side constraints on Russian growth: the state of the global economy

Russia's sensitivity to movements in the global economy is at least partly due to the product- and partner-composition of its exports. It is, to begin with, a commodity exporter. Oil, gas and oil products have accounted in recent years for three-fifths to two-thirds of its merchandise exports. If metals and timber are added, the share of commodities rises to around four-fifths. It is only fair to add that oil products and most metal products count as manufactures. However, the degree of export processing in Russia is for the most part light. Notoriously, both traded volumes and prices of commodities fluctuate quite widely as the world, or some large part of it, moves through boom and recession.

Russia duly benefitted in the boom years up to 2008, and suffered in 2008-09, even if (see above) the scale of the downturn calls for some further explanation beyond the volatility of commodity trade. Since early 2009, oil prices have moved back up. At the time of writing they are close to USD100 per barrel. But they have not resumed the persistent growth of earlier years. Shale and other unconventional oil developments have created uncertainty about future price levels. So has the faltering recovery of the developed world.

[15]Gustafson, "Putin's Petroleum Problem".

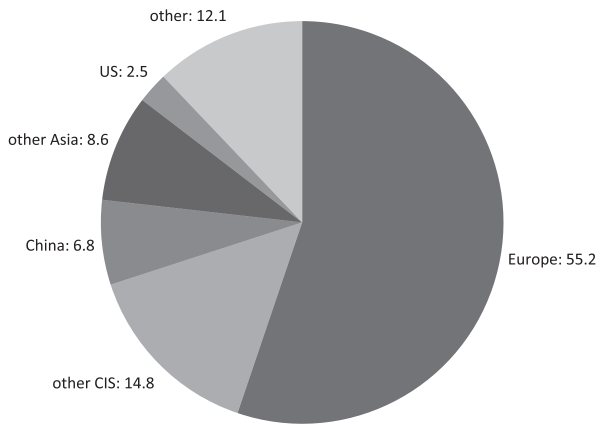


FIGURE 3. Russia's merchandise exports, 2012, by destination (%).
*Source*: Russian Customs Service (http://www.customs.ru).
*Note*: 'Europe' here is the European Union plus Switzerland and Norway. 'Other Asia' includes Japan but not Australia or New Zealand.

Gas markets have been unsettled by the development of shale gas in North America and the prospects of further shale development, perhaps, in some other places. Gazprom, with its monopoly of Russia's gas exports, has had to make concessions on price to its major European customers, partly because of the much lower price at which liquefied natural gas (LNG) has become available in Europe in the wake of shale gas. Metals markets have also been weak. Most Russian companies are in some difficulties. UC Rusal, the world's largest producer of aluminium, is at the time of writing cutting its worldwide capacity by 300,000 tons a year.[16]

The partner-composition of Russian trade presents a challenge of a different kind: not so much volatility as sluggish long-term growth. That is because well over half of Russian exports go to Europe. Figure 3 illustrates the problem.

The figure shows how important geography is. More than 80 percent of Russian economic activity is in the European part of Russia, plus West Siberia. The gravitational pull of Europe, with its huge economy and relatively modest distance from Moscow, is very strong indeed. In 2011, total merchandise exports amounted to 28 percent of Russian GDP,[17] so exports to Europe have lately been in the order of 15 percent of GDP. With Europe set to grow more slowly than the rest of the world, Russia is saddled, at least for the time being, with a main trade partner that is at best sluggish and whose future development is more uncertain than that of most other parts of the world.

[16]V. Petlevoi, "UC Rusal priostanovila vypusk alyuminii na zavode Alscon v Nigerii", *Vedomosti*, 15 March 2013.

[17]BOFIT statistics (http://www.suomenpankki.fi/). If net exports (exports less imports) are considered as one of the end-uses of Russian GDP, then net exports to Europe contribute about 7 percent to total demand for Russian output.

In time, and in principle, Russia's reliance on commodity exports and on the sluggish European market could be reduced. But how much time would such changes take? The diversification of Russia's economy and exports has not happened yet, even though it has been a declared policy objective for several years. Economic ties to Europe, moreover, go far beyond merchandise trade. The EU provides almost half of Russian imports of services and dominates both inward and outward foreign direct investment in Russia.[18] There is likely to be some tilting of Russian economic links towards Asia, as the Asian economies outpace Europe, but any very large change requires massive, long-term investments in the development of East Siberia and the Russian Far East. These will not happen overnight. The geographical pattern of Russia's external economic linkages is unlikely to be radically different even in 2020.

China's share of Russian merchandise trade has increased and is likely to increase further, but it will nonetheless be constrained over the next few years by the large and long-term investment required in the development of Eastern Siberia and the export pipelines going eastwards that would be needed to support further strong growth of Russian exports to China.

Will Russia's accession to the World Trade Organisation (WTO) contribute to export-driven growth? In the very long run, WTO accession may help in the liberalisation and further international integration of the Russian economy. For WTO accession to be a strong positive factor, however, there needs to be complementary domestic liberalisation. So far that does not seem to be forthcoming, at any rate not in the near term.[19]

## Reasons for heightened business uncertainty

Altogether, Russian businesses face uncertainty wherever they look. This is true not only for the private sector but for state-controlled firms like Rosneft and Gazprom as well, despite the measure of extra security they enjoy. Uncertainty is, to repeat a banal truth, an ineradicable fact of economic life at all times and in all places, but it is hard to avoid the conclusion that it looms unusually large at present in the world as a whole and in Russia in particular.

[18] These statements are based on Central Bank of Russia figures for part of 2012. The fact that much of the flow of foreign direct investment, in and out of Russia, consists of Russian funds 'round tripping' through tax havens such as Cyprus does not weaken the argument: the European ties of Russian business are none the less strong for resting in part on tax avoidance and money-laundering.

[19] Connolly and Hanson, "Russia's Accession to the World Trade Organization", 479-501. Russia's Audit Chamber has given a harsh verdict on lack of progress in the first six months of WTO membership, "Ot redaktsii: Rossiya tormozit vnutri VTO", *Vedomosti*, 16 April 2013.

[20] Perhaps since 2005-06, when the business world began to recover some confidence in its own understanding of the country's unwritten rules, following the arrest of Mikhail Khodorkovskii and the state's expropriation of the Yukos oil company.

For Russian decision-makers there is special uncertainty about future prices for oil and gas, about the health of their main trading partner, about future costs of oil and gas extraction, and about the capacity of their own economy to maintain even a 4 percent rate of growth. Behind those uncertainties, there is probably now less confidence in the future rules of the Russian economic game than there has been for half a dozen years or so.[20]

Street protests may have died down since early 2012, but the sense remains that Putin is no longer invulnerable. The official campaign against corruption, if that is what it is, may be mainly for show or mainly the product of clan warfare within the establishment. Either way, it disturbs the peace and threatens the stability of patron-client relations. The public squabbles among policymakers over pension reform, privatisation and who is to control the energy sector do not encourage a belief in the stability of the political or the economic order.

Add to this the possibility of a collapse of the euro, triggering a steep and possibly prolonged fall in the oil price and collateral damage to the Russian budget, and it is not surprising that the mood of Russian businesspeople is subdued. There is much talk of a brain drain or an entrepreneurial drain, but the evidence for this is only anecdotal: many people leave Russia to work, study or simply live abroad, but few count officially as emigrating, so they do not show up in Russian migration statistics. Indeed, many, perhaps most, will return.

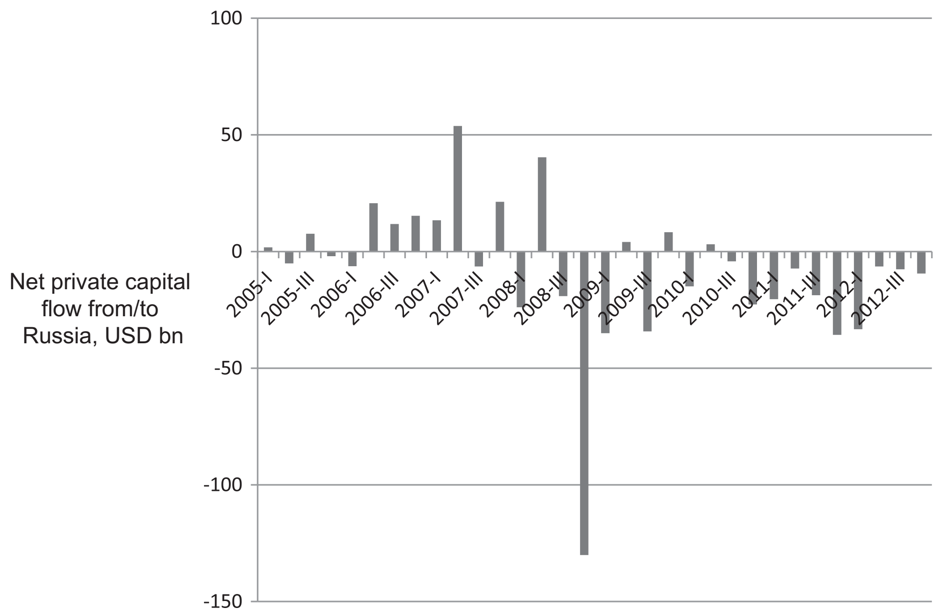


FIGURE 4. Net private capital flows in and out of Russia, quarterly, 2005-12 (USD bn).
*Source*: Central Bank of Russia (http://www.cbr.ru).

One indicator for which we have reasonably reliable numbers is the net outflow of private capital from Russia. Figure 4 shows the quarterly net flows, sometimes in but mostly out, since the beginning of 2005. Note the massive net outflow in the fourth quarter of 2008.

The Central Bank of Russia compiles this series from balance of payments data. The net flow of private capital is the sum of the changes in banks' and other private entities' foreign assets and liabilities in a given period plus the 'net errors and omissions' items. The latter is, for Russia, a persistently large and negative item. Together with the balance-of-payments item 'dubious operations' this contains what might best be described as the movement of funds by stealth. The reasons for stealth are presumably tax evasion (not legal avoidance) and the laundering of profits from illegal activities. Other elements in the gross outflow of private capital are presumably legal.

In other words, it would be misleading to call all outflows 'capital flight'. After all, capital convertibility was introduced in mid-2006. For all the recent official talk of the need for 'de-offshore-isation' of the Russian economy, investing abroad and putting money in foreign bank accounts remain perfectly legal.[21]

Russia has had a net outflow of private capital in almost every year of its post-communist existence. The exceptions were 2005, when flows in and out very nearly balanced, and 2006 and 2007, when there were net inflows. The recent net outflows, therefore, are not a novelty.

Nor are they necessarily a sign of poor economic health. It is common for countries with large natural resource exports to accumulate savings in good years beyond what can manageably be invested at home. If the state captures much of this windfall revenue, places it in a sovereign wealth fund and invests that fund abroad (which is considered good practice), that will show up as an outflow of capital. If the private sector does something similar it does not have to mean that the country is heading for trouble.

However, the repeated assertions by senior officials that this recent outflow is about to be halted and go into reverse are at least an indication of concern. This is as much a matter of the prevailing mood music, it is suggested here, as anything else. The most recent slowdown reflects apprehension on the part of the business community, aroused by both domestic and international uncertainties. The continuation of a net outflow of private capital reflects this, too.

[21]There is currently a great deal of confusion about restrictions being placed by law on the holding of foreign assets by officials and parliamentary deputies. At the time of writing, it seems that only the ownership of foreign real estate is at issue. It is not clear whether the legislation will be systematically implemented or will be used only to target particular individuals selected for other reasons. The impetus behind populist measures of this sort comes from the widespread belief that the ownership of foreign property must be the outcome of nefarious activities. Sometimes it may not have been.

## Conclusions

The dimming of Russia's medium-term growth prospects – say, up to about 2020 – is the result chiefly of domestic factors: especially demographic changes. To these, one must add the international pressure to reduce outstanding debt: 'deleveraging', accompanied by a 'flight from risk'. In this environment, some Russian firms have been able to raise foreign loans and make successful initial public share offers on foreign markets, but not on the scale of the boom years before 2008.

The more recent Russian slowdown, noticeable since mid-2012, seems to be the product of both domestic and foreign influences. Here the uncertain state of the global economy, and especially of Europe, looms large. Domestic factors, however, are also at play: the political order looks just a shade less stable than it did in mid-2011. In Russia, even more than in most other countries, that translates directly into economic uncertainty.

The argument of Russian liberals, such as the former finance minister, Aleksei Kudrin, is that Russia is now paying the price of not radically reforming.[22] In the boom years, Russia had growing employment, rising demand for its staple exports and some easy catching-up to do, in the form of shifting the structure of the economy towards previously grossly neglected activities, and importing plenty of advanced equipment.

Now conditions are different and underlying weaknesses show up more clearly. Above all, in the liberal view, the key problem is distrust between the business world and a predatory state. Competition is restricted and long-term investment is discouraged. The establishment of independent courts and a rule of law, reining in corrupt officials and undermining crony linkages that make life easy for some incumbent firms would, the argument goes, greatly strengthen competition, innovation and investment. That in turn would accelerate growth.

The liberal view is persuasive, but such reforms will not come soon or easily. Several key facts about the Russian economy are encouraging, nonetheless. Public debt is minimal. The reserve fund would probably suffice to prop up government spending through as much as two years of oil prices below USD80 a barrel. Russian banks and companies have less short-term debt than they had in 2008.

The present economic discontent in Russia arises above all from uncertainty. That does not make it any the less real. But if growth continues, even at around 3.5 percent a year, the leadership can quite reasonably point out that Russia, unlike in 2008-09, is doing better than the developed world, and it can perhaps maintain its somewhat damaged credibility at home.

If, on the other hand, Russian growth were to grind to a halt while even the euro area was managing to scrape by without disaster, the Putinist political and

[22] "Kudrin: Nyneshnyy spad rossiiskoi ekonomiki – rezul'tat otlozhennykh reform", *Vedomosti*, 15 April 2013.

economic order would be at risk. This is not likely, but the lack of a popularly acceptable alternative makes it a worrying prospect.

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