77th East Jour Fixe: Russia – economic turmoil and policy options

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The 77th East Jour Fixe organized by the OeNB on May 29, 2015, focused on a highly topical issue: the economic crisis that struck Russia due to geopolitical tensions (Crimea, Eastern Ukraine), subsequent Western sanctions (mostly from mid-2014) as well as the plunge of the oil price (in late 2014, even if followed by a slight recovery in the first half of 2015). Given the many aspects covered by this crisis and by the authorities' crisis-response measures – fiscal, monetary and exchange rate policies, banking sector and structural measures as well as trade and financial diversification efforts –, the East Jour Fixe not only delivered a number of interesting findings but also gave rise to new questions.

In her welcome address and introductory statement, *Doris Ritzberger-Grünwald,* Director of the OeNB's Economic Analysis and Research Department, pointed out that Russia, in the years prior to 2014, had boasted some impressive macroeconomic achievements but that the country at the same time remained saddled with a chronically weak investment climate, pervasive corruption, and other structural shortcomings. Russia is moreover often seen as a "Dutch disease patient," whose manufacturing sector has lost competitiveness and substance on account of the overwhelming economic impact of resource extraction. In this ambiguous situation, which had already set off a considerable slowdown in economic momentum in mid-2013, the country experienced a double shock – namely from the sanctions and oil price slump, which pushed it into recession in 2015. However, continued Ritzberger-Grünwald, so far the recession has been somewhat milder than expected, which also appears to be attributable to the authorities' multifold policy reaction, including the introduction of exchange rate flexibility, the tightening of monetary policy, bank recapitalizations, and limited fiscal loosening. Still, clear downside risks prevail, relating to possible new oil price declines and a possible flare-up of geopolitical tensions in Eastern Ukraine.

The keynote speaker, Professor *Jacques Sapir,* Director of the Paris-based Centre d'Études des Modes d'Industrialisation (CEMI) of the École des Hautes Études en Sciences Sociales (EHESS), delivered his address on "Russia in troubled times." In his view, Russian monetary policy has recently de facto switched from inflation targeting – still the official guideline – to a greater orientation toward the real exchange rate and to combating recession. The general policy thrust has been evolving over time from a liberal direction to a stronger industrial policy aim, which is by no means unfamiliar to Russian historical experience. In other words, the manufacturing industry is to be supported by an undervalued exchange rate. The economy's (partial) eastward reorientation had already started several years before the Ukrainian conflict, not least because the Russian authorities had understood that the euro area was set to face a protracted crisis. Thus, the Customs Union of Belarus, Kazakhstan and Russia had already been established in 2010, and was subsequently transformed, enlarged and renamed into Eurasian Economic Union (EAEU) in 2015. Also, the BRICS group of nations (comprising Brazil, Russia, India, China and South Africa) was founded in 2010 (South Africa joined in 2011); BRICS aims at the emancipation of emerging markets from international

[1] *The 77th East Jour Fixe was co-organized by Stephan Barisitz, Birgit Riedler and Thomas Gruber (Oesterreichische Nationalbank, Foreign Research Division).*

dominance of the IMF, the World Bank and the U.S. dollar. In the ensuing discussion, Professor Sapir added that an often overlooked dimension of the EAEU is that it strengthens the spatial link between Russia and China, which creates a vast territory open to large infrastructural investment projects, e.g. the revamping of transcontinental railroad and energy connections, which in turn could render overland transportation and transmission across Eurasia more competitive.

Session I, chaired by *Helene Schuberth,* Head of the Foreign Research Division of the OeNB, focused on the issue where Russia stands with respect to structural reforms and attracting investment. Schuberth pointed out that Russia's "old" growth model, founded on steadily rising oil prices and thus improving terms of trade, appears to have reached its limits. Therefore, she emphasized, Russia urgently needs a new model – just which one, remains to be seen.

Yaroslav Lissovolik, Chief Economist and Member of the Managing Board of Deutsche Bank, Moscow, presented his view on Russia's reform needs and its quest for a new industrial policy. At the very outset, he expressed his concerns about the authorities' apparent infatuation with a weak ruble and top-down industrial policy. He added that import substitution has lately become a catch phrase, an essential paradigm. However, Russia's growth malaise triggered by diminishing returns from previously high oil prices clearly predates the Ukrainian crisis. A key problem is the differential between relatively high real wage growth (until most recently) and rather low productivity growth. While Russia's investment climate has improved in recent years, as measured by the World Bank/IFC Ease of Doing Business indicators – the country had climbed from rank 124 in 2011 to rank 92 in 2014 and then further improved its position slightly in 2015 –, there does not appear to be much demand from the population for in-depth structural reforms. At the same time, according to polls, the public trusts the government more than business and the mass media. Lissovolik concluded by pointing to some promising and dynamic regions (e.g. Kaluga, Ulyanovsk, Krasnoyarsk and the Republic of Tatarstan – which are, interestingly, neither major urban metropolitan centers nor resource-rich territories) as a possible source of hope for structural change.

Birgit Niessner, Head of Country Analysis of Raiffeisen Bank International AG, Vienna, focused on Russia's investment climate and policy and on how conducive they are for growth. She agreed that the Russian economy had already slowed down before the Western sanctions hit the country. She expressed concern that the high interest rates triggered by the sanctions could lead to a shortage of investment funds and that there will be no "rocket-like" recovery next year. In her opinion, Russia should orient itself toward Western countries because it cannot get all the technology it needs from non-Western countries. Despite undeniable improvements in the investment climate, achieving a level playing field between state-owned enterprises and small companies still is – figuratively speaking – a major construction site. While overall foreign direct investment (FDI) in Russia is above average OECD levels in relative terms, a large part of FDI inflows actually constitutes round-tripping of Russian capital. Moreover, FDI outflows from Russia often exceed inflows. Niessner also pointed to the regional factor, focusing on the Kaluga Oblast (southwest of Moscow), where a number of reform-minded top politicians and civil servants seem to have made a difference, rendering the region attractive for investors. She wondered whether Kaluga is the exception that proves the rule or whether it is a bottom-up example of "good" growth spilling over to other regions.

The authorities' monetary policy and banking sector stability were dealt with in session II, chaired by *Peter Backé,* Deputy Head of the Foreign Research Division of the OeNB. As he pointed out, recent months have seen a slight stabilization of the monetary and financial situation: After having reached a low point in January 2015, the ruble's exchange rate, supported by the turnaround of the oil price, again recovered somewhat. This allowed the Central Bank of the Russian Federation (Bank of Russia) to reduce its key interest rate – in three steps from the crisis-triggered height of 17% to 12.5% in May 2015[2] – against the background of inflationary pressures that are judged to have passed their peak.

More details and an assessment of the current monetary policy stance of the Bank of Russia were given by *Riikka Nuutilainen,* Research Economist at the Bank of Finland Institute for Economies in Transition (BOFIT), Helsinki. While the Bank of Russia has, under conditions of free capital movements, gradually adopted inflation targeting (IT), Nuutilainen showed that according to the Taylor monetary policy rule, the Russian central bank has, from 2002 to 2015, reacted to inflation, the exchange rate, the oil price and changes in output growth in a statistically significant manner. In Russia's shock-triggered current recession, which also features spiking prices (end-March 2015: 16.9% increase year on year) and uncertainties, the IT strategy of the Bank of Russia has become off-track. The monetary authority moreover also had to re-focus (at least temporarily) on combating the output decline. The Bank of Russia officially retains its medium-term inflation goal of 4%, but this goal has been repeatedly pushed into the future, with the current target being end-2017. Yet, given that the population identifies inflation as one of its main economic concerns, it would be advisable, in Nuutilainen's view, to take inflation targeting more seriously.

Lubomir Mitov, Chief Economist for Central and Eastern Europe and Managing Director of UniCredit in London, gave a presentation on Russia's banking sector, which is facing increased vulnerabilities and challenges. Prior to the current crisis, Russian banks had made important progress in lending to households, to the point where a credit boom emerged, which was then reined in by the Bank of Russia. Against the backdrop of banks' traditional dependence on foreign financing, both the sanctions and strong capital outflows have triggered widespread liquidity shortages. While "pocket banking" and "related-party lending" – with banks functioning as de facto extended financial departments of beneficiary owners – still exist, the Bank of Russia has been actively combating this phenomenon as well as money laundering. Following the authorities' recapitalization of some of the largest banks, the sector's overall capital adequacy appears sufficient for the moment. However, given the recessionary prospects for this year, which will bring rising nonperforming loans (NPLs), the sector (save the largest bank by far – Sberbank) will probably make losses. This will increase dependence on refinancing by the Bank of Russia and on bank recapitalization. Overall, while Mitov does not expect a systemic crisis, persistent lack of access to foreign funding, in his view, spells little hope for investment picking up soon.

[2] *It was further cut to 11.5% in mid-June 2015.*

Session III shed some light on Russia's most recent steps to recalibrate its economic orientation, including import substitution initiatives and attempts to diversify economic relations toward non-Western partners. The session was chaired by *Thomas Gruber,* Head of the CESEE Analysis Unit in the Foreign Research Division of the OeNB. Gruber pointed out that both import substitution and regional re-orientation policies are phenomena that Russia had already experienced earlier or launched prior to the outbreak of the Ukrainian crisis in 2014. For instance, Russia had achieved a degree of – unexpected – success in substituting imports after the collapse of the ruble in the 1998 crisis.

The presentation by *Andreas Wörgötter,* Head of Division in the Economics Department of the Organisation for Economic Co-operation and Development (OECD) in Paris, centered on the prospects for successful Russian import substitution policy. He noted that an oil price fall of 50% would actually make for a recession of 5% to 10% in 2015, assuming an oil price-based growth equation and an estimated trend growth of 2% for Russia. But now the OECD (and other institutions) are converging to GDP growth forecasts of around –3% in 2015, and up to +1% in 2016. This may imply that import substitution, triggered by devaluation, is happening without too much top-down political intervention. Also "helped" by Russia's countersanctions, the food industry seems to have got back on its feet. Electrical and optical equipment, metallurgy and the production of finished metal products as well as the chemical and petrochemical industries have also been witnessing robust growth rates in recent quarters. However, in order to be sustainable, import substitution requires that the real exchange rate be held relatively low for a prolonged period (as was the case post-1998). Moreover, structural reforms, particularly the elimination of entry barriers (that often support oligarchic interests) are a sine qua non of sustained success – which invites a big question mark with respect to political feasibility.

Russia's policy options and efforts to reorient its economic relations away from the EU were covered by *Peter Havlik,* Research Economist of the Vienna Institute for International Economic Studies (wiiw) and Guest Research Scholar at the International Institute for Applied Systems Analysis (IIASA). Similar to a number of other speakers, Havlik observed that Russia had been "stuck in transition" for a couple of years already before the Ukraine crisis. Currently, in the regime of sanctions, their strained energy relations force both the EU and Russia to diversify their trade to reduce their mutual economic dependence. Russia's overall trade with China remained steady in 2014 as well as in the first months of 2015 (despite Russia's slide into recession), while its trade with the EU, although still dominant, declined substantially. China currently accounts for the highest of any country's share in pledged FDI in Russia. While a number of large Chinese projects launched in 2014 concerned Russian manufacturing, China appears more interested in its northern neighbor's extensive energy and natural resources. Russia also fits well into Beijing's "Silk Road Economic Belt" strategy. Havlik pointed to expectations of a major increase of energy flows from Russia to Asia in the coming years. As a "swing supplier," Russia could also redirect some hydrocarbon deliveries to Asia that may originally have been destined for the EU. In any case, a substantial increase of "clean" energy flows from Siberia will contribute to improving the pollution problem in China, which is still heavily dependent on "dirty" domestic coal as a prime energy source.

In the ensuing discussion, which focused on import substitution, opinions were divided on whether Russia will be able to muster the necessary reforms to make this a sustainable strategy. Overall, the event aroused much interest and was very well attended. The breadth of topics, discussions and opinions voiced provided much intellectual stimulus, included some areas (e.g. Russian-Asian relations) that are not so often dealt with in our part of the world but may gain more importance in the future, and sharpened views for opportunities, risks and challenges Russia is currently encountering in difficult waters and possibly at a crossroads in its (economic) history.