ISSUE 2015/15
OCTOBER 2015

THE SYSTEMIC ROOTS OF RUSSIA'S RECESSION

MAREK DABROWSKI

Highlights

- The Russian economy grew rapidly between 2000 and 2007, but growth decelerated after the 2008-09 global financial crisis, and since mid-2014 Russia has moved into recession. A number of short-term factors have caused recession: lower oil prices, the conflict with Ukraine, European Union and United States sanctions against Russia and Russian counter-sanctions. However Russia's negative output trends have deeper structural and institutional roots. They can be tracked back about a decade to when previous market-reform policies started to be reversed in favour of dirigisme, leading to further deterioration of the business and investment climate.

- Russia must address its short-term problems, but in the medium-to-long term it must deal with its fundamental structural and institutional disadvantages: oil and commodity dependence and an unfriendly business and investment climate underpinned by poor governance. Compared to many other commodity producers, Russia is better placed to diversify its economy, mostly due to its excellent human capital. Ruble depreciation makes this task easier.

Marek Dabrowski (marek.dabrowski@bruegel.org) is a Non-Resident Scholar at Bruegel, Professor at the Higher School of Economice

THE SYSTEMIC ROOTS OF RUSSIA'S RECESSION

MAREK DABROWSKI

1 FROM GROWTH SLOWDOWN TO GDP DECLINE

Recession in Russia has become a fact. Seasonally adjusted quarterly GDP peaked in the second quarter of 2014 and then started declining. In the third and fourth quarters of 2014, the pace of decline was very slow (Figure 1) and therefore growth for 2014 overall remained positive (+0.6 percent, Figure 2).

However, the first half of 2015 brought an acceleration of the negative trend. Real GDP declined by 2.2 percent in Q1 2015 and by 4.6 percent in Q2 2015, compared to the respective quarters of 2014.

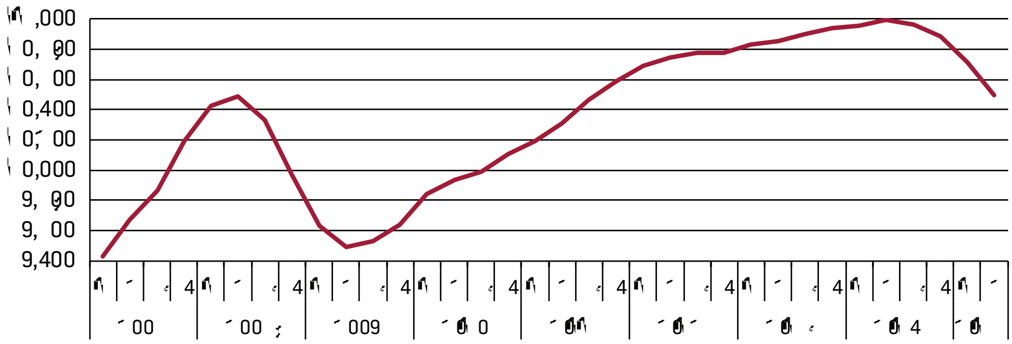
Recession was no surprise. Figure 2 shows that after the global financial crisis of 2008-09 Russian growth did not resume its pre-crisis pattern. From 2010-12 growth was muted but reasonable, with annual GDP growth of 5.4 percent, 4.3 percent and 3.4 percent respectively (although from a low level in 2009). However, already in 2013 – well before the conflict with Ukraine and resulting international sanctions, and the oil-price decline – there was economic stagnation.

To understand the causes of the trend of declining growth, we must look at the history of the Russian transition and its partial reversal.

2 THE FIRST TURNING POINT: THE YUKOS CRACKDOWN

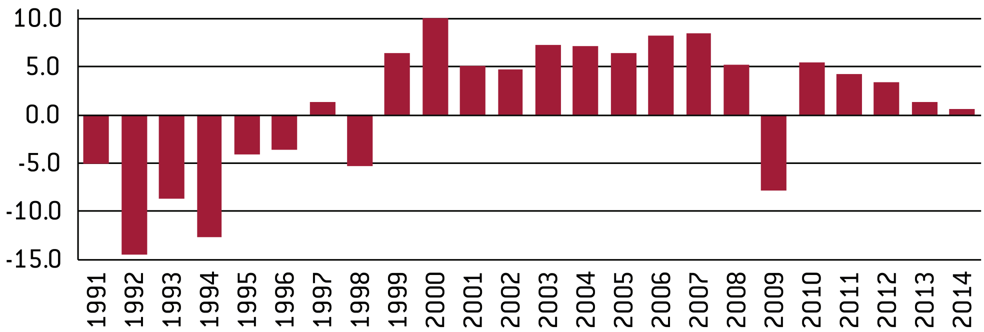
Russia was never a star reformer. Its economic transition in the 1990s was long and painful (see Figure 2) because of the complicated legacy of the Soviet system (structural distortions, macroeco-

Figure 1: Russian quarterly GDP in 2008 prices, billion rubles, s



Source: Bruegel based on Rosstat, http://www.gks.ru/free_doc/new_site/vvp/tab7a.xls.

Figure 2: Annual dynamics of real GDP in Russia, in percent, 1991-2014



Source: Bruegel based on Gaidar Institute for Economic Policy, Moscow, http://iep.ru/files/text/RED/2015/STAT-09.15.xls.

nomic imbalances and the absence of market institutions) and because of insufficient political support for radical, market-oriented reforms (Dabrowski *et al*, 2004). Nevertheless, at the beginning of the new millennium, those reforms started to bear fruit. In 1999, the Russian economy entered a phase of post-transition growth recovery, which accelerated in the subsequent years on the back of increasing oil prices.

Furthermore, the first years of Vladimir Putin's presidency (2000-03) brought completion of many overdue reforms, such as land reform, simplification of the tax system (the flat 13 percent personal income tax rate), elimination of fiscal imbalances, continuing privatisation, limited opening to foreign investors, deregulation and adoption of several pieces of market-oriented egislation. At that time, Russia could be considered a country that completed its basic transition agenda and managed to build a market economy based on private ownership, even if several distortions and imperfections continued to exist.

The turning point came in 2003 with politically motivated crackdown on the largest Russian private company, Yukos (its assets were subsequently taken over by the state-owned Rosneft). As result, the private sector share of GDP decreased from 70 to 65 percent between 2004 and 2005[1]. In the following years, this trend of state takeover continued, especially in the oil and gas industry. For example, in 2005 Gazprom acquired the private oil company Sibneft, which was transformed into Gazprom's daughter company Gazprom Neft. The activities of foreign oil and gas firms were marginalised. The best-known case was the downsizing of the shares held by Shell, Mitsubishi and Mitsui in the Sakhalin-2 project in favour of Gazprom (Sprenger, 2010).

While the Yukos takeover did not stop investment and growth immediately, it initiated Russia's gradual departure from market-oriented reforms towards the building of a sort of hybrid system that is heavily controlled and dominated by the state bureaucracy and the ruling elite. The tighter political and administrative grip on the economy was preceded by a revival of political authoritarianism. This included a clamp-down on free media, political control of the judicial system, the increasingly oppressive behaviour of various law-enforcement and security agencies, the increasing control of federal entities by the federal government, the gradual departure from free and competitive election

1. See http://www.ebrd.com /downloads/research/economics/macrodata/sci.xls.

things, massive external over-borrowing of large enterprises and banks, both private and state owned, prior to the crisis, declining oil prices and massive net capital outflow (Figure 4) when global liquidity dried up (partly because of the inability to roll over previous debt).

In 2009, the Russian economy contracted by 7.8 percent (in the second half of 2008 and first quarter of 2009, the cumulative output decline amounted to some 10 percent). The exchange rate depreciated from 23.5 rubles t of shares in the ten largest Russian firms belonged to the state and the three largest state-owned banks accounted for almost 60 percent of total banking assets at the end of 2013 (IMF, 2014, pp30-33).

At the end of 2012, the top twelve state-controlled open joint-stock companies tr as]s+SQUZWVd[KbLV]s+SQWZbV_CSC_laVCSC'd[WYZCSC'd[KrLa]s+SQUZ

2. Partly it can be attributed to changes in the *Doing Business* survey methodology.

12-month consumer price index will only be possible after March 2016 when the statistical effects of high monthly inflation between December 2014 and February 2015 will be left behind. However, this will be possible

7. However, the NWF's assets are partly illiquid; they have been in various domestic projects.

8. The oil-price decline in dollar terms has been partly compensated for by ruble depreciation.

more than one percentage point of GDP, mainly because of a shrinking denominator (real GDP).

Without further fiscal adjustment the RF will become depleted in 2017, and the NWF will suffer the same fate a year or two later. Russia's Ministry of Finance aims to avoid this and has advocated serious expenditure cuts in the 2016 budget[9]. They might involve, among others options, limited indexation of public wages and salaries, pensions and social benefits; rationalisation of employmens¥C'de[SSgUZ]s+SQTWa+[a+]d_UZSQToa+'dQTom