Russia’s sluggish economy is not a function of the Ukraine crisis or sanctions, but reflects long term economic trends

01/04/2014

One of the underlying factors in the Ukraine crisis is the health of the Russian economy, including the impact that EU and US sanctions could potentially have in bringing about a change in policy. **Pekka Sutela** *writes that while Russia is currently experiencing sluggish economic growth, this has more to do with long-term structural weaknesses than the direct effects of the Ukraine crisis. He notes that a side effect of Russia’s economic decline is that Vladimir Putin’s popularity with Russian citizens is now based largely on foreign affairs and social conservatism, rather than the economic performance which underpinned his appeal during the 2000s.*

The media seems to be unanimous: the near stoppage of Russian economic growth during early 2014 is due to the Ukrainian conflict and the sanctions decided by the EU, United States and other countries. True, the uncertainties created by the conflict have surely chipped away perhaps a percentage point of Russian growth. Whether the sanctions in force so far have had a discernable economic effect is debatable. The whole picture is however much more interesting than widely-read front pages let us understand. Today’s situation is largely determined by the character of Russia’s political system. It also has long roots going all the way to the Second World War.

Russia’s sluggish growth

Putin’s Russia was extremely lucky in the 2000s. Partial and often misguided as the Yeltsin economic reforms were, they created preconditions for catching up growth. After the 1998 ruble crisis no alternative to macroeconomic stabilisation existed. Monetisation and de-dollarisation followed, the steeply undervalued ruble attracted consumers to domestic produce, and the unused capacities inherited from the 1990s made growth on the cheap possible. Even a modest investment ratio was sufficient for fast growth, as capacity utilisation ratios could be increased fast.

The unprecedented boom in the world economy helped. Astonishingly, oil prices grew by ten times in as many years. Global finance was ample, and as the ruble appreciated in real terms, Russians could borrow at a negative real interest rate. Russia was until 2006 a model of fiscal conservatism, and reserve funds ballooned.

This was too good to last, and it was understood in Moscow. Energy specialists were the first ones to ring the alarm bell. At best a slow growth in primary energy production was possible. The share of energy in the economy would decline. The narrower base could no longer carry the rest of the economy. The economy had to be modernised to be able to maintain energy export volumes.

Nobody believed in a further ten times boom in the oil price. A further revenue windfall was not on the cards. One had to be worried about the competitiveness of non-energy jobs in the open sector. The economy needed to diversify. Capacities were coming to full use: further growth should be driven by investment, not only by consumption. And finally, the scope for catching up growth was narrowing. Russia needed to develop innovations of its own, albeit economists disagreed – and still do – on whether all of this was possible without meaningful political liberalisation.

This diagnosis was written by Economy Ministry officials in 2006-2008. The prescribed solution was and still is basically correct; however it was unclear how this solution should be realised in practice. Anyway, the financial crisis intervened. The regime, ever uncertain about its genuine popular support, concentrated on protecting existing jobs. All reforms were postponed. In contrast, very large new expenditure commitments were undertaken.

Stillborn reforms

Reformist intentions were given a new breath of life in early 2011. Academic economists were tasked by Vladimir Putin with writing another treatise on the ills of the Russian economy. It would be the basis for the economic policies of the new government to be formed after the May 2012 presidential elections. The economists – more than 1,100 of them participated – truly responded. Their tome has 864 pages – though with a biggish font. The government passed it, drafting work plans in the process.

Then, nothing. Or almost nothing. A budgetary rule was decided, tying state expenditure to the average oil price of previous years. As the oil price has been stable for a few years already, the rule basically dictates that federal expenditure should not be increased. During the financial crisis expenditure was increased by up to a fifth annually. In 2013 the increase was just four per cent. That has been one of the factors driving economic growth down. Similarly meagre growth was planned for 2014, although in early 2014 public expenditure has behaved erratically.

Putin's options for jump-starting the economy

The temptation to pump up the economy by fuelling aggregate demand is great. The regime could afford it. Public debt is just a tenth of GDP. Reserve funds are smaller than in 2008, but still serviceable. The central bank can create money. Inflation is at about six per cent, decidedly on the high side; however in the 2000s the economy was able to monetise in spite of even higher inflation. This is the debate raging just now in Moscow.

Moscow International Business Centre, Credit: Dmitry97ken (CC-BY-SA-3.0)

Probability is great that Vladimir the State-Builder will win over Vladimir the Fiscal Conservative. That would be in line with his early thinking on well-functioning hierarchies, power verticals and the guiding hand of the state. Private and semi-private interests would be forced to foot part of the bill, as we have seen in Sochi and elsewhere. Neither Europe nor the United States remains a credible role model: China is where the focus really should lie. Might Russia really admit that China is the big brother now?

We all doubt whether China will be able to deliver meaningful innovation on the wide front where it would be needed. But at least China comes closer to having a functioning party-state as a motor for the mobilisation of resources and generating growth than Russia has ever had. And, Russia's income level remains twice that of China. That may make the difference.

Russia is a rogue state well able to perform a small and victorious annexation at the cost of a poor neighbour that comes close to being a failed state. But the strength of a state is measured differently, by its ability to set goals and to reach them. On this scale Russia has become steadily weaker, as the discussion above shows. Vladimir Putin is again hugely popular among the Russians, as he was ten years ago. In the 2000s Putin's popularity was based on economic performance. Now that the economy is stagnating, his popularity is based on great power illusions and virulent conservatism.

In the 2000s Russia's growth potential was estimated at about 4-5 per cent. Ever-increasing oil prices pushed actual growth beyond that to seven per cent. Today, for all of the reasons already discussed, the growth potential is generally estimated at two per cent or less. Perhaps the biggest single reason was left without a mention. Russia's population has not declined for several years, but a shocking structural change is now underway. The grandchildren of the extremely small cohorts born during the Second World War are entering adulthood just now, with the number of 18 year olds set to decline by half. This has dramatic consequences for labour markets, tertiary education, the military and elsewhere. And there is next to nothing the regime can do about it.

Please read our comments policy before commenting.

Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

Shortened URL for this post: **http://bit.ly/1iV8Rfn**

About the author

Pekka Sutela – *Lappeenranta University of Technology*
Pekka Sutela is a Professor at Lappeenranta University of Technology in Finland. He is a specialist in Russian and Soviet economic thought, policies and developments.

-