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Russia: Economic Problems Are a Chance for Modernisation

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The rate of growth of the Russian economy is falling flat. The main reason for this is the decline in revenues from the export of oil and gas as well as a reduction of investments. This implies the need for economic reforms. For now, however, Russian authorities are using traditional methods of state intervention, changing the rules for collecting funds for future pensions, announcing big investments in infrastructure, and freezing charges for gas, electricity and rail transport prices for domestic customers. It is difficult to expect deeper and more far-reaching changes that might lead to social tensions. For the Polish economy, Russia's problems could mean a decline in exports.

After a period of relatively rapid growth (more than 4% of GDP per year in the period from 2010 to mid-2012), the Russian economy has slowed the pace of development. In the first months of 2013, GDP growth compared to the same period last year amounted to only 1.3%. Analysis of quarterly data shows that since the beginning of 2013, there has been no economic growth in Russia. In the third quarter (compared to the same period of 2012), a decline in GDP of 0.2% was reported. Forecasts for 2014 do not look good. Although the World Bank estimated GDP growth in Russia next year at 3.1%, many experts, however, including the president of the Central Bank of Russia, estimate that in 2014 GDP will grow by only 2%. Optimistic assessments were also made just this year then revised—the Russian government expected growth of 3.6% but now expects that to reach a maximum of 1.5–1.8%.

The Reasons for the Slowdown. The main reason for the slowdown of the Russian economy is that Russia has exhausted three primary available means of growth. First, the influx of funds from the export of oil and gas that powered the Russian economy during the peak period before 2008 have virtually ceased to grow. This is because these exports have actually declined, as have oil prices). Second, there has been a reduction in investments in the economy. Russia has used almost all of its production capacity and unemployment is low. Soon, some large investment projects will be completed, including the construction of facilities for the Winter Olympics in Sochi, planned for February 2014. Third, the economic growth that occurred was stimulated by private consumption, which is also declining. The relatively high level of retail sales was driven by increases in wages, especially in the public sector, as well as a large amount of bank credit. Now, wages are growing more slowly, and banks have become more cautious.

The Need for Change. After a decade of rapid growth driven by exports of oil and gas, the country needs policies and actions that would lead to long-term growth achieved in a different way than before. According to the president of the Russian Central Bank, to achieve growth of 3–3.3% in 2016, there is a need for a fast revival of economic activity.

Among the measures required are ones that encourage investment in the country and increase the productivity of the economy. This stipulates a necessity for far-reaching changes, including reform of the financial system, acceleration of privatisation (in particular, a reduction in the state's role in the largest Russian banks), as well as a reduction in spending on pensions and healthcare so as to gain funds to stimulate growth. While finance reform seems possible, a reduction in social spending would be very risky, politically and socially.

It is also necessary to improve the overall business climate in Russia. According to a World Bank study (although for Russia it was conducted only in Moscow, thus it is not representative of the entire country), the business climate is lacking necessary reform; companies face huge problems, for example, in obtaining building permits or conducting foreign trade. However, according to *Doing Business 2014*, published in late October of this year, Russia has moved up from 120th (out of 183 countries) to 92nd, which represents significant progress. However, it is not sufficient to create new opportunities for greater foreign investment, especially as investors seem to be rather leaving Russia.

Actions by the Authorities. So far, the Russian authorities do not seem to have a plan for wider reforms or to go about things in a traditional way, that is, by using state intervention in the economy.

One idea that's making its way into legislation is the reduction or elimination of payments for the cash portion of the pension system. So far, only a portion of the funds for future pensions that go to the Pension Fund of Russia is collected on ruble accounts and in the future will be paid to retirees. A bigger part goes to the state budget, and these contributions are recorded in a special points system so pensions therefore depend on the future situation of the state's finances. After the adoption of the proposal, which is already in the State Duma, almost all contributions will be directed to the state budget. In a few years, Russia may have problems providing payments to retirees, but in the short term this move will improve the state of Russian finances.

Another proposal is to invest in infrastructure some RUB 450 billion (€10 billion) from the National Welfare Fund (FNB), which has assets of RUB 845 billion (€64 billion), both in rubles and in foreign currency, mainly originating from the sale of oil and gas. President Vladimir Putin has described this fund as a "safety cushion" for the Russian economy.

The planned investments are primarily large transport projects, including an upgrade to the Central Ring Road around Moscow. The current bypass was built in the Soviet era and cannot withstand the load. A new one will be built by 2018. The government also wants to modernise the rail network, including the 110-year-old Trans-Siberian route, which needs urgent modernisation. With these projects and others, the Russian authorities will achieve two objectives: one, improve the transport infrastructure, and two, obtain a positive impact on economic development. But the National Welfare Fund will no longer grow as it did before as oil and gas prices slump.

The government has also decided to freeze fees charged by the country's monopoly utility and infrastructure companies. President Putin has already agreed to maintaining the prices for services provided by Russian Networks (electricity), Gazprom (gas), and Russian Railways (RZD) in 2014. These tariffs have normally increased by at least 15–20% per year. The authorities emphasise that this means stabilisation in the economy for businesses and ordinary citizens. But it is unclear what it will it mean for those monopolies. Gazprom probably will not feel the price freeze, but RZD may be in trouble as its railway network requires repairs, and much of its rolling stock needs to be exchanged.

All these projects will improve the condition of state finances and the acceleration of economic growth in the short term. However, they will not be conducive to long-term growth. This does not mean, however, that Russia is not able to make significant changes in its economy. Rapid economic growth during Putin's first two presidential terms did not result solely from increases in the prices of energy but also from a variety of reforms, including a simplification of the tax system and a reduction of government pressure on business (state controls, taxes, healthcare costs, etc.). Today there is a noticeable lack of similar programs. Important experts, economists and politicians seem to understand the need for reforms on a large scale. Recently, Russian Prime Minister Dmitry Medvedev published an article in the newspaper *Vedomosti* ("Time for easy solutions has passed"), in which he outlined an action plan. Stressing that no changes would mean economic development at a very low level, he suggested private businesses could increase their competitiveness and proposed support for small and medium-sized enterprises, with an emphasis on innovation and the effective use of science. Although Medvedev in his article criticizes the high level of exposure to the state in the banking sector, he has not proposed they be privatised. He only mentioned the need for modernisation, a term he used widely as president.

Conclusions. It is difficult to predict whether the economic slowdown in Russia will have serious political repercussions. With the problems with the state budget, it will be hard to increase social spending or remuneration in the so called budgetary sphere. This could translate into an increase in political tensions. However, we can predict the activation of liberal groups, which will demand radical reforms, as well as "hardliners," mainly the so called *silovikis*, which will argue that Russia has gone too far with reforms.

Either way, President Putin and his associates may have not only economic problems but also growing political problems with which to contend. Until recently, the government's responses to economic and social problems rely mainly on stricter measures against the opposition and civil society.

The problems with the Russian economy can directly affect Poland and, more broadly, the European Union, but especially Polish companies that export to Russia. Polish exports to this country between 2009 and 2012 almost doubled, including an increase of 16% recorded in 2012. In 2013, there was a slowdown, with the increase during the first eight months amounting to only 9%. We can expect a continuation of this slowing trend, especially if the Russian authorities decide to enact further protectionist measures. Polish exports of food and agricultural products to the Russian market have had problems for a long time, but now other industries may also have trouble. This means there is a need to prepare for talks with the Russian authorities so as to minimise the consequences of the expected decision on their part. On the other hand, Polish entrepreneurs should now look to other positive solutions, for example, by entering other markets, using government programmes (such as GoChina and GoAfrica Programmes 6.5.1 and 6.5.2 MG) designed to support entrepreneurs with expansion.