Economic Problems Facing the Next Russian President

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What Is not Known?

- Though the next presidential elections in Russia are scheduled for the beginning of March, 2012, their outcome is known – Vladimir Putin returns to Kremlin

- The only question – will he stay there for 6 or 12 years? Or …. even longer

- Unlike the first arrival to the Kremlin when Russian economy was already rising after the tough transformation of 1990s today Vladimir Putin will see an opposite picture:

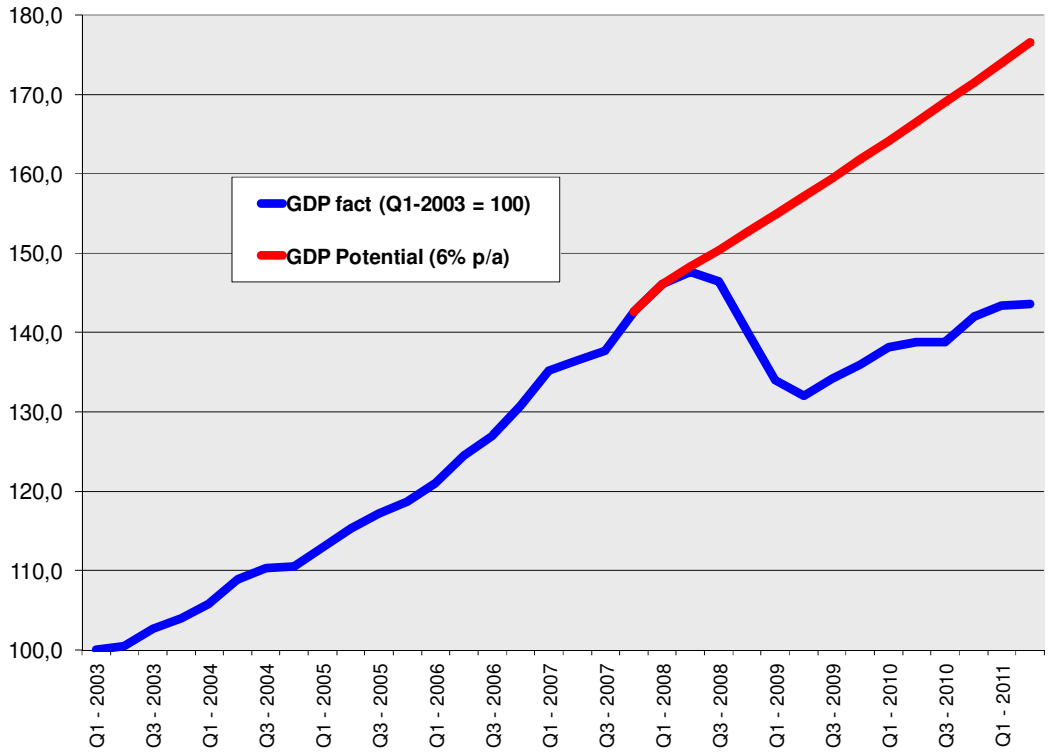
✓ *Slow after-crisis recovery*
✓ *Demographic trap*
✓ *Growing dependence on oil*
✓ *Lack of investment*
✓ *Weak financial system*

Slow After-Crisis Recovery

Deep recession of the Russian economy during the global crisis

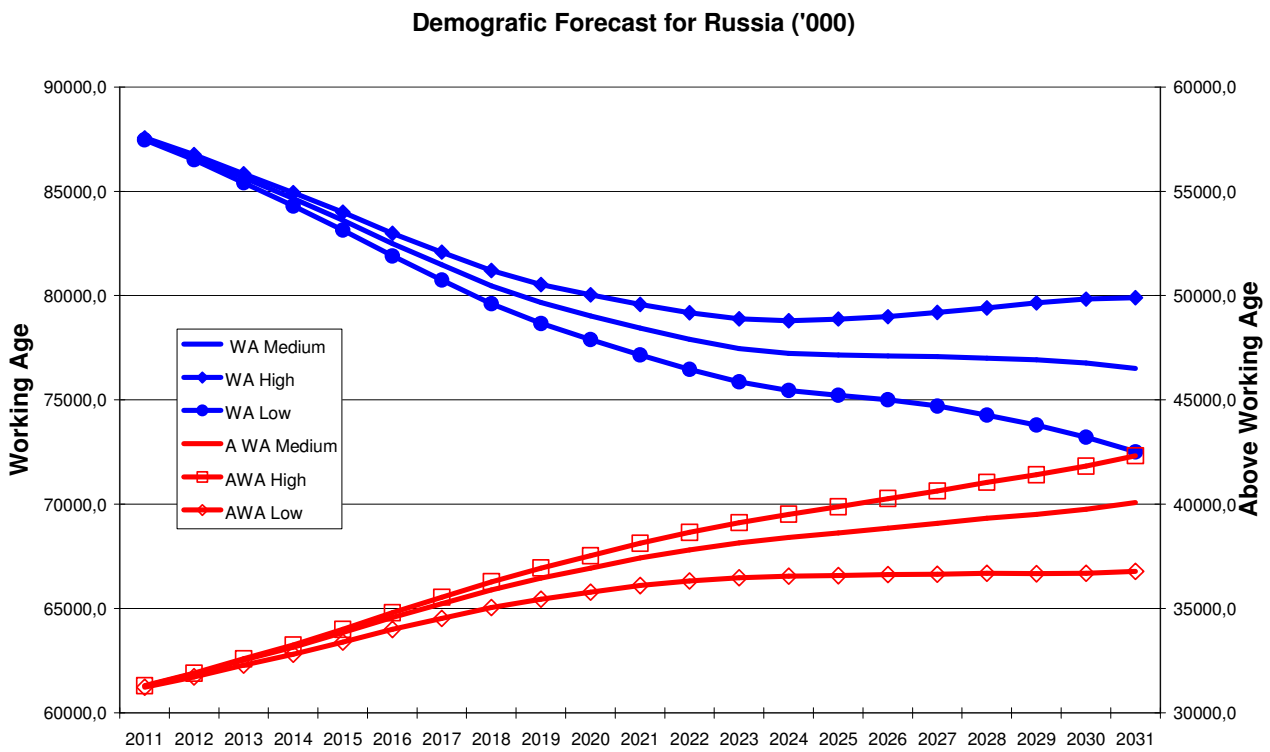
Afterwards economic recovery was neither stable nor impressive

In the beginning of 2012 the Russian economy may reach the pre-crisis maximum but it is rather far from it's potential trendline



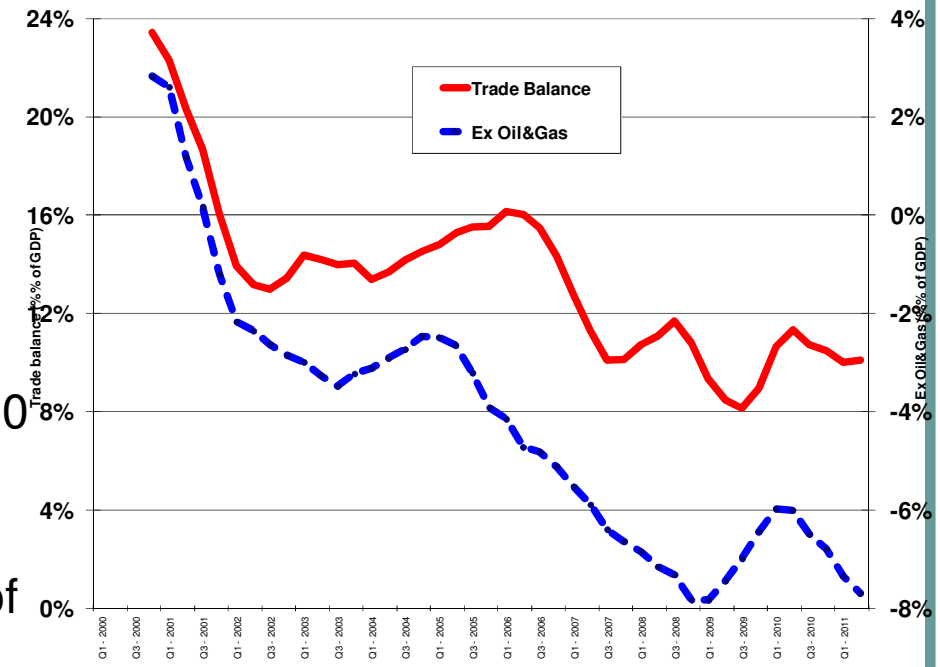
Demographic Trap

2015-2025 will be critical for Russian demography – Russia is going to face serious decline in its population and labor force that will be a strong challenge for its economy and society



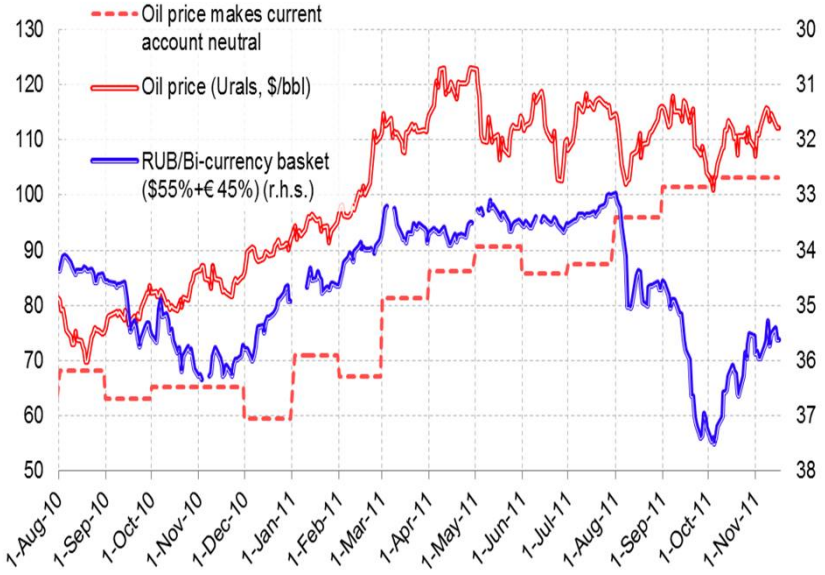
Oil Dependence: Balance of Payment

- More than 85% of the Russian export are either raw materials or primary commodities
- Export of hydrocarbons' share in the export grew steadily from 50 % in 2000 to 67 % in first half of 2008
- Trade balance remains positive but declining (23% of GDP in 2000 but 10% of GDP in 2010-2011) while excluded export of hydrocarbons it is negative and steadily growing up to 7,5%-8% of GDP in 2010-2011гг.



Oil Dependence: Balance of Payment

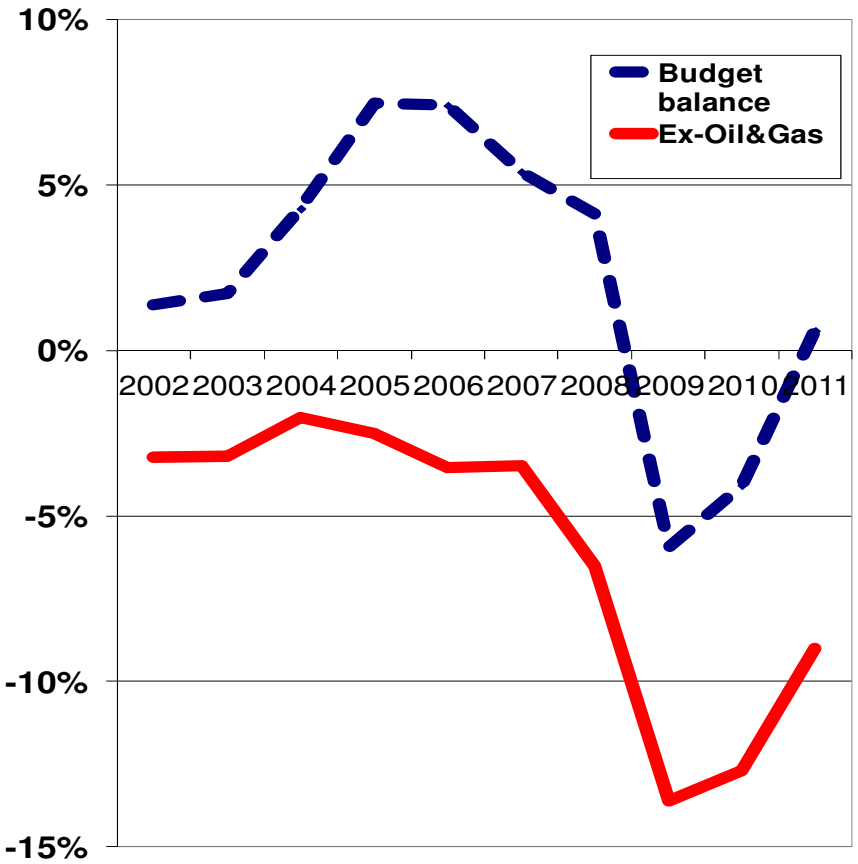
- With current oil prices ($110/bbl) and moderate growth of import Russian current account may shrink to a critical level (1% of GDP) in 4-6 quarters
- Any time current account shrinks to below 1% of GDP level ruble devaluation occurs
- This instability of the balance of payments may become permanent that will create extra-volatility for the ruble exchange rate
- Repayment of corporate foreign debt is additional concern



Oil Dependence: Budget

- The share of revenues derived from oil and gas in the total amount of the federal revenues exceeds 45%, and the deficit of the federal budget excluded those revenues - though declined to 8,5% of GDP in 2011 against 12,5% of GDP in 2009 - remains well above the pre-crisis level (2,5%-3,5% of GDP)

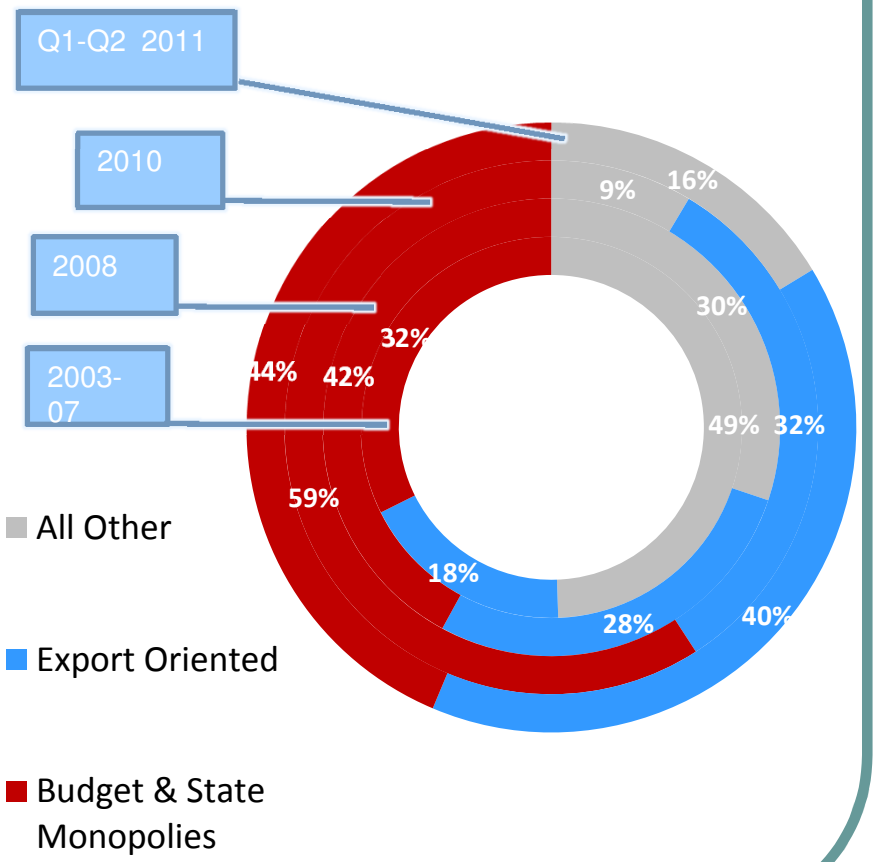
- In the medium run Russia should inevitably face the reduction of revenues from export of hydrocarbons as oil companies need to invest much more than today in order to keep the current production levels stable while the current taxation makes them short of funds



Lack of Investment

- The economy cannot grow without investments, and catch-up growth demands their higher level. In developing economies investments make 25%-30% of GDP while in Russia their level doesn't exceed 21%-22%

- Moreover investments are concentrated in export sectors, state controlled monopolies and budget while private sector …



Weak Financial System

- Share of financial system in GDP is below 4%
- In 2008-2009 banking system suffered severely because of enormous unhedged exposure (>30% of capital), lack of liquidity and non-controlled risks
- Liquidity support to the banking system (September 2008-January 2009) amounted 11,4% of GDP-2008
- Government and Bank of Russia spent 5,1% of GDP-2009 (2120 bln.Rub., $ 71bln.,) for the support of the banking system and covering it's losses (above liquidity support). Only 10% have been repaid (by 1 bank) till now
- 2010 – Mezhprombank collapse, 100 bln.Rub. ($3,5 bln.) of non-paid debts to creditors including Bank of Russia
- 2011 – hostile takeover of Bank of Moscow by VTB discovered significantly falsified reportings and resulted in huge losses of VTB group that was granted 195 bln.Rub. from the federal budget

Need for Political Changes

- Sustainable growth is not an economic but political problem in Russia
- Increase in investments is impossible without radical improvement of an investment climate that requires political reforms: fair courts, law enforcement, protection of the property rights, fight against corruption and racket, opening of economy and welcoming foreign investment
- Political transformation based on democratic freedom and real political competition must be in a focus of Russia-2020 agenda as a basic pillar for stronger economic recovery, but seems nothing demonstrates the readiness and willingness of Vladimir Putin to go this way.
- Moreover, the electoral campaign of 2011/2012 has clearly demonstrated the opposite

Demographic Trap

- Population aging leads to the inevitable growth of pension burden over the economic system

- In spite of the fact that for last 20 years the pension system In Russia was re-modified several times, actually, it remains the slightly changed Soviet system based on the generations solidarity principle

- Today the Russian pension system may be briefly described as the system where:

✓ pension expenditures as share of GDP is equal to OECD developed countries and significantly above the average for the emerging markets;

✓ the payroll tax exceeds the average OECD level and may be increased further;

✓ the level of pensions (measured by the replacement coefficient) remains 1,5-2 times below an OECD average (36% compared to 56%)

Pension Burden

- Currently the overall pension expenditures in Russia equal to 9% of GDP (5,1% in 2007) while only 70% of this amount is generated by the payroll tax and the rest is funded by the federal budget

- Stability of the Russian pension system is based today exclusively on the quite comfortable “pensioners to employed ratio” (33 %). According to Rosstat (2010), by 2030 population at pension age will increase by 9 million people while the number of people in the working age will decrease by 11 million people. As a result the “pensioners to employed ratio” will increase to 45 % by 2020 and to 52 % by 2030

- In order to keep the current replacement coefficient it is necessary to increase a transfer from the federal budget by 1 p.p. of GDP every five years, or to increase the rate of the payroll tax by 1 p.p. every year

- Thus, the problems of the Russian pension system rather soon will become not simply fiscal but macroeconomic and systematical problem of the economy

Oil Dependence: Budget

- After the most serious public finances crisis which ended with a default of 1998, the first years of 2000s have been marked by a serious progress in the Russian budgetary policy
- In 2003-2008 Russian budget could save up essential funds from hydrocarbons export initially in Stabilization fund, and then in the Reserve fund and National Welfare Fund
- The shift in the budgetary balance in the time of recession that was normal for many countries, was temporary and as oil prices started to recover the Russian budget began to move towards equilibrium
- At the same time, the qualitative component of a budgetary policy in Russia after crisis has sharply deteriorated: on the one hand, the government has cancelled the accumulation of the proceeds from oil export; on the other hand, new decisions on increase of budgetary expenditures were announced (increase of pensions, increase in military and national security expenditures) which have threatened long-term equilibrium of the budget
- Sluggish economic recovery after crisis and fast escalation of budgetary expenditures have increased the dependence of the federal budget from windfall oil revenues compared to the pre-crisis period.

Oil Dependence: Budget

- The Economic Expert Group and the Gaidar Institute estimate that with oil prices growing by 2 percent annually in real terms the federal budget deficit could rise to 10 percent of GDP by 2025 if today's tax burden and economic growth rate hold and the government finances all programs planned for the next five to seven years

- Of course future problems of the budget does not require immediate actions by Russian authorities. Nevertheless the identified trends will inevitably lead to growing macroeconomic instability during the next presidential term of Vladimir Putin.

- There is no good solutions for him: neither tax increase nor expenditure cuts could be pleasant for him. But doing none of those choices he will destroy that macro balance that was the watermark of the recent decade in Russia

- …. if oil price will not grow fast ($10-$15/bbl per year)

Conclusion

- The first decade of the XXI century has appeared lost for the Russian economy. Yes, it has been noted by a period of fast economic growth unprecedented for last fifty years that was accompanied by sharp increase of a standard of living of the population. It is true to say that Russian households never lived as good as today. But all this well-being derived entirely from external factors

- Level of corruption and racketeering by government officials has sharply increased, nepotism and chrony capitalism became a norm of today's Russia; while the degree of the property rights protection has decreased and direct and indirect participation of the state in many sectors of economy has grown. All this makes the Russian economy more and more primitive, unable to give anything to the rest of the world but raw materials

- Multi-billion investments are necessary to the country's modernization; they needed into all sectors beginning from public health services and formation going to investments into oil and gas sector. However over the last ten years the investment climate in Russia compared to other countries has considerably deteriorated that made economy unattractive and noncompetitive

Conclusion

- Vladimir Putin will return in May, 2012 to a presidential armchair in the Kremlin. He is not only going to spend much more time there (as presidential term was increased) but is going to face more serious challenges that may threaten not only its personal authority, but the stability of the Russian economy and the state
- Russia should find the decision for tough economic challenges, and very often these decisions will be connected with political reforms
- But …. Vladimir Putin has never before demonstrated his desire to carry them out

Thank you!