Post Euphoria: the challenges ahead

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Mid 2007 and Russia's economic and financial position is enviable – and a world away from those of the 1990s.

Russia's foreign exchange (fx) reserves total US$400 billion (bn), the 3rd largest in the world; its budget is set to run another whopping surplus of c5 per cent of GDP, meaning gross debt at year-end will be less than 10 per cent of GDP, and the state has net liquid assets of close to 10 per cent of GDP, given the current $150+ bn of fiscal savings in the stabilisation fund (part of the $400 bn of reserves). Its current account is in a similar surplus of 5 per cent of GDP; capital is, for the first time, staying in Russia and foreign capital flowing rapidly into the country, meaning bank deposit and loan growth are running above 50 per cent year-on-year; inflation is single digit; the ruble firm and mildly appreciating (and still undervalued: by c30 per cent at $60/bbl oil). Some Russian companies are becoming serious global players; the stock-market is taking a breather, but still is worth just shy of $1 trillion (trn); the economy is enjoying its 9th successive year of strong 7 per cent-odd real GDP growth, which equates to 25-30 per cent in US$ terms, growth that means GDP in 2007 will be US$1.2 trn, the 9th largest in the world. Most importantly, it is easy to forecast, with considerable confidence, that Russia should enjoy at least a decade of rapid, catch-up growth of similar pace, allowing it to become an increasingly prosperous economy approaching top-table status.

Not surprisingly, this situation has led to a sense of euphoria amongst its elites: Russians no longer need to feel as financial, economic and business also-rans, who are dependent on, and inferior to, their Western peers. Furthermore, in politics as in business, Russia no longer needs to bow and grovel for funding to prop itself up; instead the economy can fund its modernisation itself. The state is a big creditor of its G8 peers, while its companies can purchase businesses abroad either to access new markets or acquire leading technologies. In short, officialdom's confidence and pomp is fully understandable.

However, while strong growth from such a situation is more or less assured – unless policy were to turn straight-forwardly stupid or the globe were to slump into a true depression – the challenges in front of the policy-makers are considerable if Russia is not only going to simply see rapid catch-up growth for a while, but also see its economy and society bloom as they can do. Put another way, the challenge in front of Russia now is really whether or not it can deliver its own version of post-war Germany's Wirtshaftswunder or post-war Japan's Economic Miracle.

This fact of challenges ahead also comes down to the point that the strong situation currently enjoyed – and hence the euphoria – is in part predicated on the big moves in oil and other commodity prices in the period: a time will likely come when Russia's massive hydrocarbons resources are depleted or notably less valuable than today. If Russia is not to slip back again then, it'll have to see other industries grow and meanwhile husband its resource wealth prudently.

Specifically then, the big question confronting the country's economy and its policy-makers is: how can Russia best exploit its pre-eminence in commodities, while helping build the industries that will allow it to grow on and beyond into other fields, once the oil reserves decline or the world moves past hydrocarbon dependence? In a sense this is the 'diversification' question, but the answer is not diversification for its own sake, but trying to use the country's resources most optimally.

What follows is our short answer to this question, an answer made up of a host of specific policy areas but all resting on two basic principles: that these scarce, valuable resources need to be used efficiently, growing their production, marketing the bulk of them abroad so gaining world prices for them and then not squandering the money on state-funded white elephants; that the rest of policy should be centred around the idea of the state setting up good conditions for private businesses to bloom (not the state directing what businesses Russia 'should' have and then funding/owning them) and to keep and attract the skilled workers of the new knowledge-based industries.

Energy policy: Exporting it, tax cuts and using it prudently at home

Whether Russia likes it or not – and it should like it: having plentiful amounts of the resources that the world so wants, is a blessing – its exports are and will be, for the coming decades at least, heavily dependent on hydrocarbons (2/3rds currently). The bad news is, though, that oil production growth has stalled to

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a crawl (c2 per cent annually), gas production is little more than flat, and with domestic demand growth surging for both, Russia's exports of the two are hardly growing in volume terms and will even start declining if something is not altered soon.

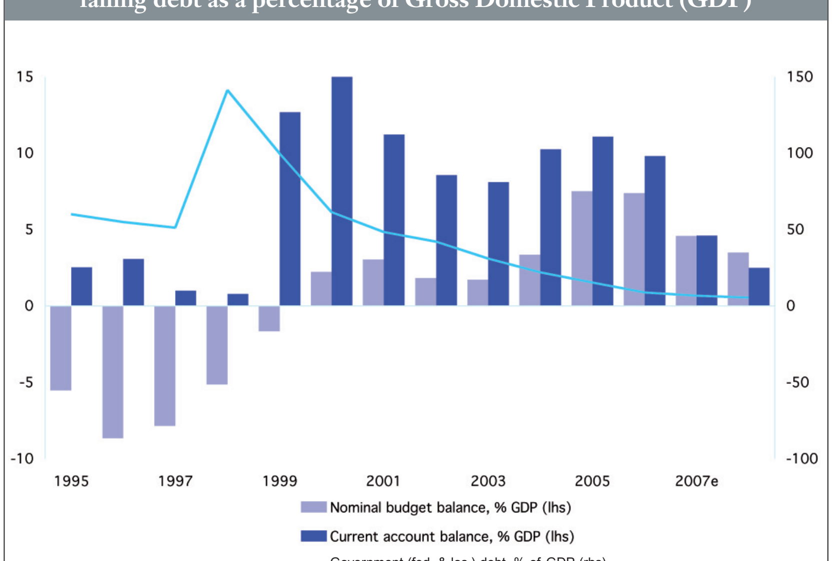
If the status quo were to be sustained, one could imagine a situation 10-20 years out where exports would have slowed to minimal levels as domestic demand growth ate up an increasing share of stagnant production. Furthermore, we would increasingly see Russia's economy's rapid growth rates ever more dependent on oil prices and, in time, run up against the classic emerging market problem of potential balance of payments crises as export receipts splutter to a halt (in the worse case decline) and imports continue to surge.

This is, frankly, an absurd situation: with oil and gas prices approaching all-time highs, and Russia's cost of production and transportation of current crude production one of the lowest in the world (c$15/bbl), there is every reason for Russia to invest billions in new fields – of which it has a large share of the world's remaining ones left to be exploited – so continue to grow production and exports to the booming Asian markets where demand rises rapidly, and the country to collect the receipts. And this both for oil and gas.

What needs to occur to make this achievable is simple: cut taxes somewhat for oil (so reducing the current c$35/bbl of a final $60/bbl price that goes to the state – and increasing in turn the c$10/bbl of profit that goes to the oil companies); probably cut the export tax on both oil and gas in particular, so meaning the discount at which oil and gas trade locally decline somewhat (though the tax as a whole should be kept to lock-in Russia's comparative advantage in cheap energy); and make sure that domestic gas prices do indeed rise to 'export net-back parity' by 2011 as is now mooted, so that users at home stop using the scarce resource so inefficiently, and so conserving more for export.

If this were to be done, higher domestic prices would force more economising, while higher profitability would engender supply growth and the financing to commit to the big new investments needed to open up the new areas. Short-term, the state would lose some budget revenue. But the combination of higher mid-term revenues (due to higher export receipts) and the fact the state now owns close to 50 per cent of the oil and gas sector by equity so it gains on the equity / dividend side, means that the direct hit to the budget over the future would be minimal, if there at all (and this calculation does not include the second-order budget gains from more rapid growth of the overall economy such export growth would help). Furthermore, while the current tax policy on the sector was just what was required – it allowed a recently bankrupt country to build a first-rate balance sheet and so ensure economic and financial stability – going forward the marginal gain from the high oil and gas tax receipts is just more surpluses, more reserves and the purchase of some foreign equities with them: hardly the best use of a developing nation's moneys when there are all those valuable resources to be exploited.

Russia's budget and current account surpluses, falling debt as a percentage of Gross Domestic Product (GDP)



Macro fiscal policy: Keeping a lid on spending and other taxes

Along with the lack of incentivisation of workers and managers that is central to communism, the other great failing of the defunct economic system is that the state is a terrible economic allocator of resources: politicians favour pet projects with dubious economics and current hand-outs to the population make for good short-term politics but do little to build wealth. The 'curse' of large natural resources is largely that they give politicians lots of financial resources to allocate funds badly. A great success of the Putin period has been the state's very prudent fiscal policy – big budget surpluses and a reluctance to spend them itself, instead saving them as reserves in foreign bonds: evidence, i.e., that the correct lesson had been learnt from the dud soviet experiment. The country cannot afford a relapse to old bad habits.

Monetary and fx policy: Slow appreciation of the ruble

The policy of keeping the ruble cheap while the economy recovered and industry restructured was exactly the right one. And it still is, to a degree. Going forward, though, increasingly it will make sense to focus on bringing down inflation to lower levels and that means allowing the ruble – slowly – to appreciate more, if oil prices continue to stay up. Such a policy would engender price stability, normal incentives in the economy in terms of savings and investments, and reduce the chances of a big inflationary boom followed by a bust – the key macro risk on the horizon today.

Social & infrastructure policy: Institutionalising public-private financing
Universal provision of healthcare, education, roads and other infrastructure work, if they do work well anywhere, only in places like Scandinavia with homogenous populations and well-functioning administrations. Furthermore, even those countries are moving away from such to a more mixed provision of these services. Russia needs to institutionalise its new status quo, with explicit payments by patients/students/road-users etc. alongside some state funding.

Education: Building first-world institutions
Such institutional reform is needed, but it alone will not address the critical need for significant funding of first-class education establishments, particularly in tertiary education. New industries require cutting edge research and, moreover, top-class human capital. Russia still relies on its (good) Soviet heritage in this sphere; it needs to develop a new one, preferably with private as well as public funding.

Labour markets & immigration: Accepting the necessity of migrant labour
A policy of closed borders is an expensive luxury that increasingly acts as a handicap in the globalised world. Such a policy when the local demographics are poor – an aging population with insufficient babies being born – is doubly difficult. The good news is that Russia is currently pretty open to migrant labour; it needs to stay that way and indeed make it more open – and attractive – for skilled foreign (and local) labour too.

Tourism: Visa policy in the modern world
Part of the labour regime needs to be a more open visa policy. This would not only help economic growth through a more dynamic labour market, it can also start to unlock the country's huge tourism potential, one that currently is heavily hampered by the expense and difficulty of gaining visas to visit the land.

Service Industry: Plurality and vibrancy
To entice skilled workers to stay/come to Russia, and indeed for the new industries to have the space and atmosphere in which to develop, there needs to be an open and pluralistic environment to work in, including such for the media.

Decentralising decision-making: "Decompression"
More generally, a more sophisticated and knowledge-based economy needs the power of decision-making to be more decentralised – both in corporations and in regional/local government – and requires the feed-back loops and mechanisms of an open society to help guide its path.

Property rights and laws: Empowerment through the market
Above all, for new businesses to flourish and entrepreneurs to be incentived to put their creative efforts into them, property rights need to be strong and upheld by courts, not rely on direct relations with officialdom. More generally, such a knowledge-based economy requires a system of transparent laws with the state policing them, rather than through state-led executive decisions.

EU trade deal: Big free zone optimal for both
Finally, Russia (and its CIS neighbours) needs a big trade deal with the EU that locks the two regions together in a big free trade zone. More than anything, this would engender the conditions for the new industries to develop in Russia and its comparative advantages to be sensibly exploited. Such would be also very beneficial for the EU as it would open up Russia's booming market more extensively, and help secure increasingly good relations for the future. F

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Central Bank of Russia (CBR) Foreign Exchange reserves, including government deposits, in billions of US dollars