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Working paper №7, 2016 (№21)

On vulnerability of Russian economy

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Over two years the Russian economy has been living under the Western sanctions, which, along with sharp decline of oil prices, have since then been frequently used as «the official excuse» for devaluation of the Russian ruble. And despite the attempts of the country's financial authorities to «explain»[1] to the citizens that they should now care not about the ruble exchange rate, but about the inflation rate, reflecting the growth of local prices in national currency, most of the Russians still perceive external shocks as the events which lead to new devaluations of the ruble[2].

The problem is not in the unfortunate inability of our citizens to stop measuring their salaries in dollars, it is in the fact that over the years of sanctions our economy failed to offer to local consumers the goods of proper quality and prices, adequate to the real earnings of Russians. Local substitutes do appear, but their prices are often comparable to former import prices. There are at least three reasons for this: low efficiency of local producers (high up-right investment costs, modest production volumes, poor quality control), use of imported components and materials due to lack of local suppliers and absence of foreign competitors in the given price range.

All those factors push the prices of Russian substitutes up following the decline of the ruble exchange rate that shifts accordingly the benchmark for prices of imported goods. As a result, it is no surprise today that premium Russian food products are just a notch cheaper than their imported competitors, and prices for Lada Vesta start at half a million rubles. But what type

[1] E. Nabiullina: ruble exchange rate is not important to Russians. http://www.vestifinance.ru/articles/65414
[2] Such shocks include speculative trans-border capital flows that take place beyond the sight of general public.

of self-financed import substitution can be developed, if nominal earnings of the majority of the country's citizens, many of whom became fully or partially unemployed during the crisis, stayed the same at best? In such conditions Russians are forced to lower their consumption level (i.e. living standards) by two dimensions at once: quality of goods and their quantity in consumer basket. Official statistics backs this conclusion, saying that among major import food substitutes production growth was evident in 2015 (compared to 2013, i.e. before the sanctions) only in pork (32%), cheese (33%) and poultry meat (20%). Other products (beef, fish, milk etc.) registered absence of growth or even production decrease.[3]

Against this background the state is testing itself in realization of Keynesian ideas, investing considerable amounts of money into infrastructure projects. The goal is clear – by creating such jobs, the state intends to stimulate consumer demand, that is now lacking in the country. But what about the fact that many workers in those projects are not Russian citizens, and thus they convert their ruble salaries into dollars to be sent to their families abroad? So, instead of stimulating internal consumer demand, an extra pressure factor is created for the national currency. And the blame is on the notorious economic feasibility, which «forces» contractors to hire for the above mentioned projects migrant workers, who came to Russia (most often without their families) in search of a job and who are prepared to work for a considerably lower compensation than Russian citizens, who have to support not only themselves, but also their families, keeping the increased cost of living in mind.

As many other useful ideas in the past, the good intentions of today stumble upon the inability to properly realize them. At a certain stage there always appears a reason to do it the old way. And every next generation of economic authorities blames their predecessors' mistakes and lack of qualified managers «in the field», which invariably «force» the state to leave its new endeavors to the mercy of «the market» to find out once again that the interests of nation and those of private business do not necessarily coincide.

The same rule applies to the Western sanctions. Formally, they were introduced against certain Russian enterprises, related to the country's political elite, whom the US and their allies blame for Crimea's annexation and the Ukrainian crisis. But in reality the sanctions affect primarily the ordinary Russians thanks to the historic decision of national financial authorities to start the free flotation of ruble. Maintaining the stable export revenue in rubles thanks to devaluation of the national currency (despite the falling oil prices) and, thus, balancing the budget in nominal terms, the state diminishes the real purchasing power of those who receive its social and other payments, as well as almost all Russian citizens who, by law, have their salaries paid in rubles.

Devaluations were often used in the history of USSR and Russia, but, for the first time, it now has the «scientifically proven» goal of «curing» Russia from «the Dutch disease»[4], the conditions for which were created «thanks to» the Western sanctions. In other words, one of the potentially wealthiest states in the world uses its citizens to pay for its oil dependence treatment. It is a custom for Russian people to sacrifice their lives for the Motherland, but there is another disturbing custom in line with which our financial authorities already in June

[3] http://www.gks.ru/free_doc/new_site/import-zam/1-1.xls
[4] https://lenta.ru/news/2016/03/24/oildesease/

2016 rushed to proclaim that «the rock solid direct dependence of oil prices and ruble exchange rate» does not exist anymore.[5]

Simple statistical analysis does not support this statement.

First. Strictly speaking, the direct dependence never existed, it has always been reverse. Second, correlation coefficient of nominal weekly oil prices and ruble-dollar exchange rate between 2008 and mid-July 2016 was equal to -0,79. Whereas, in the first half of 2016 it went up to -0,94.[6] I.e., the traditionally high correlation rose to almost complete. Third, correlation coefficient of weekly percentage changes in oil prices and ruble-dollar exchange rate between 2008 and mid-July 2016 was equal to -0,53. Whereas, in the first half of 2016 it went up to -0,69. In other words, the reverse dependence is getting stronger in relative terms as well: the situations when oil prices and ruble exchange rate change in one direction within a week are growingly scarce.

Speaking of Russian economy's dependence on the prices of raw materials as one of the critical features, affecting its vulnerability to external shocks, it is vital to understand that this dependence is just a part of a broader picture, stemming from the deficit of nationally originated financial resources. An interesting point was voiced by the Ambassador of the Italian Republic to Russia Mr. Ragalini during a session of the Academic council of the Institute of Europe RAS. In response to the question on prospects of Europe's liberation from its dependence on Russian energy resources he said that, if one looks at the situation from a different angle, it may appear that Europe exports its monetary resources to Russia who is unable to generate enough of them locally.

At this point it is worth recalling the long-term dedication of Russian financial authorities to restraining money supply, dictated by their addiction to monetarism. Two years ago this artificial deficit was aggravated by the sanctions affecting the access to affordable foreign financing. These factors multiplied Russian economy's dependence on inflows and outflows of capital. Since historically they are dominated by short-term credit resources, one could register the growing dependence on speculative trans-border capital flows, which, thanks to modern means of communication, can «change» several citizenships in a single day.

Speaking of specific features of Russian economy, it is worth recalling the above mentioned attitude of the state to its population as a renewable resource, capable of surviving regular degradations of its living standards as means of compensation for the «imperfections» of national economy structure and management. In other words, regular, «smooth and not quite», devaluations of ruble are equal in their importance to such resources as borrowing abroad and raw materials exports. These «peculiarities» form the financial basis of the modern Russian state underlined by the intentional restraint of national currency emission as means of financing national economy.

It is important to mention another component of this construction – foreign investments, which, as widely known, «require» certain climate and liberalization of financial markets in

[5] http://topnewsrussia.ru/siluanov-rubl-bolshe-ne-zavisit-ot-nefti/

[6] Calculated by the author using the data: http://ru.investing.com/currencies/usd-rub-historical-data and http://ru.investing.com/commodities/brent-oil-historical-data

recipient states. Analysis of international investment position of Russia in 2008-2015 led to the following conclusions.[7]

First. Yearly FDI stock is almost equal to official reserves. Key components of both aggregates (foreign investments in Russian companies' capital and Russian investments in foreign long-term bonds) in 2015 were almost equal (just over $200 bln) and accounted for 70% of the aggregates. It means that Russia returns the sum, equal to the amount of the most desirable long-term foreign investments, to the countries of their origin at a very moderate interest rate, offered by state bonds, while calls for active attraction of FDI to Russia are constantly heard, backed by new programs of state property privatization. No matter how many reasons one can find to keep using the official reserves as a crisis safety, it would still be much wiser to use them for proactive prevention of negative crisis shocks by supporting local enterprises, that are in desperate need of affordable financing.

Second, FDI stock reflects the condition of recipient economy. It was at its maximum in Russia in the pre-crisis 2007 ($491 bln), and at its minimum – a year after ($214 bln). Similar changes took place in portfolio investments ($308 bln in 2007 and $84 bln in 2008). The anti-Russia sanctions seriously affected both types of investments. In 2013 both figures exceeded the pre-crisis level ($566 and 274 bln), but a year after they dropped by 35 and 45% respectively. In particular, participation in capital decreased to $200 bln – the bottom line, which became evident back in 2008. In 2015, the trend continued, but at a slower pace with signs of stabilization, which means that foreign investors choose assets in Russia for two reasons: liquidity and strategic importance. The former are prepared to abandon their assets in times of trouble, while the latter hold on to them realizing that it may not be easy to buy the assets back.

If the negative effect of crises and sanctions is so pronounced for long-term investors, then what can be expected of those who come to Russia for fast gains? For such investors Russia is just another typical emerging market, promising higher profits for higher risks. The presence of speculative investors in Russia is clearly demonstrated by the volumes of trade in national currency, the amplitude of fluctuations of which, especially in the periods of «controlled» devaluation, promises fancy profits.[8] Equally attractive are deposits in Russian banks offering incredibly high rates in comparison to those in developed countries. Official data reflect these findings, registering considerable foreign investments in Russian currency, bank deposits and loans to non-financial organizations. The latter item demonstrates the dependence of Russian business on borrowing abroad which should be touched upon separately.

The stock of other foreign investments in Russia in 2015 was practically equal to that of FDI, although the former have certain maturity as opposed to the latter. And the amount of the former was close to the already familiar $200 bln. This is hardly a coincidence, but rather a reflection of the scale of modern Russian economy, in terms of its demand for external financing.

[7] Calculated by the author using official data of the Bank of Russia. http://cbr.ru/statistics/?PrtId=svs#QA_Par_47562

[8] See also K.N. Gusev. Foreign investments and the ruble exchange rate // Bankovskoe delo. №5, 2015.

Here we come up with an interesting setup: Russia invests some $200 bln of its reserves in low income, but «reliable» bonds of developed states, which are then returned to our country in the form of foreign loans to Russian enterprises, but at a higher interest rate. It is clear that the recipients of Russian reserves and the creditors of Russian business are not the same entities, but in general it is the same financial system of developed countries, which our state has been supporting for many years. This support was not reciprocal, unfortunately, as Russia suffered numerous speculative attacks of foreign partners, treating it as another developing country exchanging its abundant natural resources for paper obligations of developed states.

The political proclamations of the growing role of BRICS states in global economy, at least in respect to Russia, are upset by official statistics. And as long as the above mentioned «peculiarities» of the Russian economy exist, preserving its vulnerability to external speculative attacks, compensated eventually at the expense of ordinary Russians, it will be hardly reasonable to say that our country has finally left the group of states, subjected to the historical North-South divide in global economy.

Date of initial release in Russian: July 14, 2016.

This publication can be downloaded at: http://en.instituteofeurope.ru/publications/analytics