ИНТЕРВЬЮ

«I HOPE THAT POLICY MAKERS TAKE AN OPPORTUNITY TO BUILD A NEW RUSSIA WITH MORE ROBUST AND SUSTAINABLE GROWTH»

The Interview of the SPSU World Economy Department Head Professor Sergei F. Sutyrin and Associate Professor of SPSU Victor V. Lukashevich with Director of the Stockholm Institute of Transition Economics (SITE) at the Stockholm School of Economics Dr. Torbjörn Becker[1]

S. S., V. L. *Dear Dr. Becker, first of all let us express our gratitude for your kind consent to share some of your ideas with the readers of our journal. We would like to start with asking about your attitude to the up-to-now state of the current Russian economy? Do you regard it as one in a state of a deep long-lasting structural crisis or as one simply having some temporary structural problems?*

T. B. Before discussing the current state of the Russian economy, I think it is important to highlight the very good economic performance Russia enjoyed in the 2000's before the global economic crisis hit many countries in 2008/9. In the decade following the 1998 crisis, GDP per capita in constant 2005 dollar terms almost doubled according to World Bank data. This amount to a healthy 6.5 percent per annum growth rate in constant dollar income, which meant that Russia during this decade made significant progress in closing the income gap relative to Western high income countries. It also meant a significant boost to domestic purchasing power that translated into an expansion of retail trade and services as well as significant investments by companies.

However, this strong growth performance was strongly correlated with rapidly increasing real international oil prices. During the same period from 1999 to 2008, real oil prices increased by more than five times! (*Figure 1*).

This correlation can be shown also in a simple OLS regression over a longer time period of 17 years where annual Russian GDP growth is regressed on changes in international oil prices and an intercept. The regression has an R-square of over 60 percent, which is not bad for a one-variable macro model.

[1] Torbjörn Becker has been Director of the Stockholm Institute of Transition Economics (SITE) at the Stockholm School of Economics since August 2006. He is also a board member of several research, education and policy institutes in Eastern Europe that are part of the regional network Forum for Research on Eastern Europe and Emerging Economies (FREE) as well as the Swedish International Development Cooperation Agency (Sida). Prior to this he worked for nine years at the International Monetary Fund. His academic and policy work covers international macro and finance issues and has been published in top-ranking international journals and in several books and reports. He holds a PhD in economics from the Stockholm School of Economics and has also studied at the University of California, Berkeley and Manchester Business School.

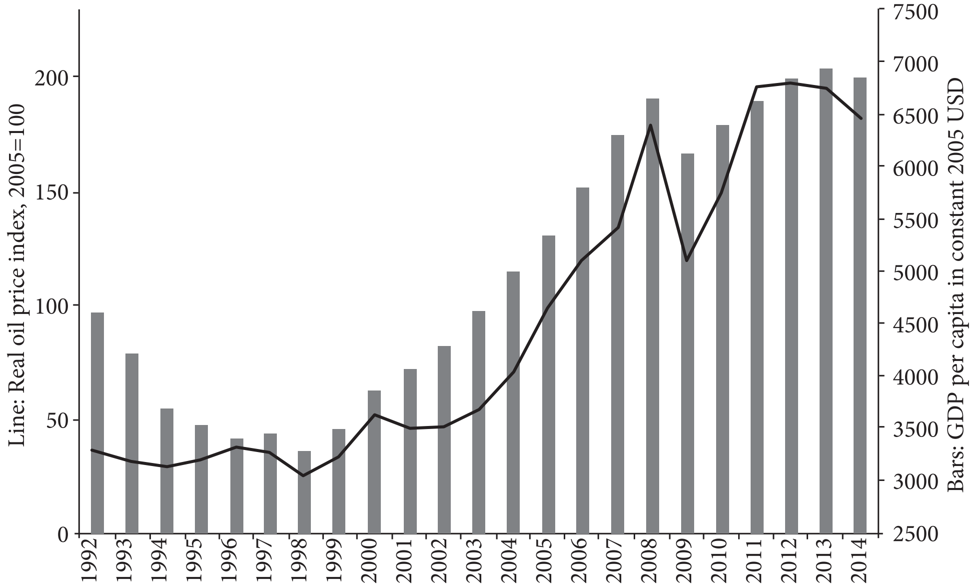

Figure 1. Russian GDP per capita and oil prices

A look at the estimated coefficients in this "model" suggests that a 10 percent increase in oil prices has been associated with roughly a 1.5 percent increase in GDP growth, while the growth without changes in oil prices (the intercept in the regression) is estimated at slightly above 2 percent.

Sometimes the strong correlation between oil prices changes and GDP growth is not well understood because the decomposition of GDP growth shows that it is domestic demand rather than net exports that have made the greatest contributions to growth. The argument is then that the low share of oil, gas and minerals in the productions side of GDP together with the demand side decomposition suggest that the extraction sectors in general and oil in particular has lost in importance when it comes to explaining income growth in Russia.

Although there has been a strong growth in domestic demand, this has in turn been driven by increases in oil income. Oil income in turn has mainly increased because of increases in international oil prices rather than in increases in Russian production volumes. Because of the limited increases in production volumes, this does not appear to be an important factor in real income growth. However, it is the increased incomes from oil (and gas) that allowed consumption and investment to grow so fast, which was linked to strong growth in imports. This can easily be seen by the correlation between GDP growth and changes in imports. In the national accounting identity, imports enter with a negative sign, so if it were the case that there were no second round effects from increases in imports, the correlation with GDP would be negative. However, imports in turn increase domestic consumption and investment (in countries that are more integrated than Russia in global value chains, it is often also an important input in the production of goods that are then exported). The consumption and investment of imported goods in turn generates locally produces goods and services. For example, if a foreign car is imported, it also leads to a Russian firm selling the car, servicing the car, selling fuel to the car and so on. In other words, a dollar worth of imports may lead to two dollars worth of domestic consumption and/or investments. But without the foreign exchange earning that comes with increasing oil prices, there will be less imports of foreign cars and thus the extra domestic goods and services that come with imports are also lost in the GDP calculation. This dynamic associated with imports is not unique to Russia, but a factor of any economy involved in foreign trade and an important reason why trade has benefits to the economy beyond the immediate imported good itself. At the same time, it comes with a risk of falling GDP when imports contract at a pace that it cannot be replace by domestic production (*Figure 2*).

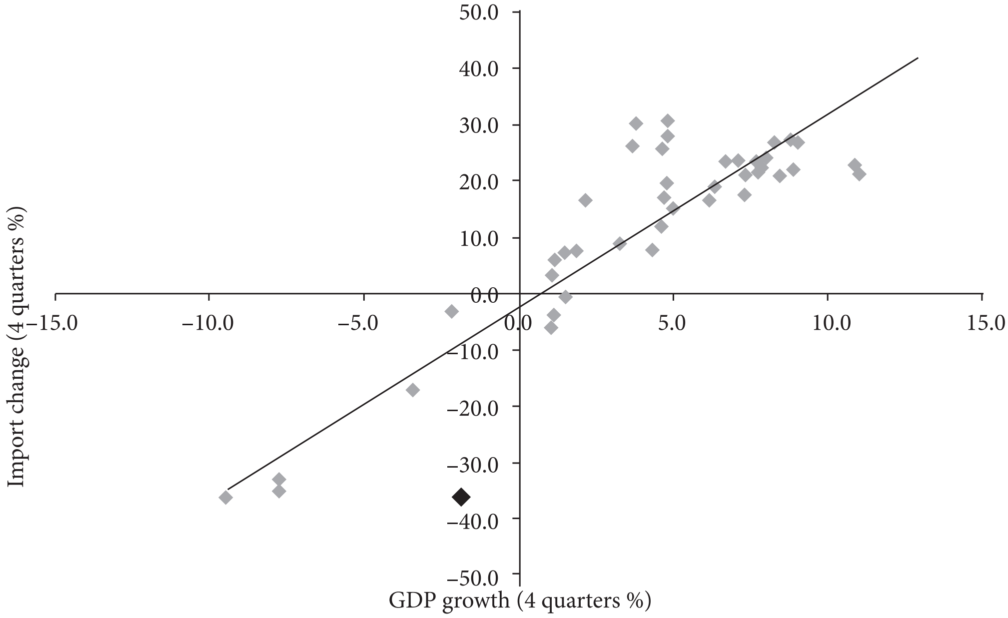

Figure 2. Scatter plot of GDP growth and changes in imports (quarterly growth rates from q1 2004 to q2 2014 м)

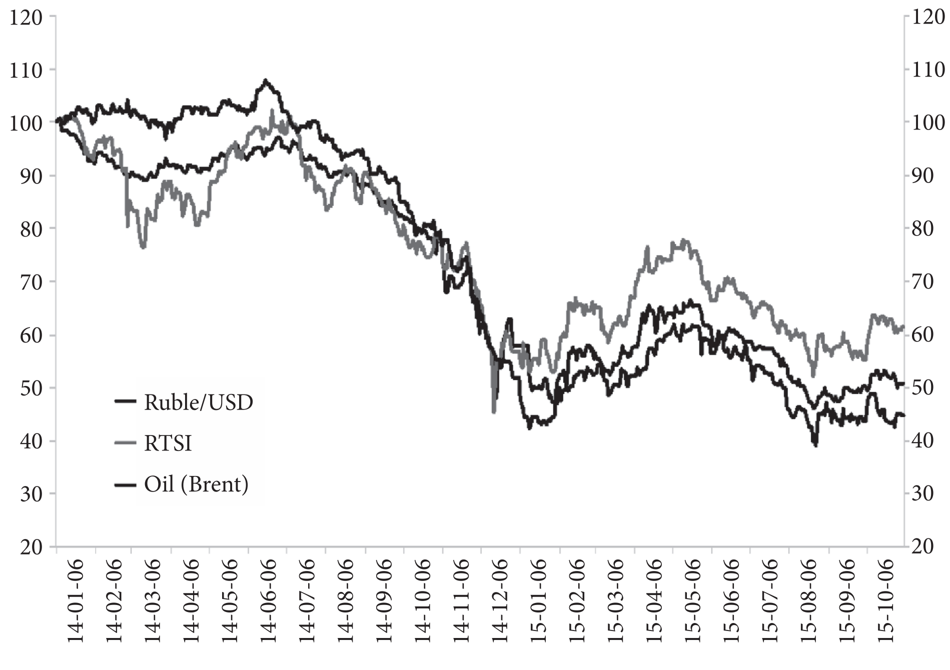

Figure 3. Oil prices, rouble and stock market moving in tandem (index values set to 100 in January 2014)

Turning to the current state of the Russian economy, it is clear that the downturn in oil prices have had serious effects on Russia, including on the Russian ruble, stock market, imports and the real economy. Since the beginning of 2014, international oil prices have declined by more than 50 percent, the ruble has halved its value against the dollar, and the stock market (RTS index) has seen a drop of almost 40 percent (*Figure 3*).

The real effects can be seen in imports and GDP. Imports have fallen dramatically and in the recent quarters, there has been a decline of around 40 percent. This is the same order of magnitude as was seen in the worst quarters of the global financial crisis in 2008/9. The impact on GDP has been less pronounced than it was then, but the question is if this signifies a structural shift in the relationship between GDP growth and imports or is a result of interventions that may not be sustainable over time (*Figure 4*).

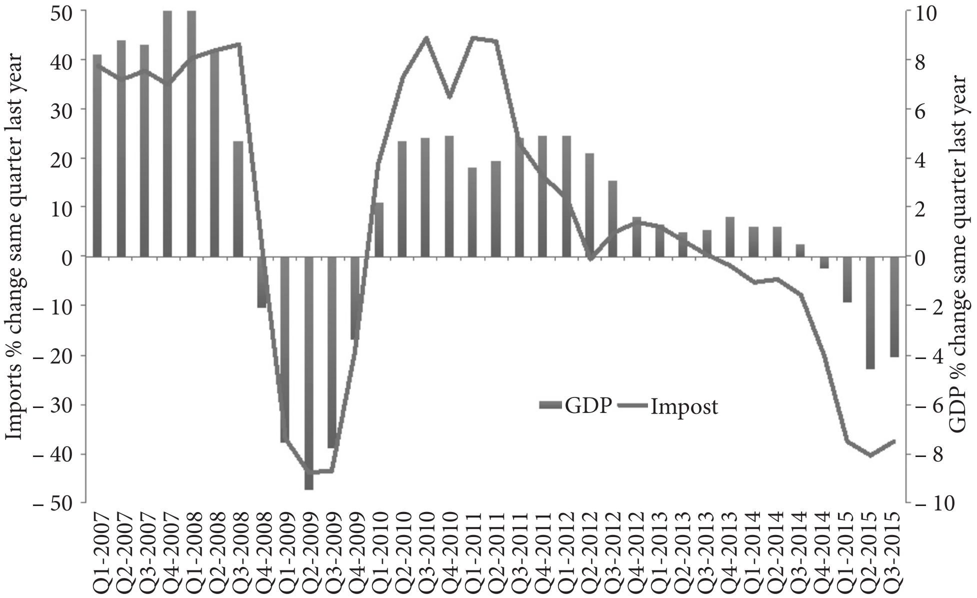

Figure 4. GDP growth and changes in imports over time

After this long introduction, the answer to the question is not too surprising. The current economic problems come to a large extent from Russia's heavy dependence on oil revenues. What is notable is that to generate economic growth, it is not sufficient that oil prices are high, but they actually have to increase at a relatively rapid pace to generate significant growth. As was seen in the simple regression, a 10 percent increase in oil prices led to 1.5 percent GDP growth. This is a point that is not always well understood. Many argue that as soon as oil prices return to a certain level, let's say 100 dollars per barrel, everything will be fine. That has not been the case in the past. It is only in years when international oil prices have shown double digit increases that Russian GDP growth has been strong enough for Russia to reduce the income gap compared with high-income countries.

Serious reform discussions that will allow Russia to generate high growth without increasing oil prices also only seem to take place when oil prices decline and the discussions then die out as oil prices increase again. Since the needed structural reforms are rather extensive, they will take time to implement, so this on-off approach to reforms is not generating a good ground for sustainable reforms and economic growth. My interpretation is therefore that the current crisis is a result of a fundamental structural challenge, which is related to the reliance on oil income and lack of long-term commitment to change this by implementing far-reaching institutional reforms.

However, the current problems may obviously disappear if oil prices once again increase sharply due to global developments that affect oil prices and to a large extent are beyond the control of Russian policy makers. This could then be interpreted as if the crisis is cyclical rather than structural, but the problem is that international oil prices are not set by Russia, which means that Russian policy makers are not in control of the cycle in any substantial way. Of course, the fiscal reserves and a flexible exchange rate will help mitigate the impact of oil price fluctuations, but will not tackle to root course of Russia's economic volatility.

S.S., V.L. *What to your opinion should be urgently done in current Russian macroeconomic, trade, and FDI policies to improve the current situation?*

T.B. Based on the above discussion, I think the current policy of letting the exchange rate adjust in line with changes in international oil prices have been key as a way of reducing the real effects on GDP and maintaining fiscal sustainability. Using some of the fiscal reserves is also motivated given the challenges the economy is facing.

However, the crisis has been deepened by other factors than oil prices that have also hurt investment flows, both from international and Russian investors. In particular, the sanctions that have come with the conflict in Ukraine has added to the uncertainty and costs associated with investing in Russia today, and taking steps that would allow sanctions to be removed would be an important way to facilitate investments and generate economic growth.

In addition, there are reforms that should be undertaken to improve the business climate in general. Russia has made significant improvements in its business climate that have boosted its Doing Business ranking, but trading across borders is still in need of much reforms. Given how modern manufacturing is organized today, with global value chains and multinationals that produce and sell goods across a wide set of countries, having significant obstacles to trading across boarders is a serious impediment to many large-scale investments.

S.S., V.L. *Some time ago (September 7–8, 2015) Dr. Sergey Glaziev, President Putin's economic counselor, has formulated in the media a series of interconnected recommendations concerning the changes necessary and urgent in Russian internal macroeconomic policies. Some of these seem just too radical for many experts, others meet practically general approval. We can regard these proposals made public as a beginning of a broad public discussion. Could you make some brief comments on Dr. Sergey Glaziev`s program (starting from the proposal of freezing the retail prices to a deep reform of monetary and fiscal policy of Russia)?*

T.B. I will start by stating that I am clearly in the camp of economists that think that a well functioning market economy beats central planning every day, year, decade and century. This is not about political ideology, but simply based on observations of economic performance over a long time period and across many countries. And this is despite the fact that the perfect market economy does not exist anywhere in the world. The challenge is therefore not to create a perfect market economy but rather to create a reasonably well functioning market economy, since this will still be superior to any actual example of central planning.

In my reading of the proposals of Dr. Glaziev, I think the vast majority of proposals are in the direction of more central planning and less of creating a well functioning market. Therefore, I do not think this is the right direction of reforms for Russia. What is lacking today in Russia is not too much market but too little. A well functioning market economy where individuals and companies are free to capitalize on ideas and investment in a predictable institutional environment that is open to free exchange with the rest of the world should be the goal of economic policy. It is easy to come up with other plans and ideas in a crisis, since many people and companies are then suffering, but in the long-run, a return to a centrally planned system would severely reduce growth and welfare.

S.S., V.L. *You mention in your publications on Russia the so called "confidence collapse". Could you specify your understanding of this phenomenon?*

T.B. The confidence collapse is really what is illustrated in Figure 3 where the simultaneous decline in oil prices, the rouble and the stock market is shown. In addition, the stock market is also responding to developments in Ukraine and associated sanctions, which have put further pressure on both trade and financial flows. Taken together, the decline in oil prices and sanctions have made it very hard for investors to maintain confidence in the Russian economy in this time period. Confidence will be restored when oil prices increase and/or sanctions regime is lifted or eased. It would also be helped by structural reforms as discussed above.

S.S., V.L. *What is your general attitude to the problem of migrant workers from CIS countries in Russia?*

T.B. I would think that both Russia and the migrant workers have a lot to benefit from a good relationship. The migrant workers are in Russia because it provides them with better opportunities to earn an income than if they stayed in their home country and Russian firms and consumers benefit from having access to a larger work force. The incomes sent home by migrant workers also contribute significantly to the welfare of the countries where they come from and the people at home that are themselves not working in Russia. In other words, the benefits go beyond the people that are in Russia. There may be social issues related to migrant workers, which is not an issue I have studied and I have therefore little to contribute to this discussion.

S.S., V.L. *Imagine, you are a solid "Russian economy optimist"… How could you briefly substantiate the logical basis for your optimism?*

T.B. I am a Russian economy optimist! I do think that Russia has too many valuable resources not to succeed in the long term. Russia has a well-educated work force in many important areas; vast natural resources; a prime location for trade between east and west; and long history of dealing with different types of challenges. The key to unlocking the potential of the Russian economy is with the Russian policy makers who should focus on generating opportunities for individuals and companies. If this is done, Russia will be an even more significant and influential economic player not only in its immediate neighborhood but also on a global level.

S.S., V.L. *Imagine, you are a solid "Russian economy pessimist"… How could you briefly substantiate the logical basis for your skepticism?*

T.B. If the focus is on the short run, I can imagine myself in the camp of economic pessimists since the outlook for a sharp increase in oil prices that would bring Russia out of the crisis quickly is not really in the cards. Although there have been some moves in the direction that may eventually ease sanctions, this is also unlikely to change very soon and thus contributes to a gloomy picture in the short run.

The main concern for the longer-run is that the needed reforms discussed previously, which are related to building solid and predictable market institutions, have been discussed many times but progress remains slow. Then President Medvedev formulated an ambitious reform program in 2009 that had most of the needed reforms listed, but as soon as oil prices turned up in 2010, these were to a large extent left undone. A Russian economic pessimist may therefore say that the interest in reforms is just as the economy very strongly correlated with oil prices, and given the volatility in oil prices, it is hard to see a reform program that will take years to implement succeed in an era of very volatile oil prices.

However, I hope this pessimistic view is proven wrong and that policy makers in Russia today take this opportunity to build a new Russia with more robust and sustainable growth that is not hostage to the volatility of international oil prices.