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Russia's Strong Balance Sheet Only Goes So Far

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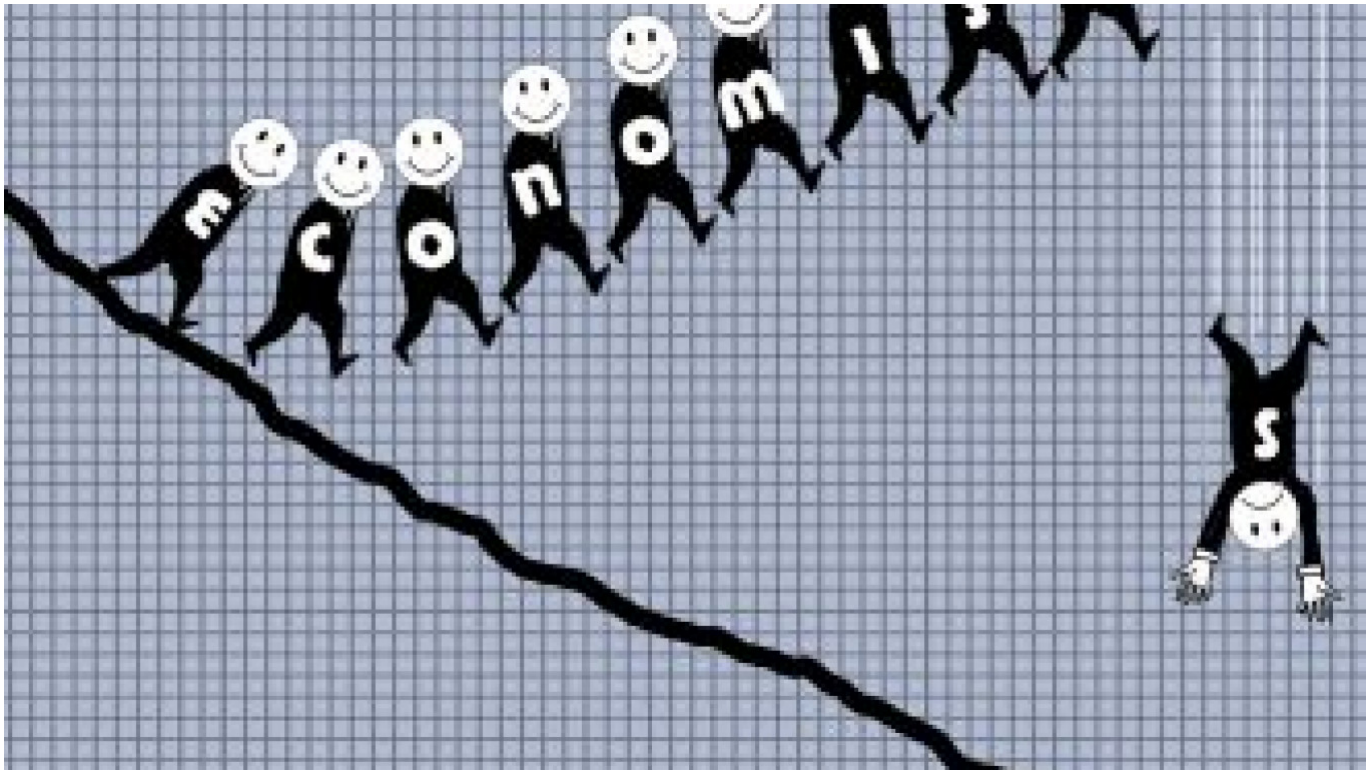

At the start of this year, it was generally accepted that 2013 was likely to be a year of consolidation for the global economy, and a year during which Russia would more than likely just "sit it out" while waiting for a pick up in global trade and investment confidence.

Underlying that pragmatism was a widely held confidence that this year would see a strong rebound in domestic growth through the second half of the year that would lead into an even stronger recovery in 2014. When the economists at the International Monetary Fund, or IMF, issued their 2013 outlook in April, they forecast growth of 3.4 percent for Russia, which was broadly in line with the consensus in Moscow and similar to the growth achieved in 2012. Last week, the IMF economists slashed their current year forecast back to only 1.5 percent growth and not far off the Central Bank's recently lowered forecast of 1.8 percent for the full year.

To achieve real growth, Russia

must institute
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The rhetoric from senior government ministers has also changed dramatically over the past six months. Through most of the first half of this year, the tone from the government could be described as cautious but hopeful. Then, last week, we heard from Prime Minister Dmitry Medvedev that the previous drivers of growth in the economy had been exhausted, and the country must "be ready to make hard decisions." This message was even more forcibly made by President Vladimir Putin at the VTB Investment Conference on Wednesday, where he also emphasized the need for increased productivity and smarter state spending. Economic Development Minister Alexei Ulyukayev has been even clearer with his comments, stating that while the economy is not on the verge of recession it does face the risk of a long period of stagnation that would be worse than a sharp crisis.

So, how did we move so quickly from the optimism of spring to this dread-filled fall? There are several factors that explain this. The global economy has not recovered as fast as expected, and serious legacy problems remain unresolved in the U.S. and in the European Union. On the domestic front, budget revenues have fallen short of expectations this year, and while the growth in budget spending is being restrained at the targeted 4 percent for this year and next, there is still far too much money being spent on nonproductive areas rather than via schemes to help industry expand.

For an economy such as Russia's, which is strong fiscally but very vulnerable to external shocks, there is always a dilemma between using the balance sheet to maintain domestic stability or using it to try and create new domestic-growth drivers. The first option is always an attractive short- or medium-term political option, while the second one is clearly needed to take the economy out of the rut it has been in since 2008. True to form, the government appears to have opted for the safer option.

While the president, prime minister and others have made strong speeches about the need for reforms and measures to boost investment, the strategy, however, is to batten down the hatches and play it safe. The revised three-year budget, which was submitted to the State Duma on Monday, still plans for increased annual spending of 4 percent next year, 10 percent in 2015 and by close to 7 percent in 2016. But there has been a lot of restructuring in the makeup of the budget so that the big bulk of spending will be directed to defense procurement and to fulfill the Putin's election promises. There is specifically nothing new to help achieve the plan for a boost to efficiency or to increase investment spending.

It certainly can be argued that it is prudent to remain vigilant against the threat of external shocks through the coming winter. The IMF still expects a pickup in global growth next year and expanding further into 2015, but its forecast assumes no fresh crisis in the U.S. or eurozone. That may yet turn out to be overly optimistic as the U.S. is now firmly in the grip of yet another skirmish between Congress and the White House over budget and debt issues. Investors still remain sanguine about the shutdown and are jittery about even a remote threat of a U.S. default in mid-October, even though most believe that a last-minute deal will be

reached with little or no consequences for the U.S. recovery. The reality is that when political forces are as vehemently opposed as Congress and the White House appear to be on the president's health care reforms, the outcome remains very unpredictable.

Even when that issue is resolved, there is still considerable uncertainty over the future of the Federal Reserve's support for quantitative easing and the contagion to emerging economies. Since the Federal Reserve first muted the idea of the so-called tapering strategy in May of scaling back quantitative easing, only to backtrack in early September, emerging market currencies and investor flows have been very volatile. But a return to tapering in 2014 is inevitable, and right now nobody has any clear idea of what the impact will be on investment flows and growth in the emerging economies.

So if you are sitting in Moscow with the memory of late 2008 and early 2009 still fresh in your mind, an element of caution is understandable. But while it is prudent for the government to be cautious against such a backdrop of external uncertainty, the tactic of blaming slow domestic recovery on external contagion is losing its effectiveness. The IMF's cut in Russia's current year growth outlook is much worse than the cuts its economists have made in other large economies. Sure, part of the reason for such a big cut is because of weaker external trade. It is also because of the much slower pace of domestic investment coupled with a gradual deterioration in consumer activity.

It is precisely this factor that is causing so much concern. Ulyukayev said last week in Sochi that economic growth over the first eight months of this year was only 1.5 percent, while the macro data report for August showed a fall of 3.9 percent in capital investment on a yearly basis. Retail sales growth, which averaged almost 6.5 percent in 2012, is now on course to average about 4 percent this year.

Compared to most other countries in the world, Russia's fiscal and budget position are enviable for sure. Even with this much slower pace of growth, the budget should end this year and next with a deficit of less than half a percent of gross domestic product, assuming oil averages about $110 per barrel in the period, albeit rising to 1 percent of GDP in 2015. With total sovereign debt equal to only about 10 percent of GDP, the question that begs to be asked is "What is the panic?"

Of course there is none — at least for the time being. Stability versus growth is a tricky balance to get right and one that venerable international organizations such as the IMF have struggled with for decades. The government, through the Central Bank's efforts to fight inflation and manage the currency and the revised three-year budget, are good at delivering on the stability side of that equation. And that will be good enough through the winter.

But a strong balance sheet only goes so far, and it is not automatically a catalyst for growth. To achieve that requires the right spending and incentive policies. In the end, raising and sustaining growth at the targeted 5 to 5.5 percent level will only be achieved with a pickup in the pace of reforms that then leads to an increase in investment spending by both domestic and foreign investors into infrastructure improvement and into industrial diversification.

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