Russian Economic Report 30: Structural Challenges to Growth Become Binding

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MOSCOW, September 25, 2013 - Slowdown in consumption, stalled investment demand, and a continuing weak external environment led to the downward revision of the World Banks May growth projection for Russia from 2.3 percent to 1.8 percent in 2013. Despite the observed slowdown, the Russian economy is projected to accelerate to 3.1 percent growth in 2014, says the World Banks Russian Economic Report ?30 launched today in Moscow.
"The economy appears to be growing close to its capacity, constrained by feeble investment activities and a tight labor market, said Birgit Hansl, World Bank Lead Economist and Country Sector Coordinator for Economic Policy in Russia and the main author of the Report. "Global recovery could result in an increase in Russian exports starting in the fourth quarter of 2013, while the World Bank projects oil prices to remain stable. Next years growth prospects will largely depend on the recovery in Russia's most important economic partner, the Euro Area, and the increased investment activities associated with the recently announced large state investment projects to be financed off-budget.
According to the report, this moderately positive outlook is subject to downside risks. "Russian exports could remain depressed if the recovery in global demand is further delayed, said Hansl. "The tapering of quantitative easing policies, notably in the US, could temporarily negatively impact Russia's economy through lower oil prices, restricted access to international capital markets, and higher capital outflows. We note also vulnerability to increasing risks in regard to the quality of the credit portfolio given continuously high credit growth.
Some key points of the new Russian Economic Report are:
 Russia fared well compared to other high-income economies or EU emerging economies. Although high-income and EU emerging economies appear to be in a recovery mode, this seems not yet to be the case for Russia. The slowdown came as a result of weaker demand due to combination of external and domestic factors, some of which are cyclical and others structural. A large part of the cyclical component is related to Russias high dependence on oil and gas exports and. with it, its exposure to commodity-price volatility. Structural challenges to the Russian economy and its growth, such as non-competitive sectors and markets, are another important factor to consider and they recently moved to the forefront of policy discussions as the economy seems to operate close to its current capacity limit. Weakness in domestic demand was reflected in subdued investment and consumption activities. Consumption, the main growth driver in the past, expanded at a much slower pace than a year ago. Investment activities tapered sharply as large infrastructure projects for the Winter Olympic Games in Sochi and the Northern Stream pipeline neared completion. Business sentiments remained skeptical, which affected investment demand negatively. External demand remained sluggish. Trade in global markets did not provide the expected relief while oil prices retreated, stabilizing below US$ 100/bbl during the second quarter of 2013. Weak export performance was an important factor for lower growth in the first quarter of 2013. Recent consumer and business confidence indices point to deteriorating sentiments and lingering uncertainty on how the global economy, and specifically the Russian economy, will play out. While investors were already in a wait-and-see mode for a while, consumers now appear to have joined them and the players in the Russian economy are sitting on the fence. The economy is close to its current growth potential. Despite the observed broad-based slowdown in the economy, most recent estimates show that the level of capacity utilization remained close to 80 percent in the first half of 2013. That is comparable with rates observed in 2007 and 2008, when the economy was expanding at 8 percent annually. Given the still-tight labor market and the depressed investment activities of the last four quarters, it appears that the economy could be running very close to its maximum capacity. This creates implications for the nature of the growth-supporting policies. Weaker growth potential is also reflected in the sector composition of growth. In the first half 2013, growth in key non-tradable sectors, such as construction, financial services, transport and communication slowed dramatically and is not compensating anymore for the gradually deteriorating industrial performance, and the manufacturing of tradables in particular."Considering these observations, overcoming structural challenges to the Russian economy and its growth would need to constitute an important aspect of growth-stimulating policies, said Michal Rutkowski, World Bank Country Director for the Russian Federation. "For Russia, this would constitute a shift from the growth model followed in the past, which focused at stimulating consumption demand. As structural challenges become binding, constraints such as non-competitive sectors and markets would need to be addressed to lift Russias growth potential.
The special focus section of the new Russian Economic Report looks at improving economic diversification, which has recently received a great deal of attention in Russia. How to help diversifying firms better survive economic cycles is an essential, but largely ignored issue. Economic diversification means doing new things in new sectors and/or in new markets. The fate of emerging firms, therefore, should be of great concern to policy makers.
The Banks research indicates that the ups and downs?the volatility?of Russian economic growth are key to that fate. Volatility of manufacturing growth is higher in Russia than in comparable economies because its slumps are both longer and deeper. They go beyond the cleansing effects of eliminating the least efficient firms; relatively efficient ones get swept away as well. In fact, an incumbency advantage improves a firms chances of weathering the ups and downs of the economy, regardless of its relative efficiency. Finally, firms in sectors where competition is less intense are less likely to exit the market, regardless of their relative efficiency.
Two policy conclusions emerge from these findings. First, strengthening competition and other factors that support the survival of new, emerging and efficient firms will promote economic diversification. Second, efforts to help small and medium enterprises may be better spent on removing the obstacles that young, infant firms face as they attempt to enter, survive and grow.
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