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Trying to Save a Sputtering Economy

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The State Statistics Service recently reported third quarter economic growth at a paltry 1.2 percent. That was similar to the growth reported in the previous quarter and brings the nine-month growth indicator to only 1.3 percent. This means that, even with the expected technical recovery this quarter, Russia will be lucky to achieve growth of even 1.5 percent for the full year.

This growth update came at the same time as the Economic Development Minister warned that Russia is potentially entering a two-decade period when average annual growth may only be 2.5 percent, while the expectation for the rest of the world is that growth may average 3 percent. Developing economies, such as Russia, are supposed to deliver higher-than-average annual growth to compensate for higher risks. Otherwise they have little hope of attracting the attention of global investors. So, should we be panicking yet? Not quite, but after yet another disappointing macro report for October, you should now be aware of where the panic button is located.

The reality is that the conditions that have contributed to this year's low growth, including delayed policy decisions, can be addressed and sustainable annual growth can be raised beyond the Economic Development Minister's worst-case prediction. For that to happen, we will need to see a greater shift in Kremlin policy priorities and an end to the many inconsistencies that we now see in the execution of monetary and budget policies. The hope is that these issues will finally start to be addressed in spring. Between now and then, it seems that all of the state's political and administrative resources will be focused on delivering a successful Sochi Olympics.

Despite the generally disappointing October macro report, which was released last week, there is still hope that the economy will stage a small rebound in the current quarter and achieve the full year target of 1.5 percent. Even that would be a very poor result for an economy that grew 3.4 percent last year and 4.3 percent the previous year. That expected modest recovery will allow the issue of the poor economy to be conveniently sidelined during the final push to Sochi. But directly after the Winter Games closing ceremony, the "economy games" will begin. The economy minister's growth warning is therefore not so much to be taken as a fixed economic indicator but an early opening gambit in the expected spring policy battle.

Some economists blame this year's poor growth on the government's befuddled macroeconomic policy rather than a shrinking output gap. The often contradictory statistics certainly suggest the explanation to be anything but straightforward as growth is recorded in some areas while shrinking elsewhere. But two factors do stand out: the continuing high cost of servicing debt and falling confidence. It means that consumers and small to medium-sized businesses are finding it too expensive to spend or invest and, at the same time, have less and less incentive to do so as they fret over the future direction of the economy. The result is that investment spending was down 1.9 percent year on year at the end of October, and retail sales are running at half the pace of growth reported this time last year.

At the same time, however, we should see a small rebound in the November and December data because of the big increase in public sector spending which takes place in the final quarter of each year. Partly it should also come because of the so-called base effect when compared to the weak results recorded in the final months of last year. In practical terms, this brief respite means that the ruble should remain relatively stable against the dollar and euro between now and early 2014, although further small weakness to an exchange rate of circa 33.5 rubles for $1 coming into the holiday season is probable. Central Bank interventions should ensure nothing much worse occurs.

But these recovery factors are all technical rather than representing a sustainable trend reversal. The problem of the underlying weak economy will almost certainly re-emerge from early next year as the base effect will be negative because of a strong first quarter this year, and we will not have the equivalent boost from, for example, the grain harvest or the year-end rush to spend budget allocations. We will, however, still have the continuing problems of high debt service costs, low confidence and some policy inconsistencies.

While first quarter scorecard will come in mid-April, Sochi will likely keep the worst off the table until March. Someplace in that time period is when the policy debate should heat up and dominate the months ahead of the government's annual economic showcase in St. Petersburg in late June. The Kremlin may also not wish to have headlines about a deteriorating economy when the Group of Eight comes to Sochi in early June, or at least not without being able to show that a remedial plan has been put in place. The International Monetary Fund expects the world's major developed economies to deliver average growth of 2 percent in 2014, up from 1.2 percent this year. My estimate is that, without some effective remedial policy action in the spring, Russia's economy may only grow by 1.8 percent next year. My estimate for the ruble-dollar exchange rate by end of next year will be close to 36, and the ruble-euro rate will be about 46.

So what actions should we hope to see the government taking in the spring? There are several categories which need to be addressed.

• One of the problems facing consumers and small businesses is the existing high cost of debt service. To a large extent, this is more of a bank-sector structural issue. The average bank lending rate is about10 percent this year, but for small enterprises and retail consumers, the rate is significantly above that. But the current overnight interbank rate is only 6 percent, and the three-month MosPrime rate is just above 6.5 percent. Last week, Central Bank head Elvira Nabiullina warned about the danger of a debt bubble if bank lending growth continues at the current pace. Surely, the issue is about the disconnect between the cost of bank funds and the rate they charge their customers from one end, and the very high amount of disposable income and cash flows required to service debt from the other.

• The federal budget is still spending far too much money in nongrowth areas such as some social programs and defense procurement. Sure, a lot of this money does eventually trickle back into the economy, but there needs to be action on the much-discussed plan to create direct investment incentives and to encourage small to medium-sized businesses to expand.

• Wage growth is too high and is being led by the public sector. Nominal public sector wages grew by more than 20 percent through the past three quarters, and the contagion pushed private sector nominal wages up by more than 10 percent. The argument has been made that the base — that is, public sector wages — is still relatively low and needs to be addressed. That is a fair argument, but so too is the argument for slowing down currently fast wage growth until the economy can again afford it. Russia is already no longer a low-cost base for manufacturing and service companies.

The critics will already accuse that these actions represent only a modest tweaking of the problem. The bigger issues are structural and the fact that the reform agenda is still creeping forward at far too slow a pace, despite some recent success. And of course they are right. The real answer to the question of how to boost long-term growth is to create a predictable business climate, boost infrastructure investment, achieve greater efficiency and create greater economic diversification. The more immediate problem, however, is to prevent the economy from repeating this year's very poor result.

To paraphrase one of Irish writer Oscar Wilde's lines: "To lose one year of growth may be regarded as a misfortune. To lose two looks like carelessness."