

Russian manufacturing: the effects of crisis and new opportunities

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From 2014 to the present there has been recession in the Russian economy. Decrease in export revenues due to lower prices for oil and other energy resources, as well as Western sanctions, could be considered as exogenous causes of the crisis. Meanwhile, a number of Russian economists, government and business representatives regard the crisis as a new opportunity for domestic manufacturing due to import substitution and growth of exports. In a broad sense, it is a matter of the Russian economy's transition from the rent, or rough, to the technological model of development. This theme, in particular, repeatedly discussed within the Gaidar Forum held in Moscow in January 2016. The questions are: whether there had been qualitative changes in the Russian manufacturing after the crisis began, and sanctions were imposed? Does the crisis contribute to acceleration of manufacturing?

At first glance, Russia simply does not remain any other way out of the crisis than to develop its own manufacturing sector. With such a sharp decline in revenues from the export of energy resources the country will not be able to buy foreign manufactured goods to maintain its own infrastructure in working order. To ensure domestic production of food, clothing, medicines must be at least of national security. In addition, there are the preconditions for economic efficiency growth in domestic manufacturing. Russian ruble exchange rate against the US dollar fell by more than 2 times for the past 2 years, that should contribute to Russian producers. Costs of domestic products became lower than foreign counterparts, so Russian goods will be more cost competitive in both local and foreign markets. Indeed, the share of manufacturing products in the total goods exports increased in 2015, and goods imports dropped significantly in the same period.

However, despite the positive changes in the balance of payments structure, macroeconomic statistics in general shows the unfavorable situation in the Russian manufacturing. The rate of decline in industrial production accelerated from -0.4 per cent in the first quarter of 2015 to -4.4 per cent in the fourth quarter of 2015.¹⁾ Confidence indicator in the manufacturing has also declined over the past two years, reaching a minimum in January 2016.¹⁾ Monthly physical volume of industrial production decreased by an average of 4.5 per cent in 2015 relative to the same period of the previous year.²⁾ Mining and quarrying have grown in physical volume in the past year, and the manufacturing sector has declined even more rapidly than industrial production in average. For example, production of autos fell by 45 per cent and production of buses crushed down by 6 times. Output of certain foods decreased significantly: meat production fell by 17 per cent; buckwheat fell by 38 per cent.³⁾ Moody's analysts found that import substitution in Russia does not work in any sector, except food production.⁴⁾ What factors limit the growth of Russian manufacturing?

Federal State Statistics Service (Rosstat) makes monthly surveys among businesses, where respondents specify the most important factors limiting the growth of output. With reference to manufacturing companies, the key factors limiting output were identified as: low demand in the domestic market; uncertainty of general economic situation; and lack of financial resources.²⁾

Real disposable income of households continues to decline over the past two years, the rate of decline increased from -4 per cent in 2015 to -6.3 per cent in January 2016.²⁾ As a result, household spending on final consumption also declined: they dropped by 9% in 2015.¹⁾ The devaluation of ruble, which has caused the inflation, and also cutback of wages measured in rubles, are the main causes for reducing the household income. Russian households are changing their consumption patterns by switching to cheaper goods and abandoning long-term purchases.

The problem of insufficient domestic demand in Russia could be solved at the

1) OECD Statistics, accessed February 20, 2016, stats.oecd.org

2)

Federal State Statistics Service, Official statistics, last modified February 9, 2016, http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/accounts/

3) "Industrial output in Russia fell by 2.7% in January" (in Russian), last modified February 15, 2016, <http://www.finmarket.ru/main/article/4220576>

4) "Moody's did not notice the effect of import substitution in Russia" (in Russian), last modified August 18, 2015, <http://www.rbc.ru/finances/18/08/2015/55d2269b9a79470b8cb0dd70>

expense of domestic credit enlargement. Central banks of Japan, Europe and especially US Federal Reserve System increased money supply after the 2008 crisis, running the programs of quantitative easing. US quantitative easing held from 2008 to 2014 worth 4 trillion dollars has been the most ambitious program of economic stimulation in the world history. However, the implementation the similar stimulation programs in Russia is limited, on the one hand, by the high volatility of ruble, and the other hand by Western sanctions.

The key rate set up by the Central Bank of Russia (CBR) is kept at 11 per cent from August 2015. This value corresponds approximately to volatility level proper to the exchange rate of ruble, which is inversely proportional to the world price of oil. High volatility of the world oil market does not allow to stabilize the exchange rate of Russian currency and to reduce the CBR key rate. That is why ruble loans are too expensive for majority of households and producers.

The largest Russian banks with state share in the capital of more than 50% were under EU sanctions since 2014. Sanctions impose a ban on trading in securities of Russian banks with maturities longer than 90 days, which limits the access of Russian banks to long-term financing in Europe.⁵⁾ As a result, Russian companies can not get low-cost long-term financing from domestic banks, that limits the possibility of their modernization, as well as obstructs starting new investment projects in manufacturing.

Financial constraints do not affect those projects, which were launched earlier, and there are quite few such new projects in Russian manufacturing. Among them, for example, special economic zone “Alabuga” in Tatarstan can be identified, where modern chemicals, automotive parts, building materials, food products are produced using new technologies. Russia has already formed several automotive clusters. Full cycle production of automobile engines has been launched in the largest of them, located in the Kaluga region, in autumn of 2015. Large enterprises producing agricultural equipment in Rostov and St. Petersburg have been modernized, and now they are using competitive by the world standards technology. Government programs supporting agricultural producers, transport engineering, pharmaceuticals have been approved and are realizing currently. Tax breaks, soft loans and subsidies to corporate customers are the basic tools supporting producers.

⁵⁾ Klinova, M., Sidiriva E., “Economic sanctions and their impact on economic relations of Russia and European Union” (in Russian), Voprosy Ekonomiki, 12 (2014): 67 - 79.

As a result of modernization and state support to producers, as well as due to reduction of costs denominated in rubles, domestic production gradually begins to dominate the domestic market in a number of industries. Foreign manufacturers, which are not able to compete, leaving the market. Such companies as SEAT, Dodge, Chrysler, and the number of less well-known Chinese and Ukrainian producers have already left automotive market of Russia. The rest are still hold the market by shifting losses on all links of their global value chains. Companies that left the market will likely not come back in the future. Their market share will be divided among Russian producers and foreign companies, which were able to localize production in Russia.

Thus, we should consider the lack of cheap loans for producers and households as the main limitation of manufacturing development in Russia. The problem of choosing the monetary policy priorities was a discussion in Russia for many years, with debate underway among supporters and opponents of the credit stimulating of economic growth. Sergey Glazyev, the Russian President's advisor in economic policy, has repeatedly stated the need to increase the money supply by additional ruble emission. His opinion was supported by representatives of big business: in particular, the problems of producers' access to financial resources were stated by well-known entrepreneur and billionaire Oleg Deripaska.⁶⁾ The central bank and the government at the same time carry out a tight monetary policy, keeping the money supply unchanged. Majority of liberally oriented Russian economists supports such kind of policy, calling it uncontested.

What the government rely on, if the funding deficit and low domestic demand, as everybody already well aware, are not conducive to the manufacturing growth? Probably, they rely on the energy exports growth in the future. According to the 'BP Energy Outlook 2035' forecasts, Russia will be the world's largest energy exporter in the next 20 years, while retaining their place in the top three in volume of oil and gas production. It is expected that energy consumption in Russia, valuated in tones of oil equivalent per currency unit of GDP, will decline, as energy exports to grow.

Recently, there was reached an agreement between Russia, Saudi Arabia, Venezuela and Qatar on the freezing of oil production, which should stop the decline in world prices. If world oil prices will rise somewhat in the future, the

⁶⁾ Osadchiy, M. "Central bank and its animadvertisers" (in Russian), Izvestia, last modified October, 9 2014, <http://izvestia.ru/news/577808>

Russian exports will grow, and then it will be possible to find financial resources to continue the modernization of manufacturing. In the meantime, during the crisis, Russian manufacturing companies are completing ongoing projects, increasing the level of localization and mastering new types of products.

[Reference]

1. OECD Statistics, accessed February 20, 2016, stats.oecd.org
2. Federal State Statistics Service, Official statistics, last modified February 9, 2016, http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/accounts/
3. “Industrial output in Russia fell by 2.7% in January” (in Russian), last modified February 15, 2016, <http://www.finmarket.ru/main/article/4220576>
4. Moody's did not notice the effect of import substitution in Russia” (in Russian), last modified August 18, 2015, <http://www.rbc.ru/finances/18/08/2015/55d2269b9a79470b8cb0dd70>
5. Klinova, M., Sidiriva E., “Economic sanctions and their impact on economic relations of Russia and European Union” (in Russian), *Voprosy Ekonomiki*, 12 (2014): 67 - 79.
6. Osadchiy, M. “Central bank and its animadvertisers” (in Russian), *Izvestia*, last modified October, 9 2014, <http://izvestia.ru/news/577808>

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