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››› Russia – import substitution during recession

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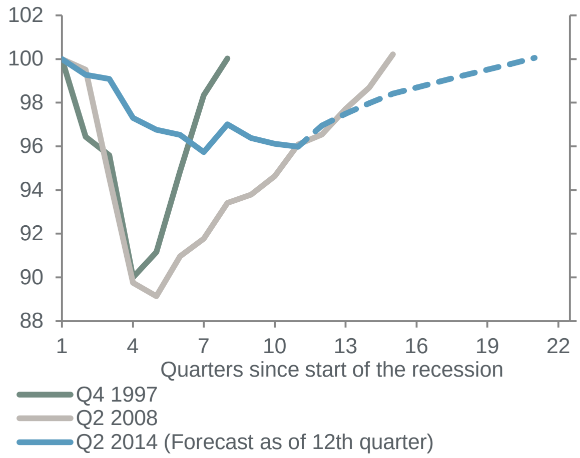
Russia is set to come out of recession this year. However, real GDP growth is expected to be muted, which is also due to the weakened banking sector. In this recession as well, imports have dropped drastically. Whether or not that has led to strengthening domestic production in the longer term – also supported by government import substitution measures – remains to be seen. Structural reforms will be necessary in any case. They will have to target institutions and property rights in order to improve the business climate and strengthen entrepreneurship. Reforms should also reduce the country's dependency on oil and natural gas for exports as well as for the overall economy.

After Russia's recession bottomed out in the course of 2016, economic output is set to rise this year. Previous recessions in the Russian Federation[1] began in the fourth quarter of 1997, the second quarter of 2008 and the second quarter of 2014[2]. The first recession coincided with the rouble crisis and the second one with the global financial and economic crisis. The present one is being associated primarily with the decline in the oil price and sanctions and counter-sanctions imposed because of the Ukraine crisis. But the country had already entered a stagnation phase before – after recovering from the global recession. At the turn of the years 2014/2015, gross domestic product (GDP) began to contract and the banking system was under massive pressure.

Figure 1: Comparing recessions

Real gross domestic product, index at start of recession=100.



Sources: Thomson Reuters Datastream, IMF, own calculations.

Unlike the fast pace of the financial turmoil, the recession took relatively long to unfold and businesses had time to adapt to the changed conditions. Even though only three and a half highs and lows are available to compare business cycle episodes, and different causes and circumstances also need to be taken into account, but it is already becoming apparent that the recovery is progressing only slowly (see Figure 1). The downturn in the current recession was not as strong as in 1997 and 2008. But real gross domestic product is taking significantly longer to return to its previous level than in the two previous recessions.

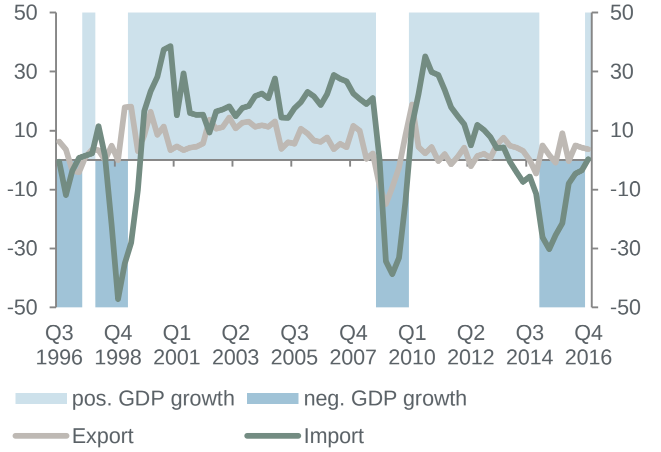
The slow recovery is typical of the economic weakness that follows banking crises, after which per-capita income levels take eight years on average to return to pre-crisis levels.[3] Even if Russia has been able to keep the banking crisis under control – thanks to massive government support – growth prospects are still subdued. Structural reforms are therefore all the more important to improve long-term growth. This is because potential growth is now estimated at only 1 to 1.5 % annually.[4] Structural problems in areas such as property rights and good governance as well as unfavourable demographic factors are slowing down long-term economic development.

Imports have been drastically reduced ...

Of the expenditure components of gross domestic product, imports have contracted most strongly in the current recession, by as much as -30 % in the second quarter of 2015 compared to the same quarter of the previous year.

Figure 2: External trade

(change on same quarter of the previous year in per cent)



Source: Rosstat, own calculations.

Exports, on the other hand, increased by around 3.6 % in real terms in 2015 (see Figure 2). This led to a corresponding strong positive growth contribution of net exports which bolstered GDP growth by around 7 percentage points. The growth contribution of net exports was previously much lower and even negative between 2005 and 2012 – with the exception of the crisis year 2009.

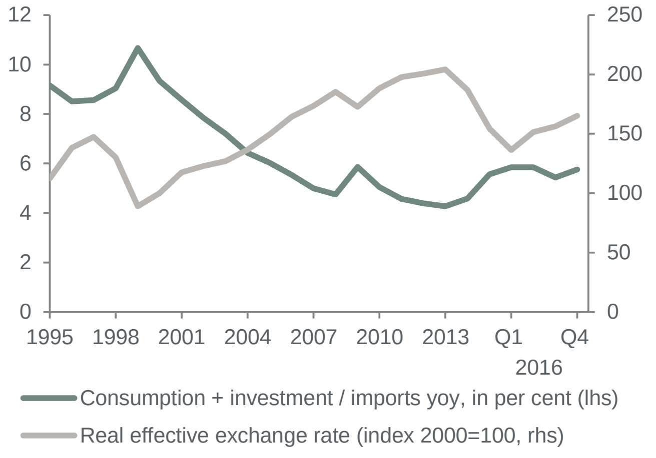
... but not widely substituted

Particularly since the Crimean crisis in March 2014, Russia has been taking targeted steps to reduce imports of foreign products and substitute them with domestic products. But import substitution was an economic policy objective even before then. Advocating for raising the domestic production of goods, however, is distinct from the traditional development policy strategy of import substitution aimed at promoting the industrial sector. This is because in Russia it also includes the agricultural sector, especially food production. Furthermore, policymakers are not seeking to substitute all imports with domestic goods but to realign in part regional trade flows – away from countries participating in sanctions to countries with which political relations are less sensitive.

The economic-policy measures are broad in scope and involve, among others, the automotive sector, the defence industry, engineering, electronics and pharmaceuticals (see box). Some, including the Gaidar Institute, regard the successes of the import substitution strategy as very modest.[5] In assessing the strategy it needs to be considered that Russia's economic-policy measures are affected by two further developments that favour the substitution of imports with domestically produced goods and services: real currency depreciation accompanied by a decline in demand in the wake of the recession, and the sanctions and counter-sanctions imposed in response to the Ukraine conflict.

Currency depreciation and decline in demand are temporary factors. Neither past recessions nor depreciation periods have led to a long-term shift in favour of domestic production. At the same time, it is very clear that the ratio of consumption and investment to imports improves in periods of depreciation (see Figure 3). During periods of appreciation, however, it deteriorates again. Among the OECD countries, this relation differs widely; the correlation between the real effective exchange rate and the ratio of domestic demand to imports ranges from +0.86 in Japan to -0.94 in Slovakia in. Russia is at the head of the ranking with a correlation coefficient of -0.93 indicating an opposing trend between the two parameters. At the current margin, however, domestic demand has increased relative to imports despite a real appreciation of the rouble. It remains to be seen whether this will give rise to a longer-term development.

Figure 3: Exchange rate and domestic demand



Source: IMF.

The agricultural sector is one focal area of import substitution. Russia's counter-sanctions in the wake of the Ukraine conflict in particular prohibit imports of foodstuffs and agricultural products from certain countries. But it can import such goods from other countries on which it has imposed no sanctions. It is thus the development of the real effective exchange rate that is being credited with having the crucial effect of making Russian agricultural products more competitive. Besides, producers have shown sufficient flexibility in adapting to the changed demand structure in the local and international market so that the production of important food categories increased. At the same time, expenditure on imported food rose in roubles, but import volumes decreased.

Box: Russia's import substitution programme[6]

The March 2015 import substitution programme provided for 2,059 individual projects in 19 economic sectors to be implemented between 2016 and 2020. The aim is to (increasingly) produce up to 800 selected products in Russia. The total cost of the import substitution programme is currently estimated at approx. EUR 35 billion (about 3 % of GDP). The process is being accompanied by the Government Commission on Import Substitution. Important measures involve restrictions and requirements on public procurement, the costs of which have risen by an estimated 40 % as a result.[7] They also include procurement by public enterprises such as the Russian postal service. Import restrictions and public finance also play a role.

The three determinants – exchange rate, sanctions and economic-policy measures – are of relevance to manufacturing, too. The depreciation of the rouble benefits primarily export-oriented Russian industries that have a high domestic share of value added and few imported inputs, such as the chemical and petrochemical industry. International trade sanctions affect the energy and defence sector in particular, as well as Russian imports of goods with dual, that is, civilian as well as military uses. On the one hand, this may benefit the respective Russian manufacturers. On the other hand, it may lead to shortages if production capacities are insufficient or suppliers are lacking.

Outlook: structural reforms and potential growth

The Russian economy needs a diversification strategy that addresses its heavy dependence on oil and natural gas. Also necessary are improvements to the business environment, a reduction in government influence on business, and greater openness. The sobering experience of Latin American countries' import substitution strategy during the 1950s and 1960s gives reason to be sceptical about whether the economic-policy measures to promote domestic production will be successful in the longer term. Most of all, the support measures are no substitute for necessary reforms. The gaps in competitiveness identified by the IMF are also diverse and extend across areas such as property rights and corruption (institutions), tax rates and tariffs (efficiency of the goods market), financial market development (statutory rights), the quality of locally produced goods and the state of development of production processes, as well as the availability of engineers and scientists. These are the areas that weigh on Russia's international competitiveness. A certain trend towards improvements that was observable before the recession has fizzled out in many areas. With the economy showing signs of recovering, the time has come to restart the reform processes. ■

[1]There are only a few ways to compare the current and preceding recessions because an analysis of the Russian economy's business cycle was not possible until the mid-1990s, after the economy's transition from a planned to a market economy. Moreover, that transition came with a protracted depression that lasted until 1996.

[2] In technical terms, a recession is defined as two consecutive quarters of negative GDP growth adjusted for seasonal variations. The exact dating also depends on the seasonal adjustment procedure.

[3] Reinhart, C. M. and Rogoff, K. S. (2014), Recovery from Financial Crises: Evidence from 100 Episodes, American Economic Review: Papers & Proceedings, 104(5): 50–55.

[4] Bank of Russia (2016), Monetary Policy Report No. 4.

[5] BOFIT (2016), Weekly Review 46, 18.11.2016, Bank of Finland.

[6] Conolly, R. and Hanson, P. (2016), Import Substitution and Economic Sovereignty in Russia, Chatham House Research Paper, Russia and Eurasia Program.

[7] BOFIT (2016), Weekly Review 19, 13.05.2016, Bank of Finland.