

Heli Simola: Russian economic growth calls for investment

Growth in fixed investment in Russia has accelerated significantly in the last 12 months. Despite a slight slowdown in the autumn, annual growth in fixed investment in January–November exceeded 20%. Continued robust growth in investment is indeed crucial for Russian economic growth, because productive investment has been too low in the last decade. Russia's investment ratio has remained around 20%, which is rather low for a developing economy. In Russia, investment is needed for furthering the diversification of the economy, supporting the energy sector that plays an important role in the Russian economy and for repairing deficiencies in infrastructure.

The aim of diversifying the Russian economy calls for major investment

To safeguard economic growth in longer term, Russia aims to diversify its manufacturing structure and raise the value-added in domestic production in order to reduce dependency on raw material income. Increasing the weight of the manufacturing industry calls for major investment especially since throughout the 21st century, the manufacturing industry has continued to account for clearly less than one fifth of fixed investment. Production has earlier been increased by exploiting existing excess capacity, but in many industries this path has been exhausted and capacity limits are approaching. Furthermore, the stock of machinery is often outdated and ineffective, so investment in new machinery and equipment is needed to boost the competitiveness of the manufacturing industry.

On the other hand, Russia cannot ignore the development of its energy sector. Russia continues to be heavily dependent on the energy sector, which has been estimated to account for even nearly one third of GDP. With its 30% share, the energy sector (incl. extraction of oil and gas, pipeline transportation, oil processing industry as well as production and distribution of electricity, gas and water) as a whole is still the single largest investment target. The share of the energy extraction sector out of total investment has nevertheless subsided somewhat owing to tight taxation on oil income, whereas the share of electricity production has increased slightly. However, energy consumption in the country is constantly growing,

attempts to improve energy efficiency have not made a noticeable difference and the energy sector is characterised by an obsolete and deficient distribution network. It has been estimated that problems in energy supply already have, to some extent, an adverse impact on the development of the manufacturing industry, so it is important to safeguard energy production also in the view of enhancing the diversification of the economy.

In addition, the general infrastructure in Russia calls for repair and new construction. The deteriorated and deficient transportation infrastructure is largely unable to meet the needs of the growing economy, and today feasible information technology solutions are crucial for business. Approximately one fifth of all investment is channelled to construction and real estate services as well as to the transportation sector (excl. pipeline transport). Despite the accelerated growth in construction seen in recent years, lack of suitable commercial and storage facilities and residential buildings is still acute.

Public sector contribution to investment decreasing

The contribution of the public sector to investment has subsided throughout the 21st century to less than one fifth, with the government reserving oil income in the stability fund. However, in next few years a large sum from the budget are planned to be spent in new investment projects, particularly those in infrastructure and energy. In addition, a number of institutions have been established in Russia to promote cooperation in investment between the public and private sector, such as the Investment Fund and Development Bank focusing on providing finance for infrastructure and innovation projects. It is important that the public sector has a role in big projects that are often too expensive for private investors, but its role as mainly a provider of conducive operating conditions should be emphasised. In Russia, however, state presence in investment projects is strong also through state-owned companies. State-owned companies have recently been criticised for neglecting productive investment in their core business at the expense of expansion to other industries.

Favourable economic development and improved stability of the operating environment have encouraged companies to increase their investment in Rus-

sia; a number of major investment projects are currently being planned in the metal industry, for example. Although still less than 10%, foreign investors' share of fixed investment has grown substantially in the 21st century. Growth in corporate investment in Russia has accelerated in recent years by developments in the Russian financial market and improved availability of foreign funding, following the upgrade of Russia's credit rating. The importance of bank loans as a source of funding has grown for large companies in particular, but they are still used to finance less than one tenth of all investment. Furthermore, foreign bank loans account for only a couple of per cent of loans, which implies that the recent rapidly grown foreign borrowing by companies has been largely used for financing corporate acquisitions rather than productive investment. However, SMEs still have problems in raising foreign funding, and recent surveys show that lack of funds continues to be one of the key factors restricting investment.

Continuing growth in investment important

It is very important for Russia's favourable economic development that investment growth continues, because economic growth cannot forever be based on higher consumption – driven by oil income– and on the exploitation of existing capacity. A key longer-term objective for economic growth in Russia to continue is the diversification of the economy. This calls for major investment in the processing industry in particular, but the processing industry needs to be supported by efficient energy supply and general infrastructure. Securing this support also requires investment. Recently, the public sector in Russia has taken a more active role in investment. It is good that the public sector contributes to improving overall operating conditions for business, but companies are still the key players. Longer-term development objectives can be supported by ensuring the efficiency of state-owned companies' investment projects, improving the availability of funding for SMEs and enhancing the investment climate in order to attract new domestic and foreign investment.

Heli Simola is an economist at BOFIT.