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The "Made in Russia" strategy: a limited instrument for economic diversification

Thanks to the efforts of the authorities, the diversification of the Russian economy is progressing, particularly in certain sectors such as information technology, pharmaceuticals, the automotive industry and the agri-food sector. In the latter case, the process was encouraged by Russian counter-sanctions adopted as a response to Western sanctions. Economic diversification is regarded as a way to simultaneously reduce the country's dependence on imports and on hydrocarbons. However, the diversification faces structural barriers. It is subject to the availability of inputs, the modernization of the productive apparatus and the improvement of the business environment. The requirement to substitute local production for imports and/or increase local content is limited by the availability and quality of local components. Additionally, the development and modernization of local production chains very often require the import of machinery and technology from Western countries. The current and, potentially future sanctions and counter-sanctions, the business environment (rated B by Coface, 5th notch on a scale of 8), the increasing political risk and the lack of available workforce weigh on domestic and foreign investments. In addition, raw materials (including hydrocarbons) still play an important role in the economy in spite of a weaker link between oil prices and economic growth. This is a result of the new fiscal rule aimed at disconnecting the economy from fluctuations in the oil environment and the growing influence of the political context on capital flows at the expense of crude oil prices.

Diversification is in progress

Diversification supported by the public authorities and encouraged by Western sanctions

This movement is part of an industrial policy that began in the early 2000s, after a decade of upheaval in the industrial structures of the Soviet era. The 2020 Strategy report issued in 2007 was formalized by Federal Laws n°57 dated 29 April 2008 and n°217 dated 2 August 2009[1]. They focused on modernization, technologies, innovation through special economic zones, clusters, human resources and education. Then, the Industrial Strategy 2030 was formalized by the Federal Law n°488 dated 31 December 2014. This text provided a foundation for the import restriction and substitution policy adopted in the agri-food sector in 2014 in the aftermath of Western sanctions. It also provided (in its sectoral versions) a targeting of projects and public funding, a rapprochement between research and industry and a support to exports. The Russian Export Centre was created the same year regrouping promotion, financing and insurance. Special investment contracts designed to encourage foreign investment were created the following year. "Made in Russia" was encouraged by selective tax cuts, privileged access to public procurement and favorable credits to finance export projects (Decree 719). Legislation on clusters and industrial parks was strengthened. Western sanctions, the sharp drop in oil prices and the concomitant devaluation of the ruble in 2014 acted as a catalyst for the authorities in **their quest to diversify the economy, as a means of reducing the country’s dependence on imports and on hydrocarbons.**

Diversification is already effective in certain sectors

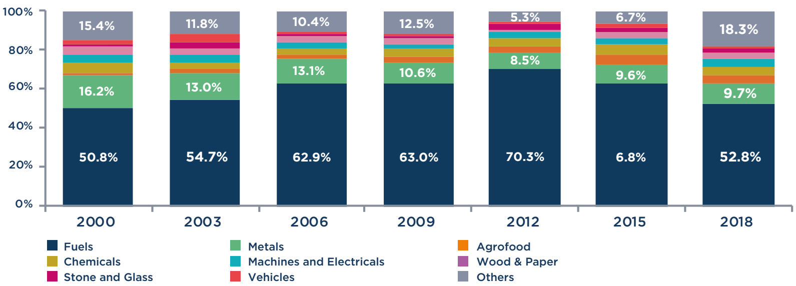
The most significant results were in **the agri-food sector[2].** Indeed, Russian counter-sanctions answered Western sanctions. An embargo was enforced on imports of agri-food products from the countries that imposed the sanctions. Affected imports accounted for 10% of food consumption, Following the same pattern, 60% of fruit consumption was imported, of which half was stopped. For dairy products, the figures were 20% and 50% respectively. Meat, fish, vegetables and processed products were also affected, but targeted imports accounted for a smaller share of consumption. Despite resorting to other foreign suppliers, significant subsidies and illegal imports via third countries, the scarcity led to an increase in prices that diverted Russian consumers from imported products to those produced locally or simply discouraged them from buying those products. However, the increase in prices also affected local products[3]. The share of imports in food consumption has decreased from about a third to 20% and self-sufficiency was achieved for meat. In total, agri-food represented 11.4% of Russian imports in 2018 compared to 13% in 2012, or 27 billion dollars (constant) compared to 41. In addition, the Presidential Decree of May 2018 includes a target (by 2024) of an 11% increase in agri-food production and a doubling of agri-food exports, the third largest item with 5.1% of total exports in 2018 against 3.2% in 2012 (USD 23 billion against 17) driven in particular by cereals and oilseeds. In this context, a USD 4 billion (2018-2020) government program aims to encourage national production through rail transport, subsidized loans and subsidies. A specific program based on USD 70 billion in private and public investment aims to increase cereal production from 118 to 140 million tons and exports from 45 to 56 million tons by 2035. Oligarchs are invited to invest in this area. However, the lower quality of local production in some instances sustains imports, even when offset by lower prices: as an example, a large part of the local production of apples goes to the processing industry[4].

Similar efforts are being made in other sectors with varying degrees of success. The search for independence products considered strategic is crucial. Additionally, another reason for restricting imports may simply be the desire to favor the local branch and its actors; chocolate makers have thus obtained the addition of their produce to the list of prohibited imports in 2015.

A decree dated February 2019 prohibits the public sector from importing **computer, telecommunications and household equipment** when there are local producers (i.e. at least 50% Russian owned). In addition, a draft legislation under discussion provides for a 20% cap on foreign ownership of Russian technology companies. Concurrently, the authorities are seeking to expand the production of electronic components currently purchased from 77 foreign suppliers. This is a response to the Western embargo on technology sales for the energy, intelligence and defense sectors. Russian exports of mobile applications, navigation systems and data security are already growing. The authorities are also promoting the development of local search engines and operating systems, with the aim of reducing dependence on Western technologies and improving information control. However, performance remains modest. Exports of information technology goods accounted for only 0.58% of total exports in 2017 (source: United Nations; Globaleeconomy.com). Exports of IT services amounted to USD 4 billion in 2018 compared to USD 2 billion in 2012, while imports reached USD 3.5 billion compared to USD 2.3 billion in 2012 (source: World Trade Statistical review). For the Russoft trade association, Russian software exports increased from USD 2.7 billion in 2009 to USD 7.6 billion in 2016 and USD 10.5 billion in 2018, while the total turnover of companies in the sector reached USD 17 billion.

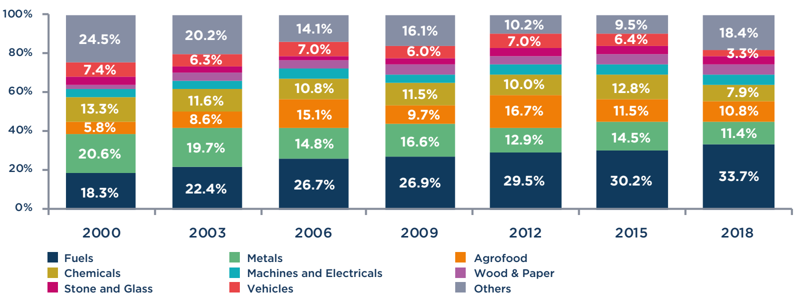
The same desire to reduce import dependency can be noticed in the **pharmaceutical** sector. Pharma 2020, a sectoral declination of Strategy 2020, includes tax incentives to produce locally and benefits to local products in public procurement. Foreign manufacturers signing a special investment contract with the authorities can benefit from an exclusivity with the State. Yet in 2018, local products accounted for only 20% of the market, but 35% in public procurement and 83% for products considered essential, below targets in all cases. Pharmaceutical imports accounted for 4.6% of total imports, as in 2012. Pharma 2030 (which has just been passed) plans to increase local production from 20 to 65% of the market and to develop exports that are currently anecdotal. Foreign manufacturers are cautious in their investments given public interference in prices, parallel imports, generics, and relative respect for intellectual property.

CHART 1
Russian exports by products



Sources: WITS, ITC, Coface calculations

CHART 2
Russian imports by products



Sources: WITS, ITC, Coface calculations

1 - *Christian Longhi et Sylvie Rochhia, Dix ans de politique industrielle en Russie (Revue d’économie industrielle 2016/3 n°155*
2 - *Judy Twigg, Russia is winning the sanctions game (National Interest) https://nationalinterest.org/blog/skeptics/russia-winning-sanctions-game-47517*
3 - *Was bringt der Einfuhrstopp für europäische Lebensmittel für Russland? https://aussenwirtschaft.vdma.org/viewer/-/v2article/render/38802458*
4 - *https://russiabusinesstoday.com/agriculture/russias-fruit-import-substitution-not-working-as-planned-data-shows/*

In the **automotive** sector, the Auto 2020 targets have been postponed to 2025. This includes increasing the share of locally manufactured components from 30 to 55% and increasing exports that, for the time being, are limited to Central Asian markets. Between 2012 and 2018, the share of vehicles in Russian exports remained close to 1%, while that of imports decreased from 17 to 11%, from USD 53 billion to 26. Special investment contracts with foreign manufacturers provide (for a period of up to 10 years) tax incentives, privileged access to public procurement and protection from future tax developments against commitments to produce locally and promote innovation. The market is 75% second hand, characterized by low capacity utilization (45%) and artificially supported by the government's aid program for the purchase of passenger cars "First car, family car" introduced in 2017 with subsidized loans and price reductions from 10 to 25%, so there should be caution. As Opel announces its return to the Russian market, Ford is closing its plants there. The commercial vehicle and truck market is more dynamic and attractive.

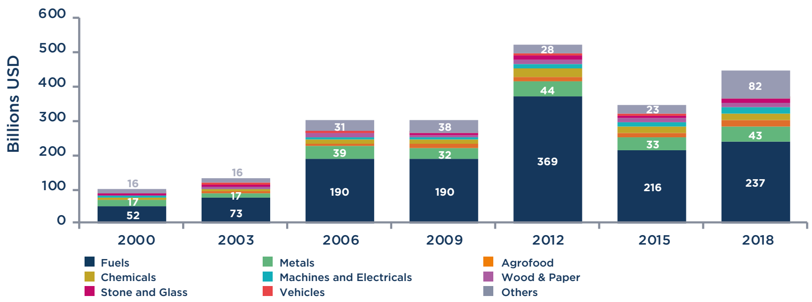
Diversification is subject to the availability of inputs, the modernization of the productive system and the improvement of the business environment.

The requirement to substitute local production for imports and/or increase local content is limited by the availability and quality of local components. Thus, the country has a deficit of some high value-added petrochemical products, such as composites or additives[5], but also of rolled metallurgical products and tubing[6]. This illustrates the inadequacy of local processing of raw materials, to which the authorities also intend to remedy.

Furthermore, the development and modernization of local production chains requires the import of machines and technologies, very often from Western countries (Germany, USA, Switzerland, United Kingdom, Netherlands...) but also increasingly from China, Korea or Taiwan where prices are lower. Although sanctions only apply to a few sectors (transport, energy, telecommunications, oil and gas exploration), the import of certain technologies is made difficult when they have mixed uses. The higher the range, the greater the obstacles. For example, according to the results of a study dated July 2019 by the Institute of Statistical Research and Knowledge Economy of the Russian Higher School of Economics, imports and exports of technological products and services increased in current dollars by 7.7 and 5.8 times respectively between 2001 and 2018 to reach USD 3.1 and USD 1.4 billion each. In imports, engineering accounted for 46% and intellectual property protected goods for 35%. We can clearly see the disproportionate weight of imports of capital goods compared to exports. In 2018, they accounted for 33.7% of total imports compared to 29.3% in 2013. In the agri-food sector, 50% of the value added is of foreign origin due to imports of inputs and machinery. Strategy 2030 aims to reduce the share of imported machine tools (currently by 70%) to triple the production of agricultural machinery, to increase the local share in construction machinery from 40% to 70%[7]. To this end, local manufacturers receive subsidies for research, production and sales.

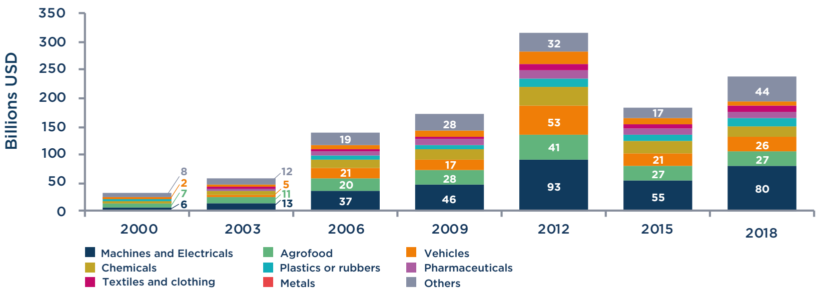
The sanctions and counter-sanctions (current and potentially future), the business environment (rated B by Coface, 5th notch on a scale of 8), the increasing political risk (faced with the erosion of its purchasing power, the population showed its disenchantment with the government during the last local elections) and the lack of available workforce due to the low birth rate, weigh on domestic and foreign investments

CHART 3
Russian exports by products in Billions USD



Sources: WITS, ITC, Coface calculations

CHART 4
Russian imports by products in Billions USD



Sources: WITS, ITC, Coface calculations

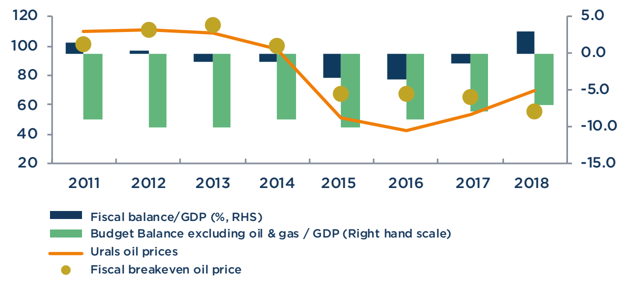
which could accelerate diversification and reduce dependence on imports. As a result, foreign direct investments excluding reinvested profits (which include profits sent to offshore centers before repatriation) represented only 0.5% of GDP in 2018. The scarcity of foreign investment and import restrictions do not favor the improvement of the business environment. In a relatively concentrated economy, including in sectors where the State has a limited presence, with obstacles to imports, competition is reduced and profits derived from a privileged situation are common[8].

Raw materials, especially hydrocarbons, still play an important role in the economy, although the link between hydrocarbons and the economy has recently weakened

The share of all hydrocarbons and the related economy amounted to 30% of GDP in 2018, with equal shares for oil and gas. Mineral products still accounted for 67% of merchandise exports in 2018 compared to 73% in 2014. For hydrocarbons alone, the figures were 58% and 66.4% respectively. For oil and its derivatives, of which the country is the world's second largest exporter, 46% and 54%. In the form of production and export taxes, hydrocarbons accounted for 45% of federal budget revenues in 2018 and one-third of total government revenues, which is a slight increase from 2014. Taxes account for nearly half of the production cost of a barrel of oil or its gas equivalent (USD 20, twice the level of Iraq, Iran and Saudi Arabia, but similar to Norway, the United States excluding shales or

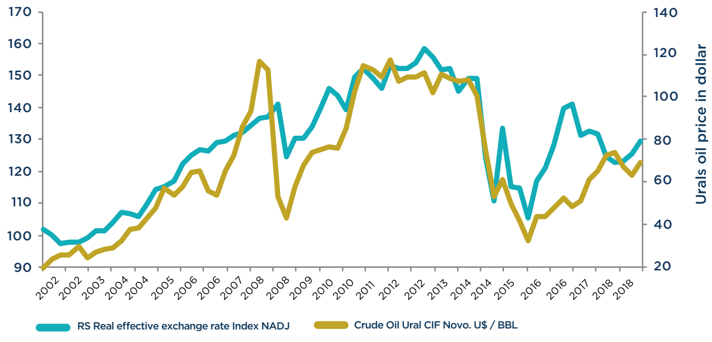
5 - https://www.hydrocarbonprocessing.com/magazine/2019/march-2019/columns/europe-russian-petrochemicals-industry-on-the-verge-of-large-scale-growth
6 - Import-substitution prospects for Russian non-ferrous metals market: https://www.acra-ratings.com/research/1279
7 - https://www.globalmarketsinternational.com/latestmarketpost/russia-machinery-mechanical-engineering-companies-projects-2019/
The Russian machine tool industry, prospects for a turnaround? par Tomas Malmlöf (February 2019) https://www.foi.se/rest-api/report/FOI-R--4635--SE
8 - https://russiabusinesstoday.com/economy/food-embargo-profitable-for-nearly-half-of-russian-businessmen-study-shows/

CHART 5
Federal fiscal deficit and oil prices



Sources: Datastream, Ministry of Finance, Intellinews, ING

CHART 6
Oil price and real effective exchange rate



Sources: Datastream

Indonesia - source: Rystad Energy UCube). However, there is also an income tax revenue component paid by companies and employees of the energy sector, as well as subsidies on the selling price of energy financed by the sector. Without oil revenues, the federal budget would have been in deficit by 7% of GDP in 2018. It is therefore understandable that the authorities are concerned in maintaining the current price (USD 65 on 16 September 2019, while the price used to balance the federal primary budget is USD 50) by participating in the OPEC+ price conservation agreement effective since 2016. Operators are seeking to offset the slow growth in production from Western Siberian fields by developing those in the Arctic, Eastern Siberia and the Caspian Sea, as well as increasing the recovery rate estimated at 30% by Gubkin University. The Western embargo on exports to this sector forces local operators to supply themselves on the second-hand market for the equipment of their fields, while Exxon has preferred to withdraw from joint ventures.

The weakening of the link between hydrocarbons and the economy can be explained, on the one hand, by the new fiscal rule aimed at disconnecting the economy from changes in the oil situation and, on the other hand, by the growing influence of the political context on capital movements to the detriment of crude oil prices[9].

9 - Hooked on oil: is Russia breaking free? K. Vartapetov, T. Lysenko; S&P Global ratings

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