CENTRE FOR EUROPEAN REFORM
policy brief

How to reform the Russian economy

By Sergei Guriev

★ Although the Russian economy is recovering from its 2009 recession, big challenges loom in the medium to long term. With its state-dominated industries, raw material dependence and weak institutions, Russia will not be able to catch up with the richer developed countries.

★ If Russia wants to avoid the kind of stagnation that plagued the Brezhnev era, it will have to improve the protection of property rights, allow for stronger competition and reform its legal system. However, Russia does not have enough private businesses to lobby for such improvements. The best way to create a pro-reform constituency would be to privatise state-owned companies and make it easier for small businesses to grow. Russia would also benefit from an outside anchor for reforms.

★ However, Russia's ruling elites gain handsomely from the current opaque and skewed economic environment; they have little interest in radical change. In the medium term, Russia's economic performance is therefore likely to resemble that of Latin America's commodity exporters in the 20th century: slow growth interrupted by bouts of macro-economic instability.

In 2009, Russian GDP contracted by 8 per cent – the worst recession among the G20 countries and among the big commodity exporters. Some observers thought that the economic crisis would encourage the Russian leadership to implement long-overdue economic reforms. However, the economic downturn was too short and shallow to trigger radical change in Moscow. Partly thanks to the government's fiscal stimulus programme, the economy quickly returned to growth in 2010. Unemployment remained under control. No big banks went bankrupt. The loss in foreign currency reserves was manageable. The government's approval ratings remained solid.

However, the government's fiscal stimulus spending contributed to a massive deterioration in Russia's public finances. As recently as 2006, Russia boasted a consolidated budget surplus amounting to over 8 per cent of GDP; in 2009, it ran a deficit of over 6 per cent of GDP – a turnaround of over 14 per cent of GDP in three years. For 2010, the authorities expect a deficit of 5 or 6 per cent of GDP although oil prices have recovered to $70-80 per barrel. Until 2008, the government would have expected to run a surplus with oil prices at this level.

Russia needs a new growth model

For now, Russia can afford to run such big government deficits: its overall debt is low, the world economy is growing again and its foreign exchange reserves are still the third biggest in the world. In the longer run, however, the outlook for the Russian economy is not good. All the factors that contributed to Russia's rapid economic expansion before the crisis are exhausted:

★ Rising oil prices accounted for about half of GDP growth in the 1998-2008 period. Rising oil prices resulted in higher government revenue and cheaper credit, thus fuelling both consumption and investment. While oil prices appear to have stabilised at a high level of $70-80 per barrel, they are unlikely to increase further in the near future. Hence they cannot make a substantial contribution to economic growth in the coming years.

★ In the years following the 1998 rouble devaluation, Russian industry expanded rapidly on the back of massive spare capacity. For the last couple of years, the Russian economy has been running at full capacity. Further growth will

Centre for European Reform
14 Great College Street
London SW1P 3RX UK

T: 00 44 20 7233 1199
F: 00 44 20 7233 1117
info@cer.org.uk / www.cer.org.uk

require new investment. However, investment in Russia accounts for only around 20 per cent of GDP, much lower than the 35-40 per cent recorded in the rapidly growing Chinese economy, or in the East Asian emerging countries when they were at a development stage similar to Russia's today. To encourage higher investment rates, Russia would require stronger property rights, the rule of law and other improvements in the business environment.

★ Another source of growth in 1998-2008 was the ample availability of relatively cheap and skilled labour. However, as the economic boom continued, employment grew and the unemployment rate halved, to around 6 per cent in 2008. Russian managers are now bemoaning a serious shortage of both skilled and unskilled workers. Since the Russian population is both shrinking and aging, the labour market will continue to be a constraint on growth.

★ Russia's dire shortage of modern infrastructure is becoming more and more problematic for businesses operating there. The government should invest extensively in roads, airports and communication technologies, such as broadband internet. However, corruption is so extensive that a large share of any infrastructure spending programme would be wasted in bribes and kickbacks, or diverted to offshore accounts.

With the pre-2008 sources of growth – rising oil prices, spare capacity, cheap labour – exhausted, Russia's future economic growth will have to come from rising productivity. This will require institutional improvements, such as stronger protection of property rights, consistent contract enforcement, more competition, and greater openness to foreign investment. Currently, the quality of Russia's institutions and governance lags behind countries with comparable income levels.

Those Russians who are hoping for a rapid catch-up with western income levels may want to look at the experience of South Korea. The growth of Russian GDP per head over the last decade has followed a path that is strikingly similar to that of Korea in the 1990s. Russia's level of development today is around the same as that of Korea at the end of the 1990s. Since then, the size of Korea's economy (measured in dollars) has more than doubled. It appears highly unlikely that Russia will enjoy a similar boom.

The quality of the state administration and the legal system in Korea in the late 1990s was infinitely higher than that of Russia today: in the various governance indicators collected by the World Bank – rule of law, government effectiveness, control of corruption and so on – South Korea was already in or near the top-third of countries included in the ranking before it began its latest growth spurt. Russia today ranks in the last third or even last quarter of the World Bank indicators.

Many in the Russian leadership seem to understand these challenges. Successive governments have adopted reform blueprints to address the country's institutional shortcomings, for example the 'Gref programme' of 2000 and the 'long-term development concept for 2020' of 2008. These programmes contain detailed reform plans for simplifying business regulations, restructuring natural monopolies, improving the judicial system and moving to a sustainable pension system. Both President Medvedev and Prime Minister Putin have warned on numerous occasions that unless such reforms are implemented, Russia's long-term development is in jeopardy.

Nevertheless, meaningful reforms look highly unlikely – for the simple reason that they would harm the interests of Russia's ruling elites. In any resource-rich and undemocratic country, the political class and the business owners close to it have little or no interest in strengthening property rights, the rule of law and competition. Indeed, such structural changes would weaken the elite's grip on political and economic power. The status quo – opaque rules, arbitrary decision-making and lack of accountability – allows insiders to enrich themselves, especially through obtaining a share of commodity export revenues. In this sense, the people who run Russia have no incentive to support structural economic reforms.

Nor is there much 'bottom-up' pressure for such reforms: Russia does not have a strong constituency of private businesses to push for stronger institutions and the rule of law. Russia's economy is dominated by big, government-owned companies that can function or even prosper without proper market institutions. The political equilibrium is similar to that of the late Soviet Union: in those days the rents from selling oil, steel and other commodities, together with state-directed redistribution of such revenues, allowed both the political elite and much of society to live comfortably enough. Once the oil price fell in 1986, the Soviet economy crumbled in just five years.

Today's leadership in Russia has more economic expertise and more experience with crisis management than the Soviet leaders had in the 1980s. The Russian economy is much more liberalised, and hence more flexible and adjustable in times of strain. So it is unlikely that Russia's economy could implode like the Soviet one did. A more plausible scenario is slow growth over the medium term, interrupted by bouts of macro-economic volatility caused by oil price swings. Russia's outlook is therefore similar to the experience of Latin America's resource-dependent economies in the 20th century.

A simple lesson: Deregulation and privatisation

How can Russia break out of this 'stagnation equilibrium' and improve its long-term growth prospects? It could gain some valuable insights by studying the economic transition of Central and Eastern Europe in the 1990s. The main lesson from these countries is that to build the institutions necessary for sustainable growth, a country first has to do two things: create a domestic constituency for reforms and find an outside anchor for them.

A government can help to create a constituency for reform by pushing forward deregulation and privatisation. A reduction in the administrative and legal barriers facing businesses will unlock the potential of small and medium-sized enterprises (SMEs). These will then lobby for things such as strong property rights and competition policy.

In 2002-04, the Russian government adopted a number of laws designed to make it easier for companies to obtain registrations, licenses and certificates; and to reduce the number of fire, health and other inspections that companies must endure. Although these reforms reduced the administrative barriers to doing business in Russia, they remained unacceptably high. Coupled with growing corruption, they are preventing the establishment and growth of SMEs.

The government enacted further measures in 2009 and 2010 designed to make it harder for bureaucrats to deny licenses and carry out ad-hoc inspections. It is too early to tell whether these new rules will make life easier for business. The fact that property rights are insufficiently protected, and corruption is ubiquitous, will weaken the impact of any legislative improvements.

The other policy that Russia should pursue is large-scale privatisation of state-owned or partly state-owned enterprises. Russia privatised most enterprises in the early 1990s and the share of private activity in the economy expanded significantly during the last decade. However, some of the largest companies, such as Gazprom and Sberbank, have always remained under state control. And in the last five years or so, the Russian government has re-nationalised many companies and the state's influence in the economy has grown across the board. This trend is going in the wrong direction.

In theory, the conditions for resuming privatisation are good in today's Russia. The economic argument for selling state-owned companies would be easy to make, given that the state budget is running a deficit and the inefficiency of Russia's state-owned behemoths has become all too apparent. Also, unlike ten or 15 years ago, Russia today has the institutional and business environment to carry out privatisation more effectively: it has financial markets to finance bids and launch initial public offerings, and investment banks to value companies and conduct the sales. The successful break-up and sale of the former electricity monopoly UES in 2008 showed that Russia is capable of implementing privatisations in a fair and transparent manner.

Lastly, privatisations should be more politically and socially acceptable today. In the 1990s, many of Russia's most valuable companies were sold to political insiders at rock-bottom prices. Russia's 'oligarchs' became famously wealthy while the benefits for the Russian population were meagre. Today privatisations would be more likely to generate significant revenue for the state budget. The government could use this money to soften the impact of lay-offs that would inevitably follow the sell-offs.

Privatisation is so important because only private businesses will lobby for stronger property rights and contract enforcement. State-owned companies will not because they can prosper on the basis of government favours and protectionism. Both private and state-owned companies with dominant market positions will be opposed to government policies that increase competition. However, even in sectors where monopolies or quasi-monopolies appear inevitable, it is better for such dominant companies to be private than state-owned. Russia's experience shows that it is much easier to regulate the powers of private monopolies than that of state-owned ones which tend to be closely linked to political insiders.

The most straightforward way for Russia to avoid Soviet-era stagnation would be to sell off state-owned companies and encourage the growth of SMEs. Privatisation and deregulation, if implemented properly, would quickly become irreversible: a new group of private business owners would push for further reforms, which would further facilitate growth in the private economy. However, as explained above, such reforms would endanger the ruling elite's spoils and its grip on the levers of power. They are therefore unlikely to happen.

Weak outside anchors

The chances of Russia heeding the other lesson of Eastern Europe's transition in the 1990s – adopting an outside anchor – are similarly uncertain. EU accession, which provided strong incentives for reforms in the Central and East European countries in the 1990s, is not an option for Russia. The anchors that are available to Russia – WTO and OECD accession, and a partnership with the EU – are weak by comparison. That does not mean they are useless. A functioning partnership with the EU, including free trade and regulatory convergence, could do much to stimulate reforms and growth in Russia. Membership in the OECD would expose Russia's economic policies, from taxation to healthcare, to international scrutiny and measure them against best practice among the developed nations.

WTO accession seems irrelevant to many Russians because their country exports mainly oil, gas and other commodities that are not impeded by tariffs. However, WTO membership would help Russia's manufacturing and services companies to sell their products abroad, thus encouraging much-needed economic diversification; it would lead to a more reliable framework for foreign investment; it would make it easier for Russian companies to import the machinery they need to upgrade their production; and it would require stricter enforcement of intellectual property rights, which would make western companies more inclined to transfer technology to Russia.

The most important condition for outside anchors to work, however, is the Russian elite's willingness to use them. After 17 years of WTO negotiations and over a decade of frustratingly slow progress towards a genuine partnership with the EU, there are doubts whether Russian leaders are prepared to accept outside checks and disciplines for domestic reforms. President Medvedev's more positive statements about WTO accession and the agreement on an EU-Russia 'partnership for modernisation' in June 2010 may give some ground for hope in this respect.

Innovation or democracy?

Although Russia is conducting a lively debate about economic modernisation and reform, the options of creating constituencies for change and anchoring reforms internationally are hardly ever mentioned. Instead, the debate revolves around the need for innovation and political democratisation.

Russia's liberal opposition argues that democratisation and political decentralisation are prerequisites for economic change. In the absence of political competition and accountability, for example, corruption and cronyism will only get worse. Those who dare speak up against corruption risk being punished, while even revelations of blatant bribery leave the regime's top cronies unscathed. A less corrupt and self-serving state bureaucracy would certainly find it easier to implement privatisation and deregulation. Yet political liberalisation is not a panacea. A more democratic and accountable government would not necessarily support pro-growth reforms if it resides over a state-dominated economy. It may well be more prone to populist policies.

The Russian government prioritises a different path to economic change, namely the top-down development of an 'innovation economy'. It hopes to do so by supporting selected state-led projects. For example, it has established a public corporation to foster nano-technologies, identified five priority areas for state support (energy efficiency, information technology, nuclear technology, space technology, pharmaceuticals and medical equipment), and started to build an 'innovation city' (a kind of state-led silicon valley) in Skolkovo near Moscow. It remains to be seen whether Russia's ineffective bureaucracy is able to identify and foster innovative technologies. The government's innovation projects could serve as useful pilots and provide the authorities with feedback about the kind of barriers that businesses face in knowledge-intensive sectors. However, they cannot be a substitute for the broad development of a vibrant private sector.

The to-do list

While Russia's short-term economic outlook is solid, sustainable growth requires thorough reform. The government has drafted and adopted detailed plans for the kind of structural reforms that are needed. But it has not implemented them because the elite benefits too much from the current opaque, state-dominated system. What Russia needs to do in order to launch and sustain such reforms is to build constituencies for reform and to find outside anchors. The first steps should include privatisation, deregulation and a credible commitment to joining international organisations, or at least building lasting partnerships with them.

Sergei Guriev is Morgan Stanley Professor of Economics and Rector of the New Economic School in Moscow

This article is based on Sergei Guriev, Alexander Plekhanov and Konstanti Sonin, 'Development based on commodity revenues', EBRD working paper No. 108, 2009; Sergei Guriev and Ekaterina Zhuravskaya, 'Why Russia is not South Korea', Journal of International Affairs, Spring/Summer 2010; Sergei Guriev and Aleh Tsyvinski, 'Challenges facing the Russian economy after the crisis', in Anders Aslund and others, 'Russia after the global economic crisis', Peterson Institute for Internal Economics, 2010.