



How strong is Russia's economic foundation?

By Pekka Sutela

★ The global economic crisis has hit Russia particularly hard, with a combination of collapsing oil prices, reversing capital flows and falling global demand ending a 10-year growth spurt. Even a sustained rally in international oil prices would not guarantee a return to sustainable growth for Russia.

★ The government's medium-term economic policy plan – the Russia 2020 programme – foresees a shift from an oil dependent economy to one powered by innovation. The programme's basic assumptions are doubtful, its prospects for implementation dubious and the underlying economic thinking flawed.

★ The true source of Russian growth since the collapse of the Soviet Union has been the shift of resources from inefficient heavy industries to modern services sectors. For this catch-up growth to continue, Russia does not need to innovate but to imitate: it can import technology, know-how and institutions from richer countries. However, successful catch-up growth requires a sound business environment, the rule of law, open markets and good infrastructure. The Russian authorities should focus on these things rather than top-down attempts to encourage innovation.

The economic crisis of 2008-09 hit Russia after a long period of rapid expansion during which annual GDP growth rates averaged 7 per cent. Very few major economies have enjoyed such protracted periods of exceptional growth. This performance encouraged the Russian leadership in late 2008 to adopt the official goal of becoming the fifth largest national economy in the world by 2020, after the US, China, Japan and India. This target – always of dubious credibility, given Russia's underlying economic weaknesses – has been reduced to irrelevance by the economic crisis, which has affected Russia's economy more than most.

President Dimitri Medvedev seems to concur. In August 2009, he stated that current economic trends could lead Russia into a "dead end" – unless Russia embraced reform and diversified its economy away from hydrocarbons. In an open letter published in September 2009, he repeated his dire diagnosis. He wrote that the Russian economy was ineffective and suffering from too much state involvement and an overdependence on oil revenues. Medvedev was in fact echoing the criticisms that Vladimir Putin, now the prime minister, had made when he first became president almost ten years ago.

Problems that are left unattended tend to get worse over time, so Russia's economic weaknesses will be a major challenge for the country's leadership. The economy is the decisive factor in determining Russia's future path. At stake are both the welfare of the Russian people and the international position of the country – and therefore the sustainability of the current regime headed by Putin and Medvedev.

To shed light on the economic basis of Russian power, this policy brief will address four questions: Why has Russia been hit so hard by the economic crisis? Why did Russia grow so strongly until 2008, and can it do so again? Do the authorities have a realistic view of what should and could be done to avoid the dead end that Medvedev fears? And what kind of economic policies are the Russian authorities likely to pursue in the future?

Russia's economy in crisis

Russia has been hit particularly hard by the 2008-09 global economic crisis because it was affected by several negative shocks at the same time: a collapse in

global demand; a plunge in the international prices of Russia's major export commodities; and a reversal of international capital flows, alongside a domestic credit crunch.

The collapse of international oil prices had a large and immediate impact on the Russian economy, which relies heavily on the sale of oil, gas and other basic commodities. Oil prices went from a peak of over \$140 per barrel in July 2008 to a trough of less than \$40 per barrel in December that year, before they recovered to around \$70 per barrel by mid-2009. Gas prices tend to follow oil prices with a lag and the prices of other commodities that Russia exports, such as metals, also tend to fluctuate in tandem with the oil price. The spreading global recession also translated into lower demand in volume terms for Russian commodities. One-off factors compounded this trend. During the first half of 2009, many EU countries bought less gas from Russia, in anticipation of lower prices later in the year. Some also sought to diversify away from Russian gas, following the cut-offs resulting from the Russia-Ukraine gas dispute in January. During the first half of 2009, Russian gas production was down by a fifth compared with the first half of 2008, while gas exports fell by 40 per cent.

Total Russian export earnings declined by almost 50 per cent in dollar terms over this period and the slump quickly spread to the domestic economy. Consumption contracted by 8 per cent in the year to July 2009, while investment spending fell by 19 per cent over the same period. Since Russia imports a lot of what it consumes and also relies heavily on imported machinery, the domestic slump translated into a steep fall in imports (by almost 40 per cent in the first half of 2009 compared with the same period a year earlier).

The impact on the public finances has also been dramatic. A solid budget surplus, equivalent to 5 per cent of GDP in 2008, has turned into a gaping deficit, which is projected by the Ministry of Finance to reach 9 per cent of GDP in 2009. Russia spent around \$200 million of its foreign exchange reserves trying to defend its currency in 2008 and it is rapidly drawing down its sovereign wealth funds to plug the hole in the budget deficit.

In late 2008, most forecasters were still predicting that the Russian economy would grow by 5-6 per cent in 2009. By August 2009, the Russian government was foreseeing a contraction of 8.5 per cent. And while economists have started to revise their forecasts upwards again for many other countries, their prognosis for Russia remains bleak, despite the recovery in oil prices and Russia's sizeable fiscal stimulus programme.

Economists have not only been revising their short-term forecasts for the Russian economy. They have also been reassessing their medium-term outlook. In

May 2009, when economic expectations had started to stabilise, three economists at the Brookings Institution compared the IMF's latest forecasts for 2013 with those the Fund had published six months earlier. They found that Russia was one of the countries whose outlook had darkened most: the IMF revised its 2013 forecast for Russian national income down by a fifth between October 2008 and April 2009.

The global environment will not help

A less propitious international environment is one reason why Russia will do less well in the coming years. First, before the crisis, global growth had been unusually strong, pushed up by the partial opening up of China and India and the internationalisation of financial markets. Another 'globalisation boost' of that magnitude is unlikely in the near future. Inflation will increase in many countries, and so will exchange rate volatility. International capital flows will decline and investment will be lower. Long-term unemployment will affect the quality of the labour force in many countries.

Second, more sluggish global economic growth implies lower prices for oil and the other commodities that Russia sells abroad. EU countries will continue their attempts to diversify their energy imports, so that Russia may no longer be able to regard the EU as such a captive market. But Russia's own plans to sell more gas to Asia and other non-European markets will take many years to come to fruition.

Third, emerging markets like Russia will suffer more from slowing international capital flows than rich countries. Less finance will be available, and at a higher price. And this at a time when Russia will need more, not less, foreign direct and portfolio investment because its domestic financial development is slowing, its reserves have shrunk and investment has collapsed during the crisis.

Russians reacted to the economic crisis first with complacency, then with anger. Initially, the country's leadership claimed that Russians had little to worry about. They saw the crisis as caused by, and confined to, the Anglo-Saxon market economies with their complex financial systems. When Russia then descended into its deepest recession since the collapse of the Soviet Union, many Russians felt resentful and bitter. They sensed that they were paying a heavy price for economic mistakes that had been made elsewhere. Many still hope that once the oil price resumes its upward trend and the world economy picks up, growth will return to pre-crisis levels.

However, predictions about Russia's future performance need to be based on a thorough understanding of what Russia's economy is today, and what has powered the long growth spurt that preceded the current crisis. Is Russia's economy

fundamentally sound? Or was the 1999-2008 period an exceptional performance that cannot be repeated?

What has driven Russian growth?

Oil, gas, corruption, autocracy and instability in the North Caucasus – these things spring to the minds of most people when they think about Russia today. Those looking more closely will see a country that has persistent pockets of poverty, a declining population, shoddy infrastructure and mounting environmental problems; a country where the state plays an ever more dominant role in the economy and which in international league tables of competitiveness and the quality of the business environment usually ranks very close to the bottom. This bleak picture is certainly based on reality but it is not the whole picture.

Energy – the extraction and sale of oil and gas – is indeed hugely important for Russia. At times when international oil prices are high, energy accounts for two-thirds of export earnings, almost half of all public sector revenue and around a quarter of total GDP. If metals are added, the basic commodity sector produces some four-fifths of Russia's export revenue. Whenever the international oil price fluctuates, Russia's economic fortunes change abruptly. Between 1999 and 2008, international oil prices rose steeply and continuously, helping Russia's long growth spurt. Then they collapsed, leading to steep falls in export and budget revenues, as well as investment and consumption spending.

Although the current slump illustrates clearly Russia's over-dependence on the resource sector, it would be wrong to assume that its economy is all about energy and raw materials. While energy is crucial for export and tax revenue, it does not provide many jobs. Only 2 per cent of all Russian workers are employed directly in the extraction and transport of basic energy – although the share increases if one adopts a wider definition of the energy sector, to include for example refineries and the various subsidiaries of energy giants such as Gazprom and Rosneft.

In the past, the gas and power sectors have massively subsidised the rest of the economy because households and industries paid very low prices for their energy. So the energy sector has indirectly contributed to job creation by keeping companies afloat and allowing households to consume more. However, low domestic energy prices are not sustainable: they undermine the profitability of Russia's energy companies and they encourage a hugely wasteful use of energy. The government has adopted a schedule for gradual increases of domestic gas prices, which by and large it has followed.

Although the exact share of jobs depending on the oil and gas sector is difficult to determine, it is clear that most Russians are working, and will work, in other

sectors. In a country of 141 million people, most jobs will have to be created outside the energy sector.

The cheap rouble and idle factories

Oil prices were not the only factor that determined Russian growth rates over the last decade. To some degree, the growth spurt that ended in 2008 was simply a rebound after the post-transition slump of the 1990s. Following the 1998 currency and debt crisis, growth was helped by a massively devalued rouble, which provided a major price competitiveness advantage to Russian producers. Few Russian products are of sufficient quality to compete in international markets, no matter what they cost. But after the 1998 rouble devaluation, they became much more attractive to domestic buyers whose purchasing power in foreign currency had collapsed and who could no longer buy imported goods. It was the devalued rouble that provided the initial impetus for Russia's industrial recovery; the impact of high oil price came later.

Another crucial factor was that in the beginning of the recovery, Russia had ample spare capacity because in the 1990s factories had been standing idle and workers had been under-employed. After 1998, companies could ramp up production quickly and cheaply. Only in recent years did Russian companies start building new factories, adding new machinery and offering higher pay cheques to attract skilled workers. The resulting investment boom was financed not only by ample corporate profits but also by a flood of international liquidity and generous public funds coming from Russia's mounting budget surplus.

The real source of Russian growth

While the oil price, the cheap rouble and the availability of capital have all added to Russia's recovery, structural change has perhaps been the most important, but also the most frequently overlooked, factor. Many people may already have forgotten quite how over-industrialised and under-serviced the Soviet economy had been. The Soviet Union was focused on military might and the heavy industries needed to sustain it. Services ranked very low on central planners' priority list. Most modern services – ranging from department stores to cafeterias, travel agencies and investment banks – did not exist or were underdeveloped. Over the last two decades these industries have developed rapidly, providing previously unavailable services and creating countless new jobs. This shift of resources (money, labour and skills) from inefficient heavy industries that made things most people did not want into more productive manufacturing and modern services has been the true source of Russian growth in recent decades.

Such structural change is one aspect of what economists refer to as catching up or imitation. A

badly functioning economy with low productivity and income levels can enjoy rapid growth simply by adopting products, technologies, processes and structures that have already been invented, introduced and tested in more advanced economies with higher productivity and income levels.

This was the path followed successfully by Japan and Korea decades ago. They adopted western production technologies and started making western goods more cheaply. Only much later did they start to acquire the technological skills needed to innovate at home and move into more high-tech production for exports. China has begun this shift from imitation to innovation more recently, as shown by its growing outlays on research and development, and rising numbers of international patent applications.

Russia has displayed elements of this catching up process. It did not need to invent capitalist institutions and the laws of a market economy when it started its economic transition more than two decades ago. It did not need to re-invent service stations, supermarkets or stock exchanges. It could import them, and much else.

But in Russia, the result has not been a smoothly functioning western-style economy. Because of the Soviet historical legacy, bad institutions and policy mistakes, the outcome has been an ill functioning economy with insufficient competition, a bloated bureaucracy, ubiquitous corruption and widespread crime. Nevertheless, today's Russian economy works a lot better than the Soviet one did. Although the state has increased its role in the economy in recent years, it is still much less pervasive than it was three decades ago. And in spite of growing authoritarianism and state control, consumer preferences matter more than ever before. This is why the economy has been growing fast, and most Russians live better than they used to.

These improvements are bound to continue for some time. The structural changes under way are to some degree self-perpetuating. The same people are often the producers and the consumers of economic change: the owner of the travel agency frequents the cafeteria, and therefore the cafeteria manager can travel, and both industries expand. Russia's new middle class – where this dynamism resides – so far comprises only around a fifth or a quarter of the population. The expansion of the middle class, and with it the transformation of the economy, still has a long way to go.

However, there are constraints that could prevent this internal dynamism from being unleashed. For every economy that has successfully embarked on catch-up growth, there is one that has remained stuck in poverty. Latin America provides plenty of examples of missed opportunities. Policy clearly matters and Russia's to-do list is longer than most.

The authorities must do more to ensure that the business environment keeps improving, and that the

state does not strangle enterprise through excessive regulation and interference. Productivity needs to rise in the non-resources sectors, where most jobs are located. Otherwise, the government may have to extend subsidies and rely on tariffs and other protectionist measures to shield inefficient sectors from international competition. The financial system, while much improved, still has serious shortcomings in many areas, such as start-up finance for smaller companies. The fragility of the banking sector has been exposed during the current crisis.

Lofty ambitions of the 2020 programme

Are the authorities aware of what needs to be done to set Russia on the path towards sustainable growth? The best way to gauge this is to examine Russia's latest long-term policy programme, the so-called Russia 2020 programme.

Russia has adopted numerous long-term policy programmes over the years but most of them have been of little relevance. As the Russian saying puts it: "Paper is paper but practice is practice." Nevertheless, any such programme reflects the prevalent thinking of policymakers. And it is bound to influence economic policy to some extent.

The government started work on the 2020 programme in summer 2006 and finally adopted it in November 2008. The programme thus bridges the Putin and the Medvedev administrations. To some observers, the fact that the leadership adopted the document in the middle of an economic crisis indicates that turbulent economic conditions could not deflect it from thinking long term. But the more important question is whether the crisis has robbed the programme of its relevance. In truth, it never had much credibility to start with.

One of the programme's shortcomings is that it is based on assumptions that lack credibility. Demographics is the most glaring example. It is well-known that Russia's population is ageing and shrinking. Fewer young people are entering the labour market, while a growing number of older workers are retiring. This combination will lead to labour shortages and overwhelm the pension system. Widespread health problems aggravate the situation. Yet according to the 2020 programme, a population that has been shrinking for decades will soon start growing again and Russia should have the same number of people in 2020 as today. While there has been a slight recovery in the birth rate in recent years, the kind of demographic turn-around that the 2020 programme foresees would be surprising. It is true that Russia has been receiving large numbers of immigrants since the collapse of the Soviet Union. But government policy on immigration changes almost every year and public opinion is overwhelmingly hostile towards admitting more foreign workers.

More importantly, the economic thinking that underlies the 2020 programme is seriously flawed. The programme is based on three scenarios, drawn up by the Ministry of Economic Development in 2006-7. The first and least desirable one assumes that Russia continues on its current path. The ministry's economists predicted that this would soon lead to very slow growth, while Russia's problems of poverty, inequality and social exclusion would remain unsolved or, more likely, become worse. This was what Medvedev referred to as a dead end.

In the second scenario, Russia would allocate more resources to increasing energy production and efficiency. This would be preferable to the first scenario, but it would still not guarantee Russia a sustainable path to growth and development.

One reason is that although Russia's natural reserves, especially of gas, are abundant, official forecasts predict at best a modest growth of output for oil and gas over coming years, which will turn into decline after 2020. Russia's largest and most easily accessible oil and gas fields will be well past their peak production by that time. Meanwhile, investment in new fields has been low. Russia will only be able to keep exporting energy at current levels if its economy becomes vastly more energy-efficient, and if it continues to import growing amounts of gas from Central Asia.

Another reason is that export prices of oil and gas tend to fluctuate wildly, which makes managing macroeconomic stability very difficult. Experts do not agree on whether international oil prices will return to the upward trend they were on before the economic crisis. Even if they do, high oil prices pose their own challenges. The appreciation of the real exchange rate, for example, diminishes the competitiveness of non-oil industries. As other sectors wither, the economy becomes more dependent on oil and gas. The 'oil curse' has other consequences that are detrimental to long-term development: an ever-increasing role of the state, widening income disparities, political authoritarianism and endemic corruption. These dangers are particularly acute in a resource-dependent country with a large population, as the energy sector tends to create relatively few jobs, as discussed above.

The government's third scenario was nothing less than to turn Russia into an innovation-based society by 2020. According to the Russia 2020 plan, this is the only path that could lead Russia away from its current economic problems. Vladimir Putin suggested that if Russia managed this transition successfully, it would become the best place on earth for human beings to live in by 2020. But however one defines 'the best place to live', the lofty goals of the Russia 2020 programme are hopelessly unrealistic.

The missing i-word: imitation

"Innovation, institutions, infrastructure and investment" – these were the catchwords that President Medvedev used to explain how Russia would achieve its economic goals. He then added a fifth i-word: "intellect", highlighting the importance of improved education and skills for upgrading Russia's economy.

The government's modernisation agenda looks uncontroversial at first glance: Russia undoubtedly needs better institutions, more highly skilled workers and more developed roads networks and power lines. However, the 2020 programme's fundamental flaw is that one i-word is missing – imitation. As pointed out above, all successful emerging economies over the last 50 years or so have followed the path of imitation and catch-up. Only once they are well on their way does indigenous innovation become a necessary, and feasible, basis for further growth. This is a basic fact of economics. Since Russia's economic policy debates have become more open and sophisticated, it is not surprising that some of Russia's best economists have reminded the government of that fact.

The government's answer – as formulated by the allegedly liberal-reformist First Deputy Prime Minister Igor Shuvalov at the 2008 St Petersburg Economic Summit – was a very peculiar misreading of Russian and world history. For centuries, Shuvalov claimed, Russia had tried to imitate others. These attempts had simply plunged the country deeper and deeper into backwardness. It was time for Russia to end imitation and develop models that others would follow.

Shuvalov's reading of history is eccentric, to say the least. The truth is that Russia has frequently sought to plough its own *Sonderweg*, and these attempts have usually ended in failure – as the collapse of the Soviet experiment surely illustrates.

Russia's peculiarity is that it is not only an emerging market but also a recently failed superpower. As a result, Russians think that achieving development on the basis of imitation is simply not appropriate for their country. Hence Shuvalov's antipathy towards following the path others have trodden, even if that path was successful.

Stability versus openness

Even if the Russian government is right that the best bet for economic success is to rely on indigenous innovation, its chosen method for going about this is questionable. The entire 2020 programme is infused with a strong belief in the effectiveness of top-down policies: innovation will start to flourish when the government throws money at the problem and establishes new innovation-promoting state institutions; exports will diversify away from oil and

gas because the government wants them to; and problems will be solved by passing laws through the pliant State Duma (the parliament), rather than by consistently implementing smart policy. The logical consequence is that Prime Minister Putin himself needs to get involved in solving the country's each and every problem.

This emphasis on top-down policies reflects the inbuilt contradiction of the Putin system. The regime rests on a more or less authoritarian political system. Stability and sovereignty are its overriding goals. If anything, the leadership will have become more convinced of their importance during the crisis: stability will remain a key goal for a country that can expect to be hit by further shocks in the future; and sovereignty will be at a premium because of the expectation that such shocks will come from outside.

In Putin's autocratic system, political legitimacy cannot come primarily from elections (which tend to be neither free nor fair), nor from accountability and openness. It must come from economic growth and rising incomes. To guarantee future economic success, the government must introduce more competition, strengthen the rule of law, improve the environment for entrepreneurs, encourage start-up finance, improve infrastructure, and so on. But free markets and autocratic government are not compatible (as the Chinese will also find out in due course). The Russia 2020 programme appears to try and resolve this contradiction by emphasising top-down solutions for the economy. The government pays lip service to the importance of openness and competition, but the real emphasis is on state intervention.

WTO application on ice

Russia's prevarication over joining the World Trade Organisation is a good illustration of the leadership's indecisiveness and incoherence. Russia is the last big country outside the WTO, which means it does not sit at the table where global rules for trade (and increasingly investment and other global commercial issues) are made. By being a member of the WTO, Russia would gain better access to international markets for its non-energy products. Other countries would find it harder to impose anti-dumping duties on Russian steel and chemicals. Moreover, WTO rules on, for example, public procurement could help make the Russian economy more efficient and transparent.

During its first term, the Putin government strongly supported WTO membership. But once it became clear that painful reforms would have to be implemented before accession, and once industrial lobbies started voicing their opposition to these, the government started backtracking. In June 2009, Putin suddenly announced that Russia would enter the WTO only as part of a customs union with Belarus and Kazakhstan. Only a few months later, in October, President Medvedev said that Russia

would resume WTO negotiations by itself. But Shuvalov insisted that it would still join at the same time as its neighbours.

Russian leaders may consider that their country, with its current export specialisation in oil, gas and heavy metals, would get only limited benefits from joining the WTO. But their indecision about membership suggests that they do not believe that Russia will be able to make products and provide services that can successfully compete in international markets in the near future. Perhaps they even fear that the ability of Russian companies to compete in their home markets is deteriorating. In this case, they may consider WTO membership politically unsustainable: job losses resulting from the opening of the economy could undermine public support for the leadership. Many Russian politicians know that the reforms and export opportunities that would stem from WTO membership would boost their economy. Yet the leadership may decide to forego these benefits for the sake of stability and sovereignty.

Russia's difficult choices

Slower economic growth is likely to herald a 'return of politics' in Russia – primarily in the form of disputes within the elites about how to divide the spoils. The regime's overall priorities, however, are unlikely to change in the foreseeable future. The truth is that there is no meaningful political opposition arguing against the government's economic policy objectives. Although there has been much speculation about the more liberal-minded Medvedev becoming a little independent from Putin, the prospect of a fundamental rift emerging inside the existing leadership is remote. Most Russians think that the policy choices made by Putin and his governments over the years have been vindicated. Real wage growth averaged 15 per cent a year during the time that Putin was president and the official unemployment rate halved.

In particular, Russians applaud the government's decision to use a major part of the windfall revenues from selling oil and gas at high prices for repaying foreign debt and accumulating reserves. This revenue could have been spent on consumption and investment, for example on building new roads. Instead, the government decided to prepare for a rainy day. In late 2008, when the rainy day turned into a prolonged downpour, Russia's accumulated reserves (almost \$750 billion in official reserves and sovereign wealth funds) provided a welcome umbrella.

The roads, however, still need to be built: Russia today has slightly fewer hard-surface roads than in 1990, even though the volume of traffic has multiplied. The long-term decline in infrastructure that started in the later decades of the Soviet Union continues, leaving the economy increasingly brittle and crisis-prone. Whether one looks at public health

or education or even the military, one sees deterioration, yet public bureaucracy has boomed. Clearly, the government has to make trade-offs between its aims of maintaining stability and absolute sovereignty on the one hand, and ensuring the economy's long-term sustainability and competitiveness on the other.

Best-case scenario: muddling through

As Russia's growth slows, the country will have to adjust its grand international ambitions too. Russia will maintain the strategic deterrence of its nuclear arsenal, which should guarantee it the position of a great power. But the country will not be a global power that is able to project itself in many parts of the world. Russia's obvious choice will be to concentrate on its neighbourhood. The fact that some neighbouring countries are doing even worse in economic and political terms gives Moscow opportunities to increase its influence. However, Russia's past attempts at meddling in its neighbours have seldom been successful, and in the future they could result in further regional instability.

Although Russia saw some demonstrations at the height of the economic crisis, the risk of widespread social unrest seems low. Russians want growing incomes but their thirst for economic freedoms and civil liberties appears to be limited. The idea of Schumpeterian creative destruction and entrepreneurship has never had mass support in Russia. Most people were always more likely to

believe in large, orderly and hierarchic organisations. In Russia, as in other countries, such statist, top-down instincts and practices usually grow stronger at times of crisis. This further diminishes the prospect of a liberal breakthrough in Russian politics. The initial hopes of some people inside Russia and outside that the economic crisis would provoke a move towards a more liberal political and economic system have been dashed.

Russia is not condemned to economic stagnation, because the underlying trend of structural change is too prominent. The situation is fragile, however. Political leaders freely admit that the heavily skewed export structure and the lack of competitiveness of non-energy industries (where most Russians work) are pressing problems. However, the solutions they propose are ill conceived – and that is before one starts contemplating the challenges of implementation. Russia's growth rate will continue to depend on world prices for the commodities that Russia exports, as well as on its ability to produce those commodities in sufficient quantities. Russia has proven that it is able to manage high export revenues – albeit at the cost of neglecting the badly needed diversification of the economy. Faced with such challenges, the Russian leadership looks lost. In these circumstances, the country's best hope is probably just to muddle through.

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