

Development Progress in Russia

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Abstract

Russia has been a prime mover in the organization of the BRIC group of nations. The BRICs, originally a Goldman-Sachs conception, comprise the leading developing economies in their respective regions, with Russia central among the Eurasian emerging economies. In response to the question, “Can the BRICs be the drivers of world economic growth?,” we briefly explore Russian economic performance and structure, and the prospects for Russia to become a driver of the world economy in the coming decade.

1 The Resurrection of Russia

Russia emerged from the collapse of the Soviet Union a disorganized and greatly shrunken economy, struggling through a ‘transformational depression’ from 1991 through 1998, when Russia defaulted and its emerging financial markets collapsed. To the surprise of many, the economy ‘bottomed out’ in the 1998 financial crisis and a strong recovery began, a recovery that coincided with the first Putin Presidency, beginning with appointment by the resigning Boris Yeltsin on 31 December 1999, and then his first round election victory, 26 March 2000. Driven by a four-fold devaluation of the ruble and subsequent import substitution opportunities, tight fiscal and monetary policies, and renewed structural reform, the macro economy grew rapidly during Putin’s first presidential term, overcoming the transitional depression by 2004 (Ericson, 2009).

Putin’s second term as President, 2005 – 2008, witnessed new economic growth and a significant and sustained, if unequally distributed, rise in the Russian standard of living. This growth of GDP, at a rate over 7% per year 2003 – 2008, made Russia the fastest growing as well as the largest economy in its region, and evidently a driver in regional, and indeed world, economic development. The performance indicators, presented in Table 1, gave credence to the Goldman-Sachs (2003) conceptualization of the BRIC economies as presenting significant investment opportunities in emerging markets, with Russia as the Eurasian regional anchor.

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Indicator	2000	2004	2005	2006	2007	2008
GDP2000 = 100	100.0	126.6	134.7	145.7	158.1	166.3
GDP % Δ	10.0	7.2	6.4	8.2	8.5	5.2
Industry % Δ	11.9	8.0	5.1	6.3	6.8	0.6
Investment % Δ	17.4	13.7	10.9	16.7	22.7	9.9
Unemployment %	10.2	8.3	7.6	6.9	6.1	7.8
Consumption % Δ	5.9	9.2	11.0	11.0	13.0	8.0
Current Account, \$billion	46.8	59.5	84.6	94.7	77.8	103.5
FDI, \$billion	4.43	9.4	9.0	29.9	47.1	76.0
Budget Balance %GDP	1.2	4.4	7.5	7.4	4.1	7.0
FOREX +Stab Funds, \$billion	32.1	143.4	211.4	392.1	633.2	652.2
Inflation %	20.2	11.7	10.9	9.0	13.3	14.7

Fig. 1: Russian Macroeconomic Performance pre-Crisis (Source: Compiled from BOFIT Russia Statistics Reports)

Putin and the Russian leadership seized on this concept as a way to return Russia to a significant position in world affairs. The humiliation of the 1990s — the loss of economic and military power, the loss of empire, and the encroachment of NATO in the post-Soviet spaces of Eurasia — had to be erased in the revival of Russia, and her renewed leading role in a new world order.¹ Russia looked to international organizations, and alliances of convenience with other major and rising powers, to restrain the United States, to create a multi-polar world with Russia as a pole. Thus Russia actively used the United Nations, OSCE, and other organizations in which it had a veto or decisive vote to block initiatives it opposed, and actively pursued the development of international organizations it could control such as the SCO, the Eurasian Economic Union, and a “Gas OPEC.”² And with its substantial rate of growth, Russia had the 8th largest economy in the world in PPP terms by 2010, and has become the 6th largest in 2012 with expectation of moving into 5th place in the next 3 years.³

Thus Russia in 2008 had great expectations for a new world order, one in which it would play a pivotal role. Russia had not only economically recovered, but had substantially internationalized her economy, with international trade a major factor in both Russian economic growth and standards of living. The leading producing sectors of the economy were substantially integrated into and

¹This can be seen in numerous speeches by Putin throughout his time in office, especially in the address to the Munich Conference on Security Policy, 10 February 2007, and in his recent election platform statements (<http://www.putin2012.ru/>). See Vladimir Socor, “Putin’s Eurasian Manifesto Charts Russia’s Return to Great Power Status,” *Eurasia Daily Monitor*, 8(185), 7 October 2011.

²On the Eurasian Economic Community see <http://www.evrazes.com/i/other/EurAsEC-today_eng.pdf>. On the SCO (Shanghai Cooperation Organization) see <<http://www.sectSCO.org/EN/>>. Representatives from Russia, Qatar, and Iran, the top 3 holders of proven NG reserves with 60% of the total, met October 21, 2008, in Tehran to discuss forming a gas exporting cartel. RFE/RL, October 22, 2008, and the AP report in *WSJ*, 22 October 2008. Nothing, however has come of this initiative.

³See Medvedev’s final “State of the Nation” address, 22 December 2011 (*RIA Novosti*), and Putin’s final “Report to the Duma” as Prime Minister, 11 April 2012 (*RIA Novosti*).

dependent on world markets, and consumption, particularly of electronics and automobiles, was heavily dependent on imports. Outside of dying rural regions, the economy was monetized and marketized, with financial and ‘real’ markets substantially intertwined. And state finances were on a firm financial basis, with minimal state foreign debt and substantial state reserves and FOREX holdings.⁴ While Russian entities owed international creditors some \$420 billion, over 93% of that was the private debt of large Russian companies, a reflection of the ‘globalization’ taking place in the Russian economy. And both GDP and consumption, the standard of living of the Russian population, were apparently inexorably growing, and the poverty level inexorably shrinking, as Putin had promised in 2004 at the beginning of his second term (Ericson, 2009). This evident success was understood by the Russian leadership as the consequence of wise monetary and fiscal policy and the ‘firm hand of the state’ directing economic development and reallocating its fruits. But as one commentator quipped, “The Russian government confused high oil prices with the genius of their economic management.”

Thus high growth, high export prices, and substantial reserves spurred increasingly assertive state policy both domestically and abroad. In 2007-08. among the policies pursued were growing State intervention in the domestic economy, including price controls and openly questioning the property rights of companies failing to hold down prices and maintain employment.⁵ Major business leaders were required to regularly report to the government, i.e. Putin, on progress toward goals the government had proclaimed, and Putin has reminded business leaders that they needed to “pay back society” for their wealth.⁶ Major companies, including *Gazprom*, *Lukoil*, *Rusal*, etc., were encouraged to expand abroad as “national champions,” acquiring equity in companies in the same or related (upstream or downstream) industries. This was accompanied by an increasingly aggressive foreign policy, particularly in Russia’s “near abroad,” actively intervening in the Ukrainian elections, dictating the terms of ‘peacekeeping’ in Moldova and the Caucasus, blocking any independent OSCE initiatives, and rejecting the right of any outsiders to monitor Russian elections.⁷ The assertion of Russian preeminence in the region included ‘cyber warfare’ in Estonia and Georgia, winter energy cutoffs (both oil and natural gas to Belarus and natural gas to Ukraine) ostensibly over pricing, and culminating in the long prepared invasion and dismemberment of Georgia in August 2008.⁸ Economic confidence was evident in increasingly frequent calls for a new world economic order and replacing the dollar as the international currency, medium of exchange and unit of account. Indeed, both Putin and Medvedev, elected President in May 2008, asserted that the Ruble should become

⁴Energy export revenues, largely from oil and natural gas, comprised some 25% of Russian GDP and over 40% of budget revenues in 2008 (World Bank, *RER*, #18 and 19, 2009).

⁵Numerous food price controls were introduced beginning in 2007, in July 2008 a federal investigation of *Evrax Holding* and *Raspadsty Ugol* mining companies for price fixing was launched, and *Mechel* steel was publically attacked by Putin for its price policies. See *BOFIT Weekly*, #31, 1 August 2008.

⁶Most recently, see Putin’s speech to the Union of Industrialists and Entrepreneurs on 9 February 2012, reported in “Putin Seeks Payments From Those Who Made Fortunes in ‘90s,” *WSJ*, 10 February 2012.

⁷One can see a complete record of this behavior in the Jamestown Foundation’s *Eurasia Daily Monitor* from 2003 through 2012, <<http://www.jamestown.org/programs/edm/>>.

⁸Putin recently admitted that the invasion was preplanned and provoked by Russia, Pavel Felgengauer, “Putin Confirms the Invasion of Georgia Was Preplanned,” *EDM* 9(152), 9 August 2012. On Russian use of cyberwarfare, see A. Melikishvili, “The Cyber Dimension of Russia’s Attack on Georgia,” *EDM* 5(175), 12 September 2008.

an international currency, equal to the dollar, with Moscow as an international financial center, and that Russia was ready to become a leader in the new world order (Ericson, 2009, p. 221). And as a step in that direction, Russia took the initiative in organizing and convening a BRIC group, beginning with ministerial discussions after G20 meetings in 2006 and 2008 and culminating in a BRIC Foreign Ministers Meeting in Yekaterinburg in May 2008, to provide a common front and supporting actions in the development of the new world order.⁹

2 Growth Foundations

This growth, and the confidence it engendered, was however built on a rather unstable foundation. While Putin's first term had finished the transition process from Soviet-type to a market economy, completing many of the structural reforms started in the 1990s and reestablishing central authority and state functioning, much institutional and structural reform remained to be done (Ericson, 2006). Further, much, if not most, of the economic recovery and new growth was based on favorable world market conditions, on high and growing prices for that which nature and Soviet development had bequeathed Russia — energy carriers and raw materials. Thus the foundation of this strong performance was resource extraction and the export of energy, metals, and grain, generating a huge financial surplus which the newly effective state was increasingly able to capture.¹⁰ The export earnings of these leading, largely extractive, industries multiplied through the economy as they purchased inputs from domestic manufacturing and service industries, generated new incomes and stimulating a rapid rise in consumption and the standard of living. This demand fueled a rapid rise in imports, as well as domestic consumption. The subsequent expansion of domestic economic activity spurred borrowing on international markets, particularly as domestic financial markets remained seriously underdeveloped. While newly created wealth remained highly concentrated, the Russian State redistributed much of these rents, primarily to maintain political power and the support of the elite (Gaddy, Ickes, 2011). Hence rents were used in support of existing industrial, and other, economic structures in order to maintain employment and their continuing operation, a primary component of social and political stability.

In this fortuitous international economic environment, in part as a reaction to the economic and political chaos of the prior decade, it was easy for the Russian state to reassume a leading role in the economy. Indeed, some 50% of Russian economic activity remained under state control at the Federal, regional, or local level.¹¹ Putin's Russia opted for state-directed development in the pursuit

⁹Russia has continued as a prime mover in organizing BRIC summits, first in Yekaterinburg in 2009, then in Brazil in 2010, China in 2011, and New Delhi in March 2012. South Africa joined at the 2011 Summit, making the BRIC organization 'BRICS'. The fifth summit will be hosted by South Africa. See BRICS Information Centre, University of Toronto, <<http://www.brics.utoronto.ca/>>.

¹⁰See the World Bank's *Russian Economic Report*, especially #1–#6, 2001-03, for the statistical record and budgetary impact. The origin and use of resource rents in the Russian economy are analyzed in Gaddy, Ickes (2005).

¹¹This was asserted by both Finance Minister Alexei Kudrin and Deputy Minister of Economic Development Andrei Klepach in interviews, *RIA-Novosti* on 5 October and 2 July 2009, respectively. A detailed study by the Siberian Academy of Innovation, October 27, 2007, concluded that "the share of the state sector in the economy (is) ... no less than 50%." <<http://www.sibai.ru/view/1185/1330/>>.

of national power and the autonomy of action of a world power.¹² Thus the extractive industries were natural leaders in the recovery and development processes, but they had to be kept under tight state supervision, if not direct control, for the state to properly benefit from their success. The “oligarchs” were reigned in, and they and their firms subject to close political supervision, as were other of major economic operations/firms. All major development projects/investments required prior (at least tacit) ‘authorization’ by the leader, and business leaders undertook regular accountability reporting to him.¹³

Major corporations with foreign operations became ‘National Champions’, and priority development areas are led by state directed “Federal Corporations” and “National Projects.” Among the National Champions’ at the time were *Gazprom*, *Rosneft*, *Lukoil*, *Rusal*, *Polyus Gold*, *Alrosa*, and *Severstal*. And the major “Federal Corporations” / “National Projects” [major funding channels] were *Rosatom*, *VEB*, *Rostekhnologiya*, *Rosnanotekh*, *Olimpstroi*, and the *Housing and Municipal Infrastructure Development Fund*. In addition, ‘leading sectors’ and elites, however directly and deeply integrated into the world economy, often served as (indirect) agents for the Russian State, e.g. *Alfa-group* in Central Asian energy development, and in Turkish telecoms (Ericson, 2009). This ‘development structure’ was controlled by Putin, both directly and through his plenipotentiaries, and through state control and use of the “financial commanding heights” and key state banks: *VTB*, *VEB*, *Gazprombank*, *Sberbank*, and *Rossel’khozbank*.¹⁴ It was a system of control, far looser than that of the Soviet command economy, that appeared effective in an environment of effortlessly rising resource incomes and extremely easy international financial credit.

This system, however, allowed only limited room for institutional innovation. Maintaining control in such a system requires limiting experimentation with alternate structures or activities. This institutional conservatism was reinforced by the fear of political and social instability, of the chaos associated with the “democracy” of the 1990s. Hence there was no room for Shumpeterian “creative destruction” of firms and economic activity; only the politically inconvenient could be removed, and only the familiar and authorized could be initiated. Stability was maintained, cooperation reinforced, by the redistribution of resource rents, directing subsidies, benefits, and privileges toward social and political groups, and traditional economic activities/industries, supporting the existing structures of economic growth and political power (Gaddy, Ickes, 2011). Finally, a substantial portion of those rents were sequestered in stabilization (Welfare and Development) Funds and State FOREX Reserves as a buffer against outside shocks, against market and price volatility.

¹² Putin was quite explicit about this strategy of using natural resources for state power in his doctoral dissertation at the St. Petersburg Mining Institute. See Balzer (2005).

¹³ This can be seen in the regular meetings reported on the web site of the President of the Russian Federation, <<http://www.kremlin.ru/>>, particularly during Putin’s presidency.

¹⁴ State officials were placed on Boards of Directors, usually as Chairman, or in executive positions, of major business operations, e.g. Medvedev at *Gazprom* prior to running for President, Igor Sechin in *Rosneft*, Vladislav Surkov in *Transnefteprodukt*, Sergei Prikhodko in *TVEL* (nuclear fuel), and Viktor Ivanov in *Aeroflot* and *Almaz-Antei* (air defense).

2.1 Crisis and Recovery

Vladimir V. Putin handed over the (formal) presidency to Dmitry A. Medvedev on 7 May 2008 as the Russian economy began showing signs of overheating. Inflation was accelerating (to 15% year on year in June), provoking the controls noted above, both output (10.3% to 3.2%) and investment growth (25% to 9.9%) began slowing. Financial markets were sharply hit (stocks down over 50%; Ruble down almost 18%) by September, from both war induced (invasion of Georgia) capital flight and the severe contraction in world financial markets, both of which led investors to pull out of Russia. Major Russian firms, heavily indebted to foreign banks, faced loan recalls, just as commodity prices collapsed, destroying their ability to repay.¹⁵ After initially denying that Russia could be seriously affected, the Russian government (Putin, as Prime Minister) reacted strongly and decisively, providing both direct and indirect funding to Russian banks and firms, using control of the financial ‘commanding heights’, to the tune of one seventh of Russian (dollar) GDP, an intervention unmatched in size, relative to that of the economy, in the world.¹⁶ The primary focus of this support was on preventing equity transfer to foreigners, shutdown of manufacturing operations, and an increase in unemployment. Thus subsidies, and zero interest loans, were provided to pay off foreign debts and to maintain manufacturing activity, compensating for the collapse in non-state demand and sales revenues.¹⁷

Despite this strong policy response, the world financial crisis of 2008/9 hit Russia harder than the other BRIC countries, although it only reached Russia late in 2008.¹⁸ Indeed, in the first half of 2008, GDP grew by almost 8%, investment and consumption by over 13%, and unemployment fell to a new post-Soviet low (5.3%). This maintained the appearance of continuing economic strength through 2008, with the full extent of the collapse in growth and economic activity only evident in the figures for 2009.

¹⁵The inability to repay loans led creditors to demand the loan collateral, often equity in Russian firms, which the Russian state did not want transferred. Hence the state massively intervened, providing easy credits/grants to pay off loans, forcing sales of foreign subsidiaries, or blocking equity transfer through Russian court decisions. See Ericson (2009), p. 223.

¹⁶For comparison, the US immediate response package of \$752 billion, was about 5% of US (2008) GDP, and less than half of it was expended by the end of 2008. President Obama’s near \$800 billion “Stimulus Package” raised the total intended US effort is about 10% of US GDP.

¹⁷Putin attacked a prominent oligarch, Oleg Deripaska, for failing to maintain operations in unneeded factories in Pikalevo, and subsidized the automobile maker, Avtovaz, to maintain employment despite a 90% drop in sales. See Ericson (2009), p. 224-5.

¹⁸China, India, and South Africa continued to grow at robust, if slower, rates. Only Russian and Brazilian GDP fell in 2009, and Brazil’s drop was only 0.6%. <<http://www.goldmansachs.com/our-thinking/topics/brics/brics-reports-pdfs/brics-remain-in-the-fast-lane.pdf>>

Indicator	2000	2008	2009	2010	2011
GDP2000 = 100	100.0	166.3	153.3	159.9	166.8
GDP % Δ	10.0	5.2	-7.8	4.3	4.3
Industry % Δ	11.9	0.6	-9.3	8.2	4.7
Investment % Δ	17.4	9.9	-15.6	6.0	8.3
Unemployment %	10.2	7.8	8.2	7.2	6.1
Consumption % Δ	5.9	8.0	-5.0	2.1	6.5
Current Account, \$billion	46.8	103.5	48.6	71.1	101.1
FDI, \$billion	4.43	76	27.7	13.8	18.4
Budget Balance %GDP	1.2	4.1	-5.9	-4.1	0.8
FOREX +Stab Funds, \$billion	32.1	652.2	591.1	593.3	610.6
Inflation %	20.2	13.3	8.8	8.8	6.1

Fig. 2: Russian Macroeconomic Performance post-Crisis (Source: Compiled from BOFIT Russia Statistics Reports)

Indeed, in the first half of 2009, Russia suffered a much deeper drop than the table reflects, as second half performance was supported by the massive subsidies of business that Putin implemented, including the use of over \$250 billion from the Stabilization funds. Growth from 2009 was also supported by a rapid recovery in energy prices,¹⁹ cushioning the drop in stabilization funds and renewing the substantial flow of funds into government coffers. Energy export revenues came to the rescue, supporting the subsidization policies of the government's crisis rescue operation. Massive state intervention had pulled economy out of serious contraction by 2011, albeit at a lower growth rate, but with higher incomes and employment, and lower inflation. But the result remained unsatisfactory; Russia was no longer a world leader in economic growth.

Russian economic policy in the face of the crisis had been sufficient to block a depression, and restore some growth, but nowhere near the prior rates that had made Russia a regional development driver. The economic situation, post crisis, reflected the stability and resilience of the system, but also showed its apparent inability to generate qualitatively new growth. President Dimitry Medvedev, who assumed his position as the country was overwhelmed by the crisis, began calling for a "new growth model," moving from a resource to technology driven basis, in order to restore the dynamism of the Russian economy and its position as a potential engine of world economic development.²⁰

2.2 Seeking a New Growth Model

In 2009, as the recovery from the crisis was underway, President Medvedev declared it inadequate. In a series of speeches, he pointed to the stultifying impact of the current economic system on

¹⁹From about \$40/bbl, Brent oil rose over \$80 within a year and was near \$120/bbl in less than 2 years. See <<http://www.mongabay.com/commodities/>>

²⁰This was the focus of his second "state of the nation" address, 12 November 2009, "Address to the Federal Assembly" available at <http://archive.kremlin.ru/eng/speeches/2009/11/12/1321_type70029type82912_222702.shtml>.

economic growth and dynamism. In a major White Paper, presented to the legislature, “Forward, Russia!” he called for a new innovative, liberal economic ‘model’, one built around the initiative of the “creative classes,” that would create qualitatively new growth driven by technological innovation.²¹ His administration also commissioned, in 2008, the development of a new growth strategy, consistent with this vision, to be prepared by the National Research University – Higher School of Economics (NRU-HSE).²² The Russian Presidency (Medvedev) also proposed to the Russian Government (Putin) and legislature (Duma and Federation Council) a series of administrative reforms and anti-corruption measures, and pushed WTO negotiations to a successful conclusion in December 2011. A major government program to create a ‘Russian Silicone Valley’ in Skolkovo, outside Moscow, was launched, and a new “Direct Investment Fund” with \$2 billion state seed money was created to attract \$100 billion in ‘venture funds’ in support of Russian innovative development.²³

The logic of the new growth model was laid out in a major set of analytic reports in late 2011 by scholars largely from NRU-HSE under the title: “Strategy 2020: New Model of Growth.”²⁴ This was to be a model of controlled innovation, innovation that avoided social disruption and upheaval, while pursuing the progressive objectives of the Russian State and Society. Its key recommendations were: (i) emphasis/reliance on human capital, on innovation by the “creative class;” (ii) pursuit of institutional reform, removing barriers to economic growth and improving the business and regulatory climate; and (iii) stimulation of economic competition through trade liberalization and integration in world manufacturing. Hence a critical role is to be played by expanding trade relations, with particular focus on CIS and the EU.²⁵

This pursuit of this new growth model, a more liberal economic system, appears now to be something of a mirage. Despite new anti-corruption laws, repeated anti-corruption campaigns, and the constant rhetorical push during the Medvedev Presidency, the patrimonial system, run by and for a politically connected elite revolving around Putin, remains fundamentally unchanged.²⁶ Reform measures and laws have been stalled in endless and repeated ‘consultations and negotiations’ among state and government bodies — presidential, executive, and legislative — rarely emerging with any impact.²⁷ The sole exception appears to be WTO membership, for which Russia received

²¹This was the fullest statement of his approach, available at <http://archive.kremlin.ru/eng/speeches/2009/09/10/1534_type104017_221527.shtml>.

²²See <<http://www.ipamm.hse.ru/eng/authorities/>> for the official web page of the HSE program, and discussion of its origins. The final Summary Report document, released 13 March 2012, is available at <<http://2020strategy.ru/documents/32710234.html>>.

²³Skolkovo was announced on 12 November 2009 by Dmitry Medvedev, to be headed by Russian oligarch Viktor Vekselberg and co-chaired by former Intel CEO, Craig Barrett. It is still developing with little payoff, despite international buy-in. See I. Mokrousovo, “Kto zarabatyvaet na <Skolkovo>,” *Vedomosti*, 2 August 2012. On the new Direct Investment Fund, see its web page <<http://rdif.ru/>> and G. White, “Russian Fund Seeks Foreign Investment,” *WSJ*, 6 April 2011.

²⁴The documents can be accessed at <<http://2020strategy.ru/>>.

²⁵*BOFIT Weekly*, #13, 30 March 2012.

²⁶See Ledeneva (2011) and Tulaeva (2011) for recent analyses of the imperviousness of corruption to reforms and campaigns in the patrimonial system.

²⁷This has been particularly true of Medvedev’s efforts toward legal reform ‘decriminalizing’ private economic activity, where the Interior Ministry and *Procuratura* have worked to delay and nullify the proposed and decreed legal reforms. See Pomerantz (2011) and L. Biryukova, “*Presidenta popravili*,” *Vedomosti*, 17 February 2011 on how administrative departments “corrected” Medvedev’s legal reforms.

sufficient concessions to allow buy-out of the political opposition.²⁸ For all but superficial changes, the need to maintain social and political “stability and order,” emphasized by both Putin and Medvedev particularly in the wake of the economic crisis, has triumphed. The system and its leaders are united in blocking socially disruptive, unauthorized, economic change, in pursuing the current leadership’s vision of managed ‘progress’ to a technological frontier. Indeed, even the rhetoric of “Forward, Russia!” and a new growth model has vanished with the (evidently long planned) return of Putin to the Presidency, and the demotion of Medvedev to the role of an implementor of Putin’s initiatives.

3 The Future: Problems and Prospects

Russia remains the dominant economic power in its region, and a growing presence in the world economy. But can it be a driver of regional and world economic growth, and a significant part of an international investment portfolio, over the next two decades? The answer must depend not only on the ability to Russia to return to high rates of economic growth, but also on its ability to move to the world technological frontier. Medvedev and his advisors recognized this truth in the call for a qualitatively new economy, one based on innovation and human initiative and diversified across a broad range of new technologies and activities. But that is apt to require changes that the renewed administration of Vladimir Putin is unlikely to accept.

3.1 Obstacles to Qualitatively New Growth

The primary obstacle to qualitatively new economic growth in Russia is the nature of the economic system built by Putin since 2005. It is a highly *dirigiste* market economy, subject to a patrimonial system of governance. The patrimonial system, built around personalized authority and reward, remains strong and thriving. Its beneficiaries, both state and ‘private’, have no incentives to give it up, yet are the only ones with the power to carry out (non-revolutionary) change. They comprise the top political leadership, the burgeoning bureaucracy, and the owners and managers of the major firms, particularly in the “leading sectors” of the economy: natural resources and energy, banking and finance, transportation, and some critical manufacturing and “strategic industries.”²⁹ Liberalizing and decentralizing institutional reform directly challenges their power, perquisites, and wealth, and hence such reform founders in endless bureaucratic discussion, consultations and reviews, only making it into a law in a highly watered down, ineffectual form.

Such has been the fate of reform attacking that essential lubricant of most Russian economic

²⁸See William Mauldin, “Russia to Join WTO,” *WSJ*, 10 November 2011, right after the deal was struck clearing the way for Russia’s membership. Russian attitudes toward WTO membership have been ambivalent, with serious opposition from some affected businesses and in the Duma. WTO Ministerial Conference approved Russian accession in mid-December 2011, but only on 22 August 2012 did Russia fully agree to join. *BOFIT Weekly*, #46, 18 November 2011, and *BOFIT Weekly*, #34, 24 August 2012.

²⁹A list of 11 “Strategic Sectors” was codified in a law of 5 May 2008 (*Vedomosti*, 6 May 2008), restricting foreign investment in them. The list remains, but amendments to the law implemented in December 2011 eased some restrictions on foreign investment. *BOFIT Weekly*, #2, 13 January 2012.

interaction, corruption. Legal reforms, liberalizing economic law and decriminalizing unauthorized private economic initiative, have similarly died between the Procuracy and Duma, and even administrative reorganizations, threatening the livelihood of current office holders, have faded away before passage and implementation.³⁰ For example, state corporations are infamous for their wastefulness and non-transparency in operation.³¹ Medvedev announced an effort to eliminate the “state unitary firm” as a legal and administrative structure and to reform the ‘federal corporation’ (e.g. *Rostekhnologiya*, *Rosnanotekh*) to introduce better control over, and greater efficiency in the use of, state property.³² To date these reforms appear to have vanished into bureaucratic discussions and interdepartmental consultations. Indeed, the patrimonial governance structure is essential, is central to the ‘rent redistribution’ system that maintains social stability and fuels economic activity. Hence it is critical to the maintenance of political stability and control. So, as in Soviet days, we see a ‘treadmill’ of administrative reforms and anti-corruption drives ultimately doing little to alter the existing system.

Another obstacle arises from the need to mobilize the “creative class,” those capable of truly innovating, of creating a new technological basis for economic expansion, development and growth. Such creativity, such innovation, requires substantial individual freedom. In particular, it relies on the freedom to step outside of existing structures and constraints, to experiment with new, unauthorized and even hereto unimagined, activities, and on the ability to choose one’s own leaders and dispose of one’s own resources and incomes, without political direction from above. Such people are naturally politically restive, and their innovative activity presents an inherent threat to ‘controllability’ of the development process, as well as to existing political structures. Further, they pose a ‘flight risk’ as they are readily employable in the more liberal market economies of the West. Thus stimulating qualitatively new economic growth poses a danger to the foundations of the current political system, the patrimonial structures insuring social stability and the well being of the current elite. And perpetuation of that system blocks true innovation and qualitatively new growth.

Further, new growth is undercut by the structural legacies of the Soviet economy, including an aged and obsolete capital stock, a stagnant working age population lacking appropriate skills for new technologies, an inefficient organization of production and distribution, and inadequate infrastructure.³³ These problems are aggravated by the inappropriate, and high-cost, location of much production/manufacturing activity, a consequence of decades of economically irrational Soviet

³⁰See the analyses in Pomeranz (2011) and Tulaev (2011), and *BOFIT Weekly*, #25, 23 June 2011.

³¹See for example “State Corporations Caught in Violations” [*Goskorporatsii poimali na narusheniakh*], *IFX.RU*, 10 November 2009.

³²See *BOFIT Weekly*, #1, 5 January 2012 on criticisms regularly made of state corporations. Medvedev ordered a review of them in 2009, and raised the issue of abolishing State Unitary Enterprises; *BOFIT Weekly*, #38, 18 September 2009. Nothing appears to have come of this initiative. As Prime Minister he has ordered the government to prepare suggestions for doing so. See 27 April 2012, *Prime* news report at <<http://www.1prime.biz/news/>>. Also see OECD report by Y. Vaziakova, G. Barnard, T Lysenko (2011).

³³See Ericson (forthcoming) on these Soviet legacies. MGI (1999, 2009) studies the inefficiencies in 10 critical economic sectors in Russia in 1997 and 2007, show the impact of structural legacies in 1997, and both the improvements to 2009 and what needs to be done to reach western efficiency levels.

investment, and the emigration of many of the highest educated skilled employees, a classic “brain drain.”

3.2 Drivers of Continuing Growth

Despite the obstacles to implementing a new growth model, there are factors that will help sustain continuing economic growth and Russian economic predominance in the region. Resource prices, and in particular the price of oil, are apt to remain high and rising. Indeed, Russia’s relatively rapid recovery from the financial crisis can be largely explained by the rapid recovery in the price of oil, generating sufficient state income to support recovery measure and replenish state financial reserves.³⁴ Unless there is a collapse of demand in Europe and/or China, energy and resource prices should continue rising, again generating an investable state surplus for development, infrastructure projects, and a substantial planned increase in military and social spending.³⁵ The Russian government has also made a priority of restoring Russia’s prominence in science and technology, earmarking substantial budgetary resources to both fundamental and applied sciences and to R&D, reversing a two decade contraction, that will become available with continuing strength of resource and energy prices. Thus rising energy prices should also help counter the “brain drain” of the past decades. Finally, increased business and state revenues from strong export prices will stimulate rising consumer demand and the development of both consumer and business services.

Another factor that should support continuing solid economic growth is Russia’s recent accession to WTO, negotiated and signed in December 2011 and ratified by the Duma 22 August 2012. The agreement opens 11 service sectors to foreign participation, introduces international technical and phyto-sanitary standards, requires a 50% cut in agricultural subsidies, and general tariff reductions spread across 8 years, 1/3rd immediately, 1/3rd in 3 years, and the rest in 8 years.³⁶ This is apt drive some further internal liberalizations and reforms, and open more foreign markets to Russian goods, while increasing production efficiency by subjecting Russian manufacturers to (slowly, by design) increasing competition.³⁷ It will also help foster greater openness to foreign investment and technological sharing, enhancing modernization of industry. And this boost to growth is apt to be reinforced by the announced renewed privatization drive, aiming to reduce the state share in many industries without sacrificing state control.³⁸

³⁴Oil and natural gas export revenues provide over 40% of the state budget revenues; World Bank, *RER*, #14, 24, 26, 27. Also see “Russia’s Oil and Gas Revenues: Federal Budget Dilemma, *ISI Emerging Markets Blog*, <<http://blog.securities.com/2011/05/>>

³⁵See S. Blank in *EDM*, 8(3), 5 January 2011 and P. Felgenhauer in *EDM*, 8(213), 17 November 2011. The military build-up is a recently emphasized Putin-Medvedev priority. Spending on the “power agencies” is planned to rise from 24% to 30%, driven by defense spending rising from 15% to 20%. Social spending is to rise to 29% of the state budget. See *BOFIT Weekly*, #41, 14 October 2011. The Finance Minister, Alexei Kudrin, lost his position in September 2011 after criticising the planned 2.1 trillion ruble (\$66 billion) increase in defense spending. See T. Adelaja, “A Laundry List for the Kremlin,” *Russia Profile*, 19 October 2011, in *JRL* #189.

³⁶See “WTO Accession Means Many Changes,” *Moscow Times*, 10 November 2011.

³⁷World Bank, *RER*, #27, April 2012, contains a summary of the World Bank’s detailed analysis of the impact of WTO accession on Russia, indicating its strongly positive potential. As noted above, this is a major part of “Strategy 2020.”

³⁸Further privatization is emphasized in all government discussions of reform, although its contours and specific

Growth in the near term will also be driven by the continuing restructuring of inherited industrial capacities, investment in modernization and in new technologies and equipment. Transportation and energy infrastructures are also the subject of state development plans, where massive investments are required, and in social service, including housing, infrastructure. This ‘development’ investment can be expected to provide a stimulus for increased industrial production and investment. There are also a number of major state investment project that will stimulate economic activity, including the 2014 Olympics and 2018 World Cup facilities, and off-shore Siberian and Arctic energy field development, with its supporting oil/gas export infrastructure.

3.3 Can Russia Help Carry World Growth to a Higher Level?

For the structural reasons discussed above, it is doubtful that Russia will have the impact on world economic development of the other BRICS, especially China. Russia, however, is and will remain the dominant economy in central Eurasia, and an engine of growth for the former FSU countries of that region. Its forecast growth to 2015, largely driven by oil prices, is unimpressive but stable; most analyses see growth in the 3.5-4.2% range per year.³⁹ But that is clearly inadequate for Russia’s ambitions, and will be only mediocre in international comparisons, particularly with the other BRICS.

The government sponsored Russia-2020 program demands at least 5% per year to meet social needs, and provides three potential scenarios for Russian economic development.⁴⁰ The first is what is called the “Inertia Scenario,” without significant change in the structuring or functioning of the current system. It promises annual growth stagnation at 3-3.5% to 2020. The second is an “Energy Resource Based” scenario, where Russia focuses on fully exploiting its comparative advantage in energy resource development and export. In this scenario annual growth steadies at 4-5%, but around 2020 begins tapering off. Finally, an “Innovation Based” scenario, built on economic liberalization and mobilization of the ‘creative class’, is outlined. Here, annual growth rises to over 6%, 2015-20, and the foundation is built for high growth beyond that. Unfortunately, none of these scenarios begins to grapple with the patrimonial system that is the true obstacle to rapid economic growth, despite much talk of reforms to “improve the business climate.”⁴¹

Again for the reasons adduced above, the innovation based, and even the resource based scenarios are much less likely than inertia, barring a major political change in Russia. Russia will provide a steady source of growing demand on the world market, but not enough to call forth new growth in the way Chinese demand has and will.

content continue shifting and remain unclear. See *BOFIT Weekly*, #26 2011 (1 July) and #24 2012 (15 June), *Vedomosti*, 3 August 2011, and I. Iosebashvili, “Russian Privatization Plan Raises Questions,” *WSJ*, 21 June 2012.

³⁹At the end of 2011, all forecasts were lower: Russian domestic: 3.1-3.7% /year; BOFIT: 3.5% /year; WB-Russia: 3.3-4.0% /year. Following 4.3% GDP growth in 2011, WB-Russia increased its forecast growth rate to this range, with high oil prices driving growth at the upper end.

⁴⁰See the preliminary report from August 2011 and the final report of January 2012 on the web site <<http://2020strategy.ru/>>. An early analysis of the state assignment is contained in Kuchins, Beavin, Brynza (2008).

⁴¹The ambivalence about systemic reform was evident at the 2012 Davos Conference in St. Petersburg. See “Davos on the River Neva,” *The Economist*, June 30, 2012.

Russia's primary impact on world economic growth is far more likely to lie on the supply side. Russia will support world, especially Asian, economic growth by providing energy supplies and raw materials, while maintaining a steady demand for finished products from other countries. And its biggest impact will undoubtedly be regional. Russia is a primary purchaser of raw materials and semi-fabricates from the FSU states of eastern Europe and central Asia, and is a primary supplier of energy and finished products. And Russia is apt to maintain that position for the next decade, despite the efforts of some of these countries to diversify their international economic interactions. This role will be enhanced by closer integration of the Eurasian Common Market, and customs union, and the Shanghai Cooperation Organization (SCO) where Russia shares leadership with China, now her primary competitor in Central Asia.⁴²

Finally, we might expect greater Russian integration into, and impact on, northeast Asian development through both energy supply (new oil and gas pipelines and LNG supply) and attracting development investment and skilled labor into its underdeveloped far eastern and east Siberian regions. While both political (Kurile/Northern Territory dispute) and psychological (Russian xenophobia) barriers remain, we might expect the natural economic benefits of such integration, the development of natural resources and the opening of foreign markets, to overcome these barriers in the coming decade. However, it is rather unlikely that Russia will become more than a regional economic engine in the coming decade, despite perhaps having the fifth largest (PPP) GDP in the world on the strength of its resource and energy export earnings.

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