



Working Paper Series
Department of Economics
University of Verona

The Present Challenges to Russia: Modernisation and Diversification

Silvana Malle

WP Number: 16

October 2011

ISSN: 2036-2919 (paper), 2036-4679 (online)

Silvana Malle

Director of the Centre of East -West Studies and European Integration (CEWSEI)
Department of Economic Science, University of Verona

The Present Challenges to Russia: Modernisation and Diversification
Please do not cite without permission.

"20 Years since the Disintegration of the Soviet Union: Looking Backward, Looking Forward"
October 6-7, 2011, Seoul. Conference organized by the Asia-Pacific Research Center, Hanyang
University in South Korea

A premise

Twenty years from the disintegration of the Soviet Union and the Russian Federation's market transformation seem a time span long enough to assess results achieved and challenges ahead. However, the two financial and economic crises that hit Russia, 1998 and 2008, each time just when the country seemed to be finally entering into a sustainable path of growth, suggest that an assessment on the viability of the Russian model of growth transformation may yet have to wait. Twenty years, however, should allow for a preliminary assessment that may be subject to change depending on the intricacies of Russia's political and economic landscape that underwent profound changes, first, in the nineties and, then in 2000s.

From today's perspective, the nineties revealed, first of all, how difficult it was to attain positive results from structural change while coping with the legacies of seventy years of communism. The output fall in a middle income economy excessively dependent on output for defence was dramatic compared to any other post-communist country. Hyperinflation in 1991-1992 destroyed people's savings. It took seven years to bring down inflation to one digit. The tenuous signs of recovery surfacing in 1997 were abruptly reversed by the effects of the 1998 financial crisis that, once again, in less than ten years, resulted in the annihilation of people's savings and the revamping of inflation.

Nonetheless, market institutions combined with large scale privatisation and better understanding of the working of the market mechanism helped Russia to recover fast from the crisis and, starting from 1999, almost a decade of robust growth ensued. Unfortunately, growth came to a halt in 2008 reversing under the effects of another crisis, this time of an international nature, to a tremendous output fall in 2009. Russia is still struggling to recover from this crisis while a) trying to understand the reasons for a very poor performance over the crisis in comparative terms and b) striving to lay down more solid foundations for growth,

This paper intends to examine the challenges posed by the global crisis to Russia since they help better to understand the pluses and minuses of her transformation path in so far as they reflect both the legacies from the past - the Soviet one and the more recent - and the weaknesses of a process of change that after twenty years seems still to be incapable of animating a sound competitive market dynamics supportive of sustainable growth.

Over almost a decade Russian economic growth has been heavily dependent on natural resources and energy: sectors by and large under direct or indirect government control. Under the crisis the role of the state in the economy has increased. The state share in the economy has grown to more than 50% and is becoming increasingly costly to the government. At the same time, the crisis helped uncover the inherent weaknesses of the Russian economy.

A debate on the Russian model of development stirred by reformers and by President Medvedev himself with his manifesto "Russia, forward" electronically published and widely disseminated in September 2009, has laid the ground for a number of reforms that should help modernise and diversify the Russian economy while at the same time calling for an innovation drive to which state and private businesses are supposed to contribute.

While strategic goals are constrained by the need to restore macroeconomic balances through post-crisis tighter budget constraints, comparatively low public debt and the on-going current account surplus from energy and commodities revenues make *prima facie* the overall macroeconomic balances sustainable. However the economy remains exposed to foreign price and reversal shocks.

In this context, the government may be forced to relax its grasp on the economy and start a new wave of privatisation.

This paper focuses on changes in current Russian policy pointing to a new approach to economic development and growth that is still unfolding, where the scope for private undertakings appears to be broadening though subject to their commitment to back the government's efforts in the pursue of national goals. Whether this could evolve in the future towards a greater emphasis on the market and free choice instead of the prevailing tendency towards government power and control remains uncertain, largely because the divide between contrasting priorities and constituencies is not always clear.

From changing constraints to changing path

Changes in Russian Government's policy on state companies, privatisation and Foreign Direct Investment deserve attention as they may effect the structure of the Russian economy in this decade (2010-2020) . Much – but not all - of what is being discussed and hoped for in these areas falls under the programme of modernisation of the Russian economy – focussed on the revival of industry, technology and science that was conceived under Putin in 2006 and has been reinforced under Medvedev with somewhat more emphasis on innovation. Under the effects of the crisis, public debate on economic diversification - a policy that should help emancipate Russian growth from oil/gas dependence, has intensified. While apparently stemming out of necessity rather than virtue, policy changes such as the renewed focus on privatisation of which more below¹, are worth considering, as they could evolve beyond expediency into more radical structural changes.

During the crisis the stake of the state in the Russian economy has grown by some 15% up to 50% in 2009 according to official declarations,² and even up to 75% if state indirect control is included.³ The problem of how to manage and finance such an impressive amount of state property is acutely felt. This concerns not only inefficient state entities, but also many public utilities in dire state the privatisation of which had been postponed over the years of bonanza. The room for costly structural reforms to be domestically financed is narrow. The financial crisis has badly hit central and regional budgets owing to foregone oil, oil products and gas exports revenues. With public and private investment falling tremendously, the latter also hit by the credit crunch, 2009 GDP and industrial output fell by 7.8% and 10.8% respectively – the worst outcome within the BRICs group of large emerging market economies (Brazil, Russia, India and China).

The financial market was also badly hit. Bad loans increased from September 2008 to December 2009 by 7.2% up to about 10% of total loans according to Russian evaluation standards.⁴ Though, apparently, the banking sector started recovering in 2010, using international standards S&Ps in May 2010 estimated non -performing loans (NPLs) at c.40% of total credit.⁵ The situation may be

¹ An observer calls it “pragmatic privatisation”, see <http://www.rg.ru/printable/2009/10/01/privatizacia-site.html>

² <http://www.vedomosti.ru/finance/news/2009/10/06/853393>

³ See A. Shokhin in <http://www.rbcdaily.ru/print.shtml?2009/12/15/focus/447977>

⁴ See I.O. Sukhareva, “Upravlenie problemnymi dolgami v bankovskom sektore: uroki krizisa” 17.8.2011 from http://www.forecast.ru/mainframe.asp?ADDR_FROM=http://www.forecast.ru/news.asp

⁵ See <http://top.rbc.ru/economics/19/05/2010/408807.shtml?print> . On the basis of Russian evaluation standards, Sukhareva, cited above, bad loans at 8.2% of total credit on 1 April 2011

getting worse for a number of banks, since the number of loss-making banks increased from 90 to 127 in six months from the beginning of 2011.⁶ Those data point to little room for credit expansion, while at the same time many large companies, after restructuring their foreign loans, still need to fully repay their debts. As it usually goes for Russia, effective economic growth and budget performance, however, is more dependent on oil prices than on other factors, as also noted by the OECD.⁷ In the light of still uncertain world economic recovery, the Russian Ministry of Finance (MOF) has been cautious, projecting different levels of budget deficit in 2011 according to a fork of oil prices going from 50 to 70\$pb.⁸ However, given the scale of social spending incurred in 2009 and 2010 and pensions' rise approved by the government - despite a perverse combination of rapidly ageing population and excessively low retirement age - oil prices at even \$80pb could jeopardise macroeconomic stability. A fall of \$10 in the price of oil is estimated to cause a fall of budget revenues equal to one percentage point of GDP.⁹

A moderate pace of recovery in 2011 with a 4.1-4.0% rate of growth y-o-y (some three percentage points less than the annual average from 2000 to 2007) as projected by the MED and other international agencies¹⁰ may hamper the agenda of structural changes envisaged over 2011-2020. Those range from modernisation of the arm forces estimated to cost some 20 trillion roubles (c.\$666bn) to innovation that over the same period would need some 16 trillion roubles (c.\$533bn) according to the ministry of Economic Development.¹¹ Even railways now claim that the budget will be badly hit if investments up to 400bn roubles (some \$13.5bn) are not found to finance the upgrading of the network over 2011-2015.¹² Despite Russian government's comparatively easier access to foreign lending –justified largely by Russia's good track record in honouring foreign debt - already envisaged in the 2010-2012 budgets on debt emission, financing strategic goals has become problematic in the light of an incumbent world recession looming by the third quarter of 2011.¹³

⁶ See <http://www.banki.ru/news/bankpress/?id=3184702>

⁷ See OECD Economic Outlook, 2010, cit, p.215.

⁸ Versus the more optimistic 76US\$ hoped for by the Ministry of Economic Development (Minecon), see <http://www1.minfin.ru/ru/press/transcripts/index.php?id4=9676> accessed on May 14, 2010.

⁹ See M. Dmitriev in <http://www.novayagazeta.ru/data/2011/096/10.html?print=201101091247> on 30 August 2011. Recently (13 September 2009) Kudrin cautioned that even an oil price of \$116pb in 2012 would be barely sufficient for a balanced budget, see <http://grani.ru/Politics/Russia/m.191382.html>

¹⁰ See MED's table http://www.vedomosti.ru/newspaper/article/258259/bez_ambicij also projecting a 3.5% rate of growth in 2012.

¹¹ See http://www.vedomosti.ru/finance/news/1353016/dorozhe_armii and <http://www.europarussia.com/posts/2326> on an estimated military expenditure of \$650bn over 2011-2020. Note that the text bases, as a rule of thumb given the highly volatile rates, dollar estimates on a virtual exchange rate of \$30 per rouble.

¹² See http://www.vedomosti.ru/companies/news/1355059/milliardy_dlya_yakunina on 2 September 2011

¹³ See Malle S., "The Impact of the Financial Crisis on Russia", Nato Defence College Forum paper, Research Division, Rome, December 2009, pp.11-12.

Current policies and plans on restructuring state entities, privatisation and foreign direct investment (FDI), therefore, will need to be made consistent with tighter fiscal policies that may limit scope and scale of state support. All in all post-crisis government policy seems to be driven by expediency on the one side, and opportunism, on the other. There is no firm direction of change. While reform-orientated circles call for privatisation to increase efficiency and complete the 90s market reforms, the vast majority of the population is in favour of keeping state control of the economy.¹⁴ But recent developments as discussed below may bring about more radical reforms.

The context of post-crisis structural reforms

The nature and prospects of Russia's changes need to be put in perspective. Major plans of modernisation and diversification (M&D) were already contemplated in Putin's Strategy-2020 – a long and detailed programme – launched on 21 July 2006 and finally approved on 17 November 2008.¹⁵ The strategy envisaged the progressive emancipation of Russia from dependence on energy. The key drivers of this programme were to be innovation, investment and infrastructure with an emphasis on innovation in the financial sector capable of developing in Moscow an international financial hub.

An additional focus on institutions contributed to the shaping of Medvedev's four "i" (investment, infrastructure, innovation and institutions) electoral manifesto in March 2008. It is worth noting that the institutional driver is not irrelevant in comparing the pre- to the post-crisis approach to structural reforms as discussed below. Medvedev has pushed, and continues to push through the Parliament anti-corruption laws complying by and large with OECD best practices, including making income declarations obligatory for state officials, new provisions on state procurement, an area of widespread corruption and bribery, higher test requirements to enter police corps, interdiction to top state officials to have managerial positions in state companies; facilities for foreign direct investment; and a number of other, perhaps minor, if taken separately, but of substance altogether, reforms meant to create if not the necessary mass of provisions for a modern state, at least better grounds for implementation of the rule of law. Some laws have been passed; other provisions – notably on state procurement - encounter resistance.¹⁶ Nonetheless a process of change after many years of inaction is taking place. Even if approved, reforms will take time to deliver, and could even be reversed. But it would be wrong to dismiss efforts to change since they respond to the demands from both the more advanced sections of society and the international community.

On the other hand, a number of reforms undertaken under the new Presidential Administration retain the flavour of the ruling from above, so common to Russian history, relying on organization tools and government priorities rather than market incentives.¹⁷ An example is the Commission for Modernisation and Technological Development (CMTD), composed by influential government official, businessmen, state managers and experts that has been attached to the Presidential

¹⁴ See the results of an opinion poll in www.vedomosti.ru/newspaper/article/2009/11/10/218439

¹⁵ See on this, Malle S. cit., pp.24-26 and the Conception of Long-Term Development of the Russian Federation to 2020 in <http://www.comission.economy.gov.ru/minec/activity/sections/strategicPlanning/concept/concept>

¹⁶ See http://www.vedomosti.ru/politics/news/1353993/zakupka_nevypolnima on 1 September 2011 and <http://www.ng.ru/printed/258889on> 2 September 2009 where Nabiullina, the Minister of economic Development, announces tentatively the approval of new state procurement provisions by end-2011/beginning 2012 warning that at any rate they will need at least three years to be put in force.

¹⁷ Perrie M., "Modernisation under the Tsars and the Soviets", Paper presented at the CREES Annual Conference, Cumberland Lodge, Windsor Great Park, 4-6 June 2010 presents a fascinating overview.

Administration on May 20 2009.¹⁸ This Commission meets monthly to discuss progress in priority areas specifically targeted for development and works under instructions from the President.¹⁹ Medvedev's five strategic priorities have been announced in his "Rossia, vperyod!" internet manifesto on September 10, 2009 – and replicated in his Address to the Nation on 12 November 2009. They focus on energy, nuclear technology, informatics, space technology, medical/pharmaceutical equipment, each considered to be an area for innovation, as by and large did Strategy-2020 under Putin, clearly a Soviet-style branch approach.²⁰

The financial crisis could help stimulate a more market-friendly approach. In 2011 21 groups of experts, under the direction of respected scholars Vladimir Mau and Iaroslav Kuz'mynov, have been charged by the government to propose appropriate changes and amendments to the Strategy.²¹ The first draft of this document has already been circulated but it will need to go through different states of comments before being validated. At this stage, it is unclear how substantive the changes will be and whether they will entail a change in priorities. What has become a main issue of contention from government bodies (the Ministry of Economic Development, in particular), however, is the presumption on the part of experts that economic diversification will take time, certainly longer than a decade, since any structural change will need to be financed out of export revenues from natural resources. This could be seen as a blow to Medvedev's calls for accelerated structural changes, as discussed below.

While Medvedev is often portrayed as a liberal compared to the former President, it is worth noting that many of Medvedev's pronouncements and sense of urgency in this area are influenced by Surkov, the energetic first deputy chief of staff in his administration and Putin's ally.²² Medvedev runs the CMTD as a decision-making and operational vehicle that should be capable of threading between companies' activities and claims, and state/regional bodies. He frequently visits regions/enterprises that carry out projects considered to be technologically advanced in the five priorities areas.²³ Companies' concerns discussed at the meetings are subsequently conveyed for solution to ministerial bodies and high government officials in charge.²⁴ But acting this way

¹⁸ See the Ukaz No. 579 in <http://graph.document.kremlin.ru/doc.asp?ID=52509>

¹⁹ See A. Dvorkovich's comments in <http://www.rian.ru/economy/20090521/171811977-print.html>

²⁰ See the Manifesto <http://news.kremlin.ru/news/5413/print> and the Address to the Nation in <http://www.kremlin.ru/transcripts/5979>

²¹ See <http://www.kommersant.ru/doc.aspx?DocsID=1576907&NodesID=2>

²² See Vladimir Frolov, "Medvedev's Motor to Drive Modernisation", The Moscow Times November 23, 2009.

²³ For example on 31 August 2009 to Vladimir oblast where are located some pharmaceutical companies (see <http://archive.kremlin.ru/text/appears/2009/08/221352-shtml>); Gorki (Moscow Oblast)'s enterprises on 13 May 2010 developing telecommunication and IT technology, see <http://news.kremlin.ru/news/7741/print> and Khanty-Mansiisk, an oil producing district on March 23, 2010, in <http://www.rg.ru/printable/2010/03/23/prezident-anons.html>

²⁴ See the meeting in Gorki in <http://news.kremlin.ru/news/7741/print>, meeting with I. Sechin on energy savings in <http://www.kremlin.ru/news/5629> after a visit to the Sev Mash company and Medvedev's irritation with Nabiullina (Minecom) and Kudrin (MOF) for delays in implementation in http://www.ng.ru/politics/2009-10-01/1_modernize.html

Medvedev adopts a manual management approach similar to that of Putin: both are reminiscent of Soviet practice.²⁵

Does Medvedev perform **the sorcerer's apprentice**?

Many of Medvedev public speeches have been openly critical of the state of the economy. Whether intended or not, Medvedev's criticism of an economy that "to a large extent ignores the needs of the people" stirred a debate on the pro and cons of his blueprint for progress that would have not been otherwise stimulated by the Strategy-2020 a dry style bureaucratic document unsurprisingly downplayed by the Russian press. After Medvedev's start, other commentators started competing on criticism. Few of those are reported below to help understand the unfolding of pressures for reform.

Maslennikov observed that the conditions for a diminished intervention of the state in the economy and an overall reconstruction of the banking and financial system were missing in the manifesto.²⁶ Others pointed to lack of constituency for modernisation and criticised the approach to modernisation from above.²⁷ Shokhin, the Chairman of the Russian Union of Industrialists and Entrepreneurs - and at that time a candidate member of Edinaya Rossia - observed that without global competition there was no way to modernisation in a closed or semi-closed economy, comparing Medvedev's efforts to Gorbachev's inane perestroika and uskorenie.²⁸ Lack of attention to competition and private businesses in Medvedev's M&D was also noticed by financial experts.²⁹ Gontmakher, while somewhat critical of Medvedev's command approach to reform, described it a necessary but not sufficient condition for change.³⁰ Some of the best comments were formulated by Inozemtsev, currently a member of the reformed Right Cause Party, who criticised Russian foreign policy on energy and efforts to build privileged relations with Venezuela and Ecuador in alternative to Europe and other advanced economies, as conducive the M&D's programmes to a dead end,³¹ also unfavourably comparing Russian energy policy to the successful Brazilian policy owing the privatisation of the state oil company Petrobras and ensuing access to foreign technology.³² He also

²⁵ Cfr. Malle S., "Soviet Legacies in post-Soviet Russia: insights from crisis management", *Post-Communist Economies*, Vol.21, no.3, September 2009

²⁶ See <http://www.ng.ru/printed/232144>, published on October 13, 2009.

²⁷ See Leonid Radzikhovskii in <http://www.rg.ru/printable/2009/11/10/modernizacia.html> and Konstatin Limonov in <http://www.vedomosti.ru/newspaper/article/2009/11/10/218442> and Alexei Chesnasov in <http://www.rg.ru/printable/2009/11/27/modernizacia.html>

²⁸ Shokhin A., "Modernocracy", *Itogi* no.46, November 9, 2009 from <http://www.itogi.ru/russia/2009/46/145838.html>

²⁹ See Nikolaev and Morozov in <http://www.vedomosti.ru/newspaper/article/2010/01/11/222572>

³⁰ See Gontmakher A., "Politekonomia: Zadanie nachalniky", in <http://www.vedomosti.ru/newspaper/article/2009/11/20/219327>

³¹ See Inomentsev V., "Modernizatsya.ru: Byt' razborchivee", in <http://www.vedomosti.ru/newspaper/article/2009/11/30/220097>

³² See <http://www.vedomosti.ru/newspaper/article/2010/03/22/228682>