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Mission Impossible: Modernization in Russia after the Global Financial Crisis

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Хотели как лучше, а получилось как всегда.
[We wanted better, but it turned out like always.]
- Former PM Viktor Chernomyrdin

After the global financial crisis, Russian President Dmitry Medvedev made modernization the centerpiece of his economic policy agenda. Most importantly, modernization meant diversifying the Russian economy to become less dependent on natural resource revenues. Medvedev, like many other policy makers and scholars, argued that the financial crisis hit Russia especially hard because of Russia's over-reliance on oil and gas revenues and its concomitant failure to nurture high-technology export industries.

The latest Putin administration now must decide whether or not to press forward with an aggressive modernization agenda. Medvedev and economic liberals both within and outside the government have lobbied strongly in favor of doing so. However, seriously pursuing such a modernization agenda would be an impossible and perhaps even counterproductive policy at this point in time, for three reasons.

First, the underlying structure of the Russian political-economic system makes implementing modernization policies quite difficult. Second, rather than challenging this system, Russia's response to the global financial crisis reinforced its central characteristics, in the process rendering it even more resistant to modernization efforts. Finally, Putin's return to the presidency in the context of a highly visible protest movement and restless political elites puts him in no position to carry out a meaningful modernization agenda, even if he made doing so his top priority. Focusing the government's efforts on modernizing the Russian economy is an attractive goal in principle, but right now it cannot work in practice.

Given this hard reality, I argue that Russia would be better off intensifying the development of its oil and gas industries rather than wasting energy (literally and figuratively) in a futile and costly attempt at high-tech diversification. In short, Putin's government should treat Russia's resource wealth as a boon rather than as a curse.

Why Modernization?

Russia is one of the world's leading producers and exporters of oil and gas. Its dependence on natural resources has risen in recent years; as of January 2012, energy sales accounted for over three-quarters of Russian exports. This dependence leaves Russia vulnerable to swings in world commodity prices, making it difficult for the government to plan its budget and to conduct monetary policy.

From 2000 to 2008 this dependence—while acknowledged as concerning—was not treated as a pressing issue. Oil prices rose and the Russian government conducted restrained monetary policies, leading to several years of GDP growth at 7-8 percent per year and moderate but stable inflation of 9-15 percent per year. As Russia raked in cash from natural resource exports, it accumulated foreign exchange reserves of nearly $500 billion and created a $225 billion stabilization fund to protect again future oil price volatility. Russian politicians and financial markets brimmed with confidence; Russian leaders even began discussing the ruble as a possible international reserve currency and declared Russia immune from global crises. These developments all served to legitimize the political-economic system.

But in the wake of the global financial crisis, Russia's declining terms of trade, capital flight, and a rapid drop in international oil prices combined by mid-2008 to plunge the Russian economy into turmoil. The ruble's value declined steadily, sparking a domestic rush to convert rubles to dollars and euros. Russia's stock exchanges repeatedly halted trading during the fall in the face of collapsing share prices. Russian banks and companies that had taken out foreign-currency loans were squeezed, and credit dried up. The crisis continued through 2009, a year in which Russia's GDP fell by 7.9 percent. The swing from nearly 8.5 percent GDP growth in 2007 to -7.9 percent in 2009 was among the largest in the world. This economic reversal and the public protests that resulted understandably led many to expect significant structural changes to Russia's political-economic model.

Indeed, in response to the crisis, Medvedev's famous "Go Russia!" speech in September 2009 condemned Russia's "economic backwardness," corruption, and paternalistic culture, and proposed an aggressive campaign of modernization as the way forward. The Skolkovo project on the outskirts of Moscow, projected to cost upwards of $4 billion and to feature a techno-park, university, and start-up incubator, represented the showpiece of this modernization plan.

More recently, the Strategy 2020 proposal drafted by Russian economic experts emphasized the pursuit of diversification, promotion of transparency and the rule of law, and maintenance of macroeconomic stability. At the same time, the Ministry of Economic Development posed a stark choice: Russia can either stagnate as an energy superpower (the conservative scenario) or grow by investing heavily in diversified high-tech industries, health and education, and transportation infrastructure (the innovation scenario). However, while ambitious and in many ways laudatory, serious efforts to diversify away from resource dependence and foster high-tech innovation in the Russian economy are doomed to fail under the current regime.

Problem #1: Russia's Political-Economic System Resists Modernization

The Russian political-economic system is one in which the state controls or directs the commanding heights of the economy (particularly natural resources and finance) through formal and informal means, and relies heavily on revenues from natural resources channeled through the state-controlled financial sector to subsidize inefficient economic sectors controlled by insider elites. Richard Ericson has called this a "constrained market economy," Neil Robinson "patrimonial capitalism," and Clifford Gaddy and Barry Ickes "Putin's Protection Racket."

This system privileges a small group of loyal economic elites and informal rules to the detriment of medium/small business and foreign investors. It is also not particularly compatible with democratic governance. The system itself represents the major obstacle to modernization, as it promotes economic uncertainty and stifles bottom-up innovation.

Successful modernization arguably requires an atmosphere of economic and institutional predictability in order to attract and keep foreign investors and domestic capital (both human and financial). The current system cannot provide this predictability. As capital flight and ruble savings figures suggest, even Russians do not trust their political-economic system.

Furthermore, modernization means developing innovative, high-tech export markets. Yet money alone cannot create new high-tech industries from above in an atmosphere without competition and burdened by corruption. Under the current system, even Skolkovo may simply turn out to be another avenue for shunting government resources to well-connected elites. To their credit, many Russian leaders understand the problem, which is why anti-corruption policies and privatization have held an important place in the modernization agenda. To date, however, vested interests within the system have successfully beaten back anti-corruption efforts and repeatedly delayed further meaningful privatization efforts.

Problem #2: The Global Financial Crisis Reinforced the System

Many policy makers and scholars expected the global financial crisis and the resulting Russian economic meltdown to create an opening for systemic economic change. In the end, however, the Russian crisis did not create such an opening. Not only did it not result in systemic change, but it actually reinforced the basic pathologies of the Russian political economy. This occurred in part because Russian authorities drew exactly the wrong policy lessons from the crisis and its aftermath.

Government response to crisis depends in the first instance on *why* policy makers think a crisis evolved as it did. Russian leaders believed that the Russian crisis was externally generated; that is, they believed it was caused entirely by fundamental flaws in the global neo-liberal economic system as led by the United States, rather than by any problems with the Russian political-economic system. For example, Medvedev said that the United States "has tripped up almost everyone" with the crisis in its financial market, while Prime Minister Putin called the world financial crisis a "contagion" that had spread from the United States and said that the Russian situation was "due to the ... irresponsibility of [the U.S.] system."

As a result, the government's natural reaction was to try to shield Russia from future shocks originating in this pernicious and unstable international system. In the process, Russian leaders paradoxically both "learned" that Russia should diversify away from resource dependence and reacted to the crisis by reinforcing the central characteristics of Russia's existing political-economic system.

The Russian government responded to the crisis in three ways. First, it carried out massive fiscal expansion to stimulate the economy and currency intervention to ease the ruble's slide in value. Second, it bailed out politically connected oligarchs and firms such as the state oil company Rosneft and wealthy businessmen Mikhail Friedman and Oleg Deripaska. Third, it promoted significant recentralization of the financial sector, enhancing a trend that began after the 1998 financial crisis. State-owned banks now represent about fifty percent of the sector; the percentage is much higher if we include state-connected banks as well.

The Russia government thus responded to the crisis by reinforcing rather than restructuring the existing system. As Richard Ericson has written, "While all governments have moved to provide massive liquidity injections and a substantial fiscal stimulus . . . few have moved as vigorously to centralize control over those stimulus and liquidity support packages." The economic results seem to have justified this approach, at least from the perspective of the Russian government. The Russian economy returned to growth in 2010, recovering from the severe recession of the previous year, triggered by strong domestic demand and rising oil prices. By fall 2011, foreign exchange reserves, which had fallen to almost $380 billion in early 2009, had hit $545 billion—a complete recovery.

In sum, unlike the 1992 and 1998 financial crises, in which Russian leaders identified the key causes of crisis as homegrown, the most recent crisis did not lead to significant changes in Russia's political-economic system. Instead, it served to reinforce and further entrench the existing one, in the process moving the starting line backwards for any subsequent modernization efforts.

Problem #3: The System is Stronger, but Putin is Weaker

The presidential and parliamentary elections further complicated the prospects for modernization, because they returned a weakened Putin to power without breaking the underlying system on which his power rests. This limits Putin's ability to make fundamental changes to the system.

In the face of a protest-laden election season, Putin made extensive electoral spending promises, most incompatible with the modernization agenda. He promised to raise both pensions and public sector pay, and he promised massive new investment in the military-industrial complex. Putin himself estimated that the social spending commitments could cost three percent of GDP per year, while other estimates put the figure as high as eight percent. This is on top of the military spending commitment of $870 billion through 2020. Given that Russia's GDP growth is expected to plateau in the medium term to 3-4 percent per year, fulfilling these commitments would not only leave few resources for modernization initiatives, but could undermine Russia's macroeconomic stability.

For all its energy and excitement, the election season also deepened political uncertainty in Russia, as protest movements strongly challenged but did not defeat the regime. Such uncertainty discourages foreign investment everywhere except the natural resource industries and spurred a new round of domestic capital flight, with nearly $23 billion leaving Russia in January-February 2012 alone. Political uncertainty makes it more difficult to convince investors to back a state-led modernization program, a key problem when the program assumes significant private investment in concert with state investment.

Most importantly, now that Putin, the architect of this political-economic system, has been weakened politically, it would be doubly hard for him to dismantle it. Even government liberals disagree on how modernization should be carried out, with the Finance Ministry emphasizing the need for fiscal restraint while the Economic Development Ministry advocates deficit spending in order to fulfill the entire wish list. More broadly, as different elite factions jockey for power, Putin must reward his supporters in the military and natural resource industries as well as fulfill at least some of his election promises. As such, Putin is not in a position to invest heavily in new high-tech industries, to crack down on corruption, to reform the judicial system, or to strongly reduce the state's hold on the economy—that is, to do anything that would make serious modernization possible.

The final nail in the coffin is perhaps Putin's own ambivalence towards modernization, even setting aside the political issues above. Although Medvedev boarded the modernization bandwagon long ago, Putin has always viewed modernization as but one desirable goal among many. Moreover, although he pays lip service to economic diversification, Putin has consistently acted to strengthen the state's role in (and thus dependence on) Russia's natural resource industries. Given the choice between vigorously pursuing modernization or a host of other often contradictory and desirable political, economic, and social policies, it is not at all clear that Putin will come down on the side of the modernization agenda.

The Second-Best Solution: Increase Investment in Natural Resources

As Gaddy and Ickes have pointed out, natural resources are Russia's comparative advantage. Windfall energy revenues under Putin allowed the Russian government to pay off nearly all its foreign debt ahead of schedule. Moreover, while fluctuating energy prices make Russia more vulnerable to crises, energy resources handled well have also been vital in getting Russia *out* of such crises. Natural resources have made Russia a wealthy state indeed in comparison to most of its post-communist counterparts.

Rather than diversifying away from natural resource exports, a politically impossible and economically challenging task, the Russian government would be better served by focusing its efforts on making its vital oil and gas sectors more effective producers, processors, and exporters, as well as on increasing domestic energy efficiency in order to allow Russia to export more of what it produces. Doing so would be politically feasible and would maximize Russia's chances to achieve steady, deficit-free medium-term economic growth.

Yet Russia has invested little to date in improving its extractive capacity and infrastructure. It has also made foreign investment in the sector extremely difficult. Russia has made more headway with energy efficiency, as Medvedev approved a comprehensive energy efficiency policy in 2010. Still, much ground remains to be covered between paper policy and economic reality. As a result, Russia is not producing as much energy or consuming it as efficiently as it should be—a sorry state of affairs for an energy superpower.