Russia's Economic Prospects - Modernisation or Stagnation?

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Executive Summary

- Although Russia has now emerged from the recession that accompanied the start of the Ukraine conflict, growth is likely to remain stuck at around 2% for a prolonged period without major domestic reform. This is significantly below the 7–8% growth rates that underpinned Russia's resurgence and cemented Vladimir Putin's leadership during his first period in the Kremlin. With GDP and living standards essentially flat since the 2008 financial crisis, Russia's stagnation looks set to continue.
- Russia's reduced economic prospects have important domestic and international implications. Regime legitimacy in Putin's fourth presidential term will not be sustained with the kind of rapid increases in personal wealth that characterised the 2000s. Russia's status as a rising power will be challenged as it lags behind other emerging markets and even many industrialised economies. The affordability of Putin's assertive foreign policy and ambitious rearmament plans will be called into question.
- Russia has the means to forge a different and more successful developmental path, including a unique endowment of natural resources, an educated population and a strong track record of scientific discovery. Fulfilling that potential will require Russia's leaders to grapple with the country's major economic deficiencies, the most important of which are:
    - **Resources dependence**: Oil and gas revenues are estimated to account for as much as 70% of the federal budget, leaving Russia acutely sensitive to shifts in global energy prices. Despite repeated promises to diversify the economy, reliance on energy exports has grown under Putin's leadership.
    - **The failure of modernisation:** Efforts to modernise the economy and narrow the technology gap with its main competitors have so far failed to produce results. An initiative to create a Russian equivalent of Silicon Valley has gone the way of previous top-down attempts at economic modernisation. One of Putin's former economy ministers warns that without change, Russia is destined to face "technological subjugation" in the emerging economic order.
    - **Corruption:** The latest edition of the Corruption Perceptions Index, ranking countries from least to most corrupt, puts Russia in 131st place out of 176. It has consistently been among the worst performing countries since the Index was launched in 1995. Independent analyses suggest that corruption consumes between a fifth and a third of total output. Efforts to reduce corruption are undermined by the willingness of the Russian political elite to use it as an instrument of statecraft.
    - **Weak property rights**: The Russian business environment is undermined by weak property rights and, in particular, a widespread form of corporate raiding known as *reiderstvo*. As the authorities acknowledge, tens of thousands of businesses are stolen from their legitimate owners every year by this method. Poor legal protection stifles the development of small and medium-sized businesses and deters investment and entrepreneurship.

- Many of these weaknesses are understood and acknowledged by Russian leaders, including President Putin. Workable proposals to address them have been put forward, especially by "regime liberals" like Alexei Kudrin. But most of the reforms required to improve Russia's long-term economic performance pose an obvious challenge to the patrimonial and authoritarian style of government developed under Putin's rule. They also conflict with the nationalist goals that define current Russian foreign policy. Although Putin will continue to pay lip service to the idea of economic reform, it is unlikely that his fourth term will involve a significant change of direction.

- The West should take little comfort from Russia's economic problems. Far from blunting Putin's geopolitical ambitions, a prolonged squeeze on living standards could lead to a more aggressive foreign policy as the Kremlin tries to deflect attention by stoking nationalist sentiment. The West should help Russia fulfil its long-term ambitions by encouraging it to make the transition to a modern, rules-based form of capitalism. Because progress towards that goal is unlikely in the short term, Western governments should be prepared to play the long game and wait until Russia is ready to engage on the right terms before considering a full normalisation of economic ties.

1. Introduction

Russia has emerged from its longest economic downturn since the mid-1990s. After four years of declining growth rates between 2011 and 2014, the economy contracted by 3.7% in 2015 under the combined impact of falling oil prices, systemic inertia and Western sanctions imposed as a result of Russia's military intervention in Ukraine. A further contraction of 0.6% followed in 2016. The economy is now expanding again, but at a much lower level than a decade ago. The World Bank is forecasting growth of 1.7% in 2017 and 2018, followed by 1.8% in 2019.[1] Analysts expect growth of around 2% or lower to persist indefinitely unless Russia undertakes major reforms.[2]

This has important geopolitical implications because Russia's economic resurgence in the decade prior to the 2008 global financial crisis cemented the legitimacy of Vladimir Putin's leadership and emboldened him to adopt a more assertive foreign policy. Looking back at his achievements shortly before the end of his second presidential term in 2008, Putin boasted of the transformation that had occurred under his direction:

> Russia has returned to the world stage as a strong state, a country that others heed and that can stand up for itself ... We have now completely restored the level of social and economic development that was lost in the 1990s. People's real incomes now exceed their pre-reform levels. The economy is growing steadily. Last year, we had our best GDP growth result yet – 8.1 percent. According to the figures for 2007 (according to international experts' data), Russia is ahead of G8 countries such as Italy and France in terms of GDP as calculated on a purchasing parity basis, and is now one of the world's seven biggest economies.[3]

Rising prosperity transformed Russia's relations with other countries as it ceased to be a sovereign debtor and began flexing its muscles as a dominant energy supplier. The effects were psychological and diplomatic as much as material. In 2001, Goldman Sachs identified Russia, alongside China, India and Brazil, as one of the BRIC group of large emerging markets. Russia suddenly belonged to a vanguard of rising powers with potential to shape the emerging world order of the twenty-first century. What started as a form of analytical shorthand became political reality in 2006 when the foreign ministers of the four BRIC countries began meeting. Russia hosted a summit for BRIC leaders three years later, which demanded a bigger say for emerging and developing economies in international financial institutions.[4]

Growth rates of 2% or less for a sustained period would put Russia on a path of stagnation relative to its peer group of emerging markets, the global economy as a whole and even most Western countries. Although still an important economy, it would no longer meet the criteria of a rising power in the literal sense of the term. This would call into question President Putin's claim that

[1] 'Russian Economy Returns to Modest Growth in 2017, says World Bank', Press Release No: 2018/ECA/43, *The World Bank*, 29 November 2017, available at: http://www.worldbank.org/en/news/press-release/2017/11/29/rer-38, last visited: 20 December 2017.
[2] Hanson, P., 'Russia's Economic Battles Expose Turmoil', *Chatham House*, 28 April 2016, available at: https://www.chathamhouse.org/expert/comment/russias-economic-battles-expose-turmoil, last visited: 20 December 2017.
[3] Putin, V., 'Speech at Expanded Meeting of the State Council on Russia's Development Strategy through to 2020', 8 February 2008, available at: http://en.kremlin.ru/events/president/transcripts/24825, last visited: 20 December 2017.
[4] 'UPDATE 6 – BRIC demands more clout, steers clear of dollar talk', *Reuters*, 16 June 2009, available at: https://www.reuters.com/article/bric/update-6-bric-demands-more-clout-steers-clear-of-dollar-talk-idUSLG67435120090616, last visited: 20 December 2017.

"sovereign democracy" offers a better route for overcoming backwardness and competing with the West than the liberalising approach of President Boris Yeltsin. It would become impossible for him to reconstruct the implicit social contract he struck during his first period in the Kremlin, according to which limitations on political freedom were accepted in exchange for rapidly rising living standards. The "national greatness" project that replaced it would also be imperilled, with low growth rates putting financial limits on military modernisation and power projection. The Putin system would not be immediately threatened, but it would be denied some of the ideological and material underpinnings that have allowed it to thrive, and it would create uncertainty about its viability in the longer term.

Russia's economic predicament raises important questions. How real is the risk of stagnation? What are the underlying sources of economic weakness? Can the system Putin has created adapt in ways that allow those weaknesses to be addressed? This paper is an attempt to provide some answers. It starts by looking at Russia's attempts, reaching back to the Soviet era, to achieve convergence with the world's most developed economies and describes how those attempts eventually relapsed into stagnation. It then looks at the reasons why the most recent period of catch-up – the "Putin boom" – failed to provide a sustainable path of development. The nature of the debate within Russia about its economic future is then described before some conclusions are drawn about the likely political repercussions.

2. The Russian Economy from Stagnation to Reform and Back Again

An enduring theme of Russia's economic history since the time of Peter the Great has been a desire to catch up with the West.[5] There have been periods of rapid progress towards that goal, such as during the late nineteenth century, after the abolition of serfdom, and again during the Stalin era. Yet these have invariably been followed by periods of stagnation and crisis that have seen the country lose ground again. We appear to be living through another turn of that cycle today as Russia struggles to restore growth after eight years in which the economy has effectively flatlined. To understand the challenges Russia now faces, it is worth looking back to the end of the Soviet era to see how Russia has tried to close the developmental gap in the recent past and why it has been unable to sustain progress towards that goal.

2.1 Soviet Stagnation and the Transition to Capitalism

The Soviet experiment began with the utopian promise of material superabundance and ended in economic decay and collapse. Although there were times in its history, such as during the rapid industrialisation of the 1930s and the growth years of the 1950s and 1960s, when it looked to some people as if the communist vision of universal plenty could be realised, the underlying reality was one of long-term economic decline. Even official Soviet data showed that growth weakened in each successive decade from the 1950s onwards. Independent estimates suggest that by the first half of the 1980s growth had slowed to a virtual standstill at just 0.6%.[6]

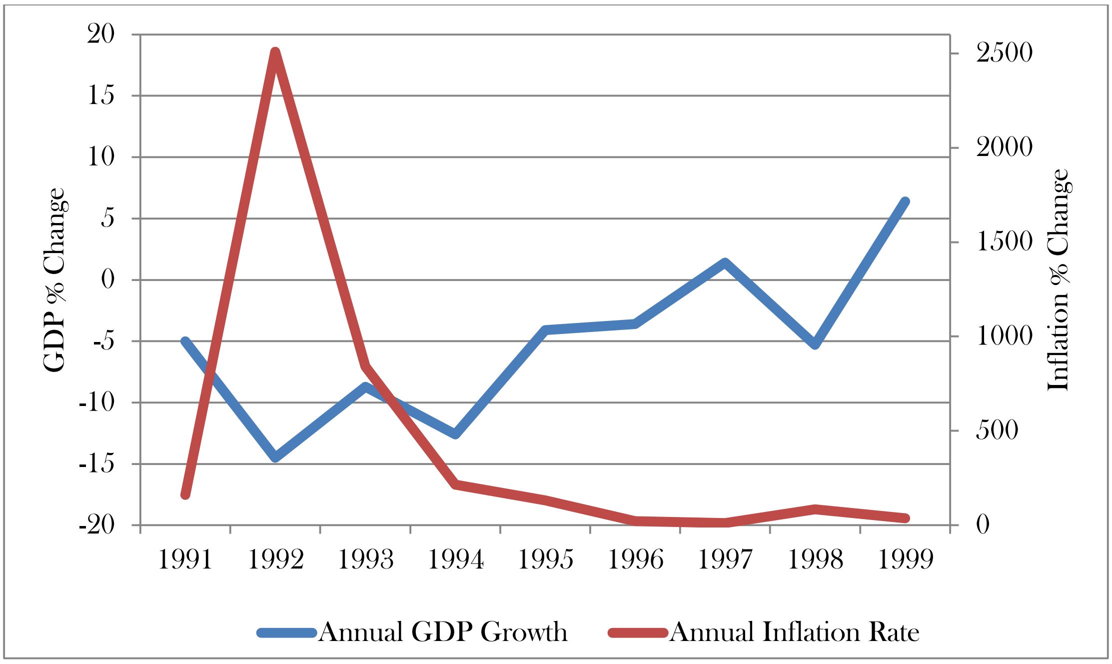
The launch of perestroika under Mikhail Gorbachev's leadership in 1987 was an attempt to save the Soviet economy by introducing more dynamism and efficiency. Private business was legalised for the first time since the 1920s and the managers of state enterprises were given more freedom to reorganise production and retain surpluses. But the liberalisation of economic activity in the context of ongoing price controls created new pressures, including shortages and hyperinflation. Weakened central control led to the withholding of tax revenues and a budget deficit that reached around a third of Gross Domestic Product (GDP). As the rate of economic decline accelerated, the Soviet Union broke apart.

Boris Yeltsin picked up the baton of radical economic reform at the end of 1991 in his capacity as President of a newly independent Russia. Proposals for a rapid transition to a market economy that had been rejected by Gorbachev were revived and implemented with three goals in mind: macroeconomic stabilisation, price liberalisation and privatisation. Yet Russia's economic transition turned out to be more prolonged and painful than its architects had expected. In the medium term, the freeing of prices undermined the goal of macroeconomic stability as inflation leapt to 245% within the space of a month, with the annual rate for 1992 reaching 2508% (see Figure 1). As savings were wiped out, living standards collapsed and poverty increased. Within the space of five years, Russia went from being one of the most egalitarian societies on earth to

[5] Mau, V. and Tatiana Drobyshevskaya, 'Modernization and the Russian Economy', in *The Oxford Handbook of the Russian Economy*, edited by Michael Alexeev and Shlomo Weber (Oxford University Press, 2013), pp. 30-33.
[6] ibid., p. 40, Table 2.3.

being among the most unequal. This decline took its physical toll in the form of an unprecedented health crisis that saw mortality rates leap by 60% between 1990 and 1994.[7]

Figure 1: Russian GDP and Inflation (CPI), 1990–1999



Data Sources: World Bank and StatBureau

Against a background of extreme hardship, two further developments turned public sentiment against the Yeltsin reforms. The first was a backdoor privatisation scheme known as "loans for shares". Banks were allowed to auction off large state enterprises that had been put up as collateral for loans, but the auctions were often rigged to ensure that the banks themselves, or people close to them, secured the businesses at the lowest prices.[8] It looked as though the country's most valuable assets had been sold to a few regime insiders on the cheap. The final blow came with the 1998 rouble crisis, which struck just as growth was returning for the first time since the collapse of the Soviet Union. Fears provoked by the Asian financial crisis of the previous year, Russia's persistently high budget deficit, a fall in the price of oil and political uncertainty led to a run on the rouble. After spending $27bn in a failed attempt to defend the currency, Russia defaulted on its $70bn domestic debt, around half of its commercial banks went into liquidation and ordinary Russian depositors lost about two-thirds of their savings.[9] Nothing did more to associate the reforms of the 1990s with chaos and national humiliation.

Perhaps the most significant and enduring legacy of the Yeltsin years was its impact on Russian attitudes to democracy and the market. In a 2015 poll for the Levada Center, 77% of Russians expressed "mostly" or "very" negative attitudes towards the economic reforms of the 1990s.[10] Another Levada poll from 2016 showed that support for a return to Soviet-style government was

[7] Popov, V., 'Transformational Recession', in *The Oxford Handbook of the Russian Economy*, p. 105.
[8] ibid., pp. 204-205.
[9] Aslund, A., *Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed* (Peterson Institute for International Economics, 2007), p. 179.
[10] 'Fall of the USSR and Yeltsin Era', *Levada Center*, 5 April 2016, available at: http://www.levada.ru/en/2016/04/05/fall-of-the-ussr-and-yeltsin-era_/, last visited: 20 December 2017.

higher (19%) than support for Western-style democracy (16%). Echoing Putin's justification for restricting political freedom, 46% favoured a democracy "appropriate to Russia's national traditions".[11]

2.2 The Putin Boom: 2000–2008

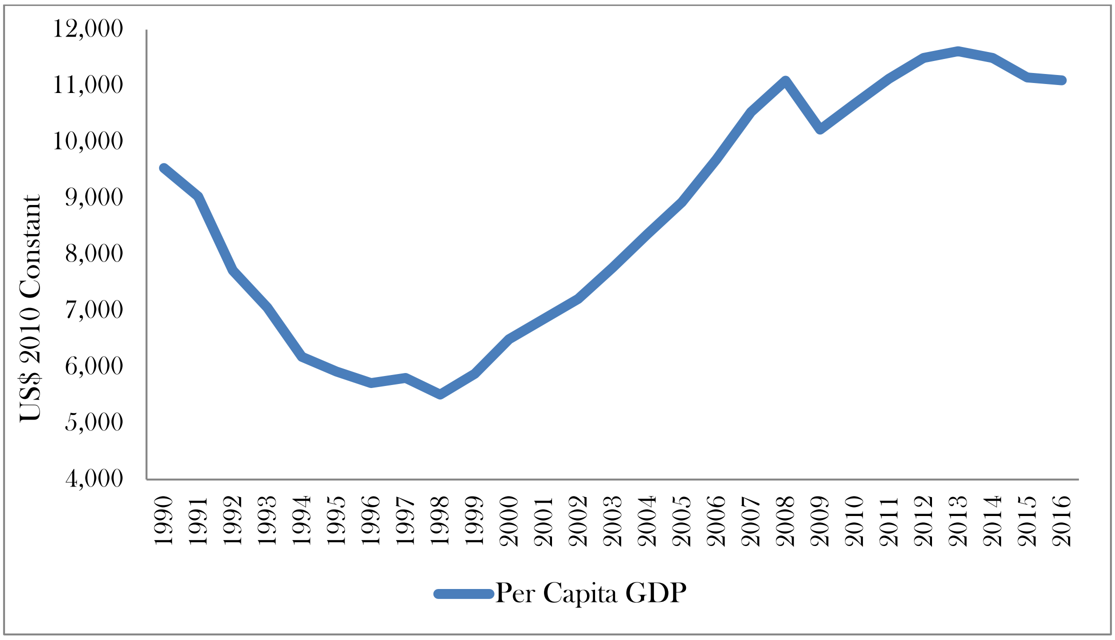
If the 1998 rouble crisis marked the nadir of Russia's post-Soviet trauma, it can also be seen as a significant turning point. In the decade that followed, confidence returned and the economy rebounded as dramatically as it had collapsed. The period of recovery coincided with Vladimir Putin's rise to power in 1999, first as Prime Minister and then as President. Between 1999 and 2008, growth averaged 6.9% and dollar GDP rose from $196bn to $1.7tn, making it Russia's "best decade of economic growth ever", according to one estimate.[12] Healthy budget and trade surpluses enabled the government to amass large foreign exchange reserves totalling $600bn in 2008, in addition to a Stabilisation Fund that reached $157bn in the same year. The impact on living standards was equally impressive, with average monthly wages rising from $62 in 1999 to $696 in 2008.[13] The proportion of Russians living below the poverty line fell from 24.6% in 2002 to 13.3% in 2007 and 10.7% in 2012.[14]

Economic recovery gave rise to a palpable sense of national rebirth. In 2007, the humiliations of the 1990s were consigned to the past as the collapse in output was fully reversed and GDP surpassed Soviet levels for the first time (see Figure 2).[15] Russia passed another psychological milestone in 2007 by paying off the remaining $22bn of its Paris Club debts 13 years ahead of schedule. Growth returned Russia to the ranks of the world's ten largest economies and transformed perceptions of its status within the international system. Russia was no longer a military superpower on a par with the Soviet Union, but it was increasingly spoken of as an "energy superpower" with the capacity to influence global outcomes through the supply of hydrocarbons.

Three factors lay behind Russia's economic revival. The most important of these was a surge in the value of Russia's premier export commodities – oil and gas. The price of oil increased from around $10 per barrel in 1998 to a peak of more than $140 in 2008, while the volume of Russian oil exports rose by 66% in the same period. Although the volume of gas exports remained largely static, their value rose by approximately one-fifth because gas prices are linked to oil. As a result, total annual earnings from energy increased from $28bn to $310bn in the decade prior to the 2008 crash. According to RAND, this windfall accounted for an estimated 68% of the rise in GDP between 1999 and 2008.[16]

[11] 'Democracy in Today's Russia', *Levada Center*, 20 January 2016, available at: http://www.levada.ru/en/2016/01/20/democracy-in-todays-russia/, last visited: 20 December 2017.
[12] 'Russia's Medium-Term Economic Prospects', *The RAND Corporation*, 2016, p. 3.
[13] ibid., p. 4.
[14] 'Poverty and Equity Data Portal: Russian Federation', *The World Bank*, available at: http://povertydata.worldbank.org/poverty/country/RUS, last visited: 20 December 2017.
[15] Entov, R. M. and Oleg V Lugovoy, 'Growth Trends in Russia After 1998', in *The Oxford Handbook of the Russian Economy*, p. 133, Figure 6.1.
[16] 'Russia's Medium-Term Economic Prospects', *The RAND Corporation*, 2016, pp. 4, 9.

Figure 2: Russian GDP Per Capita (Constant 2010 US$), 1990–2016



Data Source: World Bank

The second reason for Russia's economic recovery was that the economic reforms of the Yeltsin era finally began to pay dividends. The creation of an economy based primarily on the free exchange of private property initially caused huge disruption, but the efficiencies it introduced laid the foundations for later growth. While oil and gas exports provided windfall revenues during the boom years, the most dynamic sectors of the economy were construction, retail, transportation and telecommunications.[17] Privatised enterprises and new businesses drove double-digit annual increases in manufacturing productivity. Private energy companies out-performed their state-owned counterparts by wide margins.

Third, it should be noted that Vladimir Putin initially pursued important economic reforms of his own through the appointment of a broadly liberal government under Prime Minister Mikhail Kasyanov.[18] Tax reform saw the rate of corporation tax cut from 35% to 24%, the introduction of a flat rate of income tax of 13% and a reduction of social security contributions from 39.5% to 24%. These changes helped to improve collection rates and strengthen public finances. Procedures for registering business were simplified, increasing new business growth to 7% per annum. The sale of agricultural land, blocked by Yeltsin's opponents throughout the 1990s, was finally legalised in 2002.

Putin's reformist phase ended in 2003–2004 with the Yukos affair and the sacking of Kasyanov. The subsequent dismantling of Yukos, Russia's largest private energy company, and the imprisonment of its head, Mikhail Khodorkovsky, heralded a wider reassertion of state control and a significant retreat from the political and economic reforms of the 1990s. Putin saw the oligarchs as a threat to his own authority and wanted the energy sector, in particular, to become a strategic asset in the hands of the state. He moved to centralise political power and renationalise

[17] ibid., pp. 9-10.
[18] Aslund, A., *Russia's Capitalist Revolution*, pp. 214-219.

other energy companies. The effect was to sacrifice many of the efficiencies introduced with privatisation. Russia's two most successful energy companies, Sibneft and Yukos, were achieving returns on total assets of 33% (2004) and 30.6% (2002) respectively in the private sector. They were taken over by state energy giants Gazprom and Rosneft, posting returns of only 7.3% and 9.5% (both 2004).[19] Foreign energy investors BP and Shell came under regulatory attack and new subsoil law banned majority foreign ownership in the energy sector, reducing Russia's international openness.

2.3 The Return of Stagnation: 2009 to the Present

Russia's recovery came to an abrupt end with the global financial crisis in 2008. Initially, Russian leaders sought to dismiss the crisis as a specific failure of Western capitalism. In June 2008, President Medvedev blamed market turmoil on American "economic egoism" and suggested that Russia was ready to assume a new position of global financial leadership.[20] However, the aftershocks caused by the collapse of Lehman Brothers in the US on 15 September showed that Russia was not immune to the crisis. Trading on Russia's two main stock exchanges had to be suspended for several days as share prices plummeted, the rouble came under pressure, capital flight accelerated and the country's leading banks had to be bailed out. As global trade contracted and the price of oil fell sharply, Russia experienced its first recession for more than a decade, losing 7.9% of GDP in 2009.

Significantly, Russia was the only one of the BRIC countries to go into recession as a result of the 2008 financial crisis. This was mainly because of its dependency on oil and its exposure to external shocks caused by the collapse of commodity prices. Yet there were also domestic factors that pointed to a longer-term decline in economic performance. The fall in the value of Russian shares actually began in July when Vladimir Putin, taking time out from the Kremlin in the role of Prime Minister, publicly attacked the private steel and coal producer, Mechel, ostensibly over its pricing policy. In the context of the Yukos affair, ownership of the company appeared to be in doubt, and the value of its shares slumped by 38%, or $6bn, overnight.[21] Capital flight began two weeks later with the Russian invasion of Georgia. An estimated $19bn flooded out of the country within a month in the first indication that Russia's geopolitical ambitions might be at odds with its economic interests.[22]

Growth resumed in 2010, but at a much lower level than before the crisis. Rates of 4.5% in 2010 and 4.3% in 2011 dented the optimistic plans published by the Ministry of Economic Development and Trade at the end of Putin's second presidential term in 2007. Known as Strategy 2020, these plans envisaged Russia becoming one of the world's top five economies by 2020 thanks to average growth rates of more than 6% per annum.[23] They also suggested that Russia could become a world leader in finance and technological innovation. The realisation that

[19] Milov, V., 'The Power of Oil and Energy Insecurity', *Institute of Energy Policy*, January 2006, p. 12.
[20] Blomfield, A., 'Russian president Dmitry Medvedev blames US selfishness for global financial crisis', *Daily Telegraph*, 8 June 2008, available at: http://www.telegraph.co.uk/news/worldnews/europe/russia/2095070/Russian-president-Dmitry-Medvedev-blames-US-selfishness-for-global-financial-crisis.html, last visited: 20 December 2017.
[21] Kramer, A. E., 'Vladimir Putin's comments drive a company's stock down $6 billion', *The New York Times*, 25 July 2008, available at: http://www.nytimes.com/2008/07/25/business/worldbusiness/25iht-steel.4.14798463.html, last visited: 20 December 2017.
[22] Harding, L., 'Russia: Kremlin wins war but faces new battle as investors scramble for exit', *The Guardian*, 6 September 2008, available at: https://www.theguardian.com/world/2008/sep/06/russia.globaleconomy, last visited: 20 December 2017.
[23] Kuchins, A. C., Amy Beavin and Anna Bryndza, 'Russia's 2020 Strategic Economic Goals and the Role of International Integration', Center for Strategic and International Studies, July 2008, available at: https://www.theguardian.com/world/2008/sep/06/russia.globaleconomy, last visited: 20 December 2017, p.2.

these goals would not be met came in 2012–2013 when growth shrank to 3.4% and then 1.3%, despite the fact that oil prices had returned to pre-crisis levels of more than $100 per barrel. For much of this period, investment was low and net capital flows remained negative to the tune of tens of billions of dollars each year, reflecting low business confidence.

Russia's economy took another turn for the worse in 2014. Annual growth slumped to 0.6% and capital flight reached a new annual high of $154.1bn. Russia entered recession again in 2015 with a contraction of 3.6%, and this was followed by a further contraction of 0.6% in 2016. This had a major adverse impact on living standards and public finances. Real disposable incomes fell by

12.3% between 2014 and 2016 and the poverty level rose again to 13.9%.[24] Russia posted successive budget deficits of 2.6% and 3.7% in 2015–2016. In order to cover the shortfall in state spending, the Reserve Fund – accumulated with energy export revenues during the Putin boom – was raided, and fell from almost $92bn in 2014 to $16.5bn at the beginning of 2017.[25]

This downturn was the product of a unique combination of factors. The sharp slump in oil prices from around $100 a barrel in the first half of 2014 to less than $50 a barrel by early 2015 was largely beyond Russia's control. However, other negative factors were the result of policy choices made by Russia. With the annexation of Crimea and the military intervention in Eastern Ukraine, Russia was suddenly at war with a major trading partner. The conflict also created market uncertainly and provoked Western economic sanctions. Although the latter were limited in scope, they had an important short-term effect in limiting access to Western financial markets for banks and businesses placed on the sanctions list, and forcing the Russian state to deplete its reserves in order to support them. Russian and Western estimates put the cost of sanctions within the range of 1–2% of GDP in the first year.[26]

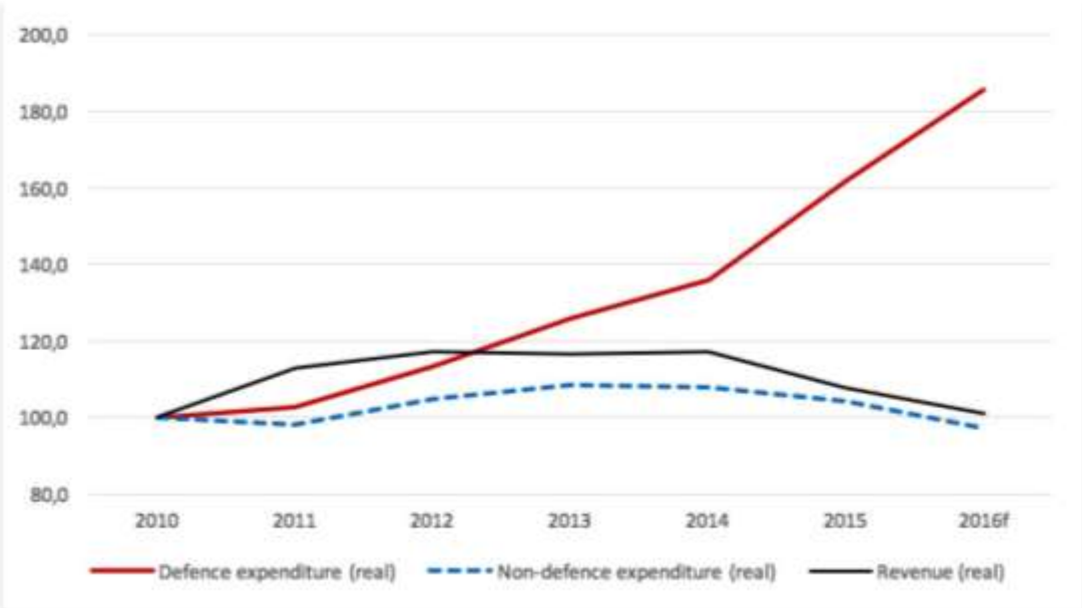
Although it emerged from recession in the second half of 2016, Russia faces ongoing challenges that are likely to put a cap on growth in the medium term. The reduction in financial reserves means that Russia's room for manoeuvre in responding to future economic shocks has been narrowed. Any further deterioration in public finances would eventually have to be covered by increased sovereign debt, higher taxes, significant budget cuts or a combination of these measures. All of the available choices have important implications for both Russian power and the domestic popularity of the Putin regime. There would, for example, be reluctance to expand sovereign debt to levels that would create new opportunities for external leverage over Russian policy. Tax rises would depress economic demand and cuts in social programmes would hit the most vulnerable. Both would prove extremely unpopular at a time when living standards are stagnant and poverty rates have increased.

As things stand, the Russian economy will not be able to generate the rapid increases in personal wealth that underpinned Putin's legitimacy during his first two presidential terms. It is also doubtful that Russia will be able to sustain the military rearmament programme that has become

[24] Karpova, M., 'Real income in Russia falls by over 12% in 2 years', *Russia Beyond the Headlines*, 23 December 2016, available at: https://www.rbth.com/business/2016/12/23/real-income-in-russia-falls-by-over-12-in-2-years_666751, last visited: 20 December 2017.
[25] Tanas, O. and Anna Andrianova, 'Russia Eyes a $90 Billion Sovereign Wealth Fund', *Bloomberg Markets*, 19 June 2017, available at: https://www.bloomberg.com/news/articles/2017-06-19/russia-to-discuss-merging-wealth-funds-into-90-7-billion-coffer, last visited: 20 December 2017.
[26] Russell, M., 'Sanctions over Ukraine: Impact on Russia', *EPRS Briefing*, March 2016, available at: http://www.europarl.europa.eu/EPRS/EPRS-Briefing-579084-Sanctions-over-Ukraine-impact-Russia-FINAL.pdf, last visited: 20 December 2017, p. 11.

integral to the populist and interventionist foreign policy Putin has used to rebuild domestic support since returning to the Kremlin. Defence spending rose steadily during the boom years and accelerated after the 2008 war with Georgia revealed major deficiencies in Russian military capabilities. These included low levels of combat readiness and a lack of modern equipment.[27] The new State Armament Plan adopted in 2010 sought to address these weaknesses by approving a four-fold increase in the military procurement budget. Between 2011 and 2020, the Russian government decided to spend 19tn roubles with the goal of increasing the proportion of advanced weaponry used by its armed forces to 70%. The proposed shopping list included 400 long-range ballistic missiles, eight ballistic missile firing submarines, six aircraft carriers, 100 military satellites, 600 combat aircraft, 1,000 helicopters and 2,300 tanks.[28]

Figure 3: Evolution of Defence Spending, Non-Defence Spending and Total Government Revenue at Constant Prices (2010 = 100)



Graph taken from: Christie, E. H., 'Does Russia have the financial means for its military ambitions?', *NATO Review*, 21 October 2016, available at: https://www.nato.int/docu/review/2016/Also-in-2016/Does-Russia-have-the-financial-means-for-its-military-ambitions/EN/index.htm, last visited: 21 December 2017.

These plans were drawn up at time when the Russian government expected the economy to continue to grow at around 4% a year.[29] In fact, growth was already declining sharply by 2013. Figure 3 shows how military spending increased in line with overall state revenues until 2012, after which there was a sharp divergence as state revenues plateaued and then declined while military spending continued to rise. Clearly, that divergence cannot be sustained indefinitely without creating serious fiscal problems, so defence spending is projected to fall by around 30% in real terms in 2017.[30] According to a study by the US Defense Intelligence Agency, the financing

[27] Russell, M., 'Russia's armed forces: Reforms and challenges', *European Parliamentary Research Service*, April 2015, available at: http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/554213/EPRS_IDA%282015%29554213_EN.pdf, last visited: 21 December 2017, pp. 7-8.
[28] Mills, C., 'Russia's Rearmament Programme', House of Commons Library Briefing Paper Number 7877, 24 January 2017, available at: http://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7877, last visited: 21 December 2017, pp. 21.
[29] 'News', *VTB Capital*, 5 October 2010, available at: https://www.vtbcapital.com/events/2010/moscow/news/682044/, last visited: 21 December 2017.
[30] 'Russia Military Power: Building a Military to Support Great Power Aspirations', US Defense Intelligence Agency, 2017, available at: http://www.dia.mil/Portals/27/Documents/News/Military%20Power%20Publications/Russia%20Military%20Power%20Report%202017.pdf, last visited: 21 December 2017, pp.20-21.

of Russia's State Armament Plan was back-loaded with 70%, due to be spent in the years 2016–2020.[31] This means that defence spending should actually be rising if Russia's procurement targets are to be met. Among other things, financial constraints may require an adjustment in Putin's rearmament plans and a recalibration of his foreign policy ambitions.

[31] ibid.

3. The Sources of Russia's Underlying Economic Weakness

The failure of the Russian economy to return to the high growth rates of the Putin boom, even as global activity was picking up and commodity prices rebounded following the 2008–2009 crisis, is an indication that its problems are structural and institutional rather than purely cyclical or external. An attempt to carry on as if nothing has changed therefore risks a prolonged period of stagnation in which Russia's economic performance lags behind the growth rates of the world's leading industrial powers and other emerging markets. Indeed, on current projections, it may cease to be considered an emerging market at all. To prevent this, Russian policymakers will be required to make a serious attempt to address their country's systemic weaknesses. Of these, the most important are an excessive dependence on natural resources, the failure to achieve economic modernisation, the financial drain caused by corruption and the persistent weakness of property rights.

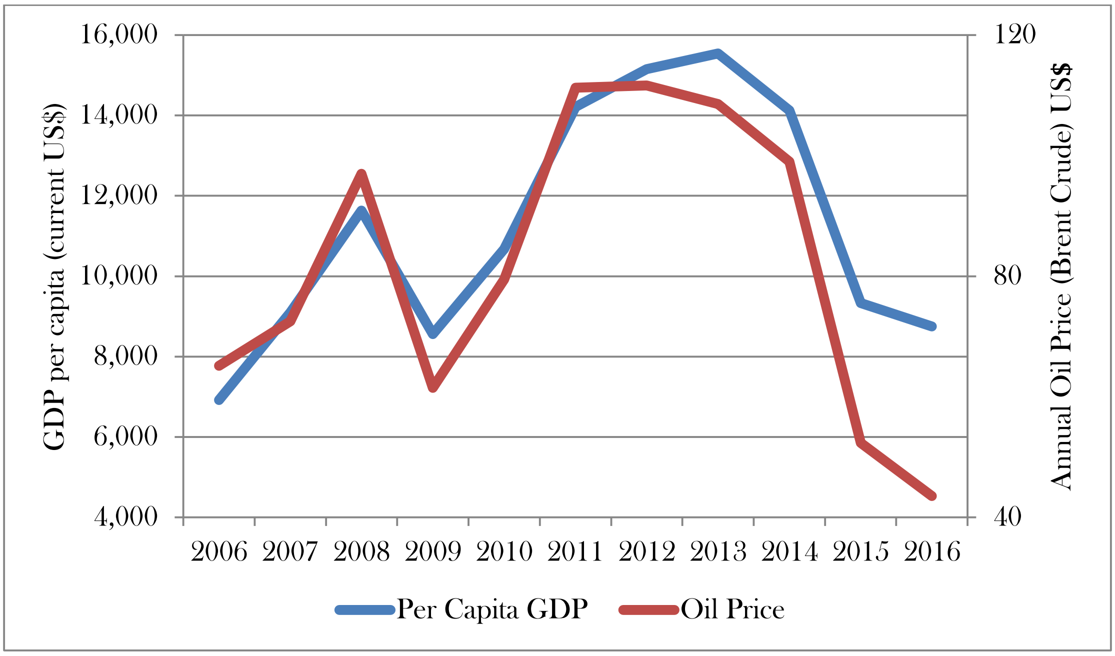
3.1 Resources Dependence

Energy has been a major factor in Russia's economic development since the large-scale production of Caspian oil began in the late nineteenth century. The peaks and troughs of the global oil and gas markets have consequently influenced perceptions of national strength. High oil prices corresponded with the years of apparent Soviet ascendancy between America's withdrawal from Vietnam in 1973 and the Soviet invasion of Afghanistan in 1979, and did so again during Russia's resurgence under Putin between 1999 and 2008. Even more telling has been the impact on economic reform. Rising oil and gas revenues masked Brezhnevite decline during the era of stagnation, just as their collapse gave urgency to the perestroika reforms that followed. Prices continued to fall during Russia's accelerated transition to capitalism, and then began another rapid ascent shortly before Putin abandoned the reform path in favour of state capitalism.

Russia became heavily dependent on oil and gas revenues during the Putin boom, with the energy sector's direct contribution to federal budget revenues rising from 30% in 2004 to 47% in 2008.[32] Its total contribution, direct and indirect, is estimated to have been as high as 70%.[33] The result is that Russia has become acutely sensitive to shifts in global energy markets (see Figure 4). It has been calculated that changes in GDP, budget revenues and financial reserves have a 90–95% correlation with changes in the oil price.[34] The rouble–dollar exchange rate is similarly linked.

[32] Sabitova N. and Chulpan Shavaleyeva, 'Oil and Gas Revenues of the Russian Federation: Trends and Prospects', *Science Direct*, 2015, available at: http://www.sciencedirect.com/science/article/pii/S2212567115010163, last visited: 21 December 2017.
[33] Movchan, A., 'Decline, Not Collapse: The Bleak Prospects for Russia's Economy', *Carnegie Moscow Centre*, February 2017, p. 7.
[34] ibid.

Figure 4: Russian GDP Per Capita and the Oil Price 2006-2016



Data Sources: World Bank and statista.com

Returns from the export of oil and gas have brought surges of wealth in periods of booming commodity prices, but they have not provided Russia with a growth trajectory consistent enough to close the gap with the world's most developed economies. Between 1990 and 2015, Russia's per capita GDP increased by only 15.8% compared to 42.2% for the United States. China's per capita GDP grew by 789% in the same period.[35] The rapid growth that came with the Putin boom did little more than make up for the losses of the Yeltsin era. Since 2008, Russia's per capita GDP has actually declined.

Russia's leaders acknowledge the limitations of remaining dependent on oil and have been talking for more than a decade about the need to achieve economic diversification. The Concept of Long-term Socioeconomic Development of the Russian Federation (known as the 2020 economic development strategy), signed off by President Putin in 2007, envisaged Russia becoming a leader in technological innovation, a major international financial centre and one of the world's top five economies by 2020, thanks to average annual growth rates of 6%.[36] Key to this vision was the idea that Russia would develop new sources of growth in high-tech and knowledge-intensive sectors of the economy.

In setting out the strategy, Putin highlighted the risk of maintaining an economic model that:

> increases our dependence on imported goods and technology and reinforces our role as a commodities base for the world economy. In the future, this could lead to us lagging

[35] 'GDP per capita, PPP (constant 2011 international $)', *The World Bank*, 1990–2015, available at: https://data.worldbank.org/indicator/NY.GDP.PCAP.PP.KD?locations=RU-CN-IN-BR-US, last visited: 21 December 2017.
[36] Kuchins, A. C., Amy Beavin and Anna Bryndza, 'Russia's 2020 Strategic Economic Goals and the Role of International Integration', *Center for Strategic and International Studies*, July 2008, pp. 1-3.

> behind the world's big economic powers and could push us out from among the world leaders. If we continue on this road we will not make the necessary progress in raising
>
> living standards. Moreover, we will not be able to ensure our country's security or its normal development. We would be placing its very existence under threat.[37]

Despite this, Russia has made no significant progress towards the targets set out in the 2020 strategy. Instead of posting annual growth rates of 6%, the economy has remained essentially static since 2008. If anything, Russia has become even more dependent on the production and export of raw materials than before. Oil and gas made up less than half of export earnings in 1999, but accounted for 68% of the total in 2013.[38]

The problem, according to the political scientists Clifford Gaddy and Barry Ickes, is not resource dependence per se, but the way that Russia's addiction to oil revenues distorts economic decision-making and impedes the efficient allocation of resources.[39] Windfall revenues are disproportionately claimed by inefficient sectors of the economy closely tied to the state. These sectors are then protected when commodity prices fall and revenues dry up, reproducing backwardness and a tendency towards stagnation. The specific example cited is the railway industry, which has continued to expand through boom and bust despite obvious excess capacity.[40] The result is a major economic imbalance. In 2008, Putin noted that the state employed 25 million people and argued that Russia "cannot support and does not need such an enormous public sector".[41] Yet, in the four years that followed, private sector employment shrank by 300,000 while the government payroll increased by 1.1 million.[42]

3.2 The Failure of Modernisation

Russia's inability to diversify is directly linked to its failure to achieve another major policy goal: economic modernisation. The recognition that Russia is falling behind its competitors in technology and innovation was a theme of Putin's first state of the nation address in 2000, but few concrete steps were taken to address the problem until Dmitry Medvedev took over as president eight years later. In a radical personal manifesto published in 2009, Medvedev lamented Russia's "primitive economy" and its "humiliating dependence on raw materials".[43] His solution was a modernisation programme intended to turn Russia into a centre of high-tech innovation and a net exporter of technology

The centrepiece of Medvedev's modernisation plan was the Skolkovo Innovation Centre, a technology hub built on the outskirts of Moscow, touted as Russia's answer to Silicon Valley. Built at a cost of $4bn, Skolkovo was designed to attract foreign investors, high-tech businesses and new start-ups and was anticipated to employ 50,000 people on site by 2020. The idea was to build on Russia's strong scientific base by turning technological invention into commercial

[37] Putin, 'Speech at Expanded Meeting of the State Council on Russia's Development Strategy through to 2020', 8 February 2008.
[38] Adelaja, T., 'Why Russia fails to cope with "resource curse"', *Russia Direct*, 16 August 2016, available at: http://www.russia-direct.org/analysis/why-russia-fails-cope-resource-curse, last visited: 21 December 2017.
[39] Gaddy, C. G. and Barry W. Ickes, 'Russia after the Global Financial Crisis', *Eurasian Geography and Economics*, 2010, 51, Number 3, available at: https://www.brookings.edu/wp-content/uploads/2016/06/05_russia_financial_crisis_gaddy.pdf, last visited: 21 December 2017.
[40] ibid., pp. 295-296.
[41] Putin, 'Speech at Expanded Meeting of the State Council on Russia's Development Strategy through to 2020', 8 February 2008.
[42] Adelaja, T., 'Why Russia fails to cope with "resource curse"', Russia Direct, 16 August 2016.
[43] Medvedev D., 'Go Russia!', *President of Russia*, 10 September 2009, available at: http://en.kremlin.ru/events/president/news/5413, last visited: 21 December 2017.

innovation. There was early success, signing investment deals with prestige foreign partners such as Cisco and the Massachusetts Institute of Technology, while hundreds of domestic companies took up residence.

However, initial enthusiasm for the project did not survive the departure of its patron from the Kremlin. The return of Vladimir Putin to the presidency marked a change in fortunes as Skolkovo faced deep budget cuts, pressure from anti-corruption investigators, new restrictions on internet freedom and fallout from the conflict in Ukraine. The result has been a brain drain that has seen skilled workers and Russian tech companies looking to locate abroad.[44] Despite political pressure to repatriate capital, Russian entrepreneurs still prefer to invest in Silicon Valley rather than at home.[45] Investment attracted by Skolkovo in 2014 was only $60m.[46] In 2015, Skolkovo's management was ordered to cut costs by 20–40%.[47]

Figures compiled by INSEAD for its annual Global Innovation Index of more than 100 countries show that Russia has so far failed to make meaningful progress towards the high-tech future envisaged by Medvedev.[48] Although its ranking in the Index rose from 51st to 45th place between 2010 (when Skolkovo was launched) and 2015, a detailed look at the figures reveal that the gap between ambition and reality remains as wide as ever. Russia continues to score badly on political environment (100th place) and has improved on measures of human capital and research (23rd place). Yet its performance in achieving knowledge and technology outputs has slipped from 32nd to 45th place. Significantly, its ranking for ICT service exports is down from 34th place to 76th. The more forward-thinking elements of the Russian elite have a realistic assessment of what this means. In 2016, German Gref, the former Economic Development Minister who authored Putin's 2020 strategy, warned that Russia had become a "downshifter" country, destined to face "technological subjugation" in the emerging economic order.[49]

The fate of Skolkovo is consistent with Russia's previous attempts at top-down modernisation, all of which failed to create a sustainable path of development. In seeking to explain this, Loren Graham, Professor of the History of Science at MIT, has highlighted the paradox of a country that has often been at the forefront of scientific discovery yet has usually failed to yield any significant commercial benefit from it. His conclusion is that in their preoccupation with obtaining the latest technologies, Russian leaders have paid insufficient attention to the social and economic conditions that allow technologies to flourish and adapt.[50] This requires a society that, among other things, guarantees basic freedoms, encourages risk and protects property. Dmitry Medvedev's call for modernisation did have a social as well as an economic dimension. He recognised that innovation requires "a culture based on humanistic values" and promised reforms

[44] Appell, J., 'The Short Life and Speedy Death of Russia's Silicon Valley', *Foreign Policy*, 6 May 2015, available at: http://foreignpolicy.com/2015/05/06/the-short-life-and-speedy-death-of-russias-silicon-valley-medvedev-go-russia-skolkovo/, last visited: 21 December 2017.
[45] Hartog, E., 'Silicon Valley Still Beats Skolkovo for Russia's Richest Tycoons', *The Moscow Times*, 28 January 2016, available at: https://themoscowtimes.com/articles/silicon-valley-still-beats-skolkovo-for-russias-richest-tycoons-51615, last visited: 21 December 2017.
[46] Rice-Oxley, M., 'Inside Skolkovo, Moscow's self-styled Silicon Valley', *The Guardian*, 12 June 2015, available at: https://www.theguardian.com/cities/2015/jun/12/inside-skolkovo-moscows-self-styled-silicon-valley, last visited: 21 December 2017.
[47] Appell, J., 'The Short Life and Speedy Death of Russia's Silicon Valley', *Foreign Policy*, 6 May 2015.
[48] Dutta, S., Bruno Lanvin and Sacha Wunsch-Vincent (eds.), 'The Global Innovation Index 2017: Innovation Feeding the World' (tenth edition), *Cornell SC Johnson College of Business, INSEAD, WIPO*, available at: https://www.globalinnovationindex.org/gii-2017-report, last visited: 21 December 2017 p. 281. Dutta, S. (ed.), 'The Global Innovation Index 2012: Stronger Innovation Linkages for Global Growth', *INSEAD, WIPO*, available at: https://www.globalinnovationindex.org/userfiles/file/GII-2012-Report.pdf, last visited: 21 December 2017, p. 284.
[49] '"Downshifter" Russia Is Losing Global Competition, Warns State Bank Chief', *The Moscow Times*, 15 January 2016, available at: https://themoscowtimes.com/articles/downshifter-russia-is-losing-global-competition-warns-state-bank-chief-51474, last visited: 21 December 2017.
[50] Graham, L., 'Why Does Russia Have So Much Trouble Modernizing?', 28 November 2011, available at: https://eu.spb.ru/images/centres/sts/Loran_Graham_text.pdf, last visited: 21 December 2017.

to root out corruption and create a more open society.[51] Modernisation has stalled, in part because Russia has continued to move in the opposite direction.

3.3 Corruption

Endemic corruption is a major problem for most post-Soviet societies, and Russia is certainly no exception. Opportunities for corruption that were limited by the nature of the Soviet system grew exponentially with the legalisation of private property, the creation of free markets, the privatisation of state assets and Russia's integration into the global economy. The problem was amplified by the imperative to carry through these reforms quickly, leaving little time to establish either an effective legal framework of market regulation or a rules-based business culture.

The latest edition of the Corruption Perceptions Index, ranking countries from least to most corrupt, puts Russia in 131st place out of 176. It has consistently been among the worst performing countries since the Index was launched in 1995.[52] Its rank is the lowest in Europe, apart from Ukraine, and significantly worse than the other BRIC countries – China, India and Brazil – placed equally 79th. Estimates of the cost to the Russian economy vary enormously. Rosstat, Russia's Federal Service for State Statistics, put it at 3.5% of GDP in 2011, but independent analyses produced around the same time estimated figures of between a fifth and a third of GDP.[53] There are grounds for thinking that the higher figures are more accurate. For example, one survey has put the cost of road construction in Russia at three times higher per kilometre than neighbouring Finland.[54] Corruption is widely thought to be the main reason why the 2014 Winter Olympics in Sochi turned out to be the most expensive ever, at $51bn: more than four times the original estimated cost.[55]

Corruption, encompassing bribe taking, procurement fraud, extortion, asset seizure and money laundering, damages the economy in multiple ways. It distorts competition by rewarding corrupt economic actors at the expense of more efficient, law-abiding entrepreneurs, raising costs to the consumer, increasing inflation and misdirecting scarce resources. It reduces investment from foreign and domestic sources by deterring legitimate businesses from risking their capital in new ventures. It creates fiscal pressures by narrowing the tax base and putting additional tax burdens on legitimate businesses. Finally, it damages competitiveness by significantly raising the costs of doing business. In 2009, Anatoly Golubev of the Committee to Fight Corruption estimated that it added as much as 40% to the production costs of Russian businesses.[56]

The Russian authorities have made some efforts to deal with corruption. Reforms enacted in 2012 reduced the administrative hurdles required to start a new business in a conscious effort to minimise opportunities for corrupt officials to demand bribes.[57] A survey published by PWC in 2016 showed that the number of organisations asked for a bribe had fallen to 21% from 41% since 2014.[58] Even so, this remained significantly higher than the global average of 16%. At the

[51] Medvedev, D., 'Go Russia!', *President of Russia*, 10 September 2009.
[52] 'Corruption Perceptions Index 2016', *Transparency International*, 25 January 2017, available at: https://www.transparency.org/news/feature/corruption_perceptions_index_2016, last visited: 21 December 2017.
[53] 'Russia's Medium-Term Economic Prospects', *The RAND Corporation*, 2016, p. 40.
[54] ibid.
[55] Yaffa, J., 'The Waste and Corruption of Vladimir Putin's 2014 Winter Olympics', *Bloomberg Businessweek*, 2 January 2014, available at: https://www.bloomberg.com/news/articles/2014-01-02/the-2014-winter-olympics-in-sochi-cost-51-billion, last visited: 21 December 2017.
[56] Russia corruption costs $318 billion – one-third of GDP, csmonitor.com, 23 November 2009.
[57] 'Russia's Medium-Term Economic Prospects', *The RAND Corporation*, 2016, p. 38.
[58] 'Russian Economic Crime Survey 2016', *PWC*, 2016, available at: https://www.pwc.ru/en/recs2016.pdf, last visited: 21 December 2017, p. 15.

same time, Russia's most senior anti-corruption official reported that the average bribe demanded in 2016 had increased by 75% to $5,600 from the previous year.[59]

If Russia's leaders understand the economic cost of corruption, their ability to deal with it is hampered by the nature of the governing system created by Putin. Corruption, which in its modern form began as a malign by-product of weak institutions and hasty reforms, today serves as an instrument of political management and statecraft.[60] Access to state assets and revenue streams for personal gain has become an important mechanism for maintaining the support and loyalty of different constituencies within the power elite. It has the additional advantage that disloyalty can be punished at any time under the legal guise of anti-corruption. It has even become an important tool of foreign policy.[61] The problem is that corruption cannot be stamped out selectively, by executive decree. It requires independent judicial and law enforcement bodies with the authority to pursue investigations and prosecutions free from political interference. The risk of exposure that would come with the creation of such institutions is one that the ruling elite is not currently prepared to take.

3.4 Property Rights and the Rule of Law

A major impediment to investment and entrepreneurship in Russia is a particular form of corruption and criminality known as *reiderstvo*, or raiding. This is the practice that enables predatory groups to seize control of businesses and assets from their legitimate owners. Unlike hostile takeovers in the West, which use purely legal means, *reiderstvo* subverts the law for criminal ends using a mix of legal, semi-legal and illegal tactics. Raids typically begin when an entrepreneur is arrested on false charges of tax evasion, or some other economic crime, and held in pre-trial detention. Ownership of their assets is then changed with the help of forged company documentation and/or bogus shareholder meetings. The premises of the targeted business are sometimes violently seized by groups of hired thugs. Often the raid is over by the time the real owner is free again. The whole process is executed and legalised with the assistance of corrupt police officers and judges. By paying bribes of around $120-170,000 to the right officials, a raider can usually expect to acquire assets worth millions.[62]

Businesses large and small can be targeted in this way. In 2011, Ruslan Telkov, the owner of an upholstery business employing 18 people, was arrested by armed police and charged with breach of copyright in a raid believed to have been organised by business rivals.[63] Most of his fabric stock was seized and he spent a year in pre-trial detention. Although eventually released, he was unable to recover the property that had been confiscated. At the opposite end of the spectrum, Togliatti Azot (ToAZ), a large industrial enterprise that produces 11% of the world's ammonia supply, has repeatedly fallen victim to raider attacks since 2005 when the company's owners were charged with tax evasion as part of an attempted takeover organised by one of their competitors. This bid

[59] Eremenko, A., 'Average Russian Bribe Jumps 75 Percent, Anti-Corruption Tsar Tells Newspaper', *NBC News,* 16 March 2017, available at: https://www.nbcnews.com/news/world/russian-bribe-jumps-75-percent-anti-corruption-tsar-tells-newspaper-n734246, last visited: 21 December 2017.
[60] Galeotti, M. and Anna Arutunyan, 'Commentary: Hybrid Business -- The Risks In The Kremlin's Weaponization Of The Economy', *Radio Free Europe, Radio Liberty,* 20 July 2016, available at: https://www.rferl.org/a/russia-commentary-hybrid-business-weaponization-economy/27869714.html, last visited: 21 December 2017.
[61] Conley, H. A., James Mina, Ruslan Stefanov and Martic Vladimirov, 'The Kremlin Playbook: Understanding Russian Influence in Central and Eastern Europe', *Centre for Strategic and International Studies*, October 2016, available at: https://csis-prod.s3.amazonaws.com/s3fs-public/publication/1601017_Conley_KremlinPlaybook_Web.pdf, last visited: 21 December 2017, pp. 17-21.
[62] Shelly L. and Judy Deane, 'The Rise of Reiderstvo: Implications for Russia and the West', 9 May 2016, available at: http://reiderstvo.org/sites/default/files/The_Rise_of_Reiderstvo.pdf, last visited: 21 December 2017, p. 12.
[63] Yaffa, J., 'Signs of a Russian Thaw (Toward Business)', *The New York Times*, 28 December 2013, available at: http://www.nytimes.com/2013/12/29/business/international/signs-of-a-russian-thaw-toward-business.html, last visited: 21 December 2017.

eventually failed when the charges were dismissed in 2010. A second raid began in 2012 when another competitor reportedly threatened the owners with a campaign of legal harassment unless they surrendered control of the business. New charges were brought and the raiders briefly seized control in 2015 with the help of a sympathetic judge and a stage-managed shareholder meeting. Although the seizure was subsequently reversed, the case is ongoing.[64]

The scale of disruption caused by *reiderstvo* is huge, as even the Russian authorities are forced to admit. In his 2015 state of the nation address, President Putin offered the following assessment:

> During 2014, the investigative authorities opened nearly 200,000 cases on so-called economic crimes. But only 46,000 of 200,000 cases were actually taken to court, and 15,000 cases were thrown out during the hearings. Simple math suggests that only 15 percent of all cases ended with a conviction. At the same time, the vast majority, over 80 percent, or specifically, 83 percent of entrepreneurs who faced criminal charges fully or partially lost their business – they got harassed, intimidated, robbed and then released. This certainly isn't what we need in terms of a business climate. This is actually the opposite, the direct destruction of the business climate.[65]

According to Putin's own estimate, tens of thousands of Russian businesses are being stolen every year.

Russia's raiding epidemic stifles investment by creating uncertainty and insecurity. Entrepreneurs are sometimes reluctant to expand their businesses or start new ones in case they attract the attention of criminals and opportunists with the connections needed to orchestrate a raid. A study published by the Rand Corporation pointed out:

> Russia has a low rate of investment for a country with its level of per capita GDP, averaging 20 percent between 2000 and 2014. Estonia, Kazakhstan, and Malaysia, countries with similar per capita GDPs, invest 28 percent or more of GDP, and East Asian countries at a similar stage of development as Russia often invest well over 30 percent.[66]

The impact is particularly felt by small, domestically owned businesses that lack the political protection needed to fend off a raid. Weak and unenforceable property rights partly account for the fact that small and medium-sized enterprises (SMEs) contribute less to the Russian economy than in most developed countries. A 2010 study estimated that the Russian SME sector generates 21% of value added, compared to 51% in the UK and US, 52% in Poland and 60% in China.[67] Because SMEs are an important source of commercial innovation and dynamism, their relative weakness in Russia provides one explanation for its failure to modernise and diversify. Raiding

[64] Keena, C., 'Russia "raider attack" case makes it to the High Court', *The Irish Times*, 12 November 2016, available at: https://www.irishtimes.com/business/energy-and-resources/russia-raider-attack-case-makes-it-to-the-high-court-1.2864787, last visited: 21 December 2017.
[65] 'Presidential Address to the Federal Assembly', *President of Russia*, 3 December 2015, available at: http://en.kremlin.ru/events/president/news/50864, last visited: 21 December 2017.
[66] 'Russia's Medium-Term Economic Prospects', *The RAND Corporation*, 2016, p. 11.
[67] 'Small business: a global agenda', *The Association of Chartered Certified Accountants*, September 2010, available at: http://www.accaglobal.com/content/dam/acca/global/PDF-technical/small-business/pol-afb-sbaga.pdf, last visited: 21 December 2017, pp. 35-36.

also encourages capital flight as entrepreneurs seek to expatriate their profits to safer jurisdictions. Russia experienced net capital outflows totalling $423.5bn between 2008 and 2013.[68]

Although efforts to improve the business climate since 2012 have had some positive impact in reducing the regulatory burden, progress in upholding property rights has been modest at best. According to the World Economic Forum's Global Competitiveness Index, Russia ranked 133 out of 148 countries for the protection of property rights in 2013–2014 compared to 123 out of 138 in 2016–2017.[69] The apparent inability of Russia's leaders to deal with a problem they have identified as a significant impediment to economic growth is the result of systemic failure. The patrimonial power structure developed by Putin creates the context in which *reiderstvo* is able to flourish because it fosters institutional weakness and legitimises the arbitrary redistribution of assets according to political favour. It is certainly relevant that the two largest raider attacks – the seizures of Yukos Oil and Hermitage Capital – were organised at the highest levels of the Russian state. Change requires major reform and leadership by example.

[68] Aris, B., 'Russian Capital Flight – How Big a Problem Is It for Russia's Growth?', *Russian Analytical Digest*, No. 140, 28 November 2013, available at: http://www.css.ethz.ch/content/dam/ethz/special-interest/gess/cis/center-for-securities-studies/pdfs/RAD-140-7-10.pdf, last visited: 21 December 2017, p. 8.

[69] Schwab, K., 'The Global Competitiveness Report 2013–2014', *World Economic Forum*, available at: http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2013-14.pdf, last visited: 21 December 2017, pp. 326-327. Global Competitiveness Report 2016–2017, *World Economic Forum*, pp. 306-307.

4. Russia Debates its Economic Future

The problems described above are widely acknowledged and openly discussed within ruling circles, even if the conclusions are often disputed. As in previous periods of lagging performance, the prospect of stagnation and the fear of falling behind have stimulated a debate about the country's economic direction that pits liberal reformists against more conservative and statist elements of the elite. Similar divides manifested themselves during debates about the abolition of serfdom in the mid-nineteenth century, the New Economic Policy of the 1920s, the *perestroika* reforms of the 1980s and the transition to capitalism under Yeltsin. On each occasion, the argument that greater economic freedom would lead to higher growth has been countered by those who fear the inevitable weakening of political control.

The leading voice for reform today is Alexei Kudrin, the liberal economist who served as Putin's Finance Minister from 2000 to 2011 and retains an informal advisory role from his seat in academia. In 2016, Kudrin was tasked with producing ideas for a new economic strategy to be implemented following Putin's expected re-election in 2018. His conclusions, presented in January 2017, gave an unsparing assessment of the economic difficulties Russia faces without a change of course. He said the country was "currently at a historically low pace of economic growth, even lower than during the period of stagnation in the Soviet era", and argued that it has "fallen behind technologically in the world".[70]

Significantly, in a bid to frame the debate in terms most likely to influence Putin's thinking, Kudrin chose to portray economic reform as a civilisational challenge with clear national security implications: "We will struggle with diminishing defence potential and threats to national sovereignty if we don't become a technological power. Even military experts say that technological challenges facing Russia are bigger than geopolitical and military ones ... Our entire foreign policy should be subordinated to the task of technological development."[71] These comments echo Mikhail Gorbachev's reasons for launching *perestroika* 30 years earlier and imply that Putin's gains in restoring Russia's sense of national greatness are imperilled by the very system he has created.

Dismissing the idea that declining economic performance is the result of low oil prices and Western sanctions, Kudrin argued: "The main problems lie within Russia and they are structural and institutional ... In our country the state dominates everything, so you have to start with reforming the state."[72] He proposed reducing state spending, privatising state-owned businesses, decentralising power to the regions and creating stronger institutions. Particular emphasis was given to reform of the judiciary to create the kind of clean and impartial court system needed to protect property rights, encourage entrepreneurship and stimulate private investment. By implementing these changes, Russia could achieve annual growth rates of 4%, allowing it to close

[70] Hille, K., 'Failure to reform threatens Russia's security, Putin adviser warns', *Financial Times*, 13 January 2017, available at: https://www.ft.com/content/68177906-d9a8-11e6-944b-e7eb37a6aa8e, last visited: 21 December 2017.
[71] ibid.
[72] 'Alexei Kudrin wants to liberalise Russia's economy to save it', *The Economist*, 19 January 2017, available at: https://www.economist.com/news/europe/21715022-donald-trumps-election-many-russians-think-putins-model-winning-alexei-kudrin-wants, last visited: 21 December 2017.

the wealth gap with the West. Without them, according to Kudrin, Russia faces long-term stagnation with growth at around half that level.[73]

Arguments for reform in Russia invariably provoke a conservative reaction from those threatened by change. The alternative to the Kudrin plan has been put forward by the Stolypin Club, an organisation headed by Boris Titov, Putin's business ombudsman, and Sergei Glazyev, a hardline nationalist who serves as Putin's adviser on Eurasian economic integration and was placed on the US sanctions list following the annexation of Crimea.[74] The Titov–Glazyev plan calls for a state-led growth strategy, including the abandonment of inflation targeting, managed exchange rates, cheaper credit and higher public investment financed by printing money. According to Glazyev, pumping an extra $64bn into the economy would produce an annual growth rate of 8%.[75] The advantage of this approach from a conservative standpoint is that the impetus for investment comes from the state rather than the private sector, thus limiting the need for institutional reform and the decentralisation of power. The system can carry on more or less untouched.

Whatever the reality of Russia's position as a country that needs to attract foreign capital and technology, statism and economic nationalism have an obvious appeal to elements of power elite that are in a strong position to block change inimical to their interests. This is particularly true of those who command authority and access to resources through their positions in charge of state agencies and state-owned enterprises, many of whom have a background in the security and intelligence services. Several of them have been placed on international sanctions blacklists and have even less reason to favour a new policy of economic openness. Typical of this group is Sergei Chemezov, head of the state technology conglomerate Rostec, who has expressed public opposition to calls for reform.[76]

Putin himself has maintained a position of studied ambiguity. He commissioned both the Kudrin and the Stolypin Club reports and has given verbal encouragement to both camps without so far endorsing either vision as the economic blueprint for a fourth presidential term. However much he accepts the intellectual force of Kudrin's argument, Putin knows that embracing it fully would require him to dismantle a power structure that allows him to reward loyalty with control of valuable public assets. It was notable, for example, that Kudrin's call at the 2017 St Petersburg International Economic Forum for the energy sector to be fully privatised within seven or eight years was immediately rebuffed by Dmitry Peskov, the Kremlin's official spokesman.[77]

What should be noted is that the political context currently favours those arguing for policies based on economic nationalism. The first moves in this direction began more than a decade ago with a new Subsoil Law that limited foreign companies to a minority stake in strategic energy projects. This preoccupation with "economic sovereignty" continued to grow, achieving new urgency with the onset of the Ukraine crisis and the imposition of Western sanctions. One

[73] ibid.
[74] Dokuchaev, D., 'Liberals and statists battle for Russia's economic future', *Russia Direct*, 5 August 2016, available at: http://www.russia-direct.org/analysis/liberals-and-statists-battle-russias-economic-future, last visited: 21 December 2017.
[75] Adrianova, A., 'Putin's Maverick Adviser Defies Nabiullina With $64 Billion Plan', *Bloomberg Markets*, 30 October 2016, available at: https://www.bloomberg.com/news/articles/2016-10-30/putin-s-maverick-adviser-defies-nabiullina-with-64-billion-plan, last visited: 21 December 2017.
[76] Lowe, C. and Alexander Winning, 'Rival Kremlin camps prepare for battle over economy', *Reuters*, 20 June 2017, available at: https://www.reuters.com/article/us-russia-economy-reform/rival-kremlin-camps-prepare-for-battle-over-economy-idUSKCN0Z61WR, last visited: 21 December 2017.
[77] Meredith, S., 'Russia should privatize its oil companies by 2025, says ex-Finance minister', CNBC, 1 June 2017, available at: https://www.cnbc.com/2017/06/01/russia-should-privatize-oil-companies-by-2025-finance-minister-alexei-kudrin.html, last visited: 21 December 2017.

consequence was a major programme of import substitution launched by Vladimir Putin in 2014 with the aim of reducing Russia's dependence on foreign goods and technology. Procurement rules were changed to limit the use of imported goods by public contractors, 570 important substitution projects were launched and an overall budget of 2.5tn roubles was supposedly allocated to the programme.[78] In spite of this, imports of equipment and machinery have increased sharply since the end of 2016, which suggests that the programme is failing to meet its most important objective of strengthening Russia's technological independence.[79]

Even Russia's leaders appear to doubt that their goals are attainable. The new Economic Security Strategy approved in May 2017 failed to mention important substitution and instead emphasised the need for international economic cooperation, albeit through organisations in which it plays a leading role, such as the BRICs, the Shanghai Cooperation Organisation and, in particular, the Eurasian Economic Union (EAEU).[80] The idea is for Russia to achieve the benefits of trade and market integration as a "rule maker" rather than a "rule taker". To that end, it has invested heavily in the development of the EAEU as the one economic forum in which it enjoys a position of undisputed leadership. Yet EAEU members lack the political will to make it effective, even to the point of failing to respect its common external tariff. The block is, in any case, too small to replace Russia's economic relations with the West, with a combined GDP of $1.5tn compared to $16.5tn for the EU and $18.5tn for the US.

In summary, the contradictions between the Kremlin's political ambitions and Russia's economic needs are unlikely to be resolved in the immediate future. Putin sees reform as a risk, yet he also knows that going into the 2018 presidential election offering more of the same in conditions of economic stagnation risks provoking a public backlash similar to the one that greeted his return to the Kremlin in 2012. Faced with this dilemma, the most likely outcome is that he will attempt to split the difference between rival positions, echoing the rhetoric and concerns of Kudrin and his liberal supporters without accepting their most radical proposals in practice. While this may be enough to solve his short-term political problem, it will do little to alter Russia's longer-term economic prospects. To the extent that Putin is making clear economic choices, he seems to be making the wrong ones.

[78] Connolly R. and Philip Hanson, 'Import Substitution and Economic Sovereignty in Russia', *Chatham House*, 9 June 2016, available at: https://www.chathamhouse.org/publication/import-substitution-and-economic-sovereignty-russia, last visited: 21 December 2017, pp. 9-11.
[79] Aris, B., 'MOSCOW BLOG: Russia's import substitution has not been a great success', *Intellinews*, 13 October 2017, available at: http://www.intellinews.com/moscow-blog-russia-s-import-substitution-has-not-been-a-great-success-130456/, last visited: 21 December 2017.
[80] Gould-Davies, N., 'Russia's Economic Security Strategy Has Become an Internal Critique', *Chatham House*, 20 June 2017, available at: https://www.chathamhouse.org/expert/comment/russia-s-economic-security-strategy-has-become-internal-critique, last visited: 21 December 2017.

5. Conclusion

There is no doubt that Russia is capable of joining the ranks of the world's most developed economies. It possesses many competitive advantages, such as a unique endowment of natural resources, a highly educated population and a remarkable track record of scientific discovery. Converting these assets into long-term economic success would be possible with the kind of reforms advocated by Alexei Kudrin and others. Independent courts, effective mechanisms to stamp out corruption and an end to widespread asset theft would raise investment by encouraging the most creative and entrepreneurial elements of Russian society to launch new business ventures and take the kinds of commercial risks that define successful knowledge-driven economies. It would enable the failed top-down approach to modernisation to be replaced with a spirit of innovation and modernisation driven from the bottom up.

The real question is whether the Putin system is capable of adapting in ways that would allow it to embrace this vision in practice instead of simply paying lip service to it. The biggest obstacle is the tendency of Putin himself to attribute the problems of Russia's recent history to the risks associated with liberalisation and the loss of control by the centre. Certainly most of the institutional and policy reforms needed go against the grain of developments over the last two decades, most of which have sought to strengthen Kremlin control and subordinate independent centres of authority in the name of maintaining order. Yet, as Kudrin clearly recognises, the desire for national stability and regime survival is also the strongest card reformers have to play. If Putin or his successor comes to see stagnation as a greater threat to Russia's national interests than the prospect of change, space may yet open up for a serious reform project to take root.

The West should take little comfort from Russia's diminished economic prospects. Far from blunting Putin's geopolitical ambitions, a prolonged squeeze on living standards could lead to a more aggressive foreign policy as the Kremlin tries to deflect attention from its domestic problems by stoking nationalist sentiment and fostering a siege mentality. As we have already seen, Putin skilfully exploited the hardships and humiliations of the 1990s to build popular support for his belligerent style of authoritarianism. A weak Russia should not therefore be the aim of Western policy. The West should seek to help Russia fulfil its long-term ambition of catching up with the most advanced economies by building mutually beneficial commercial relationships based on openness and trust. In other words, the West should encourage Russia to make the transition from a patrimonial, rent-seeking model of capitalism to a rules-based capitalism.

The West's ability to influence Russian policy is now at its lowest ebb since the Soviet era. Economic sanctions imposed on Russia following its armed intervention in Ukraine are unlikely to be lifted in full until the Kremlin meets all of its obligations under the Minsk II agreement. Indeed, the United States Congress has tightened sanctions as relations have continued to deteriorate over allegations that Russia interfered in the 2016 presidential election. Russia's reaction has been to intensify counter-measures, including the adoption of an interbank payment system to replace the Western-operated SWIFT network, yet there is no realistic alternative to a restoration of economic ties with the West in the medium term. Attempts to achieve economic autarky would accelerate the country's stagnation by starving it of the trade, investment and technology needed to sustain energy production and modernise its economy more generally.

Closer ties with China could lead to a relationship of strategic dependency that would be incompatible with Putin's vision of Russia as a fully independent Great Power.

It is inevitable that Russia will remain integrated in the global economy if it wishes to attain its long-term goal of catching up with the most developed nations. The key will be to shape the nature of that engagement in a way that is most likely to foster the development of a rules-based model of capitalism. This will require a significant policy adjustment on all sides. The approach to foreign economic relations pursued by Russia under Putin has been characterised as "sovereign globalization".[81] The essence of this idea has been to frame economic relations in a way that allows Russia to benefit from the "supply effect" of having access to global markets and finance while limiting its exposure, as far as possible, to any "influence effect" that would require it to align economic governance with international norms.[82] In other words, Russia has sought to maximise the benefits of globalisation while minimising the obligations.

For most of the Putin era, Western governments have been reluctant to acknowledge, let alone challenge, this approach. The assumption was that rapid economic integration and accession to international economic institutions would lead naturally to a process of internal reform without the need for overt political pressure. That hope can no longer be sustained. When the moment comes, the resumption of normal economic relations should be governed by a policy of conditional engagement that establishes a clearer link between the rights and responsibilities of being part of the global economy. The aim should be to remove "sovereign globalisation" as a viable option.

Russia has weathered Western sanctions in the short term, but the full impact has yet to be felt. This is most obvious in the energy sector where the ability to sustain oil and gas production over the coming decade will depend on access to large amounts of foreign investment and technology. The depletion of existing onshore oil and gas fields means that Russia needs to open up new production in the Artic north, much of it in extremely challenging offshore conditions. The Russian Energy Minister has put the cost of this at $400–600bn over the next twenty years.[83] Furthermore, it has been estimated that around 80% of the technology needed to begin offshore production in the Arctic would have to come from the West.[84] US and EU sanctions adopted in 2014 prohibit the supply of capital and technology to sanctioned Russian oil companies, curtailing their ability to undertake many of these projects.

Any future lifting of sanctions should be linked to new safeguards designed to create a rules-based framework for investment. Russia has not been subject to any binding measures to protect foreign investments since it withdrew from provisional application from the Energy Charter Treaty (ECT) in 2009. This decision was taken because Russia objected to the ability of investors to use the ECT to seek compensation following the expropriation of Yukos. Before permitting a resumption of investment in major Russian energy projects, Western governments should

[81] Gould-Davies, N., 'Russia's Sovereign Globalization: Rise, Fall and Future', *Chatham House*, January 2016, available at: https://www.chathamhouse.org/publication/russias-sovereign-globalization-rise-fall-and-future, last visited: 5 January 2018.
[82] ibid, p. 9.
[83] 'Russian Minister determines investment potential in Arctic energy sector', *Russian Construction,* 29 March 2017, available at: http://russianconstruction.com/news-1/26980-russian-minister-determines-investment-potential-in-arctic-energy-sector.html, last visited: 21 December 2017.
[84] Umbach, F., 'Rosneft and Russia pay the price of Western energy sanctions', gisreportsonline.com, 1 December 2014, available at: https://www.gisreportsonline.com/rosneft-and-russia-pay-the-price-of-wests-energy-sanctions,energy,394,report.html, last visited: 5 January 2018.

demand new treaty-based commitments that replicate and expand the binding investor protection measures contained in the ECT.

Similar conditionality should be applied to membership of international economic organisations. Russia was admitted to the G8 in 1997 because it was deemed to have embraced the principles of international openness and cooperation on which the organisation was founded. It was suspended from membership 17 years later. It acceded to the World Trade Organization (WTO) in 2012 despite growing concerns about its commitment to multilateralism. These concerns were justified. The first official review of Russia's membership, published in 2016, found that it had violated a number of its accession commitments by applying discriminatory trade restrictions against several European countries.[85] Even now, Russia remains an applicant to join the Organisation for Economic Cooperation and Development despite its failure to meet the conditions of membership laid down by the organisation: "OECD Members form a community of nations committed to the values of democracy based on the rule of law and human rights, and adherence to open and transparent market-economy principles."[86] Russia is very far from meeting these criteria and it makes no sense to pretend otherwise. There should be no question of membership short of serious reform.

It is unlikely that Russian leaders will come to appreciate the benefits of building a rules-based capitalism at home unless they are held to the rules and norms that are meant to apply in the global economy. Even with this, there will be no short and easy path to the kind of economy Russia needs to meet its aspirations and become a constructive international partner. Instead of ignoring these inconvenient facts, as they have been prone to do in the past, Western governments should be prepared to play the long game and wait until Russia is ready to engage on the right terms before considering a full normalisation of economic ties.

[85] Safaryan, H. and Artem Rodin, 'Russia and the WTO: first review', *Lexology*, 21 October 2016, available at: https://www.lexology.com/library/detail.aspx?g=ba31377e-ec50-4130-bca8-54cd277cbed2, last visited: 21 December 2017.
[86] 'Report of the Chair of the Working Group on the Future Size and Membership of the Organization to the Council, OECD, June 2017, available at: http://www.oecd.org/mcm/documents/C-MIN-2017-13-EN.pdf, last visited: 21 December 2017, p. 4.

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