

The Russian economic puzzle: going forwards, backwards or sideways?

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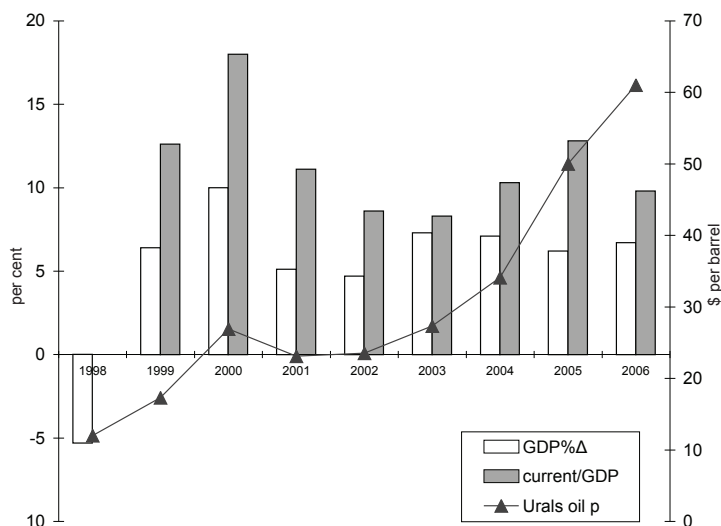
Getting Russia right is still difficult. So far as the economy is concerned, those inclined to take a benign view can look at nine years of rapid growth and eight years of budget surpluses, together with declining inflation and the near-extinction of public debt, and declare a Russian economic miracle. Sceptics can just as easily point to the rise of state economic intervention since mid-2003, and the harsh treatment of private oil companies in particular, and declare that the economic miracle must soon be dead: surely uncertainties about property rights have increased, the engine of growth—the oil industry—has been damaged and the business environment, never brilliant, has been darkened?

In this article I shall weigh the evidence for and against the view that Russia's growth is robust. The first section is a review of the macroeconomic record since the 1998 financial crisis. The second section is about the scale and nature of Russia's economic dependence on oil and gas. Then there is an attempt to characterize the turn to statism since 2003 and consider its impact. The fourth section is a consideration of the ways in which that policy development has been entangled with political processes. The fifth section considers the limits to the turn to state control, and the ways in which parts, at least, of the Russian economy are developing in a more or less healthy manner. Finally, I shall offer a few guesses about the future.

The main contention that I put forward is that Russia is a dual economy in which the rules of the economic game have been evolving rather differently in different sectors. There are factors making for somewhat slower growth overall in the next five years or so, but on top of that the prospects are rather different in different parts of the economy. Some sectors will probably go on being damaged by the state's efforts to pick winners and keep out foreigners. Others are capable of thriving so long as they remain beneath the politicians' radar.

The macroeconomic record: nearly a decade of growth and stabilization

Since the financial crisis of 1998 Russian economic growth has averaged 6.7 per cent a year. That is about par for 'emerging' market economies over the past four years or so, but above par for the whole period since 1998. China is the most striking

Figure 1: Russia: growth, balance of payments and oil prices, 1998–2006

Notes: GDP year-on-year % change (right-hand column in each pair, measured on left axis); current account balance of payments as % GDP (left-hand column, measured on left axis); average annual Urals oil price (line, measured in \$ per barrel, right axis).

Sources: Rosstat; Troika Dialog.

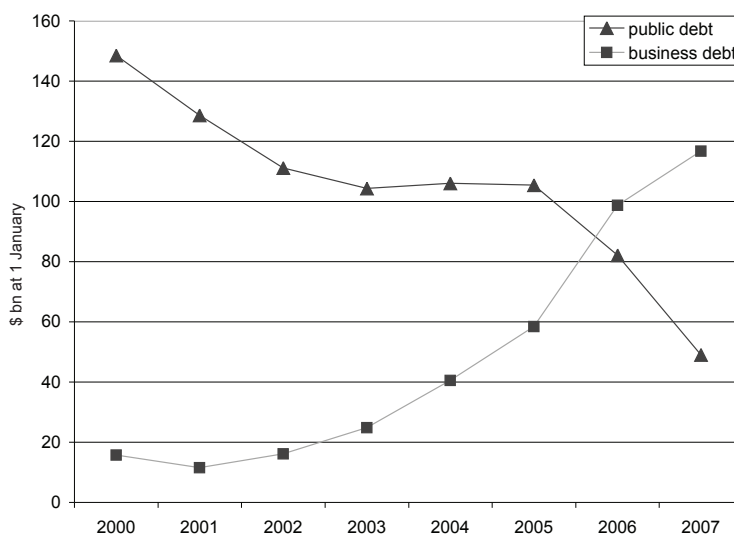
example of an emerging economy that has grown faster, but a growth rate above 6 per cent over very nearly a decade is impressive for any country.

It could be argued that Russia ought currently to grow at this sort of rate or even faster. It is a middle-income country with a relatively well-educated population. It has emerged from a long post-communist decline (starting in fact in 1989, when the communist machine was still formally in place but the wheels were coming off). It therefore had in 1998 two clear growth advantages: a technological backlog which it had the human resources to make up; and a substantial margin of under-utilized capacity.

Two developments jolted the economy into growth after the crisis: a fivefold devaluation of the rouble in the course of a few months and, a little later, an upturn in oil prices in 1999 and 2000. Large tracts of Russian manufacturing had been almost destroyed by import competition at 5–6 roubles to the dollar; at 25 roubles to the dollar, they revived. And the price of Urals oil climbed from around \$10 a barrel to above \$20, and from 2002 rose further. Figure 1 traces this development. It suggests a link between Russian growth and increases in the oil price, a link whose nature will be discussed later.

This rapid GDP growth has been well managed. The Ministry of Finance, latterly under Aleksei Kudrin, has been relentlessly prudent, resisting public spending increases and channelling a large slice of the windfall revenues from high oil prices into a Stabilization Fund. That fund, in turn, has been used in part to pay off government debt. Government external debt is now below 5 per cent of GDP,

Figure 2: Russia: foreign debt, 1 Jan. 2000 to 1 Jan. 2007 (\$bn)



Sources: Central Bank of Russia (debt); Troika Dialog (GDP).

and domestic public debt is even smaller. Russian firms have taken enthusiastically to borrowing abroad, even as the state has paid off its debts.¹ Figure 2 illustrates these diverging trends in foreign debt. Despite the growth in private debt, total private plus public foreign debt is low by international standards—below a third of GDP at the beginning of 2007.

As an oil exporter in a period of rocketing oil prices, Russia has run very large balance of payments current account surpluses (shown in figure 1). The resulting inflow of currency has boosted the rouble money supply. During 2007 that particular inflow declined, but a sharp increase in inward investment kept the total currency inflow high. It has not been easy for the Central Bank of Russia to manage this, even with the helpful ‘sterilization’ of some of the inflow in the Stabilization Fund. Nonetheless, inflation has gradually been brought down, finally dipping to single-digit numbers in 2006. This has been helped by fast growth in the demand for roubles because of rapidly increasing economic activity accompanied by increased confidence in the Russian currency.

It was foreign trade that kicked off the recovery: a cut in imports because of the rouble devaluation and then a surge in export earnings as oil prices rose and a number of private Russian oil companies, led by Yukos, responded by boosting oil production and export volumes. In recent years, however, domestic demand, for both consumption and investment, has been the immediate driver of growth. But domestic demand has been able to grow because of the surge in profits, government

¹ One complication in this picture is that a good deal of the borrowing has been by state-controlled firms. The Central Bank of Russia publishes figures for state debt proper and for state debt plus the debt of majority-state-owned banks, but does not compile figures for a state + state-controlled sector that would include the likes of Gazprom and Rosneft.

revenue and personal incomes generated by rising oil, gas and metals earnings from abroad. Russian growth may not have been directly driven by the natural resources sector, but it has been fuelled by it.

Some Russians have become famous, in this boom period, for being very rich. *Forbes* magazine in March 2007 identified 53 Russian dollar billionaires, 49 of them resident mainly in Russia.² And inequality has increased. But this is not a country in which the rich have got richer and the poor poorer. The rising economic tide has lifted most boats. Both unemployment and the proportion of the population living below the official poverty line have declined. The general sense of rising prosperity has been one of the bases—perhaps the most fundamental of all—of Putin's popularity.

At the same time, Russia's business environment has remained problematic. The turn after mid-2003 to a rather aggressive form of state intervention will be discussed separately. Here it should be noted that the Russian business environment more generally remains difficult.

Perhaps the most thorough international comparative measurement of national business environments is the World Bank's 'Doing Business' rankings.³ These covered (for 2006) 175 countries, and were based on survey and other information on ten aspects of business, including numbers of procedures, time taken in and cost of starting a business, dealing with licences, getting credit and trading across borders. In 2006 Russia ranked 96th out of 175 countries overall. It had some respectable rankings: 25th on enforcing contracts, 33rd on starting a business and 44th on registering property. But it also showed up very badly in a number of areas: 143rd on trading across borders (the customs service is notoriously corrupt); 159th on getting credit; 163rd on dealing with licences.

On the overall rankings for April 2006, Russia's business climate is substantially worse than that of any of the eight ex-communist countries that joined the European Union in 2004. That may not be too surprising; but it is also well below that of, for example, Mongolia. On the other hand, Russia ranks above Greece (109th) and not that far below Italy (82nd).⁴

Corruption remains a large problem and may be getting worse rather than better. The World Bank's Business Environment and Enterprise Performance Survey provides evidence on corruption (not merely perceptions of corruption) from businesses. Bribe frequency increased between 2002 and 2005, and in comparison with other ex-communist countries and some other emerging market economies, Russian bribe frequency is high, given the country's per capita GDP level.⁵

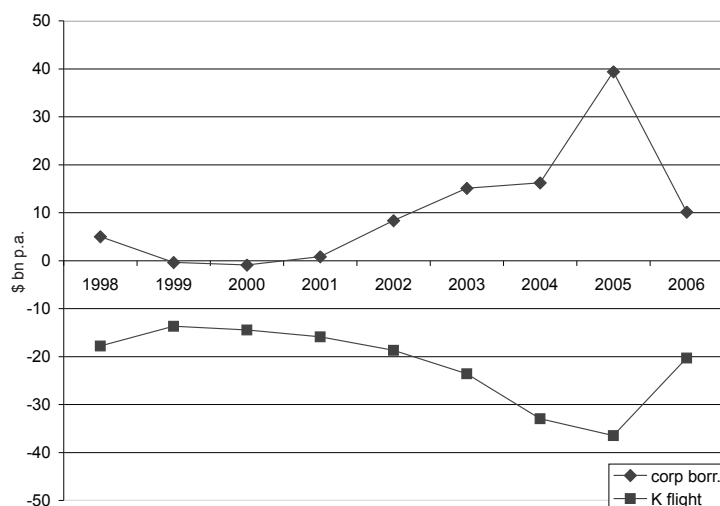
² http://www.forbes.com/2007/03/07/billionaires-worlds-richest_07billionaires_cz_lk_af_0308billie_land.htm, accessed 30 March 2007.

³ See <http://www.doingbusiness.org/ExploreEconomies/?economyid=159>, accessed 29 September 2007. The top rankings do not go only to Anglo-Saxon-style 'free market' countries. Nations with strong welfare states that also have efficient public administration, such as the Nordic countries, are close to the top of the rankings.

⁴ <http://www.doingbusiness.org/EconomyRankings>, accessed 26 June 2007.

⁵ See J. H. Anderson and C. W. Grey, *Anticorruption in transition 3: who is succeeding . . . and why?* (Washington DC: World Bank, 2006). Bribe frequency and prosperity (as measured by per capita GDP) are inversely related.

Figure 3: Russian corporate borrowing and capital flight, 1998–2006 (\$bn)



Note: Capital flight is estimated as the sum of two line items from the Central Bank's presentation of the balance of payments: (1) exports receipts overdue + imports paid for and not received + transfers for fictitious operations in securities, and (2) errors and omissions.

Source: Central Bank of Russia.

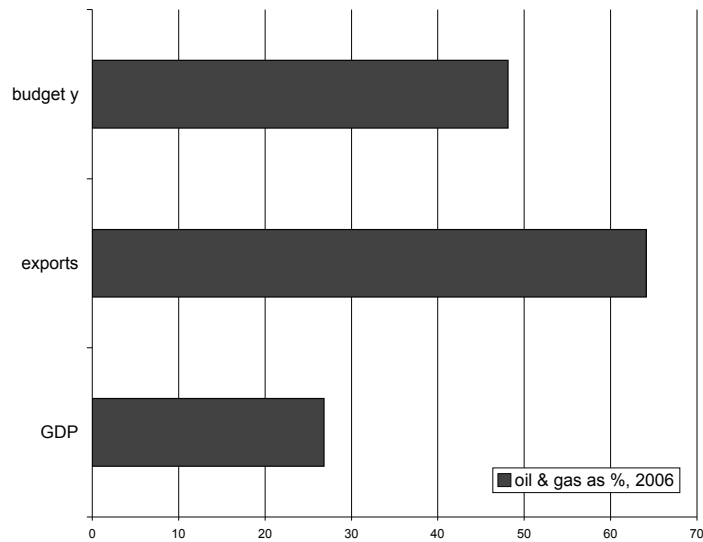
These features of the Russian business environment, exacerbated perhaps by recent state interventions, probably help to account for two rather striking observations. The first is that fixed investment is only about 19 per cent of GDP, which is low for a middle-income, 'catching-up' country. The second is that there has been a large volume of capital flight, alongside rising corporate borrowing from abroad: knowledgeable Russians moving their money abroad; less knowledgeable foreigners putting money into Russia. The latter phenomenon is illustrated in figure 3.

It should be added that the 'capital flight and borrowing abroad' anomaly did lessen in 2006. That was partly because corporate borrowing abroad eased somewhat and partly because, with the introduction of full rouble capital-account convertibility, capital flight dropped. Latterly company borrowing from foreign banks and raising of money abroad in other ways has jumped again—primarily because state-owned companies like Gazprom and Rosneft have been on an acquisitions binge and have financed their lavish spending mainly from abroad.

Energy dependence

Oil, gas and metals have not been driving Russian growth directly. That is to say, the rise in value added, in real terms, in these sectors has not been a major component of the increase in real GDP. That is hardly surprising. Output of gas has been almost stagnant; oil production growth was fast in 1999–2004 but has since slowed; and the oil and gas industries employ fewer people than the Russian railways—less

Figure 4: Some indicators of Russian dependence on oil and gas (%)



Notes: The bars indicate the % contributions in 2006 of the oil and gas industries to, in descending order, federal budget revenue; merchandise exports, and GDP.

Sources: Derived from Central Bank of Russia (budget and exports); Aleksei Kudrin lecture at the Higher School of Economics, 21 Feb. 2007, for the GDP share (presumably value added share at current prices).

than 2 per cent of the employed workforce. What has driven growth is the rise in revenues of these industries, chiefly derived from their sales to Europe at rapidly rising prices. Those revenues feed the state budget (some but not all of this financial inflow being withdrawn from circulation in the Stabilization Fund), personal incomes and company profits.

The importance of exports in all this can be illustrated in the case of gas. In 2006, only 24 per cent of gas output was exported outside the CIS, almost all of it to Europe, yet non-CIS-export receipts were more than half of Gazprom's revenue.⁶ The Russian GDP, exports and federal budget depend heavily on oil and gas production, as figure 4 illustrates.

If metals (steel, nickel, aluminium and gold, in particular) are added, Russian export dependence on raw materials-based industries rises to around 80 per cent. The success of these industries as exporters has had obvious benefits for the country: rising revenues funding investment (and this investment has not been only in these natural resource industries themselves); rising state funding of social benefits and pensions; and a greatly increased claim on the wider world's attention. But it also has drawbacks. Broadly speaking, Russian hydrocarbons and metals exports are not highly processed. This might not matter if research-based production in other sectors was flourishing; that could open the way for sustained long-run growth when oil prices fall—or merely stop growing. But it is not. A detailed, product-

⁶ Output data from Rosstat; export volumes from Russian customs data (<http://www.customs.ru>, accessed 20 July 2007); revenue share quoted from Gazprom sources in *Vedomosti*, 26 June 2007.

group-by-product-group study shows that Russia is weaker as an exporter of medium- and high-technology products than Brazil, China or Turkey.⁷

Russia is in no position to compete with low-wage Asian producers of manufactures. It might perhaps, as the Putin leadership plans, build on past strengths in military-related high-technology areas like aerospace, but it has not yet done so. Worse, domestic industrial output that competes with imports has been growing less strongly than the corresponding imports.⁸ This suggests that the so-called 'Dutch disease' may be infecting Russia: growth in natural resource exports pushes up the exchange rate, making other parts of the economy less competitive than they would otherwise have been, whether as sources of exports or of import substitutes.

Dutch disease—from which the Netherlands has made a pretty good recovery—is one of a family of ailments that some economists have grouped together and labelled the 'natural resource curse'. The empirical basis for this diagnosis is the relatively slow growth in the late twentieth century of countries that at the start of a 20- or 30-year period of observations had a high ratio of natural resource exports to GDP: relatively slow growth even when adjustment was made for other influences.⁹ One version of the curse is that wealthy and powerful natural resource companies, whether privately owned or state-owned, provide a setting in which corruption can flourish; the economy can easily come under the sway of politicians who live off the (relatively) easy pickings of these industries. This may or may not be a widely developed phenomenon, but it certainly fits contemporary Russia. That does not augur well either for economic diversification or for good government in the future.

The turn to statism from 2003

There has been a clear increase in direct state intervention in the economy since 2003. What exactly lies behind it, and what its implications are for the future, are controversial matters.¹⁰

The turn to statism is far from being the only significant development in the Russian economy since 2003. To most Russians it is much less important than the general improvement in the material conditions of life. To many Russian business people, moreover, there seems to have been little break in the building of new and expanded firms, in mergers and takeovers and other business adventures.¹¹ At

⁷ J. M. Cooper, 'Can Russia compete in the global economy?', *Eurasian Geography and Economics* 47: 4, 2006, pp. 407–26.

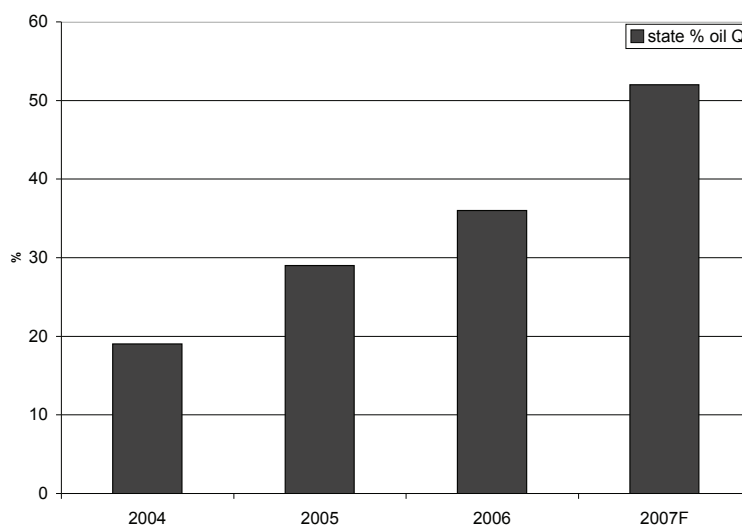
⁸ Simon-Erik Ollus and Stephan Barisitz, 'The Russian non-fuel sector: signs of Dutch disease? Evidence from EU-25 import competition', Bank of Finland, *BOFIT Online*, no. 2, 2007.

⁹ See, out of a large literature, J. D. Sachs and A. Warner, 'The curse of natural resources', *European Economic Review* 45, 2001, pp. 827–38.

¹⁰ For a more detailed account (written in late 2006) see Philip Hanson, 'The turn to statism in Russian economic policy', *International Spectator* 42: 1, March 2007, pp. 29–42.

¹¹ Though superficial similarity with western business activities can conceal underlying differences. This is clearly shown in a comparison of EU and Russian legislation on takeovers, in which the scope for illegal practices in Russia is stressed: Ye. Demidova, 'Vrazhdebnye pogloshcheniya i zashchita ot nykh v usloviyakh korporativnogo rynka Rossii', *Voprosy ekonomiki*, no. 4, 2007, pp. 70–85.

Figure 5: The rising share of state ownership in the oil industry, 2004–2007 (% output, end-year)



Note: 2007 figure projected.

Sources: Author's estimates from OECD, Rosstat and Gazprom data.

the same time, however, the kinds of state intervention that have been seen cast further doubt on an already unclear set of property rights. They have probably increased political uncertainty and thereby damaged the business environment in general—not least by the continuing lack of clarity about what is and what is not a 'strategic' asset. So it is worth assessing this particular development rather closely. I will start with a brief narrative, to set the scene.

In mid-2003 the Russian authorities arrested Platon Lebedev, an associate of Mikhail Khodorkovsky and a fellow stakeholder in Khodorkovskii's Yukos oil company. From then on, with numerous twists and turns, the Yukos saga developed, culminating in Lebedev's and Khodorkovskii's imprisonment and the eventual bankruptcy of Yukos in autumn 2006. Yukos assets have been taken over mainly by the state oil firm, Rosneft. Rosneft borrowed \$22 billion, mostly abroad, to finance its purchases of Yukos assets at bankruptcy auctions in 2007.¹²

In 2005–2007 Gazprom, the state-controlled gas monopolist, bought another previously private oil company, Sibneft, and acquired majority stakes in the Shell-led Sakhalin Energy company and the previously TNK–BP-owned Rusia Petroleum, which holds the development licence for the giant Kovykta gas field in eastern Siberia.¹³ These acquisitions have been made by purchase, but the purchases

¹² *Vedomosti*, 27 June 2007. Nearly \$10bn of this is being paid back quite quickly, as Rosneft, in its role as a Yukos creditor, receives some of its auction spending back.

¹³ To be precise, Gazprom is due to take over the 62.8% stake in Rusia in October. TNK–BP is a 50–50 joint venture between the British company BP and a group of Russian private firms. It was established in 2003. Nobody now imagines that a foreign firm could any longer acquire such a large share of a major Russian natural resource company.

have been made under administrative pressure over environmental infringements and non-fulfilment of licence conditions. These pressures were not without some legal basis. However, the environmental and licence issues ceased to be urgent matters for the Russian authorities once Gazprom owned the assets.

This sort of crude intervention, contrary to due process, has been largely confined to oil and gas—and chiefly to oil, since the state already controlled over 80 per cent of the gas industry. The resulting growth of state ownership in the oil industry is striking, as figure 5 illustrates.

The growth of state control has not, however, been confined to the oil industry. The OECD compiled a list of 22 state acquisitions of companies between August 2004 and September 2006. Some of these transactions entailed a minority state stake becoming a majority stake; others were acquisitions of previously wholly private companies. Nine of the 22 businesses were outside the oil and gas sector. They included banks and engineering companies.¹⁴ Other state acquisitions have been made since September 2006. They include Gazprom's acquisition of majority stakes in Sakhalin Energy (the Shell-controlled firm running the Sakhalin-2 project) and in the Kovykta gas field, previously controlled by TNK-BP.

The western press has reported the use of administrative pressure against the likes of Shell and BP in Russia, but Russian private firms get bullied, too. The controlling stakeholders in the titanium firm VSMPO-Avisma did not want to sell out, but were forced by harassment involving taxation and other means to conclude that it was an offer they could not refuse.¹⁵ The upstart private Russian oil company Russneft—no relation of Rosneft yet—has been subject to tax-led investigations into the company structure.¹⁶ The purpose might be simply to make the owner, Mikhail Gutseriev, slow down his own acquisitions, or it might be to prepare the way for a state takeover.

It is true that there have also been some privatizations. These include—slowly and after long delays—sales of some electricity-generating companies. But there have also been many postponed privatizations. And in the case of electricity, the state-owned Gazprom has bought controlling stakes in several of the generating companies—which is not in the spirit of the original electricity reform plan. The net effect is a shift towards greater state ownership. The European Bank for Reconstruction and Development (EBRD) estimates the private sector share of Russian GDP at 70 per cent in 2000–2004, and at 65 per cent in 2005 and 2006.¹⁷ State ownership now looms large in banking, oil, gas and defence-related production. In oil and gas the Russian authorities had preserved from Soviet times a state monopoly in export pipelines, even during the period of strong private oil companies up to 2004.¹⁸

¹⁴ *OECD Economic Surveys: Russian Federation* (Paris: OECD, 2006), pp. 33–4.

¹⁵ *Washington Post*, 19 Nov. 2006, pp. A1, A13.

¹⁶ *Vedomosti*, 13 June 2007.

¹⁷ *EBRD Transition Report 2006* (London: EBRD, 2006), p. 168.

¹⁸ Export of oil in railway tanker wagons remained a marginal, high-cost option outside direct state control (though the railways themselves are still state-owned). Also, the very small number of oil and gas production sharing agreements (PSAs) negotiated in the early 1990s left the western partners contractually free to arrange their own exports. In the case of the originally Shell-led Sakhalin-2 project, that freedom has for practical

Two other processes complete the outward and visible signs of this turn to statism. One is the formation of state holding companies in several sectors designated strategic. So far, these comprise the Rosoboroneksport grouping—arms-related but also incorporating the largest Russian carmaker, VAZ; the United Aviation Company (making aircraft, not running airlines); the United Shipbuilding Corporation; Atomenergoprom (for the civil nuclear industry; due to come into operation in 2008); and a grouping being formed for research and development in nanotechnology.

The other process is the drawing up of legislation to define what natural resource deposits will be deemed strategic and what will be classified as a strategic enterprise. Only in exceptional circumstances, and subject to approval by the government, would a foreign-controlled entity be allowed to control either a strategic deposit or a strategic enterprise. The question of strategic deposits is to be covered by a revised law on the subsoil, the subject of enterprises by a law on strategic enterprises.

President Putin promised in spring 2005 that these strategic definitions would be made clear in legislation by autumn of that year. They have not been. The new law on the subsoil is now widely expected to be unveiled only after the presidential election due in March 2008. A late 2005 draft, posted on the Ministry of Industry and Energy's website, listed five oil, gas, gold and copper fields as 'strategic'; a mid-2006 draft, not made public but obtained by a Russian newspaper, had lowered the minimum size for a strategic deposit, raising the number of such fields from five to 70.¹⁹

The policy shift has been not only statist but nativist. Indeed, it is not clear whether the leading members of the presidential administration most associated with it—Putin himself, Igor Sechin and Vladislav Surkov—are concerned to put so-called strategic assets under state control or merely under Russian control. This question will be picked up again in the next section.

One interpretation of the increase in Russian state involvement in the economy is suggested by Peter Ferdinand in his article in this issue. It is that Russia, having dallied rather unhappily with free-market ideas in the 1990s, is shifting to policies associated with 'developmental' states, where the political authorities lead development in an active way. One could supplement this interpretation by noting that, in increasing state ownership of the oil industry in particular, Russia is merely conforming to the petro-state norm of the past quarter of a century. In comparison with OPEC countries or Norway, its mainly private oil industry of a few years ago might be considered an oddity.²⁰

purposes disappeared now that Gazprom has a majority stake. Gazprom has a monopoly on storage, processing and export of gas in Russia, as well as controlling not far short of 90% of production. That leaves the Exxon-led Sakhalin-1 project and a smaller PSA project led by Total.

¹⁹ *Vedomosti*, 6 July 2006.

²⁰ Whether the general shift of control of oil deposits from international to national oil companies has net benefits or not is another matter. One study finds national oil companies to have lower 'operational efficiency' than international (private) oil companies (S. L. Essler, P. Hartley and K. B. Medlock, 'Empirical evidence on the operational efficiency of national oil companies', study sponsored by the Japan Petroleum Energy Center and the James A. Baker III Institute for Public Policy, Rice University, March 2007), but the efficiency crite-

Another account of this rise in state intervention is that it is propelled more by domestic Russian politics than by ideas about development or the proper management of oil reserves.

There is no readily available evidence that would allow us to dismiss either of these readings. Still, foreign policy and internal power struggles have certainly played a role. The turn to statism has been promoted by the real political leadership, that is, the presidential administration. It has nothing to do with the technocrats who lead the key economic agencies of the government: the Ministry of Economic Development and Trade and the Ministry of Finance. Indeed, the government technocrats have criticized the rise in state control and the attack on Yukos.²¹ Therefore, this is not a shift of economic strategy devised by those officially designated as economic policy-makers. It comes from the presidential administration, the heir to the Soviet Politburo. It is closely linked with the recent growth in the self-confidence and assertiveness of the Russian state. And it is marked by, perhaps even determined by, power struggles among groups within the political elite.

The imprint of Russian traditions, especially the patrimonial state and the rulers' deep distrust of the ruled, is apparent in these developments. In the next section we consider the politics of the turn to statism, before returning to a more general assessment of Russian economic prospects.

Russian politics and the economic role of the state

There is a good deal of evidence for the view that serendipity played a large part in the Yukos affair, and that this affair in turn promoted the more general shift to statism.

The state's attack on the Yukos oil company began as an attack on an individual—Mikhail Khodorkovsky. There are numerous versions of how and why it was launched. This is not the place to rehearse them in any detail.²² Many stories circulated: Khodorkovsky spoke disrespectfully to Putin; he bribed parliamentary deputies to block proposed tax increases; he supported political parties not loyal to Putin; he was planning to sell Yukos to a foreign oil company; he was cultivating influential contacts in the United States; and so on. As pressure on him mounted and most of his close associates prudently emigrated, it appears he was being given time to leave the country; but he stubbornly stayed put.

rion used, revenues relative to reserves, is in my view too narrow to be convincing. One finding that Essler et al. come up with is nonetheless very striking for any study of Russian policies. They find that all sorts of oil companies, on their efficiency criterion, perform worse in Russia—adjusting for other factors—than elsewhere.

²¹ German Gref, the economic development minister, called for the privatization of Rosneft and the reprivatization of the main Yukos asset, Yuganskneftegaz (*Finansovye Izvestiya*, 11 Jan. 2005). Aleksei Kudrin, the finance minister, described the Yukos affair as damaging for trust in the Russian economy (*Moscow Times*, 2 June 2005). The ministers of industry and energy and of natural resources have been more equivocal, but they are not the prime makers of economic policy.

²² The fullest account I have seen is by Wojciech Konończuk, 'The "Yukos affair", its motives and implications', *Prace OSW/CES Studies* 25, Aug. 2006, pp. 33–60. To be strictly accurate, the first person to be arrested was not Khodorkovsky but his associate, Platon Lebedev. Nobody doubts, though, that Khodorkovsky was the main target.

The fraud and tax evasion charges actually brought against Khodorkovsky could have been brought against many others and were not. The action taken against him was the implementation of what Alena Ledeneva calls 'suspended punishment'. Here is a rough summary of her analysis of suspended punishment:

The rules of the game in Russia are non-transparent and frequently change. The formal rules (laws) do not function coherently. Therefore everybody violates some of the formal rules and can always be punished for this. Punishment has to be selective, since you cannot punish everyone. Infringement of informal rules is what determines whether the authorities pursue some (inevitable) infringement of a formal rule in order to punish you.²³

Suspended punishment is a traditional means by which the rulers keep a monopoly on power in Russia. The dismantling of Yukos, I suggest, began as an attack on an over-mighty subject by the leadership. Why the attack? Fundamentally, because that leadership deeply fears the development of any base of social and political power that it might not be able to control. As the attack developed, previously influential and business-friendly Yeltsinites, notably the prime minister, Mikhail Kasyanov, were eased out of power, while Putin associates, often with a security services background, took over more and more high positions. The subsequent, meandering development of the affair looks very like a mixture of improvisation and unintended consequences.

The attack on the Yukos company, as distinct from the attack on its main beneficiary owner, came only after the arrest of Khodorkovsky.²⁴ It was based on a revisiting of Yukos's tax returns for years which the tax authorities had previously signed off. President Putin said that the state did not intend to bankrupt Yukos. The affair ended with the company finally being made bankrupt, after an appeal, in September 2006.²⁵

Breaking up Yukos made its assets available to others. While this was happening, a policy of developing national champions in 'strategic' industries was taking shape. One result of this has been the establishment of the state holding companies referred to above. For a time it was official policy, endorsed by President Putin, to merge the two main state-controlled hydrocarbons companies, Rosneft and Gazprom, into one.²⁶ By some clever footwork, including the use of an unknown front company to buy the main Yukos production asset at auction, Rosneft evaded being absorbed into Gazprom. The two state companies remain separate. Indeed, Moscow analysts in summer 2007 were reckoning that the Exxon-led Sakhalin-1 project stood a good chance of eluding Gazprom control because Rosneft holds a 20 per cent stake in the Sakhalin-1 consortium.²⁷

²³ That is my paraphrase and précis of Ledeneva's account: Alena V. Ledeneva, *How Russia really works* (Ithaca, NY: Cornell University Press, 2006), pp. 12–13.

²⁴ According to a knowledgeable but not citeable source, Khodorkovsky, when in pre-trial detention, was offered a dropping of all charges if he surrendered his assets. He refused, reportedly on the ground that such an action would be so damaging to Russia's business reputation that the authorities would not dare to carry it out.

²⁵ *Vedomosti*, 19 Sept. 2006.

²⁶ For Putin's approval of this planned merger, see *Finansovye Izvestiya*, 14 Sept. 2004.

²⁷ *Oxford Analytica Daily Brief*, 19 June 2007.

Rivalry between two state companies in hydrocarbons (Gazprom mainly in gas, Rosneft mainly in oil, but with some overlap) may be preferable, in the eyes of economists, to a monopoly. But there are two striking things about the Gazprom–Rosneft rivalry. First, it has come about contrary to a presidentially endorsed policy of merger. Second, the companies are chaired by two men who were both senior members of the presidential administration at the time they were appointed: Dmitrii Medvedev and Igor Sechin, respectively. (Medvedev is now a first deputy prime minister.) It is hard to escape the conclusion that personal rivalry, not grand state policy, determined the failure of the merger.

Meanwhile, another senior member of the presidential administration, Vladislav Surkov, has been putting together a doctrine of sorts that has something to do with the rise of state control. It is more likely to serve as *ex post* rationalization than as guidance. The economic liberals, he says, failed to understand the importance of sovereignty. Russia needs sovereign democracy and an economy to match. ‘National capital’ has to be dominant in strategic communications, pipelines, federal highways, railways, most electricity transmission, the financial system, key defence production facilities and, for as long as so much in Russia depends on it, the ‘fuel-energy’ sector. Poland does not have a ‘national banking system’ (meaning that most banks in Poland are foreign-owned). That may be all right for the Poles but it will not do for Russia.²⁸

‘National’ in ‘national capital’ seems to mean ‘Russian’, rather than ‘formally owned by the Russian state’. Entrepreneurs who are Russians and who will obey the Russian state may be enough to preserve ‘sovereignty’. That, at least, is my interpretation: Surkov does not spell it out. He distinguishes between trusted big businessmen and what he refers to as ‘offshore aristocrats’. Others have distinguished between ‘trusted’ (*doverennyye*) capitalists and *kosmopolity*.²⁹ The notion is not merely, and perhaps not chiefly, nationalist; it is to do with people, whether state officials or private businessmen, who can be relied upon to do what the authorities want. This is, I suggest, a ruling elite who want to be sure that all social actors of any consequence will do what they are told. This does not mean, as in communist planning, that the centre must plan all economic activity. It is a default arrangement: enrich yourselves, by all means, but come to heel and do our bidding when we need you.

Still, in one industry in particular direct state ownership has markedly increased. One interpretation of the growth of state control in the oil industry is a very simple one: it is a honey-pot effect. There is a lot of money to be made in this industry, and leading members of the political elite have been making sure they do not miss out. This view is widely held in Moscow. The innocent westerner may ask how being on the board of a state company can bring the sort of wealth acquired by the Yeltsin-era ‘oligarchs’. The question will be greeted with a pitying smile.

²⁸ This is taken from the transcript that surfaced, after the event, of an off-the-record speech to a Russian business group on 17 May 2005: <http://www.svoboda.org/programs/tp/2005/tp.071105.asp#1>, accessed 11 July 2005. The authenticity of the speech has not to my knowledge been denied. Surkov has said much the same things on the record elsewhere, but this speech is relaxed, wide-ranging and particularly explicit. It is also amusing.

²⁹ Under Stalin, ‘cosmopolitan’ was code for ‘Jewish’. It is not clear that the word, in the present context, has that connotation.

The Russian tycoons are not popular heroes, any more than tycoons are anywhere. But the notion that there was a great popular demand for the state to take over 'oligarch' oil companies in the name of social justice is mistaken. If the Levada Center's opinion polls are any guide, the Russian public did not see the state takeover of Yukos as an act either of justice or of economic strategy. Asked in October 2006 (a month after the Yukos bankruptcy) why Yukos had been made bankrupt, only 9 per cent chose the answer 'Because it could not pay its debts'. The answer 'So that its remaining assets could be sold at less than market price to Kremlin-backed companies' was chosen by 43 per cent. (A sensible plurality of 48 per cent opted for 'Hard to tell'.) Asked in the same survey whether Khodorkovsky had been imprisoned for tax evasion or because he refused to make a deal with the Kremlin, 19 per cent chose the former and 48 per cent the latter. Thirty-three per cent wisely said they did not know.³⁰

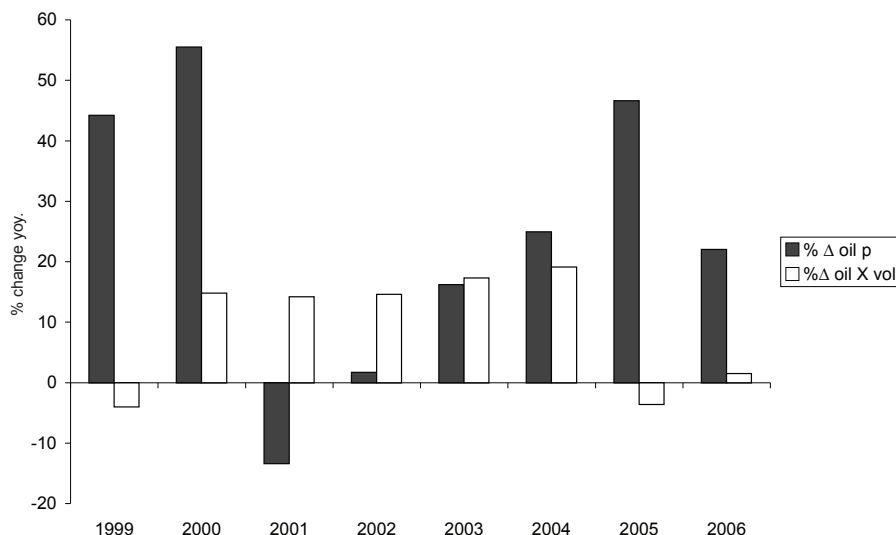
As the Yukos affair gradually unravelled, oil, gas and metals prices were rising strongly. Russia's public debt to the West was falling to trivial levels. To judge by their speeches, the President and his close associates were looking back at the weak Russia of the Yeltsin era and its (admittedly patchy) adherence to western economic and political advice as a shameful episode that they would put behind them. It was time for Russia to show that it was strong again. It would not be lectured or pushed around. Russia would go its own way, making Russian judgments about Russia's best interests. The rejection of economic liberalism is part of this. Economic reform had in any case become unpopular after the economic decline and social dislocation of 1989–98.

One consequence of Russian state meddling is a slowdown in the growth of production and export of oil. Oil and oil products matter far more to the Russian balance of payments and budget revenue than gas. Western headlines are more often about gas supplies, but that is because gas is delivered to Europe through pipelines according to long-term supply agreements; glitches in that supply are both obvious and troubling. But Russia consumes most of its gas production at home; indeed, it relies, at the margin, on cornering Central Asian gas and re-exporting it to meet its obligations. So anything that damages oil earnings, though less newsworthy, is more serious for Russia. Figure 6 shows the recent slowdown in the growth of oil export volume. There has been a similar slowdown in the growth of output.

It would be misleading to blame the slowdown in the oil industry solely on the Yukos affair and state companies' takeovers of Sibneft and other private assets. There have been other influences reducing the incentive or the capacity to produce and export oil: increased taxation in 2004 (which is being partly reversed in 2007); the constraints on export volume imposed by Transneft pipeline capacity: and perhaps also an end to so-called 'easy oil'—the increased output from previously underexploited fields by relatively modest investments, a development in which Yukos led the way. What the dynamic private oil firms of 1999–2004, such as Yukos,

³⁰ Cited in Troika Dialog, *Russia Economic Monthly*, Oct. 2006.

Figure 6: The slowdown in Russian oil export volume growth, 1999–2006
(% change, year on year)



Notes: The columns represent % changes in average annual Urals oil price (left-hand column of each pair) and % changes in export volumes; volumes include oil products.

Source: Derived from Russian customs data.

Sibneft and TNK, did not do was make long-term investment in the development of new fields.³¹

In the present context, however, the relative importance of these different influences does not matter. They are all to do with state policy. The Russian state insisted that export pipelines must be controlled by the state-owned Transneft, and blocked proposals by private firms to build and manage new pipelines. The Russian state increased the tax burden. And if the Russian state had done more to create confidence in private property rights, the private oil firms might well have invested long term in developing new fields.

Curiously, the Russian government’s Energy Strategy envisages very slow growth in total Russian oil output up to 2020.³² If that proves indeed to be the case, further growth in Russian oil earnings will depend far more on price rises than was the case up to 2004. Big price increases in 2005 and most of 2006 covered up the stagnation in barrels of oil delivered. It cannot be assumed that prices will continue to rise in the longer term. They may remain for several years in a historically high range, but that by itself will not boost earnings.

³¹ One private oil firm, Lukoil, has done more exploration and long-term development, though it showed less dynamism in current production. But the exception proves the rule. Lukoil has maintained close relations with the Kremlin. Its boss, Vagit Alekperov, is said to spend 80% of his time maintaining political contacts and monitoring the shifting positions of different groups in the Putin court. See Isabel Gorst, ‘Lukoil: Russia’s largest oil company’, study sponsored by Japan Petroleum Energy Center and the James A. Baker III Institute for Public Policy, Rice University, March 2007. Gorst quotes the observation about Alekperov’s allocation of his time at p. 3.

³² This strategy is still, at the time of writing, posted on the Ministry of Industry and Energy (Minpromenergo) website. See <http://www.minprom.gov.ru/docs/strategy/1>, accessed 2 July 2007.

That circumstance may not be too damaging for Russian economic growth, because a large proportion of incremental oil revenue is ‘sterilized’—taken out of circulation by withdrawing it from the circular flow of funds—by being placed in the Stabilization Fund. Even so, the effect on the oil industry of the turn to statism does look rather like a self-inflicted wound.

It is necessary, however, to note both the nuances and the limited coverage of Russia’s current state intervention, and put its damaging attributes into perspective.

The Russian economy as a curate’s egg

The most obvious answer to critics of recent Russian state intervention is to point to the country’s continued high growth and surging inward foreign investment. Russian economic liberals like Evgenii Yasin or Andrei Illarionov counter this by arguing that the economy would be doing even better if the state intervened less (or intervened in a more predictable, rule-of-law-governed way). The liberal counterargument is in my view plausible. The continuing modest share of investment in national income is one piece of circumstantial evidence in its favour. Still, it does not dispose of the observation that, when all is said and done, the Russian economy is booming. Maybe things would be even better without the new statism; but the new statism is hardly proving lethal. If the Russian state is undermining business confidence by making property rights more uncertain than they were before, how does it come about that western banks are lending more than ever to Russian companies, western and Russian investors are shovelling funds into a spate of Russian company initial public offerings, mainly on the London Stock Exchange, inward foreign direct investment exceeded outward in 2006 and the first quarter of 2007, and capital flight is down?³³

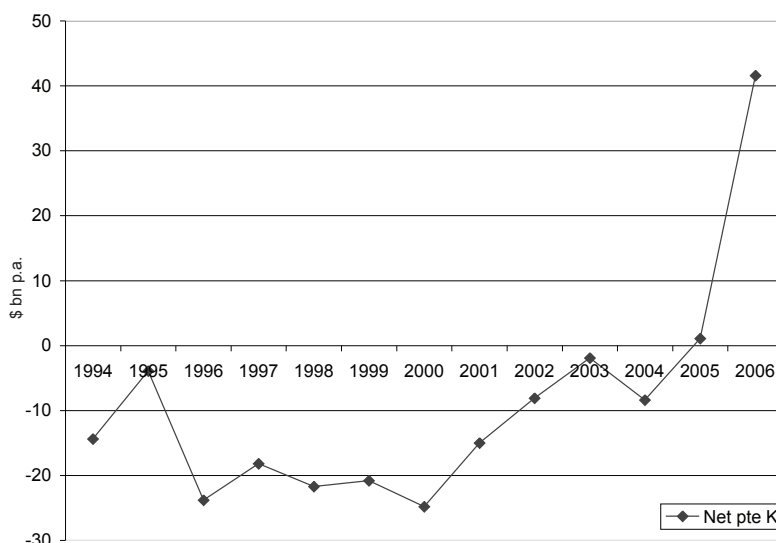
The number that summarizes all this information is the private sector net capital flow into or out of Russia. That is shown in figure 7. The improvement is clear. It came in 2005 and 2006.

Of course, a great many investors could be wrong. They often are. But one reason for doubting that this so in the present case is that some substantial part of the incoming money is Russian-controlled. It is ‘hover capital’ (hovering offshore) that is being brought back to Russia by people who know—or at any rate, have as good a chance of knowing as anyone—‘how Russia really works’. The assertion that business confidence in all sectors has been severely damaged and not repaired from 2003 is hard to sustain.

What may be happening is that business people are coming to believe that there is a new set of informal rules of the game. The old set was indeed rather shockingly revised in 2003–2004. The upset did for a while stall the Russian stock exchange index and spur capital flight. But the entrepreneurs’ animal spirits soon picked up again. Yes, the limits of direct state intervention remain ill-defined.

³³ Data from the Central Bank of Russia. See http://www.cbr.ru/statistics/credit_statistics/print.asp?file=bal_of_payments_est.htm, accessed 13 June 2006.

Figure 7: Net private capital flows into/out of Russia, 1994–2006 (\$bn)



Source: Central Bank of Russia.

What is ‘strategic’? The legislation is still in the pipeline. Will the state move into the metals sector, extending its titanium bridgehead? Will the state take over the remaining private oil companies, or will it be satisfied that they are run by loyal and obedient Russian tycoons?³⁴ These questions cannot be answered with anything approaching certainty, but a great many economic agents evidently consider they know the answers—or rather, that they know them well enough to take practical decisions in an unavoidably uncertain world. And they are not deterred from investing. Gross fixed investment rose 8.3 per cent year on year in 2005 and 13.9 per cent in 2006.³⁵

Part of the new understanding may be sectoral. Recent major direct investments into and out of Russia suggest the following pattern.

Outward acquisitions, plus at least one large greenfield investment abroad, provide one indication of sectoral strength and confidence on the part of Russian private business. Russian metals companies, having strong market power at home and proving themselves competitive abroad in low-value-added product markets, have begun to develop into multinationals. They are acquiring assets well beyond the CIS. UC Rusal is now the world’s largest aluminium and alumina producer. Norilsk Nickel, Polyus Gold, and the steel companies Evraz, Severstal, NLMK and Mechel are also global players with major assets beyond the CIS. In the oil and gas sector the picture is less striking. Gazprom is acquiring downstream distribution assets in Europe. Lukoil has modest distribution networks in the United

³⁴ Lukoil, with more foreign investments beyond the CIS than the state oil and gas companies, is a case in point. It has been argued that Lukoil is protected above all by its record of loyalty to the Kremlin, extending to a readiness, when required, to follow political guidance at the expense of commercial objectives. See Gorst, ‘Lukoil’.

³⁵ Rosstat figures, as reported in Troika Dialog, *Russia Economic Monthly*, June 2007, p. 2.

States and Europe. Russian mobile-phone companies (a post-Soviet, heritage-free industry that has not so far been cursed with the 'strategic' label) have become strong enough to develop a presence in other CIS countries and Turkey, but not yet further afield.

Major inward direct investments, at any rate in the form of acquisitions, were in 2006 concentrated on the financial sector, where four of the five largest foreign acquisitions took place. The other big inward acquisition was of Ilim Pulp by International Paper, for \$650 million.³⁶

Meanwhile, dwarfing all the above deals, the Russian state was buying out foreign oil and gas assets inside Russia. In 2006 Gazprom paid, reportedly, \$7.45 billion for 50 per cent plus one share of Sakhalin Energy, and the Shell, Mitsui and Mitsubishi stakes were reduced to make way for it.³⁷

Unless the people who made these deals are deluded, which is unlikely, not even the whole of the Russian natural resource sector is heading for state control. Loyal private oil companies may perhaps stay private as long as they serve state interests when called upon to do so. The metals sector may see some assertion of state control, but it contains rising multinationals that are—whether deliberately or not—acquiring a role beyond Russia's borders that the state could not easily take over. In much of the rest of the economy, and perhaps above all in the services sector,³⁸ business is robust. What the state has done is to create problems and weaknesses in the hydrocarbons sector. That matters a great deal. But it may now be widely believed that the problem will not spread.

That interpretation may seem at odds with the creation, outlined above, of national state holding companies in aerospace and other 'high-technology' sectors. But these are overwhelmingly defence-related industries, in which the state had retained a strong presence since Soviet times. This is a tolerably well-defined field. What is going on in it seems quite distinct from what has happened in the oil industry. These engineering concerns are not financial honey-pots, or at any rate not on anything like the scale of oil companies. Other countries may be content to have private defence contractors; the Russians, evidently, are not.

The strategies for these industries appear to be pragmatic. In the strategy for aerospace, for example, it is laid down that the United Aircraft Company and its affiliates are to seek alliances with leading foreign firms—Boeing, Airbus, Embraer or Bombardier—in the development of leading-edge new aircraft, in order to upgrade their own technology. Shortly after the state acquired a significant stake

³⁶ The Russian periodical *Pogloshcheniya i sliyaniya (Acquisitions and Mergers)* tracks deals. The deals referred to here are set out in *Vedomosti*, 30 Dec. 2006. There was also what looked superficially like a major foreign acquisition in the Russian oil industry: Sinopec's acquisition of Udmurtneft. But this purchase by the Chinese state oil company was just a manoeuvre: Sinopec sold its acquisition on to Rosneft. The transaction was in reality another step in the Russian state's raising of its stake in the oil industry.

³⁷ *Vedomosti*, 22 Dec. 2006.

³⁸ This is not to say there are no problems emanating from the state in the services sector. It is worth pointing out that in June 2007 the British electrical retailer DSG abandoned a plan to acquire the Russian electrical retailer Eldorado, after two years of due diligence, because of high 'corporate, economic and political risks' (emphasis added): *Oxford Analytica Daily Brief*, 21 June 2007. And it is not clear to me whether foreign investment in Russian banks is entirely proof against views in the Putin court (such as that of Surkov) that Russia needs a national banking system, even if the Poles don't (cited in n. 27 above).

in the titanium producer VSMPO–Avisma, a 50–50 joint venture between Boeing and Avisma was announced.³⁹

It is, as ever, hard to judge how these different elements in the Russian economic picture should be assembled. I suggest, as a tentative first approximation, that the Russian economy is a mix of sectors in some of which, despite the generally weak rule of law and insecure property rights, entrepreneurs confidently expand economic activity in the belief that there is a viable framework of informal rules that they understand, and in others of which crude state intervention of doubtful legality has done and continues to do a great deal of harm. The aggregate result is a dynamic economy that could be doing even better if the rules of the game were more formal and predictable.

Prospects

It is one thing to call the Russian economy a curate's egg. Is it a sustainable curate's egg? There are a number of factors that favour further strong growth in the next few years, and another set of factors that do not. First, there are the following encouraging elements in the picture.

- Prudent macroeconomic policies have been maintained, just, in the run-up to parliamentary and presidential elections. It ought to be easier to maintain this stance after the elections. One influence supporting this trend is that the population has vivid memories of high inflation in the 1990s and very low trust in politicians' ability to spend money to anyone's advantage but the politicians' own.
- There is a middle class, small but probably growing and with a huge appetite for more goods and services, capable of keeping the consumer-demand pot bubbling. This middle class may also, along with the super-rich, be a source of pressure for more regularity and predictability in the behaviour of state organs.
- If oil prices do not continue on a steeply rising trend, the rapid growth of import volume will erode the trade surplus, reducing the inflow of funds through the balance of payments current account and, to that extent, easing inflationary pressure.
- As long as economic growth continues, the inflow of foreign finance and technology, which is still modest by international standards, will be encouraged to expand, bringing productivity gains with it. Russia's eventual accession to the WTO, still delayed on what should be its last lap, should assist in this; it should also promote competition in domestic Russian markets, with benign medium- and longer-term results.
- The growing involvement of Russian companies abroad, through the buying of foreign companies, borrowing from western banks and share issues on western markets, makes for an internationalization of Russian management practices. This ought to be beneficial for performance.

³⁹ In August 2006, though details were finalized only in June 2007. See *Defense Industry Daily*, 12 June 2007. For the official Russian strategy see <http://www.minprom.gov.ru/activity/avia/strateg/1>, accessed 2 July 2007.

The factors tending to brake the growth of the economy, including through a revival of inflation, are the following.

- The working-age population began to decline this year. The population as a whole has been falling for several years but the decline affecting the workforce is new.
- Some of the growth of output after 1998 was made possible by the re-utilization of production capacity that had been grossly under-used during the depression of the 1990s. Capacity utilization measures are particularly difficult in Russia, where it is unclear how much of Soviet-era-installed capacity is useful. But whatever the real margin of under-exhausted capacity was, it must by now be largely used up. Whether new investment has been sufficient to maintain output growth is uncertain.
- The strengthening of the rouble in real terms against the currencies in which most of Russia's trade is settled (US dollars and euros) is probably taking its toll on manufacturing competitiveness. The evidence for this was referred to above. The expected erosion of the trade surplus, itself partly a result of this real exchange rate appreciation, could presage an end to rouble real appreciation. But it will not help much if a rising net inflow of capital takes over as a factor strengthening the exchange rate.
- The inflow of currency associated with oil and (in future) gas earnings can to a considerable extent be taken out of circulation by devices like the Stabilization Fund, reducing its potential inflationary effect. No such mechanism is to hand for 'sterilizing' the capital inflows that have begun.
- Moreover, the 2008 reorganization of the Stabilization Fund into a Prosperity Fund (for long-term benefits) and a Reserve Fund (to protect budget spending against a large and sustained fall in oil prices) could weaken sterilization. Under the new rules, amounts coming to the Reserve Fund when it is already at or above 10 per cent of GDP can go either to the Prosperity Fund or to subsidize the budget. Three-year budget plans, now being introduced, are supposed to tie the hands of policy-makers and keep them prudent, but these new arrangements are untried.⁴⁰
- The capital inflow may be less benign in other ways than might be expected. A substantial part of it is western bank lending and stock market flows (including through initial public offerings of shares) to state-controlled companies. Banks and investors like Gazprom and Rosneft: they are big; the financially strong Russian state is their main owner; the Russian state gives them administrative favours. But they are unlikely to invest the money well.⁴¹
- Falls in the oil price are not necessarily a trigger for economic slowdown. Price changes over quite a range may not directly affect the flow of funds in the

⁴⁰ 'Russia: oil fund reform risks spurring inflation', *Oxford Analytica Daily Brief*, 20 June 2007.

⁴¹ This is not to say that investors do not pay attention to their policies. Transneft, Rosneft and Gazprom shares all fell in the first five months of 2007, and continued to do so even when world oil prices were rising: *Vedomosti*, 22 May 2007. Rosneft had to get a one-year emergency loan from the state-owned Vneshtorgbank to help cover interest payments on its existing debt (\$34 bn in early June 2007): *Vedomosti*, 9 June 2007.

economy because a large top slice of oil revenue is sterilized by impounding it in the Stabilization Fund and its successor funds. But the link between Russian prosperity and the oil price is widely perceived to be strong, so a fall in oil prices could affect sentiment, triggering withdrawals from financial involvement in Russia.

- Finally, competition within the Russian political elite will continue to be an economic problem. Rival groups, it seems, compete for assets, not only for the most obvious reason—to get rich—but also to provide a material basis for promoting one insider group against another and for a retreat in the event of losing out. Some of the most recent turmoil over oil industry assets may be a side-effect of internal strife within the political elite ahead of the 2008 presidential election. The worst scenario for the economy would be one which might also presage the development of genuinely competitive politics: Kremlin insiders failing to agree on the Putin succession. But even if, as is likely, the succession is smoothly managed, there may be scores to settle afterwards, with industrial assets among the weapons deployed.

Of all the influences, benign and malign, the more intractable ones are negative: labour force decline, real exchange-rate appreciation, lack of competitiveness outside natural resources and, more speculatively, insufficient new investment. On the other hand, the Russian economy has momentum and the state is financially robust. With those attributes, rapid growth in a late-developing, middle-income country can last a long time.

On balance, a slowdown over a few years to growth rates closer to 5 per cent a year, as suggested by the Bank of Finland,⁴² is quite a persuasive scenario. It is less dramatic than either a collapse or an acceleration towards Chinese rates of growth. But that may reflect good sense, rather than a drab lack of imagination, on the part of the scenario-writers. Western commentary has tended for years to overdramatize Russian prospects, both up and down. The country itself has tended to muddle through, fulfilling neither our fondest hopes nor our darkest fears.

⁴² 'BOFIT forecast for Russia 2007–2009', published 14 Feb. 2007, http://www.bof.fi/bofit_en/seuranta/ennuste/index.htm, accessed 9 March 2007.