

***Two Decades of Post-Communist Change in Europe and the CIS:
What Has Been Achieved? What Is Still To Be Done?***

CRCE Colloquium – September 2011

The Russian Economy since Communism: The Long View

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Silvana Malle: This session is open to discussion from at least three major perspectives: the post-communist transformation (mainly the 1990s); the achievements of 2000-2008; and the post-crisis challenges and strategies of 2011-2020. The boldest and youngest amongst us – who should be able in the future to verify the correctness of their speculations – may well venture beyond 2020. I am leaving out 2009-2010, the years of the global crisis that could entail discussion on short-term macroeconomic and monetary policies, because I consider them to be less relevant to the subject of this session, though certainly an exchange of views on this matter would be very interesting.

Let me say from the beginning that my interest and solicitations will principally address post-crisis developments, with an aim to explaining why and how the Russian authorities may be stimulated or forced to adjust their economic and political strategies to unexpected constraints.

The initial and early developments of post-communist Russia, nonetheless, deserve a separate consideration, which I am sure will emerge from the floor. I will resume my own approach to this period in a few words. Twenty years from the disintegration of the Soviet Union seems a long-enough time span to assess results achieved and challenges ahead. However the two financial and economic crises that hit Russia in 1998 and 2008, each time just as the country seemed to be finally entering into a sustainable growth trajectory, suggest that an assessment about the viability of the Russian growth model may yet have to wait. Twenty years, however, should warrant a preliminary assessment of the pros and cons of Russia's transformation – not only with the sort of detachment required for an impartial outlook regardless of any personal feelings towards the protagonists of change; but also with the personal memory and emotions that such changes produced amongst many of us – as close observers, supporters or participants.

Looking back today, one lesson that I have learnt from the 1990s is how difficult, painful and demanding it was for the leadership to undertake major structural change in Russia whilst managing the legacies – both mindsets and structures – of seventy years of communism and the command economy. My memory goes in sympathy to the late Yegor Gaidar, Sergey Vasiliev, Anatoly Chubais, Sergey Ignatev, and other colleagues with whom I was fortunate to meet and exchange views.

But the 1990s were also terribly painful for the population. On the positive side, the period revealed the capacity of Russians to withstand the abrupt disappearance of certainties, having to cope on their own – some for the first time in their lives – and to struggle against the loss

of purchasing power by taking on all sorts of second and third jobs. But some legacies, such as the networks of family and friends which had developed as a response to Soviet life, also helped. The economic collapse of a middle-income economy like Russia which was excessively dependent on its defence output was dramatic compared to any other post-communist country. Very high inflation between 1991 and 1992 destroyed people's savings. It took seven years to bring inflation down to one digit. The tenuous signs of recovery surfacing in 1997 were abruptly reversed by the effects of the 1998 financial crisis that, once again in less than ten years, resulted in the annihilation of people's savings and the revamping of inflation.

Nonetheless, market institutions, combined with large-scale privatisation and a better understanding of the market mechanism, helped Russia to recover quickly from the crisis. From 1999 the country enjoyed almost a decade of robust growth (on average around 7% annually). Unfortunately, growth came to a halt in 2008 due to the effects of another crisis, this time of an international nature, which resulted in a serious fall in output in 2009 (7.8% year on year). This time, thanks to a better managed exchange rate policy and a better interaction between the Central Bank and society, Russians managed not to lose all their savings – though some certainly suffered again. Russia is still struggling to recover from this crisis whilst, first trying to understand the roots of its inferior performance throughout the crisis in comparison to other G20 economies, and secondly striving to establish more solid foundations for growth.

This session offers us the opportunity to examine the challenges posed by the global crisis in light of the pros and cons of Russia's transformational path. It is my opinion that these challenges in part reflect some legacies from the past – including the Soviet era – and in part the peculiarities of a process of change that even after twenty years still lacks the policies and incentives necessary to animate the dynamics of competitive markets and to sustain non-inflationary growth.

For almost a decade Russian economic growth has been heavily dependent on natural resources and energy: sectors generally under direct or indirect government control. During the crisis the role of the state in the economy has increased. The state share in the economy has grown to more than 50% and is becoming increasingly costly to the government. International oil price shocks have highlighted the inherent weaknesses of the Russian economy.

A debate on the Russian model of development has recently been instigated by reformers and President Medvedev himself, with his manifesto 'Russia, forward' – published electronically and widely disseminated in September 2009. This debate has created the conditions for a number of reforms that should help to modernise and diversify the Russian economy; whilst at the same time stimulating an innovation drive to which state and private businesses are supposed to contribute. Notably, however, neither this manifesto, nor successive Presidential public speeches, point clearly to the need to improve or upgrade existing institutions – though minor changes, such as lowering the threshold for party representation from 7 to 5% (as it was before Putin lifted it) – which started after the scheduled 2011 December Duma elections – and opening TV debates to political contenders, have been approved. The theory underlying the modernisation drive is that economic growth must come before democracy or, to put it another way, that democracy inevitably follows economic growth. Representative

democracy for Medvedev is an obsolete idea. Direct interaction with people facilitated by IT is apparently considered to be more rewarding.

Whilst strategic goals are constrained by the need to restore current account balance through tighter budget constraints post-crisis, due to comparatively low public debt and the ongoing current account surplus from energy and commodity revenues, this adjustment should be – *ceteris paribus* – comparatively easy. However, the Russian economy remains exposed to international slowdown and unstable energy and commodity prices. A fall in oil prices by \$10 brings about a one percentage fall in budget revenues. At the moment an \$80pb oil price is considered insufficient to guarantee macroeconomic stability. In this context Russia's government may be forced to relax its grip on the economy and to start a new wave of privatisation.

Indeed, a new approach to economic development and growth is unfolding, where the scope for private undertaking appears to be broadening and economic diversification away from energy is considered to be necessary. The role of the state in these developments, however, remains paramount. Changes so far have followed a top-down approach, and have occurred in a technocratic style that has its roots in Tsarist and Soviet history. One innovation site Skolkovo, near Moscow has been selected by Medvedev to host foreign companies who wish to form partnerships with Russian colleagues in high-tech projects. The cost of this initiative to the national budget should be no more than \$3bn, with foreign partners providing equal financial participation. Some projects have already been approved; with some foreign companies signing up to joint ventures in specific fields. There are at present twenty-eight resident companies. Another top-down initiative is ASI (The Agency on Strategic Initiative). ASI has been set up by Putin with the intention of helping young talent to emerge in the field of small and medium size enterprises thanks to support from state financial institutions and government guarantees.

As has happened many times in the past, from Peter the Great to Catherine and Alexander II and even later to Witte and Stolypin, reforms have been undertaken because of pressure to upgrade and strengthen the armed forces after military defeats or incumbent challenges. This time too, the emphasis has fallen on defence, to which some twenty trillion roubles (more than \$650bn) have been allotted over the next decade (2011–2020). This is a significantly larger share of government spending than that allotted to any other single item in the budget. But other structural changes are also in the pipeline. These include transport infrastructure, large-scale enforcement of energy savings, and transformation of the mono-towns, just to mention the most expensive. In such areas, the obvious question is whether the Russian government has the necessary resources to finance expensive projects. So far resources have been earned by exporting energy and commodities. If the government's strategy is diversification out of natural resources, from where is the money going to come? This is a dilemma which the group of experts called by the government to revise the Strategy 2020 – a strategy drawn up before the crisis – has attempted to resolve; coming to the conclusion that diversification will take a long time.

Another, and perhaps more interesting, set of reforms concerns institutions. Among the institutional reforms – approved or in the process of approval – that could, in theory, lay the foundations for a major shake-up of the economy are the following:

- The transformation of state entities under a special mandate into a hundred percent Joint-Stock companies, the equity of which could be put up for sale if and when the government decides
- The revision of the Law on Strategic Sectors, which brings down the number of those to remain under full state control (approved by the Duma in its first reading, March 2011), and making it easier for foreign investors to acquire minority stakes without incurring government selective action of approval or disapproval
- Prohibition of high-ranking state officials to chair, or belong to, the board of public companies
- Plans to privatise large-scale companies, including energy, in part or in whole (still a blueprint only to be considered for future state divestment)

These and other provisions potentially point to a new wave of privatisations on a scale similar to those of 1995, according to some of the most recent plans devised for 2012–2017 by the Ministry of Economic Development. The value of the total assets put up for sale has been estimated between \$75bn and \$180bn. Much will depend on the timing and procedures of the sale. The memory of the corrupted privatisation deals of 1995 is still fresh; which is perhaps a good deterrent against similar attempts, but also serves as a warning to interested investors. On the positive side, one should note that the authorities' approach to foreign direct investment (FDI) is changing relative to the hostile attitudes of the past. Both Medvedev and Putin have attempted to court FDI with attractive promises. Medvedev's attempts sound like more than just promises. 'We have changed,' he announced in the summer of 2010 at an annual meeting with the business community of Saint Petersburg. On the more problematic side, the reality is that Khodorkovsky and Lebedev remain in jail and the death of Magnitsky, Hermitage Capital's lawyer, whilst in jail remains suspect – since the two doctors who were officially blamed a few weeks ago of improper assistance were possibly scapegoats rather than the primary perpetrators.

Whilst promised structural changes look impressive, it may be interesting to see the changes to political organisation which are supposed to be the driver and foundations of reform. As we know, the Parliament is controlled by the majority party, Edinaya Rossiya (ER), founded by Putin a few years ago. To date, other parties (altogether six) have had practically no role. Right Cause (RC) led for a while by billionaire Prokhorov seemed at one point to be capable of attracting enough votes to be represented at the Duma where Prokhorov was hoping to win 7 to 15% of the vote. This project collapsed as a result of RC's internal squabbling. But, interestingly, Prokhorov is presently one of the candidates for Presidency in 2012 after drop in support for ER at the December 4 2011 elections and the subsequent turmoil amidst vote rigging.

In this context – that is, one of far-ranging modernisation goals and rigid political structures – one needs to mention the creation of the All-Russian National Front (ARNF) by Putin; an organisation which reminds me of some developments seen during the twenties and thirties in Italy. The ARNF is supposed to help coalesce independent people and organisations around a few slogans such as love for the Motherland, might of the state, social justice, improved welfare – whose relevance should be appreciated *a contrario*. That is, who would dare to distance themselves from such goals? In fact only a few intellectual groupings and people have openly refused to join the Front. This organisation, led by Putin, was created before the Duma elections in December 2011. It is helping to attract independent candidates to the Duma by including them in the Edinaia Rossiya party list (25% of the total allotted to the

party), on the proviso that they are selected at the so-called primaries, organised throughout the country, and approved by Putin. This development simultaneously broadens Putin's own constituency for change beyond 2011. Apparently some 4,700 people emerged from the primaries as talented people who can qualify for elections either at the federal or at the regional level, or for other relevant positions. On September 24 2012, in agreement with Medvedev, Putin announced that he will run for the Presidency in March 2012².

Philip Hanson: I am going to discuss the 1990s and focus on the earlier processes of transformation (or lack of transformation) in Russia to shed some light on why change in Russia has been so distinctive- why it has been what it has been. I will focus on the Yeltsin period and in particular on the importance of initial conditions which have had very long lasting effects in the case of Russia.

At the end of 1991-beginning of 1992, Russia had certain advantages: it had a popularly elected leader who was anti-communist; it had a dedicated team of reformers who had been looking at more or less radical versions of reform for a decade or so, and they were put in place to push the process of change: so far, so good.

The disadvantages are the ones I want to focus on. First, the scale of the initial distortions in the economy, the extent to which, if you marketised the economy, prices and quantities had to move enormous distances. That was fundamental. All other ex-communist countries had distorted economies but Russia had a particularly distorted economy.

The other point which is highly significant is the fragility of political support for this process of reform. Here there is an interesting comparison with Poland. The Gaidar team was very much influenced by the Balcerowicz reform process in Poland. They went there, studied, and talked to the people in the Polish reform team. Before the end of 1992 Polish output was recovering already, so this was quite a hopeful example. One of the differences, however, was the lesser degree of disequilibrium in Poland to begin with. When the heavy-handed, difficult reform process started there, some things had already been done by the previous communist government, which had partially liberalised prices for example. In the Russian case, there were these huge distortions which were always bound to lead to very big shifts in levels of economic activity and price levels.

When prices were liberalised in Russia there were some restrictions imposed. In particular, the government passed down to regional authorities some powers to constrain price levels of basic goods. I do not mean just energy and housing, but food prices as well. It was not by any means a thorough going liberalisation, though still a pretty substantial liberalisation of prices. It produced a 1500% increase year on year (1991-1992) in consumer prices. That was a traumatic experience, on a scale not experienced in Poland, nor in other ex-communist countries. The political support proved to be very fragile under those extremely demanding conditions¹.

I think it is interesting to compare those countries in which there was some element of patriotism or national spirit, which could be harnessed to the reform process. When the Estonian bank moved to its own currency in April 1992, they were looking to build up

¹ see also: *The Psychology of Post-Totalitarianism in Russia*, by Leonid Gozman & Alexander Etkind, CRCE, London, 1992

² Putin was inaugurated President on 7th May 2012 and Medvedev became the Prime Minister

reserves from practically nothing. They needed gold and foreign currency to support the currency board. They offered the kroon in exchange for the people's hoards of dollars, Finnmarks, Deutschemarks etc. Their estimated amounts turned out to be much less than was in fact forthcoming. So there was this sense of Estonian patriotism and of the restoration of sovereignty. The idea of returning to their own, Estonian currency was very popular (unfortunately now they have the euro). There was a feeling that adopting the kroon was consistent with being a real Estonian: the two things went together.

Compare the reaction to reforms in Russia of many people, including the intelligentsia: there was this feeling which was summed up by Alexander Zinoviev: 'the anti-communists tried to destroy communism, and ended up destroying Russia.' There was the sense that the '*sovetskiy obraz zhizni*', the Soviet way of life, was some way identified with being Russian. This is not unreasonable: after all, the Soviet way of life was a Russian invention. It had not been imposed by an occupying power. One indication of what the reformers were up against was that the Gaidar team described themselves as a Kamikaze team. They were criticised for not consulting, persuading, trying to put across why they were doing this to the population, but they apparently did not see explaining and justifying their actions as part of the job description. If you see yourself as a Kamikaze pilot diving onto an enemy aircraft carrier, you do not consult with the captain of the carrier. Not surprisingly, such political support as they had ebbed away very fast in 1992.

Two consequences are worth pointing out. First, of the standard agenda of liberalisation, stabilisation and privatisation, it turned out that the process of macroeconomic stabilisation was the most difficult. If you read Yevgeny Yasin's account of developments in the 1990s, he said: we tried stabilisation in the spring of 1992 and gave up. Then we tried in 1994-1995, and gave up; tried again in 1995-1997 and finally got somewhere with macro-economic stabilisation. Compare this with Poland, where tough and persistent macroeconomic stabilisation was pushed through at an early stage. Macroeconomic stabilisation in Russia was not credible and very slowly became incredible; that was part of the problem.

One thing that is often misinterpreted is to do with privatisation in Russia. Privatisation was not the biggest difficulty, it was stabilisation. There were 16 500 large industrial enterprises privatised in the voucher programme 1992-94, an astonishing administrative achievement, that was primarily the work of Anatoly Chubais. He was and is an exceptional economic administrator.

The second point concerns the loans-for-shares episode in privatisation. Duncan Allan was the first person, to my knowledge, to point out that given all the circumstances, it was not such a rip off as it is usually perceived to be. And now Daniel Treisman has done a further study of the loans for shares story and comes to the same conclusion as Duncan did.

Chubais gave an interview about a year ago, talking about his view of the early privatisation and early reform process as a whole. The policy choice, he said, was between allowing continued theft of Russia's assets by those best positioned to steal them, and to create some degree of legitimacy to the process of asset acquisition. Those who were nearest to the assets, he said, were bandits, OBKOM [regional] party secretaries and enterprise managers. Those people were stealing the assets anyway. What we did, he said, was to give the assets to these people [directly or indirectly – PH], and thus imbue the process with an element of legitimacy that would not otherwise have been there. That is a bleak view but, it is a tenable

argument about the way in which privatisation developed. (Incidentally he is also saying that Vitaly Naishul was the person who first put forward the voucher process, and it was Naishul who advanced the view that a form of *de facto* ownership of assets by officials had already developed in the 1970s and 1980s.)

Duncan Allan: We have had a review of transition in Russia and also some thoughts about where Russia might be heading. That is a pretty good start. I am going to throw the floor open now. Tomasz, would you like to kick off please?

Tomasz Mickiewicz: I shall try to be brief. First of all, why is it important to talk about the case of Russian transition? Because unless we understand what happened in the 1990s, we cannot understand where the support for Putin is coming from. We need to understand the 1990s, or else Putin cannot be explained.

The second point is that I truly enjoyed Phil's diagnosis. I could not agree more; lack of stabilisation was a bigger problem – privatisation initially had public support. There was a big difference between mass privatisation and then what happened later: the loans for equity and other scandals, which undermined the legitimacy of privatisation. Between those two was the breakdown of political consensus. If you were to paint a timeline, what happened between was the conflict between Yeltsin and the parliament. And it was clear then that it was not going to be a democratic country any longer and therefore also detrimental for establishing a liberal economy.

There are two further points – one is an image that I would like to give you. It is the image of Moscow, which was very much like Warsaw at the beginning of the reforms, where everybody was trading on the streets. The difference was that at one stage Luzhkov sent police to clear the streets, because he did not believe that this was the way in which an economy should function. And that was the defining point and because it happened in all other cities thereafter. This also had economic implications, social implications, because poor people found it far more difficult to support themselves, and so on.

My second point is a question to Silvana: what about Russia joining the WTO? It's a symbolic point, and clearly it links to some hope of liberalisation.

Duncan Allan: We have got three more questions, and then I shall take the answers as a group. Mr. Stanchev.

Krassen Stanchev: I have several points. I really do not think that there was another approach to privatisation other than the one implemented. I remember Vitaly Naishul¹ explaining these alternative connections to central planning; and in this respect you could not have had another approach to privatisation besides allowing everybody who was already taking stakes, bits and pieces, of the state-owned companies, just to have them legalised somehow. Obviously in this competition the managers were much more reliable new owners. What did not help managers or Russia, was that ultimately the playing field was not level. It was not level because at the beginning they believed that they would need a court, or a prosecution, to go after the bandits. So they believed – it was a top-down approach – that an economy cannot function without a contract and property law, or enforcement of it. One of

¹ See by "The Supreme and Last Stage of Socialism" Vitaly Naishul., CRCE, London 1991

the reasons not to make a level playing field for everyone was, from the start, their negative sentiment towards foreigners. If they opted for access to foreign savings, they would have introduced the rule of law, at a very early stage, but they did not want to do so. Ultimately, I think that the entire reform was fairly ideological. It is most helpful that Phil reminded us of the negative patriotism of the early nineties, when this dismantling of communism was perceived as the construction of Russia; but it is still there! A year and a half ago Putin said that the greatest tragedy of the twentieth century was the dissolution of the Soviet Union. I think just the opposite. Imagine if the coup of 1991 had been successful – what would have been the story afterwards? I think that there could have been a civil war, or a war between different republics, and it would have ended in something disastrous. What actually happened was that the coup failed, and the Soviet Union was dismantled in a fairly reasonable way. Most of the problems of the former Soviet Union can be found in those constitutional arrangements of the dissolution.

Duncan Allan: I am conscious that we have three further people who would like to ask questions. Laszlo, could I ask you to contribute please?

Laszlo Csaba: I will continue from where Krassen has left off. My comments on Silvana and Phil could be long, but I will just state a thesis to generate debate. First, this tendency to keep outsiders and foreigners from business – if we are somehow to name and explain this insider domination – cannot be because it is a strategic choice. You can have such a strategic choice – one thinks about China and Japan. But Russia is just one of the nations, or one of the elites, which has chosen insider domination; for the reasons that you have started to explain; in part dependency, in part conscious political choice. That is one of the models of capitalism that we know.

The second point, which relates to the first, is that whole theory and debate about resource curse. This is a theory which was developed to understand why, especially in the African countries, the more natural resources you have, the weaker the state and the poorer the performance. For example, the wars in Angola and so on. Is this not also the case for Russia? Once you have the resources, as the theory goes, it is easy to expropriate – you do not have to make all the efforts and sacrifices; you do not have to buy all the uncertainty – you just get the money and run. It is easily understandable; in fact it is a micro foundation for what we see.

Thirdly, I think that if prices are above \$110–\$120 a barrel, it is very difficult to imagine that it translates into a soft budget constraint. A tight budget constraint existed only for one year in Russia; a point which has several implications for how long your theory will hold, and which of the two options they are likely to take.

Duncan Allan: Can I ask Silvana and Phil to respond to the first three contributors to the discussion?

Silvana Malle: I will start by responding Laszlo's last comment. Oil prices are very volatile. I am not sure that they are going to stay at 120, or around that level, but there is now agreement among the authorities that there will be a need for at least \$116 per barrel to keep a balanced budget. Noticeably, only one year ago the government believed that \$80 per barrel would be sufficient. One may say that Russia is currently approaching some hard budget constraints. If the world economy is going to stagnate, as many projections are showing, it

will be very difficult for oil prices to increase and/or remain comparatively high. The bonanza in the early 2000s is no longer possible, and most Russians realise that. The crisis was helpful in this regard, because it showed how dependent Russian growth is on oil prices and why Russia should diversify moving to a different model of growth. This is indeed the current goal, but its mechanism, in terms of actors and incentives, is still incomprehensible to me. What emerges is a top-down strategy to diversification that belongs to a well-known Russian frame of mind, although other paths proposed by reformers should have been considered.

The resource curse: I am not sure how compelling this is. Certainly Russia has been leaning on resources, like many other countries as you said. Ljubo Sirc has compared Russia and Saudi Arabia. I am not sure about the fatality of the resource curse itself, because we have other examples in the world of 'resource-based countries' – the United States was a resource country in the very beginning; Canada has been a resource country and Australia still is in large part though rapidly moving out of this straight jacket. Countries can work their way out of a 'resource curse', if they choose more flexible paradigms of development. If they do not, they are likely to remain rent-seeking economies, as you suggest.

On the subject of foreign direct investment (FDI), I agree that the choice could be difficult because foreign investors are inclined to strive for quick returns. But their incentives to invest long term do also depend on the business environment and protection of property rights. These institutions in Russia are still weak. FDI is exposed to comparatively higher risks. Of course you will always find some greedy foreigners, who would be ready to invest no matter what the business environment is, particularly if they are confident that their own country/taxpayers would come to rescue them if things go wrong. Unsurprisingly, many European state companies are bolder in investing in Russia.

Duncan Allan: There was also particularly a question by Tomasz, about the WTO.

Silvana Malle: The WTO question is a very good one. This is an area where you can really see that Russia has not made much effort to integrate into the world economy. They applied for WTO membership in 1993, the same year as China, and China managed to enter in 2001. The Russians are still waiting (though the time for accession is approaching)¹. Instead of accelerating work for membership into WTO, the government decided to opt for a Custom Union with Belarus and Kazakhstan that has been approved and is being considered as a basis for the enlargement of a Eurasian Economic Space. The tripartite Custom Union was Putin's strategic choice, and the countries involved managed to agree upon it relatively quickly, despite several problems in making it work properly.

Nonetheless, for Putin the creation of a Custom Union and its possible enlargement have not only economic grounds but are also a way to provoke the existing members of WTO, whom he accuses of unfair negotiation treatment. The intention is to show that if WTO is not really interested in Russia, the country can and will do without. Putin's ambition is to attract Ukraine, despite its WTO membership, into the Custom Union. While Ukraine resists, for good reason, there are smaller republics, like Kyrgyzstan, which are pleading to be included and other poor countries may follow. Russia is, indeed, moving to recreate some sort of post-Soviet economic space, even though each country in the existing Custom Union still carries

¹ Russia joined WTO in 2011

out separate negotiations for entry into the WTO. Russia's entry into the WTO has been envisaged - after the agreement of the 2011 December Ministerial meeting in Geneva - for mid-2012. In the meantime however, resistance to some WTO requirements is increasing and the thorny issue of the Jackson-Vanik amendment has still not been resolved with the US. It is still possible that – all things being equal – ratification will take longer than expected! All in all, yes, Russia will enter WTO sometime in the near future, but this will not be at the expense of other projects, like carrying out and enforcing a post-Soviet Eurasian economic space, the security contours of which are more evident than the economic advantages.

Duncan Allan: Phil: would you also like to have an opportunity to explain?

Phillip Hanson: Just to pick up on the point about the WTO. I agree about what Silvana has said – I do think that it is an interesting area where Putin and Medvedev quite clearly have different positions. It is always difficult to know how much weight to attach to that, but it is quite clear that Medvedev is more favourably disposed towards WTO accession than Putin. So it might make a difference what happens in the managed election this year.

I am easy about this hard budget constraint/soft budget constraint approach, because I always think of that, although it has macroeconomic consequences, it is a microeconomic phenomenon. I am not entirely happy about talking about a *state* being subject to soft budget constraints. I know what Silvana means, and I agree that the windfalls from rising – not just high-level, but rising – oil prices have been a very significant factor. But the 'Dutch Disease,' that particular part of the resource curse, *does* affect all sorts of countries – it is affecting Australia at the moment; where the currency has gone so high that other parts of the Australian economy are suffering. So this is not something which is necessarily controllable by the government.

I would like to raise the question of whether perhaps we should think of the Russian economy as a kind of dual economy; in the sense that there are parts of it that function, for want of a better word, fairly normally. I am thinking of things like the whole development of business services in Russia, which did not exist before – you have got recruitment agencies, property development firms; a whole sector of the economy has developed which simply did not exist in Soviet times. And those are to my mind reasonably competitive on the whole. They are operating in this highly corrupt environment, in which an incumbent firm can use its political connections, its official connections, to keep out new entrants. That is a very fundamental problem in the Russian economy. But given those overall environmental differences, I think there are some parts of the Russian economy that are reasonably competitive in some broad sense. If you look at software, there is Yandex in search engines and Kaspersky Lab in anti-virus software; which are highly successful; not just nationally, but internationally. I think that the common element in this part of the economy, which is a little bit more helpful looking, is that it does not have a Soviet heritage. It is almost the case with retailing as well. And in these areas – certainly in retailing – there has been a reasonable amount of openness to foreign direct investment.

The other point that I would like to draw attention to is whether keeping outsiders out can be a viable strategic choice: I just wonder whether it is viable for Russia given the condition of the Russian state machinery. What may have been workable for Japan, may not have been in reality a practical medium to long-term possibility for Russia. If you have such a very

corrupt state, a very ineffective state, can you really manage that preference for insiders rather than outsiders?

My final point is that the revisions to the Putin plan are now underway. There is an interim report, which I expect some of you have seen consisting of 517 pages of revisions to the strategy of 2020. But the executive summary, which is all I have read so far, says all the correct liberal things – that there must be a level playing field, that there must be a removal of those circumstances which enable incumbents to have advantages over new entry etc. What I suspect I will not be able to find in the report is exactly how this is going to happen politically. But the intentions of the people producing that interim report are impeccably liberal.

Duncan Allen: Could I ask Karl-Peter Schwarz and then Oleg Manaev please?

Karl-Peter Schwarz: I would like to return to Silvana's initial question. Do we expect changes in Russia, or should we expect a continuation of the status quo? And if I think of the current behaviour of the politicians tasked with Russia, I see very few elements of this talk of educated change or of strategy. Maybe there are still differences in the prices of gas and oil, but the revenues will always be there. There is a budget constraint; well, the American example is to do some quantitative easing, and you can manage it. I do not see any *real* incentive for the Russians to change their strategy.

Duncan Allen: Could I also inject a supplementary question: to what extent is serious economic reform possible without political reform? Oleg Manaev.

Oleg Manaev: I think that both Silvana and Phil have presented very important and well argued points. But I think that we should slightly alter the aspect of our discussion. We should not just analyse or summarise the experience of what could be the case of change in Russia, but what we could, or should, expect. And the answer to this question depends on our answer to the first one. What are the major factors behind these changes and here you have to make a projection, from the experience of the previous two decades to the next ten or twenty years; or as Silvana will probably mention: what are the drivers of modernity? Who are the drivers? Is it the leadership, the public, natural resources, foreign investments? Silvana herself emphasised leadership, with a view to why and how the Russian authorities could be forced to assimilate. Yet Phil emphasised the public. I really do not know but I think on the one hand everything is equal. I think that in Russia's case, in particular, we ought to identify the dominant factor. To my mind (maybe because I am a sociologist, not an economist), the *most* important element is exactly what Phil was stressing – it is the public. Not the public itself, but public expectation, because of the point that he highlighted about public and political support. But generally speaking, it is the public, or society, which counts.

We are not speaking about the old authoritarian Russia; we are talking about modern Russia, not very free and fair, but with elections, so the leadership depends on the public. What can we find in the Russian public now, and what could we expect in five, ten, twenty years from now? On the one hand we have the results of various public opinion polls. On the other we could now analyse, and we see what kind of new leaders are emerging, what they are trying to offer to the society. In this regard a judgment was made referring to the experience – did you watch, did you read about, he was an unsuccessful candidate, but he wanted to stand. Did you read about Ivan Okhlobystin who ran recently? He is an actor, a cinema actor, about

fifty years old – who announced a month ago that he will run for the presidency. He organised a huge presentation in the Kuban stadium and thousands of people came to hear about the programme for the future. It was a sort of a response to the ‘Russia, forward!’ programme by Medvedev. He was impaled. It’s terrible! Orthodox belief, you know the sort of thing, self-sufficient ... no country for foreigners and so on. This is a very clear answer to our question about what the priorities for the future. And let me stress again, he is not from the former nomenklatura, he is not from the right, he was not from Zhirinovskiy’s party, KGB or whatever. He is from a liberal background.

Duncan Allen: Thank you Oleg. I’ll take one more question in this block – Alena.

Alena Zemlinerova: Yes, my question is to Silvana. I have a question, related to innovation and the transfer of technology, and related to the competitiveness of Russia. Economists in general agree that innovation is an important assumption for growth (of an economy). But economists do not reach any consensus as to the drivers of innovation. You have the opinion of Schumpeter, who says that monopoly and large companies are important. You have Barro, who says that competition and small businesses are important for innovation. We also know that most developed countries encourage innovation and research and development. They support books, space for research, universities, but also companies. So my question is what would be your advice as related to Russia?

Duncan Allen: Thank you. Silvana would you like to respond to that question, and then I sense that there is an interesting, more general issue which emerged from those questions, about the political context of future reform in Russia.

Silvana Malle: That is a very good question. As you know, there are indicators of innovation; and the OECD is one organisation that produces a report on innovation each year or so, basically (but not only) ranking all countries by how much they spend on innovation. The budget reveals how much is spent on research and so on. My problem with this approach, even when I worked at the OECD, is that the budget tends to measure innovation spending through salaries paid to professors, teachers, researchers and similar staff. These people are indeed a part of the process of creating new products and processes, of critical thinking and new approaches to innovation. But whether the sum a government spends this way is really an indicator of (better/worse) innovation, I doubt. So you are right in pointing to different positions on the structure of the economy – and the real drivers of innovation. Well, from what we know, I would suggest that the actual drivers are rather small and medium – mainly the latter – sized companies. This is simply because they are more exposed to competition. Competition is an important ingredient of innovation. And once again, in Russia, we do not see much of that. So my advice to Russians would be: first tackle your competitive environment. Top-down innovation may deliver in some cases but it is not the right approach. In Russia there is Skolkovo, which we all know about, and the agencies created by Putin – such as the Agency for Strategic Initiative. While one cannot rule out some positive developments in selected areas, particularly if military items are included, it is highly unlikely that this approach would help the whole country to modernise let alone achieve the status of a high tech country.

Duncan Allan: What about the wider question of the political context of economic reform?

Silvana Malle: The political context – you know, I love this topic! I *love* it. I have been writing about it. A new article of mine should be published soon, the first section of which deals exactly with the the political context of Russia’s modernisation drive- which is awful! If we tackle critically issues such as modernisation, we need to first ask ourselves *who* wants it. To be more serious: what is the political context? This could be quickly summarised by the deputy head of the Presidential Administration Vladislav Surkov’s assertion that economic growth has to *come before* democracy. He put it in a nicer way, arguing that democracy inevitably follows economic growth. Is that so? If you go through the history of Russia, you certainly do not find evidence of that. True, Russia had spells of growth through history, as I argued in my introduction, but was that followed by democracy? Similar features can be found in other countries, perhaps mostly in the East. First, we can find some arguments in western political literature in favour of growth, followed by better government based on some historical comparative evidence. But this is neither theoretically robust, nor deterministically proved. Going back to Russia – the underlying belief is that the government is going to force diversification, modernisation, economic growth on a better economic basis, *only* if there is *no* democracy, only if government can guarantee stability. Even for the reform-minded President Medvedev, ‘democracy is an obsolete idea’! Frankly, I would like to know why many consider him as a liberal, in contrast to Putin.

What Medvedev suggests is that other institutions, of a technical nature, such as the internet and its various devices to connect/chat to people, offer an alternative to traditional forms of democratic representation. Most Russian authorities, think that having the levers of change in their own hands will facilitate this process of modernisation, just as it was with Peter the Great, Catherine II, and so on throughout history. This is a highly questionable approach. But does this mean that Russia will not modernise? I think that would be a strong, and possibly wrong, assertion in the light of Russia’s history and on-going command on resources by the authorities. Russia has a legacy of top-down modernisation before and during Soviet Union. Where did the modernisation start? It always started in the military. The current government allocated 20 trillion from now until 2020, which is six hundred and fifty billion dollars or something – about \$65bn each year – to modernise the army. I am convinced Russia will indeed modernise the army and there will be some positive spill-overs, as in the past, even in the less than accommodating competitive environment which will make them comparatively costly. If so, we would do better to start thinking about what Russia can become, after the formation of, and thanks to the support of, the All-Russian National Front in ten to fifteen years.

Phil Hanson: I largely agree with what Silvana has said. On incentives to make changes: there seem to me to *be* incentives to do so, from the fact that everybody now is seeing Russian growth, at least in the medium term – let us say until 2020 –at about 4% per annum *at best* (it could be worse), whereas they had a period of being accustomed to 7%. And, as Oleg has indicated, its public expectations were raised by that period of relatively rapid growth. And now there is a sense of disappointment; at least amongst the policymakers, and I suspect more widely than just the policymakers, that somehow Russia has fallen back again. Now of course, 4% would not be bad internationally, given the current set of conditions. But it is not good enough for the Russian leadership. They want and they have a serious desire to make the economy grow faster; which brings us on to the question of the political environment for that.

I personally think that the direct individual material interests in the present order of things, of the top leadership, are so strong, that they have every reason not to change the fundamental way in which the economy works; *not* to make it a level playing field – because they are heavily invested, so to speak, in the present set of networks and crony relations which prevail.

Finally, if I am right – just on innovation, technological innovation – there is a very interesting open letter by an expatriate Russian scientist; a Russian born, Russian educated scientist, working abroad. An open letter to the president and prime minister, published in late 2009, regarding intellectual property organisation data on international patent applications. And Russia does not look too bad, given its per capita GDP level, in total number of applications. But if you compare over time – I selected between 2000 and 2001 together against 2009 and 2010 together – just the number of these patent applications compared with Brazil, China, India, Mexico and Turkey, all those other emerging economies show a big jump in the number of patent applications. Russia shows barely any change at all over that period. So a lack of dynamism is I think an absolutely fundamental problem. And that is not something which is going to be overcome by something like Skolkovo.

Duncan Allan: I have three people on my list. Could I please invite Krassen, Matej, and then John?

Krassen Stanchev: I will start with a famous Russian aphorism of the mid nineteenth century. It goes as follows: if in the zoo you see on the elephant's cage a sign reading hippo, do not trust your eyes. So when you look at Russia you never take what is being stated as reality. One of the things, which explains competitiveness in some of the very good quality sectors of Russia, in my opinion, has to deal with the very fact that there is a natural Russian, or former Soviet Union, market, and which is close to three hundred million. So you produce Russian coffee, and you sell your coffee to a market of two hundred and fifty million, and you make money. That's why both Yandex and Kaspersky are doing well, and why many other similar industries are flourishing.

Secondly, the former Soviet Union – those countries excluding the Baltics and Georgia – the politics in this area, should be understood not from the point of view of the international relations but from the point of view of the small groups such as sociologists. Because of what happened in Russia with the enterprises, this happened in the former Soviet Union with the countries. Those who were in the best position to rob them were basically given the countries. So what is going on now is the protection of this position and it goes through the WTO and everything else. I have worked in Central Asia and I was amazed by how free the Kazakhstani economy is; not only the Kazakhstani economy, these special relations that go through to the former Soviet clubs, so to say. You cannot export a drop of petrol from Kazakhstan, without a connection to Putin. It is as simple as that.

Then you have all the instruments like the WTO, the customs union and so on; just to keep this position of these people who control the peace. But this is the sociology of small groups. This is nothing more complicated.

Matej Kovac: I want to share a personal experience, and an experience of how companies are taken away. Without property rights and without intellectual property protection all these modernisation and high-tech ideas are really a blunder. We wanted to expand our company using information technology, liberal informatics and up to date publishing, and were keen to

work with foreign countries. We started negotiations with several venture funds for financial backing. For these negotiations we prepared studies on expanding our services to Italy, Serbia, Turkey and Russia. We needed to select one country to start where together with the financiers we found a most likely investor, someone who was very interested in the business, in the technology and so forth. But after some discussion of various problems he said drop Russia from the list; it is not interested at all, and we were very upset because to us that was the most promising market. We had already researched local competition and knew it was not highly connected to the *nomenklatura*, and so on, and we had received encouragement that everything will work out fine as long as you do not make money. Once we started making money there would be no guarantee, no insurance. They told us stories – not about strategic material, not about raw materials—about clothing retail chains, and the like, where Western entrepreneurs were put across the table and their lives threatened for coming back. This is not only relevant for foreign investors, but I think it is also true for the young Russian; a young, technologically-minded person. He will get a scholarship for Skolkovo, he will do all these things and everything will be fine, until he starts to make money and keeps his earnings for his innovations. I believe that young people are capable of participating in Russia's technological advancement and they know it. That is why they leave the country because they know that they are in the same position as the foreign investor.

Duncan Allan: Thank you for that wonderful advert for the business environment in Russia. John.

John H. Moore: Well Phil mentioned Kamikaze pilots a while ago, and I want to begin by saying that I think there are very few Kamikaze pilots who are politicians; they do not operate that way. What they want to do is to maintain and increase power, that is universal I think. One striking thing to me about the discussion so far, has been that it has focused largely on plans in Russia to modernise; *plans* in Russia to modernise! These are plans that are coming from the top from the leadership – when what is really needed in my opinion is spontaneous development; a development if you will of a spontaneous order. This is so for Russia and any other country for that matter.

Steve and I were at a conference recently when Erica Michalowski was one of the main speakers. I do not know how many of you are familiar with her recent work. She tries to explain why it is that for several thousand years the per capita income worldwide was only about the equivalent of three dollars a day, and then suddenly at the beginning of the eighteenth century and for the next hundred and fifty years and so on it went through the roof. Her argument really has to do with the development of spontaneity and a change in attitudes towards innovators, and people who make money, who earn money – she calls it bourgeois dignity. There are two components to that: one is respect for the bourgeois, and the second is liberty, or freedom to innovate; those are the two things that she identifies as being the keys.

This links, by the way, a little bit to what Phil was saying about the possibility of a dual economy. Perhaps it is the case that in these areas, where the state does not have a previous interest, a dual economy is developing – or a secondary sector – that is outside the purview. If that is the case this might be the place to look for, or to hope for, some future. But the problem is that it requires relinquishing power. The leadership somehow has to be willing to relinquish some power – to allow this spontaneity to develop. And as I say, there are a few Kamikaze pilots among these leaderships. I'll say that the U.S. is not immune to this *at all*. For many years – and it still exists of course – there is this agency called DARPA, which has

been credited in some circles for developing the internet. A lot of people claim authorship for that of course, including Al Gore, and now people think that we are faced with an energy problem. So what is the idea? Create an energy DARPA, within the department of energy that will do the same kind of thing. Hey DARPA succeeded – we shall do it again for energy! But, I guess my question, apart from what I said about Phil's point, is that is there any hope for the development of spontaneous order in Russia, that will get it out of this development trap that it seems to be in?

Steve Pejovich: Phil and Silvana mentioned several times, the word corruption. You see, if corruption plays such an important role in the Russian economy, the real question to be asked is: what are the factors on which the corruption depends? Because I would say that one such important factor is the legal system and the theory is just one point.

Duncan Allen: Can I just take one more question, and then I will invite Silvana and Phil to respond.

Bernard Brscic: On the issue of spontaneity, I very much doubt whether it is the case, as John claims that one should allow spontaneous forces to run freely. The experience from Russia in the early nineties was such that there was also emergence of a spontaneous disorder. So it is not like that if you were to pursue a kind of anarchic policy – if all the politicians would bind their hands – you would necessarily end up with the Pareto optimal solution. It could be the case that certain spontaneous disorder would emerge, as was the case of Yeltsin's Russia, which was a kind of anarchic spontaneous process. However, I think that it is the informal institutions that matter, the values. But one has to ask oneself: where do the values, the bourgeois values come from?

My view is that it is the heritage of the Judeo-Christian tradition. Now the sixty-four thousand dollar question is that when you destroy the religious pillars of the West, as was the case during the Renaissance and the Enlightenment, where do these bourgeois values come from? The respect for private property and law are basic Judaic and Christian values, and in my view it is not the case that you simply adopt a kind of vulgar, laissez-faire policy, if you are without the substance of informal institutions. Secondly, I think that one also needs a well-defined structure of formal institutions; and again if one deals with this type of precise framework, an enlightened politician is required, to install these formal rules, the rules of the day. In the case of Russia, it is the question of course that you do not have the enlightened taskforce that believes in a type of installed liberal democracy. For me it is actually not a question of democracy, as Silvana discussed, because democracy is not a value per se; but just a technology to decide who is to rule the country. So for me the more appropriate question to ask is whether you have a totalitarian system or a liberal system.

Duncan Allan: Thank you very much. I shall ask Silvana and Phil to respond to a broad range of questions. I detect a number of common themes here; to do with corruption and state capture, values and the role of informal institutions. Silvana, would you like to respond to that thought please?

Silvana Malle: I agree with most of what has been said here, as a matter of comment. On spontaneity, my view is that its room in Russia as of today is minimal, despite the post-electoral turmoil and recurrent street meetings in major towns much discussed in the press. On democracy, contrary to what Bernard argues, for me, democracy remains a value. Of

course democratic institutions can be organised in different ways, some more effective than others, but altogether democratic institutions represent people's will. This will is that of different people: investors, workers, pensioners, other groups whose aims and interests are different. Democracy provides an arena for discussion after which decisions are taken according to the rules of the game. The foundation of democracy is protection guaranteed by law to the minority in such a way that there is a possibility for any group of interest to emerge, have voice and eventually coalesce with other. That is, in short, democracy to me, and I have yet to see a better system than this one.

Unfortunately this is not the case in Russia. We do not have time to discuss the nature of the Russian state. There have been many definitions of the Russian state order. In my perception, Russia is a corporate state, though it should be better defined as a *stato corporativo* an expression that does not find a correct translation in English: i.e. a state where the interest of different groups are conveyed first to the authorities and then organised through a top-down institutional compromise in such a way as to serve the government's priorities whilst avoiding major conflicts. This is similar to the state that Italy had in the twenties and thirties. I will not qualify it further; as such qualifications carry with them emotional reactions that are of no use for analytical comparisons. But many of you certainly know what I am referring to. Let me only add that I see with extreme concern, the formation of the All Russian National Front (ARNF) that we did not have time to discuss here. It was formed in May 2011 and won a number of seats in the post 2011 elections Duma after emerging at the ER primaries. This was Putin's idea to which ER conformed with dislike. Having obliged Edinaia Rossia to reserve 25% of seats to ARNF independent candidates, Putin later lifted that threshold letting the number of independent politicians rise from 150 to 185. Acting this way Putin has distanced himself from ER and has gathered the consensus of broader groups to his personal agenda that, as we learned thereafter, aims at winning the Presidency of the Russian Federation from March 2012.

What does this mean in perspective? What would the All Russian National Front militate for? As mentioned earlier its slogans have a populist tone: the might of the state, better justice and so on. They are simple and therefore dangerous because few would argue against them. When the ARNF was formed anyone could join, and many did: individuals and associations, entire streets, condominiums and factories. Only a few people dared to speak out against them openly. This is the political development that really worries me. The organisation is built and controlled from above; it is large, widespread and capable of withstanding criticism with the candour of grass root people's arguments. Spontaneity is left to intellectuals and educated/urbanised youngsters: both groups have little in common and are unlikely to gather around an alternative manifesto and credible leadership.

Duncan Allan: Phil: final word to you please.

Philip Hanson: I am fascinated about the issue raised between John and Bernard about spontaneous order, spontaneous disorder. I do not think we have time to remark on it now, but perhaps for some future conference it would be a good thing to debate. Is Somalia a case of spontaneous disorder, for example? Anyway: just to link up some of the points that have been made about the inward-looking, protectionist nature of the CIS market, as it could loosely be described, and the arguable competitiveness globally of some of the companies to which I drew attention. I think that it is very interesting to look at the pattern of outward foreign direct investment from Russia. Russia is unusual amongst emerging markets in

having the stock of its outward foreign direct investment pretty much on a par with its inward foreign direct investment. Now if what is driving a lot of that outward direct investment is system escape if you like – just getting way from a predatory state – that explains quite a lot of it. But it would be interesting to look in more depth at how it is that Russian metals companies have very successfully invested in North America, in Africa, in Latin America, elsewhere; outside their sphere of political influence if you like.

Now on the question of what deters outside investors from operating in Russia, there is of course, and it is a cliché, this balance of risk and reward. The rewards are potentially very, very high. I am struck by the example of BP, which has been going through a very rough time in Russia; never mind what has been happening to it elsewhere. But through T and KBB they have made sixteen billion dollars out of an initial nine billion dollar investment – that is just the dividends that have come back. Now, the rewards are extraordinarily high. And Steve's point: to look at the risks, or the disadvantages, of the legal system being a key to understanding corruption: IKEA is a beautiful example of this. They have this programme of opening thirty mega-malls, with large IKEA stores as the anchors to those malls, across Russia; more or less in most major cities. And they halted it in 2009 I think after eleven or twelve had been completed, because they had been hampered so much by local officials; seeking, in some form or another, kickbacks for approvals. Now, from what I have read about this, the problem that IKEA faced was that to get all the permissions needed to build a mall, you would have had to spend years just going round to the various offices; just getting the forms, and collecting the stamps, and getting them signed, and so on. So what they did was to embark on building a mall, collecting permissions as they went along, which was the only practical thing to do. And of course they got caught. They got to a crucial point where hooking up the local electricity supply was something that they urgently needed, and they were held to ransom for it. Now that is an example of the point you are making: a legal system full of ambiguities, full of loopholes, full of additional complexities which are not necessary. In fact, facilitate the wielding of this gatekeeper ability by local officials, and not just local officials but national ones too.