

## Russia and the world

by Igor Yurgens for Baltic Forum

Russian history from the mid XIX century — *the history of reform*, successes and failures.

As Russia began to interact with the Western world, it became clear that it was necessary to implement reforms that would encourage dynamic development of the state and society.

To this day, there have not been examples of reforms that have been completely successful: acceleration was always followed by the application of the brakes and as a result the country remained partially isolated and lagging behind with an outdated political and economic system. Over time, it became clear that another application of the accelerator was necessary.

"No matter what types of changes are introduced, after a brief period of successful modernisation, conflict always arises with conservative social forces which block full implementation of further reforms so that modernisation remains incomplete and progress comes to a standstill." Anatoly Vishnevsky, 'The hammer and the rouble'

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1985—1990 — another application of the accelerator to reform — moving towards a market economy, the rule of law and the introduction of Western values.

Incomplete: the market economy was introduced but the political institutions that were introduced are only partially functioning as imitations of the real things and structural reforms have not been implemented.

From the middle of the first decade of the 21<sup>st</sup> century

- New reforms are becoming increasingly necessary
- Conditions are becoming more and more complex

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The institute of contemporary development (founded late in 2007)

2010 '*Russia in the XXI century: a vision of tomorrow*'

'Russia has fallen into a historical trap. The country needs to continue the process of modernisation, but has to do so in an environment in an environment full of inertia and decay.'

"Reaching for the future: Strategy 2012" (2011, for a new presidential cycle)

- Reboot democracy. Move forward on the constitution
- Develop a new economic model based on private business and property
- Reduce the influence of the bureaucracy on the economy by preventing the involvement of bureaucrats in economic transactions
- Social policy: from the fight against poverty to the growth of the middle class

- The Russian people: finding themselves
- Regional policy: to equalise the pace of development through competition
- Developing sustainability: from innovation to ecology, from ecology to innovation
- The army, police, intelligence services – to take the side of the people
- Foreign Policy: Russia in a ring of friends

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2003—2013 — During this period, Russia's economy became increasingly dependent on the production of raw materials, a structural deformation caused by the situation in the world commodity markets and compounded by underdeveloped political institutions, centralisation and both overt and covert nationalisation of the economy.

2013—2016 — economic crisis, caused primarily by falls in commodity prices and to some extent by political factors

From the beginning of the XXI century:

- a deterioration of the investment climate and a reduction of the protection of property rights and of the interests of entrepreneurs leading to a fall in investments, a reduction of business activity and capital flight (from the beginning of the century total capital outflow exceeded revenue from commodity exports)
- deterioration of human capital
- budget commitments outpacing income growth
- Strengthening of corruption at all levels of government

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### **The structure of Russia's GDP**

(from A. Movchan 'The Russian economy in the XXI century')

- Up to 20% — oil and gas production;
- Up to 30% — commodity exports (double the average for developed countries);
- about 15% — the internal energy market and infrastructure;
- about 15% — state projects;
- >10% — the financial sector;
- >10% — independent services and production not linked to natural resources.

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'Ultimately, following the fall in the price of oil, Russia was left with an undiversified quasi-monopolistic economy lacking both the necessary factors and the resources for growth.'

A Movchan 'The Russian economy in the XXI century'

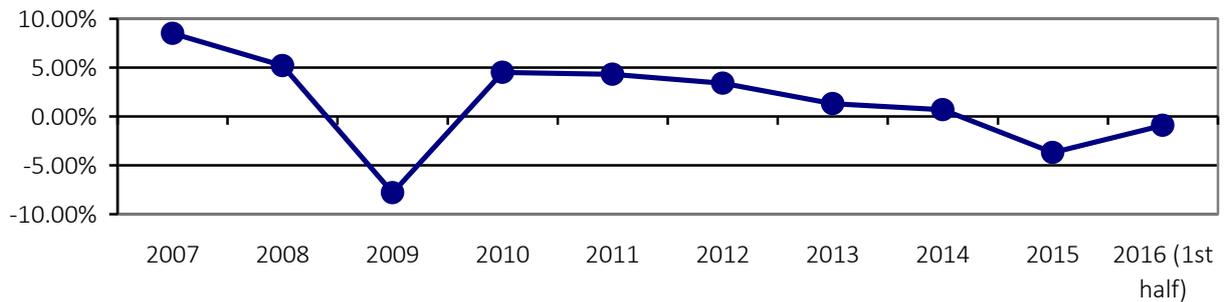
- Industry is operating at 85% of capacity despite the fact that up to 2/5 of this capacity is worn out and technologically outdated;
- Competitiveness is low because of poor efficiency in most areas;

- Labour resources are contracting and their quality is reducing
- Social stratification is increasing
- the share of the private sector as a whole in the GDP does not exceed 35%, whilst the share of small and medium businesses is about 20% (in developed countries this figure is about half)

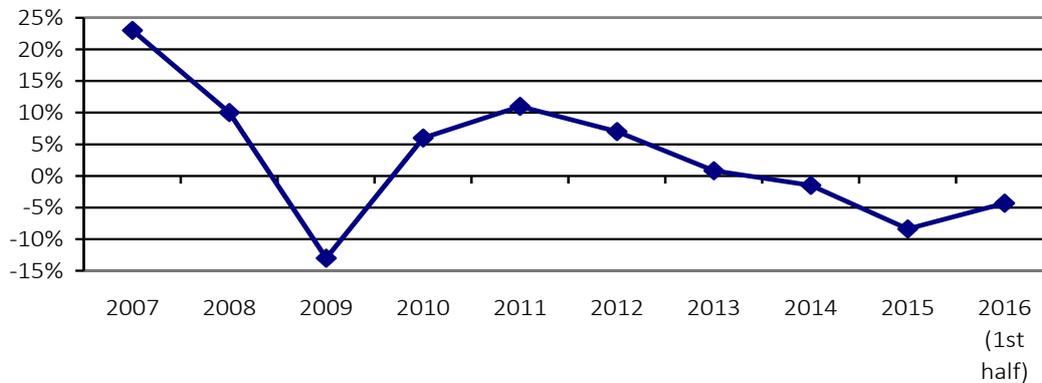
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### The Russian economy in figures

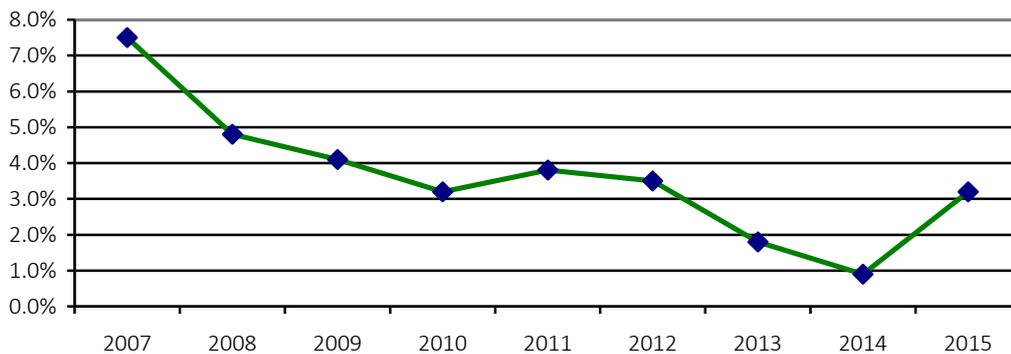
GDP annual growth rate



Capital investment annual growth rate

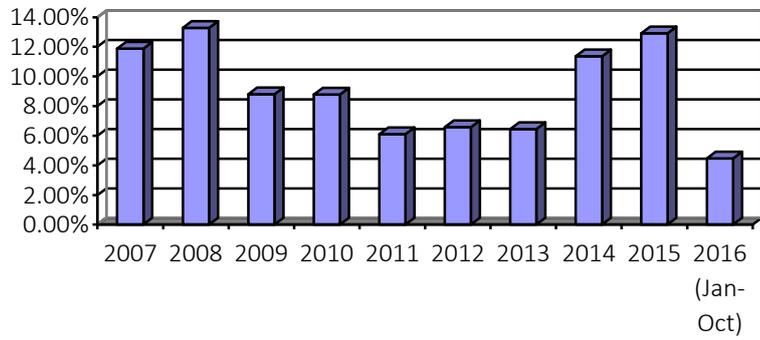


Labour productivity annual growth rate

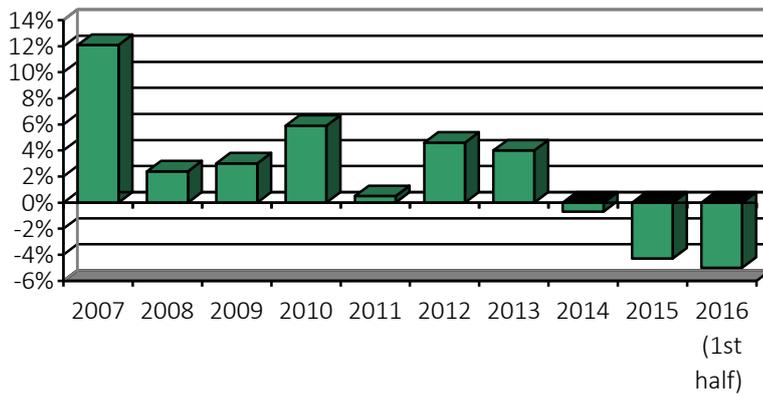


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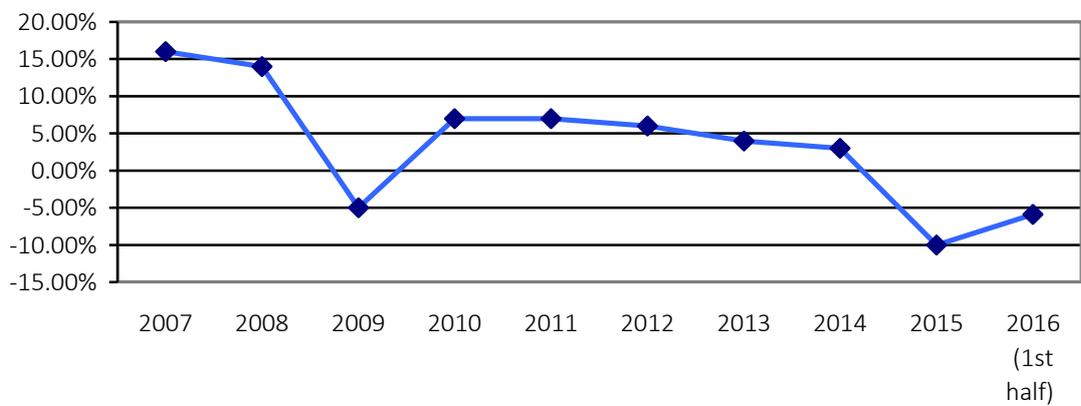
Consumer Price Index (annual growth %)



Real disposable income annual growth rate

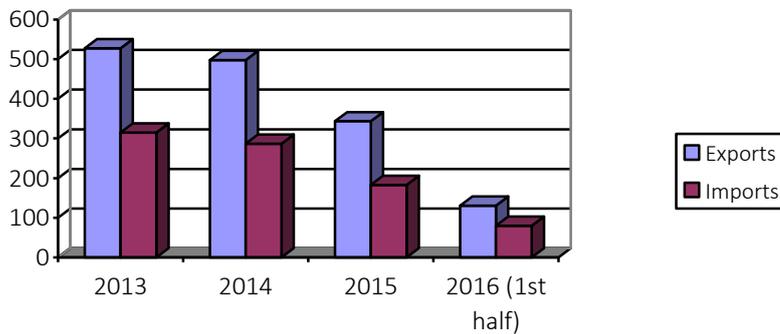


Retail trade turnover annual growth rate



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Foreign trade turnover (US\$ bn.)



Russian foreign trade turnover by country, January-July 2016.

- **European Union (total) 43.7%**
  - Germany 8.7%
  - Netherlands 7.4%
  - Italy 4.4%
  - France 2.8%
  - Poland 2.7%
  - Great Britain 2.3%
- **China 13.6%**
- **Eurasian Economic Union (total) 8.5%**
  - Belarus 5.2%
- **USA 4.3%**
- **Japan 3.5%**
- **Turkey 3.5%**
- **South Korea 3.3%**
- **Ukraine 2.1%**

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The Government is aware of the need to respond to the challenges of the crisis by means of structural reforms. In reality, however, such reforms are only taking place in the banking and financial sectors. The overall policy is to *maintain the level of budget revenues in the short term* by increasing the tax burden, broadening the tax base, cutting budgetary obligations and transferring them to the federal level. The reduction in the revenue from the extraction of raw materials in companies connected with the government is forcing a search for methods of extracting funds from businesses and consumers. One example is the 'Plato' system. The "safety cushion", accumulated by the state and by the population in recent years makes it possible for stagnation to continue at least until 2018) with no catastrophic disruption. The

level of economic well-being at the present time corresponds approximately to that existing in 2006 - a time of stable growth, and of consumer confidence.

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The impact of sanctions - postponed:

- There might be a need for large scale foreign loans;
- The extraction of raw materials could fall drastically due to a poor technological base;
- The attempts to achieve autonomy in various areas such as in IT and the financial system may sharply increase costs and decrease effectiveness.

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**Risk factors** that could turn stagnation into overall collapse: critical mistakes made by the Government;

- A infrastructural crisis;
- A crisis on one of the non-state business sectors such as banking, construction or trade;
- A substantial decline in oil production or a contraction in the external oil market.

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The ministry of economic development of the Russian Federation

**Forecast up to 2035** (October 2016)

Base case:

- GDP growth on average 2% annually (between 1.7% and 2.6%). This is 50% higher than the expect growth of the world economy as a whole;
- By 2035, the real incomes of the population will exceed pre-crisis level by 30%;
- The average annual growth in investment will be 3.3%;
- The annual rate of growth of imports at 4% will be double the growth rate of exports (2%).

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In the absence of other potential sources of growth, the only way out of the general economic crisis is to *reduce risks* by increasing legal protection of property and entrepreneurial activity, and by improving the quality of legislative work through political reform.

**Structural reforms of the Russian economy:**

- A substantial reduction of the pressures applied to the entrepreneurial class at the same time as improving the effectiveness of the legal system;
- Simplifying the burden of supervision;
- Reducing the public bureaucracy;
- Privatisation of large businesses;
- reducing the share of public sector in GDP up to a maximum of 40%;
- reducing the number of employees in the public sector.

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## 2016: discussion on potential sources of growth

### *liberals*

the financial group within the Government

The centre for strategic research (in April 2016, Alexei Kudrin was appointed Deputy Chairman of the President's Economic Council)

Successive structural reforms

### *Central planners*

The social group within the Government

'The Stolypin club'

The 'economic growth' programme. "This is a textbook example of the economic policy illusion, which is supposed to combine super soft monetary policy to stimulate savings, counter-cyclical tax reductions and the total deregulation of business." ("Kommersant", March 9, 2016)

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## The conservative trend

The political conflict between the Duma elections of 2011 and the Presidential elections of 2012 was a conflict between the authorities and the "inner West." From this period developed the open anti-Western rhetoric and the growing conservative trend.

2012—2016

- statist patriotism
- paternalism
- militarism
- 'traditional values'
- Criticism of Western values

Over time, the conservative trend develops:

- more and more harsh and defiant;
- more and more focused on conflicts within society;
- less and less dependent on the Kremlin's intentions.

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2014 y. — the beginning of a new area in Russian foreign policy

*The stated objectives:*

- The formation of a fair multi-centric international system;
- Co-operation in dealing with common challenges.

"Our Western colleagues sometimes heatedly say that with Russia, there will not be business "as usual". I am convinced that this is, in fact, true, and here we agree with them: no more business "as usual", when we tried to impose agreements that take into account, first and foremost, the interests of either the European Union or the United States, and urged us not to take into account our own interests. This story has finished. A new story begins, which can only develop on the basis of equality.'

Sergei Lavrov, Russian Foreign Minister, 26 January 2016.

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*Current priorities:*

- recovery of the world-power status;
- Strengthening ties with the non-Western world;
- Use of foreign conflict to maintain political stability.

The main current problem is the weakness caused by international isolation. "Compulsion to engage in dialogue" (Ukraine, Syria).

Russia intensifies the crisis with the West in the hope that the West will want to first back down. They will not want the conflict to heat up.

The story of the 'plutonium ultimatum'

Vladimir Putin commented about its meaning at a meeting of the Valdai club on 27 October 2016 as follows: 'The conditions you are talking about now and which you call offensive, they set out on paper. This Presidential Decree. This piece of paper.'

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Russia does not have sufficient resources for an open military confrontation with the West nor for a long-term and full-scale arms race - and there is no desire to seek such resources.

**Military expenditures in 2015 (\$ bn.), expenditure as a percentage of the world total expenditure**

- USA \$596.0, 36.0%
- China \$215.0, 13.0%
- Saudi Arabia \$87.2, 5.2%
- Russia \$66.4 4.0%
- Great Britain \$55.5 3.3%
- India \$51.3 3.1%
- France \$50.9 3.0%
- Japan \$40.9 2.4%
- Germany \$39.4 2.4%

*Data: SIPRI, Stockholm*

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'In the next five years, relations between Russia and the United States and Europe will be competitive and intense. Moscow, if not provoked, will not encroach on the territory of NATO, but from time to time there is a potential for incidents on the line of a new confrontation - from the Arctic and the Baltic Sea to the Black Sea, and maybe elsewhere. . Russia will continue to try to compensate for its weaker position. Compensation methods may vary from greater reliance on nuclear deterrence to arranging a favourable balance of forces on the ground. Rapid decision-making and bold action, including the power of obfuscation and "hybrid" operations may also be used. And insofar the stakes for Russia in this renewed confrontation are higher than in Western countries, the country will be willing to take more risks and be more damaging than its opponents.'

*Dmitri Trenin, 'Russia's foreign policy in the next five years: goals, incentives, guidelines '(April 2016)*