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Capitalism* »

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From crisis to crisis: the high cost of the post-soviet institutional lock-in

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Introduction

In this contribution, we shall try to characterise the Russian growth model the way it appears to have emerged in the 2000s, which we believe useful to explain the country's macroeconomic successes at an earlier stage as well as the severe problems it has to face now. The reasons for the choice of the subject are multiple. First of all, whilst numerous analyses have recently sought to understand and appreciate the impact of the crisis, its transmission channels as well as the economic prospects of various nations, the non-OCDE world has not received so much attention. This is somewhat surprising given that the majority of the post-crisis scenarios tend to ascribe the leading role to pull the world economy out of the deadly depressive spiral to the so-called BRIC countries. Among the BRICs, Russia appears to be hit most of all and it is important to understand how and why. Furthermore, the recognition of important differences among institutional set-ups in capitalist economies led to the emergence of an extremely interesting literature on the "varieties of capitalism" in the 1990s and 2000s. But this literature has also mainly dealt with the OCDE countries. Our ambition is to pursue this analysis and shed some more light on the salient characteristics of the specific post-Soviet rent-seeking "exportist" capitalism that gradually emerged in Russia in the 2000s.

We shall begin by presenting the macroeconomic indicators of the Russian Federation between the 1998 crash and up to the recent 2008 crisis, showing their very significant improvements in practically every area (part 1). However, the qualitative aspects of the economic growth suggest asking whether one the main reasons of Russia's economic success (high commodity prices) did not make it seriously sick with the "Dutch disease" (part 2). We shall further show that the impressive growth before the 2008 crisis was followed by a yet more impressive shock hitting the economy to the extent that very few analysts had imagined (part 3). We believe that the propagation of the crisis was amplified by the specific features of the capitalist system that emerged in Russia in the 2000s, particularly its "international regime" (part 4). We conclude our contribution by saying that the Russian model in the 2000 appeared to be intrinsically unstable before suggesting possible scenarios of finding paths to a sustainable growth model.

1. Rebound and Boom: Russian comeback in the early 2000s

The main macroeconomic indicators of the Russian economy since 1999 and until the recent global economic meltdown are quite impressive. The record would look even more spectacular against the backdrop of the economic and social catastrophe the country went through in the 1990s.

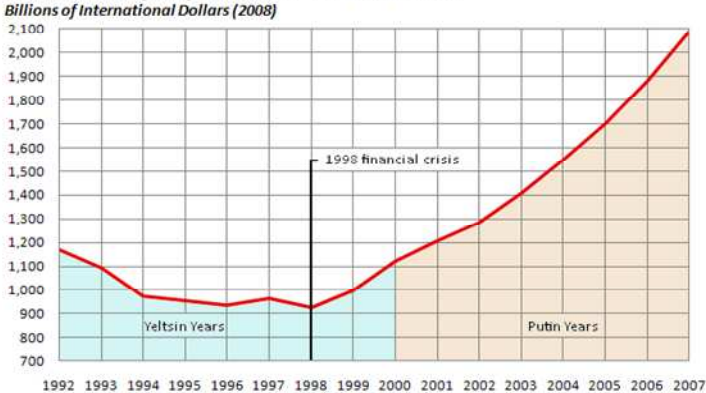
Between 2000 and 2008, Russia's GDP grew at an average annual rate of 7% in real terms (Figure 1). After having nearly halved between 1991 and 1998, it fully recovered its 1991 level by 2007, which made Russia the world's 6th or 7th large economy sorted by purchasing power parity, according to different sources¹.

The investment dynamics during this period – although arguably insufficient given the needs to modernise the economy – is positive as well. The investment recovers considerably after

¹ According to the IMF data, Russia's GDP in PPP was the 6th in terms of size in 2008. The World Bank and CIA estimates place Russia 7th, after Great Britain.

the 1998 financial crash and grows in nominal and relative terms at a steady pace in the 2000s reaching 22.3% of the GDP in the second quarter of 2007.

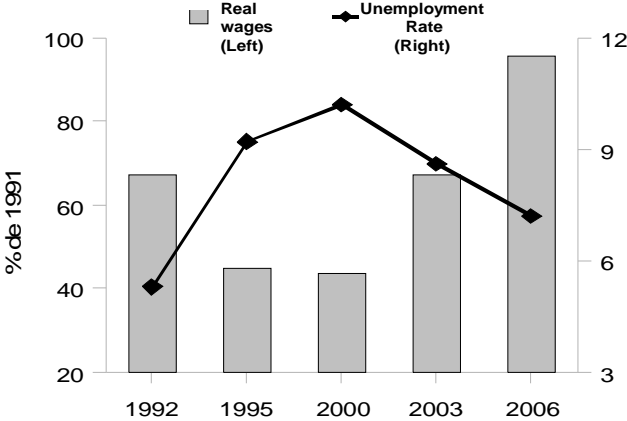
Figure 1: Russia's GDP growth between 1991 and 2008



Source: IMF, www.imf.org

Finally, substantial increases in real wages and very reasonable unemployment rates have an undeniably strong positive effect on the living conditions of the Russian population. The annual increase in real wages during Putin's presidential terms is about 10%, hitting the highest of 16% in 2007. As a result of this continuous progression, real wages nearly double between 1999 and 2007. Again, the contrast is stark when these data are compared to the general impoverishment of the Russians in the nineties. At the same time, the unemployment rate glided down progressively from more than 12% in 1999 to less than 7% in 2006 (Figure 2).

Figure 2: Real Wages and Unemployment in Russia before the 2008 crisis



Sources: Goskomstat, EBRD.

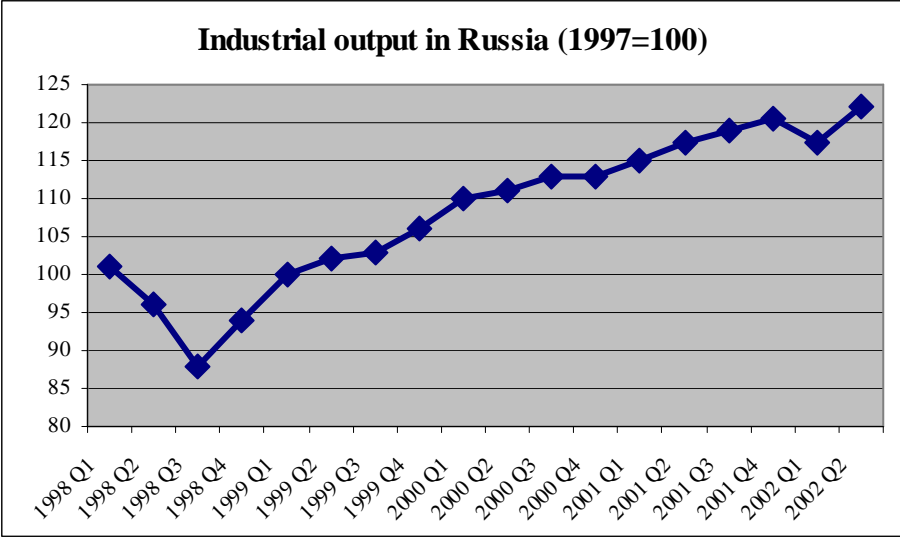
These enviable macroeconomic indicators of the Putin era have been most often explained by skyrocketing commodity prices during the same period. Although this factor was - beyond any reasonable doubt - extremely important, linking Russia's macroeconomic performance to the rise of commodity prices alone would be a simplification. The developments in the Russian economy since the 1998 financial crisis suggest that the high rates of economic growth the country enjoyed since 1999 were not based on exactly the same factors and policies. We think it useful to distinguish between at least two periods in the recent economic history of Russia since the 1998 crash. The first one runs from the end of 1998 until

approximately 2003, when the Russian industry benefited primarily from the stimulating effects of the ruble devaluation. The second one starts in 2003-2004, when economic growth becomes driven primarily by high commodity prices and redistribution of export windfalls. It is also during this second period - corresponding roughly to Mr. Putin's second presidential term - that the State gets much more actively involved into the economy and the policies of the Russian government become much more "interventional".

1.1. 1998-2002: reaping the benefits of the ruble devaluation

The 1998 financial crash results in an extremely strong devaluation of the national currency. The speed with which the seemingly moribund industrial sector manages to respond to this devaluation is quite remarkable. The growth of industrial output in Russia is already observable in the last quarter of 1998 (Figure 3), i.e. in the aftermath of the financial crash. This might appear astounding and perfectly counterintuitive but the reason of this reactivity is the peculiar form of adjustments of the Russian firms to the economic conditions of the nineties. Non only are they completely disconnected from the predatory financial sector (which explains why its crash has no effect on the industry), but they also tend to keep their workforce and collective competencies available despite the ever-shrinking demand, instead of laying-off their workers and/or closing down the sites as orthodox models would suppose them to [Petrovski, 2004]. The ruble devaluation makes locally manufactured goods competitive inducing significant import substitution, which turns out to be immediate: the only thing Russian firms have to do is to increase their capacity utilisation and ship goods to market. Capacity utilisation rate of the Russian enterprises goes up from about 50% before the crisis to nearly 70% two years later (RECEP, 1998-2003). Higher rates of capacity utilisation contribute, in turn, to productivity growth and improvement of competitiveness, thus creating a "virtuous circle".

Figure 3: Industrial output in Russia after the 1998 economic crisis



Source: RECEP, Russian Economic Trends, 1999-2003.

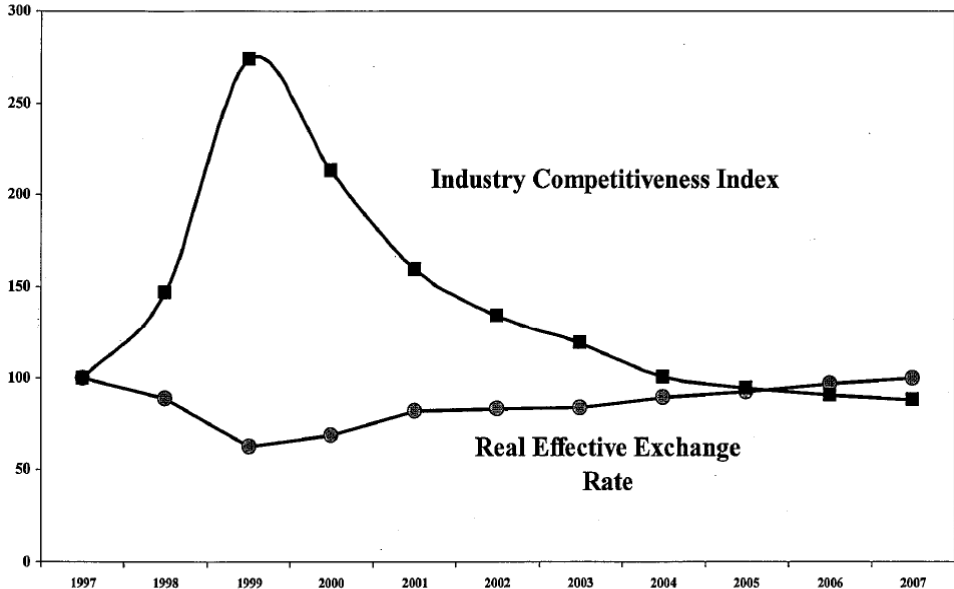
Strong growth of industrial output in Russia continues at a steady pace to reach 120% of its 1997 level by mid-2002. Even more interesting is the sectoral dynamics, with the fastest growth during this period occurring in chemicals, machine-building, wood, paper and wood products, and food industry.

The period running from 1999 to 2003 is also characterised by a set of policies that differ considerably from what will follow later. President Putin himself described at the time his political agenda as that of ‘pragmatic liberalism’. The reforms of his first presidential term appear to confirm this statement: a new Tax Code simplifying and reducing taxes on the business and the rich, a reformed Labour Code authorising easier lay-offs to make labour market more flexible, rather orthodox macroeconomic policies.

1.2. 2003-2008: commodities boom and “Golden Years”

However, as Figure 4 shows, the competitive advantage derived from the ruble devaluation in 1998 tends to vanish progressively by 2003-2004, with industry competitiveness index² going down sharply as the ruble real exchange rate goes up. This corresponds to the period when the prices of commodities that Russia exports (hydrocarbons as well as ferrous and non-ferrous metals, in the first place) start reaching extremely high levels. In this respect, it is important to emphasise that while oil prices double in 2000 as compared to 1999, they actually fall between 2000 and 2002. It is only in 2004 that they really start skyrocketing.

Figure 4: Real exchange rate and industry competitiveness



Source: Ministry of Economic Development and Trade [2008], presentation of the director of the department of macroeconomic analysis A. Klepach.

By 2003-2004, ruble appreciation combined with soaring commodity prices change the macroeconomic landscape to a considerable extent. The economic growth continues to be strong but it is no longer based on a favourable exchange rate and import substitution, but on extremely high commodity prices (hydrocarbons and metals) as well as on the redistribution of export windfalls.

Moreover, precisely during this period, the economic policy of the Russian government takes a nationalistic ‘developmentalist’ turn, which resembles the post-war trajectories of certain Asian and European countries [Durand, Petrovski, 2008]. This is reflected for example in significant extension of public property, sometimes by using fiscal and environmental

² This is a UNIDO index based on two sets of components, namely industrial development indicators and competitive industrial performance.

pressures and leaving no choice to the owners of the assets concerned, but also by acting through state-owned companies that buy (entirely or partially) formerly private businesses. In addition, no serious analyst would fail to notice the deployment of various industrial policy instruments or the fact that Russian investment abroad is being actively encouraged and supported by the government. Ostensibly, the objective of this voluntarism is to preserve the autonomy of the Russian economy and to use the rent from the export of natural resources to modernise the largely obsolete industrial base.

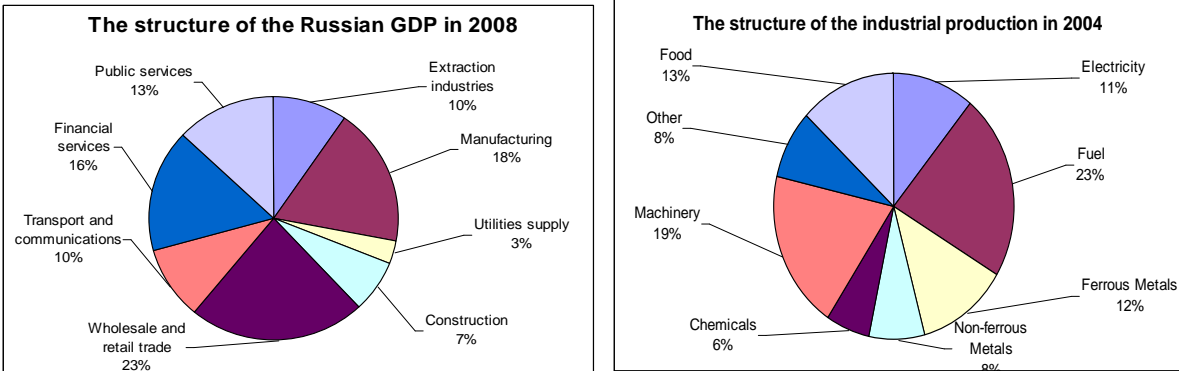
2. Is Russia a victim of the “resource curse”?

The drivers of the Russian economic growth in the 2000s, the apparent importance of hydrocarbon exports as well as the political evolution of Russia during the same period brought to the forefront the hypothesis of the “resource curse”. The main questions seem to be: does Russia suffer from it at all? If this is the case, how badly does it? How can these negative effects be mitigated? What are adequate policy responses to the problem?

2.1. An economy heavily based on natural resources

In order to understand the existing structure of the Russian economy, one has to deal first with certain difficulties related to the data. The official statistics, while technically correct, paint a somewhat distorted picture, because a significant share of the value added generated by the oil and gas sector in Russia is not taken into account due to the prevalence of transfer pricing [Kuboniwa *et al.*, 2005 ; World Bank 2004 a and b ; Gurvich, 2004, Ellman, 2006]³. Indeed, according to the data compiled by Goskomstat, extraction industries account for less than 10% of GDP in 2008 (Figure 5), and about 18% of industrial output in 2004 (the latest data available, Figure 6).

Figures 5 and 6: The structure of the Russian GDP and of the industrial production



Source: Goskomstat.

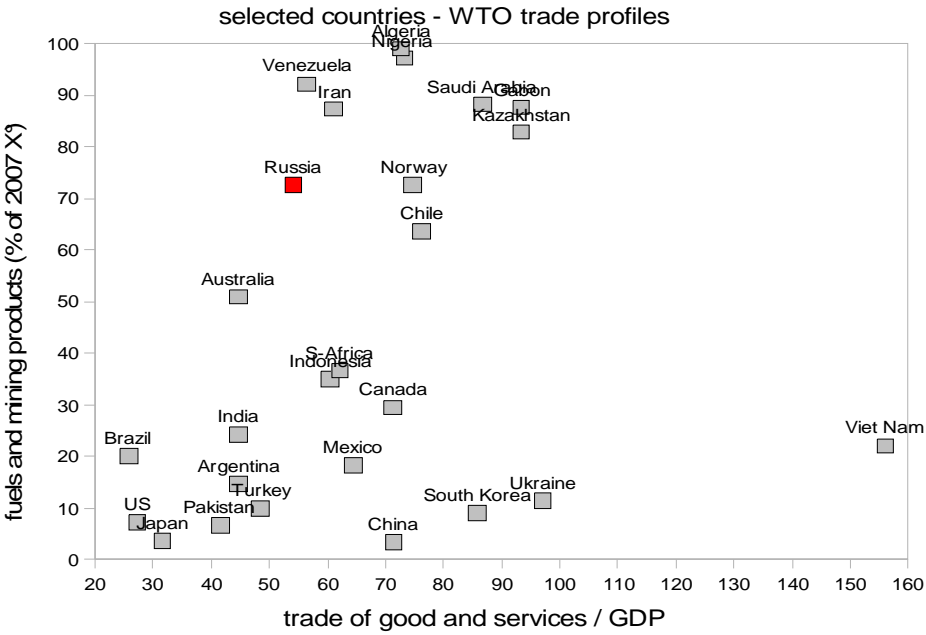
So, at first sight, the ‘resource curse’ does not appear to be an issue. However, exports of oil, oil products and natural gas alone represent 18.5% of GDP, which raises the question of their coherence with the former figure. Adjusted data suggest that in reality, the contribution of oil and gas to the Russian GDP is 24.1% in 2000 and 20.5 % in 2001 as against 7.8% and 6.7 % respectively, according to the official statistics [Kuboniwa *et al.*, 2005]. According to the World Bank, about 49% of industrial added value comes from the hydrocarbons against 29% in the official statistics [2004 a and b]. Whilst it is true that these estimates are not very recent,

³ This point is summarised in C. Ruehl and M. Schaffer, ‘Potemkin's GDP’, *Wall Street Journal*, February 19 2004. <http://go.worldbank.org/LGWSRQDNF0>

there is no serious reason to believe that the measurement of the contribution of the hydrocarbons to the Russian economy, has considerably improved ever since.

The problem of the dependence of Russia on natural resources is better understood when looking at the international specialisation of the country. A rapid comparative outlook (Figure 7⁴) shows that despite its size, Russia is strongly dependent on foreign trade. The average Trade/GDP ratio is 54.2% between 2005 and 2007, with exports being heavily dominated by hydrocarbons (72.5 % of the total exports in 2007).

Figure 7: Comparative trade profiles

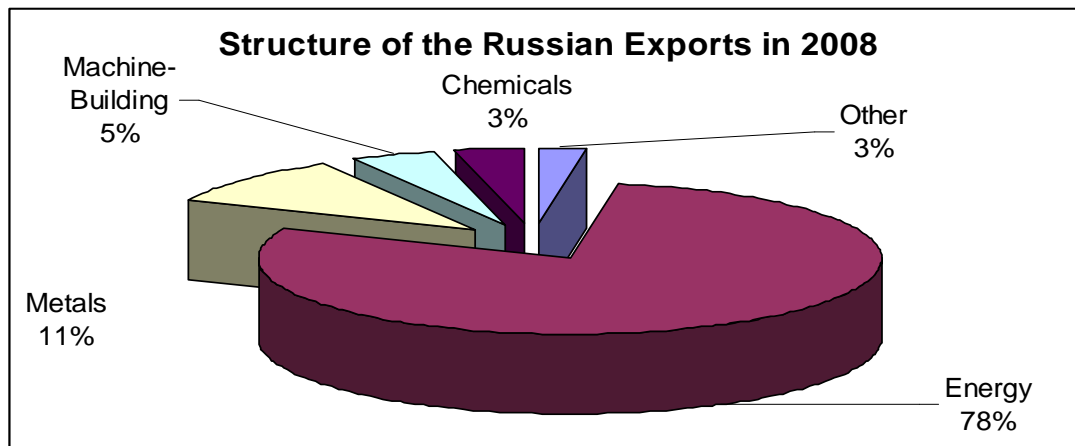


Source: WTO trade profiles, 2009

The picture would be even more impressive if one takes into account all the exports that depend, in one way or another, on natural resources. These include: i) all the products directly related to energy (such as oil products, coal and electricity); ii) ferrous metals because the steel industry benefits considerably from the availability of local minerals, coal and cheap energy; iii) non-ferrous metals whose competitiveness relies heavily on the available local minerals (nickel and gold) and/or cheap Siberian hydro-electrical energy (aluminium); iiiii) chemicals that are derived from natural gas (such as fertilizers). In this case, the conclusion will be that nearly 90% of exports are somehow resource based (Figure 8).

⁴ The sample has been compiled so as to show the position of Russia as compared to various trade profiles of big and medium sized countries: the BRICS, exporters of natural resources, exporters of manufacturing goods, developed economies, transition economies.

Figure 8: The Structure of the Russian Exports



Source: Russian Customs, Eco-Win, 2008.

2.2. “Resource curse”, negative lock-in, and the problem of persistent dependency

The dependency perspective focuses on the reproduction of asymmetrical relations between core and peripheral countries in the capitalist world. Furtado [1972, 1997] argues that underdevelopment is a sub-product of the industrial revolution: modern consumption patterns spread rapidly worldwide whilst new production technologies that induce these consumption patterns are mainly concentrated in the most advanced economies. The result of this asymmetry between consumption habits and the localisation of production capacities is that less developed economies are locked in a state of dependency.

The “Russian resource curse” hypothesis, which has received a growing attention in recent years in the West [Aslund, 2005; Desai, 2006] and in Russia [Smirnov, Arbatov, 2004; Guriev, Sonin, 2008] may be seen as a peculiar form of this process. Modernisation and dependency co-exist, since consumption patterns can be funded by export windfalls whilst the development of high added value sectors may remain weak. Numerous empirical studies suggest that countries generously endowed with natural resources tend to be underdeveloped and enjoy slower rates of GDP growth [Karl, 1997; Papyrakis, Gerlagh, 2004; Sachs, Warner 1995; Pessoa, 2008], even after adjusting the results to fluctuations in commodity prices [Sachs, Warner, 2001].

In spite of this strong evidence, the “resource curse” is not inevitable. Resource-based development can also be a powerful driver to modernise the economy, as it was, for example, in the US in the nineteenth century. This appears all the more true if one considers various lines of theoretical arguments found in the literature in support of this thesis, suggesting the existence of significant room for manoeuvre to pursue adequate policies and mitigate adverse effects of the “resource curse” [Ahrend, 2006].

Potential vulnerability in case of external shocks is the most obvious problem. As abundant empirical evidence suggests, crises in emerging markets are most often caused by severe shocks arising from sharp falls of prices of the country’s main export commodities. Obviously, economies dependent on exports of natural resources are particularly exposed to this risk [Narain *et al*, 2003].

A second range of arguments is based on the hypothesis that “easy riches lead to sloth”. In a nutshell, the abundance of natural resources suppresses the need to compete internationally in manufacturing sectors (and in some cases, in agriculture), which leads to the persistence of

specific institutional weaknesses. Auty [1994] distinguishes four aspects of the phenomenon : *“the richer the natural resource endowment then, first the longer lax macro policies are tolerated; second, the less pressure to achieve rapid industrial maturation; third, the longer rent-seeking groups are tolerated (and the more entrenched they become); and fourth, the greater the likelihood of decelerating and more erratic economic growth”*.

Following the “Dutch Disease” approach, the “resource curse” can also be linked to the “crowding out” effect that the expansion of commodity exports has on the development of manufacturing sectors [Ellman, 1977; Grégory, 1976; Corden, 1981 and 1984; Corden, Neary, 1982; Van Winjbergen, 1984; Sid Ahmed, 1987; Sachs, Warner, 2001]. The main point here is not the negative effects on investment and employment in the short and medium term but rather the long-run negative impact of such an international specialisation on manufactured tradables.

In fact, manufacturing sectors tend to be more competitive and innovative as compared to other sectors and are characterised by technological spill-overs [Krugman, 1987]. As comparative advantage evolves over time through learning-by-doing, The “Dutch Disease” may well lead to a negative lock-in resulting in persistently lower productivity and GDP growth rates. In low and middle income countries, a weaker exchange rate can off-set two kinds of disadvantages that affect local production of tradables much more than that of non-tradables [Rodrick, 2008]. The first one stems from institutional weaknesses and more radical contract incompleteness in these countries. The second one is related to market failures that hinder structural reforms and economic diversification. Consequently, an undervalued exchange rate fosters the growth of tradables and, as a second best solution, accelerates structural change and learning processes. Conversely, an overvalued exchange rate acts as a tax on local production of tradables. It impedes growth i) by reducing incentives to invest in tradable goods since local production loses competitiveness [Prasad *et al*, 2007] ; ii) but also, indirectly, by making the country miss opportunities to improve its institutions and pursue more efficient policies that could have emerged along with the development of manufacturing sectors.

2.3. How seriously is Russia sick with the “Dutch Disease”?

There have been several recent studies addressing the issue of ‘Dutch Disease’ in Russia. At the macro level, Desai’s estimate [2006] suggests that continuing ruble appreciation seems to have some negative effect on the manufacturing sector between 1999 and 2004 but the result is statistically non-significant. Ollus and Barisitz [2007] conducted an analysis of the Russian imports from 25 countries of the European Union and found more convincing evidence of the phenomenon. Their study shows that in clothing industry but - more importantly - in machinery and equipment, imports grow faster than does the domestic production. The trend is the same in chemicals, plastics, paper, publishing and wood products. Not surprisingly, imports do not appear to threaten domestic production in mineral extraction and metallurgy. This is not the case in the food industry either, but this sector benefits from one of the highest levels of trade protection in Russia. More unexpected is the fact that in the area of electric, electronic and optical equipment, Russian firms seem to resist well to foreign competition. Of course, the interpretation of these results is subject to some caution: for example, the rise of imports in machinery and equipment may be related to the modernisation of obsolete industrial capacities through investment. However, the overall picture appears to confirm the thesis of incipient des-industrialisation.

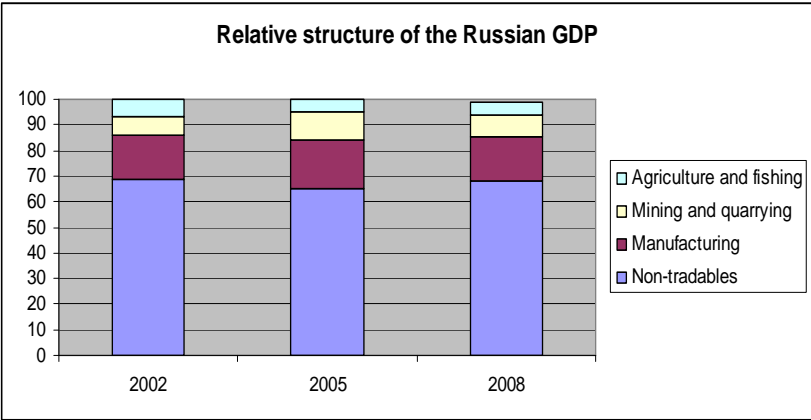
A recent IMF working paper [Oomes and Kalcheva, 2007] finds that Russia has all the symptoms of the “Dutch Disease”, that include: i) real exchange rate appreciation, ii) slower

manufacturing growth, iii) fast development of the service sector, iiiii) high growth of wages. However, the authors' conclusion is that the diagnosis of the "Dutch Disease" in Russia is yet to be confirmed. In particular, they point out that slower growth in the manufacturing sector as compared to the service and resources sector may be a "natural transition phenomenon", given that the manufacturing sector was overdeveloped during the Soviet period whilst the service sector was underdeveloped. In addition, they argue that some des-industrialisation in relative terms may also have been "natural" given the growth of real wages: as households get richer, their demand tends to shift away from goods to services.

An OECD study [Ahrend, de Rosa and Tompson, 2007] gives a more nuanced appreciation of the recent macroeconomic dynamics in Russia. The authors compare Russia and Ukraine, trying to neutralise the contribution of natural resources over the period between 1997 and 2005. Their study shows that Russia's manufacturing sector had been completely destroyed in comparison to Ukraine's. In addition, productivity remains significantly higher in Russia, even if productivity growth had been faster in Ukraine. The authors put forward several explanations but the main factors appear to be the appreciation of the real exchange rate and the relative protection of the Russian industry from foreign competition. This allowed Russian manufacturers to increase their prices above international levels, in particular for non-tradables. Securing higher prices for their products permitted Russian industrial enterprises to pay larger wage bills. Thus, relative protection against foreign competition mitigated the crowding-out effect and limited further negative consequences of the "Dutch Disease" in Russia.

However, this optimistic analysis is somehow contradicted by the evolution of Russia's foreign trade. There is a loss of competitiveness of the Russian manufactured tradables in terms of unit labour costs as well as in terms of added value. Between 1997 and 2004, Russia enjoyed growing revealed comparative advantages (RCA) in hydrocarbons (oil, oil products and gas), wood, pulp and paper, as well as energy intensive products, such as non-ferrous metals, fertilizers, and steel. At the same time, Russia's comparative disadvantages grew worse in industrial machinery and equipment, electronic consumer goods, car manufacturing and medicinal and pharmaceutical products. By and large, as living standards rose, Russia imported more goods than it was importing in the mid-nineties. At best, this would indicate that the sectors manufacturing these goods were either non-existent at the start of the transition or had virtually disappeared by 1996-97.

Figure 9: Relative Structure of the Russian GDP



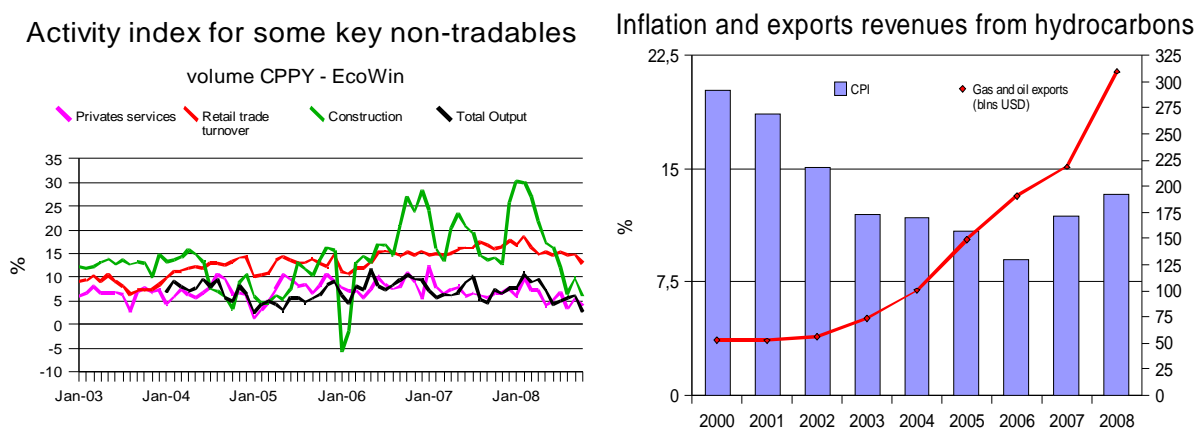
Source: Goskomstat, 2009

A somewhat provocative interpretation of these results is also possible. While limiting competition, rent-seeking could have acted as a partial antidote against the devastating effects

of the “Dutch Disease” on the Russian industry. The developments during the most recent period, when oil prices skyrocketed, could give some credit to such a hypothesis. Due to the aforementioned methodological problems, it is difficult to put a clear diagnosis regarding the “Dutch Disease” on the basis of the aggregate sectoral data available (Figure 9).

But it is obvious that the growth rate of the key non-tradables is substantially above that of the output (Figure 10). Moreover, as we have seen earlier, Russian real wages rose substantially in 2000s, whilst CPI increased considerably as well, even if these developments might not be related exclusively to high hydrocarbon export revenues (Figure 11). Such symptoms appear to support the diagnosis of the “Dutch disease”.

Figures 10 and 11: Activity index for key non-tradables and Inflation and export revenues from hydrocarbons



Sources: Goskomstat, CBR, Eco-Win.

At the same time, the growth rates of some manufacturing industries are quite surprising. High-tech manufactured goods and machinery are among the fastest growing, while oil, mining, basic metals and chemicals are growing at a much slower pace. The only sector where a clear trend towards des-industrialisation is noticeable is textile. The manufacturing sector pursued a rapid growth in comparison with oil sector and non-tradables. This occurred despite higher wages and substantial appreciation of the real exchange rate. However, the country’s international trade profile has been deteriorating with growing specialisation in energy products and basic manufacturing on the one hand and increasing dependency on manufactured goods, particularly in automotive industry but also in high-tech products, such as computers and telecommunications, on the other hand (Tables 1 and 2).

Table 1 and 2: Russia’s Revealed Comparative Advantages in 2001 and 2007 expressed in thousandths of GDP

| 2001 | | | |
|------------------------------|--------|-----------------------------|---------|
| Strong points | | Weak points | |
| Crude oil | 59,853 | Cars | -8,1665 |
| Non-ferrous metals | 22,608 | Specialised machinery | -7,7529 |
| Natural gas | 21,803 | Computers & accessories | -7,3649 |
| Oil based products | 18,365 | Pharmaceuticals | -7,2739 |
| Other | 14,929 | Telecom equipment | -7,2596 |
| Steel | 8,5063 | Other agricultural products | -7,0719 |
| Fertilizers | 3,7819 | Sugar | -6,0225 |
| Basic chemicals | 2,9784 | Leather | -5,8097 |
| Coal | 2,8811 | Plastics | -5,6907 |
| Edible agricultural products | 2,603 | Meat & Fish | -5,3025 |

2007

| Strong points | | Weak points | |
|------------------------------|--------|-----------------------------|---------|
| Crude oil | 56,291 | Cars | -21,349 |
| Natural gas | 35,451 | Computers & accessories | -8,399 |
| Oil based products | 22,853 | Telecom equipment | -7,7514 |
| Non-ferrous metals | 10,791 | Specialised machinery | -7,438 |
| Steel | 5,5422 | Other agricultural products | -6,1573 |
| Edible agricultural products | 4,7636 | Utility vehicles | -5,5102 |
| Coal | 4,1702 | Plastics | -5,3988 |
| Other | 4,1374 | Hardware | -4,9602 |
| Fertilizers | 3,875 | Leather | -4,8122 |
| Basic chemicals | 2,906 | Electric equipment | -4,761 |

Source: CEPII - Chelem estimates, 2009

Moreover, Russia has persistently negative revealed comparative disadvantages in most consumer goods. All this suggests an increased dependence of Russia on foreign countries. This dependence is defined here as discrepancy between consumption patterns and production patterns: to simplify somewhat, increasing imports have been funded by increasing exports of natural resources.

In summary, Russian economy before the recent crisis is characterised by a small high added-value manufacturing sector outside of the basic manufacturing industries whose competitiveness is strongly dependent on natural resources. Russia's terms of trade suggest that the specialisation of the country as an exporter of primary goods has even worsened during the recent period while its dependence on imported manufacturing goods has increased. This evolution, along with the strong dynamism in non-tradables, such construction, financial services and domestic trade, is clearly symptomatic of the 'Dutch Disease'. In this context, the resilience of domestic manufacturing output seems an anomaly. Our tentative hypothesis is that this could be related to somewhat restricted competition on the internal market due to tariff and non-tariff barriers to trade and also the first consequences of the emerging industrial policy⁵. It also suggests that so-called rent-seeking strategies and the embeddedness of manufacturing activities in private-public networks may have protected Russian firms from the most ruinous effects of the 'Dutch Disease' resulting in total destruction of industrial capabilities. This is a crucial point since the literature suggests that the preservation of the national industrial base is a key element for long-run development prospects.

3. 2008-2009: a new major economic crisis

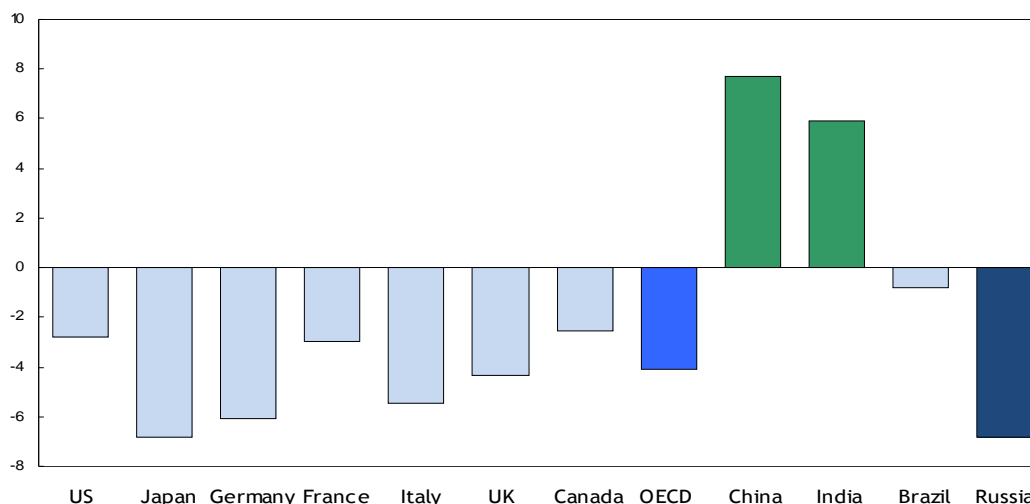
Just like after the 1998 economic and financial crash, the evolution of the Russian economy in the aftermath of the 2008 crisis has been somewhat counterintuitive. This time however, the surprises have turned out to be very unpleasant. The strong macroeconomic fundamentals seemed to indicate that the Russian economy was robust to face extremely adverse conditions. First of all, Russia's growth rates were high and driven to a large extent by internal demand (household consumption, in particular). In addition, financial sector was relatively weakly developed, which might be seen as a disadvantage in normal conditions but appeared rather as a risk-reducing factor given the nature of the global financial crisis. Furthermore, the country's foreign reserves before the crisis were the world's third largest, whilst Russia's public debt was very low. And to crown it all, the country continued to run significant budgetary and trade surpluses and had accumulated significant "Stabilisation Fund".

⁵ For example, machine-building industries could benefit from oil and gas industry orders placed to support them. At the same time, centralising ship-building and aerospace industries under public control could have a positive effect on the output of their Russian subcontractors [Durand, Petrovski, 2009].

3.1. A brief comparative outlook

Despite all this, not only the impact of the crisis was particularly violent but Russia seems to be impacted - for the time being at least – more than the vast majority of countries. The recent OECD projections say that Russia is to go through a deeper recession in 2009 than most developed and emerging nations.

Figure 12: OCDE projections of GDP growth in 2009



Source: OECD, June 2009⁶

In addition, Russia's economic downturn contrasts unpleasantly not only with China's and India's continuing dynamism, but also with the Middle East oil-monarchies whose growth should remain positive in 2009, according to the World Bank's recent estimates [IMF, 2009]⁷.

The OECD projections are not the worst-case scenario. The latest World Bank assessment paints an even bleaker picture with possible 7.9% GDP contraction in 2009. Suffice it to say that the real GDP contraction in Russia in the first quarter was 9.8% [Goskomstat, 2009] and the prospects for the rest of year look very uncertain despite the current rise of commodity prices, particularly hydrocarbons, since April and May economic data were again highly negative.

Dramatic as it appears however, the Russian economic slump is not an exceptional phenomenon in terms of magnitude. But instead of the OECD, BRICs or oil-producing countries, one has to look in the post-Soviet family to find similar and even more spectacular orders of GDP contraction. For example, Ukraine's GDP is expected to shrink by 12 to 14% in 2009, while Lithuania's output should be down by 13% and Latvia's by 19%.

3.2. Stylized facts at the sectoral level

First of all, let us look at the sectors that are behind this impressive output contraction in Russia before turning to the qualitative explanations and the transmission channels of the global economic crisis.

As Table 3 illustrates, all sectors report negative dynamics in the first quarter of 2009. The tradables shrink strongly (-14.4%) as a result of deteriorating external environment and consumer confidence. The contraction is the most dramatic in manufacturing (-23.5%)

⁶ We are thankful to Geoff Barnard from OCDE for having communicated us the most recent OECD estimates.

⁷ IMF, May 10th 2009, Middle East and North Africa Department.

reflecting the weak domestic demand and particularly radical cuts in enterprise investments. Extraction industries and agriculture, while going down as well, stay at quite reasonable levels, given the general context. The damage also appears less pronounced in non-tradables (-6.2%), where the contraction is very severe only in construction (-20.9%), with trade, transport & communication and utilities resisting much better.

Table 3: GDP dynamics in Russia by sector

| | 2006 | 2007 | 2008 | Q1-2009 |
|---|------|------|------|---------|
| Total GDP growth | 7.7 | 8.1 | 5.6 | -9.8 |
| Tradable sectors | 3.4 | 3.9 | 1.8 | -14.4 |
| Agriculture, forestry | 3.8 | 2.6 | 8.4 | -2.4 |
| Extraction industries | -3.3 | -2.6 | 0.2 | -2.2 |
| Manufacturing | 7.3 | 7.8 | 0.9 | -23.5 |
| Non-tradable sectors | 9.7 | 10.3 | 7.4 | -6.2 |
| Electricity, gas, water production and distribution | 5.7 | -0.7 | 1.2 | -5.3 |
| Construction | 11.8 | 9.3 | 13.2 | -20.9 |
| Wholesale and retail trade | 14.1 | 13.7 | 8.4 | -4.9 |
| Transport and communication | 9.6 | 3.4 | 6.9 | -7.4 |

Sources: The World Bank, June 2009

The most recent statistical data indicate that the decline in tradables has been worsening in the second quarter of 2009, with growth rates of -25.1% and -23.7% in April and May respectively on year-to-year basis. The contraction in manufacturing between January and April 2009 is 22% as compared to the same period of the previous year. The most serious declines are reported in electro-optical equipment (-42%), transport and transportation equipment (-36.4%) and machinery (-34.3%). In certain industries, the contraction is simply staggering: car production between January and May 2009 is only 38% compared to the same period of 2008, the output of trucks stands at 29% whilst excavating equipment is reported at just at 12% of its 2008 level [Goskomstat, June 2009].

3.3. Causal mechanisms of crisis development in Russia

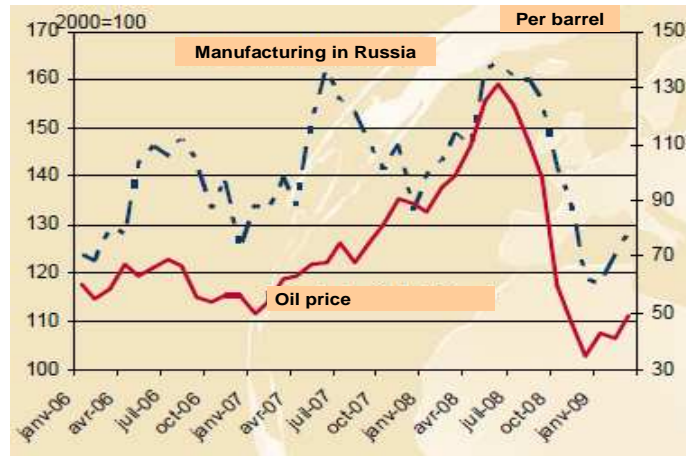
The question is obviously why the deterioration of the Russian economy has been so spectacular while Russia's fundamentals appeared to suggest that it was sufficiently robust and – in any case – much better equipped to face the crisis than many other countries. In our view, three main factors should be emphasised: drastic fall of commodity prices, imported credit crunch, and impressive capital flight. These factors seem to have been aggravated by an inadequately tight monetary policy.

The first transmission mechanism is obvious and is imposing itself: a significant part of the shock came from the drastically falling commodity prices on which the country remains highly dependent. This would confirm the common wisdom that Russia is nothing more than a “colossus on hydrocarbon legs” to which one should probably add a couple of crouches made of ferrous and non-ferrous metals. There is no need to resort to econometric regressions to affirm that there is a seemingly strong link between oil prices and the Russian industrial production (Figure 13).

Peaking at 147 US dollars per barrel, the oil price went under 37 dollars at its lowest in December, which made the proceeds from exports of crude oil and diesel fuel fall by 42% in the last quarter of 2008 as compared to the third quarter. At the same time, steel prices went down considerably and the slumping demand on foreign markets - on which Russian steel

manufacturers are particularly dependent⁸ - resulted in the contraction of the sectoral output of more than 44% in the last quarter 2008. Although it did go up somewhat in April and May, it still recorded a 29% drop between January and May 2009 on year-to-year basis. Despite RusAl's serious financial problems, the output of non-ferrous metals appears less affected, even if aluminium export revenues declined by about 9% with comparable rates of output contraction (-8%).

Figure 13: Manufacturing in Russia versus oil price



Source: Coface, Yves Zlotowski's presentation, May 2009

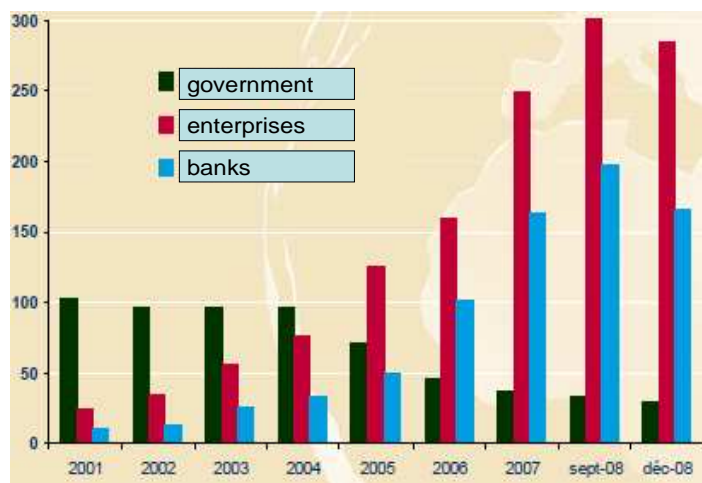
However, it is not so much about what happened to the exporters themselves but rather about their structuring role in the Russian economy. The falling commodity prices do not only affect commodity producers, they hit badly all the companies dependent, in one way or another, on oil, gas and metal mastodons' activity and investments. It is worth noting the Russian oil industry does not seem to suffer that much. According to the most recent statistics, oil extraction and transformation between January and May 2009 remained, roughly speaking, at their 2008 levels. Although natural gas output contraction was much more significant (-20% between January and May), Gazprom still has considerable resources and strong support of the public authorities to face the current crisis. The problem is what happens to the resources generated by hydrocarbon exports and recycled in the Russian economy. In the context of global financial crisis, oil companies, Gazprom, steel and non-ferrous metals manufacturers were desperately looking for cash, which made them seek to improve their working capital figures, as well as to reduce dramatically their investment programmes. All this led to record declines in the output of investment goods manufacturers.

This brings us to the second crucial mechanism of transmission of the global crisis in Russia, which is the particularly acute credit crunch imported from the international financial markets starting October 2008. Contrary to what happened in 1998, the problem did not come from the public but from the private debt this time. Just like their Western counterparts, Russian banks and businesses were involved in the process of "financial optimisation", which, in the context of a huge bubble, suggested the idea of "returning cash to the shareholder" through either dividends or share purchase programmes and borrowing heavily cheap money on international markets. Financial optimisation efforts might not have been the only reason, since endemic insecurity of property rights, ruble appreciation, as well as restrictive monetary policy of the Russian authorities whose priority was to curb inflation, might have also

⁸ Severstal and Novolipetsk steelworks had more than 50% of their output exported in 2008 [Sapir, 2009].

encouraged banks and enterprises to look for funds abroad [Sapir, 2009]. As Figure 14 demonstrates, whilst the public debt is going down progressively since the beginning of the 2000s, the private debt is, on the contrary, exploding and reaching 500 billion USD by September 2008.

Figure 14: Russian public and private debt



Coface, Yves Zlotowski's presentation, May 2009

As the movement of panic, falling oil prices and catastrophic expectations after the bankruptcy of Lehman Brothers started producing their disastrous effects on liquidity, Russian enterprises and banks, badly needing refinancing, could not find any. And their refinancing needs were considerable: orderly payments for the last quarter 2008 alone were estimated at 72 USD billion [World Bank, 2009]. The doubts about the health of the financial system led to the virtual freeze on the Russian interbank market in the last quarter of 2008 stopping de facto any lending activity. This is when big export enterprises started desperately looking for cash by reducing their stocks, delaying the payment of their bills, slashing their investments and output, some of them finding themselves on the verge of bankruptcy⁹.

The third transmission channel is directly related to the previous one. The generalised panic made international investors massively desert Russia. This is reflected in the impressive capital outflow of 130 USD billion during the last quarter of 2008. The movement continued, at a lesser magnitude, in the beginning of 2009 (Table 4). This capital flight put extraordinarily strong pressure on the national currency and contributed to the stock-market crash, more important in Russia than in the rest of the world, leading to further ruble depreciation, still more negative expectations and so on.

Table 4: Net Capital Flows in Russia in USD billions

| | 2006 | 2007 | 2008 | Q1- 2008 | Q4- 2008 | Q1- 2009 |
|---|------|------|--------|----------|----------|----------|
| Total net capital flows to the private sector | 41.4 | 82.4 | -132.7 | -23.6 | -130.6 | -38.8 |
| Net capital flows to the banking sector | 27.5 | 45.8 | -57.6 | -9.9 | -56.3 | -5.8 |
| Net capital flows to the non banking sector | 13.9 | 36.6 | -75.1 | -13.7 | -74.3 | -32.9 |

Source: World Bank, June 2009.

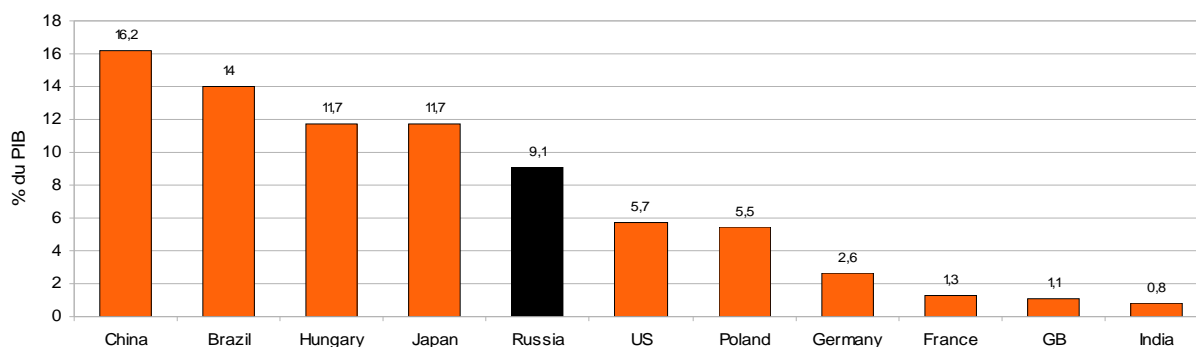
⁹ The situation was particularly dire for the aluminium producer RusAl that had to find 7.4 USD billion to pay its international creditors. RusAl was one of the first big Russian companies to benefit from VneshEcoKomBank's (VEB) loan of 4.5 USD billion. «Русал получил отсрочку по уплате долга в 7,4 миллиарда долларов» (RusAl has managed to postpone the payment of its 7.4 billion dollar debt), the 6th of March 2009, <http://www.lenta.ru/news/2009/03/06/rusal/>

The capital flight was an important factor contributing to the virtual freeze of credit in Russia, be it to enterprises or to households. In this respect, one should note that the expansion of credit to households observed since 2005 was very rapid and quite spectacular. Whilst Russian households were still far from having the same debt/revenue ratios as compared to their Western counterparts, the expansion of credit was becoming an important driver of domestic demand, notably for cars and homes. Its virtual stoppage by the end of 2008 was certainly among the reasons behind the enormous declines of output reported by car industry (although negative expectations and inventory minimisation cannot be neglected either) and construction.

Finally, these factors seem to have been aggravated by an inadequately tight monetary policy of the Central Bank pursued from the beginning of the crisis. At the moment when nearly all central banks were seeking to ease credit conditions for the financial sector by reducing their interest rates, the Russian monetary authorities raised theirs from 11% to 13%. Obviously, the objective was to stabilise ruble, curb inflation and stop capital flight. While the efficiency of these measures is open to doubt, they undeniably contributed to the virtually total freeze of credit to real sector and had a clearly depressing effect on activity [Sapir, 2009].

This tight monetary policy, which was somewhat softened in the end of April, appears to be at odds with the ambitious budgetary stimulus programme announced by the Putin government. As Sapir [2009] argues, there is an apparent contradiction between the highly restrictive monetary policy epitomised by the recently announced intention to withdraw 850 RR billion (25 USD billion) from circulation in May-June 2009, and the ambitious budgetary stimulus programme pouring 1.6 RR trillion (47.5 billion USD) into the economy, with 60% of this package scheduled to be spent before July¹⁰.

Figure 15: Budgetary stimulus effort by country in 2009 (as announced in March 2009)



Source: Sapir, 2009, CEMI-EHESS

To the budgetary stimulus proper, one should add the generous assistance package offered to the troubled financial sector to avoid its collapse and provide liquidity to banks¹¹. All this puts

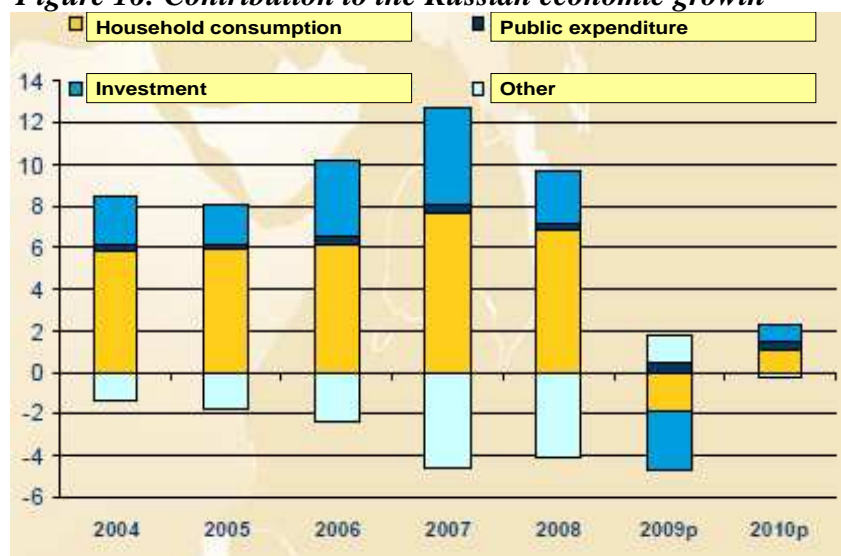
¹⁰ It is clear today however that this has not been the case.

¹¹ The efficiency of the measures to ease credit conditions (preferential loans, public guarantees offered for loans, partial compensation to enterprises of the interest paid etc.) leaves to be desired, which is proved by a new 25% contraction of credit to real sector in May reported by Goskomstat. On the 25th of June, when speaking publicly during a governmental meeting, Mr. Putin basically ordered that banks make loans to the real sector. "I'm addressing myself to banks with public shareholding... I believe that given [recent] governmental decisions, the credit portfolio should be increased by 150 billion rubles in June, plus 150 billion more by the 1st of September, which makes it 300. By the 1st of October, the increase should be between 400 and 500 billion... Before you put things on the rails for this to happen, I ask you to forget about your summer vacations". N.

the total anti-crisis effort of the Russian government at a quite considerable level as compared to the majority of the OECD and BRIC countries (Figure 15).

But despite the ambitious interventionist stance of the Russian government, analysts are quite sceptical about these measures yielding a significant contribution in terms of growth. The current estimates show that the impact of the public expenditure in 2009 should remain limited (Figure 16). Of course, it will depend upon several factors hard to predict at this stage, among which the efficiency and speed of the implementation of public programmes, their positive multiplying effect on various sectors and, of course, the level of commodity prices in the coming months with its determining impact on the domestic demand and investor confidence.

Figure 16: Contribution to the Russian economic growth



Source: Coface, presentation, May 2009

Another extremely important factor to take into account is the consumption of households. Whilst it has been one of the main drivers of growth in recent years, the current situation on the labour market can affect it in a highly negative way.

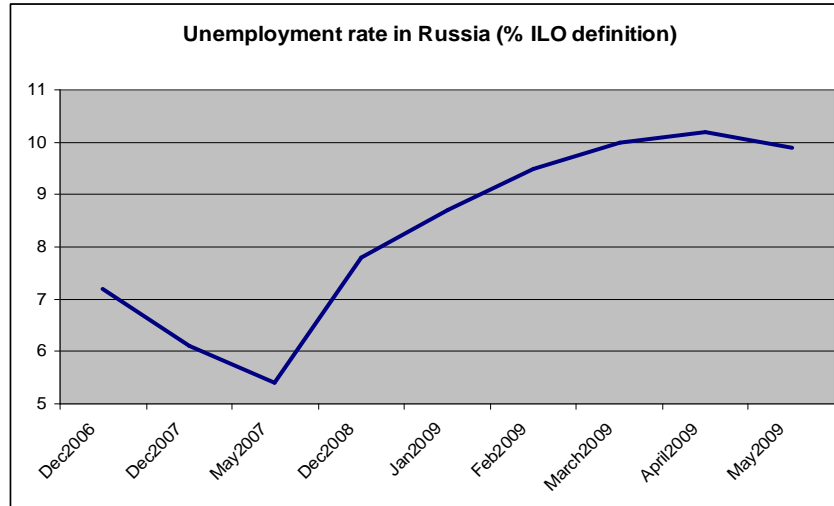
3.4. Unemployment: severe adjustments and come-back of some 1990s practices

The dramatic declines in output reported in the first quarter of 2009 have induced sharp adjustments on the Russian labour market. The unemployment rate jumped to 10% (ILO definition) by the end of March, which is 2.2% more than three month earlier and nearly the double of the May 2008 figure (5.4%) (Figure17). The slight improvement registered in May is ascribable to seasonal factors [Goskomstat, June 2009].

Although the economic situation in Russia exercises strong pressure on real wages, their reduction has remained - for the time being at least - rather limited (-2%). However, a significant increase in wage arrears starting the end of 2008 should be noted. Although wage arrears fell slightly in March-April, preliminary numbers in May indicate a new rise [Goskomstat, June 2009].

Vianova, "Банкиры проведут отпуск на портфелях" (Bankers to spend their vacations on portfolios), the 26th of June 2009, <http://www.gazeta.ru/financial/2009/06/29/3216698.shtml>

Figure 17: Unemployment rate in Russia

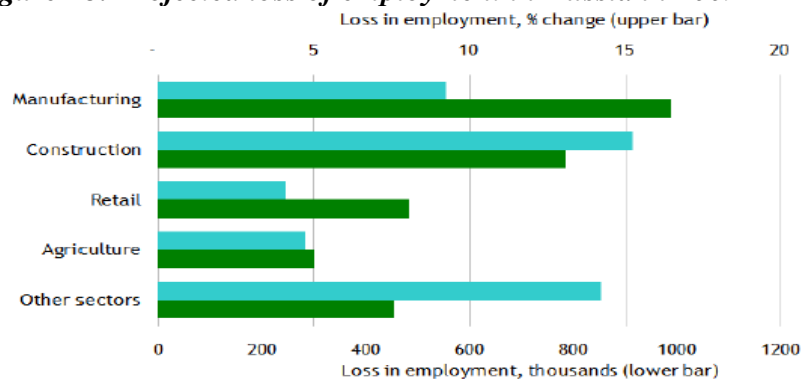


Source: World Bank, Goskomstat, June 2009.

While their absolute volume remains limited (stock of 8.8 RR billion or 284 USD million), they might become an important issue in some mono-industrial towns, sometime sparking social unrest (World Bank, 2009)¹². The comeback of this practice, which appeared just several months ago as an unfortunate atavism of the 1990s, is a curious phenomenon illustrating the dire liquidity situation in which many Russian enterprises found themselves.

The loss of employment in Russia 2009 projected by the World Bank (Figure 18) shows the strongest destruction in relative terms is to occur in construction and “other” sectors. It is worth noting that unemployment generated by manufacturing, while remaining high in absolute terms, does not reflect the magnitude of the output contraction in relative terms. As we have seen before, manufacturing is likely to contract by 22-25% in the first half of 2009 as compared to the same period of 2008 while its loss of employment should increase by just 8,5%. A tentative explanation of this phenomenon is attempted in the next section.

Figure 18: Projected loss of employment in Russia in 2009



Source: World Bank, June 2009.

¹² The recent social unrest in the town of Pikalyovo, when Prime Minister Putin had to intervene directly to settle the conflict, was triggered partially by the problem of wage arrears. “В.Путин потребовал погасить все долги перед рабочими Пикалево” (V. Putin demanded that all debts to Pikalyovo workers be paid), the 5th of June 2009, <http://top.rbc.ru/society/04/06/2009/308033.shtml>

4. Russian post-soviet “exportist” capitalism

The previous developments bring us to the last section where we try to characterise the Russian post-Soviet capitalism in a more systematic way. In our view, there appears to be some coherence between the Russian development trajectory in the 2000s and the way the country is affected by the current global financial and economic crisis in 2008 and 2009. The factors that contributed to Russia’s relative success before turn out to be its main weaknesses in the present context.

4.1. *Enlarging the “Variety of Capitalism” approach*

Since the beginning of the 1990s, a rather extensive literature on “the varieties of capitalism” has emerged and steadily grown. Albert [1991], Crouch and Streeck [1996], Hall and Soskice [2001] to mention just a few, have emphasised persistent and important differences – not to say divergences – in crucial institutional arrangements between what can be roughly termed “Anglo-Saxon” and “European continental/Japanese” models¹³. Amable [2005] goes further and proposes a multi-dimensional approach, less centred on the business firm, which results in a taxonomy of five stylised types of modern capitalism.

However, the general trend observable in this literature is to focus primarily on the OECD countries and more specifically on the “Western” countries¹⁴. The rest of the world is hardly ever explored. One of the main reasons is probably the position of less developed nations in the global economy, which makes it hard to carry out analyses with traditional analytical tools, particularly without considering the international regime as the centrepiece of the economic system heavily affecting all the other institutions and policies. To be fair, abundant literature on “developmentalism” has addressed similar issues [Johnson, 1995; Amsden, 1989; Wade, 1990] but these studies do not seem to have been largely influential in the “varieties of capitalism” approach.

Some scholars from the French “Regulation School” (Ecole de Régulation) have attempted to understand the success of East-Asian newly industrialised economies in terms of institutional variety. For example, Jessop and Sum [2006] point out that such an approach could offer a credible alternative to market-centred, state-centred and culturalist explanations of the “Asian miracle”. The problem is that early regulationists’ attempts to do so had some apparent defects, particularly their pronounced tropism to analyse economic development along the lines of the “fordist model” and its success or failure.

But the “newly industrialised” Asian economies are obviously not the only possible target for such an analysis. Chavance and Magnin [2006] look into the institutional variety in Central and East-European countries to show that despite quite similar initial conditions before the “transition to the market economy”, these countries do not form a homogenous group in the 2000s. While common post-socialist “path-dependent” features, institutional imitation, influence of the European Union and international organisations, and globalisation trends

¹³ Obviously, the adjectives might differ while making reference to similar phenomena. Albert [1991] distinguishes between neo-American (Anglo-Saxon) and neo-corporatist (Rhine model) whilst Hall and Soskice [2001] speak of “liberal” and “coordinated” market economies.

¹⁴ It is revealing that among Amable’s five capitalisms [2005], four types comprise European and other anglo-saxon countries (US, Canada, Australia, NZ). The fifth type comprises the developed Asian nations (Asian capitalism).

have certainly been factors of convergence, there are also very important differences springing from specific historical events and endowments, but also from public policies and political choices, as well as possible preferences for the model of a particular “developed” country. This is not to mention certain original institutional solutions found in an *ad hoc* way during the transition process. However, there are scholars who tend to insist more on the similarities among post-socialist countries. Bohle [2006], for example, stresses the dominance of trans-national capital and “passive” adaptation of the new EU member-states during the transformation process. Noelke and Vliegenthart [2009] have recently suggested the emergence of a specific group of Dependent Market Economies (DME) in Eastern and Central Europe. Given the dramatic impact of the current economic and financial crisis on these economies, the authors appear to have been overly optimistic about the coherence of the model and its sustainability. Nevertheless, their diagnosis concerning the centrality of the existing hierarchy between foreign headquarters of multinational companies and their subsidiaries located in Central and Eastern Europe seems correct. Such a situation induces fundamental dependence of these economies on the investment and production decisions made by trans-national corporations.

Given the existence of all this literature, the Russian case looks somewhat paradoxical. Whilst the Soviet economy was widely studied as a specific system, post-soviet Russia - despite the emergence of certain highly idiosyncratic properties - has hardly retained any attention at all as a specific type of capitalism. Of course, no attentive observer could miss the salient changes during Vladimir Putin’s second presidential term, but very little conceptual work has been done to account for them and to go further than qualifying them as “*state capitalism*”, “*corporate state*” or « *strategic turning point* »¹⁵. These appreciations have most often turned out to be mere judgements of value and have not led to any systematic and systemic analysis. There have been some exceptions, of course. Speaking of the consolidation of the Russian elites, David Lane [2008] suggests that the country has evolved in the direction of a corporate, cooperative, state-led capitalism. However, Lane’s analysis focuses on the changes in the economic policy and misses many original features of the post-soviet capitalism in Russia. Indeed, as Jessop and Sum [2006] argue, state-led approaches assume that the political apparatus of the state is a kind of unified bloc, which is able to remain isolated and place itself above all the other social and economic agents. In reality, the situation appears to be much more nuanced with the key issue being the role of economic and political networks in policy-making and the ‘governmentalization’ of the Russian society.

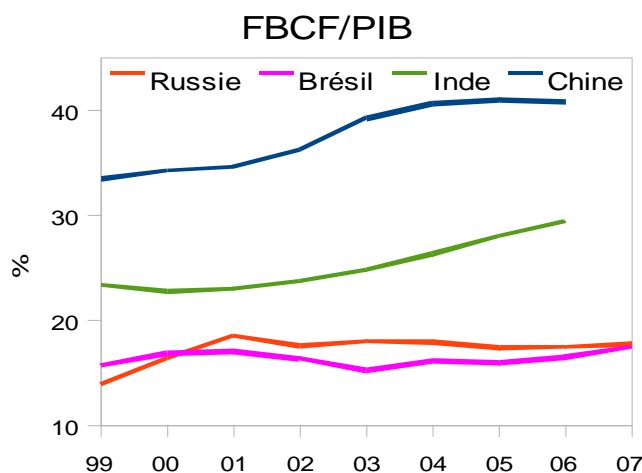
We believe that the contemporary economic and political system in Russia is the original historical result of at least three distinct processes. Firstly, one should take into account the specific socio-economic transformation of post-Soviet Russia. Secondly, Russia’s international regime has been characterised by its extremely high dependence on the export of natural resources, the import of manufactured goods and liberalised capital movements. Finally, the persistence of an obsolete but extensive manufacturing base inherited from the Soviet times continues to play a crucial role in the socio-economic and geographical organisation of the country. We will try to briefly describe and link these factors here by focusing on the “growth regime”, the dominant coordination mechanisms and the capital-labour nexus.

¹⁵ A. Illarionov, « When State Means Business », *International Herald Tribune*, January 25, 2006; Zlotowski [2006] ; J. Sapir [2007]

4.2. Weak autonomy of the growth regime based on the export of natural resources

As we have shown before, one of the key characteristics of the Russian economic development in the 2000s is its heavy reliance on exports of natural resources and the consecutive lack of autonomy. This situation can be characterised as a specific form of “exportism” [Jessop and Sum, 2006] making the economy doubly vulnerable. The first source of vulnerability comes from the structure of the Russian exports and potential external shocks associated with them, in particular due to the volatility of international commodity prices. The second one is related to Russia’s place in the international economy and the nature of its economic relations with other nations. On the one hand, Russia’s macroeconomic performance depends to a considerable extent on its access to global commodities markets, as well as tariff and non-tariff rules conditioning this access. In this respect, one should also stress the importance of the international financial and commercial networks but also the characteristics of globalized value chains, for example for producers of ferrous and non-ferrous metals. On the other hand, the Russian economy is also heavily dependent on imports of high-tech consumption goods and some key capital goods. Against this general backdrop, the weakness of the growth regime in terms of development prospects is revealed by the fact that investment rates remain rather modest. Although growing strongly until the 2008 crisis¹⁶, the Russian investment rate still hovered at around 20% of GDP, which is much lower than the Indian rates and nearly half of the Chinese (Figure 19).

Figure 19: Comparative investment levels in BRIC countries



Source: EcoWin, Reuters.

True, Russian investment rates are comparable to Brazil, but Brazil did not go through a dramatic recession the way Russia did in the nineties and does not need to restructure its obsolete industrial base in such a profound way. It is also worth noting that investment rates in Russia are significantly inferior to the rates of major European nations during their ‘reconstruction period’ after World War II or those of Asian countries whose model can be characterised as ‘developmental’. Even more worrying is the fact that modest as it looks, the investment remains concentrated in extractive industries, ferrous and non-ferrous metals, transportation, energy, communications, and construction. The machine-building sector gets just 0.5% of the total in 2005 and 2006, which is even less than during 2000-2004 period

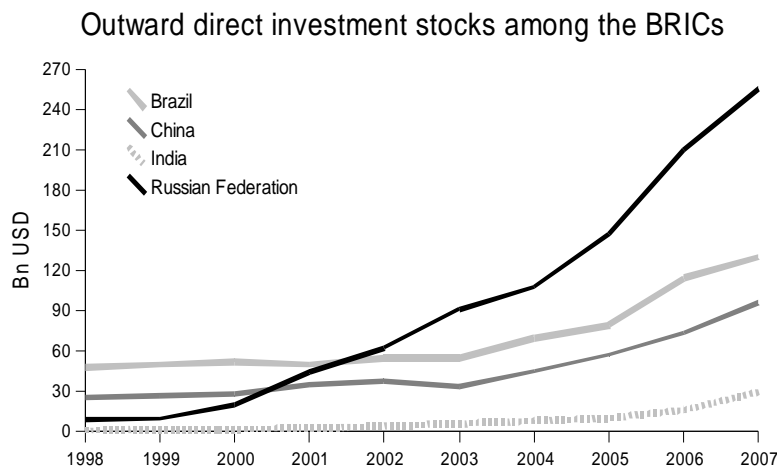
¹⁶ Investment increased by 42.6% in 2006 and 26% in 2007, according to Rosstat. The method of making these estimates was contested by some analysts but strong investment growth during this period is not subject to any doubt.

(Goskomstat, 2008).

The opportunity cost of arbitrating in favour of investment instead of consumption should also be taken into account. The point here is that the same monetary amount of investment might not have the same opportunity cost. As Gaddy [2007] argues, markets of consumption goods are rather competitive in Russia whilst markets of investment goods are pretty much closed, which results in a sort of “mark-up” when investing in fixed capital. Consequently, spending the same amount on investment in Russia does not yield the same results in comparison with a country where the markets concerned are more open. According to Gaddy, the Russian investment rate should be halved if the opportunity cost is taken into account.

In parallel, Russian outward direct investment (ODI) has expanded rapidly since the beginning of the decade. The country has become the leading direct investor among the BRICs (Figure 20). Hydrocarbon companies are clear leaders here, followed by steel and non-ferrous metal producers [Liuhto, Vahtra, 2007; Skolkovo, 2008; Durand, 2007]. In comparative perspective, this recent upsurge in investment abroad can be seen as an anomaly by the “Investment development path paradigm” [Kalotay, 2008]. In reality, it should be considered as a logical follow-up of Russia’s economic openness during the post-Soviet period. In the beginning, the internationalisation of some Russian enterprises was suggested by the extremely challenging conditions on the internal market with domestic demand collapsing in the nineties. Later on, international expansion was based on different reasons as Russian firms tried to secure their access to strategic markets and globalised supply chains. In addition, the industrial policy of the Russian State should have played an important role, at least in certain cases. The recent acquisition of Opel by the publicly controlled Sberbank allied with Magna appears to aim at gaining access to technological and/or management know-how.

Figure 20: Outward direct investment in the BRIC countries



Source: UNCTAD, 2009

Nonetheless, at the macro level, the unexpectedly high levels of ODI, especially when internal investment remains rather modest, seem to support Gaddy's thesis suggesting that Russia belongs to “investment constrained economies” [Rodrick, Subramanian, 2008]. The growth prospects of such economies are constrained primarily by inadequate investment demand (due to low return on investment for public or private agents) but also, as argued earlier, by an unfavourable exchange rate.

In this situation, the liberalisation of financial flows completed by the Russian authorities in 2006 does not seem to make any sense. At the macroeconomic level, the objective was certainly not to attract additional speculative capital flows leading to further ruble appreciation, but this is precisely what happened between 2006 and 2008. When the “Dutch Disease” is potentially an issue, it appears much more logical to keep at least some control over the capital account, barring the entry to speculative short-term capital and reducing the vulnerability of the country’s financial system to external shocks that could result from abrupt reversal of capital flows [Sapir, 2009].

4.3. Public/private networks as dominant coordination mode

The second key characteristic of the Russian capitalism in 2000s is the prevalence of public/private networks as the dominant form of economic coordination. To be sure, public/private coordination in itself is not a specific feature of Russia. France and Korea [Tylecote, Visintin, 2007], but also Italy, Germany, Japan, Taiwan and other countries were characterised by similar phenomenon in the second half of the 20th century. The pioneering studies by Gerschenkron [1943, 1962] on Germany, Japan and Russia were followed by extensive research on the post-war development of Asian nations, such as Japan [Johnson, 1995], South Korea [Amsden, 1989] or Taiwan [Wade, 1990], to name just a few. In all these studies, the authors emphasise an extremely important role of the state in developing national industries and “governing the market”, to use Wade’s expression. This meant pursuing clearly mercantilist commercial policies by limiting foreign competition on domestic markets and creating conditions for the national champions to succeed on international markets.

The Russian case is quite peculiar and different from the post-war situation in Western Europe or Asia. The extension of public/private networking in Russia can be explained by at least three idiosyncratic factors.

First of all, the privatisation process in the 1990s was widely perceived as opaque, unfair and disrespectful of basic legal standards, which undermined its legitimacy. The endemic weakness of property rights up till now is largely the consequence of this process. The extension and consolidation of public ownership – a process that accelerated sharply in 2003-2004 - marked the beginning of a new phase in the attempts to gain control over the rent. Formally, the process was respectful of the international legal standards protecting private property. In reality however, the State often recovered control of assets by using “administrative” methods, such as fiscal or environmental pressures [Durand, 2008 ; Durand and Petrovski, 2008]. At the same time, the emergence of huge publicly controlled conglomerates in the energy sector, arms trade and banking was apparently meant to become a powerful instrument of the State to pursue an ambitious industrial policy. Although private vested interests of high profile officials were most certainly an important factor, another seeming objective was to foster and shape industrial restructuring and even to support the expansion of national companies abroad. It seems that Russian authorities wanted to use part of the rent from natural resources to import technological and management know-how by acquiring foreign assets¹⁷. Furthermore, corporate governance of big private businesses in Russia is characterised by high concentration of ownership. The owners, many of whom are the so-called “oligarchs” of the 1990s, managed to keep control of their assets by accepting some form of co-decision on strategic issues with high ranking public officials in charge of

¹⁷ This appeared to be the case in 2007 when Russian buyers (reportedly Rosoboronexport) wanted to acquire the French semiconductor manufacturer Altis. Malakhov A., « Росборонэкспорт приземлился у Парижа » (Rosoboronexport has landed near Paris), *Kommersant*, 03/09/2007, <http://www.kommersant.ru/doc.aspx?docid=800766>

the sectors concerned¹⁸ [Sakwa, 2008].

Secondly, an extensive but largely obsolete industrial base inherited from the Soviet times, although shrinking severely during the transition process in the 1990s, continues to remain a crucial part of the Russian economy. On the one hand, it plays an important role in the extraction of natural resources as well as arms exports, still competitive internationally. On the other hand, it delivers various manufactured goods to domestic markets, which is much more surprising. The most obvious explanation is that Russia has to deal with a limited number of big manufacturing facilities, often located in mono-industrial towns scattered around Russia's huge territory and providing jobs as well as various social services to a significant part of the least protected population. Their closure or heavy restructuring could thus result in devastating social consequences. Since social stability and economic viability of the regions appear to be one of the strategic concerns of the Russian authorities, to which one should probably add the occupation of the country's huge territory, the management of these firms cannot take decisions based on economic efficiency alone. The Russian growth model requires some mechanisms providing flexibility in order to absorb external shocks and limit their damaging consequences. This flexibility is partially achieved through political compromises between economic efficiency and social feasibility of certain decisions, making it necessary to organise the exchange of information and some co-decision between political and business elites at the local and/or national level. When this is not done, the way the conflicts are resolved shows that the use of private property in Russia is still subject to some rather particular constraints¹⁹.

Thirdly and finally, the importance of hydrocarbons for the Russian economy should be appreciated beyond their contribution to the country's GDP. Suffice it to say that the sector accounts for about 50% of the federal budget revenues. Politically motivated decisions over the use of the rent are crucial for the survival of a great number of industrial enterprises. In particular, Russian enterprises benefit from low energy prices bolstering their competitiveness. But support to the national industry can also be provided by constraining energy mastodons to place orders with national producers while cheaper and better quality products could easily be acquired on export markets.

To summarise, public/private networks appear as a dominant form of coordination in Russia because of (i) the weak legitimacy of the property rights, (ii) the size and the importance of the industrial base inherited from the Soviet Union from the social but also strategic point of view, (iii) and finally, the possibility to provide support by centralising and redistributing huge rents from hydrocarbons. As far as the growth model is concerned, such coordination mode may be seen as an "either-too-much-or-not-enough" solution. Indeed, it might be "too much" because the investment of the state and publicly controlled companies acts as a disincentive

¹⁸ It is hardly a secret that all the important acquisitions made by formally private companies in Russia have to be approved by the Kremlin. This was clearly the case when Severstal wanted to acquire Arcelor. Severstal's CEO Mr. Mordashiov was received by president Putin's to get the approval ("Мордашову - 20% Арселора" (20% of Arcelor to Mordashiov), *Vedomosty*, 26/05/2006.

¹⁹ The recent conflict in Pikaliovo is an excellent case in point. When local population protested against wage arrears and massive lay-offs blockading motorways in the Leningrad oblast, Prime Minister Putin came to town in person accompanied by Mr. Deripaska (the owner of one of the factories), VTB's CEO Mr. Kostin and several high-ranking government officials. Addressing himself to the owners of the factories on the 4th of June 2009, Mr. Putin said: "You've made thousands of people hostages of your own ambitions, non-professionalism and most possibly trivial greed. This is flatly unacceptable." He further added: "I give you three months. Either you find a solution or the problem will be settled without you". The problem with wage arrears was settled on the same day. In addition, VTB granted loans to factories to be able to restart their production. "Путин заставил Дерипаску подписать договор в Пикалево" (Putin made Deripaska sign an agreement in Pikaliovo), the 5th of June 2009, <http://www.rb.ru/topstory/economics/2009/06/05/100507.html>

for private companies to invest themselves in certain areas. At the same time, it might be “not enough” because the authorities seem unable to really constrain or incite private companies to invest in areas where the state would like them to.

4.4. Polarization and “dual labour market”

Although inequalities were already significant during the Soviet era, the “transition to market” in the nineties dramatically accentuated them. During the 2000s, things did not change fundamentally and actually grew slightly worse. According to the latest estimates, the Gini coefficient in Russia was at the level of 41.5 in September 2008, as against 41.0 in 2006, 39.0 in 2002 and 29.0 in 1991²⁰. The current economic crisis is very unlikely to change this situation for the better. Other indicators, although incomplete, tend to confirm the hypothesis that the gap between the rich and the poor has at least remained as wide as it was in the 1990s. As Bank of Finland reports, the average monthly income in Russia in November 2007 was 13,700 rubles (€380) with wage income accounting for slightly over two-thirds of total income²¹. During January-September 2007, the top quintile accounted for 47 % of all income, while the second quintile enjoyed 23 %. The poorest quintile received just 5 % of all income. About half of the Russian population has incomes that are only two-thirds of the average, and nearly 13 % of the population lives on less than €100 a month [BOFIT, 2008]. To these high social inequalities, one should also add extreme inequalities among regions. According to a recent UNDP study [UNDP, 2007], the city of Moscow alone accounts for nearly 20% of the Russian GDP and 7% of the population and the average income of its inhabitant is almost 5 times higher than that of the Republic of Dagestan.

It should also be noted that public policies during President Putin presidential terms showed that the issue of growing inequalities did not rank very high on his priority list. The 2002 fiscal reform introducing the 13% flat tax illustrated that political authorities were ready to accept and even reinforce high levels of inequalities.

However, Russia is not only a highly polarised society but also an economy where the cost of adjustments to external shocks rests mainly on the shoulders of workers. The shock of the 1998 financial crisis was mainly absorbed by wages whose part in the value-added dropped from 52% in 1997 to 39% in 1999 (Figure 21).

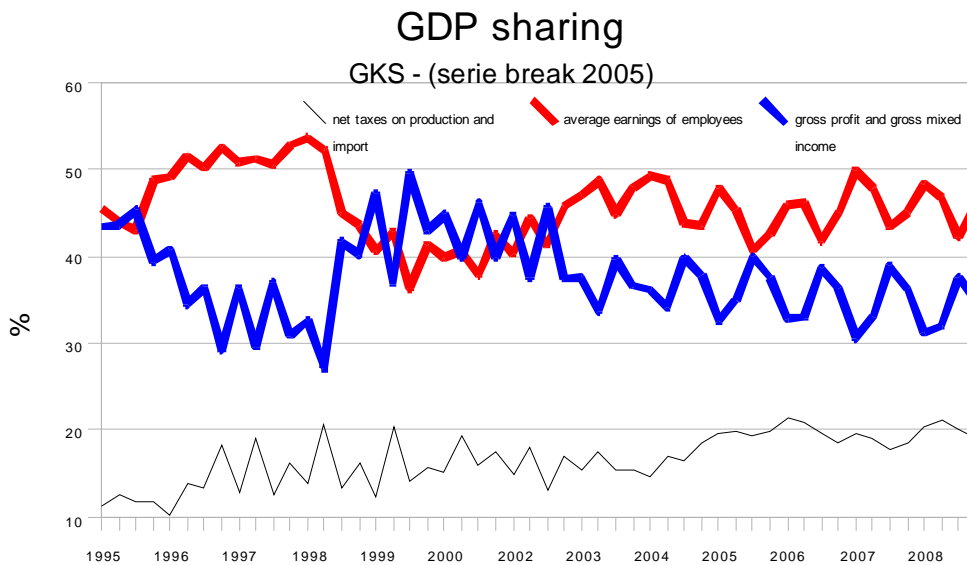
It is too early to say whether the same adjustment mechanism has been in place to absorb the shock of the 2008 crisis. At first sight, the statement regarding high flexibility of the Russian labour market might appear somewhat counter-intuitive. As we have seen in the previous section, the rise of unemployment in manufacturing, although very sharp, is still not as sharp as the output contraction. To be sure, the specificity of manufacturing is such that output and labour adjustments cannot be strictly proportional. The competitiveness of industrial sites is based on collective competencies or “routines” [Nelson and Winter, 1982], which - just like Lewis Carroll’s Humpty-Dumpty - once destroyed, “cannot be put together again” [Stiglitz, 1999]. So, one cannot reasonably expect unemployment to grow exactly in line with output contraction. However, Russian manufacturing seems to proceed to less radical adjustments as compared to “developed market economies”. In the United States for example, a less pronounced slump in industrial production was followed by more severe adjustments of the

²⁰ CIA World Factbook [2009], Rosstat [2009], UN Development Programme Report [2006].

²¹ In addition to wages, Russians get income from such sources as small side businesses, capital earnings and various social payments (BOFIT, Weekly report, January 11th, 2008). <http://www.bof.fi/NR/rdonlyres/90A161D9-2CAA-4633-84FF-A5B6DCD69A4C/0/w022008.pdf>

workforce²².

Figure 21: GDP and the breakdown of the value added



Source: GKS 2009

Our tentative explanation is that Russian labour market is characterised by persistent dualism inherited from the Soviet period. Industrial enterprises continue to shed workers reluctantly, especially in mono-industrial towns. This is done only when all the other possible solutions (wage arrears, short-time working, holidays, unpaid leaves etc.) have been explored. The conclusion is that real unemployment rate in manufacturing in Russia is mostly certainly grossly underestimated. Nevertheless, moderate official unemployment should not be taken as a proof that enterprises pay for the adjustments, because workers who are formally in employment generally do not get paid. The question is obviously: why then would they accept such a situation instead of getting unemployment benefits? The fact is that when chances of finding another job in the area are close to nil and employment benefits are very low, staying in employment formally permits avoiding the “stigma of being jobless”, keeps the opportunity to benefit from social protection provided by the company, and increases the chances to recover the pay once the economic situation gets better.

At the same time, new sectors, such as services and construction, whose development in the 2000s in Russia was particularly strong, tend to be much more reactive in adjusting their workforce. This is apparent in the statistics provided Goskomstat, with construction and “other sectors” displaying high levels of headcount reduction. These adjustments should be encouraged by the fact that the workforce in these new sectors is younger and much more flexible whilst the bulk of employment is located in big metropolitan centres where possibilities to find a new job are much more abundant.

Consequently, the flexibility on the Russian labour market is not uniform and the adjustment mechanism differs significantly depending on the sector. Internal flexibility mechanisms seem much more popular in manufacturing, with employment decreasing moderately and real wages diminishing considerably²³. In some cases, internal adjustments can get more radical,

²² According to the most recent statistics, American industrial production fell by 13.4% between May and May 2009 while industrial employment contracted by 11% between January and May 2009 [Federal Reserve Statistical Release, June 2009]. <http://www.federalreserve.gov/releases/g17/Current/default.htm>

²³ The evidence on the ground seems to indicate for example that real wages might be reduced up to 30% in metallurgy.

taking the form of wage arrears or unpaid leaves, for example. In the service and construction sectors, adjustments appear to be more “classical”, with companies reducing their workforce as demand goes down.

It is important to emphasize however that in both cases the brunt of the adjustment to the economic shock is shifted on the side of the labour. One has to wait for the data regarding the value added split between wages and profits to validate this hypothesis but even its stability in the present context would mean that the shock is mainly absorbed by wages²⁴.

Table 5: A stylized model of 'post-soviet exportism'

| MODE OF GROWTH | |
|--|--|
| EXTROVERT RESSOURCE BASED | <ul style="list-style-type: none"> ● Heavy reliance on exports makes the system vulnerable to external shocks ● High dependence on imported consumption and investment goods from developed and developing economies ● Strong embeddedness of corporations and banks in international financial, trade and production networks ● High levels of Russian Outward Direct Investments ● Heavy reliance on the rules and institutions of the prevailing international regime ● Rather modest investment levels |
| DOMINANT FORM OF COORDINATION | |
| PUBLIC- PRIVATE NETWORKS | <ul style="list-style-type: none"> ● Weak property rights dependent on the support of political leaders and extensive public property ● Strong interdependence between big private firms and political leaders at the local, regional and national levels ● Coordination of rent distribution and the absorption of external shocks |
| CAPITAL LABOR NEXUS | |
| DUALIST FLEXIBILITY | <ul style="list-style-type: none"> ● Adjustment mainly absorbed by workers: variability of value-added sharing as a symptom ● Intra-firm flexibility within corporatist sectors (export-oriented industries + mono-industrial towns) ● Extra-firm flexibility within liberalized sectors (non tradables) |

²⁴ Even if the share of real wages in the value-added does not shrink, it will still be a proof of fairly high labour flexibility. The stability of wage/profit ratio in the context of contracting output suffices to illustrate that the labour market is highly flexible [Askenazy, 2003].

Conclusion

The brief analysis of the main developments in the Russian economy undertaken in this paper, has attempted to put emphasis on the peculiarities of the country's growth model in the 2000s. The conclusion to which one is led when analysing this model is that it looks intrinsically unstable, which is confirmed by the current crisis. In a way, Russian economy is a hybrid path-dependent system shaped by constructivist attempts to transform a centrally-planned economy into some sort of ideal "liberal market economy", which are constantly upset by attempts to mitigate the adverse economic and social effects that an "ideal liberal market economy" is bound to produce. To this fundamental contradiction, one should add a plethora of other factors, such as the pursuit of vested interests by powerful rent-seekers, objective geo-strategic interests of the Russian state, perception of potential external threats by the elites, as well as profound ideological differences between some key members of the government.

All these factors explain the incoherence of certain policies pursued before the crisis (for example, treating the "Dutch disease" by sterilizing money whilst simultaneously liberalising capital flows, which makes this disease worse), as well as apparently blatant contradictions in the recent policy mix to fight the crisis (restrictive monetary policy accompanied by an ambitious budgetary policy).

Some analysts and political leaders in Russia say that the current economic crisis illustrates clearly the failure of the model that emerged in the 2000s and presents a formidable opportunity for a deep change²⁵. This change would imply building a different type of capitalism based on the development of innovative and high value-added sectors. Whilst the latter suggestion is obviously pretty much consensual, building such a model is easier said than done.

And yet, on a more normative note, what could be the solutions to escape from the "resource curse"? We believe there are two broad types of strategies that could be explored. The first one, for the want of a better term, could be called "competitive Schumpeterian". Since it is not realistic that high value-added sectors, competitive nationally and internationally, can emerge in Russia spontaneously, political authorities should assume and pursue more actively their "developmentalist" efforts by supporting innovative sectors the way post-war Japan, South Korea or Taiwan did. However, such strategies suppose a rather weak national currency on the one hand and "leap-frogging" capacity to catch up with the industrial leaders on the other hand. Given that Russia is rich in resources and that its exports will continue - beyond any reasonable doubt - to exercise a very strong effect on the real exchange rate, the macroeconomic policy mix will then have to be completely changed. As for leap-frogging, it requires well-educated workforce and a specific "social contract" fostering learning and long-term commitment. This will also suppose a considerable shift away from the social policies that could be observed in Russia in the 2000s.

The second type of strategy can be called "non-competitive anthropogenetic". The general idea is canalise the resources generated by exports in the direction of high value added non-tradables produced for the needs of the internal market. Their development will take time, but once in place, they will be impossible to weed out by foreign competitors. As Boyer [2002] puts it, such a strategy is based on the "reproduction of man by man". It could seek to bolster

²⁵ S. Shelin, "Путин выбрал депрессию" (Putin has chosen depression), www.gazeta.ru, the 1st of July 2009.

the attractiveness of the country and foster its economic dynamism through investment in non-tradable services, such as education, health, ecology, but also – possibly - into modern high-value added industrial sectors (green energies, biotechnologies etc.).

These two strategies are not necessarily incompatible, but they do present a potential conflict. There is a strong temptation to base the “Schumpeterian competitive” strategy on what is often called by the Russian authorities “the natural comparative advantage of the Russian industry”, i.e. low energy prices. This is clearly not compatible with “anthropogenetic” approach where the impetus should be put on modern cutting-edge technologies, often related precisely to energy saving and externality reduction.

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