

Hanson, Philip

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CESifo Forum

Provided in Cooperation with:

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Hanson, Philip (2008) : State-led, Oil-fuelled Development: Is That Good for Russia's Future?, CESifo Forum, ISSN 2190-717X, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 09, Iss. 2, pp. 22-27

This Version is available at:

<https://hdl.handle.net/10419/166322>

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STATE-LED, OIL-FUELLED DEVELOPMENT: IS THAT GOOD FOR RUSSIA'S FUTURE?

PHILIP HANSON*

Russian economic policy-makers are taking an optimistic view of Russia's future. After nine years of GDP growth at an average rate of 7.0 percent per annum, this is understandable. My aim in this article is to offer an assessment of their vision of the future. The question to be addressed is whether a continuation of state-led and oil-fuelled growth, even if the official strategy is to diversify the economy, is likely to produce the strong growth that is anticipated.

Some recent Russian government forecasts

In recent months a number of economic projections and forecasts have emerged from the Russian government. They come from different parts of the executive branch and are not integrated into a single, agreed programme. Some are elaborated in detail but are so far drafts not yet approved by the government as a whole. These include Minpromenergo's draft "conception" of an energy strategy from 2005 to 2030 (Minpromenergo 2007) and the Ministry of Economic Development and Trade (MERT) draft programme of social and economic development to 2020 (for a discussion of which, see Mau 2008). Firmer in status is the Ministry of Finance's three-year rolling federal budget; this is already approved, but it could be revised, as the 2007 budget was. Then there are the figures, rather few of them, given by Prime Minister Putin in his address to parliament on 8 May 2008 ("Nastuplenie na bednost'," Rossiiskaya gazeta, 9 May 2008). These look precise but turn out at second glance to be of uncertain meaning. Thus expenditure on healthcare from the national and sub-national budgets combined will be close to two trillion roubles in 2010, about four times the 2004

level. Is this in current prices or, if in constant prices, of what year?

In short, the details of government projections are often hard to pin down.

At the same time, the general orientation is clear. Russia is to diversify its economy, pursuing an 'innovation' strategy. Its GDP growth is to exceed 6 percent a year up to 2020, with investment growing over that same period at more than 10 percent annually, while spending on research and development (R&D) is to rise from 1.8 to 4.0 percent of GDP, and therefore to grow at about 14 percent a year over 12 years.¹

This is the preferred "innovation" scenario, but the current official Russian understanding of innovation is the opposite of Joseph Schumpeter's. Instead of creative destruction from below by entrepreneurs, R&D is supposed to be state-led, with the new state holding companies in the vanguard: Rostekhnologii, Rosnanotekh, Rosatom, United Shipbuilding Company, United Aircraft Company, etc.

At the same time Minpromenergo specialists are drawing up a revised energy strategy for the period 2005–30, replacing the existing 2000–20 strategy, finalised in 2003. The most striking feature of the early draft of the new strategy (Minpromenergo 2007) is the confidence with which downside risks are omitted, even in the less favourable ('conservative') of the two scenarios offered. It is explicitly assumed that the world as a whole will see only very slow growth in hydrocarbons production, while nominal oil prices stay in a historically high range. Against this background two scenarios are offered for Russia. Table 1 shows some key figures from them, alongside some GDP growth figures from the MERT socio-economic programme in its "innovation" variant – the variant that has been implicitly adopted by Prime Minister Putin.

¹ The 14 percent growth rate of R&D is my inference, not something given by MERT. It is a guesstimate. If the R&D/GDP percentages were calculated in projected current prices and the price deflator for R&D was expected to be different from the GDP deflator, the implied "real" R&D growth rate would be different.

* Chatham House, London.

Table 1

Some Russian government projections for 2005–30

	2005A*	2010	2015	2020	2025	2030
<i>Minprom 1</i>						
Urals oil price (\$/b)	50.6	48	52	58	65	75
Oil output (mn t)	470	490	500	510	520	525
Gas output (bcm)	638	650	660	670	710	730
<i>Minprom 2</i>						
Urals oil price (\$/b)	50.6	63–64	62	65	75	85
Oil output (mn t)	470	510	530	550	565	570
Gas output (bcm)	638	670	705	750	780	800
<i>MERT innovation scenario</i>						
GDP growth in % (over previous five years)	6.3	6.6
<i>Notes: A* denotes actual; other numbers are scenario projections; Minprom 1 is the Minpromenergo conservative scenario; Minprom 2 is the Minpromenergo favourable scenario; oil and gas output figures are annual rates in the year indicated; oil prices are actual or projected annual averages.</i>						

Sources: Minpromenergo (2007), Tables 3.1, 3.2, 3.6 and 3.7; MERT projections as reported in Mau (2008), Table 3.

The MERT and Minpromenergo projections have been developed semi-independently; where they overlap in coverage they do not always agree on precise numbers. Nor, of course, do they cover the same periods. Still, it seems legitimate to take them together as a source of insight into how Russian officials, at least when putting their forecasts on record, view the likely future. Considered against the background of recent policies, they support the following interpretation of Russian official views.

- The world nominal oil price may dip a little in the medium term but will be on an upward trend. The worst-case scenario is still pretty good for oil exporters.
- Russian output of oil and gas will not fall in any of the benchmark five-year periods.
- Russia's output of oil and gas will grow slowly (average annual growth rates of 0.8 and 0.9 percent in 2005–30 at most for oil and gas, respectively).
- Export earnings from hydrocarbons can be relied upon to grow strongly nonetheless.
- The economy will be diversified primarily by state-supported R&D funding and state-supported investment in education and in telecommunications, aerospace, and other "high-technology" industries.
- Public-private partnerships, particularly in infrastructure projects, and foreign participation will be part of the diversification process, but will be subordinate to state-directed strategy. This is implied by the coverage of the state holding companies listed above, and by the coverage of the law on foreign investment in strategic activities, signed on 5 May 2008. (On the latter, see *BOFIT Weekly*, 9 May 2008.)

The question is: how effective can such a strategy be? I will consider this in two stages: first, the influence of the hydrocarbons sector; second, concerns about growth and diversification more broadly.

Any answer to the question of effectiveness has to be a judgement of likelihood. It is possible that oil prices will remain in a historically high nominal range for a long time; it is possible that the Russian economy will continue to grow at something like recent past rates for a long time; it is possible that such growth will be accompanied by successful diversification so that by 2020 Russia has, as the MERT planners intend, become a competitive knowledge-based economy. My contention here is that the last of these possibilities is not likely while present policies are maintained.

Assessment (1): The role of the oil and gas sector

In this section I consider the role of energy in future Russian development. The relevant concerns are the oil price (affecting export earnings from oil products and gas as well as crude oil), production bottlenecks, and the so-called "resource curse". The first two considerations are to do with the short-to-medium term (say, up to five years). The third consideration is long-term.

To begin with, a sustained and substantial fall in the oil price would in the short to medium term tend to reduce Russian economic activity, other things equal. For example, one econometric study concludes that a sustained \$10/barrel rise or fall in the oil price generates a 2 percent rise or fall in Russian GDP, when other influences are controlled for (Ollus 2007). This effect comes through the

change in the Russian terms of trade and the impact on revenues and hence on consumption, investment and government spending.

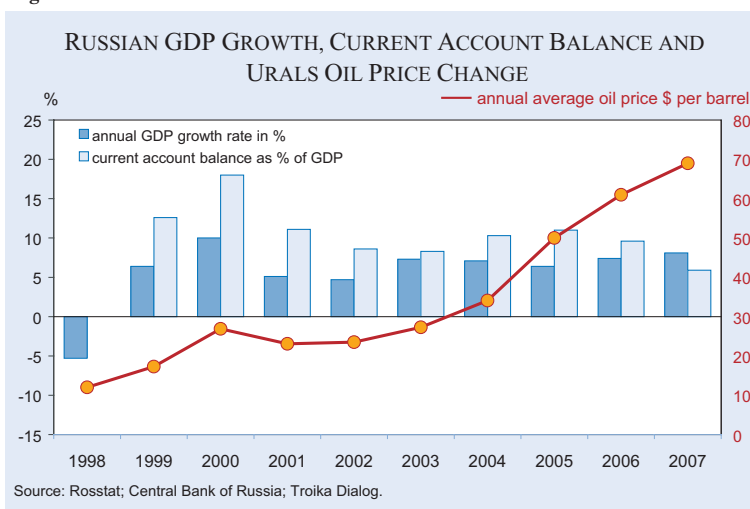
The Reserve Fund – formerly known as the Stabilization Fund – provides some insulation. It sterilises part of the currency inflow from hydrocarbons export earnings, to lessen the inflationary effect. It also gives some protection for the budget, since around half of federal budget revenue comes from oil and gas-related taxes; the Reserve Fund is a source of finance for expenditure commitments if those revenues fall sharply. However, public spending has increased strongly in 2007–08, and become more vulnerable to oil price declines than before. Previously the Ministry of Finance was able to get approval for federal budgets that would be in surplus at a Urals oil price above \$30 a barrel; in 2008, before any upward spending revisions are made, the breakeven point is \$60 (Sutela 2008).

In general, a sharp fall in the oil price would be likely to disturb investor confidence in Russia. For good reasons, perceptions of Russian prospects and the likely future strength of the rouble are closely tied to the state of the oil market. In May 2008 Goldman Sachs, Merrill Lynch and Deutsche Bank were reportedly advising their clients that the rouble was a currency with a very high potential for appreciation (*Vedomosti*, 12 May 2008). That judgement would change if the oil market changed drastically.

How likely is such a development in oil prices? Not likely at all in the foreseeable future, according to most analysts. However, as Egor Gaidar has noted, it is precisely when everyone expects the oil price to stay high in the long term that it becomes worthwhile for businesspeople to invest in energy-saving technologies (Gaidar 2007). One could add that this is also precisely when it becomes attractive to develop high-cost energy sources, affecting the market on the supply side.

Gaidar (2007) also contends that a fall in the oil price contributed to the collapse of the Soviet

Figure 1



Union, whose policy-makers had allowed the economy to become too dependent on oil export earnings – principally to buy food. He goes on to argue that contemporary Russia, albeit with some very important differences, is running the same risk.

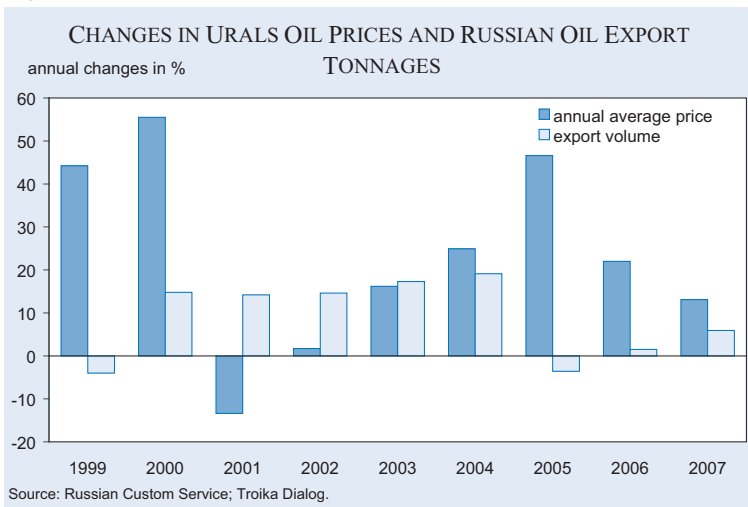
From 1999 until today Russia has benefited from mostly rising oil prices. Figure 1 illustrates this.

The second issue is Russian oil and gas production and export supply prospects. The official view, as we have seen, is that production will rise, albeit slowly, without any acknowledged interruptions, at any rate across bench-mark five-year periods.

This rosy view is open to doubt. In fact, Russian gas production decreased slightly in 2007, and oil output was down year on year in first-quarter 2008 (see Milov 2008; *BOFIT Weekly*, 25 April 2008). These might be only brief blips, but they occur against a background of rapidly decelerating oil output growth. That has been reflected in an equally marked deceleration of oil export volumes (crude plus products), as Figure 2 illustrates. Rising prices have continued to enlarge export earnings and thus stimulate the economy, but the earlier period of rapid petroleum output and export-volume growth between 1999 and 2004 has come to an end. Figure 2 illustrates the deceleration in oil export volumes.

The slowdown in oil production is often ascribed to the “end of easy oil” in Russia, as the limits to boosting output from established fields were reached. But it is striking that the preceding rapid output growth was generated by private companies, notably, Yukos,

Figure 2



Sibneft and TNK. The owners of these companies were probably uncertain about the long-term security of their property rights, and that inhibited them from investing in new fields. As things turned out, at any rate for Yukos and Sibneft, those apprehensions proved to be well-founded. State ownership accounted for 11 percent of oil production in 2004 and 39 percent in 2007 (Milov 2008), and no Russian state hydrocarbons company has yet demonstrated an ability to grow its business except by acquisitions. The modest (2.3 percent) increase in oil production in 2007 is largely accounted for by foreign-led development projects on Sakhalin (*ibid*).

The state has also restricted output by maintaining the state-controlled company Transneft's monopoly of export pipelines, and developing that network only slowly. And it has imposed a heavy tax burden on the oil industry. Now natural resource extraction tax rates for oil are to be reviewed with a view to reducing that burden (Sterkin 2008). That should help, but it may not be enough to prevent a plateauing or even decline in Russian oil output in the medium term.

Russian gas production, very largely controlled by the state in the form of Gazprom, has been sluggish throughout the post-Soviet period (and in the late Soviet period, too). One expert assessment is that annual investment of the order of \$4–5 billion in the Yamal fields would be needed to prevent a decline in gas output in 2008–15, while the current actual rate is about \$1 billion (Milov interview 2008).

The Russian state therefore faces problems in maintaining its export earnings from oil and gas over the next few years unless the oil price keeps on rising; an

oil price that simply remains in a historically high nominal range may not be enough.

There are two sources of rescue from this problem, apart from a turnaround in the trend of extraction rates, and both are to do with gas. They are the import and re-export of growing quantities of Central Asian gas and a drastic curbing of domestic gas consumption. The former is already built into the draft energy strategy to 2030, so what is required on that front is that production in Turkmenistan and

Kazakhstan (the main sources) does indeed grow as expected. The latter would most likely be secured by further rises in the domestic price of gas – at present centrally controlled for both business and household customers at levels latterly around one-third of the “European” price: the netback border price of gas delivered to Europe, exclusive of transport costs and export duties.² Domestic prices are being raised but the “equalization” of domestic and European prices, originally due in 2011 for industrial users, has been postponed. Even administered-price rises help, but the present domestic industrial-user price, at about one-third of the “European” price, is bound to encourage more wasteful domestic use of gas than a de-controlled price would do.

One hopeful sign is the re-emergence of big business as a source of open criticism of excessive state control of the energy sector. As chairman of the energy committee of the Russian Union of Industrialists and Entrepreneurs (RUIE), Vagit Alekperov voiced such criticism in April 2008 (*Interfax*, 21 April 2008). Alekperov is also the boss of Lukoil, so his views are hardly impartial. What is striking is that Alekperov also has a reputation for having close political contacts, and the RUIE has been extremely docile from the Yukos case (starting in 2003) until very recently.

The third concern is of a different order: the evidence that countries with a high ratio of natural-resource exports to GDP have tended, other things equal, to have sluggish growth in the long term

² Some “over-quota” gas is traded in a free market but that has not prevented some shutdowns of gas-fuelled power stations because of gas shortages.

(Sachs and Warner 2001). This observation is not well understood, and there can be no certainty that it will apply in all cases. However, Gaidar and other liberal Russian economists mostly take the view that oil and gas wealth, in a period of high and rising oil prices, has weakened incentives for reform and created problems for Russian competitiveness in non-natural resource tradable goods. Imports of manufactures have certainly risen faster than domestic production (Ollus and Barisitz 2007), though that is not conclusive evidence of Russia succumbing to the so-called Dutch Disease (from which the Dutch recovered pretty well).³

From this point of view, a collapse in the oil price would be good for Russia – but only in a long run of uncertain duration.

To sum up: Russian policymakers appear to be relying on a benign environment of high oil prices continuing. They could be right, but there are a number of downside risks in this reliance on energy that appear to be underplayed in current Moscow official thinking. And one of those risks, paradoxically, is that even a continuation of historically high oil prices may, if one can judge from historical evidence in other countries, have side-effects that hinder successful diversification.

Assessment (2): State-led modernisation

The shift towards state-led development in Russia begins with the Yukos case in 2003. I have discussed this at greater length elsewhere (Hanson 2007) and will only summarise here the main conclusions about these recent changes.

First, state control has been asserted primarily in the oil industry (gas was already state-controlled), in a milder form in banking and in an array of so-called “strategic” industries that are mostly defence-related but which are characteristically not run by the state in OECD countries: they include shipbuilding and aerospace, as well as nuclear energy, for example.

Second, the increase in state control has been achieved, in a great many cases, without due process and with often blatant manipulation of state administrative power: claims about unpaid back-taxes,

about infringements of natural-resource extraction licence agreements and about environmental infringements, usually. These pressures have been deployed in the most extreme way against Yukos but have also been used against, among others, the Shell-led Sakhalin-2 project, TNK-BP (at least partly over control of the Kovykta gas-field), the VSMPO-Avisma titanium company and the Russian oil company.

Third, it does not appear that a pre-planned, coherent economic strategy was involved. Senior policymakers in the ministries of finance and economic development, far from devising and supporting the shift to statism, have from time to time criticised it. The time-line of developments, and anomalies such as the failure to implement the planned merger of Gazprom and Rosneft, suggest a serendipitous process, perhaps originating in a desire to suppress a rich political critic (*Khodorkovskii*) and evolving into a series of state acquisitions: what might be termed learning by grabbing. Corruption has tended to increase during this period (Anderson and Gray 2006). The common Russian view that it is all about asset-grabbing is not refutable, even though it may not be the whole story.

Fourth, it is not clear that there is a definite strategy of continually increasing state control, but there does appear to be an element of nativism – of suspicion of foreign ownership – and a concern that the Russian business elite should be – if not necessarily holders of public office chairing state-controlled companies – at any rate demonstrably loyal to the Russian state.

By limiting competition (and finance and technology transfer) from foreign firms and competition from non-crony entrepreneurs and by weakening the rule of law, which was not strong to begin with, these policies look almost designed to do the opposite of what the Russian leadership undoubtedly wants: to make Russia a diversified, modern economy.

The distance that has to be travelled, as well as the way of getting there, looks to be misjudged by Russian officials. In 2007, on preliminary figures, Russia accounted for 0.3 percent of international patent filings (http://www.wipo.int/pressroom/en/articles/2008/article_0006.html, accessed 15 May 2008). That compares with 3.5 percent for China, 1.9 percent for Italy, and 1.3 percent for Finland. Despite having a relatively large R&D workforce for a middle-income

³ To be fair, Ollus and Barisitz (2007) claim only that their evidence is suggestive, not conclusive.

country, Russia has a science base that is strikingly unproductive on most indicators. Yet in the MERT plan this base is to grow very rapidly to a point where R&D spending is higher relative to GDP than it currently is in highly developed countries.

This, combined with the structure of state holding companies described earlier, suggests there is a strong possibility of a distorted and wasteful state diversification programme that may well fall short of its objectives.

To be fair, one should also note that there are some indications of flexibility within this top-down strategy. The approach to foreign participation could well be more pragmatic than at present looks likely. Exceptions to the restrictions on foreign participation in “strategic” industries and natural-resource developments might prove to be made quite readily. Within the state-led programmes there can be room for *ad hoc* foreign involvement. The aerospace strategy, for example, sets involvement in international projects with Boeing and other leading producers as a target, for learning purposes, and indeed VSMPO-Avisma, the titanium producer that now comes under Rostekhnologii, duly has a 50-50 joint venture with Boeing (Hanson 2007).

The overall approach, nonetheless, is not promising.

Conclusions

State-led, oil-fuelled development is problematic for Russia, as it would be in any country. It looks as though, nonetheless, official Russian policy has been seduced by nine years of strong economic growth into adopting this approach. Apart from anything else, it fits well with the political leadership’s evident fear of anything resembling pluralism and political competition.

The approach, however, is not guaranteed to last indefinitely. Most Russia-watchers, it is true, do not at the time of writing expect significant policy shifts to result from the Putin-Medvedev succession. But the novel new leadership arrangement may open the way for more open divisions within the elite to emerge – and perhaps introduce some competition into policy-making. There is a business constituency that is unhappy with the present policy line. In an early-2008 survey of business opinion, the question was asked: “What government activity does Russia

need urgently?” Respondents could choose any two out of seven answers. More than 60 percent chose “Formation of legal environment for business activity,” the most popular answer. Only about 20 percent chose “Financial support of selective priority enterprises and industries”, and less than 20 percent chose “Direct regulation of the most important economic sectors” (All-Russian Center for the Study of Public Opinion, as cited in Troika Dialog 2008, 14).

At the same time, there is a substantial part of the Russian economy that is beneath the Kremlin’s radar: most services and part of manufacturing. The state-led, “Putinist” system in general allows for much more flexibility than the old Soviet system did. If the economy runs into difficulties, for whatever reason, a leadership and a policy approach that are currently “legitimised” by rising prosperity may face challenges.

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