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Research Report

Russia's Reform Failures and Putin's Future Challenges

Policy Notes and Reports, No. 20

Provided in Cooperation with:

The Vienna Institute for International Economic Studies (wiiw) - Wiener Institut für Internationale Wirtschaftsvergleiche (wiiw)

Suggested Citation: Havlik, Peter (2018) : Russia's Reform Failures and Putin's Future Challenges, Policy Notes and Reports, No. 20, The Vienna Institute for International Economic Studies (wiiw), Vienna

This Version is available at:

<https://hdl.handle.net/10419/204263>

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MARCH 2018

Policy Notes and Reports 20

Russia's Reform Failures and Putin's Future Challenges

Peter Havlik



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Russia's Reform Failures and Putin's Future Challenges

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Abstract

Vladimir Putin's presidency will last until 2024 – longer than most other Russian or Soviet leaders ruled. This Policy Note provides a brief review of past economic developments and reform attempts. We argue that past reforms have in effect failed yet the main economic challenges currently facing Russia remain essentially the same as two decades ago: excessive dependence on energy, lack of diversification, poor investment climate, corruption, etc. What has changed is the resort to assertive behaviour and inward-looking economic policies which replaced the European integration vector prevalent at the beginning of the 2000s. We argue that without normalisation of external relations, there will be no breakthrough in the vicious circle of sanctions, protectionism, and lack of investments and economic integration. Otherwise, Russia will likely face not only economic stagnation, but even the risk of economically falling behind the peers in the East, South and West – ultimately endangering the social and eventually even political stability at home and in the neighbourhood.

Keywords: Russia, Vladimir Putin, economic reforms, economic integration

JEL classification: E6, F4, O4, O5

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Russia's reform failures and Putin's future challenges

1. INTRODUCTION¹

Vladimir Putin is poised to win the March 2018 presidential election by a comfortable margin, the actual voters' turnout – anything less than 60% would be an alarming signal – being practically the only unknown. Coming to power at the turn of the century for his first term, then endorsed by the ailing Boris Yeltsin as his little-known successor ('Who is Mr Putin?' asked many at that time),² the next one will be his fourth presidential term. Being now in power already for 18 years – including an interregnum during 2008-2012 when he formally switched the presidency for premiership with Dmitry Medvedev, he is also the by far most influential and popular Russian politician.³ But Mr Putin has been not only popular at home, but also demonised abroad. He has been accused of interfering in numerous elections and referenda, of ordering cyberattacks and various disinformation campaigns, of supporting right-wing and populist parties in the West, and of being responsible for other mischievous deeds against adversaries both abroad and at home. Mr Putin managed to appear on the cover of *The Economist* twice just in the last two years.⁴ The presentation of Mr Putin as an almost almighty KGB-style plotter and Tsar in the West is viewed with some consternation by many observers both outside and inside Russia since it probably helps to raise his popularity at home.⁵

Mr Putin's forthcoming presidency will presumably last until 2024 which – by that time almost for a quarter century – will be longer than most other Russian or Soviet leaders ruled – except for Peter the Great, Catherine the Great, Nicholas I and Joseph Stalin. But already now is the length of Putin's rule comparable with that of Leonid Brezhnev during the Soviet period, the final years of which were nicknamed the 'era of stagnation' which ultimately ended with Mikhail Gorbachev's failed attempt at perestroika launched in April 1985 and, subsequently, the dissolution of the Soviet Union in December 1991.

Given the current bleak economic outlook, there is a legitimate question: Will Russia overcome the stagnation with reforms or is it facing another 'perestroika' and will it succeed this time?

Definitely, Mr Putin has already left a decisive mark on Russia and beyond. Still, many uncertainties

¹ The author thanks Vasily Astrov, Vladimir Gligorov, Richard Grieveson, Mario Holzner and Robert Stehrer (all wiiw) for useful comments on an earlier draft. The views presented in this note are solely those of the author.

² See <https://www.youtube.com/watch?v=6cECPakuA6M>. For a written account see <https://www.google.at/url?sa=t&rct=j&q=&esrc=s&source=web&cd=8&ved=0ahUKEwiFrgLdspbZAhXSKVAKHXeUAPIQFghSMAC&url=https%3A%2F%2Fwww.brookings.edu%2Fwp-content%2Fuploads%2F2016%2F07%2FChapter-One-1.pdf&usq=AOvVaw0vZDK-J1W1POMLRnvGusSz>.

³ A recent Levada opinion poll revealed a lasting support for Mr Putin who is facing no realistic opposition – see <http://carnegie.ru/2018/02/06/perils-of-change-russians-mixed-attitudes-toward-reform-pub-75436>.

⁴ See *The Economist*, 22 October 2016 and 27 October 2017. See also *The Economist*, 24 February 2018.

⁵ See <http://carnegieendowment.org/2018/02/13/former-soviet-empire-strikes-back-pub-75545>; *The New York Times*, 25-26 November 2017, pp. 1 and 7; *The Economist*, 2 December 2017; Gessen, M. (2017), 'Russia: The Conspiracy Trap', *The New York Review of Books*, 6 March (<http://www.nybooks.com/daily/2017/03/06/trump-russia-conspiracy-trap/>).

regarding the future course remain. As before, there are rumours about signs of infighting within Russian elites and other potential instability risks (we shall deal with economic challenges later on).⁶ The above-quoted Levada poll from late 2017 revealed also that although '80% of Russians would favour some degree of change, few are for more economic liberalisation while a majority would favour to re-impose state regulations'. Most Russians 'understand that the country cannot move forward, or even stay in place, without reforms' (ibid.), but essentially would prefer a return of the past. In this situation, what changes can be realistically expected in the future, and are there any similarities to the past? Regarding the economic challenges Russia is currently facing, one can indeed identify many similarities with the past. In addition, there are now a number of formidable challenges arising from the sphere of external relations (Ukraine, Syria, conflict with the West, etc.).⁷ In this note, we shall focus on the economic perspectives and start with a brief review of economic developments and associated reform discussions. On this basis, we will not only try to identify the outstanding challenges, but also attempt to formulate some of the key economic policy directions which should be considered in order to counter the threats of looming economic and societal stagnation.

2. A RETROSPECTIVE ASSESSMENT OF REFORM AGENDAS AND OUTCOMES

2.1. Volatile economic performance

After a deep and prolonged transformational recession during the 1990s, the Russian economic upswing from the early 2000s was enhanced by surging world market energy prices while political stabilisation along with some reform progress was instrumental as well (Figure 1). The main factors behind the dismal growth performance during the 1990s were identified at the very beginning of Putin's first presidency as follows:

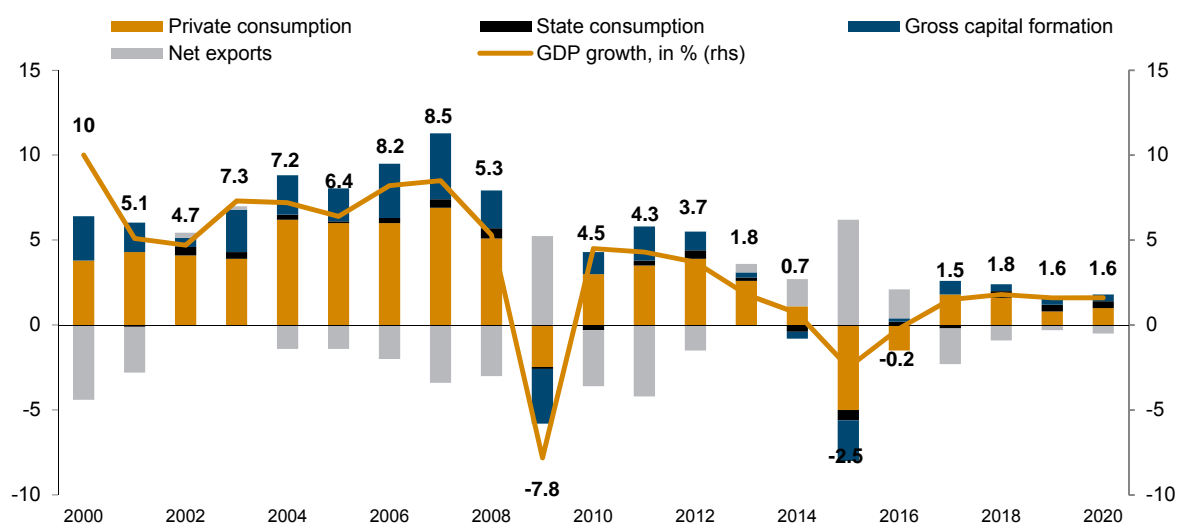
- › the legacy of communist central planning which – contrary to Central and Eastern European countries – lasted much longer and was not imposed from outside;
- › large structural distortions of the economy, especially the predominant role played by energy and defence-related industries;
- › disintegration of the country, loss of traditional markets in both the former Council for Mutual Economic Assistance (CMEA) countries and the Soviet Union, and loss of the superpower status;
- › ill-advised, inconsistent and poorly implemented reform policies from the early 1990s, especially regarding liberalisations, privatisation and institution building;
- › political instability and the lack of an external institutional anchor (like the EU accession prospects for Central and Eastern European countries);

⁶ See, for example, <https://www.vedomosti.ru/opinion/articles/2018/01/18/748172-opasen-chetvertii-srok>.

⁷ A comprehensive recent analysis can be found in Hamilton, D. and S. Meister (eds) (2017), *The Russia File: Russia and the West in an Unordered World*, Center for Transatlantic Relations, The Paul H. Nitze School of Advanced International Studies, Johns Hopkins University, and German Council on Foreign Relations/ Deutsche Gesellschaft für Auswärtige Politik.

- › the resulting poor investment climate, persisting huge capital flight and the related collapse of investments, little and distorted FDI;
- › weak foreign trade performance: stagnation (at best) of exports and a large decline in imports, with a petrified commodity composition of exports;
- › an overall decline of living standards, consumption and deteriorating infrastructure.

Figure 1 / Russian GDP growth (%) and contributions of main components (in pp)



Source: wiiw Annual Database, national statistics, own estimates and forecasts.

The past economic policies and the way they still impact on the future economic prospects must be analysed and assessed along the above-outlined broad problem areas. While some of the mentioned factors are gradually disappearing over time, and signs of improvements in other areas initially began to appear with Putin's presidency at the beginning of the 2000s, the challenges remain essentially the same – and are becoming even 'chronic'. The medium- and long-term growth outlook is correspondingly gloomy. Before outlining the key areas of economic reforms, we will provide a brief review of Russian economic policies and reform challenges as they have been evolving during the past two decades.

2.2. Initial reform progress, albeit modest

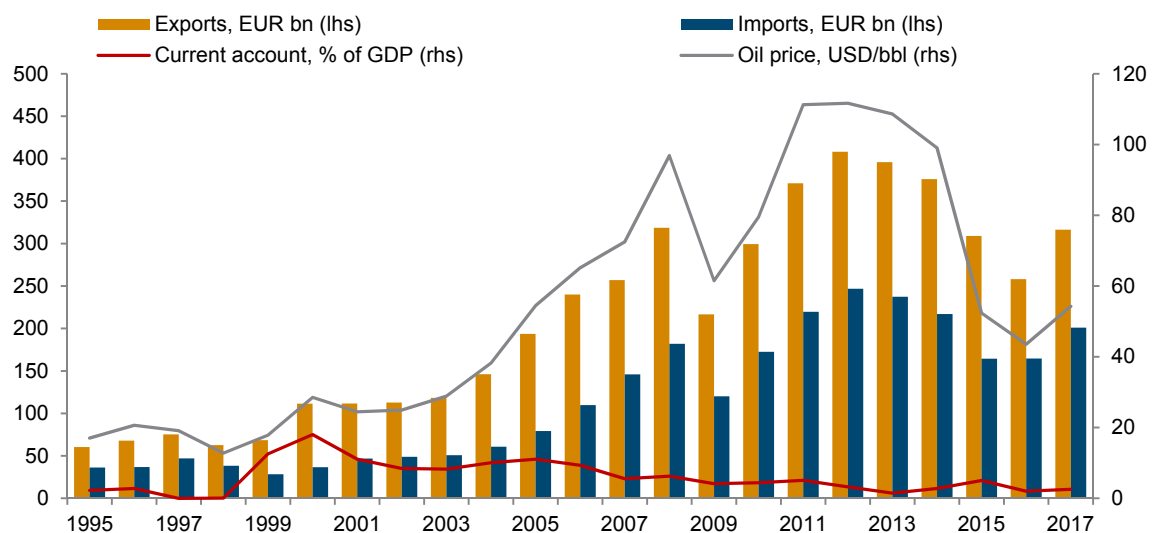
The positive economic developments during Putin's first two presidencies 2000-2007 were associated with surging energy prices (Figure 2). However, flourishing energy export and fiscal revenues also put off the pressure to introduce further urgent structural and institutional reforms. Thus, delays (and even some confusion) in the formulation of economic policies gave rise to disappointment, despite the adoption of an ambitious long-term development strategy in mid-2000. As of end-2001, basically only pieces of relevant new legislation had been implemented. Priority reform measures included at that time the taxation of profits, further privatisations, restructuring of natural monopolies (including the Unified Electricity System, Gazprom and Russian Railways), the adoption of the Land Codex enabling private ownership and sale of non-agricultural land, as well as pension and

legal reforms. A major innovation in the fiscal sphere, proposed first by the President's economic advisor Andrey Illarionov, was the introduction of a flat tax and the idea to create a 'financial reserve fund' from windfall oil export revenues. The Stabilisation Fund was eventually established in January 2004; in 2008 it was split into the Reserve Fund and the National Wealth Fund.⁸

Already in October 2003, before Mr Putin's second presidential term had started, I provided the following summary assessment of outstanding challenges:⁹

*'Despite the largely positive economic indicators, a sustainable development is still uncertain considering the **lagging implementation of administrative reforms, legal regulations and, last but not least, growing structural distortions in the economy.** There is a broad consensus that the **current pace of economic growth is not sustainable in the medium and long run unless the speed of structural, institutional and banking sector reforms increases substantially.**'*

Figure 2 / Russian exports, imports and the oil price



Source: wiiw Database.

As is argued below, both this assessment and the outstanding challenges remain essentially the same in 2018.

2.3. The Putin-Medvedev 'tandem switch' from 2008

In March 2008, immediately after the Putin-Medvedev 'tandem switch' and before the financial crisis struck, we wrote the following:¹⁰

⁸ In 2005, Mr Illarionov resigned from his position in Russia and subsequently moved to the USA to become a fellow at Cato Institute in Washington DC.

⁹ See *wiiw Monthly Report*, No. 2003/10.

¹⁰ See Havlik, P. (2008), 'Russian Economic and Integration Prospects', Paper presented at the 'Special Conference on Russian Economic Development and Future Perspectives' organised by the Institute of Economic Research, Hitotsubashi University, Tokyo in March 2008.

*'The recent **economic developments have been overshadowed by politics**, in particular by the issue of Vladimir Putin's successor after the March 2nd, 2008 presidential elections. The elections were not entirely fair since Putin's preferred candidate had been disproportionately endorsed by the state-controlled media, yet there is little doubt that both Mr Putin and Mr Medvedev (the latter seen as a guarantee for the continuity of Putin's successful policies) enjoy an overwhelming support in the Russian electorate. Owing to his popularity and age, **Mr Putin is likely to dominate Russian politics in the years to come** – he may even return to the Kremlin after some time. With a stronger economy, more financial resources and power consolidation at home, **Russia's self-confidence (as well as its outward investments) will grow further – and this may lead to more conflicts with both the EU and USA**, although the present tensions may calm down provided the new President Medvedev will keep his credentials as a liberal politician who supports the rule of law and fight against corruption. However, there is little doubt that either Mr Medvedev or Mr Putin will both defend Russian interests and these need not be necessarily identical with those of either the EU or the USA and may lead to additional tensions.'*

Again, the above assessment – now ten years old – is not much different from the present situation.

Medvedev's presidency largely disappointed, although the financial crisis of 2008/2009 was managed relatively successfully as the Russian government adopted various rescue and financial stimulus packages already in the autumn of 2008. The aim was to improve the liquidity of the banking sector and restore confidence, to support the exchange rate and domestic consumption with a huge fiscal stimulus amounting to about 10% of GDP in 2009. With respect to declared economic reforms, Medvedev's priority areas ('Russia Forward' from September 2009), allegedly supported by appropriated financial resources, were:

- › to become one of the world's leaders in the efficiency of production, transportation and the use of energy;
- › to develop new quality benchmarks in the field of nuclear technology;
- › to improve information technology and to effect developments of global information technologies;
- › to implement indigenous ground- and space-based infrastructure for the transmission of all types of information services;
- › to achieve a leading position in the development of medical equipment, diagnostic tools and pharmaceuticals required for the treatment of viral, cardiovascular, cancer and neurological diseases.

The success of the attempted modernisation strategy (the so-called '4Is': Innovation, Information, Infrastructure and Institutions), as well as of the 'Partnership for Modernisation' launched at the EU-Russia Summit in June 2010, was doomed from the very beginning, though external factors played a role in its failure as well:

'The chances for the success of an "innovation development" scenario had never been particularly high. They have diminished in the aftermath of the war with Georgia at the latest. The collapse of the oil price and effects of the global crisis had radically curtailed financial resources initially earmarked for modernisation programmes. At the same time, the limits of the resource-based growth scenario became even more obvious.'

The sharp deterioration of Russian relations with the West will have serious repercussions for the future path of Russian economic reforms. It may strengthen the inward-looking, autarky development strategy which is doomed to fail. Russia has never been too enthusiastic to join the WTO (in fact, the recently envisaged Industrial Policy tools could well be in conflict with WTO rules). The accession to WTO was postponed once more in June 2009, this time after the agreement about forming a Customs Union with Belarus and Kazakhstan (starting from January 2010) was finalised ... **Russia has become increasingly assertive.** Dangers of escalating external conflicts (e.g. a confrontation with Ukraine over Crimea) are being recognised.¹¹

2.4. Back to Putin in 2012, start of troubles

In early 2012, at the end of Medvedev's presidency, the troubles became obvious after the December 2011 Duma elections and the announced 'tandem reshuffle'. The years of robust economic growth fuelled by surging energy prices had not been used for launching economic restructuring and institutional reforms which would have brought about the badly needed improvements of the business climate. We wrote in early 2012:¹²

'Russia is as dependent on exports of commodities as ever: oil and gas account for about two thirds of export revenues. **Restructuring, modernisation and the "innovation development" preached by the authorities already for a number of years have so far been just empty slogans ...** Modernisation prospects suffered another blow after President Medvedev's announcement in September 2011 that Vladimir Putin should stand for the next presidential elections in March 2012. Paradoxically, this news created some disappointment in both Russia and abroad. Disappointments with this uninspiring switch in the ruling tandem result not least from a growing scepticism regarding modernisation and fears that Russia will turn back- and inward in the coming years. As the modernisation will likely stall, a rising number of people will give up initiative for resignation (according to polls, emigration is being considered by an ever growing number of young and educated Russians).'

Again, as far as political developments and reform prospects are concerned, the assessment at that time (early 2012) was in many respects similar to the current (early 2018) situation:

'... Despite Mr Putin's convincing victory already in the first election round on 4 March 2012, his authority and the room for manoeuvre will be far more constrained than previously considered. In particular, his relatively low support in Moscow (he received less than 50% there) will require policy adjustments in order to accommodate (hopefully not to suppress) protests of disappointed middle class intelligentsia. There have been a lot of other worrying signals as well. Besides growing nationalism (common to many opposition figures such as the leading anti-corruption blogger A. Navalny and others), the openly expressed praise for the Soviet past (in particular for the Brezhnev era) by both Messrs. Putin and Medvedev do not bode well for modernisation and forward-looking policies either – despite official claims to the contrary. These and other disturbing signals [...] foster the views that instead of 'forwards' (Medvedev's slogan 'Russia Forward' from September 2009) the forthcoming years of Putin's presidency will lead Russia backwards, or at least to social and economic stagnation.' (ibid.)

¹¹ See 'Russia: heading for crash and clash?', *wiiw Current Analyses and Forecasts*, No. 4, July 2009, pp. 112-115. For an evaluation of the Modernisation Partnership see: EU-Russia Centre (2010), 'The EU-Russia Modernisation Partnership', Review No. 15, October.

¹² See 'Russian Federation: Instability ahead?', *wiiw Current Analyses and Forecasts*, No. 9, March 2012, pp. 129-134.

The elements of Putin's economic programme for 2012-2017 were made public in October 2011 and January 2012. Then Mr Putin announced the **priority of Eurasian (EurAz) integration of the post-Soviet space**.¹³ Apart from stressing again 'stability', as well as repeating the necessity to overcome the 'raw materials character' of the economy via **modernisation and diversification while rejecting protectionism** (sic), the announced economic reform blueprint represented a somewhat confusing mix of industrial policy measures, the rejection of 'state capitalism' (despite praising the experiences of China and – presumably – South Korea), the support of further **privatisations and foreign direct investments**.

In Putin's view at that time, the business climate remained 'unsatisfactory' – an indirect criticism of Medvedev's presidency while avoiding to admit own responsibilities as Prime Minister. Possibly reacting to the widespread criticism of United Russia as the 'party of crooks and thieves' (© Alexei Navalny), Mr Putin also complained in unusually harsh words about the lack of transparency and failures of the state apparatus – including customs and tax officials, the legal and court systems – mentioning even 'systemic corruption' and demanding the elimination of all remnants of Soviet legislation from the business legal codex which may hinder entrepreneurship. Within the next couple of years, Mr Putin aimed at the improvement of Russia's ranking in the World Bank Doing Business indicator (in 2011 rank 120 out of 183), to reach at least the rank of Kazakhstan (47).¹⁴ Last but not least, he proclaimed that **the state's role in the economy should be reduced and competition fostered while maintaining macroeconomic stability. Taken together, all these and other outlined measures should contribute to economic diversification, productivity increases and the development of high-tech industries. In all these areas, including job creation, SMEs should play a crucial role.**

Our assessment at that time was again sceptical:¹⁵

*'Pre-election rhetoric notwithstanding, any significant breakthrough is unlikely in the near future. Rather, uncertainties have increased: a more pronounced recession in Europe and a slowdown in the global economy may result in lower oil prices [...] **The unimpressive or diminishing drive for reforms and restructuring in Russia, together with the prospect of a weaker next presidency by Putin, may well get reflected in a continuation of capital flight and a poor climate for investments. In the medium term, a certain modernisation drive could come from WTO membership.***

The expected modernisation drive from WTO accession did not materialise, however, and the optimistic expectations regarding economic growth proved wrong as well. And in November 2012 we wrote:¹⁶

*'... Unfortunately, all by and large positive economic news has been overshadowed by **deteriorating political and societal developments after the Medvedev-Putin tandem shuffle**. Mr Medvedev's weakness (and also a general retreat from liberal values which he tried to pursue during his presidency) came repeatedly to the open during the first months of Putin's new presidency. The strange coalition between the Orthodox Church and political leadership, which is gambling on the support from conservative parts of Russian society, raises uneasy feelings among the liberal opposition yet it is popular with the nationalists and*

¹³ A certain progress in this direction, at least on paper, was made in October 2011 in St. Petersburg when eight CIS republics (including Ukraine) announced the establishment of a free trade area.

¹⁴ This has been one of the few targets which have been achieved: Russia's ranking in Doing Business jumped to 35, ahead of Kazakhstan, in 2018.

¹⁵ See 'Russian Federation: Instability ahead?', *wiiw Current Analyses and Forecasts*, No. 9, March 2012, pp. 129-134.

¹⁶ See 'Russian Federation: Growth flat, politics bad', *wiiw Monthly Report*, No. 2012/11, pp. 20-21.

populists. On the external front, Russian relations with the USA and the EU further worsened (Syria, Russian ban of USAID and other restrictions on foreign-supported NGOs, etc.). Russia also became more assertive in energy issues with pressures on Bulgaria, Moldova and Ukraine and Gazprom's conflicts with the EU.'

Russian economic growth came to a standstill in 2013 and the conflict with the EU about Ukraine started to escalate. In October 2013 we stated:¹⁷

*'... **Lacking progress of diversification and modernisation remains to be the main obstacle to faster economic growth and there has been hardly any change in this respect, despite frequent official rhetoric. More assertive domestic and external policies represent another bottleneck.** The latest sore point in external relations with potentially **adverse economic consequences is Russia's bullying of Ukraine** (as well as of Armenia and Moldova) related to the expected signature of an Association Agreement/Deep and Comprehensive Free Trade Agreement (AA/DCFTA) with the EU at the forthcoming Eastern Partnership Summit in Vilnius at the end of November 2013. Several crude Russian attempts to prevent Ukraine from signing the AA/DCFTA with the EU prior to the Vilnius Summit, together with efforts to 'lure' Ukraine into joining the Russian-dominated Customs Union (CU) with Belarus and Kazakhstan instead, have led to a veritable tug-of-war with the EU. The latter, while claiming that 'this is not a choice between Moscow and Brussels' and presenting the AA/DCFTA as 'a contribution to creating the area of free trade between Lisbon and Vladivostok', is promising a speedier DCFTA implementation. Ukraine, for its part, is manoeuvring to maintain good business-like relations with both Russia and the EU. Nevertheless, **the current polarisation of both Russian and EU standpoints is not only endangering future Russian-EU relations, but is also counter-productive in relations with Ukraine which will be ultimately adversely affected the most.**'¹⁸*

The situation radically changed after the **Ukraine crisis and the Russian annexation of Crimea in April 2014**. The imposition of Western sanctions, magnified by the collapse of the oil price with subsequent devaluation of the rouble and Russian counter-sanctions affecting food imports in August 2014 had devastating effects: altogether, the estimated loss of Russian GDP amounted to a cumulated EUR 100 billion during 2014-2016.¹⁹ Regarding reform prospects, we wrote in October 2014 (ibid.):

*'Apart from the worsened investment climate, it is the missing progress in diversification and modernisation that has been the main obstacle to a revival of economic growth. **The escalating conflict over Ukraine and ever more assertive domestic and external policies represent another modernisation bottleneck ...** Even barring a further escalation of the conflict, **modernisation ambitions will doubtlessly suffer also in the medium and long run due to lower FDI inflows and reduced imports of advanced technologies – despite efforts to mobilise additional domestic resources ...** In any case, the serious and probably lasting damage to Russian external relations with Ukraine and the West will be very difficult to repair.'*

Facing the prospect of a severe recession in 2015, the repeatedly underlined necessity to improve the institutional, administrative and infrastructure prerequisites for investments has become more challenging. However, the efficiency of state-sponsored industrial policies and import substitution

¹⁷ See 'Russian Federation: Firm in stagnation, with dim way out', *wiiw Monthly Report*, No. 2013/11, pp. 19-21.

¹⁸ For a more detailed analysis regarding the implications of the Vilnius Eastern Partnership Summit see *wiiw Policy Note*, No 14, 'Economic Consequences of the Ukraine Conflict', November 2013, <https://wiiw.ac.at/economic-consequences-of-the-ukraine-conflict-p-3427.html>.

¹⁹ See 'Russian Federation: Stagnation and isolation ahead', *wiiw Forecast Report Autumn 2014*, pp. 117-120.

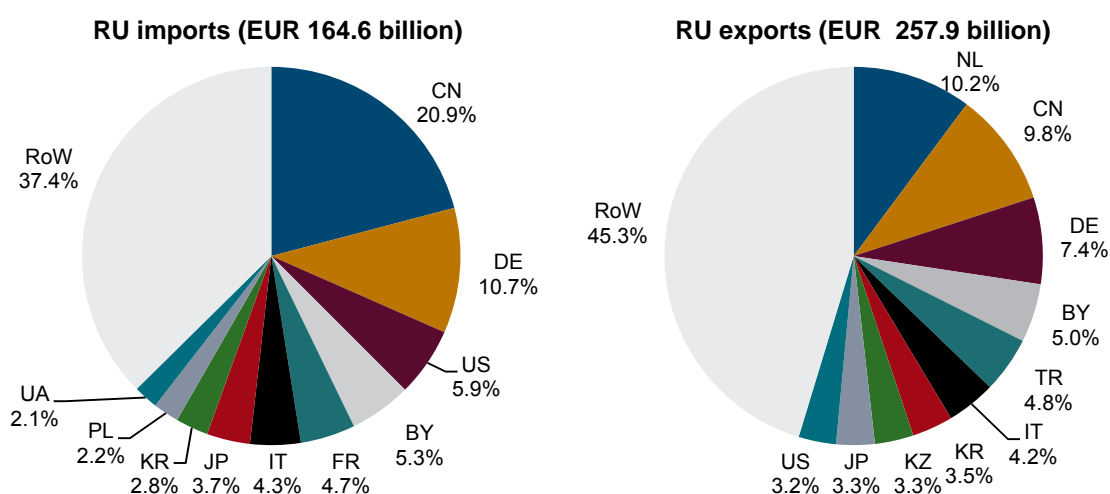
measures was doubted. The scepticism concerning the successful implementation of re-launched reform declarations – in particular with respect to the success of the ‘new’ FDI policy, austerity, import substitution, trade re-orientation and innovation strategies – was justified. For example, the Russian per capita FDI stock is not only much lower than in CESEE peers, but a large part represents recycled domestic flight capital via various off-shore tax havens (Figures 4 and 5). Moreover, **an inward-looking development strategy, even under the working assumption that the current financial and trade sanctions will be eventually lifted, will hardly yield the envisaged modernisation results. Without a ‘reset’ of external relations with Europe and a resolution of the Ukraine conflict, the success chances for a sustainable Russian development in the medium and long run are rather poor.**²⁰

Again, in early 2016 we warned:²¹

*‘There seems to be a consensus that **Russia is facing a prolonged period of stagnation** in both economic and societal developments. Turning inward and continuing with more assertive policies is not helpful. **Changing the pivot to China cannot substitute for trade with and investments from the EU**, and the damaged links with most of the near neighbourhood both west and south (Ukraine and Turkey in particular) will be hard to restore. Moreover, even the Eurasian Economic Union flagship project has been adversely affected by these policies and other ill-considered unilateral steps on the part of Russia.’²²*

China has become Russia’s most important import partner, but its role as an export market is still modest (Figure 3). Moreover, there are important structural differences: imports from China cannot substitute for those from the EU. As far as FDI is concerned, the role of China remains negligible (as of mid-2017, Chinese FDI stocks in Russia amounted to less than 1% of the total) – though this may change in the course of the realisation of the Chinese ‘One Belt One Road’ project.

Figure 3 / Russia’s main trading partners, 2016, in % of total



Source: wiiw Annual Database, national statistics.

²⁰ See Havlik, P. (2015), ‘Russian Federation 2015: From Stagnation to Recession and Back’, *wiiw Research Report*, No. 406, September, <https://wiiw.ac.at/russian-federation-2015-from-stagnation-to-recession-and-back-p-3654.html>.

²¹ See ‘Russian Federation: Recession not yet over’, *wiiw Forecast Report Spring 2016*, pp. 113-116.

²² Contrary to most expectations, relations with Turkey were normalised fairly quickly – already in the course of 2016/2017.

2.5. Is stagnation the 'new normal'?

By mid-2017, the Russian economy emerged from recession as it had apparently adapted to the 'new normal' of lower oil prices and sanctions. A speedy and complete lifting of Western sanctions was not expected: it became soon clear that any 'deal' with Trump would be difficult to reach and implement, and the fragile ceasefire in Donbas may not be sustained. The EU's largely hostile stance towards Russia is not going to change markedly either, at least so long as Angela Merkel remains German chancellor and Russia continues to support the insurgency in Donbas.²³ A resuscitation of a dialogue with the EU could happen after the formation of the new coalition government in Germany, yet a normalisation of Russian relations with neighbours (especially Ukraine, but also Poland and the Baltics) will be difficult and the damage incurred so far will last. A reset of the Minsk process and an agreement on more OSCE/UN involvement in Ukraine would be helpful.

As the above brief review has shown, the overall assessment of **Russian economic challenges has not changed very much in the last couple of years and, if anything, these challenges have become more acute and even aggravated by external conflicts.** The major reason for the **disappointing growth prospects is that – unless something unexpected happens – no substantial domestic reforms are on the horizon**, even after the presidential elections in March 2018. Whether Putin's next presidency will bring any change in economic policies remains to be seen – the previous experience is not very encouraging. With respect to external policies, no major turnaround is expected either and many uncertainties and associated risks (relations with the EU and USA, Donbas, future of the Eurasian Economic Union, etc.) will persist.

3. WHAT IS TO BE DONE (CHTO DELAT') AFTER 18 MARCH 2018?

There has been no lack of various ideas and often controversial proposals for economic reforms in Russia. As the above brief review of the last two decades' policy discourse has shown, there have been repeated calls for reforms aiming at **economic diversification and modernisation**. Initially these were to be assisted by FDI inflows and several attempts at **closer integration with the EU (Common Economic Spaces, Strategic Partnership with the EU, etc.)**.²⁴ Later on, calls for **industrial policy tools** and an increased role of the state gained prevalence.²⁵ Yet the majority of these reform proposals have not been implemented and, if yes, they were sometimes even reversed. Along with the emerging conflict with the West and **Russia's rising assertiveness** over the last decade, the European integration vector was gradually abandoned in favour of Eurasia (and with Western sanctions later on amended by the attempted **change of pivot from the EU to China**). Again, this switch occurred gradually – at least in rhetoric – starting from about the mid- 2000s, but it became definitely more visible simultaneously with the Medvedev-Putin 'tandem reshuffle' in 2011/2012. The conflict with the West (US and EU) has been escalating since 2014 – after Russia's annexation of Crimea at the latest.

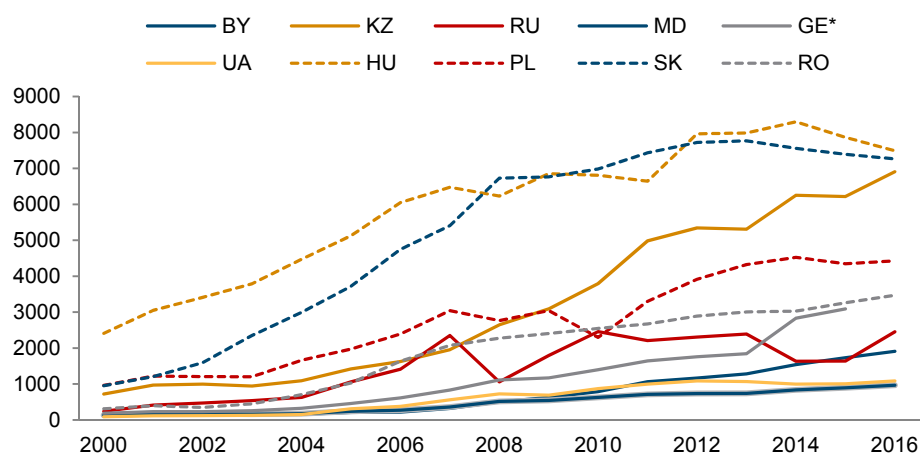
²³ However, the readiness for a revival of EU-Russian dialogue – provided there is progress in the implementation of the Minsk-2 agreements – has been reiterated by the new EU ambassador in Moscow Markus Ederer – see: <https://www.kommersant.ru/doc/3548904>.

²⁴ The idea of EU-Russia 'Common Spaces' was explored at the beginning of the 2000s, also in the framework of the EU-financed TACIS programme (RECEP).

²⁵ The calls for the use of industrial policy measures (instead of liberal 'laissez-faire' approaches) appeared in the second half of the 2000s at the latest – see Grinberg, R. (2008), 'Restructuring and Economic Reforms in Russia: A plea for an Effective Industrial Policy', in: Grinberg, R., P. Havlik and O. Havrylyshyn (eds) (2008), *Economic Restructuring and Integration in Eastern Europe. Experiences and Policy Implications*, Nomos, Baden-Baden.

Another tendency has been related to **the changing role of the state: growing aversion to liberal market reforms** which had been largely discredited during the 1990s. Liberal reforms were replaced by (largely ineffective) attempts to employ various industrial policy instruments instead, the latter usually associated with an increasing role of the state, more centralisation, bureaucratic controls, protectionism, etc. Russia's WTO accession in 2012 did not bring the expected change towards modernisation. On the contrary, with the simultaneous escalation of the conflict with the West and the imposition of sanctions, inward-looking and protectionist policies have prevailed. This tendency **should be reversed, or at least corrected**. As a first step, a credible and lasting ceasefire in Donbas should be initiated and maintained, possibly with the involvement of more OSCE observers and/or UN peacekeepers. This could be followed by a Transnistrian-type of solution where economic relations between separatist regions and the rest of the country would be restored and the path to a gradual lifting of sanctions would be cleared.²⁶

Figure 4 / Russia and CESEE peers: FDI inward stock per capita, EUR



* Georgia: Excluding data on population of Abkhazia and South Ossetia.

Source: wiiw FDI Database. Georgia: UNCTAD, World investment report, wiiw calculations.

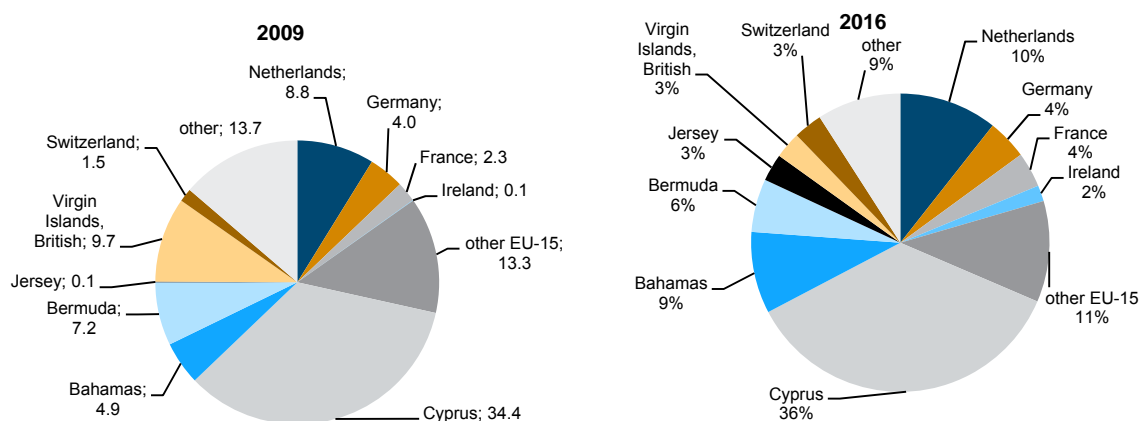
Excessive and lasting **dependence on energy and the related structural distortions** in exports, fluctuating fiscal revenues and the appearance of 'Dutch Disease' type of problems (exchange rate fluctuations, lagging competitiveness of non-energy sectors, etc.) represent another challenge which needs to be addressed. In this respect, the current oil price of some USD 60/bbl offers a window of opportunity to implement reforms aiming to reduce the excessive dependence on energy while avoiding the painful austerity measures which would result from a lower oil price. An appropriate taxation of energy export earnings (e.g. by a reformed Sovereign or Reserve Fund) and associated regulations related to the deployment of the fund's resources to finance infrastructure development (both physical and human) should be elaborated using the available experience.

Persisting **corruption, capital flight and other factors leading to an adverse investment climate** represent another bulk of problems that have to be addressed (despite apparent recent improvements in Doing Business investment rankings). The long-term low investment ratio (not only FDI; the share of

²⁶ A similar proposal has recently been formulated in more detail in Emerson, M. (2018), 'The Strategic Potential of the Emerging Wider European Economic Area', *CEPS Policy Insights*, No. 2018/05, February.

gross investment in GDP barely exceeds 20%) and the deteriorating physical and human infrastructure (the latter magnified by the adverse demography) need to be addressed.

Figure 5 / Russian inward FDI stocks by key partners



Source: wiiw FDI Database incorporating national statistics (CBR).

4. CONCLUSIONS

Never ending, often contradictory and mostly inconclusive **reform disputes** between Russian liberals, centrists and conservatives (Kudrin – Titov – Glazyev have been among the prominent representatives of the respective reform camps) represent another challenge for decision-makers.²⁷ As mentioned above, the views of external policy advisors and institutions such as the IMF and the World Bank were largely discredited already during the early 1990s.²⁸ Unfortunately, the present geopolitical conflict is hampering even normal academic exchanges with Russian-based scholars.²⁹ In Russia, the spiral of assertive external policies is rolling on; outside reactions lead to a vicious circle of protectionism, sanctions, more autarky, and so on. As mentioned above, the recent dangerous tendency of deteriorating external relations with neighbours in both the 'near and far abroad' has to be reversed as one of the first reform priorities.

The list of Russian economic distortions and other related structural challenges could naturally be extended, but the above problem areas represent, according to my assessment, the most urgent fields for action. Obviously, there is a **close link between external and domestic policy dimensions**: without normalisation of external relations (probably starting with Ukraine, followed by the EU) there will

²⁷ Some recent reform proposals: INSOR (2015), 'The Future of Russia in the Global Economy', Moscow (a centrist position); Glazyev, S. (2015), 'Strategy for Growth in the context of the Global Economic Crisis', published by Decision of the European Academy of Natural Science Publishing Council (left-wing/conservative position); Medvedev, D. (2016), 'Социально-экономическое развитие России: обретение новой динамики', *Voprosy ekonomiky*, No. 10 (official government position); World Bank (2015), 'Russia Economic Report. Balancing Economic Adjustment and Transformation', September (Western position); Titov, B. (2017), 'Growth Strategy', Stolypin Institute (centrist position); CSR (2017), 'Making the Future: People, Technology, State. Strategy 2018-2024' (liberal-centrist position).

²⁸ For illustration see: Mc Clintick, D. (2016), 'How Harvard Lost Russia', *Institutional Investor*, 27 February, <https://www.institutionalinvestor.com/article/b150nqqs1wz840/how-harvard-lost-russia>.

²⁹ See Vinokurov, E. et al. (2016), 'Challenges and Opportunities of Economic Integration within a Wider European and Eurasian Space', IIASA Synthesis Report, Laxenburg, Austria.

be no breakthrough in the **vicious circle of sanctions, trade protectionism, and lack of investments and economic integration**. And without such normalisation of external relations, there will not be any significant modernisation and economic diversification. Domestically, investments need to be supported with a reasonable **mix of industrial, monetary and fiscal policies**.³⁰ Institutional reforms have to be addressed, giving priority to fighting corruption, improving the legal system and reducing bureaucratic obstacles for businesses. It remains to be seen whether Putin's next presidency will deliver in any of these policy areas. Otherwise, Russia will likely face not only economic stagnation, but even the risk of economically **falling behind the peers** in the East, South and West – ultimately **endangering the social and eventually even political stability at home and in the neighbourhood**.

Most importantly, with the currently expected **disappointing growth prospects** – GDP growth is forecast to stay below 2% per year in the medium term – the Russian economy will not catch up with its more advanced EU-CEE peers, not to mention China. Neither will the poor growth outlook help to underpin aspirations to (re)gain geopolitical parity with the United States. The next presidential term of Mr Putin may resemble the late Soviet period of stagnation under Leonid Brezhnev. It remains to be seen whether it will be followed by a Gorbachev-like 'perestroika' or otherwise.

³⁰ The stability-oriented monetary policy pursued by the Central Bank of Russia (CBR) during the past couple of years should be continued. Indeed, this is a declared CBR policy for the forthcoming period – see: [http://www.cbr.ru/publ/ondkp/on_2018\(2019-2020\).pdf](http://www.cbr.ru/publ/ondkp/on_2018(2019-2020).pdf).

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Wien 6, Rahlgasse 3

ZVR-Zahl: 329995655

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