Russia

Can Russia Sustain Strong Growth As a Resource Based Economy?

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Following a decade of strong economic growth, the question arises whether Russia – being a resource-based economy – will be able to sustain such a rapid pace of expansion in the future. While in the 1950s and 1960s economists generally believed that abundant natural resource endowments would facilitate a country's economic development, in the last two decades many have come to see natural resources as an obstacle. Examples of resource-rich countries experiencing both poor economic growth and little technological progress abound.

This article briefly reviews the economic evolution of the Russian economy since 1999, before discussing the specific challenges of resource-based development in the Russian context. It argues that – with the right institutions and policies – the resource curse is no *fatalité*, as the example of several countries witnesses: natural resource abundance did not prevent successful economic development either in large countries such as Australia or Canada, or smaller ones like Norway or Finland. There is hence no inherent reason why Russia – if establishing a suitable economic and political environment – should not be able to follow their example.

Russia's post-crisis economic history can roughly be divided into three phases. In the immediate aftermath of the 1998 financial crisis, growth was mainly driven by the temporary boost to competitiveness brought about by the sharp devaluation of the rouble. As the effects of the devaluation gradually faded, the resource sector took over as the main driver, and in 2001–2004, Russia experienced an oil-extraction boom. With oil production growth starting to slow in 2004, Russian growth has since been increasingly driven by a consumption boom, supported by rapidly improving terms of trade.

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Russia's post-crisis recovery (1999–2001)

Despite widespread pessimism, in the wake of the crisis, as to Russia's prospects,[1] the economy started to recover fairly rapidly. While growth was broadly based, initially, the recovery was strongest in those sectors that had been doing worst before the crisis – domestically oriented non-resource sectors. The dramatic turnaround resulted mainly from the huge fall in wages and energy prices, in both real rouble and foreign currency terms, following the devaluation. A large initial decline in input costs allowed a significant share of Russian industry to become competitive and profitable again, while the sharp rise in the rouble prices of imported goods facilitated import substitution on a large scale. The improvement in the economic situation in the "real sector" was also reflected in steadily declining levels of barter, arrears and non-payments as the economy became re-monetised. The early post-crisis years also saw a wave of sometimes very aggressive ownership consolidation, as those who had weathered the crisis sought to acquire assets cheaply, while exploiting the general confusion in the aftermath of the crisis to default with impunity on their more vulnerable creditors, or to squeeze out minority shareholders via share dilutions or simply asset transfers from company to company. Some of today's leading Russian champions of good corporate governance were among the most aggressive in employing the above-mentioned schemes after the crisis. Russian companies also became adept at exploiting the weaknesses of the 1998 bankruptcy law in order to execute hostile corporate takeovers on the cheap, a practice its most expert practitioners have developed into an art form.[2] Many of the large financial groups were also extremely adept at "restructuring" failed banks in

[1] For an exception to this view, see Ahrend (1999) and Breach (1999).
[2] To some extent, the use of bankruptcy as a takeover mechanism reflected the absence of a well functioning market in corporate control, which would have enabled acquisitions to be executed in a more "normal" fashion.

such a way as to shift as much of the value as possible into other vehicles, leaving the state and other creditors empty-handed.[3]

While the devaluation kick-started the economy, a low exchange rate by itself was not the only reason for the post-crisis recovery. In 1994, much the same combination of factors – a weak rouble, cheap domestic energy prices and relatively high export prices for oil – had failed to prevent a 12 percent drop in GDP and a fall of more than 20 percent in industrial production. By 1999, however, liberalisation and privatisation, controversial and incomplete though they were, had facilitated the emergence of an economic system in which private enterprises could and did respond to the opportunity provided by the devaluation. The economy's response to the devaluation and to the subsequent recovery in oil prices was in no small measure a product of the structural changes wrought during the 1990s. In this respect it is important to note that the economy began to grow strongly *before* oil prices started to recover. Improving terms of trade were undoubtedly helpful later on, but the initial post-crisis recovery was not dependent on, let alone driven by, oil-price increases.

The oil extraction boom (2001–2004)[4]

While in the immediate aftermath of the crisis growth was particularly strong in domestically oriented manufacturing sectors, this changed dramatically in the period from 2001 through 2004, as export-oriented natural resource sectors became the main engine of economic expansion. Correcting for a distortion in official data caused by transfer pricing,[5] natural resource sectors directly accounted for roughly 70 percent of the growth of industrial production in 2001–04, with the oil sector alone accounting for just under 45 percent. This implies that natural resource sectors directly contributed more than one-third of Russian GDP growth over the period, and the oil industry alone close to one-quarter.[6]

With respect to the oil sector, two points stand out. First, state-controlled companies barely increased output or exports. Russia's private oil companies accounted for almost all of the growth recorded over the period. This means that private oil producers directly accounted for somewhere between one fifth and one quarter of GDP growth, not even taking into account the knock-on effects from oil-sector procurement and wages on domestic demand. Secondly, the private companies that did the most to drive this growth were those controlled by major financial groups (the so-called *finansisty*) rather than those under the control of oil-industry insiders (the *neftyaniki*).

While the longevity of the post-crisis recovery beyond 2001 owed much to a boom in oil extraction, other drivers, such as structural changes and macroeconomic policies, were also crucial. A large push on a wide array of structural reforms, as well as a prudent fiscal stance with a federal budget that was balanced over the oil-price cycle, were arguably the authorities' most important contribution to sustaining growth.[7] In the corporate sector, far-reaching restructuring and strong productivity gains were achieved against a background of rapid consolidation in the aftermath of the crisis. The industrial structure became dominated by a relatively small number of large industrial groups,[8] most of which had been founded around some commodity exporting business, and subsequently mainly pursued strategies of vertical integration.

A full-fledged consumption boom on the back of rising commodity prices (2004–2008)

The consumption boom accelerated from late 2003 onwards, as the authorities increasingly allowed gains in budget revenues from rising oil prices to feed into the economy in order to boost domestic demand. The resulting consumption boom stimulated activity in the service sector – not in small measure as retail trade benefited from strongly increasing imports. Starting in 2005, thriving domestic demand contributed to a construction boom, and from early 2006 onwards also resulted in strongly accelerating investment outside construction, stimu-

[3] See Tompson et al. (1999) on the use of "bridge banks" to escape creditor demands during 1998–2000.
[4] For a more detailed discussion of Russia's post-crisis growth performance, see e.g. Ahrend (2006).
[5] Using estimates of the relative weights of different sectors in GDP from World Bank (2004). On these estimates, the oil and gas sector's share of GDP rises from around 8 percent in the official data for 2000 to just above 19 percent, and the share of industry increases from 27 to 41 percent.
[6] This also corresponds closely to the conclusion reached by Gurvich (2004), who – using a different methodology – estimates that during 2000–03, the oil sector directly accounted for 24.8 percent of GDP growth.

[7] See OECD (2004) for an in depth discussion.
[8] It is estimated that in 2001 the ten largest industrial groups, together with the state-controlled national gas and electricity companies, accounted for roughly half of Russian industrial output (see Dynkin 2004).

lating in turn activity in domestically oriented manufacturing sectors. Especially in 2004–05, the expansion in domestically oriented sectors counteracted an oil sector driven slowdown in industrial production growth. While undoubtedly the oil sector would not have been able to sustain double digit extraction and export growth indefinitely, its slowdown was mainly a consequence of a sharp fall in oil sector investment amidst the deterioration in the business climate that resulted from the complex legal and political campaign directed by the state against the private oil company Yukos and its main shareholders,[9] combined with substantial increases in oil sector taxation and tightening infrastructure constraints.

While Russia's growth performance in 2004–07 at an average of slightly above 7 percent remains impressive in absolute terms, it should be seen alongside average growth of above 9 percent in the other CIS countries, and in the context of an external environment that arguably has rarely, if ever, been as benign for Russia.

Potential advantages and challenges of being a resource-based economy[10]

Having a rich natural-resource base has some obvious advantages. If exploited, natural resources provide a country with export revenues that are largely sheltered against competition,[11] and higher income provides the potential for increasing investment and improved living standards. Moreover, despite frequent claims to the contrary, specialisation in natural resources does not necessarily imply low levels of technological know-how. Resource extraction – as it moves to deposits that are ever more difficult to exploit – has become quite intensive in the use of specific high technology.[12] Russia, in particular, would seem to have the potential to become a global provider of high-tech services connected to natural resources.

Poor economic performance may also not have been caused by resource abundance in isolation, as in recent decades many countries' resource sectors have been dominated by state-owned or state-controlled enterprises. This is especially true of capital-intensive extraction sectors like oil. Given the ample evidence that private enterprises tend to be more innovative and efficient than state-owned ones, the substandard growth performance of resource-based economies may – at least to some degree – have been brought about by state ownership of large shares in key sectors, rather than by natural resources *per se*. State ownership can be particularly devastating for companies in countries where administrative capacities are limited and corruption is rampant. Moreover, the impact of state ownership is likely not to be restricted to the performance of the state-owned enterprises *per se*: by potentially preventing a level playing field, it can easily foil the development of the concerned economic sectors as such. The contrast between the largely state-owned Russian gas sector, and the (until 2005) almost entirely privately owned oil sector is suggestive. While from 2000 to 2004 the oil sector prospered, the gas sector continued to stagnate.[13]

Nonetheless, resource-based development obviously presents important challenges. These include an increased vulnerability to external shocks, the risk of "Dutch disease",[14] and institutional pathologies often associated with heavy reliance on natural resource sectors. These challenges are indeed serious, but they can be overcome or at least very substantially mitigated with the aid of appropriate institutions and policies.

As resource-based economies are particularly exposed to external shocks arising from commodity price fluctuations, their margin of error is much smaller than for economies with more diversified economic structures. Good macro-economic management thus becomes a *sine qua non* condition for the avoidance of boom-and-bust cycles. In this respect it is difficult to exaggerate the importance of fiscal discipline. In short, what is needed for Russia is a counter-cyclical fiscal policy with respect to oil prices, which is based on conservative oil price as-

[9] While the onslaught against Yukos was the most visible case of arbitrary state action against private business, it was not by any means the only one. Numerous Russian companies came under pressure from the tax service, the prosecutors and the courts, often in cases that clearly appeared to be motivated by private commercial or political motives. The Federal Tax Service was perhaps the most aggressive player of all, reflected in a dramatic increase in the service's propensity to reopen tax cases from past years, often penalising taxpayers for practices that it had previously approved. As a result – while the state moved to tighten its grip anew on key "strategic" sectors, especially resource sectors – the general investment climate deteriorated significantly.

[10] For a more detailed discussion on the issue of resource-based development, see e.g. Ahrend (2005).

[11] It is a banal point – but worth stating – that in order to compete in natural resources, a country needs to possess the relevant deposits, and neither highly advanced technology, nor an ultra-cheap labour force can substitute for a lack of deposits.

[12] See Wright and Czelusta (2002).

[13] For a discussion of the Russian gas sector, see e.g. Milov (2006) or Ahrend and Tompson (2005).

[14] On the threat of Dutch disease in Russia, see e.g. Ahrend et al. (2007).

sumptions and strikes a reasonable balance between spending revenues from higher oil prices and sterilizing windfall gains in a stabilisation fund.

To avoid "Dutch disease" and assist development of the non-resource sector, in addition to a stabilisation fund that invests cyclical commodity windfalls in foreign currency denominated assets, the tax system is also key. Direct taxation of natural resource sectors in general should eliminate rents, but must assure that these sectors remain sufficiently profitable to allow for their further development. The proceeds of the resource taxes allow for low direct tax levels in the economy and in particular lower corporate and payroll taxes, which in turn help boost investment and keep non-resource sectors competitive. In this respect, Russia's abolition of turnover taxes, the decrease in the Unified Social Tax (UST), and those measures that increased in an equitable way the tax burden on the oil sector were steps in the right direction (though current oil sector taxation is too high for most greenfield developments, requiring further modifications). However, taxation of other resources or resource-related sectors (e.g. gas) remains low.

Institutional pathologies connected with resource abundance generally include worsening corruption, increased income inequality, as well as a bias of talent towards the resource sector, as highly capable individuals focus on securing resource rents rather than building successful businesses in other sectors. Capturing a significant share of resource rents for the state through the tax system goes a long way in resolving these issues, though this requires a fairly efficient and non-corrupt administration.[15] Interestingly, all resource-based economies that have developed successfully had strong civil societies, relatively well functioning and independent judicial systems and high levels of press freedom – indicating that these are not a luxury without relevance for economic progress.

Finally, to the degree that a more diversified economy is less prone to the risks enumerated above, diversifying the economy can also solve potential problems of resource dependence. But there is no miracle recipe for achieving diversification overnight. Fostering diversification is a long, protracted process, and will need appropriate policies in many areas. There is no shortage of examples of failed diversification policies, and economists know far more on the basis of international experience about what does not work than about what does. Fiscal irresponsibility as well as large-scale state investment in pet industrial projects rank at the top of the list of things to avoid.

In any case, there should be no illusion about Russia's export structure in coming years. Not only do oil, oil products and gas account for about two thirds of Russia's exports, but in recent years Russia's revealed comparative advantage (RCA) has been largely limited to natural resources, especially hydrocarbons, energy-intensive basic manufactures (steel, aluminium, nickel, fertiliser), plus some other commodities. It is therefore clear that in the short and medium term commodities will continue to dominate Russia's export bill, regardless of whether or not policies aimed at the diversification of economic activity are successful. Even if Russia manages to increase sharply its exports of more sophisticated manufactures, their contribution to total export growth will remain modest for years to come, simply because they start from such a low base.

Russia's growth prospects

While a large degree of uncertainty remains with respect to future developments in Russia, a number of points on whether and how Russia could sustain high growth can be made.

- Russia's medium-term growth potential is, at least to some degree, likely to remain dependent on oil and gas extraction. While, in principle, other high growth scenarios can be envisaged, in practice medium-to-long-term growth prospects are likely to be higher under the assumption of Russia achieving decent export growth. While some increases in exports may come from new areas as well as from a deepened processing of commodities, robust export growth in the medium term will probably require further increases in mineral exports, including hydrocarbons, and will, at a minimum, be hard to achieve if commodity exports actually started declining significantly.[16] Maintaining, let alone achieving continued growth in hydrocarbon exports will necessitate some investment in the transport infrastructure,

[15] On the issue of administrative reform in Russia, see OECD (2006).

[16] Basic manufacturing in energy-intensive sectors may also be able to make some contribution to future export growth.

especially pipelines, as well as quite substantial investment in the development of new fields. A healthy business climate and especially clearly assigned and secure property rights are important determinants of the degree of private investment available for such large projects.[17]

- The service sector is likely to remain another driver of long-term growth. With Russia becoming a richer country, demand for services – such as banking, insurance, restaurants, travel and hotels – is increasing. As the Russian service sector is still comparatively underdeveloped, there remains ample scope for growth there.[18] The service sector, however, will not develop very strongly if there is not a general increase in living standards – i.e. Russia will not be able to solely rely on strong growth in services, but also needs to increase industrial production to some degree.
- From a macro-economic point of view, Russia is in a better position than many other oil exporters. Even though Russian fiscal policy has been expansionary since the second half of 2004 and windfall oil revenues are increasingly being spent, Russia has so far still saved a much larger share of its oil windfalls than many other oil-producing countries. This relative fiscal discipline has served Russia well by taking off some inflationary pressures, and should oil prices retreat from current highs, the negative effect on the Russian economy would likely be less severe than for many other resource-exporters. However, with the economic policies of 2004–07, it is unlikely that Russia would be able to sustain the kind of rapid growth the authorities are aiming for in neutral – let alone adverse – circumstances.

For the time being, and assuming oil prices stay around the high levels seen in the first half of 2008, Russia still has a quite significant buffer, both on the fiscal and the external side. While debatable from the viewpoint of good macro-economic management, it is likely that the large oil-generated budget surpluses will continue to be progressively fed into the economy to boost growth. This will further add to already very high import growth, but thanks to the large current account surplus, there is still some time before external constraints will become binding. This said, while it is uncertain for how long Russia will be able to pump up its economic performance in the manner described, it is certain that the strategy as such is unsustainable; over the longer term external constraints will require a need for much stronger – and preferably private – investment to increase Russia's supply potential of *tradable* goods and services.

At this point, having efficient economic structures with correct incentives will become a key issue. The oil sector, for example, has in the past shown that with correct incentive structures – including multiple privately owned production companies and fair access to the export infrastructure – production increases on a totally unexpected scale have been possible. In all likelihood the same would hold for a gas sector reformed along these lines.[19] Unfortunately, the structure of the oil sector has moved in the direction of that prevalent in the gas sector rather than the other way round, and such a trend has also emerged in some other sectors. But as those sectors that remain privately owned should continue to experience solid growth, even relatively inefficient state-controlled oil and gas companies should, in principle, be able to achieve some output increases, not least by teaming up with foreign private oil majors for specific projects. Nonetheless, having the state at the commanding heights at some of the key sectors of the economy will likely come at the price of not allowing Russia to reap its full economic potential, and exacerbating some of the risks connected with resource-based development.

Conclusion

All in all, even though Russia as a resource-based economy faces specific risks and challenges, the resource curse is no *fatalité*. Economies with strong private entrepreneurship in resource sectors, such as Canada, Australia or the Scandinavian countries, show that, with the right institutions and policies, developing a successful modern economy based on natural resource exports is feasible. In principle, there is no reason why Russia should not be able to follow their example, but progress will increasingly depend on the right policy choices. Simplifying somewhat, while initially strong economic growth was largely a result of improved economic policies and successful structural reforms (in part undertak-

[17] On the importance of institutional framework conditions for realising a country's oil supply potential, see Ahrend and Tompson (2006).

[18] Part of the increasing weight of services in GDP will also come from a shift in relative prices. Domestic prices for non-tradables will be increasing faster than for those for tradables with the Russian currency appreciating.

[19] If other producers were given fair access to the trunk pipeline network and some access to export markets, then non-Gazprom producers could increase investment and output very rapidly indeed. See Ahrend and Tompson (2005).

en during the 1990s), in recent years economic performance has been largely assisted by increases in commodity prices. With those tailwinds likely to abate at some point in time, speed limits of Russian growth will return to being mainly determined by the structural features of the Russian economy. Hence, as the economic impact of global price developments diminishes, the fate of the Russian economy will increasingly come to depend on the actions of the Russian authorities again.

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