

## Russia's Economic Future

**Dr. Peter Lavelle**  
Russia Analyst and Commentator

Russia's political scene has changed significantly over the past half year. Kremlin-supported parties won an overwhelming mandate in the country's December parliamentary vote and President Vladimir Putin was returned to office in a landslide victory in March. During both elections, many Russia watchers raised concerns questioning the Kremlin's commitment to democracy and freedom of expression. Putin may not be a democrat, though there is no doubt he is committed economic reformer. By the time Putin is scheduled to leave office in 2009, Russia's economy stands to be significantly transformed as well as its place in the world.

### Introduction

When Vladimir Putin was plucked from near-obscurity to become Prime Minister in 1999, Russia's economy was on its knees. With high inflation and enormous capital flight on the back of the preceding year's default and currency devaluation, Russia's economic prospects, even commitment to developing a market economy, looked dismal. Since then, Russia has experienced a remarkably strong turn-around. If the last four years is any indication of the future, it can be expected that Russia's economy will be less reliant on raw material exports and competitive in the international marketplace.

### Fault lines: where politics and economics meet

The great debate consuming Russia's political and moneyed elites at present is what should constitute the Kremlin's main economic priorities covering Putin's second term. The oil sector lobby was the last to present its preferences this year when the top five producers announced their plan to significantly expand and export capacity, with the intent to aggressively allow for almost uninterrupted growth in oil production and exports. Market observers and analysts assess the oil lobby's strategy as the "easy money" option, especially with an eager and prepared market for oil and gas exports in the U.S. , which desires a rapid diversification of its energy reliance away from the volatile Middle East , and to Russia's immediate neighbors in Europe and Asia for the same reasons.

The counterpoised agenda comes from the powerful and resurgent industrial lobby, which is campaigning hard to have the government diversify away from the dangerously high reliance on the oil and gas sector. This lobby petitions for government special preferences and investment incentives for Russia's other traditional industries, including aerospace, aviation, defense, steel fabrication. These are the sectors where Russia still has a chance to develop global leadership while also helping to push the development of a domestic financial services industry.

Both lobbying groups have been quite forceful in the media when conveying their respective agendas in an effort to determine Russia's economic future. During Putin's first term it appears that the oil lobby has and to the present remains ascendant. However, in the larger scheme of things this may only be temporary. There is another plan for Russia 's long-term economic future that has been aired, repeatedly supported by none other than Putin, but almost forgotten. This economic plan announced at the start of 2000 calls for an enhanced budgetary and economic policy agenda resulting from the high inflows of cash from oil and gas exports to aggressively push broad-based growth across all economic sectors. Putin's equally clearly and consistently stated objective is to eventually achieve a more diversified and balanced economy, i.e. along the lines seen in most of the counties of the European Union, with the intent of creating a greater and more egalitarian dispersion of wealth across the entire population.

Upon observing the duration of Putin's first term, it is not difficult to come to the conclusion that the oil sector and the industrial lobbyists have not heard, remain ignorant of, or simply do not believe in Putin's commitment to radically transform Russia's economy. Both should understand that their perceived "either-or" visions for Russia's economic future neglect to consider "third way" priorities found behind Kremlin's walls.

A big picture overview of the Kremlin's economic agenda demonstrates that it is not only interested in supporting large industries that the economy depends on for growth, but also aggressively attempts to promote growth in the small and medium enterprise sectors (SME)-- manufacturing, consumer, services, finance. Part of that strategy is to promote reforms that will both remove current obstacles to growth (through administrative and banking reforms, etc.), while also creating investment incentives to attract domestic and foreign investment into these business sectors. This is not incompatible with also supporting growth and development in Russia's traditional industries, but it does allow for a different investment case with other investment risks and priorities in the near and medium term.

### **Putin's economic policy agenda**

Since 2000, Putin's Kremlin has been overwhelmingly unswerving on key long-term economic objectives. These include achieving wealth distribution across the population, accelerating economic growth, building a balanced economic model, and the creation of an attractive investment climate so as to attract capital inflows.

Did Putin come to the presidency with a well-thought out economic vision for Russia? This appears to be extremely unlikely. Ideas about how Russia should proceed most probably were a logical reaction to the economic policies of Putin's predecessor, Boris Yeltsin. Under Yeltsin the primary preoccupation was on privatization in the hope that private enterprise would encourage a reinvented ethos of entrepreneurship and the creation of a free market. It was hoped that this would eventually be an incentive for immediate economic growth. Unfortunately, this initiative did not produce the intended results. Understanding how Yeltsin's plan failed to deliver growth and directly led to the creation of the "oligarchs", the new Putin Kremlin team appears to represent a more interventionist as well as statist interpretation in order to push for the realization of core economic objectives.

### **Standing pat while seeking competitive advantage**

Newly inaugurated President Vladimir Putin most likely concluded that the crisis of 1998 came to pass because the Russian economy was far too dependent on oil and gas exports, which had fallen due to poor management and a lack of capital investment. It also appears to be clear that he understood that Russia had no meaningful say in the price control mechanism (read OPEC) when the price fell just prior to 1998. The funding crisis was inevitable, especially in the absence of any long-term economic planning during the Yeltsin administrations.

Putin's first major initiative was to pursue an aggressive growth strategy to partially restore oil production and exports. At the time, the government pushed for the adoption of PSAs (production sharing agreements) in order to attract foreign capital to help stimulate growth as fast as possible, although this drifted off the agenda in 2001 when it became clear that the domestic oil companies would be able to fund the required capital expenditures.

As international petroleum prices recovered, extra revenue that accrued from the oil and gas sector allowed for the main objectives of the first part of the economic plan. Namely, the budget's hapless reliance on the price of oil was reduced (from needing an average Brent price of \$26 p/bbl in 1998, with little difficulty balancing the budget, to \$20 p/bbl in 2003).

Second, it allowed for a significant improvement in Russia's fiscal position and the creation of the "staging opportunity" from which the more ambitious longer-term economic policy could be brought to fruition. Third, it bought the time that Putin (and the Kremlin) needed to prepare for the main growth phase of the economy and the achievement of its core economic objectives (See Box 1).

**2000-2004 Putin's Economic Agenda and Achievements:**

- **Push restoration of oil volumes**
- **Reduce budget oil price vulnerability**
- **Removal of inherited problems and change in attitudes towards growth**
- **Create fiscal "platform" to support core objectives**
- **Prepare for growth push and create favorable investment climate**
- **Secure legislative support for growth**
- **Neutralize opposition to core economic agenda**

Fourth, using the "soft landing" created by oil and gas revenues, Putin and the Kremlin have been able to remove some inherited obstacles to future growth. Among these obstacles were the replacement of powerful individuals at the natural gas monopoly Gazprom and the head of Russia's Central Bank. These changes would facilitate an aggressive push to achieve the core objectives. To a large extent Putin (i.e. the Kremlin) has been working on the assumption of an eight-year agenda, with the first presidential term devoted to removing problems and changing attitudes while the second four-year term will be devoted to the broad restructuring envisaged at the outset.

**Timeline of Major Objectives**

The strong growth in the oil sector was a necessary part of that plan, but it is clear that at some point there would have to be a break in this growth so as to shift priorities to the core economic objectives of achieving better balanced growth, a more broadly based economy, and wealth distribution. The natural break point has always been the reaching of capacity in the existing export pipeline, and the fact that the government is now clearly dragging its feet on approving new capacity is evidence of that.

The fact that we are now reaching that natural barrier to growth in the oil sector, albeit only for a few years, most likely coincides gracefully - from the Kremlin's perspective - with the possibility of greater political support for swift passage of the next critical phase of reforms in the next Duma (See Box 2).

**2004-2008 Putin's Economic Agenda and Challenges:**

- **Aggressive Push on administrative reforms**
- **Aggressive push on broad economic structural reforms**
- **Create incentives to stimulate growth in SME sectors**
- **Reform of legal and judicial system**
- **Education and communal housing reform**
- **Financial infrastructure reform, i.e. banking and pensions**
- **Wealth creation and broad distribution**
- **WTO accession**

**Core economic objectives**

The past four years support the view that Putin's core objective is to see a European-style balanced economy that would allow for a wide distribution of wealth.

The short-term plan has certainly worked in that Russia's fiscal position is now clearly much better than at any time in the past and the government has a very strong financial position from which to initiate and financially support its broader plan. Just as importantly, the past several years of strong growth have also bought the time and stability that Putin and the Kremlin needed to make the changes and make preparations to achieve their main goals.

However, there is a big difference between having a better current fiscal position, i.e. money in the bank, and future growth possibilities. In order for the objectives of the core economic plan to be achieved the government now needs to use, or to leverage off, the current strong fiscal position to help push the targeted broad-based growth.

**The recent past suggests**

Putin's tightening grip over the government may be indication that he is aware of the uphill struggle that can be expected as he addresses the issues concerning the next stage of reform. If the initial reform project appears to have been difficult, the next stage will be even more difficult. However, the first stage of reform has created a solid foundation for the second stage of radical reform of the Russian economy during Putin's second term. The struggle to determine Russia's economic future is between those who wish to continue the "easy money" generation and those who demand that Russia take a renewed attempt to strengthen the economy the old fashioned way – hard work with domestic wealth creation based on international competitively-priced industrial products. This will take time, but Russia is poised to realize this tried and tested development plan.

*This essay is original and was specifically prepared for publication at Future Brief. A brief biography of Peter Lavelle can be found at our main [Commentary](#) page. Other essays written by Peter Lavelle can be found at his [web site](#). Other websites are welcome to link to this essay, with proper credit given to Future Brief and Mr. Lavelle. This page will remain posted on the Internet indefinitely at this web address to provide a stable page for those linking to it.*



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