

The Russian economy at the crossroads

Before and beyond the Ukrainian crisis

An interview with Andrei Yakovlev

by **Ilja Viktorov**

Andrei Yakovlev is head of the Institute for Industrial and Market Studies at the Higher School of Economics in Moscow. His research on Russian industrial policy, corporate management, state-business relations, and the political economy of the Russian transition has garnered much attention, and Professor Yakovlev has an extensive list of publications in international academic journals. Ilja Viktorov met Yakovlev in Moscow in the spring to discuss Russia's economic development and its mechanisms and challenges. A poor business climate is commonly cited as one of the main systemic factors that impede Russia's economic development. Ilja Viktorov asked Yakovlev, first, to explain the fundamental reasons for this institutional disadvantage:

"The poor investment climate in Russia is deeply rooted in the price formation inherited from the Soviet economy. It also depends on the particular circumstances of the transition to the market economy in the 1990s. The fundamental reasons are closely interrelated with the rent-seeking behavior from both state agents and Russian business. Most of the business models developed in Russia since the late 1980s rested on rent-seeking mechanisms when quick and exclusive enrichment was secured for a limited number of insiders. Unfortunately, Russia experienced more opportunities for such rent-seeking behavior than most of other postcommunist economies. Historically, the planned economy, with its price distortions, lasted longer in the Soviet Union than in countries in Eastern and Central Europe. This means that the disproportion between higher prices on consumer durables and investment goods, on the one hand, and lower prices on raw materials, electricity and transport costs, on the other, was stronger in post-Soviet countries. This created an illusion that investment projects like huge industrial plants in remote places in Siberia and in the Far North were economically effective. As soon as the Russian economy was opened and foreign trade was quickly liberalized, exports of raw materials became a source for rent-seeking, simply because of the price gap on raw materials between the domestic and the world markets. The period of liberalized, uncontrolled export was very short, and a highly selective group special exporters started to control the lucrative export flows by the mid-1990s. This export mechanism was the main source of rent-seeking behavior and pursuit of wealth for economic and state agents in post-Soviet Russia."



Andrei Yakovlev, professor and head of the Institute for Industrial and Market Studies at the Higher School of Economics in Moscow.

Yakovlev continues:

“Paradoxically, the scale of the economy and the availability of abundant resources made the Russian situation worse than that of Central European economies. Here, the stakes were much higher, and the size of the pie to be divided was greater. From the business’s point of view, the potential gain from distortion of competition and violation of unclear rules of the game were higher in Russia. This in turn led to institutional distortions that accompanied the development of the nascent Russian market economy from the beginning. The business environment that emerged from this process was characterized by a lack of genuine competition and a violation of property rights.”

Did the privatization of the 1990s play an important role in this negative outcome?

“It certainly did. Privatization proceeded in different ways and was the result of complex arrangements and compromises between the old Soviet enterprise managers and the new Russian political elite. Boris Yeltsin’s privatization minister Anatoly Chubais and his team had the clear political goal of making privatization irreversible, so the state assets became private during what was, historically, a very short period – three to four years, in the early 1990s. This political goal was achieved, but at a price. These several years were completely lost in terms of economic growth since the new private owners were not interested in investments but rather mostly in asset-stripping and the subsequent bankruptcies of their companies that resulted. Only in the late 1990s did the owners start to think about development of their businesses in Russia.

“And there were also a third, very controversial part of the story, the loans-for-shares scheme, which put the most lucrative state assets under control of a handful of insiders, the future oligarchs. At first glance, this was better from an economic point of view, since these companies quickly underwent restructuring and started to grow, as happened in the case of Norilsk Nickel and Yukos. But there was

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the other side of the coin, namely social injustice and the lack of legitimacy of this kind of privatization. Through the loans-for-shares program, these large companies were sold at a much-discounted price; they were practically given away. Unfortunately, the new owners had to learn the consequences of this lack of legitimacy when the Russian people supported the state attack on Yukos in 2003 and 2004. Strategically, Russian big business lost the battle because the population never trusted the new entrepreneurs and new businesses. This depended to a great degree on the dramatic drop in the standard of living for the majority of the population after 1991.”

Yes, the situation was alarming in the mid-1990s. In 1998, the economic crisis altered the situation even more. But then, in the aughts, the standard of living started to increase again?

“That’s true, but the population did not understand this to be a result of Russian capitalism’s development but rather as an outcome of Vladimir Putin’s rule. And that corresponded to the real state of affairs to the degree that his governments acted quite rationally by redistributing part of the national income in favor of the population as a whole. The narrow circle of Putin’s friends was never forgotten in terms of enrichment, of course, but the mass electorate was and continues to be the real social basis for Putin’s presidency.”

Professor Yakovlev adds that this situation is not unique to Russia; similar tendencies could be observed in autarchic regimes throughout the world, such as in Latin America and Asia. Such hybrid regimes restrict democratic institutions and freedoms but at the same time need to appeal to the population at large for their political survival, he notes. He returns to the Yukos affair: He suggests that the outcome of the Yukos affair was the key element of the new political-economic regime that gradually emerged under Putin in the two-thousand aughts. It was not only about the personal conflict between Mikhail Khodorkovsky and Vladimir Putin, but it also reflected a more fundamental conflict between the oligarchs and the federal bureaucracy over the control of rent flows. The top bureaucratic elite needed additional resources to support political stability by redistributing natural rent in favor of deprived regions and parts of the populace to compensate for the imbalances brought about by the initial economic growth that followed the 1998 devaluation. Yakovlev comments that, naturally, not all of these resources were used to support the population, but this moment was still a very important part of the story. Before the Yukos affair, the largest resource-rich companies rejected the sharing of rent flows with the state.

“Unfortunately, both sides in this conflict, Russian big business and the federal bureaucracy, demonstrated a very restricted mode of thinking. Russian capitalism was perceived rather as a marriage between the state and big business, a model, so-to-speak, of oligarchic capitalism similar to what existed in South Korea between the 1960s and the 1980s. The only difference concerned who would control the rent flows. The dismantling of Yukos meant that the federal bureaucracy won this battle. A new set of informal rules emerged that presupposed the presidential administration’s ultimate informal control over big business. At the same time, private owners were able to retain operative control over their corporations and were still permitted to receive a quite substantial part of the rent income. This model of institutional compromise brought about some stability and enabled economic growth during Putin’s first two presidencies. Foreign investments also started to flow into Russia. This is because business is not particularly concerned with democratic values, but rather with the existence of stable rules of the game and secured property rights for investors.”

The global financial crisis and the Arab Spring of course had an effect on the Russian economy, and fears were raised among the Russian ruling political class. What did the global financial crisis demonstrate regarding Russian economic development?

“The 2008–2009 crisis revealed that this post-2003 authoritarian model that resembled the South Korea of the period between the 1960s and 1980s did not work. The set of informal rules inherent in this model created a highly centralized system, the famous power vertical, that reacted quite poorly to the global financial crisis. The reaction to the crisis was delayed, the panic was not prevented; in terms of financial resources spent on minimizing the negative effects of the crisis, as well as the results these financial injections produced, Russia was one of the worst performing economies in the G20 Group. The 2008–2009 crisis reversed the trend of positive expectations of economic agents. The ensuing pessimistic stance continues to this day. The crisis demonstrated that those in power did not completely comprehend what was actually happening in the economy. This was dangerous, since it called into question the legitimacy of the Russian political decision makers. The latter understood it quite well; they initiated a new dialogue with the business and expert community which entailed, among other measures, discussions during 2011 of the Strategy 2020. This dialogue re-

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sulted in a number of institutional reforms aiming to ease the bureaucratic pressure on the Russian business and entrepreneurial class, including the establishment of the Agency for Strategic Initiatives, the introduction of an entrepreneurial ombudsman, amnesty for entrepreneurs sentenced for economic crimes, and other initiatives that potentially would further the interests of Russian business.”

Did these initiatives produce visible results?

“Unfortunately, this tendency towards liberalization and creation of a new model of economic development was interrupted by the events of 2011. The street protests in Moscow did not actually play the most decisive role in this respect. It was rather the Arab Spring and its outcome that spread fear at the top of the Russian bureaucracy. The anti-Western stance that finally resulted in the aggressive media campaigns during the recent Ukrainian crisis first started in 2012 and originated in this fear. This change affected both foreign and domestic policy, entailed repressions against opposition, and finally left a very negative impact on the Russian economy.”

“The creation of the conservative anti-Western think tank, the Izborsk Club, in 2012, illustrates this tendency. Izborsk Club relied on the initial support from the Presidential Administration and united a quite broad circle of people under its umbrella, including some famous economists like Presidential Adviser Sergey Glaz’ev and Mikhail Delyagin, but also some radical anti-Western persona such as the writer Alexander Prokhanov. Unofficially, the first deputy prime minister, Dmitry Rogozin, is also affiliated with the Club. Their message is expressed in their Manifesto, and appeared on their website in January 2013, both in Russian and in English. This document is quite logical and straightforward. Its first main thesis is that during the next five to seven years the world will face the Third World War, started by global financial oligarchy, and directed against everybody, but first and foremost against Russia, because Putin was one of the few who attempted to resist the hegemony of this oligarchy. This provision is not discussed but presented as a self-evident truth. The second thesis deals with the mobilization of the Russian economy and society similar to the previous historical mobilizations under Peter the Great and Stalin. The rest of the document, including the practical suggestions, such as the reform of the state apparatus and so on, rests on these two provisions. Izborsk Club envisions Russia as a beleaguered fortress that would be in conflict with the rest of the world. This vision is actually not favored by the powerful, since until recently the Russian political and economic elites have been extremely pro-Western. They keep their money in Swiss banks, their children study in the UK or the US, and they do not wish to partake of the increased confrontation with the West, especially with Europe. The initial support that Izborsk Club received from the presidential administration eventually decreased. But the very fact of its appearance reflected both the fear of and search for new ideology inside the Russian political elite.

Professor Yakovlev suggests that what has happened during the last year, since the outbreak of the Ukrainian crisis, is historically unprecedented.

“Putin is de facto the Russian leader. His decision to unleash a period of open confrontation with the West challenged the fundamental interests of Russia’s ruling class that was and continues to be pro-Western. At the same time, this radical change has not so far entailed a radical change of the Russian political and economic elite. This is a contradiction that entails a possible inner conflict, and this conflict has not yet been resolved. That is why I would claim that Russia is currently at a crossroads.”

Is there any feasible liberal alternative that would compete with the ideologies advocated by such think tanks as the Izborsk Club?

“Unfortunately, the liberal expert community has so far not been unable to formulate something new that would appeal to Russian society. The 2020 strategy was in reality not a strategy at all, just a compilation of some ideas and policy measures. Russian liberals continue to reproduce the old visions about democratization, liberalization, and the like, rooted in the 1990s political reality. These visions are correct in and of themselves, and many effective economies in the world are based on these values. But the probability that all these concepts can be realized in Russia in the coming years, or even decades, is almost non-existent. This means that the liberal expert community should think about the formulation of alternative models that could be reconciled with the current political, social, and economic realities in Russia. It is clear that the Russian population supported the Crimea accession in 2014.

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Those in power who started this wild propaganda in the state-controlled media, they use this public mood to receive social and political support.”

THE PROBLEM, ACCORDING TO professor Yakovlev, is that the model of liberal capitalism attempted in Russia in the 1990s promised great opportunities and freedoms for the majority. In reality, however, only a tiny minority could enjoy these freedoms and use those opportunities. This is one of the reasons why the anti-Western mood among the Russian population started to grow as early as in the 1990s, especially during the war in Kosovo, he notes. And the liberal reforms of the 1990s are closely associated with Western influence.

“There are objective reasons for the current propaganda. The Russian ruling class did not invent this mood; they just used it for political mobilization purpose.”

He underlines that it is very important to understand that Russia does not currently face an alternative between democracy and authoritarianism.

“To be realistic, real prerequisites for the development of authentic democracy will not exist for many years. Instead, the real choice is between state-led authoritarian modernization and chaos. It is crucial that the Russian elite achieve an inter-elite consensus about informal rules of the game, about redistribution of rent flows, to make the alternative of the authoritative modernization feasible. This consensus should rely on a broader coalition of interests, beyond the federal bureaucracy, oligarchs and the security services, and include representatives from the middle-level business sector and public sector alike. The character of anti-Western media propaganda and its cynicism, the dramatic ruble devaluation in December 2014, and the killing of one of the leading oppositional politicians, Boris Nemtsov, just outside the Kremlin in February 2015, among other things, have demonstrated that the current political and economic system in Russia does not work properly. The alternative, chaos and disintegration of Russian society, is quite realistic.”

The negative consequences of the Ukrainian crisis in terms of sanctions and counter-sanctions are currently being widely debated in academic literature. Can you identify any positive effects for the Russian economy since the start of the sanctions?

“It is beyond question that the isolation entails great challenges; those are apparent to everyone. At the same time, this new situation provides additional opportunities that should be used by Russian business. Take the example of the Russian counter-sanctions of the food embargo. It might seem ridiculous, that we’re just punishing ourselves with it. Yet the embargo provides new growth opportunities for Russian agriculture, and the businesses involved have started to make quite good profits from it. The recent dramatic ruble devaluation makes Russian goods even more competitive in the domestic market. High-quality cheese, which previously was mainly imported from the EU, was almost absent in Russia before the counter-sanctions were enacted. However, I believe that quite soon, probably in one to two years, high-quality Russian cheese will appear, because there is a strong demand for it. After the 1998 ruble devaluation, it was impossible to buy yogurt in Moscow, because until the 1998 financial crisis all yogurt was imported from Germany. Yet the demand from the population led to the emergence of reliable Russian yogurt producers, and since then we have no shortages of this particular product. Such effects could be potentially used for economic development and growth. However, the current political uncertainty may impede the development of these positive consequences. In a number of branches and industries like metals and chemicals, Russian entrepreneurs make substantial profits due to sanctions and counter-sanctions. Yet they face a dilemma: to invest these new profits to expand their businesses, or to convert them into foreign currency and withdraw them from Russia to offshore accounts. That is why the capital outflow from Russia was as high as USD 150 billion in 2014.”

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THE POST-CRIMEAN political reality made the 2014 changes irrevocable, according to Yakovlev. It is apparent that any full restoration of the pre-2014 relations between Russia and the West is unrealistic, he notes, and predicts this to be true for the foreseeable future:

“The current situation with Russia’s economic isolation will persist for many years, probably decades, and it does not depend on any particular person, Putin or somebody else, occupying the presidency. We need to learn how to live in this new situation and to formulate new economic strategies based on the new reality.” ✕

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