

Why Russia Is Lacking an Economic Strategy for the Future

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gling businesses to keep their workers employed and avoid social tensions, particularly in industrial regions and Russia's "monotowns." Similar to the aftermath of the 2009 financial crisis, this means that the state's footprint in the economy is set to increase. Nationalization of the most affected sectors has already begun where foreign investors are withdrawing: Renault's 67.7 percent share in car manufacturer Avtovaz, for instance, has been taken over by the state-owned institute NAMI.

As a consequence of falling incomes and a larger state role in a less productive economy, the distribution of energy rents will play an even larger role in Russia's political economy. A larger share of Russia's budget will consist of subsidies and social policy expenditure. Although oil extraction is expected to decline by up to 30 percent as a result of the combined effect of technology and energy embargoes, the relative significance of oil and other commodity exports for the state budget has been growing in recent months. In contrast, Gazprom will no longer be able to cross-subsidize Russian businesses and households with cheap energy in the coming years after losing its key high-price export market:

the EU. Instead, the gas behemoth is likely to become a liability for the Russian budget.

Finally, Russia's economy will become less transparent and the informal sector will likely grow. Access to statistics about trade, production, and budgetary spending has already been curtailed, ostensibly to make sanctioning Russia harder, but more likely to hide negative developments from the public eye. Public scrutiny about the distribution of rents by the Russian state will become even harder, creating fertile ground for embezzlement and misappropriation of funds in the coming years. Meanwhile, sanctions and the retreat of Western companies are creating strong economic incentives for parallel import and shuttle trading. Sanctions evasion could even become a significant business model in the Russian economy. Shuttle trading will mainly be a boost to Russia's informal economy. Because transit countries are trying to avoid the risks of secondary sanctions, sanction evaders will often operate in a legal grey zone, making it likely that organized crime will try to get its share of the sanctions arbitrage business as well.

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ANALYSIS

Why Russia Is Lacking an Economic Strategy for the Future

By Michael Rochlitz (University of Bremen)

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Abstract

Even before the economic crisis caused by Russia's full-scale attack against Ukraine and the ensuing sanctions, the Russian economy was plagued by a number of growing problems. As a result, Russia's economy has hardly grown for almost a decade, with an average annual growth rate of just 0.5% between 2013 and 2021. However, the Russian government does not have a strategy for addressing the fundamental economic challenges that are looming just over the horizon. There also seem to be no public debates about these challenges, whether in the policy circles around the government or among the wider public.

Introduction

Even before the economic crisis caused by Russia's full-scale attack against Ukraine and the ensuing sanctions, the Russian economy was plagued by a number of growing problems. The attempt to reform the education system had produced mixed results, with many of Russia's

regional schools and universities failing to equip their students with the necessary skills for a modern economy. In many parts of the country, the transport infrastructure, energy grid, and healthcare system remain outdated and are slowly decaying. After some small demographic policy successes in the mid-2010s, Russia's population is

now again declining. Insecure property rights are keeping investments and firm entry far below their potential. At the same time, large amounts of resources are being pumped into the bloated state sector and an inefficient military industry. As a result, Russia's economy has hardly grown for almost a decade, with an average annual growth rate of just 0.5% between 2013 and 2021.

Russia's Economic Challenges

However, the Russian government lacks a long-term economic strategy and the country lacks even a public debate about the issue. This is a serious problem, as the challenges Russia will have to face in the near future were daunting even before the onset of the current crisis. Now, Russia's renewed attack on Ukraine and the start of a full-scale confrontation with the West have exacerbated many problems, making it even more difficult than before to prepare a strategy for the future.

What challenges is Russia facing? The most important is to create an alternative model of wealth creation for the time after oil and gas. For the last 20 years, the budget of the Russian government has been heavily dependent on the export of hydrocarbons, a source of income that—even before the current sanctions—was destined to decline in the near future. Russia's war in Ukraine has only accelerated this process. Russia would need to urgently diversify its industry to avoid a severe economic crisis, but despite numerous calls to action (see, e.g., EBRD 2012), almost no economic diversification has taken place over the last 15 years.

Another challenge will be climate change. With the number and intensity of Russian forest fires increasing every summer, as well as the thawing of the permafrost and the resultant damage to infrastructure in Russia's north, the country will be heavily affected by warming temperatures. Yet compared to the centrality of the topic in European societies, and considering Russia's role as one of the world's most important exporters of carbon-based energy, climate change has played almost no role in Russian debates, whether within the government, in the media or among the general public. When the topic has been addressed, it has been in the form of sarcastic comments about Swedish activist Greta Thunberg on state media; the teenager has been treated as a symbol of everything that is going wrong in Western societies (Konyaeva and Samsonova 2021).

A problem that has been less visible in recent years, but which the current sanctions have made painfully apparent, is Russia's technological backwardness. Despite President Putin's claims about the technological achievements of the Russian defense industry, Russia seems to lag behind other countries technologically far more than most observers assumed. The war in Ukraine has demonstrated that most of the presumed technolog-

ical achievements of Russia's defense sector have not yet reached the stage of mass production, with Russia's army fighting mainly with equipment from Soviet times. At the same time, Western sanctions have revealed that Russia's manufacturing sector depends not only on high-tech imports, but also—to a large extent—on intermediate imports of lower technological sophistication. Over the last couple of weeks, I have had a number of conversations with representatives of German small and medium companies, who have repeatedly emphasized that even many relatively simple components used to be imported and that until the start of the war, Russian clients relied heavily on the expertise of—mostly Western—suppliers to keep their equipment functional.

The problem of technological backwardness is exacerbated by a science and technology system that lags behind its Western and Asian counterparts. With the exceptions of some leading universities in Moscow and St. Petersburg, most Russian research institutions are not on the same level as their foreign peers. The race for primacy in such technologies as artificial intelligence is between the United States and China, with Russia not playing any visible role (Lee 2019; Karpa et al. 2021). The situation is similar in biotechnology, automation, medical research, and technologies such as virtual and augmented reality or the internet of things. Quantum computing is one exception where Russia is trying to keep up with international developments (Schiermeier 2020). Here, too, however, it is doubtful if the first successes of Russia's quantum program will survive the crash and international isolation of Russia's science system after February 24, 2022.

The lack of a scientific base, in addition to an industry that largely relies on foreign expertise and imports, will make it very difficult to develop an independent Russian manufacturing sector that could one day replace oil and gas as the country's major source of income, particularly as Russia is now completely isolated from most of its traditional economic partners. It will also prevent Russia from maintaining even a semblance of military parity with such powers as China or the US. However, there does not seem to be any visible debate within the Russian government and Russian elites about the challenges the country is facing. Why is Russia steering into an economic abyss, without any economic strategy for the future?

Development Strategies in Other Oil-Dependent Autocracies

To put the absence of an economic vision into perspective, it is instructive to look at other authoritarian states that also depend to a large extent on the export of hydrocarbons, like Saudi Arabia or the United Arab Emirates (UAE). Saudi Arabia is even fighting a bloody war in

Yemen and is entangled in a struggle for regional supremacy with Iran. And yet, both governments committed a couple of years ago to a strategy for structural transformation towards a post-hydrocarbon future.

In the UAE, the emirates of Dubai and Abu Dhabi have invested heavily in higher education and have managed to build an internationally competitive university system over the last 10 years, with sustainability as one core objective (Wilkins 2019). Dubai has also managed to become a major transport hub and well-known international tourist destination; today, it no longer depends on hydrocarbon exports.

While Saudi Arabia is lagging a couple of years behind the UAE, the Saudi government has also committed substantial resources to prepare the country for the time after oil and gas. The country's current development strategy has a clear focus on upgrading the quality of human capital and shifting Saudi Arabia's economic structure toward that of a knowledge economy based on science, services, and tourism (Rundell 2021). It remains, of course, unclear whether these strategies will be successful, and history is full of examples where state-led strategies of economic transformation ultimately failed. One also has to remember that Saudi Arabia, in particular, remains a repressive autocracy, which might or might not be compatible with a development strategy based on improving human capital. Nevertheless, the fact that many of the authoritarian oil-producing nations in the Gulf are now trying to diversify their economies away from oil and gas, while Russia has made no attempt to do so, raises the question of why Russia is not even trying.

What Factors Determine a Push Toward Economic Diversification?

One major explanatory factor is political leadership. In the UAE and Saudi Arabia, the decision to build a post-hydrocarbon economy based on raising the quality of human capital was forcefully imposed by the countries' political leaders, often over strong resistance from the religious establishment, as when women were offered equal opportunities in university education (Rundell 2021). Neither country had a democratic public debate about the question. Instead, the decision was imposed from above by the countries' leading politicians—Mohamed bin Zayed in the UAE and Mohammed bin Salman in Saudi Arabia—who then coopted pro-reform groups in their societies. Both politicians were relatively young and influenced by Western ideas when they came to power, and believed in the necessity to push for economic transformation, albeit without intending to liberalize their countries politically.

In Russia, the political leadership around President Putin is old and has been in power for over 20 years.

Most of Putin's close associates share the worldview of the *siloviki*, namely that Russia is a powerful nation with abundant natural resources that are the envy of the rest of the world. The *siloviki* believe that they are the only political actors within Russia that really understand this threat and that—in a world dominated by hard-core realist politics—it is their geopolitical mission to defend Russia against outside aggression (Soldatov and Rochlitz 2018).

At the same time, however, they lack an understanding of how a modern economy and science system work, as well as an awareness that openness to new technologies and ideas are fundamental ingredients of economic and technological progress. This, as well as oil prices that have remained reliably high, has prevented them from grasping the urgency of economic reform. This lack of understanding has been exacerbated by the overcentralization of a system that relies on ever fewer sources of information. Similar to President Dmitri Medvedev between 2008 and 2011, both Mohamed bin Zayed in the UAE and Mohammed bin Salman in Saudi Arabia frequently visited Western countries and technology companies to encourage the exchange of new ideas. Following Putin's return to the presidency in 2012, such visits became less and less frequent in Russia, then stopped altogether after the annexation of Crimea. With increasing control over the media, Russia's authorities now mostly rely on information from the security services and the bureaucracy, severely limiting their understanding of the real situation of Russia's economy. This lack of feedback channels—in particular from the business community—makes it very difficult for Russia's government to design a sensible long-term economic strategy and to grasp the real economic cost of Russia's attack on Ukraine.

While Russia's top leadership seems to lack the necessary economic understanding to address the country's challenges, Russia's ruling elites more broadly are characterized by a surprising lack of will and urgency, and increasing political apathy. With the failed modernization attempt under President Medvedev, Russia's elites missed the opportunity to negotiate a new redistribution of economic rents, which could have provided the basis for an economic transformation of the country (Rochlitz et al. 2020; Yakovlev 2021). Instead, the *siloviki* gradually imposed their control. They were able to do so because of the weakness of Russia's political opposition and of organized business, as well as through selective arrests of Russia's economic, political, and administrative elites (Petrov and Rochlitz 2019; Buckley et al. 2022). As a result, Russia's remaining elites seem to have accepted the status quo, probably out of fear that any attempt to challenge it would endanger their economic situation immediately, a more threatening pro-

spect than slow economic decline resulting from a lack of economic reform.

Since 2012, the rise of new politicians and ideas has also been successfully prevented by the *siloviki*, who have managed to restrict access to political office further and further. Finally, since February 2022, any attempt to criticize current policies—whether about the war in Ukraine or economic policy in general—seems to have become a criminal offense, as, for example, when the police visited the office of well-known economist Natalya Zubarevich in June 2022 (Zubarevich 2022).

Under these conditions, a debate about economic policy no longer appears possible. Those among Russia's liberal economic elites who have decided to remain

in the country—such as Central Bank director Elvira Nabiullina, Finance Minister Anton Siluanov, and presidential economic advisor Maxim Oreshkin—seem to have limited themselves to the role of firefighters, trying to save what they can without speaking out on issues of foreign or economic policy. In the process, they become ever more complicit with a system that seems geared toward self-destruction, without being able to prevent what is happening. At the end of the day, the story of lacking economic reform in Putin's Russia has come to resemble that of the frog in the pot who refused to act when the temperature was still bearable, until the water became so hot that it was too weak to jump.

About the Author

Michael Rochlitz is Professor of Institutional Economics at the University of Bremen. His research focuses on Russian and Chinese politics, the impact of authoritarian political institutions on economic growth, and innovation in authoritarian regimes, as well as the role played by collective memories in the post-Soviet space.

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