

# DGAPanalyse

Prof. Dr. Eberhard Sandschneider (Hrsg.)

Otto Wolff-Direktor des Forschungsinstituts der DGAP e.V.

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## Growth without Sustainability

What the financial crisis says about Russia's economy

by Stefan Meister



## Zusammenfassung

# Wachstum ohne Nachhaltigkeit

## Was die Finanzkrise über die russische Wirtschaft sagt

von Stefan Meister

Der Anstieg der Preise für Öl und Gas seit 1999 war Voraussetzung für die wirtschaftliche und politische Stabilisierung Russlands. Als Ergebnis hat der internationale Einfluss Russlands zugenommen. Das enorme Wirtschaftswachstum ist die Basis für ein neues außenpolitisches Selbstbewusstsein der russischen Elite. In den letzten acht Jahren hat Russland seine Auslandsschulden zurückgezahlt und einen konstant wachsenden Stabilitätsfond angelegt. Moskau hat damit Handlungsspielraum gewonnen, um sich an der Vermittlung internationaler Konflikte zu beteiligen und in internationale Wirtschaftsinstitutionen zu integrieren.

Gleichzeitig existieren weiterhin grundlegende Defizite in der Umsetzung von Wirtschaftsreformen durch die russische Führung. Korruption, ineffektive Verwaltungsstrukturen sowie der wachsende Einfluss des Staates auf die Wirtschaft haben grundlegende Reformen verhindert. Hinzu kommt, dass der hohe Ölpreis kurzfristig dazu beigetragen hat, wichtige Reformen zu verschleppen. Die russische Führung hat die Wachstumsjahre nicht genutzt, um wichtige Reformimpulse zu setzen. Die größten Herausforderungen für die russische Wirtschaft sind die Diversifizierung der Produktionsstruktur, die Stimulierung von Investitionen in allen Bereichen der Wirtschaft sowie die Erhöhung der öffentlichen Ausgaben für Infrastruktur, das Gesundheits- und Bildungswesen.

Im internationalen Rahmen möchte sich das heutige Russland in alle wichtigen wirtschaftlichen Institutionen integrieren und auf gleicher Augenhöhe mitreden. Gleichzeitig ist es bestrebt, z. B. im Energiesektor, die Regeln neu zu verhandeln oder, wie beim WTO-Beitritt, die Integration zu verlangsamen. Gründe dafür liegen in der negativen Einstellung wichtiger Teile der russischen Elite gegenüber internationaler Integration, im Interesse, bessere Bedingungen auszuhandeln, und in der fehlenden Umsetzung wichtiger Wirtschaftsreformen. Der wachsende staatliche Einfluss in der Wirtschaft, verbunden mit einem hohen Regulationsbedarf der russischen Politik, verhindert das Entstehen von Vertrauen in die russische Wirtschaft. Vertrauen jedoch ist wichtig, um internationale Investitionen anzuziehen.

Die aktuelle globale Finanzkrise hat die Strukturmängel der russischen Wirtschaft bloßgelegt und zeigt, wie abhängig Russland von internationalen Entwicklungen ist. Russland ist durch die Krise doppelt betroffen: Einerseits hat sich der internationale Kreditmarkt für russische Unternehmen praktisch geschlossen. Andererseits ist der Ölpreis von seinem Höchststand von 147 Dollar auf weniger als 50 Dollar pro Barrel gefallen. Damit wurde die Achillesferse des russischen Wirtschaftssystems getroffen: die große Abhängigkeit von Auslandskrediten und einem hohen internationalen Ölpreis. Wenn die russische Führung nicht fähig ist, die aus der Finanzkrise resultierenden Probleme zu lösen, könnte sie ihre Legitimität gegenüber der eigenen Bevölkerung verlieren. Russland steht vor enormen inneren Herausforderungen bei der Modernisierung und wird weiterhin in hohem Maße von externen Faktoren abhängen.

## Summary

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The growth of the price of oil since 1999 was the prerequisite for the economic and political stabilization of Russia. As a result the international influence of Russia has increased. The enormous economic growth is the basis for a new self-confidence among the Russian elite concerning foreign policy. During the last few years, Russia has serviced its foreign debts and built up a constantly growing stability fund. Thus the country has gained room to maneuver internationally and to participate in the mediation of international conflicts.

But there are still considerable shortcomings in implementing comprehensive reforms of the economic structure by the Russian leadership. Corruption and inefficient administrative structures, including the increasing influence of the state on the economy, have hindered fundamental reforms. The high price of oil has contributed to delaying the readiness for more reforms in the short term. The Russian leadership did not use the years of growth to set important reform impulses. The major challenges for the Russian economic policy are to diversify its production structure, to stimulate private investment in all areas of the economy, and to increase public funding for infrastructure, the health system and education.

In terms of the international framework, Russia intends to integrate itself in all important economic institutions and be on equal footing with other members. At the same time, for instance in the energy sector, Russia aims to either renegotiate the rules or, like with the WTO-accession, slow down the process. This is due to the increasing misgivings of parts of the elite about international integration, the interest to negotiate better conditions and the delaying of important economic reforms. The intervention of politics in the economy linked with a high regulation requirement undermines the build-up of trust in Russian economic policies.

The global financial crisis has uncovered the shortcomings of the Russian economic structure and shows how Russia is dependent on international developments. Russia is affected by the crisis in two ways: first, the international credit markets have been closed off to Russian companies; additionally, the price of oil declined from its peak of \$ 147 to less than \$ 50 per barrel. Thus, the two Achilles heels of the Russian economic system have been hit: a significant dependency on foreign credits and a high international price of oil. If the Russian leadership is not able to resolve the problems emerging with the financial crisis, it can lose its legitimacy. Russia faces substantial modernization challenges in its domestic policy and will continue to depend largely on external factors.

## Contents

Linking foreign and economic policy.....	5
Results of eight years economic growth .....	5
Macroeconomic Indicators.....	6
Tax policy and stability fund.....	6
Innovations as means for modernizing the economy .....	7
Education as a key.....	7
The four Is .....	7
The Global Financial Crisis .....	8
Russian Foreign Economic Policy .....	9
Example 1: The European Energy Charter .....	9
Example 2: Russia and the WTO.....	10
Results .....	10
Notes.....	11

Die DGAP trägt mit wissenschaftlichen Untersuchungen und Veröffentlichungen zur Bewertung internationaler Entwicklungen und zur Diskussion hierüber bei. Die in den Veröffentlichungen geäußerten Meinungen sind die der Autoren.

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### Linking foreign and economic policy

During the presidency of Vladimir Putin the international influence of Russia has increased. This is due to soaring prices for oil and gas and the stabilization of the Russian state. The enormous economic growth is the basis for a new foreign policy self-confidence of the Russian elite. Sergei Lavrov, the Russian foreign minister, describes this view as a “return of Russia to global politics, global economy and the financial world as an active and full-valued player.”<sup>1</sup> Part of this self-conception is the idea to establish Moscow as an international finance centre and the ruble as a leading currency. During the last few years, Russia has serviced its foreign debts and built up a constantly growing stability fund. Thus the country has gained room to maneuver internationally and participate in the mediation in international conflicts. The present-day Russia would like to integrate itself in all important international institutions and concurrently to renegotiate the rules of political and economic relations.

At the same time, Russia tries to develop an alternative alliance policy towards the West in order to fulfill its aspirations as an independent great power. It has tried to convert its energy power into real political influence—with partial success. Thereby, it is looking for new international partners who constitute an alternative to the United States' influence in the world. These are states like China, India, and countries of the Middle East and South America. Thus Russia has used the Shanghai Cooperation Organization (SCO) to superficially cooperate with China and Central Asian States on matters of terrorism. However, the organization's prime interest and its main common denominator is to keep the US out of the region. Iran, India and Pakistan have an observer status in the SCO.

Nevertheless, Russia's influence in international relations is limited, because it is lacking instruments to implement its policy effectively. Russia's attractiveness as a soft power is limited. Its influence is constrained to developments in the region of the former Soviet Union only. There Moscow reacts aggressively, especially with regard to changes and influences from outside, as the example of the latest conflict in the Caucasus has shown. Until now, Moscow preferred the preservation of the status quo in the region. The war in Georgia may be the beginning of a more active policy within the former Soviet empire, while Moscow tries to resolve conflicts in its interest. Signs of this can be observed in its more active involvement in the conflicts in Nagorno-Karabakh and Transnistria recently.

### Results of eight years economic growth

The foundation for the new self-confidence is the economic development since 2000. For eight years, the Russian economy has been growing between 5% and 8% per year. This economic growth has one central source: two thirds of the export revenues and half of the federal budget stem from the export of oil and gas. For this reason, the Russian economy is highly dependent on the international price of oil, which has constantly increased until the summer of 2008. Ensuing from these revenues is the rise in consumption and the growth of foreign investment, especially during the last few years. Trade is the driving force behind the Russian economic growth and is closely intertwined with a growing middle class. In 2007 the consumption increased by 13%, supported by a 16% growth rate of wages.<sup>2</sup> As a consequence thereof, we can observe a structural change towards the modernization of the service sector during the last few years.

Nevertheless it is first of all the global market and not the national one that supplies the Russians with brand products. Russian products still have a competition problem, not so much because of the price but due to quality, reliability and marketing. For this reason, the import of finished goods, technical equipment, cars and machines for the industry has grown. Russia constantly reduces its positive balance of trade and will possibly import more than it exports in a couple of years. The bulk of Russian exports are raw materials and energy products, which are growing slower than the imports. Increasing demand for raw material and the consumption can attract more foreign investment in the next years. On the other hand, Russia has high custom tariffs on oil and gas revenues as well as an unfavorable business climate in the energy sector with high taxes and a strong influence by the state.

### Macroeconomic Indicators

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008
<b>GDP %-change</b>	10,0	5,1	4,7	7,3	7,2	6,4	7,4	8,1	7,3*
<b>Industrial production, %- change</b>	11,9	2,9	3,1	8,9	7,3	4,0	3,9	6,3	3,7**
<b>Fixed investments, %-change</b>	17,4	10,0	2,8	12,5	13,7	10,9	16,7	21,1	11,3**
<b>Exports, bn. \$</b>	105,0	101,9	107,3	135,9	183,2	243,6	304,5	355,2	442,7**
<b>Imports, bn. \$</b>	44,9	53,8	61,0	76,1	97,4	125,3	163,9	223,1	268,0**
<b>Unemployment, %</b>	9,9	8,7	9,0	8,7	7,6	7,7	6,9	6,1	6,6***
<b>Population, mln persons, Jan. 1st</b>	146,9	146,3	145,6	145,0	144,2	143,5	142,8	142,1	142,0

Quelle: BOFIT,37 \*1-9/08, \*\*1-11/08, \*\*\*11/08

In 2007, the industrial production increased by only 6%. This sector has principally lower growth rates than the raw material and service sectors: In 2005 and 2006, it stagnated by 4%, last year it increased to 4,7%.<sup>3</sup> The growth can be explained by the domestic demand. However Russia plays no role on the international market for technological innovation and engineering because of a lack of competitiveness.

The third pillar of the economic growth is foreign investment, which increased by 21% to \$ 121 bn in 2007 (direct foreign investment \$ 28 bn).<sup>4</sup> Admittedly, compared with other growing regions the level of growth is low: In 2007 India has had an investment growth rate of 34%, South Korea of 38% and China grew by 42%.<sup>5</sup> Nevertheless, if investment conditions are improved, Russia may

experience a boom in the next few years. Most of the investment is for raw material industry, transport and telecommunication. In 2007, all investment into the raw material industry increased, but investment into industrial production declined.

### Tax policy and stability fund

During the last few years, the government has set important impulses in the realms of tax and finance policy so as to provide for times of crisis. As of now, the Ministry of Finance under Aleksei Kudrin has rejected demands by the Duma and the broad public for higher state expenditures. Because of the high tax revenues from selling oil and gas, the federal budget generated high surpluses. Since January 1, 2004, a great share of the revenues flows into the stability fund, which will stabilize the fed-

eral budget if the price of oil decreases to \$ 27. If the stability fund surpasses the level of 500 bn rubles, the money can be used for other aims. This point was reached in 2005, and thus the Russian government has used the money to pay back its foreign debt. As of the end of January 2008 the stability fund included nearly \$ 160 bn—twice as much as by the end of 2006.<sup>6</sup> The national foreign debt decreased to only 3% of the GDP or \$ 38 bn in the beginning of 2008. Besides this amortization, \$ 1.04 bn have been designated for the national pension fund to cover the accrued pension deficit.<sup>7</sup> Furthermore, the wages in the public sector have been rising.

Since February 1, 2008, the stabilization fund has been used to found a national reserve fund and a national charity fund. The former is to secure



the budget if the price of oils decline, the latter should, in the short term, help to resolve the deficit of financing pensions. On the one hand, this money should be invested in foreign currency; on the other hand it should be invested in the international financial market. On the 1 December 2008, the reserve fund contained \$ 133 bn<sup>8</sup> and the charity fund \$ 76 bn.<sup>9</sup>

## Innovations as means for modernizing the economy

A sustainable economic development needs to reduce its dependency on the export of raw materials as well as to grow on the basis of competitive industries. The major challenge for the Russian economic policy is to diversify its production structure, to stimulate investment in all areas of the economy and to increase of public funding for infrastructure, the health system and education.

### Education as a key

The lack of specialists in particular slows down the growth in some economic sectors. The situation will worsen further, if the age cohorts with a low birth rate leave the institutes of education. The number of pupils in Russian schools has fallen between 1997 and 2008 from 22 million students to 13. Furthermore Russia has a restrictive migration policy because of traditional reservations.<sup>10</sup> As a consequence Russia has more illegal migration of low qualified persons from Central Asia, the Caucasus and China than of much-needed high-qualified manpower. Problems in the education and science sector arise because of the inefficient use of resources, the lack of coordination between higher education institutions and the industry, and the state-dominated budget. The underfunding and commercialization of education in the 1990s led to a decline of quality in education. The innovative ability of Russian research has been declining despite increases in state funding. The number of patent applications has been falling for years. With less than 1% of the market, Russia plays no role on the international market for high technology.

### The four Is

Already before his election, the Russian president Dmitri Medvedev explained on the 5th Krasnoyarsk economy forum in February 2008 his economy program and defined his political goals. On the basis of four Is—institutions (state/civil society), infrastructure, innovation and investment—the Russian leadership seeks to achieve a modernization of its economy away from the one-sided dependency on raw material. Connected to this is the strengthening of an independent judiciary, combating corruption, limiting bureaucracy, tax decreases, construction of an independent finance system as well as investment in the infrastructure, technological innovations and the social system.<sup>11</sup> Medvedev's demands do not essentially differ from statements of his predecessor Vladimir Putin, but he set somewhat different priorities. First of all, his accentuation of freedom in form of personal and economic freedom contradicts the previous policy.

Basically, with regard to its reform policy, the Russian leadership will have to find a balance between the different interests of the political elites and will have to take into account the interests of the more liberal and the more state oriented wings. A central task for the government is to convince a majority of the Russian population that further market liberalization and competition is needed. As in questions of competitiveness and corruption, there is a need for mentality to change. To achieve the goal of doubling the GDP on the basis of innovation and not raw material, as it is announced in the socio-economic concept up to 2020, the state has to draw back from central areas of the economy.<sup>12</sup>

The main challenge for President Medvedev and a central part of his policy is to combat corruption. According to Transparency International, Russia belonged to the most corrupt countries, ranked 121 out of 163 countries in 2006 and in 2007 143 out of 179 countries.<sup>13</sup> The national plan to combat corruption, prepared by the head of the Kremlin administration Sergei Naryshkin, is based on three principles: firstly, the legislation should be modernized and the independence of courts strengthened, thereby targeting the restriction of the immunity of high state officials. Secondly, the public administra-

tion should be modernized, accompanied by the removal of bureaucrats from the board of directors of large state enterprises. The third element of the concept is to strengthen the sense of right and wrong within the public with help from the media and NGOs.<sup>14</sup> There is a gap between rhetoric and the action of the government. The analysis of the problems is good, but the practical consequences are very meager.

## The Global Financial Crisis

The global financial crisis began in the US real estate market and, in the beginning, had no serious impact on Russia. On one hand, this can be seen as the result of little investment by Russian banks in bad credit deals; on the other hand, it shows the poor integration of the Russian finance institutions into the world economy. In the meantime, however, Russian enterprises have lost enormously on the stock exchange. Moscow's RTS and MICEX fell 65% in a couple of weeks.<sup>15</sup> They have been closed temporarily and the government has rescued two banks. The crisis shows how Russia is dependent on international developments.

Russia is affected by the crisis in two ways: first, the international credit markets have been closed completely for Russian companies and foreign investors have withdrawn \$ 80 bn from Russia. Second, due to recession fears, the price of oil declined from its peak of \$ 145 in July 2008 to less than \$ 50 per barrel.<sup>16</sup> Still in October 2008, Prime Minister Vladimir Putin stated that Russia was not affected by the crisis. Since then, however, the Russian government has established a crisis package with a value of more than \$ 210 bn.<sup>17</sup>

Aside from the high prices for raw materials, the Russian economic growth since 2001 has been based on high domestic demand and foreign investment. While the Russian government built up currency reserves of \$ 560 bn in the last few years, Russian banks and companies accumulated debts abroad of \$ 450 bn.<sup>18</sup> While private households financed their consumption with credits, Russia's big companies—also in the energy sector like Gazprom—financed additional purchases within Russia

and abroad by loans. Right now, however, these debts are falling due; in 2009 alone, \$ 115 bn have to be paid.<sup>19</sup> While big energy companies like Gazprom have stopped investment projects, Russian oligarchs are obliged to sell their foreign shares in order to pay back their credit debt. According to Bloomberg, the 25 richest Russians lost one third of their assets by mid October on the stock exchange, which equates to more than \$ 230 bn.<sup>20</sup>

Because of the lack of trust in Russian policy, the outflow of money from Russia has intensified. This is a result of the war in Georgia which has led to substantial uncertainties worldwide and because of an increasing influence of the Russian state within the realm of the domestic economy. This policy is reflected in the reclamation of important raw material deposits by Russian state companies and by the pressure of the Russian administration in the last few years. Further examples are the forced formation of state holdings in important strategic branches since the end of 2007 and a law passed in April 2008 on the restriction of foreign investment in 42 strategic branches. Recently, Prime Minister Putin's mere criticism of the steel and mining company Mechel and its pricing policy resulted in a drop of the Mechel share price by over 30% after Putin threatened a reaction of the trust and finance administrations.

Because of the expected international recession, the price of oil, gas and metals has fallen sharply in the last few weeks. Raw materials are the most important exports of Russia; oil alone is responsible for one third of the Russian state revenues. The problems now stem from the failure to decrease the state's dependence on oil and gas revenues. As a result, ongoing and planned investment projects for the development of new deposits have partly been stopped due to lack of financing. Furthermore, many of these planned projects are only worth developing at a price of oil between \$ 90 and \$ 100 because of the climate conditions. This is also the case with the gas field Shtokman in the Barents Sea, which should supply the North Stream Pipeline in the future. In October, the major energy companies Gazprom, Rosneft, Lukoil and TNK-BP received \$ 9 bn from the state to support their debt service. Additionally, Russian Minister of

Finance, Aleksei Kudrin, reduced taxes and customs expenses to support the companies.

The deficit of the credit market and the decline of demand has by now reached the real economy and led to a decrease in production. The building sector and car industry are in particular affected. After Russian companies lost half of their value on the stock market, the central bank and the Ministry of Finance intervened and bought stocks back. The central bank and National Charity Fund injected 950 bn rubles for five years into the biggest state banks Sberbank, VTB and VEB in order to give liquidity to the economy.<sup>21</sup> As a result, the influence of the state will increase even further. These developments could negatively influence the effectiveness of President Medvedev's planned modernization program. The program is intended to facilitate investment in the infrastructure and key technologies. Critics also consider the budget for 2009 as being underfunded because it is based on an assumed price of oil of \$ 80–90.

## Russian Foreign Economic Policy

For the success of the economic reform policy it is especially important to analyze the Russia's strategy for integration in international economic institutions. With its foreign economic policy, Russia wishes to integrate in all important financial institutions of the West and to participate on an equal level. This includes access to the WTO, OECD and a close cooperation with the World Bank. According to a strategy paper of the Russian Ministry of Foreign Affairs, Russia wants to strengthen its position in the area of environmental protection and wishes to modernize its economy on the basis of ecological technology.<sup>22</sup> But there is a gap between aspiration and reality: Russia is neither a pioneer in implementing the Kyoto protocol, nor in developing measures of energy efficiency. As for the WTO, it would appear that the Russian government is less interested in a constructive consent but in bargaining for maxing out its positions and slowing down the negotiations. The central question is whether Russia is willing to obey international agreements and norms, and to make sure that they translate into national law.

## Example 1: The European Energy Charter

Russia intends to negotiate new treaties with the West, where security and economic questions are concerned. For instance Russia deems the European Energy Charter to be against Russian interests. At the same time Moscow wants to influence the rules and not adapt to an existing system without renewed negotiations. The influential head of the Russian Gas Society, Valeri Yazev, claims that future relations between Russia and the EU in the energy field should be based on a general legal understanding and a special political cooperation. For an easier cooperation, Russia should be awarded observer status in all European organizations regulating energy. Yazev criticized the Energy Charter for subjugating neighboring countries to EU principles without considering their needs.<sup>23</sup>

It is a fact that parts of the Energy Charter are not in the interest of Russia and other oil and gas producing countries. Because of the transit protocol, it was not ratified by Norway, states in the Middle East and Australia. Russia is concerned that with the acceptance of the transit protocol, Central Asian states will be allowed to transport their oil and gas through the Russian pipeline system. As a result, the Russian transport monopoly would be undermined. However, it is in Russia's best interest to invest in the European energy market and the infrastructure required to reach the consumer with reliable energy delivery. Thus, this must be an opening of the Russian energy market, which has been politicized in the context of the discussion on the Energy Charter. Russia's tactics show a preference for bilateral negotiations and agreements with single countries, companies and politicians, as opposed to negotiating or participating in internationally valid treaties. This applies not only to the energy sector. The result is a lack of transparency and a degree of mistrust of Russian policy and investment.

The North Stream Pipeline project, for example, has been viewed as a German-Russian project, arousing concern particularly in the Baltic States and Poland from the beginning. The strategy of Gazprom to supply not only Germany, but all of Western Europe, was no part of the discussion. Here it would have been in Russian (and German)

interests from the beginning not to cause anxiety and not to give rise to a politicization of energy supply but to deliver more transparency and binding agreements.

### Example 2: Russia and the WTO

President Medvedev emphasized in his speech in Berlin in June 2008 the importance of WTO accession for his country. Yet there are increasing doubts if Russia really has the political will to do so. After the agreement with the US in the end of June 2006, joining WTO seemed close. Since that time, however, Moscow has been slowing down the implementation. Examples of the hesitation are the tripling of agricultural aids to \$ 9 bn in 2008 and the increase of export tariffs for wood in 2007, which especially affects the Scandinavian states. Saudi Arabia continues to criticize the low price of gas granted to Russian industry.<sup>24</sup> This shows a direct contradiction of economic decisions and international agreements. For the Russian government, it is still more important to regulate and close the domestic markets than to accept international agreements. In Russia, skepticism is growing about whether joining WTO will bring the desired benefits and whether Moscow will lose control over some areas of the economy because of it.

The WTO-accession is considered to be an important instrument for the economic development of a country with influence on the customer policy, investor rights, agriculture and intellectual property. It has direct influence on the implementation of reforms in areas such as trade, foreign direct investment, as well as institutional change, and is an important means of reform towards an open trade and investment policy. David Tarr, the former chief economist of the World Bank, maintains that Russia's central advantage of the WTO-accession is the implementation of important domestic reforms. It was not until the Russian leadership under president Putin declared the WTO-accession to be a priority that the negotiation process started to be successful.<sup>25</sup>

Recently, however, the political support on the highest level seems to have weakened. This development can be explained with justified concerns

that if Russia joins the WTO, it must reduce its high tariffs and most of Russian enterprises will no longer be able to compete. Furthermore foreign companies will get easier entry to the Russian market and the Russian government will no longer be able to influence this development. The head of the Russian Federation Council, Sergei Mitronov, summarized the issue as follows: the later Russia joins the WTO, the better it would be for Russian national interests. Mitronov explains his position by pointing out that Russia needs more time to prepare her non-competitive economic sectors like agriculture, industry, and the banking and insurance system for international competition.<sup>26</sup> He therefore confirms the wish of the Russian leadership to join WTO, but he acknowledges the lacking competitiveness of the Russian economy.

## Results

The increasing price of oil since 1999 was the prerequisite for the economic and political stabilization of Russia. Admittedly, the Russian government has made promising decisions like the foundation of a stability fund and the paying back of foreign debt. However, there still is a considerable shortcoming in implementing comprehensive reforms of Russia's economic structure. The high price of oil has contributed to delaying the readiness for more reforms in the short term. Russia has not sold manufactured goods, but only raw materials in the last few years. The Russian leadership did not use the years of growth to set important reform impulses. The central challenge of the next few years is to implement an economic strategy that will bring growth despite lower prices for oil and gas. The Putin-Medvedev tandem needs to adjust the Russian economy on the basis of international competitiveness. Ideas and plans exist and are being discussed by the leadership. They span from combating corruption, supporting small and medium-size business and the creation of independent courts to the modernization of education and research. However, it is still not clear if the president and the government are able and willing to implement these programs. The resistance of the bureaucracy and some elite groups has brought several good reform ideas to a halt in the past.

International comparison shows that Russia holds the third largest currency deposit after China and Japan.<sup>27</sup> Thus, Russia today is better equipped to combat the current financial crisis than was the case in 1998. The Russian economic journal *Expert* estimates that the economic crisis is a chance for a more healthy growth of the Russian economy: the next month will decide whether the Russian government uses the crisis to change the rules in the interest of the whole economy or whether it will further support mostly large state companies.<sup>28</sup> One of the most pronounced problems of the Russian economy is the increasing influence of the bureaucracy in all areas linked with inefficient use of money and persistent corruption.

In the international framework, Russia intends to integrate itself in all important economic institutions and be on equal footing. At the same time, for instance in the energy sector, Russia aims to either renegotiate the rules or, like with the WTO-accession, to slow down the process. This is due to the skepticism of parts of the elite about international integration, the interest to negotiate better conditions and the delaying of important economic reforms. The intervention of politics in the economy linked with high regulation requirements undermines the build-up of trust in Russian economic policies. Consequently, Moscow faces the challenge of explaining its policies to international institutions and it fosters mistrust of governments, which are skeptical about the expansion of Russian enterprises.

Trust is particularly important in order to succeed in international economic policy, and Dmitri Medvedev should have used the positive reactions on his first conceptual speeches to achieve more trust. It is to his disadvantage that he has a weak position within the Russian elite whose main interest is their domestic image. Different rules apply in Russia than on the international stage. Yet to reach its reform goals Russia has to adapt international rules and to open its economy. Only if concept papers become laws that are implemented by an efficient bureaucracy will the Russian reform policy see success.

International relations cooperation with Russia is not difficult because Russia is too strong, but rather because it is too weak to act as a reliable partner. After the 1990s, Russia feels humbled and now overestimates its possibilities because of the positive economic developments of the last eight years. At the same time, its aggressive attitude towards the West, NATO and the US has helped to stabilize and legitimize the existing regime. The increasing price of oil has masked the structural weakness of the Russian economy. The global financial crisis has brought these issues to light. Russia faces substantial modernization challenges in its domestic policy and will continue to depend largely on external factors. Finally, the harsh political rhetoric of the Russian leadership should also not cloud our understanding of the country.

Dr. Stefan Meister, Programmmitarbeiter  
Russland/Eurasien, DGAP.

## Notes

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- 3 Vgl BOFIT Russia Statistics, <[http://www.bof.fi/bofit\\_en/seuranta/venajatilastot/](http://www.bof.fi/bofit_en/seuranta/venajatilastot/)>, 25/8/2008.
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