

Modernization in Russia: Things to Come, Things to Overcome

[John Erickson Lecture, 8 February 2012]

Distinguished Chair,

Ladies and gentlemen,

It is a great honor and a privilege for me to be invited to the world famous University of Edinburg and to have an opportunity to share with you my thoughts and feelings about Russia's today and tomorrow.

I can not deprive myself of the nostalgic pleasure to tell you that the first foreigner I met in my life was a Scott. I was attached as an interpreter to the hero of the Upper Klide Shipbuilders' industrial action Jimmy Reid. I was 17 years old and very inexperienced.

I did not understand Jimmy, but he was the best joke-teller and toastmaster in the world and the first Scottish word, which I learned and proudly use ever since is "SLANGIVA".

And of course my wife Irina and myself (and she is with me tonight) like millions of the Soviet and Russian children were raised on the books of Walter Scott and Robert Burns.

Three years ago, the title of the John Erickson Lecture delivered by Sir Malcolm Rifkind played off that famous phrase of Churchill: 'I cannot forecast to you the action of Russia. It is a riddle, wrapped in a mystery, inside an enigma.'

Churchill of course added: 'but perhaps there is a key. That key is Russian national interest.'

One of the keys on this ring is Russia's modernization – modernization as a path for manifesting Russia's national interest to the full extent, as the sole solution for securing Russia's position as a powerful, modern and prosperous society.

And Russia's future will depend on whether all of the country's 'enigmas' can be recalibrated toward modernization. We are working on this and we believe in its success.

In early 2010 our Institute of Contemporary Development presented its report titled *Russia in the 21st Century: Vision for the Future*. We endeavored to outline possible aims and objectives both for the near term and the distant future. This was not an attempt to synthesize some sort of national mission or 'the Russian dream.' Our intentions were more practical. The result was an essay about successful modernization, a forecast of its possible outcomes, a summary of results yet to be achieved, so that society and authorities could determine what our common actions should be, what we will have to invest to make this happen and the scale of the efforts required.

And we were not much different from other think-tanks and academic centers in Russia calling for the similar reforms. Where we were somewhat different at that time two years ago was the call for the deep political reform without which all economic undertakings would hit the wall.

On the face of it Russia is the sixth largest economy in the world by the Gross Domestic Product, we have 4% GDP growth in 2011, zero deficit budget and the lowest in our modern history inflation and unemployment. Cameron, Sarkozy and even Merkel would die of envy. But Russia structural weaknesses are very well known.

Number one of course, is over dependency on oil and commodities. There is nothing new. 200 years ago William Playfair, under whose shadow and intellectual patronage we have gathered here today, published a book, the title of which was one way or another borrowed by prominent authors from different countries: *An Inquiry into the Permanent Causes of the Decline and Fall of Powerful and Wealthy Nations*. Among other things, this work contains a forecast that Russia

will never become a serious competitor for England in world trade and industrial production. The Russian Empire, as Playfair wrote, was a new empire but its people was an old people, its territory was too large and so on. God himself forced Russia to build its economy around natural resources. I quote – ‘To cultivate its soil, and export the produce of its mines, the skins, tallow, hides, timber et cetera will be more profitable, and suit better the inhabitants than any competition in manufacturing.

Russia today depends dangerously on oil/commodities, with two-thirds of export receipts now energy-related, and a similar proportion of budget receipts. Despite government focus on the need for diversification away from energy/commodities throughout the Putin era, in reality little has been achieved in this respect, and indeed vulnerability has increased. One key bell-weather of this is the Urals oil price at which the Federal budget balances. Back in 2002, for example, it was around USD30 a barrel, while currently it is around USD110 per barrel, or even higher. This is the result of spending creep, as each year of high oil prices over the past decade has seen government's boost recurrent spending – higher pensions and public sector wages, and greater spending on defense, et al. The danger though is that if oil/commodity prices adjust even moderately lower now, the budget deficit would quickly spiral out of control. Likewise there would also be a marked impact both on the current account position and broader real GDP growth. Indeed, if oil prices would only have to dip to USD70 a barrel, i.e. still well ahead of the long term average, Russia dips into recession, runs a sizeable budget deficit and even a current account deficit. Capital outflows in such a scenario would likely force a depreciation of the rouble.

Demographics – Russia faces a demographic time-bomb, with a rapidly aging population, and declining population. Russians have a low life expectancy relative to its OECD peers – for various reasons, including the inhospitable climate, and too many young Russians want to, and indeed do, emigrate. The

resultant labour shortage will be a key constraint on development but also threatens to create a pension black-hole – swallowing any oil "windfalls" over the medium term.

After the crisis and credit crunch the banking sector has increased the dominance of domestic, and particularly state owned banks – which now control 60-70% of the banking sector. While currently this is having the advantage of allowing a rapid re-extension of credit to the economy the downside is that competition within the sector is declining which cannot be healthy from a longer term perspective. Broader concerns over banking supervision and regulation remains, and if anything have intensified.

Poor business environment – high levels of corruption, red tape and bureaucracy, as reflected in Russia's low scoring in the World Bank's Doing Business Survey (120 out of 183 in 2011), and Transparency International's Corruption Perception Index (143 out of 183 countries), act as a cap on investment, growth and development. Indeed, FDI inflows into Russia remain disappointing by international comparison – foreigners still complain over the lack of a level playing field, and discriminatory practices still.

The above structural weaknesses in no small part explain Russia's relatively weak real economy performance through the global crisis. In particular, in 2009 the recession in Russia was far deeper than its BRIC peers (-7.9% YOY), and the recovery since has been much weaker, i.e. currently a growth trend of 3.5-4%, around half that of China, and India, albeit Russian growth is now expected to outpace that of Brazil at least for 2012.

The structural vulnerabilities noted above have been augmented in 2011 and into 2012, by heightened political risk associated with first the disputed parliamentary elections in December 2011 and now the presidential elections slated for March 2012. This heightened level of political risk has seen a marked pick up in the level of capital flight (USD84bn for the year in 2011). Mass street demonstrations in protest at what many see as flawed parliamentary elections, with

similar concern over the fairness of the presidential election process, have raised concern that Russia faces its own "Arab spring", with the prospect of Vladimir Putin being removed from power. Evidence of in-fighting within the Putin regime, e.g. first expressed with the removal of the former Mayor of Moscow, Yuri Luzhkov last year, and then with the "competition" between Putin and "his" president, Dimity Medvedev, to run as the "official" United Russia candidate in the presidential election in March, has left an impression of flux within the administration. All this was not helped by the resignation in the autumn of the respected former Minister of Finance, Alexei Kudrin – seen by many as the guarantor of fiscal prudence in Russia – in what seems to have been a falling out with the incumbent President Medvedev.

Against this backdrop let me give you an optimistic scenario on Russia for 2012.

Let us assume that Vladimir Putin will win presidential elections in March, and likely still in the first round, by securing more than 50% of the vote. Let us assume that Putin's victory will not spark mass street protests, and even if they result, Putin will likely endure in power. Russia is hence unlikely to have its Arab Spring, or at least this will not result in regime change. This confidence in Putin's ability to ride through what is perhaps the greatest political challenge to his twelve year stint in power rests on a number of factors:

Putin does have a strong underlying, core support base, around the 50% level, given that he has delivered a decade of stability, growth and rising living standards for the population. He has also made Russians feel much better about the country's standing, which stands in stark contrast to the centrifugal forces and economic decay which characterized both the Gorbachev and Yeltsin eras for many Russians. True, voters in Moscow and St Petersburg, and especially those amongst Russia's new middle classes appear to want more (particularly political pluralism rather than the "sovereign democracy" served up by the Putin regime), but support for Putin in the regions still seems much stronger, albeit admittedly

declining amidst frustration over the regime's centralizing powers and sense that many within Putin's elite have overly enriched themselves.

The Putin administration still has considerable economic/political tools in its armoury. Fiscal policy for much of 2011 was prudent, helped by high oil/commodity prices which bolstered budget revenues. The government can also rely on state-owned banks to do their bit, and indeed, recent months have seen banks aggressively expand credit, stimulate domestic demand, helped by the CBR which has cut policy rates and pumped liquidity into the system. This fiscal and monetary easing should stimulate the economy and something of a "feel good" factor in the short term. The Putin administration, meanwhile, continues to control the TV media, through which most Russians still get most of their news/current affairs.

The opposition remains divided with few popular leaders around which opposition can rally. Western "style" liberal democrats remain largely discredited still by the shock therapy reforms instigated through the Gorbachev/Yeltsin eras. Restrictions on party politics, NGOs and also electoral rules that limit political pluralism also play to the Putin camp. The emergence of a credible opposition force has also been neutered by the Putin regime's own management of opposition politics, e.g. through the support for "favoured" or perhaps more appropriately "managed" opposition parties, e.g. "Just" Russia and Vladimir Zhirinovsky's LDP. The "un-managed" opposition thus consists of a largely marginalized Western style opposition, e.g. the Union of Right Wing Forces, or Grigory Yavlinsky's Yabloko block, and extreme nationalists. Thus far there appears to be little credible opposition leader to face Putin in the presidential poll in March.

The Putin regime retains the complete and absolute loyalty and support of the police, security services and army. Sustained street demonstrations could ultimately be met by increasingly restrictive actions by the security forces and police.

Second, while the presidential elections, like the parliamentary elections are unlikely to spur regime change, as some would hope for, the popular unrest and heightened political debate which has surrounded them will not go unanswered by the Putin regime. Indeed, the regime will respond by fast-tracking reform. Our faith herein lies in recognition that Putin has shown a considerable degree of pragmatism and political acumen over his twelve years in power. Mindful of the risks to his regime still, we think he will move to snuff out opposition by quickly naming a reform minded prime minister. He might spurn Dimity Medvedev, but will instead likely move to bring Alexei Kudrin back to head his government. Kudrin has the reform credentials, being respected for his prudent management of public finances during his decade long stint as finance minister and understanding of the need for economic reform. His appearance at street demonstrations has also established his reform credentials with the Russian "street", while he has remained loyal/close to Putin during his few months outside of government. What better way than to offer an olive leaf to the demonstrators than appointing Kudrin as prime minister. By contrast, the appointment of Medvedev as prime minister would surely disappoint those wanting reform, as his ignominious ousting from the presidency by Putin has surely eroded his political capital, particularly in the reform camp. By contrast, the fact that Kudrin had the temerity to resign from the Putin cabinet, in principal protest at Medvedev's plans for military reform surely will give Kudrin some considerable political capital to push forward with reform. He will likely need to draw quickly on this political capital though as the structural problems in Russia run deep and will require a vigour in terms of identifying key priorities, and forcing through reform against entrenched vested interests. Ultimately Kudrin may fail, but at least his appointment will provide some considerable hope.

I assume oil prices will remain elevated in 2012, which should still prop up Russia as a commodity play. Oil prices will likely continue to be buoyed by instability in the Middle East, particularly the stand-off between Iran and the West,

accentuated by the electoral calendar in the US and Iran. Supply constraints and the assumption of a "soft" landing in China will, meanwhile, likely continue to support metals prices. Continued monetary stimulus in developed markets, to underpin recovery, are also expected to see liquidity pumped into EM and also commodity markets.

The rouble will have a strengthening bias through 2012. In the early parts of the year the combination of fiscal stimulus, commodity-driven current account surplus, and CBR intervention to cap capital flight will underpin the currency.

So, in this scenario on-going political tensions are positive as without these Putin, who is conservative by nature, would likely have held to the status quo, which would ultimately have meant stagnation for Russia because of the deep structural weaknesses. The elections, and the protests which have surrounded them, offer Russia and Putin an opportunity to take a fresh, but much needed "reform" course. This new direction will likely be supported by clement commodity markets. This is an opportunity that Putin must not miss.

This was a relatively optimistic scenario. But the Russian soul is not at ease. The thinking part of Russian elites can not be satisfied with the status quo. The contradictions between autocratic rule of Putin and postindustrial technologic and cultural environment in which the educated Russians live and work has striking resemblance with the famous silver age of the beginning of the XX century.

Let me offer you one more argument in favor of the unruly scenario. Here are the 12-13 year cycles of Russian political and economic transformation since The October Revolution of 1917.

1917-1921 – Revolution and Civil War

1937-1940 – Termidor

1953-1956 – Nikita Khrushchev's antistalinist reform

1964-1968 – neostalinist restauration, Kosygin's Crash

1983-1985 – Brezhnev's Crash, Gorbachev's revolution

1999 – Eltsin’s Crash, Putin’s Era
2012 – Crash? How long?
If 2017 – 100 years’ cycle is over.

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In concluding my remarks I would like to recall another statement by our prime minister voiced nine years ago in Edinburgh and addressed to all the Scottish people: ‘In Russia we remember and know the great number of your predecessors who played an enormous role – I can say this without any doubt – an enormous role in the history of the Russian state.’ Of course, in this regard, Russia is not some special case. Such words could probably be said by almost all of your guests from the countries of Europe and North America; our gratitude to Scotland for her great sons and daughters.

But usually when people start talking about Scots in Russia’s history, they first bring up the great military planners and battlefield leaders: Alexander Leslie, Patrick Gordon, Jacob Bruce, Samuel Greig and Barclay de Tolly. But I would like to draw attention to another list of names, those of no less remarkable people – engineers and entrepreneurs who during the 17th, 18th and 19th centuries traveled from Scotland to Russia to create modern industry in our country. Here we find one of the organizers of the Russian metals industry Charles Gascoigne, and the first person to build a steamship in Russia Charles Baird, and one of the founders of the Baltic Shipyard in St. Petersburg Mark MacPherson.

Two hundred years ago a English engineer, complaining about his lot, wrote home from St. Petersburg saying that the being a Scotsman ‘is the best recommendation a man can bring to this city, the Caledonian Phalanx being the strongest and most numerous, and moving always in the closest union.’

It is not likely that the changes in the Russian economy and in Russian life which I outlined today will be either simple or quick. But there is no doubt that this will be a process of great scope and scale, encompassing much and promising much – this I can guarantee you. And I do hope that in our efforts toward these goals, we will once again have much reason to thank the Caledonian Phalanx.