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# Russia's Course: Viable in the Short Term but Unsustainable in the Long Term

ANDERS ÅSLUND, SERGEI GURIEV, AND ANDREW C. KUCHINS

The Russia Balance Sheet series assesses Russia's major assets and liabilities. In this second book we take the reader through a discussion of Russia's economy, political system, innovation system, energy sector, military, and foreign policies and relations. Unlike the first book, which was written during the global economic crisis of 2008–09, we completed this book when it was clear that the crisis was over. This is a good time to check the pulse, as Russia and the rest of the world have just faced a huge shock, allowing us to assess the real state of affairs. This is also a good time to take a long-term view, which is the purpose of compiling any balance sheet—be it for a company or a country.

This book concludes that Russia is doing well in the short run. It is highly unlikely that Russia will run out of cash, both literally and figuratively. Russia faces no public finance crisis, and its current account surplus remains impressive. Russia's international currency reserves peaked at \$598 billion in August 2008 and were at \$436 billion in mid-March 2010, still the third largest in the world. With all its deficiencies, the system has come out of crisis virtually unscathed and has shown that it can function under extreme stress. Russia has weathered a perfect storm of oil price decrease, reversal of capital flows, and political isolation following the war with Georgia. Nor has the Russian political system fallen apart. As the oil price is rising ever higher, the next couple of years will certainly be much easier than the fall of 2008. Although the Russia-Georgia conflict remains,

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*Anders Åslund has been a senior fellow at the Peterson Institute for International Economics since 2006. Sergei Guriev is rector of and Morgan Stanley Professor of Economics at the New Economic School. Andrew C. Kuchins is a senior fellow and director of the Russia and Eurasia Program at the Center for Strategic and International Studies (CSIS).*

little new drama has been added, and other global events have overshadowed Russia's recognition of Abkhazia and South Ossetia. Russia's short-term prospects appear neither dramatic nor problematic.

Yet, the other major lesson that a reader can draw from the book is that Russia is facing huge structural challenges in the long run. The analysis in this book shows that the current system has exhausted its potential. Some authors argue that the system has been successful and has solved many problems while others suggest it was flawed to start with. In some aspects, the system has evolved and is completely different from what it used to be, while in others it has come full circle. Yet, all conclude that the current system is no longer suitable for the challenges ahead and is facing a dead end; it is not sustainable in the long run and must change. This conclusion is for the economy, politics, rule of law, the gas behemoth Gazprom, the Commonwealth of Independent States (CIS), foreign relations in general, foreign economic relations, and military reform.

The discussion in this book is reminiscent of the one in the 1970s about how the Soviet Union would transition from "extensive" growth based on the mobilization of resources to "intensive" growth founded on increased efficiency and productivity. The big difference is while reform of the Soviet economic system was not possible, reform of current state capitalism is. The chapters lay out specific agendas for change. In some cases reform has already started. In particular, military reform is under way, and efforts to deregulate business and promote innovation are also being undertaken. If Russia is to succeed in the long run, however, it needs comprehensive change and needs it urgently.

Are the changes sufficient for Russia's prosperity? The good news is that Russia still has substantial assets—natural resources and human capital—and huge potential for further change: The economy is ridden with inefficiencies, energy is continued to be wasted, and Gazprom remains an inept behemoth. These changes are not going to be easy but if they happen, Russia will still be able to realize the true value of its assets, which will bring enormous benefits both for Russians and for the rest of the world.

An issue that this book touches upon only tangentially is political stability. Daniel Treisman's thorough study of presidential popularity in Russia over the last two decades reveals that economic performance is its dominant driver. Although the two political leaders' popularity has declined slightly during the last one and a half years of crisis, the decrease has been remarkably small. This can be interpreted in several ways. Perhaps the Kremlin has been successful in managing its image through controlled state television programming and extensive social transfers. An alternative interpretation is that popular dissatisfaction is growing but has not yet been fully expressed. Admittedly, new instances of social unrest have come to the surface, but so far they have been marginal.

One of the several serious structural problems that this book identifies is the nature of Russia's federalism, as Ekaterina Zhuravskaya illuminates in her chapter. It is one of the fundamental barriers to social development that has to be broken in line with modernization theory. In terms of economic development, Russia is at the upper bound from where, as Samuel Huntington indicated, a country would transition to full democracy. Indeed, all countries that are richer than Russia in terms of per capita GDP are democracies or small oil states, with tiny Singapore being the only exception.

Another broad area of structural concern is corruption, rule of law, state regulation of enterprise, and innovation. Timothy Frye shows that corruption has not abated after 2000 but become somewhat worse. The economic consequences of the poor business environment and corruption are severe. Big companies are given an unfair advantage over small firms, hampering the latter's development, whereas in the West, small businesses are the innovators. The fact that the total length of Russia's paved roads was slightly shorter in 2008 than in 1997 best illustrates the costs of poor governance. This long-promised development of infrastructure has failed spectacularly because of corruption.

Keith Crane and Artur Usanov provide similar evidence from Russian high-technology sectors. Apart from the software industry, high technology is concentrated in large state corporations, which—judging by Western experience—are unlikely to generate innovation. President Dmitri Medvedev has spelled out this dilemma: “Centuries of corruption have debilitated Russia from time immemorial. Until today this corrosion has been due to the excessive government presence in many significant aspects of economic and other social activities.”<sup>1</sup>

One of Russia's great problems is its demography, which we discussed in the first book, *The Russia Balance Sheet*. President Medvedev has said it all: “Every year there are fewer and fewer Russians. Alcoholism, smoking, traffic accidents, the lack of availability of many medical technologies, and environmental problems take millions of lives. And the emerging rise in births has not compensated for our declining population.”<sup>2</sup> The need for improvement on all these fronts remains.

In recent years, much of the public discussion in Russia has concerned the country's energy curse. The classic contribution on this topic is late Yegor Gaidar's book *Collapse of an Empire: Lessons for Modern Russia*.<sup>3</sup> In effect, Gaidar warned that the Putin regime could end as the Brezhnev

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1. Dmitri Medvedev, “Go Russia,” September 10, 2009, [www.kremlin.ru](http://www.kremlin.ru) (accessed on March 19, 2010).

2. *Ibid.*

3. Yegor Gaidar, *Collapse of an Empire: Lessons for Modern Russia* (Washington: Brookings Institution, 2007).

regime did, because the apparent achievements relied to a great extent on energy rents. This theme is the main thread in the lead chapter by Sergei Guriev and Aleh Tsyvinski. Their argument is that with an oil price of \$70 to \$80 per barrel, Russia will be like it was in the 1970s and 1980s. President Medvedev has warned against excessive dependence on energy rents: “Achieving leadership by relying on oil and gas markets is impossible.”<sup>4</sup>

At present, the predominantly private oil industry in Russia is in splendid shape. For the first time, Russia is both the biggest producer and exporter of oil in the world. The state-dominated gas industry, by contrast, is in serious crisis, as Anders Åslund discusses in his chapter on Gazprom. Because of the gas glut in Europe, gas prices are likely to stay depressed. Also, Russia has great potential for energy saving, which Samuel Charap and Georgi Safonov explore in their chapter. As a consequence, Russia’s gas rents, and energy rents in general, are likely to be much lower for a long time. This development would be advantageous for the country’s future. It is true that energy accounts for two-thirds of Russia’s exports at present, but not more than one-fifth of its GDP, so Russia is not an extreme petrostate.

The most curious element in the current Russian society is its military reform. This reform is truly radical, which Minister of Defense Anatoly Serdyukov is pursuing against furious resistance from the officer corps. Although this topic is subject to substantial public debate, as Pavel Baev shows in his chapter, it is still surprisingly low key in Russia. The problems of military reform are multiple and complex—insufficient financing, inconsistencies, military resistance, and poor armaments industry—but whatever the outcome, the Russian military will change for the better.

Four chapters in this book are devoted to foreign policy, two of them to pure foreign policy and two to foreign economic policy. All these chapters conclude that the current Russian foreign policy does not make much sense. Dmitri Trenin puts the current Russian dilemma starkly in his chapter’s title: modernization or marginalization. The essence of his argument is that Russia should not oppose the West. Instead, Russia should aspire to emulate and join the West. Russia does not have the resources to pursue a separate course, nor would it make much sense.

David Tarr and Natalya Volchkova show that Russia has much to gain from accession to the World Trade Organization, which would spur Russia’s modernization, while Russia has little to gain from the development of a customs union with Kazakhstan and Belarus, which would instead represent Russia’s marginalization. In his obituary on the post-Soviet space, Åslund shows that Russia is not succeeding in building any new alliance with even close post-Soviet partners, who instead prefer to keep a distance from Russia’s overbearing presence. He argues that Russia would benefit from winding up the CIS and all its suborganizations,

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4. Medvedev, “Go Russia.”

which increasingly are being perceived as a threat to the sovereignty of these newly independent states. Russia's relations would be better and more beneficial with a different policy.

The bottom-line for the Russia Balance Sheet project is its implications for US-Russia relations, which Andrew Kuchins discusses in the last chapter. Current strategic outlooks for Russia and the United States vary greatly, arguably much more than they should. President Barack Obama has gone out of his way to reset US-Russia relations. The key line in his big Russia speech at the New Economic School on July 7, 2009, was, "America wants a strong, peaceful, and prosperous Russia."<sup>5</sup> The US-Russia relationship has considerably improved since its low point during the Russia-Georgia war in August 2008, but its potential remains unfulfilled. Kuchins puts the main blame on the Kremlin for incorrectly believing that Washington needs Moscow more than the other way around and persisting in its belief that the United States is the greatest threat to Russia.

The Russian leadership has a great opportunity to change things for the better. On the one hand, it is evident that the current economic model cannot deliver sufficient growth in the next several years and the main problems are obvious. On the other hand, the Russian regime does not face any apparent immediate internal or external threat. Therefore, the Russian government can launch reforms if it so desires. Yet reforms always involve costs, not least to the insiders. The big question for the next couple of years is whether the stark analysis of Russia's shortcomings, which have been expressed by none other than the president of Russia himself, will prompt adequate reforms.

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5. Remarks by the President at the New Economic School Graduation, July 7, 2009, [www.whitehouse.gov](http://www.whitehouse.gov) (accessed on March 19, 2010).

