DEGLOBALIZING RUSSIA

SERGEI GURIEV | DECEMBER 2015

When Vladimir Putin won the presidential election in 2000, there was no doubt that his vision was to integrate Russia into the global mainstream. His core economic program, which was developed by then economic minister Herman Gref, included among other things joining the WTO as soon as possible.

In practice, the pro-globalization rhetoric of Putin's elites has always coexisted with protectionist policies and resistance to integration. Russia eventually managed to join the WTO, but only in 2012. Both before and after that, the government took numerous steps aimed at undermining free trade and foreign direct investment (FDI). In 2006, Russia forced the Shell-led Sakhalin energy consortium to sell a majority stake to Gazprom. In 2008, the Kremlin adopted a list of more than 30 sectors (including broadcasting, fishing, and publishing) in which foreign investment was subject to government approval; this list eventually expanded to include 45 industries. Even in industries not on the list, there were multiple cases in which foreign investors were quietly dissuaded as their acquisition targets were slated for takeover by politically connected Russian businesses that did not like competition.

Given the high level of corruption in Russia,[1] these moves were not unexpected. However, the overall vision of a more globalized Russia was never questioned—until 2014. Even as Russia's economy under Putin grew more corrupt and more statist, it was also becoming more and more integrated into the global economy.

The Ukraine crisis changed everything. Russia's March 2014 annexation of Crimea and the resulting Western sanctions brought about a clear division in Russia between "us" and "them."

The ultimate proof was the introduction of Russia's countersanctions. In August 2014 the government banned Western food imports, even knowing that this would hurt Russian households much more than Western farmers. In 2015, the government went a step further and ordered that any embargoed food that found its way into Russia be burned. Given Russia's history of famine, this move was politically risky. Yet the government still opted to demonstrate that it would rather destroy Western food than hand it out to Russia's poor.

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THE ROAD TO ISOLATION

How did Russia's elite arrive at this seemingly genuine anti-globalization stance? Even though Putin's initial intention was to integrate Russia into the global economy, the current course is actually a logical result of his regime's evolution.

Until very recently, the regime's legitimacy was based on a straightforward social contract. The public would enjoy rising incomes and living standards in exchange for the unaccountability of corrupt elites. Both would benefit from the openness of the economy, as growing commodity prices bolstered economic growth and allowed the elite to buy, among other things, luxury real estate abroad and to take their place among the world's moneyed elite.

However, by 2012 Russia's economic engine had run out of steam. The preexisting sources of growth had been exhausted. Oil prices were still high but had stopped growing, labor was no longer as cheap or abundant, and there was no excess production capacity. Russia had recovered the losses incurred during the 2009 recession, but further economic growth could come only from new investment and improved productivity of existing firms. This would in turn require reforms to secure property rights, enforce contracts, and promote competition—which would directly endanger the rents of the ruling elites.

Not surprisingly, such reforms—which were publicly announced and even promised in writing—were never implemented. Economic growth slowed from 4 percent in 2011 to just 1 percent in 2013. Given that the social contract and the regime's support were premised on rising incomes, the economic slowdown coincided with a fall in Putin's approval ratings from 79 percent in late 2010 to 61 percent by the end of 2013.

The regime started to look for new sources of legitimacy and eventually, thanks to the annexation of Crimea and hostility to the post-Maidan government in Ukraine, tapped into a vein of Russian nationalism. This quickly helped to boost Putin's popularity, driving it back up to well over 80 percent, but in the process destroyed Russia's relations with the West.

Prior to the Ukraine crisis, some public figures in Russia had employed harsh anti-Western rhetoric, but American and European politicians and businesses were assured that this was merely pandering aimed at Russia's reactionary elements. After the annexation of Crimea, however, anti-Western propaganda stopped being just cheap talk.

It may well be the case that the Russian government miscalculated the economic costs of Crimea's annexation and the violent destabilization of eastern Ukraine. The Kremlin may have thought that the interdependence of the Russian and European economies would limit the West's reaction to critical statements and perhaps limit sanctions.

In April 2014, Putin began openly referring to southeastern Ukraine as Novorossia (New Russia) and arguing that the region's six provinces should follow Crimea's example. However, after the imposition of Western sanctions—which also made threats of future sanctions credible—the Kremlin changed tactics. While Crimea became part of Russia just a week after its referendum, the other breakaway territories met a different fate. Moscow did not recognize the May 2014 referendums in Donetsk and Luhansk and shied away from publicly supporting Donbas's independence from Ukraine. The downing of Malaysia Airlines Flight 17 strengthened Western resolve and led to the imposition of sectoral sanctions, which significantly disrupted Russia's economic and financial ties with the West.

Another important element of the Kremlin's strategy has been its pivot to Asia. Russia assumed that stronger ties with China would absorb the economic impact of a break with the West. In this sense, Russia was seeking not so much to deglobalize as to redirect trade and investment flows from West to East.

Yet these hopes have not materialized. Russia has managed to sign quite a few protocols of intention and memoranda of understanding with China, but binding agreements and tangible investments have yet to follow. There may be several explanations for this.

First and foremost, while China values its relationship with Russia, its economic relations with the West are simply much more important—not only to the Chinese government but also to state-owned banks and corporations. The latter, in particular, have learned from the painful experience of the French bank BNP Paribas, which paid a $9 billion fine for violating U.S. sanctions against Iran: they understand that losing their U.S. business would be even more costly than obeying the sanctions.

Another possible explanation is that Chinese negotiators may have decided to wait until their Russian counterparts become more desperate—and then offer them better terms. This theory does not provide grounds for much optimism about Russia's predicament. With the price of oil and the value of the ruble both falling and China's own economic growth slowing down, the space for grand bilateral initiatives is shrinking. China's main geoeconomic project, One Belt, One Road, will also require tens of billions of dollars, and China may not be able to afford too many new expensive investment projects.

Finally, Chinese corporate bosses may also be affected by political pressures at home. Given President Xi Jinping's unprecedented anticorruption campaign, they may be feeling more cautious regarding deals with Russia's notoriously corrupt state companies.

Russia's growing integration with the members of the Eurasian Economic Space—Armenia, Belarus, Kazakhstan, and Kyrgyzstan—has not brought any tangible benefits either. These countries offer neither advanced technology nor large domestic markets nor substantial financial reserves. The customs union's economic impact on Russia could therefore never begin to compare with that of the West or China. Furthermore, the annexation of Crimea, along with Putin's subsequent remarks that Kazakhstan had never had any form of statehood before 1991, prompted both Belarus and Kazakhstan to start worrying about potential Russian encroachments upon their own sovereignty. Neither has recognized the annexation of Crimea, while Belarus has become an important channel for exporting embargoed food products to Russia, by either reprocessing or simply relabeling them.

The Russian government, especially the Central Bank, has largely managed to preserve financial stability, a brief outbreak of panic in December 2014 notwithstanding. To offset the loss of access to Western financial markets, the Central Bank has relied on a new instrument—foreign currency repurchase agreements. In effect, the Central Bank has lent dollars to Russian banks that essentially posted their own dollar loans to Russian companies as collateral—and in turn used the dollars to repay their external debt. This has allowed Russia to stave off a run on the ruble as well as major defaults on Russian corporates' dollar-denominated debt.

The government, for its part, looked into the issue of recapitalizing systemically important banks. This is a critical issue, as isolation is especially costly for the banking system. It is very likely that Russian banks—aside from Sberbank, which is run by Gref—will suffer losses in 2015. The Deposit Insurance Agency has already exhausted its funds and has asked the Central Bank for help.

While government support is indeed needed, the government itself lacks extra funds. Though the 2016 budget draft foresees cutting spending by 8 percent in real terms, it still includes a budget deficit equivalent to 3 percent of GDP.[2] That is why the government has chosen to recapitalize the banks with government bonds rather than cash. Doing so solves the problem for the time being, but it increases major risks in the long run. Essentially, it threatens a vicious circle of sovereign debt and bank default. If banks hold sovereign bonds, then the sovereign debt crisis will hit their capital—and to recapitalize banks, the sovereign budget will need to issue new debt. The eurozone faced this problem in recent years and tried hard to break out of this cycle by creating a banking union. It is ironic that Russia is brazenly refusing to learn from the EU's mistakes and may walk directly into this trap.

IS ISOLATION BENEFICIAL?

Having understood that its current foreign policy can only lead to isolation, the Russian government has put together a narrative in which this was its plan all along—that isolation is actually good for Russia.

By reducing imports and foreign investment, the government claims that sanctions and countersanctions will eventually promote import substitution and growth. In essence, the Russian government has once again turned to the infant industry argument that if a domestic industry is almost competitive, protectionist policies will allow it to catch up with and then outgrow its international competitors.

Many governments around the world have abused this argument, but the Kremlin is a particularly egregious offender.

For the infant industry argument to work, several conditions have to be present. First, the formula applies to a narrow set of industries, not to the economy as a whole. As a rule, a promising industry lagging behind its foreign competitors will often rely on the use of state-of-the-art technology that has to be imported. Second, the protected industries have to be very close to the productivity frontier, whereas labor productivity in most Russian industries—especially the protected ones—lags behind that in the United States by at least a factor of two. Third, in order to catch up, the so-called infant industry has to be able to depend on a large domestic market. While Russia is a large country, its domestic market, especially given the low oil prices, is no longer sizable; in nominal dollars Russia's share of global GDP is now only 1.6 percent. Finally, whatever protection is imposed must be temporary or the protected industry will have no incentive to catch up, while the cost for households will be greater than the benefit to protected industries.

It is clear that the infant industry argument cannot conjure up the supposed benefits of isolation out of thin air. Russia needs more investment. Russia needs modern technology, both in terms of technical capabilities and managerial best practices. Russia needs access to modern services, including financial markets. Russia needs access to global markets. Whatever the government says, Russia—like any other modern economy—cannot prosper on the basis of autarky.

Even in the oil sector, which is Russia's relative strong point, autarky is costly. Before the sanctions, the state oil company Rosneft struck large deals with leading multinationals as it recognized that it needed modern technology to develop new fields. Without American and European technology, Russian oil production is expected to peak in several years, with obvious negative implications for the federal budget.

In the non-oil sector, there are even fewer grounds for optimism. Non-extractive businesses need access to technology and Western finance. The same is true for the education and healthcare systems.

That is why it is not surprising that Russian exports have not increased, even with the weak ruble. The ruble's depreciation, the sanctions, and especially Russia's own countersanctions have resulted in a collapse in imports to 16 percent of GDP—the lowest level since 2009. However, exports have not budged: the average export-to-GDP ratio in the second half of 2014 and the first half of 2015 was 34 percent—similar to the 32 percent ratio in the two previous years (see figure 1).

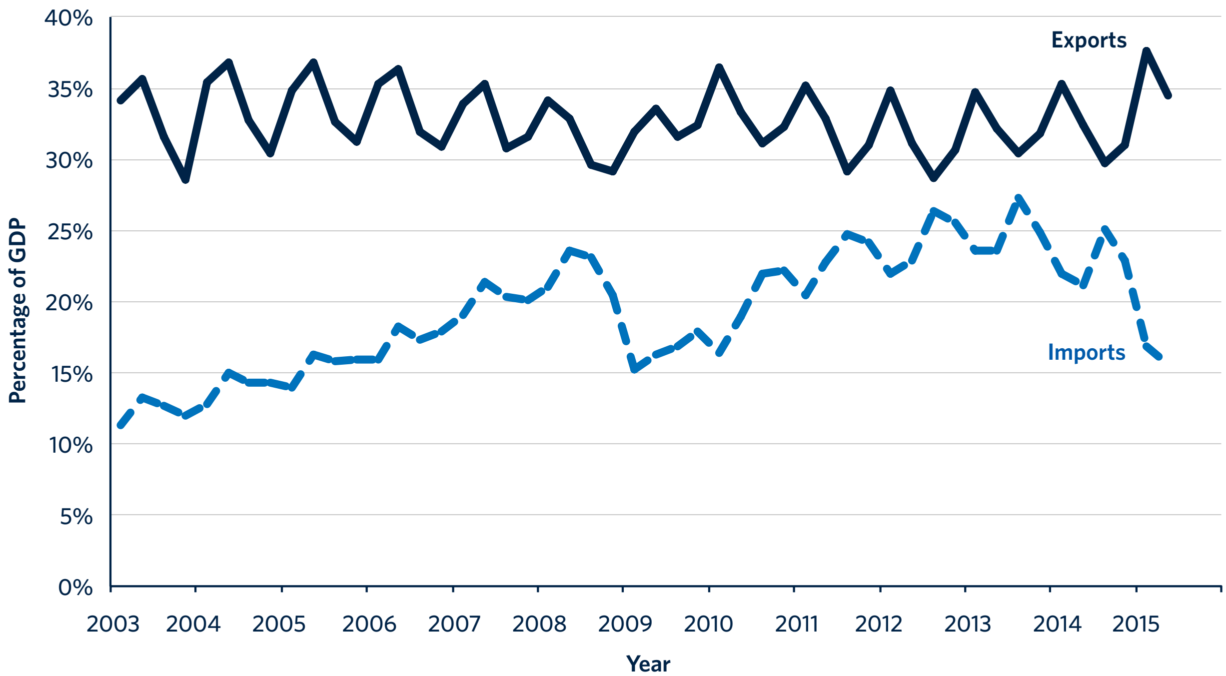
Isolation also undermines export growth potential in new markets, including the transportation sector, tourism, and agriculture. Now these can serve only the domestic market which, given low oil prices and the weak ruble, is half of its pre-2013 size.

Kremlin propaganda has repeatedly returned to one of its favorite subjects—World War II—arguing that victory was due to Stalin's industrialization, which was allegedly carried out without external help. While it is not clear how this argument can benefit Russia today, it is also false. First, the Soviet Union received substantial support during the war through the Lend-Lease program. Second, industrialization in the 1930s would not have been possible without imports of modern industrial equipment from the West. Finally, and most important, Stalin's methods of industrialization had catastrophic economic and social costs: Russian agriculture was destroyed, which in turn hampered industrialization, and millions of lives were lost to famine and political repression.

WHAT NEXT?

Where the Russian economy is heading will depend on the nature of both foreign and domestic policy. If the status quo holds, Russia's isolation will continue. The weak ruble will keep out imports, leading inevitably to import substitution. Households will have to buy expensive domestic substitutes of previously imported goods, and living standards will fall.

Figure 1. **Russia's Exports and Imports as a Percentage of GDP**



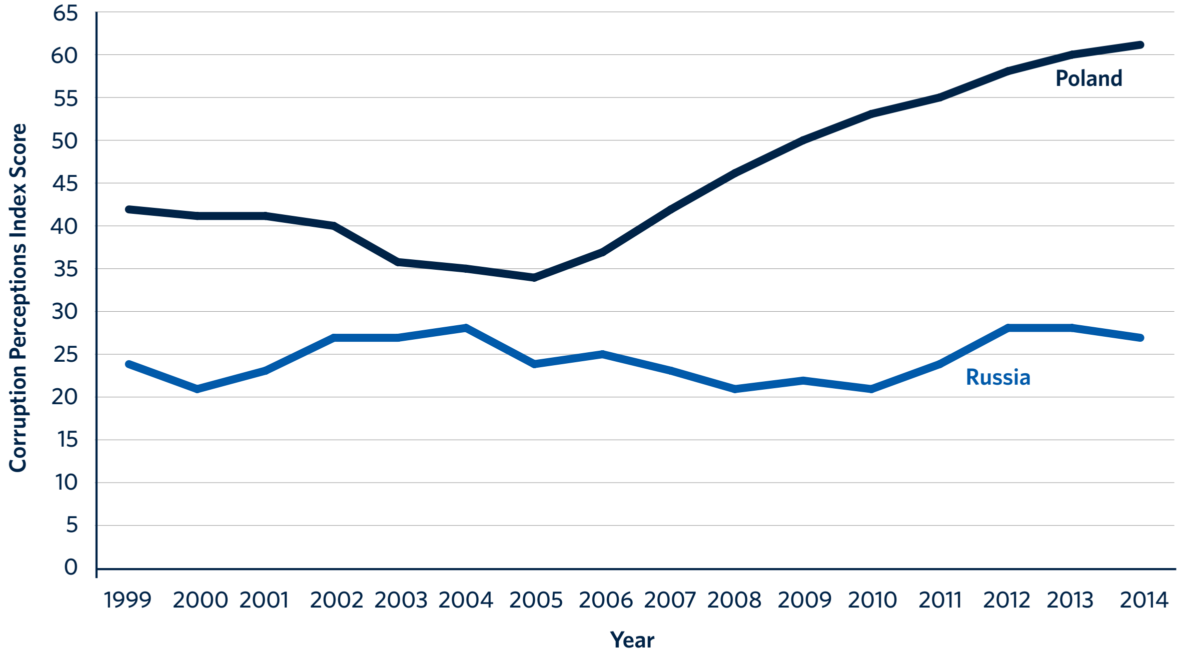
Source: Rosstat

To mitigate the threat of public discontent and possible protests, the government will increasingly redistribute wealth. It will first tap into the Reserve Fund and the National Welfare Fund, but these likely will be exhausted in one to two years. After that, it will have to increase taxes on businesses, which will undermine incentives to invest, resulting in continuing capital outflow and a further decline in GDP.

Isolation, then, is going to be very costly for the Russian economy. However, since 2014, the government has discovered that its popularity is not necessarily linked to the economy. Using a comprehensive program of propaganda and censorship, the government has managed to convince the public that the economic difficulties are driven by external problems—or conspiracies. The new social contract, in which the government's legitimacy is based on propaganda rather than on prosperity, actually benefits from isolation. The less trade and investment there is, and the less contact with the West, the easier it is to convince the public that the West is to blame for Russia's hardships.

How long can Russia stay on this trajectory? The answer may be found in the famous adage: "You may fool all the people some of the time; you can even fool some of the people all the time; but you can't fool all of the people all the time." Given the unprecedented scale of the current propaganda effort, it is hard to predict when Russians will start to see the real causes of their country's economic troubles. Until then, isolation is likely to continue, and Russia will remain cut off from international trade and investment. This may or may not have disastrous implications for the economy in the short run. The Soviet Union had a very closed economy, yet it lasted for nearly eight decades. The real cost will be the long-term one: Russia will miss opportunities for growth and will continue to stagnate.

Appendix. **Corruption in Russia and Poland**



Notes: The graph shows Russia's Corruption Perceptions Index compared to Poland's; on a scale of 0 to 100, the higher the number, the lower the corruption. (Nordic countries have ratings above 95.)

Source: Transparency International

NOTES

1 In the last fifteen years Russia consistently has ranked in the top 20 percent most corrupt countries (according to both Transparency International and World Bank data). The progress in fighting corruption during Putin's first term was undone during his second term. And the positive trend of President Dmitry Medvedev's anticorruption efforts did not continue after 2012; moreover, in 2014 the situation with corruption started to worsen again—see the appendix.

2 The 3 percent GDP deficit is not large, but because Russia lacks access to financial markets, it can rely only on its Reserve Fund. Given that the Reserve Fund accounts for only 6.7 percent of GDP, it is not surprising that the government stopped drafting three-year budgets.