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The challenges of the Medvedev era

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Abstract

Russia now ranks among the world's ten largest economies and continues to experience rapid growth. Industrial investment and real incomes are soaring. Federal finances are in excellent shape, giving the government a welcome opportunity to invest in long-term development of human capital, improvement of living conditions and bolstering of the country's infrastructure. Fixing Russia, however, is not without its challenges. For long-neglected sectors such as health care and education, financial infusions alone will be insufficient to bring change – structural reforms are needed. Double-digit inflation has also returned after slowing throughout most of the 2000s. The rise in prices has been driven by a global increase in food prices, along with a number of domestic factors. Finland has benefited from Russia's economic growth, and exports to Russia have risen rapidly even with the loss of market share to competitors. Energy's significance for the Russian economy remains large and the country has huge opportunities to improve its efficiency of energy use and production through e.g. price deregulation. While the direction is clear, the road ahead for Russia will not be easy. Russia seeks to become a leading global innovator over the medium term – a perhaps overambitious goal given the starting point.

Key words: Russia, economy, social issues, foreign trade, energy

Pekka Sutela

The legacy of the Putin era

The current decade has been an economic boon for Russia with GDP rising about 7 % a year. The once seemingly unrealistic political goal of doubling GDP (measured in roubles) over ten years is actually within reach. Indeed, Russian GDP has grown several times if measured in now-weakened dollars. This is in part due to rouble's real appreciation against a basket of currencies of its main trading partners, and, in particular, the weakening of the US dollar. At the beginning of 2008, Russia became one of the ten largest economies in the world, placing it in a league that includes Mexico, South Korea, India and Brazil. While exchange rate and other uncertainties make the exact size of the economy hard to establish (and hence, of little significance), the indisputable reality is that Russia is today one of the world's fastest growing major economies.

Excellent development trends

When we hear "Russian economy," most of us automatically think of energy, particularly oil and gas. Yet Russia also has the world's second largest reserves of coal, significant uranium reserves and vast untapped hydropower resources. Energy is unquestionably central to the national economy. The precise figures depend on how broadly one defines the energy sector and accounts for such factors as transmission pricing. Roughly speaking, though, we can say energy currently generates about two-thirds of Russia's export earnings, nearly a third of GDP and almost half of public sector revenues. The dramatic ten-fold increase in the export price of oil from spring 1998 to the present is obviously an important factor. Natural gas prices tend to lag developments in oil prices by roughly six months, though not in full measure for each buyer country.

In evaluating the implications of oil for Russia, three additional factors deserve mention. The first is that growth in the volume of Russian oil production has subsided significantly from nearly 10 % a year in the early 2000s to around 2 % in 2005. This is explained by several factors. The move to re-nationalise energy production that started with the take-over of the Yukos oil company has increased political risk in the oil sector and may well have dampened incentives to invest or improve efficiency in the sector. Second, there is the state's unreasonably high taxation of the oil sector (these tax policies are under reconsideration). Given that the marginal tax rate for oil effectively exceeds 90 %, virtually any production incentive that does not involve tax breaks is meaningless. In the long term, however, the third, and most problematic, reality for Russian oil production is the fact that production has likely peaked already. This means that the long-range trend is to lower production volumes not larger. Higher production levels over the medium term could only be achieved temporarily with monumental investment programs. After Saudi Arabia, Russia is the world's second largest oil producer, but its known reserves are only the world's seventh largest. Russia undoubtedly has more reserves, but the cost of getting at them, even at today's oil prices, may still be too high.

The second feature worth mention is that the energy sector, strictly defined, produces rather few jobs. Activity related to taking hydrocarbons out of the ground and processing them only accounts for about 2 % of the jobs in Russia. In this respect, Russia with its large population is in the same situation as Mexico, Nigeria and Venezuela. While oil revenues are sufficient to fund some of public spending, they are insufficient to finance a national lifestyle as in Norway and Kuwait. We reach the same result if we calculate export earnings from energy on a per capita basis. Revenues are simply too small to support the entire nation. Thus, Russia has little reason to be concerned about the competitiveness of its energy sector jobs. The foremost economic challenge facing the country is whether it can create a situation (or at least come close) where the vast majority of jobs are competitive by world standards.

Looking to the future, we can say with fair certainty that the rise in energy prices of the past decade will not be repeated. Moreover, modelling suggests that what is important for development of countries like Russia in terms of economic gains (in addition to the level of energy prices) is the rise in prices, which brings new resources to the economy.

Finally, we should remember Russia's other underground natural resources – metals and minerals. Prices of these commodities generally track energy prices closely. The growth in demand in developing economies, particularly China and India, has driven world market prices of both product groups upwards. While cheap domestic energy prices have fattened the bottom lines of e.g. aluminium and steel producers, this sort of competitive advantage cannot be unsustainable.

Powerful economic growth has provided an opportunity to increase wage levels. In recent years, real income growth has typically exceeded 10 % a year. In this decade, real disposable incomes have climbed an impressive 140 %. Recalling that the vast measured differences in incomes that emerged in the 1990s never converged thereafter, the general rise in incomes has caused a distinct decline in the relative share of those living below the statistical poverty line. While Russia has far fewer people living in absolute poverty than in the 1990s, this does not change the fact that poverty is still a serious and extensive problem. Russia's official unemployment figures and unemployment figures based on ILO criteria indicate that unemployment has fallen substantially. Under the ILO methodology, unemployment is currently running around 6 %, a fairly respectable level by international standards. Rising incomes, in turn, have made greater private consumption possible. Indeed, this is clearly the largest demand factor sustaining robust growth. Consumption levels are highest in the great Russia metropolises of Moscow and St. Petersburg. In recent years, the rise in consumer spending has been highest in areas surrounding Russia's two great cities, as well as in the Urals region and the Volga valley, homes to large energy and mineral-based industries. In many of Russia's poorer regions, however, the statistical data also attest to sharp rises in consumption growth.

In addition to rising incomes, access to credit promotes higher levels of consumer spending. Russian households still carry very little debt by international standards, just 15 % of GDP. In developed countries such as Finland, this figure is around 100 %. Development of the financial system has created access to credit, which has helped fuel rapid growth in consumption. This growth is continuing, while household indebtedness is not yet seen as a threat to the stability of the financial system. Households and certain banks clearly face risks, but in terms of financial system stability, Russia's core banks appear to be well protected at the moment.

The deepening of the financial system will sustain the current consumption boom and its impacts on economic growth. A second engine of growth is provided by on-going structural reforms of the economy. If we focus exclusively on energy, however, we can miss the fact that a huge amount of new types of goods, and even new manufacturing branches, have emerged in Russia over the last two decades. Above all, this concerns services (largely produced in closed sectors) and goods (of which a large part – but by no means all – is imports). The banality of this observation may be why the implications of Russia's new middle class are so easily overlooked. These people both produce and consume, which is why structural change is becoming at least partly self-sustaining and likely to be the central motor of future growth. Of course, the new middle class tends to seek out strong product brands, and reward increased choice and high quality (and fuel a propensity for imports). This trend may face limitations set by both the current account and domestic labour market situation. Imports are growing significantly faster than GDP, while export volumes are growing only slowly.

The flood of export earnings has made much of this economic miracle possible. Russia has paid off practically all of its foreign debt, which is now just 3.6 % of GDP. Because Russia paid its debts, it now enjoys low debt-servicing costs and the Russian state has seen a tremendous boost in its international creditworthiness. Moreover, the creditworthiness of companies and banks (both privately held and state-owned) has also benefited strongly. This has helped Russia protect itself at least partly for the risks associated with its one-sided export structure. Russia has also allowed the build-up of its foreign currency reserves for the same reason. The country's foreign currency reserves, which were essentially wiped out in the 1998 financial crisis, are today the world's third largest.

Exceptionally aggressive taxation of oil exports has been a major factor in the amassing of about $170 billion in the state stabilisation fund. In February 2008, this fund was divided into two parts. The size of the first fund, the reserve fund, is limited to no more than 10 % of GDP. Its purpose is to act as a "rainy day" fund for times when public sector revenues are reduced temporarily by e.g. a shock to export earning. While the second, currently much smaller, national prosperity fund will pursue a higher-yield investment strategy, it does not appear to be fashioned along the same lines as the sovereign wealth funds of China or Norway. Its revenues will mainly be used to cover pension obligations. In other words, the Russian state investment company is not out to buy half of Europe. It doesn't have the money to do it.

The third consequence of growth in export earnings has been the strengthening of Russia's money economy. Export earnings in foreign currencies had to be exchanged for roubles, which has resulted in money supply growth as high as 50 % a year. The simultaneous rise in demand for roubles, however, acted to decelerate inflation. In autumn 1998, over 60 % of industrial turnover was based on barter and various monetary surrogates. The use of such alternatives to money has today fallen out of favour, which has boosted economic productivity significantly. The problem of payment arrears that characterised much of the 1990s has also vanished. Besides raising wages and consumption, the Putin government has received broad praise for eliminating this problem. Demand for roubles has also increased as households and other economic actors have shifted their assets from weakening dollars into roubles.

One of Russia's greatest economic policy achievements of the 2000s has been the gradual reduction of inflation and the establishment of a readily predictable exchange rate. The citizenry loves this. For companies, these achievements constitute an important aspect of making business possible.

Heavy taxation of export earnings has swollen public sector revenues. Balancing of the budget by cutting spending was unavoidable after the 1998 financial crisis. The government simply had no options to finance deficits through borrowing and no taste for trying to escape the morass by printing money. Over the next three years, public spending was reduced by over eleven percentage points of GDP. Without doubt, this must be one of history's most heavy-handed public sector cut-backs – and it started in autumn 1998 with the installation of the Primakov-Maslyukov government, Russia's most left-leaning government in recent history.

The rise in oil prices came slightly later. As export earnings began to rise, the public sector started posting surpluses corresponding to several per cent of GDP (5.5 % of GDP by 2007). In addition to making it possible for the government to pay down foreign debt and accumulate large foreign currency reserves, it provided latitude for policymakers to raise public sector wages. These wages hikes benefited a wide swath of the population, including those worst affected by the setbacks of the 1990s.

Over the last two years, a fifth phase of export earning use has been planned (and to some extent implemented). Under this program, government surpluses are being applied to investment, and most notably technological innovation. It is also notable that military spending has not been the fastest-growing budget item. Furthermore, most of that spending has a social character and has gone to improving the living conditions of the army's permanent staff and enlisted personnel.

Outlook not entirely positive

Inflation began to accelerate in the second half of 2007, and today is a central issue of contention in economic policy. The actual inflation figure of 11.9 % handily beat the government's 2007 inflation target of 8.5 %. This year, inflation continues to gain steam, although there is hope it may ease during the summer due to seasonal factors. After an almost continuous decline since 1999, inflation is accelerating (at least temporarily). This is disconcerting for several reasons. Respondents to Russian opinion polls consistently rank inflation as the worst threat to their personal finances. If trust in a strong rouble falters, flight to other currencies could very well destabilise the financial system. Even small changes can have large effects on saving patterns and capital flows.

The lack of coherent economic policy response is the inability to agree on what is causing the inflation. As in other countries, the problem can be seen in higher food prices. Yet, while nearly a third of foodstuffs in Russia are imported, the biggest problem is domestic. Russian food production has not managed to keep up with the boom in consumer spending, so prices of both animal and vegetable products have shot up dramatically. A second interpretation of the leap in inflation is that larger-than-anticipated amounts of foreign currency have made there way into the country via the trade and capital accounts. The third, perhaps most realistic, explanation is that the Russian economy is simply overheated. A variety of bottlenecks put upward pressure on wages, raw material prices and building costs. All of these explanations conveniently align with the various measures proposed for fiscal, monetary and exchange rate policy.

In any case, Russia is not destined to become a country of cheap production. Wages are rising faster than productivity, and there is a dearth of workers with the appropriate skill sets – particularly in the country's major growth centres. The rouble's real appreciation is inevitable given its earlier gross undervaluation and the explosion in export earnings. Large inflows of foreign currency began to enter the country in 2007 via the capital account. As a result, net capital imports amounted to $82 billion last year. Part of this influx came in the form of direct investment. The three large ownership shake-ups boosted these capital inflows in relation to GDP to levels greater than in China. On top of this, thanks to abundant liquidity and low interest rates internationally, many Russian banks and enterprises rapidly increased their foreign borrowing. Last summer's financial hiccup dried up liquidity and raised rates, but the effects to the Russian economy have so far been minor. The stock of foreign debt held by the private sector is still negligible. Money has poured into the country in the form of portfolio investment. Indeed, Russian shares and other securities are still regarded by many foreign investors as rather good longer term investments in terms of prices.

There are also other reasons for rising cost levels. The huge investment needs in utilities, infrastructure generally and the energy sector will largely have to be financed out of cash flows from higher prices. Moreover, energy prices need to go up to encourage efficient energy use. When the volume of oil production is officially forecast to rise 1 % a year and natural gas 2 %, there is a pressing need to improve energy efficiency to sustain export volumes at their current levels. This is a serious issue for both Russia and countries dependent on energy supplies from Russia.

While Russia's internal market has seen a deep structural change with the rise of the service sector and imports are growing impressively in euro terms (up 30 % in 2007), there is still no evidence that Russia's export structure is diversifying. Russia's domestic producers were blessed with a massive boost in price competitiveness after the devaluation of the rouble in 1998, yet they seem to have managed to use this advantage only in competing against foreign imports locally – and not by increasing their own export businesses. Even exports of military armaments have met a strong headwind of opposition, most notably from the once-faithful clientele of China and Algeria. A recent wide-ranging Russian survey found that depending on the branch only 10–40 % of companies are competitive. Furthermore, most of them could claim competitiveness only because of low costs prevailing so far.

Russian spending on R&D is about 1.4 % of GDP, i.e. the same level as in China. The problem is that the lion's share of Russian R&D is state funded and mostly aimed at military applications. The military produce few products, if any, for commercial markets. Moreover, the difference between China and Russia is huge if R&D spending is measured in terms of the resulting international patent applications. The Chinese file many times more patents than their colleagues in Brazil, India or Russia – and the number of Chinese patent filings continues to rise briskly unlike the situation for other BRIC countries. Russians only submit about a quarter of the number of patent applications as Finns (half of which come from a single company).

In his 2007 state-of-the-nation speech, president Putin presented what seems to be a realistic answer to how the Russian economy might succeed in a future where it is wedged between low-cost producers in Asia and high-tech leaders in Western Europe. Putin explained it is no shame to export commodities; Russian companies just need to learn how to add value to their export products. They need to make high value-added products based on existing natural resources.

The Nordic countries and Canada, for example, have trod this path of development over the past two centuries. While Russia may have less time to catch up, the most critical question is whether Russian companies can best their foreign rivals at producing such goods. Russian companies need to change as today they are often introverted, hierarchical, rarely under competitive pressure, and unfamiliar with market research and product development.

This situation has scarcely improved in recent years. As the state has pursued assumed economies of scale, it has collected groupings of production facilities from different branches into giant conglomerations referred to as "national champions." They might be state-owned enterprises or at least state-led (often by a member of the presidential administration). The oft-repeated estimate that about half of industrial production in Russia occurs within the umbra of such arrangements would suggest a rather poor starting point in terms of budget limitations and competitiveness. Worse, it suggests a gross misinterpretation of the industrialisation model used by companies in the Southeast and East Asia, especially Japan and Korea. True, Asian states support internationalisation of their firms in many ways, but, say, Japan's world-beater companies emerged only after long competitive struggles with their domestic counterparts. It was the competition itself that forced these companies to make the efficiency gains needed to succeed.

The problem also has a second dimension. Several studies suggest that corruption is a significant obstacle to national prosperity and high living standards. For example, research among small Russian firms found that corruption has actually increased in recent years. According to some observers, corruption may well have reached fairly high levels in society. Indeed, the term "corruption" is itself problematic. It suggests an exception to the norm. Societies that get things done through personal relationships and reciprocal favours (what we Finns might characterise as corruption) are actually more the norm than the exception. The intense intertwining of the state and business only makes things worse. The international perception is that Russia is an exceptionally corrupt country.

Taken more broadly, is the type of authoritarian capitalism promoted by Russia and China valid and perhaps even a more desirable alternative than our familiar liberal forms of capitalism? The lessons from Southeast Asia may be instructive again. Koreans began to get rid of the most egregious forms of insider corruption only after broad democratisation of society. This path, if available, has yet to be taken by Russia. Two forces for change may resolve this. One is that the materially shallow post-Soviet consumer of today will assume a greater interest in civic duty and community. The second is the internationalisation of Russian business, which is growing closer to the rest of Europe.

Lucky break of political acumen?

Russia has been indisputably blessed in recent years. In the above discussion, we considered four cases: the price competitiveness that resulted from the collapse of the rouble, the discipline in public sector spending that came out of the government's fiscal insolvency, the manifold gains in core export prices and the economy's limited rouble-based options for absorbing a massive influx of foreign currency earnings. But other examples can certainly be mentioned. Due to the decline in output of the 1990s, the subsequent recovery in demand and growth of production – as a result of the devaluation of the rouble – were possible without massive investment just by lifting the degree of utilisation of existing capacity. Because of the transition from a command economy, some of the old production capacity lost its economic value, but not in all cases. The collapse in investment and drop in industrial output during the period of high, widely fluctuating inflation rates in the 1990s gradually led to a consensus on the need for monetary and fiscal policies geared to stability. The government's insolvency, of course, forced the acceptance of these policies. What is important, however, is that government's later commitment to consistent budget surpluses and a steady decline in the inflation rate could never have been sustained without a political consensus.

These examples are paradoxical in that they suggest economic catastrophe leads to new opportunities. These opportunities, of course, could have been lost. But they weren't. If nothing else, Putin's economic policy deserves credit for this.

In Putin's first term, many new economic reforms were implemented along the lines of the "Gref program." The multitude of reforms ranged from a flat income tax to bank reform, from land ownership to improvements in conditions for small businesses. Not all reforms have gone as planned, but the government's intent was always clear (even with WTO membership).

In this respect, the Yukos saga of 2003–2005 was a watershed event. Trust in private initiative gave way to acceptance of state-determined solutions. Another factor to this effect was the notion that high energy prices are here to stay. With this change, the urgency to implement reforms is gone. We have also seen the reform of converting social benefits into monetary payments partly rejected following opposition by much of the population. Even the push for WTO membership and stronger EU relations has been set aside.

Yet the reforms that really matter remain in place. Their impacts continue to be felt and will deepen as we move into the future.

Seija Lainela

Priority national projects

The circumstances of the Russian economy shifted dramatically at the beginning of the 2000s with a strong revival in production growth, falling inflation and improvement in the state's finances. For the first time since the break-up of the Soviet Union, the living standard of the average Russian began to improve as the effects of economic growth filtered through. By mid-decade, the state was ready to channel public funding into long-overlooked areas of the economy in an effort to raise living standards, increase capital investment and improve education.

Focus on living standards

In the first half of the 2000s, government economic policy focused on re-establishing economic stability in the wake of the upheaval in the 1990s that culminated in the 1998 financial crisis. The federal budget began to show surpluses already in 2000 as a result of strict spending discipline and a boom in tax revenues. During 2001–2005, federal budget surpluses averaged nearly 4 % of GDP. By 2006–2007, annual budget surpluses exceeded 6 % of GDP. The government started in 2004 to set aside part of these surpluses in a separate "stabilisation fund." By soaking up the excess liquidity, the government sought of relieve inflationary pressure and prepare for future spending needs.

Years of surplus budgets and a build-up in off-budget funds eventually precipitated calls that some of the money be used to boost living standards and develop the economy. As a result, economic policy in the mid-2000s first acknowledged the social problems, and soon thereafter, the need to get the economy in order.

During Mr. Putin's presidency, all major political and economic policy directions were either initiated or approved by the presidential administration. The tight fiscal policies have always had Kremlin support, and the Kremlin also took the lead in calling for more social approach in economic policy.

Putin announced the priority national projects in his September 2005 budget address to the parliament. The national projects focus on sectors crucial for the improvement of living standards. In addition to the state's excellent financial situation and demands that tax monies be spent on the populace, one additional force behind the projects may have been the run-up to the Duma election in December 2007 and the presidential election of March 2008. Concrete signs of increases in living standards were needed ahead of the elections.

The first three priority national projects announced by president Putin were geared to improving health care, education and housing. These were soon followed with a fourth project for agriculture. All these sectors suffer from problems inherited from the Soviet era (i.e. inefficient structures and inappropriate operational formats), and all these sectors already had stagnated structural reform programs either in progress or under planning before the priority national projects were announced. Also other state-funded development programs will continue to coexist with the priority national projects.

Focus on tangible results

Health care

A declining population and generally poor health conditions are major concerns for Russia. Health care policies remain burdened by a health care delivery system in place since the Soviet era – including the accompanying inefficiencies and poor treatment outcomes. The current health care system focuses on hospital care, while generally neglecting the state of preventative and health clinic care. The capabilities to handle special treatments and certain types of critical care are limited. While the ratio of doctors to population and number of available hospital beds per capita exceeds the EU-15 level, many of the standard procedures and hospital treatments widely available in the West are available on a limited basis in Russia. Infant mortality, a telling indicator of the quality of health care systems, is more than double the EU average.

The government has long contemplated a comprehensive overhaul of the health care system. As the first measure, a partial shift to insurance funding of health care has taken place, but the system is far from perfect. The newly installed prime minister Putin recently stressed the importance of creating a functioning health insurance system in his first policy speech. It may well be that this session of the Duma finally produces some action on the matter.

Of all the priority national projects, health care has far and away received the most money. The project includes raising the level of general and specialist care by improving the education of doctors and other medical professionals, upgrading and increasing the amount of technical facilities available to health care workers, and establishing new hospitals and clinics that can deliver high-quality specialist care. Acquisition of state-of-the-art equipment is particularly geared towards improving trauma care of traffic accident victims and those suffering from heart and blood vessel diseases, where the loss of lives is much bigger than in e.g. the EU.

Education

Reforms of the education system are currently under preparation. Because Russian education today does not meet the needs of society, trade schools and universities need to be repositioned to better serve current demands. A shortage of skilled labour has also emerged in recent years.

Spending on this priority national project will go to improving teaching skills and acquisition of IT equipment and facilities. It will promote the spread of the best educational practices by rewarding schools and teachers that follow such practices. Development of university curricula will involve partnering with the corporate sector. Business schools meeting the highest international standards will be established in Moscow and St. Petersburg, and new top universities will be established around the country through bolstering of existing universities and colleges.

A significant aspect of both the health care and education projects has been to raise the relatively low wages in these sectors. In 2005 and 2006, wages in these sectors were increased substantially to bring them more into line with prevailing wages in society. In the health care field, the average wage was 68 % of the average wage nationally in

2004, but 78 % of the national average in 2006. In education, the average wage was 62 % of the national average in 2004 and 70 % in 2006. There was no further closing of the wage gap, however, in 2007.

Housing

The current stock of residential housing and supporting infrastructure are in generally poor condition. Reform of the housing system inherited from Soviet times has long been under consideration. Indeed, dozens of laws have been enacted in recent years to promote housing construction and reform housing administration and maintenance systems. Economic growth has helped fuel housing construction activity, which has grown at about 18 % a year over the past two years. Some 51 million m^2 of liveable floorspace was completed in 2006, and 60 million m^2 in 2007. In comparison, just 30 million m^2 were completed in 2001. Apartment prices have risen quickly and Russia's construction sector is highly overheated at the moment.

The priority national project for housing targets increased construction of residential housing, as well as increasing demand for ownership of detached houses and apartments through development of a functioning mortgage/housing loan system, loan interest subsidies and state guarantees. The plan is to add 140 million m^2 in liveable floorspace a year. The project also includes spending on improving municipal infrastructure and creating social housing for special groups such as military personnel, workers returning from jobs in northern areas, young families and invalids.

Housing construction depends on factors often beyond the reach of this project such as land acquisition, zoning rules, building permits and availability of municipal infrastructure. All these areas contain obstacles to successful construction projects. Moreover, rising construction costs in Russia are likely to reduce the effect the project has on creating housing for socially disadvantaged and low-income groups.

Agriculture

Agricultural production is inefficient and living conditions in the countryside are much worse than in cities. Farm workers still make up a large share of the labour force (about 11 % in 2006). Russian agriculture must also shoulder a Soviet inheritance: the large farms created under the collective system remain today, controlled by cooperatives or corporations, while households generally retain their small plots for growing fruits and vegetables and keeping a few animals. Small farms constitute a new producer group, however. In 2006, this new type of farm accounted for 6 % of agricultural output. Large farms accounted for 41 % of agricultural output and household plots an astonishing 53 %. While large farms continued to be responsible for most grain production in 2007 (79 %), household plots produced 89 % of potatoes, 79 % of fruits and vegetables, 52 % of milk and 47 % of meat. Much of this produce, of course, went directly to household consumption.

While Russia imports meat and milk, it is basically self-sufficient in grain production. Imports account for about 40 % of meat sales on the domestic market and about 20 % of milk and milk product sales. The decline in Russian livestock herds that began in the 1990s finally bottomed a couple years ago. Even so, livestock numbers have yet to recover. The total area of land under cultivation continues to decline.

The Russian state reduced agricultural supports and protective tariffs substantially during the 1990s, only to return to a more protectionist stance in the 2000s. Even so, agriculture in Russia is still far less subsidised than in most developed countries. The stock of farm machinery is small and decrepit, and lack of access to credit prevents farmers from acquiring more productive equipment and methods. Observers note that Russian agricultural output could be boosted substantially simply by introduction new production technology and putting fallow farmland back under cultivation.

The national project for agriculture is divided into three parts: 1) increasing livestock production, 2) development of small farming, and 3) improving the living conditions of young experts posted in rural areas. A program of interest subsidies will be provided to farmers acquiring livestock, as well as machinery and equipment, and interest subsidies will be extended to small producers. Leasing activities will receive support via funding of state leasing companies.

Budget spending on agricultural development under the priority national project is relatively small, and more resources will be directed to the sector e.g. in the framework of the five-year agricultural development program approved last year. Recently, agricultural subsidies have received greater emphasis in economic policy. It appears that support measures, however, will largely be implemented outside the priority national project framework.

Funding from the budget and private sector

The priority national projects began to receive budget funding in 2006. In that year, spending on the projects amounted to 160 billion roubles (€4.7 billion), or less than 4 % of the federal budget. In 2007, spending on the priority national projects rose to 265 billion roubles (€7.6 billion) and the share exceeded 4 % of budget spending. In addition to federal budget funding, the priority national projects receive funding from regional budgets and off-budget funds. For example, the health care and housing projects receive funds amounting to about a third of that coming from the federal budget. Table 1 below presents the spending break-down for the public sector (i.e. the federal budget, regional and local level budgets, as well as off-budget funds) as realised in 2007, as well as federal funding targeted directly at priority national projects in the period 2007–2009.

The overall funding of the priority national projects (estimated at about 3 % of public sector spending) is not large enough to have a decisive impact on the development of the sectors targeted. Nevertheless, the funding is sufficient to deal with specific issues.

Initial funding was set to run for two years for the health care and education projects and three years for the housing project. The framework 2008–2010 federal budget, however, now calls for continued funding for all priority national projects through 2010 at least. Table 1 indicates that in the coming two years federal budget spending on the education and health care projects will decline from actual spending in 2007. Russia’s three-year framework budgets, however, are based on cautious assumptions, so higher-than-budgeted revenues could easily lead to eventual boosts in spending on these projects.

In 2005, before the launch of the priority national projects, public spending on both health care and education in Russia amounted to less than 4 % of GDP. These shares are smaller than in most developed nations, where the shares are typically in the range of 5–8 %. Thus, funding for priority national projects alone will not narrow the gap.

In addition to funding from the federal budget and regional budgets, there is hope the priority national projects will also be funded by local enterprises. In certain regions, officials are particularly active in seeking corporate funding, which in a way is reminiscent of how companies in the Soviet era were held responsible for providing social services for their local municipality.

Table 1. Structure of public economy spending in 2007 and the priority national projects' direct federal budget funding in 2007–2009

	RUB billion (budgeted)	Priority national projects in the federal budget, RUB billion 2007 (actual)	2008 (budgeted)	2009 (budgeted)
Public administration	1167			
Defence	834			
Law enforcement and national security	864			
Culture	247			
Social security	2717			
Environmental protection	26			
Support to entrepreneurs	1560			
Farmers' share	147	28	28	28
Housing and municipal infrastructure	1101	62	66	72
Education	1342	53	43	21
Health care	1241	122	86	92
Total	11246	265	223	213

Source: Ministry of Finance

Structural reforms also needed

Given Russia's current economic situation, which is characterised by rapidly rising output and accelerating inflation, it may make better sense for the general economy to postpone spending increases until the economy enters the cooling-off part of the business cycle. On the other hand, the degraded conditions prevailing in the areas targeted by the priority national projects demand immediate government action. The real question here is whether the priority national projects will solve any of these problems permanently.

National projects are not reform concepts, but rather they include missions and targets for each area in striving to resolve certain problems. This is the defect in priority national projects as the fields they involve are outgrowths of dysfunctional and decrepit systems. Moreover, the problems are linked to larger weakness in the general economy and Russia social structures, so partial reforms are unlikely to bring permanent improvements. The deep structural reforms required are difficult to implement as they affect every resident, and most notably those in the weakest positions in society. Russia lacks a modern social policy tasked to assuring a basic level of security for all during the process of structural reform.

Finally, given the good economic times in Russia at the moment, politicians have the luxury of throwing money at poorly performing sectors in order to paper over problems temporarily. Thus, there is very real danger that necessary reforms will be postponed, and the increased spending on these sectors now will be partly wasted as they do nothing more than fund the operation of failing systems.

Because the priority national projects take place concurrently with other development programs, it is difficult to measure the specific achievements of the priority national projects. The most high-profile change within the priority national project framework was most probably the 2006 across-the-board increase in wages in health care and education, as well as the decision to modernise the equipment in both sectors in 2006 and 2007. The highly publicised priority national projects have brought social issues to the fore, and for the first time in years the deeper problems in these areas are receiving extensive public coverage. This increased awareness may prepare the way for implementation of more far-reaching structural reforms.

If nothing else, the priority national projects have proven to be a very effective publicity stunt. Media coverage of the projects' progress has well served the PR efforts of the current leadership. Newly installed president Dmitri Medvedev was previously deputy prime minister in charge of the priority national projects. The projects gained even greater when Medvedev was tapped to be the next president.

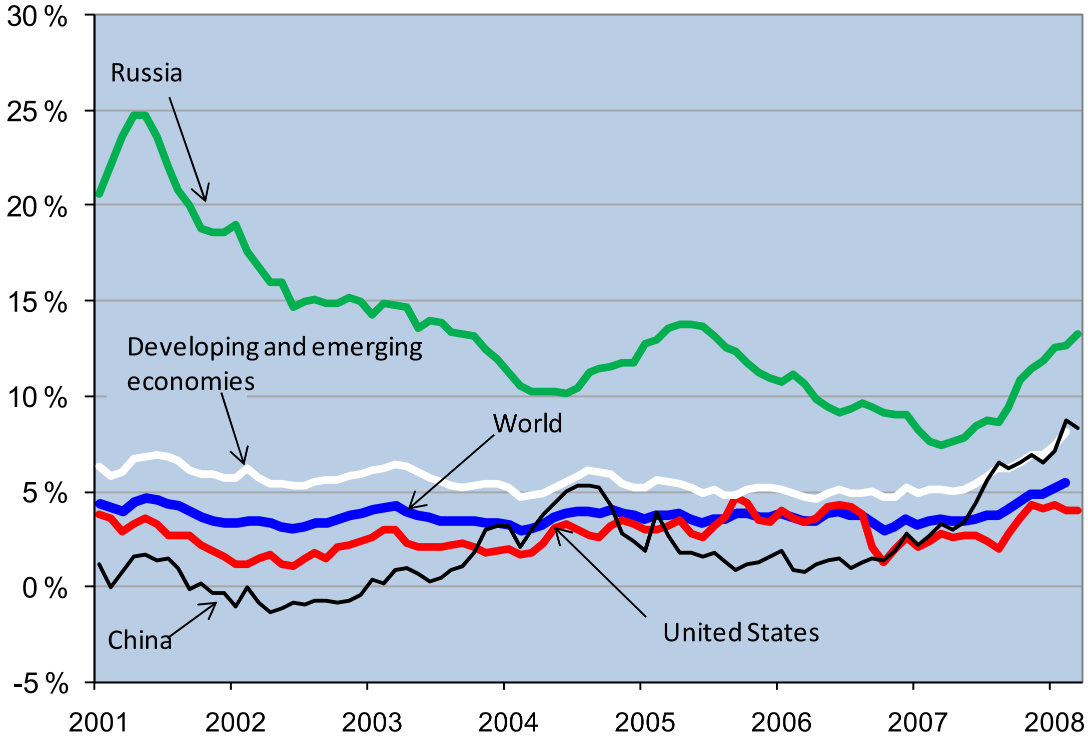
The latest statements from Russia's leaders suggest the priority national projects are here to stay – at least for the next few years. Both president Medvedev and prime minister Putin emphasised at the beginning of May in their nomination speeches that the priority national projects will be the motors for raising the living standards of citizens and modernising the economy.

Iikka Korhonen

Can Russian inflation be tamed?

Inflation has accelerated sharply around the world in recent months. Rising prices for basic commodities and food have driven up inflation, even as the pace of economic growth has slowed substantially in many countries. Russia is not an exception to inflation trends globally. Figure 1 shows the average 12-month world inflation rate, as well as average inflation in the United States, China, Russia and developing countries from the start of 2001. Inflation has picked up by three to four percentage points in nearly all developing economies since the start of 2007. For example, Chinese inflation rose over seven percentage points in just 18 months. US inflation also kicked up in 2007, although the faltering US economy now appears to be mitigating inflationary pressures.

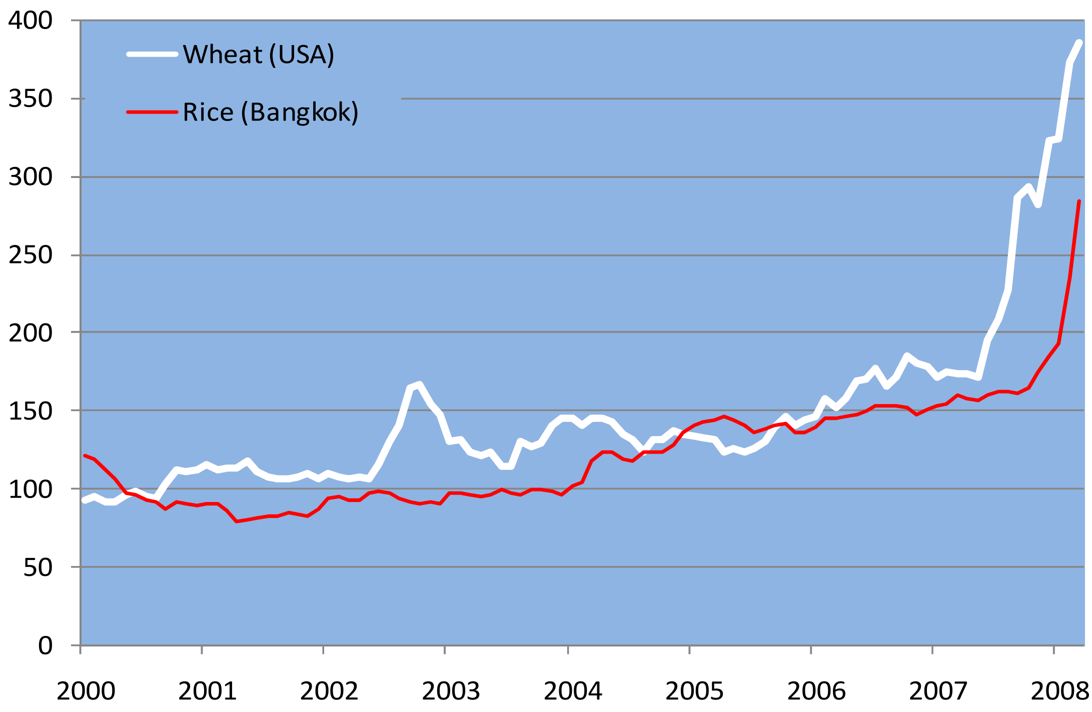
Figure 1. Global inflation trends



Source: IMF International Financial Statistics

What underlies this recent burst in inflation? Strong world economic growth throughout the current decade, particularly in China and other rapidly developing medium-income countries, has put intense pressure on commodity prices. Prices for oil and other commodities have been high for several years in a row. Nevertheless, high commodity prices in themselves do not entirely explain the general rise in price levels. In many countries productivity growth has been exceptionally high by historical standards. Moreover, the growth explosions in production and exports in China and other countries in Southeast Asia have meant that global prices of certain machinery and equipment have fallen, which to some extent reduced inflation. In particular, prices of computer technology and telecommunications devices have declined, along with a general slide in prices of telecommunications and data transmission services. The near singular driver of the most recent acceleration in inflation is the rise in prices of basic and processed foods. Figure 2 presents price trends in this decade for two of the most important grains traded internationally – wheat and rice. We see for example, that the wheat price (in US dollars) has more than doubled this year, while the increase in rice prices has been only marginally lower. Rises of other basic foods have been similar. For example, the price of maize (corn) has risen 45 % since the start of 2007. This spike in food prices has been exacerbated by the fact that some countries have imposed export quotas or tariffs to assure their domestic populations of access to inexpensive food supplies. Such policies, of course, fail to address the true causes of high global food prices. Changing consumer behaviour along with rising living standards has meant an increase in meat-eating, which in turn has boosted demand for animal feed. Moreover, the shift to biofuels has reduced the area of farmland available for growing food, particularly in the United States. 2007 also saw poor harvests around the world due to unfavourable weather conditions in many of the large grain-producing countries (e.g. the failure of the Australian wheat crop due to drought). The perfect storm of unfavourable factors, some permanent and some temporary, have driven up food prices.

Figure 2. Wheat and rice prices (based in US dollars, 2000=100)

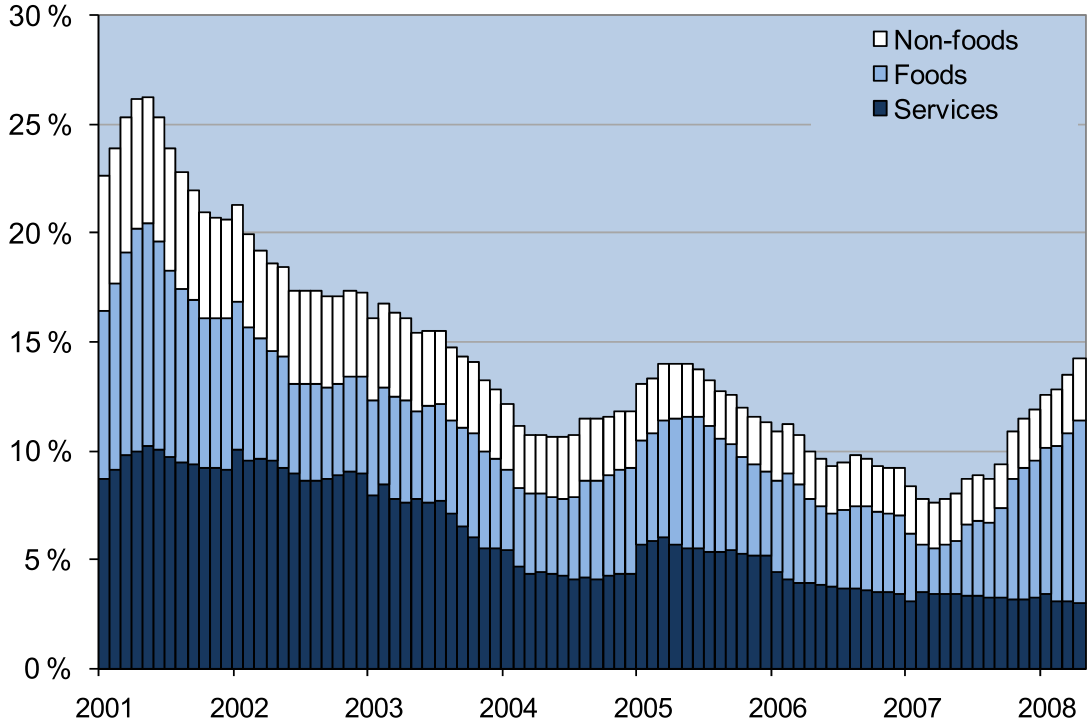


Source: IMF International Financial Statistics

High food prices have pushed up inflation rates most in poor countries, because food purchases constitute a large part of household spending. In China, for example, where food makes up about a third of the consumer price index, the spike in inflation in recent months can be attributed almost entirely to high food prices. As a rule, the share of food spending in overall household consumption declines with rising living standards. In Finland, for example, food and non-alcoholic beverages account for only 13.3 % of the consumer price index.

Russia not immune from soaring food prices

Figure 3. Russian inflation

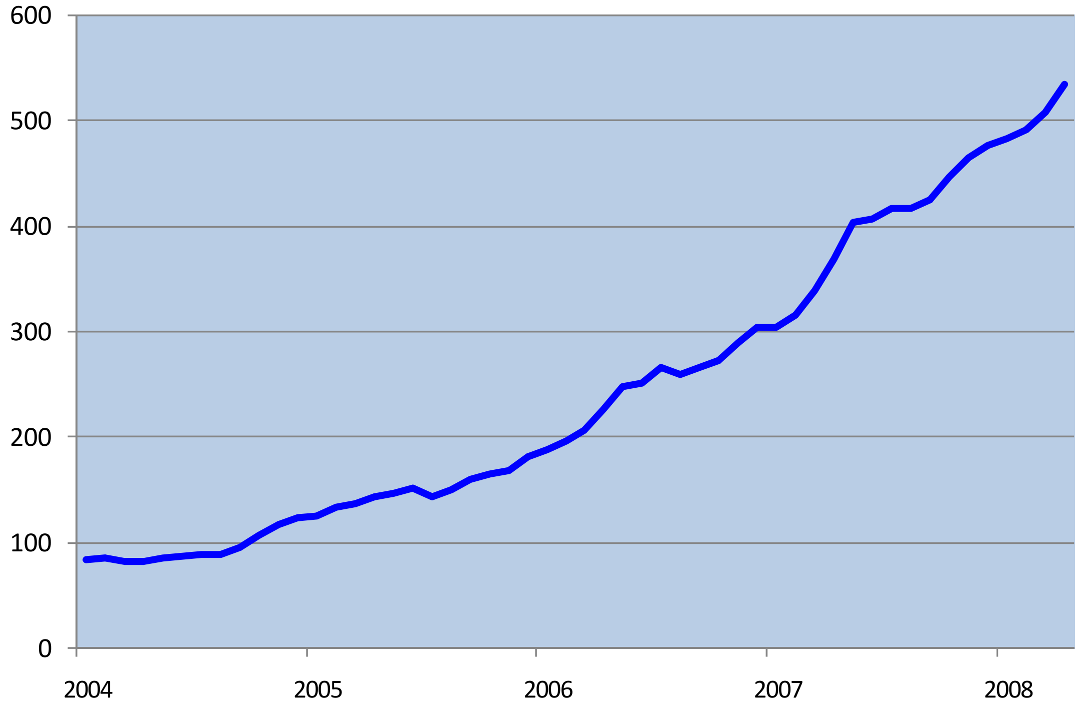


Source: Rosstat

Russian 12-month inflation in April 2008 hit 14.2 %, up from 7.5 % in March 2007. The main driver behind the pick-up in inflation, like elsewhere, was skyrocketing food prices. It should be noted, however, that while wages have risen sharply in recent years in response to Russia's robust economic growth, wage growth does not in itself explain for inflationary burst of recent months. Figure 3 breaks out the inflationary contributions of the three main categories in Russia's consumer price index (foods, non-foods, and services). Food constitutes a whopping 40.2 % of the hypothetical basket of goods and services on which Russia's consumer price index is based. Thus, of the 14.2 % y-o-y inflation recorded in April 2008, 8.4 percentage points of that came from food prices. At the moment, food prices are climbing at a rate of about 20 % every twelve months. Yet despite a general acceleration in inflation, the rise in prices of services continues to slow. From this, one might conclude that the recent flare-up in Russian inflation has not been caused by a huge jump in domestic demand, but rather a worldwide price shock from food. Prior to this price shock, Russia had achieved single-digit inflation (barely), and the anti-inflation struggle of its officials mainly involved going after production bottlenecks and upward cost pressures cause by rapid economic growth.

Will Russia get inflation back under control?

Figure 4. CBR foreign currency reserves, US$ billion

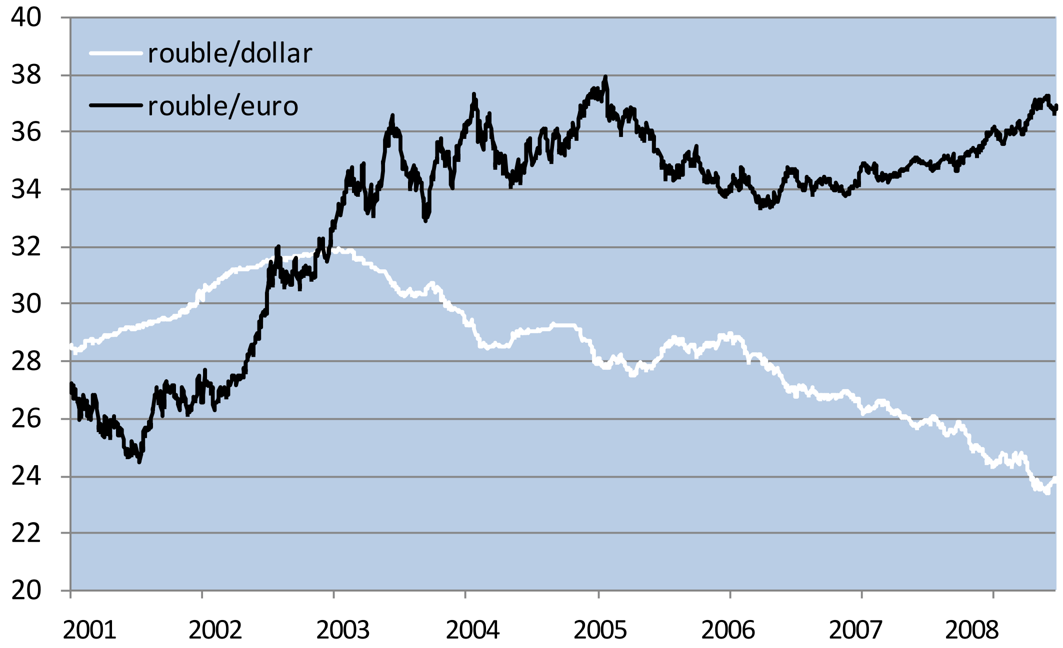


Source: CBR

As in other countries, Russia has employed a variety of fiscal and monetary measures to rein in run-away inflation. The government and the country's largest retailers agreed last October to freeze prices of certain basic food items. The freeze, which was kept in place until the end of April 2008, apparently succeeded to some extent in impeding the rise of prices, although its overall impact as is typical for such expediencies will likely to be insignificant and transitory. If Russia enjoys a bountiful harvest in 2008, food price inflation could fall somewhat nationally. Even so, no sharp decline in prices should be expected. Russia has its own rather diverse food sector, but a significant share of what Russians eat is imported. In 2007, the value of Russian food sales at the retail level amounted to 4,870 billion roubles (about 140 billion euros, or 195 billion dollars). At the same time, the value of imported foodstuffs was 660 billion roubles. It is impossible, of course, to precisely specify the margins of Russian wholesalers and retailers, but once VAT is included, one can say that imports account for at least a quarter of total retail sales of food. Moreover, it is notable that the markets for many products are truly global (the price of the good is set in international markets, usually in US dollars). This situation limits the direct impacts of Russia's domestic grain production on food prices.

The coming months will also see hikes in a number of administratively determined prices. Rate hikes are expected for e.g. rail cargo, telecommunications services, and above all, energy. The size of energy rate hikes will depend on the type of household or the sector in which the business operates, but electricity rates charged to households should roughly double between 2008 and 2011. Gas rates are also headed up, and in 2011 domestic companies in Russia can expect to pay the equivalent of the gas export prices (excluding the costs of transmission to the foreign customer). These measures are well justified in terms of economic efficiency, but they will inevitably also increase inflationary pressures.

Figure 5. Rouble-dollar, rouble-euro exchange rates



Source: IMF International Financial Statistics

Russia's central bank has used monetary tightening to slow growth of domestic demand and fight inflationary pressures, but its actions are limited in that there is very little impact on e.g. corporate investment activity from interest rate changes. Transmission of the CBR's interest rate adjustments is imperfect to the interbank markets, and the pricing of credit, in turn, is almost entirely disconnected from interbank rates. The central bank has also raised reserve requirements for banks, but to date such measures have had no visible impact on bank lending. The CBR continues to lean towards regulation of liquidity mainly through foreign currency market operations. One of the CBR's targets is to limit real rouble appreciation against other currencies, and for this reason the central bank has been fairly active in the currency markets. Although Russia's current account surplus is shrinking, growth in capital imports has led to a situation where foreign currency reserves continued to balloon even in recent months (Figure 4). The CBR has sought to defuse this potential explosion in liquidity, but has not entirely succeeded. The money supply grew at a rate of nearly 50 % a year in both 2006 and 2007. Within the current exchange rate regime, the CBR apparently cannot appreciably drive down the inflation rate. If the rouble's nominal exchange rate were allowed to appreciate, growth in foreign currency reserves would cease, and soon thereafter growth in domestic liquidity would begin to slow. A tighter fiscal stance would also dampen domestic demand, but even if growth in public spending were to cease, it would take a fairly long time before the measure would begin to have an impact on inflation. A stronger rouble would ease emerging price pressure from international food markets, and this, in turn, would reduce the spike in the food price inflator now seen in Russia. The rouble has strengthened against the dollar, but weakened against the euro (Figure 5). This is significant in that the Euro Zone, and indeed the entire EU, is a far more important trading partner for Russia than the United States (of course, a large part of Russian exports are priced in dollars). In 2007, 61 % of Russia's imports came from EU countries; just 3 % came from the United States.

Conclusions

Under current economic policies, it appears unlikely that Russia will soon get inflation back under control. Domestic demand remains strong, and more importantly, international prices for foodstuffs show no sign of retreating in the near term. The only obvious monetary measure available to curbing inflation would be to let the rouble appreciate much faster than at present – a move that would drive down the price of all imported goods, not just food. A sharply stronger rouble could impair the competitiveness of some Russian firms, at least temporarily, and would be politically daunting to push through.

Heli Simola

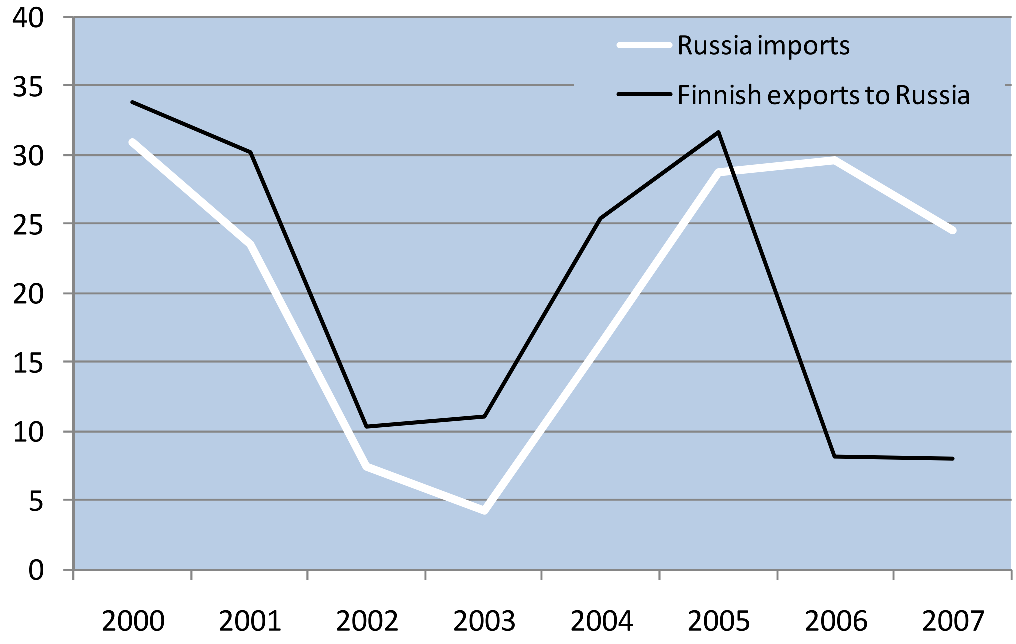
Development of Finnish-Russian bilateral trade

Russia has re-established itself a one of Finland's main trading partners. Russia is both an important destination for Finnish exporters and a critical provider of energy and raw materials for Finland. Recent years have seen several surprising trends in Russian trade, most notably a slowing in export growth and unwelcome disputes over import policies.

Growth of Finnish exports to Russia lags overall growth in Russia's imports

Russia's strong economic growth in recent years has translated into robust import growth. The country's massive oil earnings are also reflected in an increase in the average disposable income of Russians, and particularly the current consumption boom. Due to the simplicity of Russia's production structure, however, Russia's domestic producers have been ill-prepared to deal with this rapid rise in demand. Russia either does not produce or cannot produce in sufficient quantities many of the goods in highest demand. Moreover, many production branches are still unable to compete against goods produced in international markets. Russians gladly spend their money on foreign-made goods even when they are more expensive than the domestic equivalent. Real appreciation of the rouble has further contributed to the increase in imports.

Figure 1. Growth in Russia's imports and Finland's exports to Russia (in euros), %



Sources: Central Bank of Russia, Customs Finland

Figure 1 shows that, measured in euros, the value of imports to Russia has climbed at a rate of nearly 30 % a year. Finnish exports to Russia have risen at about 8 % a year over the last two years, while growth in exports from EU countries to Russia has about matched the growth in Russian imports overall. Chinese and Japanese exports to Russia have well surpassed the average rate of increase in past years.

Which is to say Finnish exports to Russia have lagged growth in Russian imports overall during the past couple years. One factor is Finnish cellphones manufactured elsewhere now enter Russia via routes other than via Finland. While this change in itself caused a large drop in export figure, it is not the sole reason for the lower growth in Finnish exports to Russia relative to other countries. Russian import demand is focused on the types of consumer goods that are simply not produced in Finland. Such products can be produced more cheaply in countries with low labour costs. In Finland, production is concentrated of high-end products such as special machinery and equipment that demand extensive know-how and capital intensity. In short, Finnish companies have not managed to respond to Russia's growing hunger for imports because they simply do not make the products that Russians most want to buy.

Another observation is that competition for the Russian consumer's rouble has also increased. Russia's booming and potentially huge markets have attracted foreign companies from near and far to compete for the rising purchasing power of Russians. The role of fast-emerging economies, especially China, in world trade is also now being reflected in the Russian market. Increased competition has somewhat eaten away at the historical and geological advantages enjoyed by Finnish firms. As a result, Finland's exports to Russia are now characterised by more traditional competitive factors, which can be see in the structure of Finnish companies engaged in exporting to Russia. We now consider the outlook for Finland's exporting to Russia is terms of the kinds of companies involved. The review is based on the database of Finnish firms engaged in trade with Russia compiled by the official cooperation development project (VIRKE).[1]

Finnish exports to Russia becoming more focused and specialised

International studies show exporting activity typically only affects a small share of companies operating in the economy. The share of companies involved in exports is generally small, and most exports are conducted by just a few large companies. National Board of Customs' statistics indicate that this well describes the structure of Finland's foreign trade overall; about 5 % of Finnish firms are engaged in export activities and small and medium-sized enterprises (SMEs) accounted for just under 10 % of the total value of Finnish exports in recent years. The situation of Finnish firms exporting to Russia, however, is somewhat different as the contribution of SMEs is considerably larger. Part of this is probably a natural outgrowth from the fact that it is easier for SMEs to export to customers just over the border than those in some distant land. As recently as 2002, SMEs accounted for nearly 30 % of the value of Finland's exports to Russia, but by 2006 that share had shrunk to less than a fifth of exports and the number of companies involved in the trade was considerably reduced. The structure of Finland's companies exporting to Russia today more closely resembles Finland's export structure

[1] A broader study based on the database will appear later this year as a BOFIT Online publication.

generally than earlier, including a concentration of the export activity into the hands of fewer large firms.

The Finnish companies exporting to Russia are also concentrated regionally. Not only are most exporters located in Finland's southern Uusimaa region, but their share has grown in recent years. Indeed, the region is central to Finnish exports of the manufacturing sector companies overall, not just exports to Russia.[2] One reason for the dominance of the Uusimaa region in Russia exports is the natural fact that most of Finland's large, economically important firms are based there. Still, Finland's exports to Russia are clearly more concentrated in the Uusimaa region than Finnish exports generally. Less than a third of Finland's total exports of the manufacturing sector companies originated from the region in 2006, but it accounted for 60 % of Finland's exports to Russia. The regional breakdown of exports reflects also the structure of products exported to Russia. The main export goods (e.g. electronics, passenger cars) are mainly manufactured or sold by companies based in the Uusimaa region. Finland's other top export goods such as paper occupy a smaller share of Finnish exports to Russia, as do regions that produce such products, e.g. Southeast Finland. The Uusimaa region also accounts for nearly half of exports to Russia by SMEs.

In recent years, Finnish companies engaged in exports to Russia have increasingly focused specifically on the Russian market. Russia's share of their exports grew clearly during 2002–2006. In 2002, an average of 60 % of these firms' total exports went to Russia. By 2006, the average share had risen to nearly three-quarters. At the same time, the number and share of firms exporting exclusively to Russia increased substantially. By 2006, over half of Finnish firms exporting to Russia exported solely to Russia. While comparable figures for other Finnish exporters are not available, it is difficult to estimate the degree of country specialisation of exporters focusing on other countries. International studies suggest, however, that usually majority of export firms focus on a single market. Only the largest export firms provide products for multiple markets. In this respect, Finnish firms exporting to Russia are hardly an exception.

Increasing importance of wholesale and retail trade

A feature of Finland's exports to Russia is the dominance of companies operating in the sector of wholesale and retail trade. More than a third of the value of Finnish exports to Russia comes from companies involved in wholesale and retail trade. In contrast, trading companies only account for about 10 % of Finland's total exports. The share of trading sector companies has grown slightly both in Finland's overall exports and in its exports to Russia.

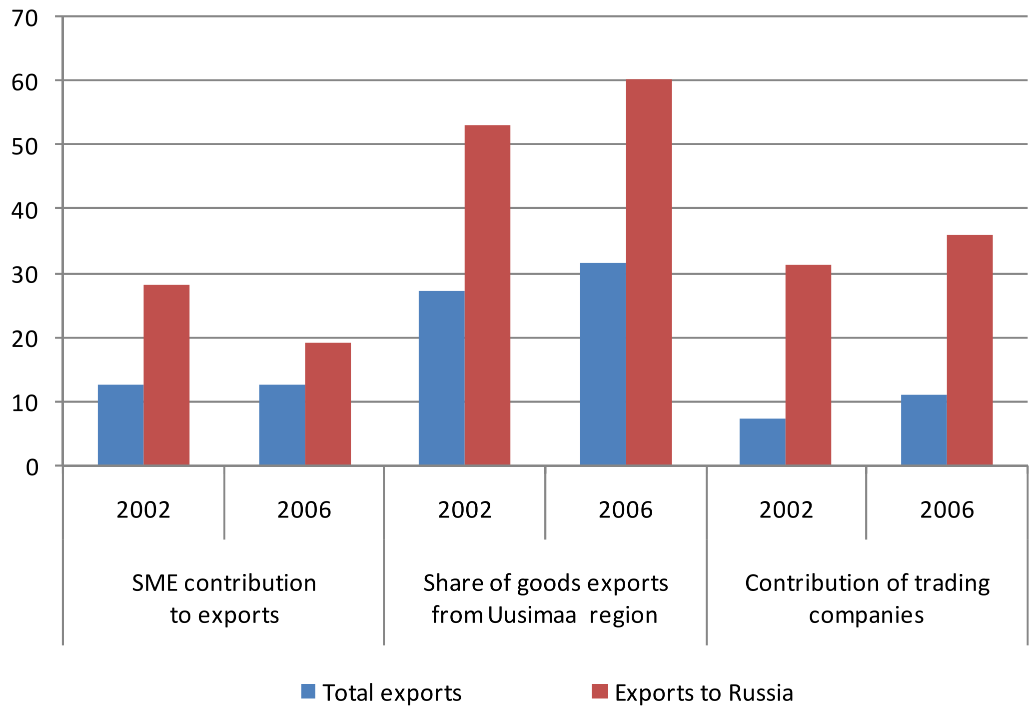
A large chunk of the Finnish trading companies' exports to Russia come from re-export of goods produced in a third country. Currently, re-exports are estimated to represent 25–30 % of Finnish exports to Russia. Companies involved in re-export are

[2] The Uusimaa region refers to Finland's southern provinces of Uusimaa and Eastern Uusimaa, and includes Finland's capital Helsinki. Companies that export to Russia are divided into regions primarily on the basis of their location. Since not all companies provide data on their actual location, their postal code or their tax office is used. Of course, the share of companies based in Uusimaa region may still be somewhat overstated, because, while they have their head office in the capital region, they may have many operations elsewhere in the country. For Finnish exports overall, we use here the regional industrial data provided by Statistics Finland. The data include exports of services, so they are not fully comparable with customs figures on goods exports.

typically large trading houses that are concentrated on serving the Russian market. The entire export business for many of these companies involves intermediation of goods going to Russia.

Companies involved in wholesale and retail trade in Russian exports are also concentrated at the corporate level and regionally. The share of SMEs in the value of trading sector exports to Russia fell from over 40 % in 2002 to just over 20 % in 2006. Some 90 % of Finland's traders exporting to Russia are based in the Uusimaa region.

Figure 2. Shares of Finnish SMEs, companies in the Uusimaa region and companies involved in wholesale and retail trade to Finnish exports overall and exports to Russia (2002 and 2006), %



Sources: VIRKE, Customs Finland, Statistics Finland

Will exports continue to grow?

The growth of Finnish exports to Russia will surely be lower than the growth of Russian imports generally as long as Russian import demand remains concentrated on consumer goods. But it is natural that Finnish firms focus on producing those goods they make best and sell them to the markets demanding those goods. On the other hand, we have recently seen resurgence in demand for investment goods also in Russia. Investment growth has accelerated rapidly and the economy's investment needs are still huge. The investment demand is fuelled by Russian plans to renew its degraded infrastructure and diversify its industrial base. The growth in investment is also reflected in an increased share of investment goods in imports. This trend offers Finnish firms specialised in the production of investment goods improved export opportunities. Figures from the start of the year indicate that these above-mentioned possibilities are being exploited as Finnish export to Russia jumped over 20 % y-o-y in January-February, nearly matching the pace of overall growth in Russian imports. This increase was due largely to higher Finnish exports of machinery and equipment.

Three features stand out when examining the structure of companies exporting to Russia: 1) ongoing concentration of exports to Russia both among companies and at the regional level, 2) increased specialisation on Russian markets, and 3) the significance of companies operating in the sector of wholesale and retail trade. What do these observations mean for development of Finnish exports to Russia? The increase in concentration among firms may indicate tighter competition on the Russian market in recent years. The significance of SMEs in exporting to Russia is decreasing to a level in line with Finnish exports generally. The more important role of SMEs in cross-border trade will probably remain, but the reduction in their share might indicate the exit of less efficient companies from the market. Indeed, many studies show companies that engage in exports are, as a rule, larger and more efficient than companies that operate exclusively in a domestic market.

Specialisation in exporting to Russia may indicate a similar trend. Several international studies note that most export-oriented companies focus exclusively on serving a single market. In other words, the situation of Finnish firms exporting solely to Russia is hardly exceptional. While specialisation in the Russian market can improve a company’s performance in that market, it also exposes the company to the full impact of shifts in the Russian market. Because the operating environment is not immune to sudden changes (e.g. revised customs procedures), exporters are constantly vulnerable to a variety of risks. For a company overly reliant on exporting to Russia, a sudden shock could cause serious problems.

The large share of companies involved in wholesale and retail trade in Russian exports may signal an unsustainable advantage over the longer term. In the trading sector, there has been also experienced a concentration and specialisation trend, so the companies are in stronger positions than if they were small firms just catching some passing opportunities. Over the long term, however, it is unclear whether all trading companies can sustain their advantage in the intermediation business. Trading is more challenging than the similar transit transport services, as a trader must provide added value to the Russian buyer when it intermediates a sale that could otherwise be conducted directly between the buyer and the maker of the product.

Oil and other commodities still determine imports

The value of Russian exports has risen rapidly in recent years due to soaring prices for oil and to a lesser extent other commodities. Two-thirds of Finland’s imports from Russia consist of oil and other mineral products, i.e. the trend is similar to development of Russian exports elsewhere. To some extent, also the rise in prices for other commodities such as refined metals has affected the import development. However, raw wood supply problems and hikes in raw wood export tariffs have reduced the amount of raw wood Finland imports from Russia.

The company structure of Finnish imports from Russia largely reflects the overall structure of imports, especially the large share of oil in imports. The value of the SME share of imports has traditionally been small, both in the case of Russia and generally. In Russia’s case, this share has actually contracted slightly, due largely to the fact that rising oil prices have increased the value of goods imported by Finland’s largest importers. As with exports, imports are tightly concentrated in the Uusimaa region, which is where most oil refining and transport occurs.

In addition to oil, Russia is also a major supplier of some chemicals and metals to Finland. Russian imports account for half of Finnish imports in these categories, although Russia's share in these categories has shrunk somewhat. The number of Finnish firms specialised in imports from Russia remained basically unchanged during 2002–2006. On average, Finnish firms engaged in importing from Russia get about two-thirds of their total imports from Russian and half of such importers get all of their imports exclusively from Russia. One example is provided by importers of raw wood. In 2006, there were just over 200 companies which imports consisted solely of Russian raw wood. These companies employed over 4,600 people.

Finland's imports from Russia continue to be dominated by oil and other commodities. Although imports are highly concentrated on large firms, also the SMEs' imports consist mainly of raw materials, particularly wood and metals. This picture has not really changed throughout 2002–2006. In the imports of the SMEs, only the shares of foodstuffs and machinery categories have increased somewhat, but still constitute only a few per cent of SME imports overall. Moreover, most food imports are also raw ingredients, not processed foods. On the other hand, foodstuffs as well as machinery and equipment, have a rather large significance in regional imports, especially in SME imports, mainly in the northern and eastern parts of Finland.

The development of Finnish imports from Russia is dictated by oil prices to an even larger extent than earlier. A distinct shift in the import structure, however, will likely occur if higher tariffs are imposed on raw wood exports from Russia as planned at the beginning of 2009 and wood imports collapse. Finland's dependence on imports from Russia, however, is not in many products as high as in raw wood and besides energy, has been shrinking in recent years in those product categories where Russia has been the most significant import provider. At the moment, there is practically no evidence that the structure of Finnish imports from Russia is diversifying, although in some regions higher value-added products such as machinery and equipment have a relatively large significance.

Laura Solanko

Will Russia go all the way with deregulation of domestic energy prices?

Some initial observations

Estimates of the energy sector's share of the Russian economy vary widely, in part, because there is no agreement on what constitutes the energy sector. Under the strictest interpretation, the energy sector covers companies involved directly in the production of oil, natural gas, coal, electricity and district heating. A wider view might include e.g. the refining of various distillates and other products from oil, as well as the distribution, transport and sale of oil and oil products. At some point, however, the line between energy and other sectors like retail and technical services begins to blur (e.g. gas and electrical power transmission).

Rosstat figures show that in 2007 production and distribution of electricity, gas and water accounted for 3 % of GDP. Russia's Ministry for Economic Development and Trade (MERT) reports that energy accounts for about 20 % of Russian GDP, although many unofficial estimates put the actual share closer to 30 %. Gazprom claims its own production accounts for 10 % of GDP. Finland's largest corporation, Nokia, generates less than 4 % of Finnish GDP.

The energy sector is critical for two parts of the economy: foreign trade and the public sector. Oil, oil products and gas account for about 60 % of the total value of Russian exports. Many export industries such as steel and chemicals, base their competitive advantage on the availability of cheap domestic energy. The export prices of energy products are largely tied to world prices for crude oil. Indeed, Russian export earnings have risen substantially in recent years despite the fact that export volumes of oil and gas have remained roughly stable. These burgeoning export earnings have helped Russia consistently post huge current account surpluses, which, despite soaring imports, continue to approach 10 % of GDP.

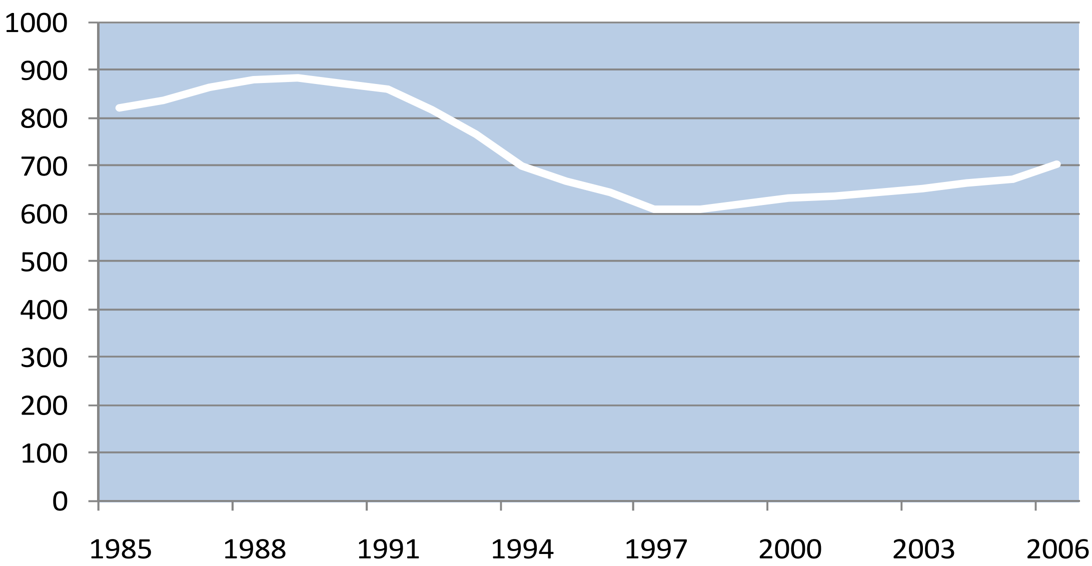
The benefits of higher energy prices, however, do not necessarily accrue to the balance sheets of Russian oil and gas companies. Because oil companies are subject to heavy taxation, the largest beneficiary of high oil prices is the national treasury. Under the new law that entered into force in 2004, the tax on oil exports is determined by the previous month's average realised world market price for Urals crude. Presently, export taxes account for about half of the realised oil export price. In addition to standard corporate income taxes, oil companies also pay a mineral resource depletion tax. While export and production of natural gas is taxed much more lightly, Gazprom is required to supply gas domestic consumers at extremely low regulated rates. Partly as a result of the heavy taxation of oil companies, federal budgets have been strongly in the black throughout the 2000s and the State Stabilisation Fund today holds assets in excess of €100 billion. Natural resources minister Yuri Trutnev says 60 % of state budget revenues originate in natural resource sectors, mainly from production of oil, natural gas and metals. The Russian research institute Economic Expert Group estimates that in 2007 nearly 80 % of federal budget revenues came from the energy sector.

The energy sector's overall impact on economic growth has been substantial. This year, MERT estimates the cumulative impact of the sector's share on national economic growth has exceeded 25 % in recent years. Without the contribution of the energy sector, Russian GDP on-year growth would have been "just" 5 %, instead of the realised 7 %. Although these figures should be taken with a bit of caution, it is indisputable that the Russian economy still would have grown substantially faster than most EU countries even without the contribution of its energy sector. It is also worth remembering that much of Russia's economic growth has come from other sectors, especially retail sales, services and construction. In addition, the energy sector only accounts for a few per cent share of total employment. Although the present discussion focuses specifically on the energy sector, its significance for the economy overall should not be overestimated.

Russia – a large producer and care-free consumer of energy

President Putin introduced Russia to the term "energy superpower" in late 2005. As Ukraine's energy crisis wore on in January 2006, the characterisation of Russia as an energy superpower gained currency internationally with the realisation that Russia could use its massive hydrocarbon endowments as a blunt instrument of foreign policy. Nobody denies that Russia is an energy superpower simply on the basis of resources. The country accounts for 7 % of the world's oil reserves and 25 % of the world's gas reserves. Russia is presently the world's second largest oil and gas producer, the fourth largest electricity producer and the world's fifth largest coal producer.

Figure 1. Primary energy consumption in Russia in million ton oil equivalent (Mtoe), 1985-2006



Source: BP 2007

But Russia is itself consuming an increasing share of the energy it produces. Russia now domestically uses two-thirds of its gas, its top strategic energy resource. Only a third of Russian gas is exported, mostly to other European countries. To meet its supply contracts, Gazprom augments its domestic supplies with gas purchased from Central

Asia, mainly Turkmenistan. About two-thirds of oil production and about a quarter of coal production also go to exports. Nearly all electricity is consumed domestically, with only a couple per cent of total production going to exports.

Table 1. Ratio of domestic primary energy consumption in million ton oil equivalent (Mtoe) to GDP (Mtoe per US$ thousand, constant 2000 prices and exchange rates)

	1990	1995	2000	2003	2004	2005
China	1.58	1.14	0.82	0.79	0.84	0.83
Non-OECD countries, Europe	1.15	0.95	0.78	0.75	0.71	0.69
Russia	2.28	2.62	2.36	2.08	1.95	1.85
Ukraine	3.50	4.69	4.29	3.69	3.27	3.17
Uzbekistan	3.30	3.74	3.66	3.27	2.95	2.62
CIS average	2.45	2.82	2.43	2.13	1.98	1.87
Non-OECD countries, World	1.00	0.85	0.75	0.74	0.74	0.72
EU-27	0.24	0.23	0.20	0.20	0.20	0.20
OECD average	0.23	0.22	0.21	0.20	0.20	0.20
World average	0.36	0.34	0.32	0.32	0.32	0.32

Source: IEA 2007

In recent years, energy consumption in Russia has increased in conjunction with the pick-up in economic growth. At the moment, overall energy consumption is still lower that in 1990, an indication that the Russian economy has made gains in energy efficiency. Even so, Russia's energy waste is huge by international standards. Based on the relative size of its economy, Russia uses several times the amount of energy of OECD countries. The International Energy Agency (IEA), which operates under the auspices of the OECD, notes that the CIS countries (in particular Ukraine, Uzbekistan, Turkmenistan, Tajikistan and Russia) are in a class by themselves when it comes to wasting energy. Relative to the size of its economy, China, for example, consumes less than half the amount of energy as Russia.

There are several natural reasons why Russians are such heavy energy consumers. Given Russia's northern latitudes and huge area, high heating and energy transport costs are understandable. However, Russia also inherited a Soviet production structure that favoured energy-intense heavy industry. Power plants and distribution grids today are creaky and crumbling, and transmission losses are huge. Yet beyond that, the most important reason Russia is wasteful is low, regulated energy prices and the wasteful lifestyle that go with it. According to MERT, a reasonable level of energy consumption for Russia would be about 55–60 % of the current level. The potential markets for energy saving, especially in heat production, distribution and in the housing sector are nearly unlimited. As long as rates for electricity, heat and gas remain unreasonably low, nobody will have sufficient incentive to invest in oil efficiency. Prices of oil and oil products, in contrast, are set by the market, so it is also hardly surprising that domestic oil consumption in recent years has barely increased at all.

Price liberalisation unavoidable

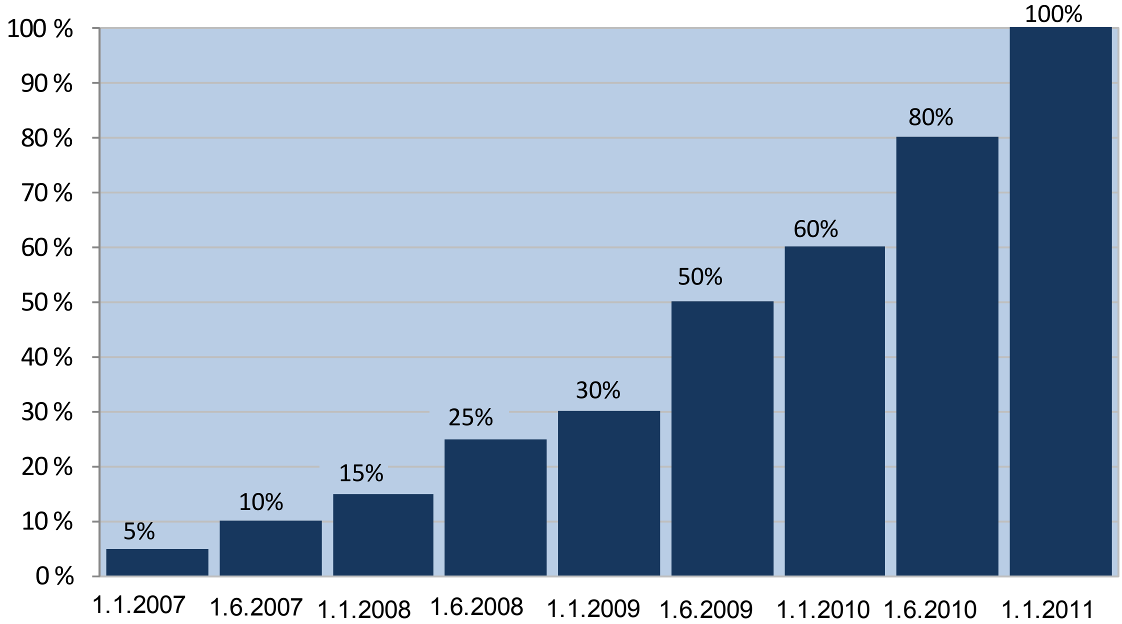
At present, markets do not determine the prices of electricity, gas or heating. Based on government decree, the Federal Tariff Service sets rates for electricity, gas and heating for every Russian region. Households and corporate users have their own separate rates. For gas and heating, household rates are significantly lower than corporate rates. There is a huge variation in regulated prices, both within regions among consumer groups and among regions. In addition, rates are typically set far below the level of export prices. Current regulated rates are so low that they do not encourage new investment in either production of consumption. Politicians, however, have been very cautious about raise rates even slightly. Industry (somewhat justifiably) fears loss of a significant competitive advantage, while households regard cheap energy as natural entitlement.

In any case, the days of cheap energy in Russia are rapidly coming to a close. The growing economy uses an increasing amount of energy every year, even if production gains are no longer possible without substantial new investment. Moreover, existing capacity, especially in transmission and distribution of electricity and heat, will require huge investments in repair, refurbishment and replacement. Leaky steam pipes and under-dimensioned electrical transmission capacity are now recurring winter themes. Yet there is no reason to await new investment unless regulated wholesale energy prices are allowed to reflect actual market prices.

The urgency of dealing with domestic energy issues became apparent during the unusually harsh 2005–2006 winter, which drove domestic energy consumption to peak levels. Russia's national electricity monopoly RAO UES warned the electrical grid and production capacity would have been stretched beyond its limits had the high demand of the cold spell continued much longer. The situation was compounded at the beginning of 2006, when Gazprom announced it faced a real gas shortage and was therefore reducing its gas deliveries to electrical power companies. Things truly got out of hand after a nearly catastrophic confrontation between Ukraine and Gazprom caused a temporary shut-down in gas supplies to Europe and Ukraine in the midst of the cold spell. These events provided the final kick that fostered action on several fronts to reform the energy sector.

The most radical decision was surely to implement the reform of Russia's electricity sector as originally drafted at the start of 1998. In 2006, Russia decided boldly to implement liberal reforms on a globally unprecedented scale and scope that aimed at simultaneous deregulation and privatisation of the nation's electricity markets. The fundamental goal of the electricity sector reform was to attract substantial amounts of new investment to the sector over the next ten years. To reach this goal, it was decided to deregulate electricity prices completely by 2011. In practice, this means that rates will be incrementally raised while the amount of subsidised electricity to companies is gradually reduced. Households and certain remote regions will be exempt from deregulation, even if regulated rates are hiked somewhat. At the beginning of 2011, with the exception of remote regions, electricity prices for all companies will be fully deregulated. At that point, prices for about 75 % of national consumption would be set by the free market.

Figure 2. Share of deregulated electricity sold to companies at the wholesale level.



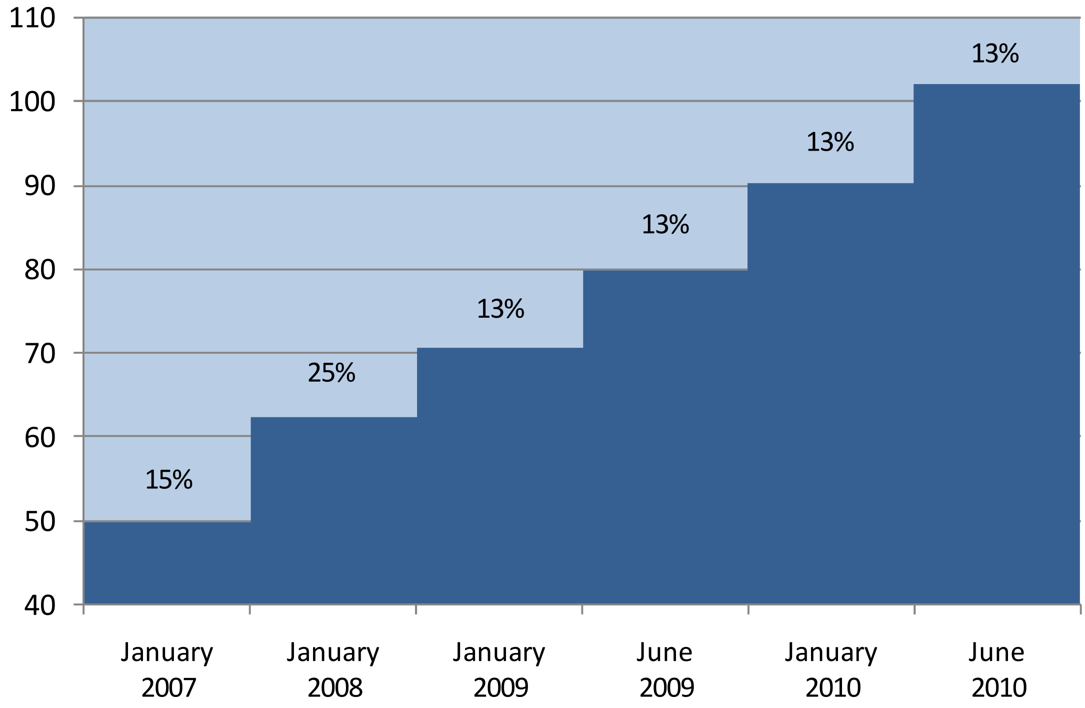
Source: RAO EES

Regulated gas prices will remain in place for some time to come and there are no plans to break up Gazprom's monopoly. Under the plan approved in October 2006, the wholesale price for gas will be raised incrementally until the beginning of 2011, when companies will pay a domestic market price that should match the export price (excluding taxes and transmission costs). At that point, domestic and export markets should be equally attractive to gas producers. The current difference is still several times. Just over a quarter of Gazprom's profits are generated by domestic sales, even though half of sales go to the Russian market.

At the beginning of 2008, corporate gas rates were raised as planned by 25 %. Rosstat figures show that in March 2008 domestic firms paid an average of about $100 per thousand cubic metres of gas. The price of gas sold to the Ukraine is about $200 dollars per thousand cubic metres and the price for gas supplied to Western Europe exceeds $300 per thousand cubic metres.

At the beginning of May 2008, the government also decided to implement large hikes in household rates for gas, electricity and heating. Without the household increases, corporate users would have had to subsidise a growing share of household energy costs.

Figure 3. Staggered hikes in natural gas rates charged to companies (USD per $1000m^3$).



Source: MERT

Is the current pace of reform fast enough?

The rapid rise in the price of crude oil has helped push the price of natural gas to record levels. When the gas rate hikes were decided one-and-a-half years ago, the average price for Urals-grade crude oil was about $61 a barrel. By early June 2008, it was $135 a barrel. Thus, it is almost impossible to achieve an export price level on the planned schedule at current oil price levels. Without significant tax changes, export markets will remain more profitable for energy producers than the domestic market. However, the gap will narrow in the future.

The government appears to be firmly committed to deregulation of Russia's electricity markets, so it may well be that in 2011 electricity rates for companies are fully deregulated while gas rates are still subsidized to some degree. From the electricity company's standpoint, this situation is ideal. On the other hand, rates for both household electricity and home heating will remain regulated and electricity companies will remain committed to providing their "household products" as demand dictates.

The rate hikes are truly sizeable for gas. In 2009, gas rates will go up 25 % for households and 20 % for companies. The following year, rates will jump 30 % and 28 %, respectively. In 2011, rates for households will increase a further 40 %. These big hikes could push some households into real payment distress. Even so, the rate hikes barely cover increases in production costs. In March 2008, the rise in producer prices in the electricity and gas sectors was 18%. Producer prices for oil refiners and coal producers were up 52 % y-o-y.

Raising regulated prices for energy are intended to provide Russians with a direct incentive to embrace energy-saving habits. If they do not, energy shortages in the future are inevitable. Growth in natural gas production has plateaued, and, without substantial investment, will go into decline. Thus, Russia must find new gas to meet its future export supply commitments or start to surrender market share. Increased electricity production will also require large investments. Even if the planning and implementation of investments began this spring, it will take years before new gas fields or new electrical power plants are on stream. Russian energy companies already compete for supplies on an internationally overheated market for pipelines, turbines and cables. Moreover, Russia is experiencing a shortage of competent engineers and project managers. The implementation of massive investment programs over a short time is a non-trivial task.

To deal with all this, producers and consumers will have to adopt new – if not innovative – ways of producing and using energy. MERT ambitiously estimates that about a third of energy savings should come from the energy sector's reduction of its own energy use.

Pekka Sutela

Medvedev's economic policy guidelines

The environment of Russian economic policy is changing. Economic growth cannot any more be based primarily on increased capacity utilisation, but increased investment is needed. This shift provides possibilities to adopt modern production technology, reorganise production and extend product selections. Growth in output of basic energy commodities is likely to remain low, and if, as assumed, there is no repeat of the run-up in prices seen in recent years, the relative significance of the energy sector in the Russian economy should start to decline. Hence, Russian growth will have to be based on other factors. Surging imports and flat export volumes mean the current account surplus will melt away over the coming years. A key issue for economists, then, is what will happen on the capital account. Ultimately, the huge pressure to increase public sector spending combined with scarce opportunities to raise tax revenues should bring about balanced budgets. The core question facing fiscal policymakers will be how to prioritise expenditures rather than how to allocate increasing revenues. This is one of the avenues via which policymaking returns to Russia.

This shift has been a long time coming, so it is likely only a coincidence that it takes place at the same moment Russia is inaugurating a new president. Future authors of Russian economic history, nevertheless, will likely distinguish the previous growth cycle from what comes next as the end of the Putin era and the start of the Medvedev era.

Economists have a richly earned reputation for poorly explaining economic growth. Since the days of classical economics, the significance of division of labour and accumulation of capital (i.e. investment) has been well appreciated by economists. In the Soviet reality, the trade-off between immediate and future consumption became the key factor of economic growth and received theoretical foundations in the economic growth theories of the 1950s. Furthermore, as measurement of economic phenomena became possible, the importance of human capital (i.e. competence) was recognised. This insight brought innovation, the once forgotten art of creating and applying new knowledge, into the central position in economics it occupies to this day. A merged version of growth and development theory contends growth issues are sharply different for economies on the front line of global productivity and economies like Russia that must still play economic catch-up through imitation and serving select market segments.

Although the "distance-to-frontier" model of economic growth is quite logical, empirical studies provide a useful reality check. Various explanations are offered for growth, but, unfortunately, our ability to assess them is not as good as we would like it to be.

As our models and descriptors are inadequate to even explain the past, how could we forecast future? Nonetheless, we have to try.

A couple years ago I was asked to chart Russia's future economic directions as part of a report under preparation by the Finnish parliament's Committee on the Future. A decision had been taken to use a scenario approach. Not only is the approach probably the most politically acceptable, it is well suited to framing developments ten years ahead.

My first step was to separate out factors likely to remain constant, or at least on known trajectories, over the next decade. There are many such factors, including the composition of built-up environments, the capital stock, existing infrastructure, expertise and various skill sets of the population, as well as geographic constraints and ecological conditions. It was also clear Russia's social structure and demographic outlook were unlikely to change rapidly over the next ten years without e.g. huge waves of international migration.

Two known factors that will undergo change stood out. The first is the emergence of a strong middle class. This is a fundamentally positive development for Russia. Interestingly, when the key consumers and producers in the society are the very same people, this creates self-reinforcing development of new products and production structures. The emergence of Russia's middle class has been, and will continue to be, a central factor in Russian economic growth and far-reaching structural change.

The second important potential driver of growth is the opening of Russia's economy to the world. This is now seen in the strong growth in imports, migration and tourism. In the future, it will also be manifested in the internationalisation of Russian business. It is a further factor promoting growth. As a result, Russian business life will become more European, not the other way around.

On these and other grounds, we conclude that the Russian economy is destined to enjoy continued growth, perhaps throughout the entire coming decade. But there are also fundamental matters for which we lack clear data.

In particular, production volumes of both gas and oil seem set to rise slowly, if at all. Levels of production further out will be governed by decisions yet to be taken by the government on taxation, investment, and energy efficiency. Simply put, Russian energy production and export capacity may or may not increase.

As noted, Russia cannot afford to live solely on energy earnings. If it tried, it would quickly precipitate employment problems and possibly a balance-of-payments crisis. Thus, it is important for the Russian production structure to diversify in a manner that generates globally competitive jobs and new streams of export earnings. Given that the energy sector, at least narrowly defined, can employ only a few people, the great bulk of jobs must come from other forms of production. The fact whether they are competitive or not will determine how Russia can integrate with the global economy. Further, it is important whether the jobs are in Soviet-type old-fashioned production or in newly created production.

Of the six scenarios created, three were chosen for a detailed analysis.

In summer 2006, at the same time we were drafting our scenarios, Moscow decided it was time to repeat the work on strategic scenarios that around the change of the decade led to the adoption of the so-called Gref economic program as the basis of president Putin's economic policy. The Gref program had strong impacts for several years, including the now-famous mantra of doubling GDP in ten years. It now looks possible that nominal GDP in roubles may increase as suggested by the program. If measured in dollars, Russian GDP has, in fact, already grown several fold, boosted by the real appreciation of the rouble.

Like at the start of Mr. Putin's presidency, the main responsibility for drafting the program is delegated to the Ministry of Economic Development and Trade (MERT), now led by Elvira Nabiullina. Last time a large contributor to the project was the Moscow-based Centre for Strategic Development, which is again involved in the work. It is notable here that the Academy of Science, which is largely composed of academics with Soviet-era credentials, also produced their own parallel proposal that runs nearly 400 pages. Perhaps even more notable is that this tome was published by the RIO Centre (now INSOR), whose board chairman was once Dmitri Medvedev.

In July 2007, MERT released three scenarios of Russia's economic future. They diverge from the scenarios of Finland's parliamentary Committee on the Future e.g. in that none of the bleak outlooks are included in their original forms.

The first MERT scenario was dubbed "Inertia." Under it, energy and raw materials retain their central economic roles, but output grows slowly and, due to persisting inefficiencies, exports contract rapidly. Over the next decade, economic growth averages 3–3.5 % a year. Spending on R&D remains at about 1 % of GDP. Finland's parliamentary Committee on the Future's corresponding scenario is "Decay," although it also shares some of the features of the Committee's scenario "Sovietland."

The second MERT scenario was "Energy/natural wealth." In this version, efforts focus on maximisation of basic production, and the economy grows at 5.0–5.5 % a year. R&D spending rises gradually to 3 % of GDP. This view corresponds to the Committee on the Future's "Industrialism" scenario.

Finally, the third scenario was "Innovation-based development." While the emphasis on energy and raw material sectors remains, the focus is on development of high- and medium-tech production. GDP rises 6.4–6.5 % a year, and spending on R&D increases gradually to 4.7 % of GDP. This corresponds largely to the parliamentary committee's "Resurrection" scenario, but also includes parts from the "Industrialism" scenario.

In the next phase, the scenario closest to the target was chosen. Naturally, it was the "Innovation-based development" scenario. The 145-page draft of the development program released in March 2008 describes the potential future for Russia according to this scenario.

Choosing "Innovation-based development" scenario was, however, not self-evident. President Putin's state-of-the-nation address in spring 2007 suggested a slightly different approach. Loosely interpreted, he argued that Russia could never hope to compete with the low-cost labour pools of Asia. Moreover, it was unrealistic to think that Russia could suddenly evolve into a high-tech country like some countries in Western Europe. Russia's competitive advantage, he said, was in pursuing the same path Canada and the Nordic countries have long followed. Russia needs to find ways to extract greater value from its natural endowments. The key involves applying new technology to transforming Russia's natural resource riches into higher-value goods.

The choice of Russia's future development strategy could just as well have been affected by selection of a different president. Dmitri Medvedev's background is that of a corporate lawyer. In recent years, Medvedev's duties included leading development and implementation of the priority national projects, so it is no coincidence that MERT's March 2008 draft stressed social issues, particularly health care and education. These themes were reiterated more forcefully in the RIO Centre report. If, say, Sergei Ivanov, who recently was in charge of the defence industry, would have been selected, the emphasis of new government could have been different.

Preparing strategy for the future includes weighing which recent events and trends matter to the extent that they should be taken into consideration. The March draft, for example, does not acknowledge the ongoing turbulence in international financial markets. While the effects have been marginal for Russia so far, the draft's assumption of average world economy growth of 4 % a year through 2020 feels just now a bit optimistic. The second oversight, even if it is much discussed in Russia at the moment, is the acceleration in inflation that began in the second half of 2007.

In Russia, as elsewhere, the rise in food prices reflects higher prices for imports, which account for about 30 % of the hypothetical food basket of Russian shoppers. On the other hand, domestic food prices have also risen, particularly for milk products and grains. Moreover, this cost pressure is likely to translate into higher meat prices.

It is easy to interpret domestic inflation as a symptom of spreading overheating. Besides food prices, wages (especially in certain fields and regions) and construction costs have been soaring. But is the Russian economy actually overheated? In an uncharacteristically public high-level debate, the MERT and the presidential administration argue no, while the Ministry of Finance ministry and central bank argue yes. The contradicting positions lead to different conclusions about the future. MERT and presidential administration want to maximise growth, while MinFin and the CBR seek economic stability. It is easy to see these differences as reflections of different agendas, but at a deeper level these are differences over interpretation of reality.

The Ministry of Finance has announced it was preparing its own long-range fiscal policy program extending through 2023. It will surely be more conservative than the fiscal policy suggestions of the MERT proposal. Nor can the CBR be expected to quietly assent to MERT’s blue-eyed view of monetary policy. MERT suggests that a capital account surplus will balance out any current account deficits, so there should be no problem in moving to a free-floating rouble. The CBR sees its monetary policy challenges as somewhat more daunting.

The third cornerstone of the MERT proposal is plagued by its assumptions on demographic and labour market development. In contrast to the prevailing view, MERT believes the Russian population can be stabilised by 2020. This will occur in a number of ways, of which the most central are age structure, education, and promoting immigration of people with appropriate professional and linguistic skills.

The fourth cornerstone suggests a more balanced distribution of population and production across regions is possible. It is difficult to see how this might happen, though. There is strong economic evidence, as well as the thinking of a large number of Russians struggling to move to urban areas, that too many people live in the countryside, not too few.

President-elect Medvedev described the fifth cornerstone of the MERT proposal in crystal clarity in a March speech on economic policy directions. He used four “i” words to encapsulate Russia’s economic future: innovation, infrastructure, institutions and investment. The speech, though well received as forward-thinking, concealed a problem in its approach. For an economy far from the global technological frontier, imitation may well provide a more appropriate modality to achieving national prosperity and well-being. A national innovation culture demands levels of investment, infrastructure and institutions that are beyond what is possible in present-day Russia. In contrast, the importance of the much more accessible strategy of imitation has been and is still part of many post-WWII economic success stories, including Japan, Korea and China.

Studies of Russian competitiveness reveal three basic aspects. The average productivity in Russian value-added industry is just a few per cent of the US level. It is on par with China and India, countries that base their competitiveness largely on cheap production costs (Russia’s competitive advantage of cheap labour continues to erode). There are also sharp productivity differences among Russian industrial branches.

The heterogeneity of Russia's economic structure is a distinctive feature of developing economies. Russia's economy is exceptionally heterogeneous in terms of geology (the significance of natural resources is exceptionally large), geography (market economy criteria for economic activities are distinct from those applied during the Soviet era command economy solutions to dealing with Russia's northern location and remoteness), and history (Russia is the only developing economy that was once a superpower). This has left many legacies. One is a remarkably large state R&D capacity that is rarely applied to creating new products for export or significant efforts that can be measured in terms of international patent activity. China's R&D investment in proportion to national income is the same as for Russia. However, China files many times more international patent applications than Russia. In terms of patent filings, Russia is comparable to India or Brazil.

MERT's proposal mentions, quite correctly, that a special feature of Russian development is that imitating sectors distant from the technological frontier coexist simultaneously with sectors on the front lines of global innovation. As a rule, most companies are far from the technological frontier, but this is hard for many to swallow. Perhaps this psychology is a remnant from Russia's days as a superpower. There is also the danger that a state company, following orders from above, tries to establish institutions and make investments for which there is no demand.

This may have something to do with the special emphasis the MERT proposal places on cooperation with a region it dubs Greater Eurasia. While it does not specify which countries are included in this region, it makes clear that the EU, China and India are not. This region is also not identical to the planned Eurasian Economic Community. In this region, Russia takes the lead in creating a customs union and economic area – which apparently would include the Four Freedoms criteria. At the same time, Russian financial institutions would take the lead and the rouble would act as a regional reserve currency. Russia's financial system would gain stability from its independence from the international economy, while dominating the Greater Eurasia region.

As one phase in Russia's economic development comes to a close and a new phase dawns, the change-over reflects more new circumstances in the macroeconomic environment than changes in economic policy. The drafting of the 2020 program began during Putin's presidency, and its authors were involved in preparing earlier economic policy. Direct critical analysis of policy and its deficiencies have been rare in recent years, although not altogether absent (notably Yevsei Gurvich, head of the Moscow think tank Economic Expert Group). Assessment of the new administration's economic policy will begin only after it implements its initial measures. In addition to dealing with inflation, these are likely to encompass WTO membership, EU relations, relations with certain former Soviet states, and regional policy – all of which are difficult to portray as complete success stories.