

# **The competitiveness of Russian economy**

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## **Abstract**

Competitiveness represents one of the major preoccupations of all world economies in an increasingly open and integrated world. The phenomenon of globalization has given a major boost to world trade bringing more and more goods to the market. For most countries this implies constant pressure for change and improvement. As the current financial crisis has demonstrated, macroeconomic imbalances and an underdeveloped microeconomic environment can seriously undermine a country's resilience to economic shocks. Maintaining and improving competitiveness in a globalized world has and will be a central preoccupation for countries whose economic models have been challenged. This in particular applies to emerging economies like Russia whose goal is to become major players on the world or regional stage. This work is an attempt to analyze and assess the competitiveness of the Russian economy. Through this process major strengths and weaknesses of the Russian economy will be revealed and suggestions will be given to improve the economic conditions of the country and its competitiveness.

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## **List of Abbreviations**

<b>DBR</b>	Doing Business Report
<b>FDIs</b>	Foreign Direct Investments
<b>GCR</b>	Global Competitiveness Report
<b>GCI</b>	Global Competitiveness Index
<b>GDP</b>	Gross Domestic Product
<b>IFC</b>	International Finance Corporation
<b>IPR</b>	Intellectual Property Rights
<b>OECD</b>	Organization for Economic Cooperation and Development
<b>R&amp;D</b>	Research and Development
<b>RCR</b>	Russia Competitiveness Report
<b>WEF</b>	World Economic Forum
<b>WTO</b>	World Trade Organization

## **Chapter 1: Introduction**

### *1.1 Objectives and structure of the dissertation*

The scope of this dissertation is to examine the evolution of the Russian economy since the dissolution of the Soviet Union and in which way the past of the country affects its competitiveness until today. In order to achieve that an attempt to provide a multidimensional analysis will be made, in terms of economic, political, social and cultural variables of the Russian Federation as regards the concept of competitiveness.

Although competitiveness is a concept that is not clearly understood by researchers, academics and entrepreneurs (something that we can see from the various interpretations that have been given) there is a consensus as regards the positive effects that has for the economy. Those efforts, which have been increased through time, point out the importance of this concept for the economy. Definitions that have been given identify that competitiveness increase productivity and economic growth which in turn increase the quality of life for the people. Thereby, competitiveness is clearly perceived as a key ingredient for the development of a country hence it is important to examine how it has been introduced to the Russian economy and in what level. By analyzing the competitiveness, the strength and weaknesses of the country will be revealed and thus favorable economic policies and strategies can be followed and implemented to increase economic growth. Institutions, a sound macroeconomic environment, an attractive business environment, the quality of labor force and the terms of trade are the most significant factors that if they are competitive they expedite the development of the country and determine the level of competitiveness.

A brief description of the following chapters will help us to better understand the structure and the scope of the dissertation while we will primarily focus on answering questions like: What is competitiveness? Which factors determine competitiveness? How important is competitiveness for a nation? How competitiveness affects the economy? How public policies affect competitiveness? Why a nation should pursue strategies towards improving competitiveness? What “answers” have been given from Russia to those questions?

In Chapter 1 we will provide some definitions that have been given to describe the concept of competitiveness and an analysis of those definitions will follow, to understand why competitiveness is so important for an economy. We will describe the diamond framework that has been deployed by Porter as it is the most recent theory about the determinants that affects national competitiveness. A brief introduction to the case of Russia will follow.

In Chapter 2 the paper will examine the evolution of the Russian economy since the collapse of the Soviet Union. We will focus on the major reforms that had undergone since then in order to understand how the macroeconomic environment of the country has been created and under which conditions the business activities are taking place. This brief review of the Russian history will give us the necessary information to understand the current condition of the country, as the majority of the problems that Russia face today is the outcome of policies and strategies that Russia followed since then. The cultural aspect will be a key concept and will reveal the willingness of the Russian government to sacrifice its political power for the sake of its economic development.

In Chapter 3 the analytical framework that has been deployed by Porter will be used as a guideline to create the framework under which the assessment of the Russian competitiveness and its current condition will follow. We will describe Russia's endowments, imports and exports, factors of production, the participation of

the country to various organizations as an external anchor to promote reforms, the macroeconomic and the microeconomic environment. Strengths and weaknesses of the country's current condition will be revealed.

Conclusions will be drawn and suggestions will be given along this whole process while a summary will follow at the end of this dissertation.

The main findings of this work are not significantly different from other relative works. The existing bibliography covers in large extent the conditions of the Russian economy and the competitive advantages or disadvantages of the country. Every time the country seems to make a step in order to improve its economy a backlash is following and progress is coming with slow pace. The economic crisis in 2008 came only to justify the main weaknesses of the country, weaknesses that have been well reported during the past by researchers and analysts. Russia is currently making some steps to alter the country's conditions and promote competitiveness. Although the results haven't been seen yet Russia seems to understand its weaknesses and be more determined to promote the necessary reforms.

The country is still suffering from bureaucracy and corruption due to its huge public sector which operates under weak and inefficient management. Procedures that are followed lack of transparency while the weak legal framework is coming only to add to this problem. The legislature is used as a tool from the Russian government in order to exercise its power and maintain its regime. Protection of property rights is still weak and a major constraint for businessmen and entrepreneurs and hampers their activities. The manufacturing sector is at an infant stage thus the Russian economy is still depended on revenues from oil and gas exports. The economic boom that the country experienced during the past has increase the income of its citizens but income inequality is still a problem. The centralization of the economic and political power to the hands of the Russian government has as a result weak local authorities that are unable to address their regional problems hence the country suffers from regional divergence.

The decentralization of the economic and political power and the diffusion to the regional level will help the country to manage better its public sector. Strong local authorities are necessary to exercise control over the public sector hence increase transparency and fight corruption. Moreover local authorities are able to address better the problems that businessmen face in their region hence they will be able to provide the necessary reform policies in order to foster the development of the manufacturing sector across the country. The development of a strong manufacturing sector will diversify the sources of revenue for Russia, increase the stability of its economy, increase regional convergence and decrease income inequality. A strong legal framework and an independent legislature will increase the credibility of the country to foreign investors and further add to the fight against corruption.

The 2008 crisis revealed the weaknesses of Russia, weaknesses that the Russian government, although a bit delayed, seem to understand. Various reforms have been announced since 2012 towards 2020-23, reforms that currently undergoing and targeting to further privatize state assets, to the protection of intellectual property rights, to increase the quality of produced goods and to promote innovation as a key factor to develop the manufacturing sector. Compared to the past, the Russian government seems to be more determined to promote the necessary reforms and decrease the dependency of its economy on natural resources.

## *1.2 Methodology of the dissertation*

In order to examine the competitiveness of Russia, a qualitative research design is adopted. The central approach is a descriptive analysis of the macroeconomic and the microeconomic environment of the country, the factors and enablers of production and the endowments.

An analysis based on macroeconomic indicators and criteria will give as the necessary information to understand how the macroeconomic environment has been formed all these years. A sound macroeconomic environment is important for a country's profile. A country with a reliable profile can achieve better access to finance through cheap loans that in turn will give the ability to the country to promote further reforms. Furthermore, the country is more appealing to investors, as it is providing a stable environment for investments. Businessmen and entrepreneurs are able to adapt and organize their strategies and activities, within a stable environment and without expecting surprises.

By examining microeconomic indicators and generally the business environment and the industrial policies, we can see, in what level firms are affected by the macroeconomic policies that the government follows and what possibilities do they have to evolve and reach their potentials. Indeed, competition among firms, within the countries, is perceived as a key factor to increase their efficiency and in turn their productivity and the quality of their products in order to claim a bigger share of the market. Industrial policy has a pivotal influence in western economies (and not only) in order to develop their business environment and had provide the main framework in which government policies should focus in order to increase their competitiveness.

The inputs to the production process, the so called factors of production, have widely been conscripted to evaluate productivity and therefore competitiveness, as they determine the outputs in the production process. From land, labor and capital to human capital and technology, the historical schools of economics as well as businessmen and entrepreneurs recognize their importance to the economy.

Terms of trade, imports and exports have been conscripted as well to assess the competitiveness of a country and more specifically to measure the strength that various domestic products and services have in the global market (in terms of market share). Trade has a pivotal influence to a country's economy and the welfare of its citizens as consumers in the domestic market have access to more products while domestic firms have access to a larger market (the world market).

When a country is participating to international and regional organizations this country is internationally accountable to its counterparts, a relationship that can work as an external anchor for that country in order to promote the necessary reforms and facilitate converge with the global standards in terms of trade and the business environment.

Keeping that in mind, in this dissertation we will examine various indicators from GDP growth rate, income and education to Foreign Direct Investments inflows and outflows, export and imports. Drawing examples from the political and economic history (a brief review) will add to further understanding how the political and economic environment have been formed while the efficiency of institutions and infrastructures will reveal further strengths and weaknesses of the country that affects competitiveness. Moreover the level of the international accountability of the county and the participation of Russia in various international organizations will be examined as participation in such organization can work as an external anchor for a country to promote reforms and thus to integrate to the world market. Key variables that affect the development of the Russian economy and the respective policies are the legacy of

the central planed economy that the country inherited along with its inefficiencies and the increase dependency of its economy on revenues from oil and gas exports. Exports and imports will be examined along with foreign direct investments, the quality of the labor force and technology.

### *1.3 Literature review*

This research is combining various authors' opinion and reports provided mainly by the Russians Federation statistical service, the Gaidar Institute, the World Economic Forum, the World Bank, the CIA fact book and the Organization for Economic Cooperation and Development. The dissertation will based primarily on various works of Anders Aslund (see references) as regards the economic and political history of Russia as well as the policies that Russia had implemented especially during the pre crisis period (until 2009). In that way we will be able to explore the political and economic environment of Russia, which is a determinant factor along with the country's reserves in natural resources, as well as the managerial practices that have been followed by the government and the firms. Various works of Professor Michael Porter (see references) as regards competitiveness and the concept of clusters within the context of his *diamond framework* will be used as a guideline in order to create the conceptual and the analytical framework that this work will follow in chapter 3. This choice has been made taking under consideration the analytical framework that had been followed be the World Economic Forum in order to create the Global Competitiveness reports and the Russian Competitiveness report (2011) as well as the fact that Porters approach is the most recent theory about competitiveness, it examines national competitiveness by multiple point of views and is generally considered as the most comprehensive and detailed approach. Moreover, Anders Aslund and Michael Porter have collaborated during the past with the Russian government and have provided works that assessed the economy and the political climate of the country for the sake of the Russian government. Data from the Doing Business Report and the Global Competitiveness report will be used as regards the macroeconomic and the microeconomic environment of the Russian Federation. Various indicators from the Russians Federation statistical service and the World Bank like FDIs, the trade balance, the goods that Russia imports and exports etc. will hopefully complete the research and contribute to the analysis of the Russian competitiveness.

## Chapter 2: The concept of Competitiveness

Competitiveness has a dynamic relationship with the economic conditions of a country as the one affects the other. This relationship is determinant for the development of the country therefore it is important to start this research by analyzing the concept of competitiveness and the way that it is applied to the Russian case.

### 2.1 Decomposing the concept of competitiveness

During the past, various attempts have been made in order to provide a comprehensive definition of competitiveness. According to the Organization for Economic Cooperation and Development competitiveness is defined as *“The degree to which a country can produce goods and services, under free and fair market conditions, which meet the test of international markets while simultaneously maintaining and expanding the real income of its people over the long run”*. The World Economic Forum gives its own interpretation according to which competitiveness is defined as *“a set of institutions, policies and factors that determine the level of productivity of a country. The level of productivity, in turn, sets the level of prosperity that can be earned by an economy. The productivity level also determines the rates of return obtained by investments in an economy, which in turn are the fundamental drivers of its growth rates. In other words, a more competitive economy is one that is likely to sustain growth”* (Global Competitiveness Report, 2012-13).

In an attempt to decompose these definitions it can be said that competitiveness is the ability of a country to manage a totality of resources (eg commodities) and competencies (eg education) to reach a goal of prosperity. As regards prosperity we can distinguish two components, an economic and a non economic. Economic prosperity depends on factors like GDP growth, industrial production, productivity etc. while non economic on factors like security, quality of life, sustainable development etc. Summarizing, we can provide a definition as regards the effects of competitiveness to a country and an economy. The role of competitiveness to the economy is to increase productivity and economic growth which in turn will give the country the necessary funds to pursue policies that will improve the quality of life for its citizens.

In its essence we can perceive competitiveness as an indicator that shows the level of dependency or better independency of a country which particularly applies in a globalized world. The ability of a country to successfully compete with other countries determines its viability and sustainability. As regards the economy, competitiveness is determined by the “assets” that a country has which in turn creates advantages for the subject of economic competition. Strong enterprises and organizations, sufficient institutions and infrastructures, the availability of factors of production (inputs) as well as good quality products and services can act as carriers of competitive advantage within and abroad the country.

The globalization of the economy has significantly change the terms under which countries were competing during the past and has increase the role of competitiveness as a mean to improve their economic performance. In that way competitiveness should be considered with regard to both internal and external markets. The majority of the countries have undergone reforms within the political and legal context in order to successfully achieve their economic targets. Hence, pursue of competitiveness engenders positive effects for countries in various fields and not only for the economy. A competitive business environment, labor force and managerial practices

as well as institutions and infrastructures are quite important to support competitiveness, raise the perspectives of a country as well as its viability and engender higher growth rates.

In an integrated global market, capital, firms and the labor force tend to seek the most profitable investments that only a competitive economy can provide therefore, without improving its competitive position a country can have only limited prospects for its future and can expect a possible deterioration of its economy. To put it simple the game is win or lose. By improving competitiveness a country can facilitate economic growth and productivity thus further improve its economy. Strategies pursued from the countries to achieve higher competitiveness should focus on improving their country's conditions in the long term and not temporarily and therefore increase its sustainability. In that way the results would not only affect positively the economy but also would guarantee the social and public welfare.

Complexity of competitiveness raises the need for a comprehensive analysis to a country's economic and political system. Competitiveness is the result of the interplay between the macroeconomic and microeconomic environment and significantly affected by the terms of trade and the factors of production thus an analysis which will embrace all this factors and examine their connection would be the most appropriate.

The role of central authorities is critical during this process and determines the ability of a country to compete or not in the world market. The necessary reforms as regards the legal system should be promoted in order to facilitate transactions between the firms, reduce their cost and let the firms interact with each other. Within a sound legal environment firms are able to organize their strategies in a way that they would be able to predict the outcomes and thus produce more efficiently. Abolition of entry and exit barriers to the market, protection of property rights, regulation against monopolies, reduction of bureaucracy, and fight against corruption will improve transparency and facilitate the transactions between the firms thus lead the economy to operate more efficiently. Policies that focus on innovation and technology will help firms to reduce their cost and produce more sophisticated products that would be appealing to consumers across the globe. Excessive state intervention will distort market rivalry and create imperfect competition that will undermine the country's competitiveness.

Toughening of competitive conditions to the world industrial development had led to the deployment of an expanded theory for the national competitiveness, a theory that have been developed by Michael Porter and the World Economic Forum since 1990<sup>1</sup>. Porter pays special attention to economic policies, being able to strengthen competitiveness of a country or undermine it. The success of a country to compete in the international arena is affected not only by the factors and how productively they are applied, but by the facts as well, those special conditions and circumstances that occur during this process.

The diamond framework, that introduced by Porter, shows the four interrelated aspects of the business environment in a country. *Related and Supporting industries* highlight the presence or absence of internationally competitive suppliers and related industries within the country. *Demand conditions* describe the quality of demand. *Factor Conditions* has to do with the availability and the quality of factors of

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<sup>1</sup> Dimitry V. Kuzin, *Competitiveness of Russia: Problems and perspectives*, Pecunia, 4 109-142, 2007

production. *Firms Strategy Structure and Rivalry* describes the business environment of a country, how companies are created, organized and managed and the nature of domestic rivalry. The macroeconomic and the microeconomic environment should be developed in parallel as those levels are closely interrelated.

According to Porter (and WEF) there are three stages of economic development. The lowest stage has to do with factor driven economies. The comparative advantage of business in this stage is low input cost, products are more simple and technology is gained by positive spillovers occurred from imports, FDIs and imitation. The second stage is the investment driven stage where the competitive advantage of firms is the efficient production of standard products and services while technology is gained through licensing, joint ventures, FDIs and imitation. To reach this stage investments in infrastructures are necessary and government should provide incentives for investments by developing a business friendly environment and guarantee easy access to capital. The final stage is the innovation driven stage where business and services should use advanced technology to produce innovative products. In that stage the country has a strong business environment and clusters. The World Economic Forum describe those stages as the factor driven stage, the efficiency driven stage and the innovation driven stage.

According to Porters definition, the cluster *is a geographically proximate group of interconnected companies and associated institutions in a particular field, linked by commonalities and complementarities*. Based to that definition firms are formed around closely related industries and supporting industries, in limited areas and interact with institutions. In that way cluster development cause the development of the respective region that the clusters have been deployed and the intra-country trade between the regions will allocate wealth among the regions. It is important here to note that although Porte have developed his cluster theory as regards the national competitiveness the regional dimension is crucial and the theory can be applied by putting regions into the core.

## 2.2 The case of Russia

There are many studies that have been conducted as regards the Russian economy and the assessment of its competitiveness. Russia represent one of the cases that researchers have been focused in large extend to political social and cultural criteria in order to analyze and assess the performance of the country as regards competitiveness. These works provide useful data for the condition of the country but a research in the micro level is necessary to highlight and describe the context in which firms interact with each other and compete and thus provide a comprehensive and complete country profile. Under which conditions the business environment of the country have been formed during all these years, what is the state of the economy right now, the implication that have been occurred after the 2008 economic crisis and what are the perspectives for the future. In other words what have been done till now or better what have not and should be.

As regards the assessment of the Russian economy until now the answer seems to be clearer comparing to the recent past. It was debatable if the huge economic growth, the fiscal surpluses and the reforms that have undergone since the beginning of 2000 were fairly enough to outweigh the government intervention and the distortions that in turn have been created for the economy (a relatively unfriendly business environment).

The government intervention in the economy and especially in the energy sector, the high oil prices and the constant appreciation of the ruble have been positioned to

the center of this criticism as regards the successful economic development and fiscal stabilization of the country. The criticisms as well as the perspectives of the country are better depicted and summarized in one question: What beyond oil and gas. It is true that without the abundant reserves of natural resources it would be impossible to imagine Russia as it is today, within the same political, economic and social context.

The huge economic growth of the country during the past years (since 2000) reemerge Russia as an important player in the international arena. That fact brings to the surface another important question as regards the perspectives of the country for the future, a question that the Russian government should take under serious consideration while assessing its performance: What does Russian want to be. I believe that been possible for a country (as it is for Russia) to answer this question, under the current global condition, with a “relative freedom” and based on its own strength is a luxury that not many other countries enjoy. Indeed, the economic crisis in 2008 had caused a devastating blow to various economies while in many others, development and growth have been suspended. Many transition economies have increased their dependency on foreign funds from the most developed countries which in turn they had to face their own problems as well.

Although the hit to the Russian economy was severe (eg FDI inflows have been reduced to about half in 2009, while the country had a negative growth rate, -9) the country was able to overcome the crisis, by using cash reserves coming from the Stabilization Fund, and maintain positive growth rates for the next years due to the high oil prices (although both had significantly reduced). Moreover Russia had made significant steps during the post crisis period to improve its business environment by promoting reforms that will improve the competitiveness of the country.

Russia is currently on the investment driven stage but according to the description given to the subchapter 2.1. for the three stages of economic development the country still lacks in many of these fields. Incentives for investments are weak as well as the business environment (eg. Law on Foreign Investments in Strategic Industries is very restrictive for foreign investors) while FDI inflows have been dramatically reduced in 2009. Russia should focus on improving its performance and fix its weaknesses while a strategy towards innovation is necessary for the future development of its economy.

Russia had mainly developed clusters that are related to the natural resources sector. The combination of the vast land mass, relatively low population density, and significant deposits of various natural resources, often located in areas with a very inhospitable climate had as a result the emergence of the one company town phenomenon which creates monopolistic trends and hamper competitiveness.

In order to asses economic performance of the country a deeper analyses is necessary to reveal the point that the economic growth is intersected with the concentration of economic and political power in the hands of the central government and the intervention of the government to the economy. The strong political intervention of the Russian government in the economy is a critical factor that has driven the development of the country since 2000 hence, it is important to focus this research within this context.

## Chapter 3: The development of the Russian economy

In order to assess the competitiveness of Russia an analysis of the Russian history from the dissolution of the USSR until the financial crisis in 2008-2009 will follow. By examining the background of the country we will be able to understand the interplay between the macro and micro level. Valuable information will be given, as regards the development of the macroeconomic environment of Russia, that explain up to a point the current condition of the country. Major reforms that had undergone during that period were determinant to create the framework under which the business environment had been formed and continue to operate until today.

### 3.1 *The post soviet era*

The dissolution of USSR in 15 post Soviet states, on 25 December 1991, was meant to be the first step towards the adoption of the democratic values. Russia's thousand years of history have been marked by multiple authoritarian regimes, tsars, oligarchs and monarchs and a constant fight to preserve the status quo within and outside the country. A culture forged with brutality and poverty, a legacy, following the steps of the country like a shadow and can explain, up to a point, the political and economic conditions from 1991 onwards.

Since the collapse of the Soviet Union Russia has undergone significant changes to its economic regime and the competitiveness of its market. Moving from a centrally planned economy, characterized by isolation and protectionism, to a more market based and globally integrated economy, a process that was rather difficult during the first decade and brought the country many times in the verge of collapse, Russia proved that it's hard to die. Since the end of the 80s and under Michael Gorbachove and Borish Yeltsins presidency Russia implemented a rather ambitious program to liberalize its economy, privatize its industries and integrate to the world market.

It was obvious back then that the globalization process and the formation of a world market economy started with the end of the Cold War had rose the pace of progress in various countries (notable the western countries) and increased the local markets dependency with each other. It would be impossible for Russia to catch up with the rest of the developed countries by maintaining the previous regime, a centralized, isolated and obsolete economy. The need for a former super power to place itself among the "league of the strong's" emerged as a necessity if the perspectives of the country were to actively participate in the new era, rather than draw back and see the whole world change outside its "closed" borders.

In June 1991 Borish Yeltsin was elected as President of Russia in the first direct presidential election in Russia history. Following the pressures from the West and in front of the dissolution of the centrally planned economy Yeltsin proposed a very ambitious program of market reforms (previously rejected by Gorbachove) towards the liberalization of the economy and macroeconomic stabilization. The so called *shock therapy*<sup>2</sup> approach have been adopted with three major elements: trade and market liberalization to allow the market re allocate resources, a stabilization program to suppress inflation and mass privatization of state owned enterprises to attract investments. The program fully implemented by 1994 and although the notable effort the program, as it was proven, was unmanageable and unsuccessful in the short term.

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<sup>2</sup> Oleg T. Bogomolov, *Russia facing the challenges of the twenty-first century*, Blackwell Publishers, UNESCO 2000

The reasons were mainly because of Russia's heritage and the absence of efficient and functional institutions that could be the vehicle to support a successful transitions process<sup>3</sup>. The Russian Government made extensive use of state control and intervention in the economy while the state apparatus suffered from sluggishness, bureaucratic practices and corruption. President Yeltsin succeeded to destroy old institutions but failed to develop effective democratic alternatives. New institutions needed to support a new market oriented system such as laws, regulation and their enforcement, as well as business practices and rules. State level policies are essential to provide the appropriate institutional framework which is necessary during the implementation of the transition process to support and regulate the business environment. The shock therapy reforms didn't fit the specificities of Russia while a slower transition process (gradualist economists or institutionalist approach) would have given the time to the Russian government to address its weaknesses and thus develop the appropriate institutional framework.

Yeltsin depended heavily on the support of various interest groups. Without creating new institutions the government wasn't able to facilitate information flows thus all the transactions were based on personal relationship rather than formal rules creating a model that had its reliance on networks<sup>4</sup>. That excessively bureaucratic model combined with the lack of information had as a result corruption and lack of transparency which were running through the system. That was apparent during the privatization process<sup>5</sup> where the majority of the shares were acquired by insiders (firm managers). The managers had the necessary information (good relationship with public officials and knowledge of the bribing system) and by taking advantage of "legal gaps", they managed to acquire the majority of the shares in prices lower than the actual value of the company and in the most cases by following non transparent procedures (bribes).

The results of the privatization process was the emergence of a new oligarchy composed by the firms managers of the previous regime, that exercise the power that they gained for their own benefit and the most of the time opposing to the general welfare and the development of the country. The emergence of a new oligarchy by the much criticized "loans-for-shares" scheme had as a result a highly concentrated equity ownership. Russia was an overindustrialized country while the enterprises were predominantly large scale and mechanized hence the power that managers acquired after the privatization process was rather strong and they could easily exercise pressure to the government to achieve favourable policies. Keeping that in mind, it is easy to understand how difficult was for the government to implement its reform program while every attempt was facing strong resistance from the powerful oligarchy.

The result of that was the high level of inflation during that period. High inflation occurred due to the massive and excessive credit growth of the Russian government primarily to subsidize the enterprises under the managers procures. In other words the funds for the enterprises was actually coming from the budget that in turn were supporting from foreign financing drawing the country into a vicious circle that

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<sup>3</sup> Eric Berglof, Andrei Kunov, Julia Shvets, Ksenia Yudaeva, *The new political economy of Russia*, MIT Press, 2003

<sup>4</sup> Sheila M. Puffer, Daniel J. McCarthy, *Can Russia's state managed, network capitalism be competitive? Institutional pull versus institutional push*, *Journal of World Business* 2007, 42, 1-13

<sup>5</sup> *Mach privatization voucher auction: 1991-1994, Loans for shares: 1994-1998*

*Many sectors of the industry and agriculture have been privatized during that period except the energy sector (as well as the defense related sectors) which remained state owned.*

increased its debt. Managers had used their power and their influence to the government to establish and maintain this regime. The managers continued to implement their obsolete, inefficient managerial techniques and combined with the absence of FDIs (which remained quite low for many years) deprived the economy from positive spillovers (technological and managerial) that would advance the economy and firms.

The shock therapy reforms lead the country to its economic collapse, the first half of 90s. The GDP declined by 50% and the productivity was cut to less than half. Rent seeking and unclear property rights (strong resistance from the managers to promote reforms) were major problems for the country as well and had worsened the countries profile to foreign investors. The structures of exports were based on fuel and energy which are the main revenues of the country till now thus the population depended on imports for about half of its food and other goods. Because of the concentration of the economy the gap between poor and rich become wider, poverty reached almost 50%, life expectancy fall and the country experienced mass unemployment. Because of the crisis billions in cash and assets flight the country<sup>6</sup>. The depression of state and economy led to the collapse of social services. Moreover Russia had took up the responsibility for settling the USSR's external debts, causing high budget deficit and resulted the financial crisis in 1998 deteriorating the situation.

Since 1999 and against all odds Russia made a tremendous reversal that meant to be the beginning of a period characterized by huge growth and development. In 2000 Vladimir Putin won the presidential elections and adopted a very ambitious reform program. The period under Putin's presidency have been characterized by the recentralization of power to the hands of the state<sup>7</sup>. Putin choose this path to deal with the oligarchy problems that have been caused during the previous period.

The devaluation of the rouble that had been caused because of the crisis, combined with the rise of world oil prices<sup>8</sup>, had as a result a huge growth for the Russian economy which was primarily based on natural resources exports. The GDP growth rate was 10 in 2000 while the following years till 2009 the average was about 7 and 4 till 2010 onwards (in 2009 was the only year that fall to -7,8 because of the economic crisis). Large current account surpluses have brought a rapid appreciation of the rouble. Tax revenues have been increased, as well as export revenues, and the government was able to finance the deficit and repay the foreign debt.

There are many authors that disagree as regards the importance of Vladimir Putin election and focus mostly on the high oil prices that brought tremendous revenues for Russia (a country based on oil and gas exports) to foster its economy. Although up to a point that's indeed true, Putin's role was without a doubt critical for the development of the country. The first step that brought significant changes was the restriction of the oligarchy which during the past decade had gained such a power that were able to manipulate policy decisions crucial for the Russian economy. Putin power wasn't the outcome of the bargaining with the oligarchs or various political powers but was directly coming from the people. Although the policies followed since then (we focus primarily on political and economic aspects) were much criticized as regards their accordance with a free markets economy values and the possible effects that their respective alternatives (policies) would have, its beyond doubt that had a positive effect for Russia.

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<sup>6</sup> Trade liberalization that was implemented during the shock therapy reforms resulted the abolition of constraints as regards cash transfers

<sup>7</sup> Concentration of power in the hands of the executive and legislative cooperation

<sup>8</sup> Oil and gas dominate Russian exports, so Russia remains highly dependent upon the price of energy

### 3.2 The economic “boom”

In 2001 the government announced a development program that of 45 billion rubbles to improve the judicial system as regards corporate governance and protection of private ownership, and further improvements as regards technology and infrastructures over a 5 years period. A profound tax reform took place till 2002 where the number of taxes reduced significantly and a more liberal tax system were introduced. The state financed schools and provides free education for at least 9 years for all children's. The number of student's at all educational levels had increased as well as the number of teachers and university professors.

At this point it is important to note that during that period, the improvements in the business environment and the rise in investments were based on perceptions for the development of the Russian economy than on real changes. These perceptions had been reinforced by the government's determination to control inflation and reduce public debt, a perception of greater political stability and policies oriented towards lower business taxes and market friendly reforms<sup>9</sup>. The reforms were implemented later, thus the conclusion is that the rise in the investment activities led to the implementation of the reforms and not the opposite as it should be. As about the tax reforms which was one of the most popular institutional changes during Putin's period, tax inspections remained burdensome mainly because they have been utilized as a tool to the hands of the Russian government to intervene the economy as it have been shown in the Yukos affair.

The Yukos affair was the prosecution of Mikhail Khodorkovsky, former CEO of the oil company Yukos, in 2003 along with other managers of the firm and the final bankruptcy of the company with the accusation of tax fraud. The case had been much criticised as regards the validity of the accusation as Yukos oil was the first company in Russia that had adopted a series of measures to converge with western companies' standards and increase transparency to its procedures. Among others, Yukos introduced corporate transparency, adopted western accounting standards, stopped using transfer prices and paid substantial taxes from 2000 while the owners of Yukos revealed their actual ownership and the company was the first that had been introduced to the stock market. Moreover the company was the second largest taxpayer in Russia behind the state owned Gazprom and the first among the private owned companies. The actual reason why Khodorkovsky end up in jail was because he pursued a series of activities that directly threatened Putin's regime and came up against the policy lines followed by the Kremlin. When Putin came into power he drew a red line between the oligarchs. Putin's “golden rule” was simple and clear *do not interfere into politics*. In that way Putin had made it clear that if the oligarchs would decide to undermine his regime and do not follow the policy lines that had imposed by the Kremlin they would be harshly punished. By advocating the construction of two pipelines that would break Transneft's monopoly, criticizing Gazprom's monopoly in its gas pipeline system, accusing Putin's regime for involvement in non transparent activities that hampers competitiveness and supporting (financially) Putin's political rivals, Khodorkovsky had clearly violated Putin's “golden rule”. The Yukos affair brought to the surface fundamental weaknesses of Russia like the weak legal framework and the poor protection of

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<sup>9</sup> Asland, Anders and Kuchins Andrew. *The Russian Balance Sheet*, Peterson Institute for International Economics Center for Strategic and International Studies, 2009.

property rights, a legislature that is subject to political pressure and interference and the interference of state to the economy and the private sector<sup>10</sup>.

After the implementation of the announced reforms during the first period of Putin's presidency and the bailout of Russia's foreign debt, on 1 January 2004, the Stabilization fund of the Russian Federation was established to support Russian economy in case of a sudden decrease in oil prices (and generally, provide liquidity to support trade activities in case of a crisis) and proved to be essential for the Russian economy in order to overcome the 2009 crisis.

The Federal Law No. 135-FZ is the Russian competition law and came into force on 26 October 2006 to regulate antitrust issues and protect competition while in January 2012 the 3<sup>rd</sup> antimonopoly package entered into force and brought significant changes in order to further liberalize the antimonopoly regulation and bring Russia more in line with the European competition regulations. Moreover, by recognizing cartels as a major problem for the competitiveness of the country, the government updated the respective legislation, in order to be more comprehensive and specific, with amendments to article 178 of its criminal code. A set back to these legal reforms were the Law on Foreign Investments in Strategic Industries that came into force on May 2008 and it's a clear turn of the Russian government towards protectionism. According to that law 42 sectors have been identified as increased strategic importance, among them the natural resources sector and various sectors that had to do with the defence sector. Although, and as regards the private activities in those sector, the respective law was very restrictive and ratified the political intervention in those sectors it is a step towards improving transparency by providing a clear, formal legal framework in which foreign investors were able to deploy their activities.

In general between 2006 and 2008 and after the successful implementation of the reform programs that have been announced during the first period of Vladimir Putin, the status of Russia had significantly increase as well as the social welfare and the country were more attractive for investments. Till 2008 the industry grew by 75%, FDIs increased more than 8 times from 2003 with a flat tax rate of 13% (2<sup>nd</sup> most attractive in the world). Real incomes more than doubled and the average salary increased eightfold. Unemployment decreased from 10,6% in 2000 to 6,3 in 2008 while the % of the population under poverty line decrease from 40% in 2000 to 13% in 2010. That combined with an increase to the labor force (increase in birth rates) was a major source for the country's economic growth. Oil, natural gas, metals, and timber account for more than 80% of Russian exports while the external balance of payments is positive. From the other hand the increased dependency of Russia growth to revenues from oil and gas exports had lead the country to import more products to support its underdeveloped manufacturing sector. Notable, imports in machinery and equipment are rather high a fact that indicates an uncertain future for the country's economic growth (see the Dutch Disease in next chapter).

Improvements in the business environment attributed primarily to macroeconomic stabilization, the growth of confidence on the Russia's business community and the rewards (mainly access to cheaper credit-loans) available to large Russians companies

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<sup>10</sup> Aslund Anders, *Russia's Capitalist Revolution: Why market reform succeeded and democracy failed*, Peterson Institute for International Economics, 2007

from adopting international managerial *good practice*<sup>11</sup> rather than legislation reforms thus the dramatic drop of FDIs inflows in 2009 can be attributed to that.

The program *Russia 2020* was introduced in 2008 by Vladimir Putin and encompassed a large number of goals towards 2020<sup>12</sup>. The program examined three alternative scenarios for the development of the economy while substantial focus have been given to innovation, regional development, human capital and revenues from natural resources exports as the key factors that would drive the economy. Putin recognized that increased dependency in revenues from natural resources were not enough for a country that targets to keep up with the leading economies. Moreover, Putin stretched the need for further reforms to modernize the Russian economy. The program as it was proven was based on assumptions and aspirations. The financial crisis (2008) revealed this weakness and the need for a more comprehensive and well organized strategy became imminent.

In 2012 Russia started to implement a more coherent and organized strategy towards 2023. Privatisations are currently undergone<sup>13</sup> while reforms to the legal framework target to improve protection of property rights. The government stretches the need for systemic changes aimed at creating a competitive knowledge and high-technology economy. Russia seems to realize that a policy turn to promote innovation is the only way at this stage, to increase productivity and economic growth<sup>14</sup>.

The economic and financial crises started in 2008, had caused a tremendous blow to the Russian economy (as well as the most western countries). Although Russia was able to overcome this hit by using the huge amount of cash reserves that had stocked for such cases, the result of the crises seems to undermine the Russian economy in the long term. The 2008 crisis revealed the weaknesses of Russia, weaknesses that the Russian government, although a bit delayed, seem to understand. Although the country had built a reliable profile to the business circles outside the country, after the crises the country experienced a slowdown of its economy which indicate that a more stable business environment is needed.

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<sup>11</sup> Asland, Anders and Kuchins Andrew. *The Russian Balance Sheet*, Peterson Institute for International Economics Center for Strategic and International Studies, 2009.

<sup>12</sup> Asland, Anders and Kuchins Andrew. *The Russian Balance Sheet*, Peterson Institute for International Economics Center for Strategic and International Studies, 2009.

<sup>13</sup> excluding joint-stock companies and enterprises which are included into the list of strategically important organizations, notable the mineral sector and defence industry among others

<sup>14</sup> Gaidar Institute for economic policy, *Russia economic Development*, No.8 2013

## Chapter 4: Assessment of the Russian competitiveness

In the previous chapter we examined the development of the Russian economy since the collapse of the Soviet Union. Major reforms that have been undergone since then have been cited in order to understand the framework under which the macroeconomic environment has been developed. At this chapter an analysis of the factors of production, endowments (as defined by Porter) and trade will follow as key variables that affects competitiveness while international accountability will be added as it is a determinant factor that particularly applies in a globalized world. Conclusions will be drawn, based on the information have been given in the previous chapter and will be cross examined by using the Russian Competitiveness Report (2011) and Index (2012) as well as the Doing Business Report (2013)

### 4.1 Endowments

In this subchapter an analyses about the endowments (based on Porters definition) of the Russian country will follow. The history of the country, the geography and natural resources are not the result of policies but they are essentially given<sup>15</sup> and can provide a significant advantage (or disadvantage) for the development of an economy. The strength and weakness of Russia are primarily attributed to these factors.

#### 4.1.1 Legacy

In the previous chapter, an analysis of the Russian economic development since the dissolution of the Soviet Union has been given. The main problems that the country faces today have their roots to that period (1991-1999). The practices of the centrally planned economy seem to be injected to the “new” Russia so we can talk about a systemic problem. Reforms had undergone since then (mentioned before) but they seem too weak compared to those problems. The state apparatus had traditionally been suffered from corruption, bureaucracy and high presence of networks while bribes and favouritism prevail until today and hamper the business activities. Weak protection of property rights, income inequality, inefficient management and business practise are the main problems that Russia inherited and face until today. Monopolies prevail in the business environment (result of the privatization process) and cause a direct hit that undermine the competitiveness of the country. Government and companies strategies are based on political criteria rather economic efficiency, sustainability and profit criteria.

However, Russia has a long tradition as a highly industrial country thus enterprises are predominantly large scale and mechanized and the labor force is relatively skilful. Moreover the country traditionally is paying too much attention on education which leads to high levels of participation among the population, especially in tertiary education. After the economic boom in 2000 many scientists that had left the country repatriated composing an academic community with highly educated scientists and engineers. The country has inherited a large number of research institutes as well.

During the past, the legal system has been formed to serve the central government. It was not independed and had been used from the political leadership as a tool. The absence of democratic history and values are the main reasons why the people in

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<sup>15</sup> Michael E. Porter and Christian Ketels, *Competitiveness at the Crossroads: Choosing the Future Direction of the Russian Economy* (2007)

Russia support a strong government that intervene to the economy and the judicial system, while foreign investors are treated with scepticism from the population.

#### *4.1.2 Geography*

Russia is a country with a vast area of 17,075,400 square kilometres and the largest country in the world. That solely indicates that development of an effective regional governance, regional institutions and efficient infrastructures are necessary for the development of the economy. Through the history Russia had developed a strong central government which was exclusively responsible for the decision making thus the local authorities have staid underdeveloped and unable to promote and manage regional policies. An effective regional policy is needed that would be able to support the business activity especially in distant areas. Social services, education and health don't have the same impact on all regions though major reforms have undergone since 2000. Another factor that exacerbates the regional divergence is the geographical concentration of extractive activities in the Urals and of business services and public administration in Moscow. Nevertheless, the vast area of Russia is a comparative advantage for the country as the size of its market is significantly larger than other countries. A large market size raises productivity as it enables businesses to realize economies of scale and it's quite attractive for foreign investments.

Although Russia has borders with Europe and Asia, the country haven't developed trade routes that would unite East and West thus deprived the country from economic benefits<sup>16</sup>. The relationship of Russia with neighbour countries aren't the best possible and have deteriorated after the war in the South Ossetia<sup>17</sup>. Russia has signed regional trading agreements with some of its neighbours but still greater effort is needed to realize its potentials (especially in a diplomatic level). The accession of Russia to the WTO (2012) may influence positively the country's relationship with its neighbours.

#### *4.1.3 Natural resources- The Dutch Disease*

Russia's huge economic growth during the last years was based almost exclusively on gas, oil and mineral exports. According to the Russian Competitiveness Report for 2011 Russia had the largest share of oil and gas reserves in the world with 5,6% and 23,7% respectively. As we have mentioned before Russia's huge economic growth was primarily based on export revenues from oil and gas. This dependence on primary commodities rose questions about the advantages that this strategy has in the long term for the economy, a phenomenon called the Dutch Disease.

In general this phenomenon describes the disadvantages that may occur, as regards the development of the manufacturing sector (decline) in countries that experience an abundance of natural resources<sup>18</sup>. The rising output and exports of primary products (natural resources) especially combined with high world prices for those products (as in our case) bring high revenues to the country, which will experience an economic "boom". This may cause problems as regards the investments decisions and particularly the capacity to use those profits for investments. Investment interests shifts to natural resources extraction as well as the service sector, thus the manufacturing sector may suffers from stagnation. Moreover, in the long run, the

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<sup>16</sup> Michael E. Porter and Christian Ketels, *Competitiveness at the Crossroads: Choosing the Future Direction of the Russian Economy* (2007)

<sup>17</sup> Asland, Anders and Kuchins Andrew. *The Russian Balance Sheet*, Peterson Institute for International Economics Center for Strategic and International Studies, 2009.

<sup>18</sup> Edward M Graham, Mina Oding Paul JJ. Welfens, *Internationalization and economic policy reforms in transition countries*, Springer Berlin, 2005

stock of these resources is reduced thus the operations to extract those resources have to move to less accessible resources that require higher technology equipment. Because of the stagnation in the manufacturing sector the equipment must be imported thus the necessary investments increase. The resource sector is not very “labor intensive” thus unemployment may rise as well as poverty. State interference in the economy, high inflation, expansion of the service sector and appreciation of the currency are some other characteristics of this phenomenon. In the long run, investments may decrease because of state interference causing lack of capital which is necessary to buy the equipment for extraction thus the extracted natural resources will be reduced. That combined with an infant manufacturing sector may cause an economic crisis.

In the case of Russia there are some similarities with that phenomenon, but in general the characteristics of the Russian economy indicate that the country is still not suffering from serious problems. According to Kolenikov and Shorrocks<sup>19</sup> natural resources is one of the main reasons that determine the poverty level of each region in Russia. Population close to natural resources (at the Urals) experienced high revenues, as the oil and gas cluster is the most developed in Russia, thus the gap between poor and rich people increased as well as regional inequality. From the other hand the country had experienced a general rise in income because of the high international oil prices, which caused increased revenues for the country and rise in the wages. Combined with a successful social policy since 2000, the general income level of the population significantly increased. The appreciation of real exchange rates caused reduction as regards employment in the manufacturing sector and increase in the service and energy sector respectively. Opposing to the Dutch disease theory production in the manufacturing sector is increasing (although slightly<sup>20</sup>) while the country manage to decrease the economic importance of natural resources as the internal market strengthened<sup>21</sup>. Facing higher tax revenues, the government increased its interference in the economy by increasing the consumption in non tradable goods (services) and by owning the majority of the natural resources directly (by owning percentage of the relevant firms) or indirectly (by owning the 100% of the Transneft pipeline network<sup>22</sup>) spend an amount of those profits to establish this regime. Because of the fear that the Russian economy will become too dependent to natural resources, government started to accumulate foreign exchange reserves (526,172 million US\$ coming 3d in the world) to prevent the nominal appreciation of the rouble in a financial crisis scenario as it happened in 2009. Although the oil prices remain high, after the crisis they had substantially reduced (140\$ in 2008<sup>23</sup> to 103\$ Sept. 2012<sup>24</sup>) hence the government need to diversify its economy and decrease its dependency on oil.

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<sup>19</sup> Kolenikov S. And A. Shorrocks, *Regional Dimensions of Poverty in Russia*, Mimeograph, 2001

<sup>20</sup> Based on the federal state statistic service of the Russian federation the production in the manufacturing sector in 2011 was 106.5 as % of 2010 and increased in categories related to the natural resources cluster

<sup>21</sup> Victoria Dobrynskaya, Edouard Turkich, Economic Diversification and Dutch disease in Russia, *Post Communist Economies*, 2010 ,22:3, 283-302

<sup>22</sup> Through the Transneft network the Russian government control almost exclusively all the transportation of oil

<sup>23</sup> <http://www.rff.org/Publications/WPC/Pages/The-2008-Oil-Price-Shock-Markets-or-Mayhem.aspx>

<sup>24</sup> Gaidar Institute for economic policy, *Russia economic Development*, No.8 2013

#### 4.2 Trade

Exports and imports significantly affect productivity and enhance competitiveness. The globalization process has increase the importance of trade activities. Through exports firms have access to a significantly wider market while imports bring goods that are not domestically produce, provide access o foreign technology and increase the levels of rivalry in the domestic market.

As we can see from the chart below the external balance of trade as a % of GDP is positive since 2000 with a downward trend after the economic crisis in 2009. The main reason for that is as we can see the decrease of the export contribution to GDP. Porter based on data developed at the Institute for Strategy and Competitiveness<sup>25</sup> attribute this fall in exports as % of GDP to the fact that Russia has lost share in the world market, in many clusters inside and outside of natural resources. Russia is a trade oriented country and the huge economic growth that the country experienced since 2000 is based on revenues from oil and gas exports. International commodity price of oil, until 2008, was rather high, but after the economic crisis, the oil price had fall enough, to affect the external balance of Russia and reduce its trade surplus.

**Table 1**

External balance %of GDP					
2000	2002	2004	2006	2008	2010
20	10,8	12,3	12,7	9,2	8,3
Exports of goods and services % of GDP					
44,1	35,2	34,4	33,7	31,2	30,0
Imports of goods and services % of GDP					
24,1	24,5	22,2	21,0	22,0	21,7
Source: UNECE and Rosstat					

In the *natural resources* sub-chapter a description of the Dutch Disease phenomenon have undergone. Natural resources are not endless thus year after year Russia must proceed to less accessible reserves of natural resources. Indeed since 2005-2006 the quantities of natural resources that were extracted remained relatively stable, while the rise at the contribution of *mineral products* (as we can see below) to total exports and the high revenues for the Russian government were due to the increase in international oil prices. The volatility of the international oil prices is an imminent threat and since Russia can't control them, an alternative source of revenues is necessary to strength its economy.

As regards the terms of trade, during the past and before its access to the WTO Russia was following practises towards protectionism, practises which reflected political considerations. A typical example is the case of Georgia and the war in south Ossetia. Russia had introduced in 2008 trade sanctions as regards imports and exports with Georgia as well as with Ukraine, Turkey and USA which supported Georgia against Russia. Three indicators that are given by the World Bank support the argument that Russia was not as free as other developed economies (as regards trade) and was following policies that hampered free trade in order to protect its domestic

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<sup>25</sup> Michael E. Porter and Christian Ketels, *Competitiveness at the Crossroads: Choosing the Future Direction of the Russian Economy*, 2007

market. The share of tariff lines with international peaks as % of all products is an indicator which shows how selectively tariffs are applied and in 2011 was 20,6% for Russia. The share of tariff lines with specific rates as % of all products, is an indicator that shows the extent to which countries use tariffs based on physical quantities or other non ad valorem measures and in 2011 was 19,7% for Russia. The simple mean applied tariff is the unweighted average of effectively applied rates for all products subject to tariffs and calculated for all traded goods and it was 7,5% in 2011 for Russia. Compared to the most of the developed countries that were members of the WTO, Russia's scores were quite negative (in many cases they were more than 5 times higher). Although the accession of Russia to the WTO is expected to have positive effects for the country, as the country was forced to comply and converge with the WTOs regulations and thus increase its credibility, the structural weaknesses that the country still face pose an imminent threat as regards the ability of its domestic products to withstand the rivalry of the respective foreign.

**Table 2**

Commodity structure of exports % of total								
	1995	2000	2005	2007	2008	2009	2010	2011
foodstuffs and agricultural raw materials (excluding textile)	1.8	1.6	1.9	1.8	2.6	2.0	3.3	2.2
mineral products	42.5	53.8	64.8	65.9	64.9	69.8	67.4	68.4
chemical products, rubber	10.0	7.2	6.0	5.6	5.9	6.4	6.2	6.2
leather raw materials, fur and articles thereof	0.4	0.3	0.1	0.1	0.1	0.1	0.1	0.1
wood, pulp-and-paper products	5.6	4.3	3.4	3.2	3.5	2.5	2.8	2.4
textiles, textile articles and footwear	1.5	0.8	0.4	0.3	0.3	0.2	0.2	0.2
metals, precious stones and articles thereof	26.7	21.7	16.8	16.3	15.9	13.2	12.8	12.8
machinery, equipment and transport means	10.2	8.8	5.6	5.8	5.6	4.9	5.9	5.4
others	1.3	1.5	1.0	1.0	1.2	0.9	1.3	2.3
Source: Rosstat								

Table 2 describes nine broader categories of commodities and their contribution to the total exports of Russia from 1995 to 2011. The category *mineral products* which include oil and gas contribute to Russian exports a 68.4 %. Important here is to pay attention to the categories *chemical products and rubber* and *machinery, equipment and transport means*. Their contribution to exports was significantly low since 1995 while until 2011 they had reduced by 50%.

**Table 3**

Commodity structure of imports % of total								
	1995	2000	2005	2007	2008	2009	2010	2011
foodstuffs and agricultural raw materials (excluding textile)	28.1	21.8	17.7	13.8	13.2	17.9	15.9	13.9
mineral products	6.4	6.3	3.1	2.3	3.1	2.4	2.3	2.1
chemical products-rubber	10.9	18.0	16.5	13.8	13.2	16.7	16.2	14.9
leather raw materials, fur and articles thereof	0.3	0.4	0.3	0.4	0.4	0.5	0.5	0.5
wood, pulp-and-paper products	2.4	3.8	3.3	2.7	2.4	3.0	2.6	2.2
textiles, textile articles and footwear	5.7	5.9	3.7	4.3	4.4	5.7	6.2	5.5
metals, precious stones and articles thereof	8.5	8.3	7.7	8.2	7.2	6.8	7.4	7.1
machinery, equipment and transport means	33.6	31.4	44.0	50.9	52.7	43.4	44.4	48.0
others	4.1	4.1	3.7	3.6	3.4	3.6	4.5	5.8
Source: Rosstat								

These two categories represent products that produced in clusters related to oil and gas cluster and thus it would be expected to present a relative development. This is a problem that points to the Dutch Disease phenomenon which it has already been described. As mention opposing to the Dutch Disease theory Russia presents an increase to manufacturing firms and their production but the sector is still underdeveloped and Russia should pay too much attention in order to avoid a deterioration of this phenomenon. As we can see to the table 3 imports in machinery, equipment and transport means are quite high and have increased through the years from 33,6 to 48,0. That is coming to further support the previous argument as the half imports of Russia are from that category. Russia should promote reforms that will strength its microeconomic environment and will help to develop its manufacturing sector.

#### 4.3 Factors of production

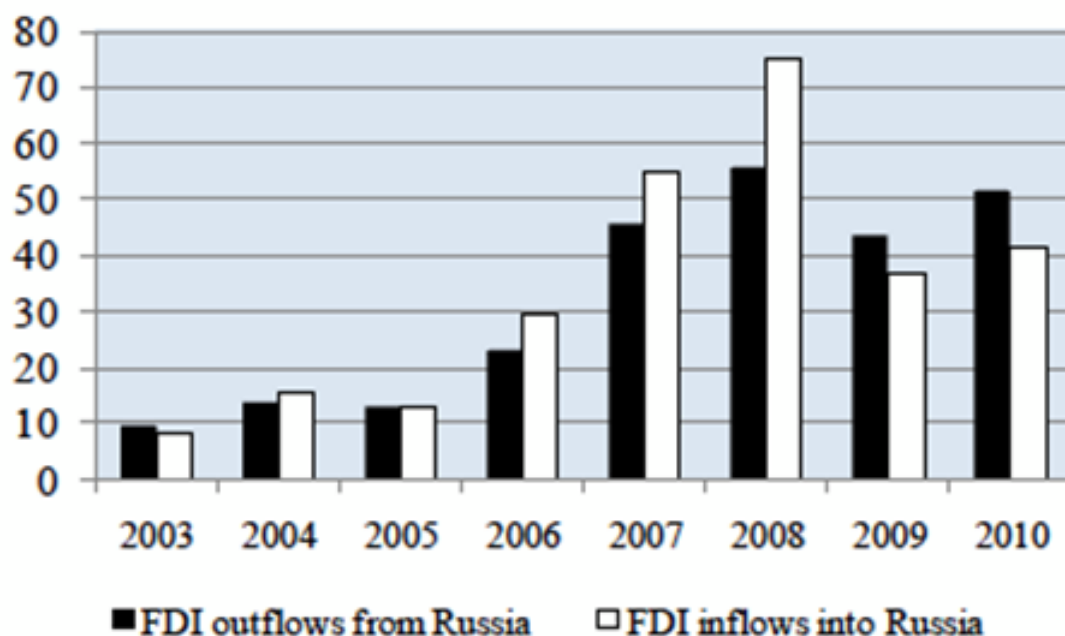
The inputs to the production process, the so called factors of production have widely been conscripted to evaluate productivity and therefore competitiveness as they determine the outputs in the production process.

##### 4.3.1 Foreign Direct Investments

In transition economies FDI inflows are usually not through *greenfield investments* (the establishment of a completely new firm in a foreign country including new operational facilities) but purchase of existing assets during privatization of state owned enterprises (*Brownfield investments* \ *Mergers*). Investors provide the necessary capital to restructure those firms which are able to adapt to the new market environment. FDI inflows generate positive spillovers, as they carry new technologies and managerial techniques that are essential for the development of a transition economy. In the long term products become more competitive to the global market thus the competitiveness of the country increases which in turn generates more revenues from exports. FDI outflows are important as well as they indirectly engenders positive spillovers for a country. Domestic firms that operate outside the country (especially in Western countries) promote reforms to meet the standards of the countries that operate as well as to join the stock markets and raise their funds. In that way they improve transparency and adopt good corporate governance practices.

**Figure 1**

#### **Foreign direct investment, US\$ billion**



*Source: Central Bank of Russia*

Figure 1 presents the FDIs inflows and outflows from 2003 to 2010 as regards the Russian case. Since the end of the cold war FDIs inflows in Russia were very low and the reasons were the poor protection of property and intellectual property rights as well as regulatory constraints. FDIs started to present a significant increase from 2006 onwards and helped the country to strengthen the internal market. Productivity of foreign owned firms, is higher in regions where reforms to the economy were greater. FDIs were essential for the development of the manufacturing sector. The significant fall of FDIs (reduced about 50% within a year) after the economic crisis should be taken under serious consideration by the Russian government as regards the development of the manufacturing sector (FDIs inflows account only 2,6% of GDP in 2012).

#### *4.3.2 Labor force and human capital*

Quality of human capital is a crucial factor as well because it determines the extent of the benefits to Russian firms of competition through FDIs. Positive spillovers are greater in more highly educated regions<sup>26</sup> and that is because a higher quality labor force is able to adapt and utilize better new technologies.<sup>27</sup> The high proportion of higher education graduates is related positively to the development of the country during the last years although the average productivity relative to labor costs is lower comparing with other countries like China and India<sup>28</sup>. Russia's manufacturing value added per worker is about the same with China and India. Its comparative disadvantage lies in its higher labor cost that indicates that the increase in wages is not accompanied by the respective increase in productivity.

Between 2005 and 2010 Russia's researchers were 3,092 full time equivalents per million<sup>29</sup> people which is rather high while the respective number of technicians (476) is quite low and point out the weakness that Russia has to create linkages between the academic community and research institutions and the market and industries. The relatively low labor productivity in the manufacturing sector can primarily be attributed to this relationship<sup>30</sup>.

#### *4.3.3 Technology and innovation*

In the fields of science, innovation and technology Russia had a notable performance since the age of Enlightenment during the 17<sup>th</sup> and 18<sup>th</sup> century. Russian inventors and engineers excelled in such areas as electrical engineering, shipbuilding, aerospace, weaponry, communications, IT, nuclear technology and space technology. During the 90s and because of the crisis the state support to such fields significantly reduced and caused a mass migration of the highly educated part of the population to the west (brain drain). Since 2000 and because of the economic boom that the country experienced the country launched a campaign, aimed into modernization and innovation. Many scientists returned to the country and the level of the higher education professors and students significantly increased. The aim of the government among others was to promote technological developments to improve the energy

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<sup>26</sup> Yudaeva K., Kozlov K., Melentjeva N., Ponomareva N., *Does Foreign ownership Matter? Russia Experience, Working paper, Center for Economic and Financial Research, Moscow 2001*

<sup>27</sup> Eric Berglof, Andrei Kunov, Julia Shvets, Ksenia Yudaeva, *The new political economy of Russia, MIT press, 2003*

<sup>28</sup> Rajm, Desul, Itzhak Goldberg; *Can Russia Compete?, Brookings Institution Press, 2008*

<sup>29</sup> *World Bank Indicators*

<sup>30</sup> *According to the RCR 2011 the quality of education in managerial schools (tertiary) is quite low because the underdeveloped industries of Russia deprived from universities the necessary feedback*

efficiency of the country. The modernization of the Transneft network increased the capacity of the network to transfer higher amounts of oil and help to the expansion of the network towards the west and the east as well bringing higher revenues for the country<sup>31</sup>. Aircraft manufacturing is one of the most science-intensive hi-tech sectors of modern Russian economy and employs the largest number of skilled personnel while the achievements of the country in the field of space technology are well known. Russia's inputs in terms of share of research and R&D investments are relatively high (among the highest along with Germany and S. Korea) but the output is low compared to other OECD countries<sup>32</sup>. Research activity had been increased after 2006<sup>33</sup> which can be attributed to the fact that till then Russia had already achieved the main targets that had set in 2000 and could focus to promote innovation as a key factor to further develop its economy. The low number of patent and trademark applications that had filed in 2011 (more than 12 times lower comparing to USA) can be considered as a problem as regards the research activities in the country and points out one of the major weaknesses that Russia has, the protection of IPRs.

#### *4.4 International accountability and external anchors*

International accountability is a type of accountability and establishes through a country's involvement in economic and political alliances, international agreements and organizations. Russia is participating among others in organizations like the World Trade Organization (WTO) as well as regional organizations like the Asia Pacific Economic Cooperation, the Eurasian Economic Community and the Shanghai Cooperation Organization. The accession of Russia to the WTO (22 August 2012) has raised concerns as regards the ability of the country to comprehend the necessary policy reforms and compete among the rest of the participants. The forthcoming benefits are that the country will increase its credibility and improve its international political position something that in turn may increase FDI's inflows which had significantly reduced after the financial crisis in 2009. WTO may work as an external anchor to promote reforms to liberalize the internal market thus the business environment become more competitive which in turn increase the competitiveness of the products. The problem of Russia is that it still needs institutional reforms that are essential to support the further liberalization of its economy. There are opinions supporting that the accession to the WTO may work indirectly as an external anchor to promote the necessary institutional reforms<sup>34</sup>. Without those reforms it's doubtful if the country will be able to strengthen its economy and the results may be exactly the opposite, hence the government should take this under serious consideration.

#### *4.5 Macroeconomic environment*

The stabilization of the macroeconomic environment is one of the biggest achievements of Russia after 2000. A successful and improved fiscal policy (based on oil and gas revenues) combined with the reforms that undergone during that period,

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<sup>31</sup> Anders Aslund and Andrew Kuchins, *The Russia Balance Sheet*, Peterson Institute for International Economics Center for Strategic and International Studies, 2009

<sup>32</sup> *Russian Competitiveness Report*, 2011

<sup>33</sup> *Strategic audit of the Russian Federation introduce in 2006 the Strategic Audit of the Russian Federation which consisted by various research activities that would asses the economic performance of the country and help the central government to deploy the necessary policies that would foster country's growth and development in the long term*

<sup>34</sup> From Eric Berglof, Andrei Kunov, Julia Shvets, Ksenia Yudaeva, *The new political economy of Russia*, MIT Press, 2003

was a significant step to improve the economic environment and make the country more appealing to investments (see chapter 3). Moreover the country was able to overcome the economic crisis in 2008-09 and avoid a “worst case” scenario that would lead to its economic meltdown. Although the impact was strong enough to slow down the economy, the country is still strong enough to restart and change its policies towards a more competitive economy. Indeed as we explained in chapter 3, the weaknesses of the country have been detected and further reforms are currently undergone to fix the problems.

The real GDP growth rate was 3,38 in 2012 and it has significantly reduced comparing to the past due to the crisis (in 2009 it was -7,82 and it was the only year since 1999 that was negative) while the GDP of the country in 2012 was around 2 trillion in US\$ and have doubled since 2006 and the current account balance is in surplus (5,3). In general Russia has a modest inflation and had reduced from around 12 before 2008 to 4,96 in 2012 which is quite low. The economically active population was 53% of total the total population in 2012 and only 5,5% of them were unemployed. The GDP per capita in PPP had slightly reduced in 2009 while in 2012 it had rose again to 23,501 and reached the pre crises levels. The total reserves rise till 2011 to 497,4 billion US\$ and reduced to 486,6 billion US \$ due to the reforms that currently undergone and fall in international oil prices. The rise in the total reserves is accompanied with a rise to the central government debt as % of GDP from 6,5 in 2008 to 9,3 in 2011. For 2008, the total public spending on education as % of GDP was 4,1 and 11,9 as percentage of the total government expenditures. Investments in transportation had significantly rise in 2012 to 4,2 billion. This percentage have reduced today because Russia decided to cut expenditures for education in order to rise the military expenditures from 3,7 % (of GDP) to 4,5 % (of GDP) in 2012.

As we observe there was a small fall to all this indicators due to the crisis that affects the general prosperity of the population. The numbers seem to rise after the crises but a general slowdown of the economy is the outcome of the crisis as we have mention before.

#### *4.6 Microeconomic environment*

In chapter 3 we have described the main reforms that the Russian government has implemented until now and in this chapter we have already mentioned the major strengths and weaknesses that Russia has. Here we will briefly summarize these data to see how they affect the business environment.

The weak microeconomic environment is a major challenge for Russia. All these years the government seemed to lack a coherent and competitive strategy to strengthen its microeconomic environment. Firms are operating under an inefficient and corrupt institutional framework. Administration is excessively bureaucratic which in turn decrease transparency and increase corruption. According to the WEF corruption is the biggest problem for investors and trade activities. Irregular payments and bribes associated with awarding public contracts and conduct import and export operations as well as public utilities and tax payments<sup>35</sup>. Russia has a very bad score in DBR 2013 in six out of ten indicators that measure bureaucratic procedures like the documents and the time needed to do business in a country. In two of them, Russia is among the countries with the worst performance. More specifically in *dealing with construction permits* Russia is ranked 178 out of 185 countries, the procedures that needed are 42 (the worst) and the days are 344. *Getting electricity* is quite

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<sup>35</sup> World Economic Forum, *The Russian Competitiveness Report 2011*, Geneva 2011

burdensome as well with 10 procedures (2<sup>nd</sup> worst) and 281 days needed, while the rank of Russia to the starting a business indicator is 101.

Weakly defined property rights are a problem as well. Acquiring land remains difficult for business especially for small companies due to administrative constraints while public authorities have limited capacity to enforce intellectual property rights. Moreover as we mentioned before the legislature is not independent and traditionally was a tool for the government to promote its policies.

As we mentioned before the labor force productivity, compared to other countries is a problem as wages are higher relatively to the outputs of production. The reason for that is because the universities are not well connected to the market and the underdeveloped manufacturing sector deprives the universities from positive spillovers (feedback). Inner company and vocational training should be prioritized for enterprises as a short term policy, while the development of a strong manufacturing sector is necessary for the long term.

The general rise in income and the exposure of the Russian market to the global market through imports has altered consumers preferences towards more sophisticated products, which in turn increase the rivalry to the domestic firms.<sup>36</sup> From the other hand state owned enterprises, that are heavily subsidized by the state and the prevalence of a few large dominant firms in the market are major constraints for competitiveness and distort domestic rivalry.

The program 2020-23 has identified some of the major weakness that country face and reforms are promoting in the respective fields. More specifically the government announced a major reform program to privatize the leading industries in each sector in order to reduce its intervention to the economy and fight monopolies. Subsidies will be gradually reduced while the government force the firms that operate inefficiently<sup>37</sup> to promote reforms or exit the market. The time to start a business has been reduced to 18 days and the procedures to 8 (from 30 and 9 respectively in 2010). Reform as regards taxation are promoting very slowly while the corporate income tax rate is currently to 20%. Amendments introduced in Article 1246 of the Civil Code of the Russian Federation concern state regulation in the sphere of intellectual property.

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<sup>36</sup> According to Porter those two factors are crucial and significantly affects competitiveness

<sup>37</sup> A research from the IFC and the World Bank has been conducted in 2009 as regards energy efficiency in Russia. The result was that not much effort have been made towards energy efficiency and the country lose every year a 45% of its primary energy consumption because of that. The Federal 261 on energy savings and energy efficiency was adopted to improve the Russian industries, while recommendations as regards improving energy efficiency in public organizations where included on the budget strategy through 2020, [www.ifc.org](http://www.ifc.org)

## Conclusions-Suggestions

Russia's competitiveness had significantly increased through the past years and the country had improved its role in international trade and business. However, compared to the possibilities that the country had according to the size of its economy and population, this growth falls far behind. The aggravated position of the Russian economy to reach the maximum of its potential and become more competitive covers a mind spectrum that has to do not only with global characteristics like traditional market of capital, technology and labor but also refers to management techniques, innovation and development of human capital. A country like Russia, with a vast market and a huge number of population, has limitless possibilities and a big spectrum of vital interests through the globe that emerge its global competitive ability as priority and a strategic target for the prosperity of the country.

The business environment of Russia has a bad international reputation for corruption, bureaucracy and administrative complexity which in turn affects negatively the industrial development in the country. Moreover the case of the oil company Yukos highlights a business environment that has formed within the red lines that the Putin's regime has drawn. Indeed restrictions that have been imposed by the central government can be perceived as a disturbance to a country that in general terms it is quite profitable for foreign investors.

Russia's growth was primarily based on the export revenues from the huge reserves of gas and oil that the country has. Although those revenues were used to create a sound and stable macroeconomic environment, by controlling inflation and public debt, the same does not apply as regards the micro level. The increase dependency of Russia to primary commodity exports exposes the country to fluctuations of the international prices. Since Russia can't control international prices especially as regards oil, the country needs to develop a strong manufacturing sector that will help the country to diversify the source of revenues and increase stability in the economy in both the macro and micro level.

In order to achieve that Russia should promote the necessary reforms in its weakest sectors. The country should continue the privatization process and cut the subsidies in order to decrease its intervention to the economy. Administrative reforms should go hand in hand with reforms to the legislature in order to fight corruption and networks. An independent legislature and administrative reforms that would decrease bureaucracy will increase transparency in transactions and the rule of law and constraints to investments will be minimized.

Legal reforms are necessary towards a more specific and comprehensive definition of the property rights. The government should further privatize its land assets and remove administrative barriers for investors to acquire. That in turn will lead to raise the competition in real estate market. A more comprehensive description as regards IPRs will help the public authorities to increase their capacity to enforce IPRs and attract investment towards innovative technologies.

The government should increase imports that would bring more sophisticated products to the local markets. That will increase competition in the local markets and force domestic firms to promote the necessary reforms and produce more innovative products in order to comprehend the intense rivalry. Moreover imported goods and services will engender positive technological spillovers through imitations.

By strengthening these weaknesses Russia will be more attractive to investors and in turn will help a strong and competitive manufacturing sector to emerge. Russia is a country with a vast market and a huge number of residents thus it is rather appealing

for investments. That, combined with a general raise in their incomes during the past years had increase consumption and engenders high profits for companies that wish to invest in Russia. Positive spillovers from FDIs and imports will inject the economy the latest managerial techniques and edge technology that will foster innovation. In turn the feedback to the universities will have as a result a highly skilled and more competitive labor force that will help the companies to increase productivity and the quality of their products.

Manufacturing products will be more competitive to the world markets and will bring high revenues to the country from exports. The country will be able to produce its own products and that specifically applies to the machines and equipment category which is crucial to further develop the industry sector. That, combined with the abundant natural resources can skyrocket the Russian economy.

Of course a scenario like this is not as easy as it sounds. Although Russia has the necessary funds to promote these reforms to the administrative and legal system, the major constraint seems to be its culture. Russia embraced the democratic and liberal economy values just 13 years ago. All the western developed countries have undergone a process that lasted more than two centuries in order to develop their industrial sector and reach their current position. Keeping that in mind Russia's biggest challenge is to forget its past and focus on the future.

Russia needs to continue increase its competitiveness to foster its economic growth and be successful in international business. For that reason it is essential for the country to create a stable microeconomic environment and promote the necessary institutional reforms to be more appealing to private investments. An unhampered business activity, and that specifically applies to foreign investors, would bring the positive managerial and technological spillovers that the country needs to keep in touch with the developments in the most advanced countries and foster growth and innovation. Competitiveness should be the priority development direction for Russia. Russia should reach its potential and join the modern world economy to its corresponding position.

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Russian Statistics Agency Rosstat

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International Monetary Fund

<a href="http://www.oecd.org">www.oecd.org</a>	Organization for Economic Cooperation and Development
<a href="http://www.ifc.org">www.ifc.org</a>	International Finance Corporation
<a href="http://www.worldbank.org">www.worldbank.org</a>	World Bank