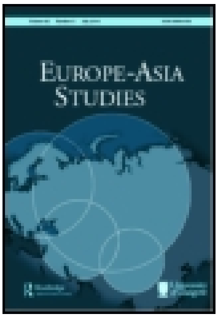

Europe-Asia Studies
Publication details, including instructions for authors and subscription information:
http://www.tandfonline.com/loi/ceas20

Putin's Economic Record: Is the Oil Boom Sustainable?

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Published online: 18 Jul 2008.

EUROPE-ASIA STUDIES
Vol. 60, No. 6, August 2008, 1051 – 1072

Putin's Economic Record: Is the Oil Boom Sustainable?

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> The economic system of Russia has undergone such rapid changes that it is impossible to obtain a precise and accurate account of it ... Almost everything one can say about the country is true and false at the same time. (Keynes 1925)

WESTERN OBSERVERS ARE DIVIDED OVER HOW TO ASSESS President Vladimir Putin's economic record. Some credit Putin with having engineered a rags-to-riches transformation of the Russian economy. Others condemn him for having squandered an opportunity to complete the transition to a competitive market economy, a job left half-done in the 1990s.

The raw data are impressive (see Table 1). The eight years of Putin's presidency saw a doubling of living standards, a 70% increase in GDP, the settling of nearly all Russia's foreign sovereign debts, and the accumulation of a war chest of $402 billion foreign currency reserves as of March 2008.[1] In current dollar prices, GDP went from $200 billion in 1999 to $1.26 trillion in 2007. Russia moved up from being the twentieth largest economy in the world to the seventh. The World Bank estimates the Gross National Income per capita at $5,780 in 2006, with a GNI of $823 billion (World Bank 2007).

Sceptics argue that this economic boom cannot be sustained, and is a house built on sand. Putin's success is simply the luck of the geological draw: Russia is the world's number two oil producer and number one natural gas producer, and global prices for oil quintupled between 2002 and 2008. The global commodity boom cannot be sustained indefinitely, and will inevitably be followed by a slump. Critics suggest that there is little sign that Russia's political and economic institutions are prepared for such a development. The surge in oil revenue has produced a spike in consumer spending, largely satisfied by imports, but has not stimulated a recovery of Russian manufacturing or agriculture. The lion's share of the wealth has been siphoned off by the new rapacious class of oligarchs who are investing most of it abroad. The second major beneficiary of the oil boom has been the Russian state, which has doubled the ranks of bureaucrats and tripled spending on the military. During the second half of

The author would like to thank Shinichiro Tabata and William Tompson for their assistance.
[1]Central Bank of Russia, available at: http://www.cbr.ru, accessed 20 April 2008.

ISSN 0966-8136 print; ISSN 1465-3427 online/08/061051-22
DOI: 10.1080/09668130802180975

TABLE 1
BASIC ECONOMIC INDICATORS (PERCENT ANNUAL CHANGE, UNLESS OTHERWISE INDICATED)

	1998	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*
Real GDP growth	−5.3	6.3	10.0	5.1	4.7	7.3	7.2	6.4	6.7	7.3
Investment growth	−12.4	6.3	18.1	10.2	2.8	13.9	11.3	10.5	12.6	21.2
Unemployment	13.2	12.4	9.9	8.8	8.5	7.8	7.9	7.5	7.1	6.3
Inflation (CPI)	85	37	20	19	15	12	12	11	9	11
Average real wages	−10	−22	18	20	16	11	11	13	13	16
M2 growth	21	58	62	40	32	51	36	39	49	48
Budget surplus/deficit (as % of GDP)	−5.3	−0.5	3.5	3.0	1.4	1.7	4.5	8.1	8.5	5.5
Urals oil price ($/barrel)	12	17	27	23	24	27	34	50	61	69

Sources: OECD (2007); World Bank (2004); M2 from Central Bank of Russia, available at: http://www.cbr.ru, accessed 20 April 2008; oil from Troika Dialog (2008a, 2008b).

the Putin presidency, the state has reasserted its control over key industrial corporations, especially in the oil sector, leading to the emergence of a new hybrid form of state oligarchic-capitalism.

Despite lip service to the rule of law, no serious efforts have been made to dislodge the corrupt elites that rule Russia, except for isolated cases where an individual oligarch fell foul of the Kremlin. And despite ambitious plans to diversify the economy and build on Russia's technological and human capital, Russia has shown little sign of being able to compete in cutting-edge industrial sectors. A downturn in oil prices will expose the shaky foundations of Russia's development model. Even without a price collapse, only a small proportion of the oil receipts are trickling down to the mainstream of Russian society. The ranks of the poor and disenfranchised will continue to grow, leading to political challenges which Russia's authoritarian regime is ill-equipped to handle.

Both critics and defenders of Putin can find persuasive evidence in support of their position. Putin's economic record certainly looks good compared to the chaos and immiseration of the 1990s. But the key arguments that divide the two camps revolve around the economy's future trajectory: above all, whether or not growth can be sustained in the face of a levelling off or decline in global oil prices. So, 17 years after the collapse of the Soviet Union, Russia is still in a state of transition from the failed model of the past to an as yet uncertain future. This contribution begins by reviewing Russia's economic trajectory under Putin and his predecessor Boris Yel'tsin, then evaluates whether Russia is, or is not, falling prey to the 'resource curse'—the argument that its oil and gas wealth condemns it to economic instability, social inequality and political authoritarianism.

An economy transformed

In the 1990s Russia experienced a wrenching slump, during which its GDP fell by 40%. It started to recover in 1997, stumbled in 1998, and then resumed growing, eventually regaining the 1990 level in 2002. Since 2000, GDP growth has averaged just under 7% a year, while real wages have grown at double that rate and investment has risen by 12% annually. 'Russia's real income per capita (in constant 2000 dollar equivalents of purchasing power parity, or PPP) rose from $5,964 in 1998 to $9,650 in 2005' (World Bank 2007, p. 15). The government has been running a substantial surplus, and unemployment has fallen below 7%. Labour productivity grew 49% between 1995 and 2005, ranging from a 23% improvement in retailing to a 73% rise in construction (Rosstat; Sosunov & Zamulin 2006). Total factor productivity grew by 5.8% per year, and the World Bank (2007, p. 17) estimates that only one third of that increase came from increased capacity utilisation. Firm turnover (the exit of inefficient firms and the entry of new ones) accounts for half the total improvement. Stock market capitalisation rose to 44% of GDP by 2005, while the RTS index went from 300 in 2000 to 2,360 in December 2007 (Lazareva *et al.* 2007). In September 2006 the market capitalisation of the 200 biggest firms was $833 billion (one third of which was Gazprom). The percentage of the population living in poverty fell from 38% in 1998 to 9.5% in 2004, and the share of family budgets spent on food fell from 73% in 1992 to 54% in 2004 (Mroz *et al.* 2005). The only macroeconomic indicator that gave cause for concern is inflation, which dropped from 20% in 2000 to 9% in 2006, before creeping back up to the 11.9% in 2007.

During the 'lost decade' of the 1990s Russia did manage to become a market economy, albeit one with 'Russian characteristics'. A total of 70% of economic activity now takes place in legally independent corporations, and a similar proportion of economic transactions occur through market-clearing prices (Aslund 2007). The centralised, command economy was smashed, although elements of such a model persist at the local level in some regions such as Tatarstan or Kalmykiya.

During the 1990s Russia was becoming more integrated into the global economy than the Soviet Union had been (see Tables 2 and 3). Trade went from 17% of GDP in 1990 to 48% in 2004 (World Bank 2004).[2] Most of this trade was with Europe, and not with the former Soviet states. By 2005 the Commonwealth of Independent States only accounted for 15% of Russia's exports and 23% of its imports (IMF 2006). This external opening has been the most dynamic and successful aspect of Russia's market transition; but Russia's charge into the global market was led by the energy sector (IEA 2005; EIA 2006). Clearly, Russia's comparative advantage in the contemporary global economy lies in energy and energy-intensive industries such as metals and chemicals. Oil and gas accounted for 61% of Russia's export earnings in 2005 (World Bank 2006), with the value of exports tripling from $76 billion in 1999 to $241 billion in 2005. Manufactures account for only 8% of Russia's exports, and only 3% are in the medium-high technology category.

When Putin took office in 2000 he voiced support for the need for continuing market reform. The most radical measure pushed through by Economy Minister German Gref was a reform of the tax system, under which a progressive income tax from 12% to 30% was replaced with a flat tax of 13% in 2001. The payroll tax was cut from 40% to 26% and corporate profit tax was raised to 35% but later cut to 24%. The income tax cut was followed the next year by a 25% increase in tax revenue, but

[2]The 48% share in part reflects the under-valued exchange rate. The World Bank's purchasing power estimate for 2002 boosted Russian GNI from $306 billion to $1,165 billion. This would accordingly reduce the share of trade in GDP.

TABLE 2
TRADE PERFORMANCE ($ BILLIONS)

	1998	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
Exports of goods	75	76	105	101	107	134	182	241
Imports of goods	58	40	45	42	46	57	76	99
Trade balance	17	36	60	58	61	76	106	143
Foreign exchange reserves	12	13	28	37	48	77	125	182
Exchange rate (ruble/$)	10	25	28	29	31	31	29	28
Capital exports	22	21	25	15	8	2	9	0

Sources: OECD (2007); capital exports from Central Bank, available at: http://www.cbr.ru, 30 March 2008.

TABLE 3
FOREIGN TRADE PARTNERS ($ BILLIONS)

	1995	*2000*	*2003*	*2006*
Exports				
Total*	82	105	136	305
Netherlands	3.2	4.4	8.7	35.9
Italy	3.4	7.3	8.5	25.1
Germany	6.2	9.2	10.4	24.5
China	3.8	5.3	8.3	15.8
Ukraine	7.1	5.0	7.6	15.0
Turkey	1.6	3.1	4.8	14.4
Belarus	3.0	5.6	7.6	13.1
Switzerland	3.5	3.9	5.8	12.1
Poland	1.7	4.5	4.6	11.5
Kazakhstan	2.6	2.8	3.3	9.0
USA	4.3	4.6	4.2	8.9
Imports				
Total*	63	45	76	164
Germany	6.5	3.9	8.1	18.4
China	0.9	0.9	3.3	12.9
Ukraine	6.6	3.7	4.4	9.2
Japan	0.8	0.6	1.9	7.8
Belarus	2.2	3.7	4.9	6.9
South Korea	0.5	0.4	1.3	6.8
USA	2.6	2.7	3.0	6.4
France	1.1	1.2	2.4	5.9
Italy	1.9	1.2	2.4	5.7
Finland	2.0	1.0	1.9	4.0
Kazakhstan	2.7	2.2	2.5	3.8

Note: *Both 'far abroad' and CIS.
Sources: http://www.gks.ru/free_doc/2007/b07_12/25-05.htm, accessed 20 April 2008.

this was probably due to the reporting of previously concealed income, rather than to any incentive effect (Keen *et al.* 2006, p. 28).[3] Another significant step was a new law on licensing, which cut the wait time and reduced the list of business activities which

[3]The reform also coincided with an increase in enforcement by the tax police, so advocates of the Laffer Curve should be wary of using Russia as an example vindicating their theory. (The Laffer Curve posits that a cut in tax rates will lead to an increase in tax revenue.)

required licenses from 250 to 103 (Yakovlev & Zhuravskaya 2007). Despite these steps, the climate remains difficult for small business development, with small firms accounting for only 17% of employment compared to 60% in the US (Reut 2007). The Transparency International index of corruption perception gives Russia exactly the same dismal score (2.3 on a 10-point scale) in 2007 that it earned in 1997.[4]

The rise and fall of oligarchic capitalism

Russia's political economy has undergone a switchback ride since 1985. Mikhail Gorbachev's faltering economic reforms helped to trigger systemic collapse. President Boris Yel'tsin's embrace of radical liberalisation in 1992 led not to a competitive market economy, but to oligarchic capitalism. That system in turn imploded in the August 1998 financial crash. After 18 months of political stalemate Putin came to power in December 1999, and proceeded to construct a new model of state corporatism.

Yel'tsin's crash privatisation programme was intended to create a market economy by dispersing ownership throughout the society, but when the dust settled the result was a remarkable degree of concentration of ownership in the new private sector. According to a World Bank study, by 2001 the country's 23 largest firms were estimated to account for 30% of Russia's GDP, and these firms were effectively controlled by a mere 37 individuals (World Bank 2004; Guriev & Rachinsky 2004). A 2005–2006 study of a sample of 1,000 firms similarly found that 35% had a single majority shareholder (Guriev *et al.* 2007). By international standards, this is an astonishing concentration of wealth and industrial power in such a large country. It was all the more surprising given the fact that private ownership had been outlawed for decades, and the entire economic elite did not exist as a class just 15 years earlier. Some economists have argued that this ownership concentration is a rough and ready solution to the problem of enforcing property rights in the absence of a strong rule of law (Lazareva *et al.* 2007, p. 13).

Western observers were initially uncomfortable with the rise of the oligarchs, whose ascendance coincided with a wave of lawlessness, contract killings and grotesque displays of wealth. At least the appearance of the oligarchs seemed to refute the argument that Russians were innately incapable of behaving like entrepreneurs, of taking risks and reaping the rewards. Soon, some Western economists were arguing that the oligarchs were playing a necessary role in creating the Russian market economy, akin to the US robber barons of the late nineteenth century (Shleifer & Treisman 2001). The oligarchs pushed out communist-era bureaucrats and managers, and in the pursuit of personal gain they turned the sow's ear of Soviet enterprises into the silk purse of profit-seeking firms. Liberal reformers such as Prime Minister Yegor Gaidar were convinced that the oligarchic capitalism that they helped to construct in Russia beat the alternative—which they portrayed as a return to central planning (Gaidar 2007).

But to function in the textbook manner, free markets require multiple producers and free entry of new firms, as well as a set of institutions that were conspicuously

[4]That placed Russia 121 out of 163 countries in 2007, an improvement over 49 out of 52 in 1997, see http://www.transparency.org/policy_research/surveys_indices/cpi/2007, accessed 20 April 2008.

absent in Russia (including the rule of law, free press, banking system and regulatory agencies). Nevertheless, the reformers assumed that oligarchic capitalism was a transitional phase, one that would give way to liberal capitalism after the economic system had matured. Once the oligarchs had accumulated some wealth, they would have a strong personal interest in seeing the rule of law take hold, in order to protect their wealth from the next wave of oligarchs. They would not want to go through life looking over their shoulder at the next asset-stripper, driving around in columns of heavily armoured vehicles, and hiding their families from kidnappers behind high *dacha* walls and on foreign estates. The counter-argument was that the oligarchs had a vested interest in trying to preserve the status quo of partial reform, since further liberalisation would compete away their oligopolistic profits (Hellman 1998).

The collapse of oligarchic capitalism was due to deep contradictions in the model, and not merely contingent factors such as Yel'tsin's incompetence or the shocks emanating from the 1997 East Asian financial crisis (including a slump in the world oil price). Three problems stand out. First, the oligarchs were parasitic on the Russian state. They were draining it of assets and revenues while profiteering from the high-interest treasury bonds (*Gosudarstvennye kratkosrochnye obligatsii*, GKOs) issued to cover the yawning budget deficit. It was this spiralling pyramid of GKOs that was the main factor behind the 1998 crash. Second, the oligarchs lacked a political strategy for legitimating their rule in the eyes of the Russian public. The cynical manipulation of public opinion through campaign shenanigans and pre-election budget spending may have secured Yel'tsin's re-election in 1996, but there was no guarantee that such tactics could work in each future election. Third, the oligarchs were deeply divided among themselves. They did not trust each other, and fought bitterly over successive privatisations. They were also split over the Yel'tsin succession. The oligarchs did not have an institutional procedure for resolving their internal disputes. The only 'mechanism' they had was to appeal to Boris Yel'tsin. Given that Yel'tsin was physically incapacitated for most of the time, this meant they competed for the favour of the Kremlin courtiers (the 'Family') who controlled access to the president. Yel'tsin's second and final term as president was due to end in March 2000, and the oligarchic system did not have any procedure in place for picking a successor.

Thus at the end of the Yel'tsin era, Russia's evolution towards what is regarded in the West as a 'normal' market economy was stalled in mid-stream. Powerful leaders had a vested interest in preserving the status quo, and there was no significant coalition of groups with a stake in further reform. The economy had been sufficiently liberalised to enable the oligarchs to enrich themselves, but not so much as to expose them to effective competition (from foreign companies, for example). This situation was inefficient and morally indefensible, but it was unclear whether or not it was politically and economically stable. Could it continue indefinitely, or would it require a fresh round of market reform? In the end, Russia moved in an unexpected third direction, neither the status quo nor a resumption of reform—the return of state control.

After his election as president in May 2000 Putin moved quickly to consolidate his political authority, his first decisive step being to wrest control of the broadcast media from the oligarchs. At the same time he assured corporate leaders that he would not interfere with their business activities, so long as they stayed out of politics (Slavutinskaya 2000). Putin maintained this 'equidistance' approach until 2003, when many business leaders became heavily involved in the preparations for the December 2003 State *Duma* elections. It is estimated that 20% of the candidates were directly linked to business corporations, even including the Communist Party nominees (Mereu 2003). The most politically active firm was Yukos, Russia's largest oil company, which was headed by Mikhail Khodorkovsky. Yukos was poised to break the monopoly of the state-owned oil pipeline company Transneft, with plans to build export pipelines to Murmansk and to China. It also seemed to be preparing itself for sale to a Western buyer (thought to be Chevron). Various Yukos executives were arrested on fraud charges in July 2003, and in October of that year Khodorkovsky, the richest man in Russia with an estimated net worth of $16 billion, was himself jailed on vague charges of tax evasion. He was eventually sentenced to eight years in prison. Yukos was forced into bankruptcy through exaggerated claims for tax arrears, and its prize assets were sold off in a rigged auction to the state-owned Rosneft. One could not ask for a more vivid illustration of the limits of business independence in Russia. The fact that business had evolved into a narrow oligarchy made it relatively easy for the state to recapture the commanding heights of the economy. But even as late as 2003, most Western observers had assumed that the system of oligarchic capitalism was there to stay: few foresaw Putin's crackdown.

In retrospect, we can see that oligarchic capitalism was highly unstable, since the economic fate of the individual oligarchs was too closely tied to the course of state policy. Who would be given the right to acquire the remaining assets of state industry as they were put up for privatisation? For how long would the government retain control over 'natural monopolies' such as the railways, Gazprom, the electricity monopoly Unified Energy System, the oil pipeline operator Transneft, and the telecom holding Rostelecom? How could the public be persuaded to bite the bullet and accept postponed but necessary reforms of the taxation system, cuts in social benefits, and increases in utility prices?

Even though Putin beat back the political challenge of the rising capitalists, the oligarchs as a class have not disappeared. On the contrary they have increased in number and seen their wealth multiply under his rule. The oligarchs benefited from Russia's booming economy, its soaring stock market, and successful stock offerings to domestic and foreign investors. *Forbes* magazine reported that there were 33 individuals in Russia in 2006 with personal assets above $1 billion, the third highest number of billionaires in the world. Their ranks had risen to 87 by 2008, putting Russia in second place after the US. *Forbes* estimated their combined assets doubled from $90 billion in 2005 to $172 billion in 2006, and more than doubled again to $455 billion by 2008 (Kroll 2008).[5]

The shift to state corporatism

One disturbing trend in recent years has been the increasing fusion of state and oligarchic power. This has been most pronounced in the all-important oil sector. In the wake of the break-up of Yukos the share of oil output produced by majority state-owned companies rose, from 10% in 2000 to 42% in 2008 (Elder 2008). The overall

[5]There are 1,125 billionaires on the list, including 439 Americans, 87 Russians and 59 Germans.

state share in the economy rose from 30% to 35% (Buckley & Ostrovsky 2006). The main Yukos production unit, Yuganskneftegaz, was sold to state-owned Rosneft for $9.35 billion in December 2004. Its other two main subsidiaries, Samaraneftegaz and Tomskneft, were sold to Rosneft by auction in May 2007 for $13.2 billion. A plan for Gazprom to absorb Rosneft was derailed after months of backroom manoeuvring, but the government went ahead with a complex plan to buy 10.7% of Gazprom shares in order to raise the state holding to 51%, using a loan to be paid off with a public offering of $7.5 billion of Rosneft stock. Gazprom was compensated for its failure to take over Rosneft by being allowed to buy independent gas producer Nortgaz and Roman Abramovich's Sibneft, the fifth largest oil company, in September 2005. Gazprom paid $13 billion for 73% of Sibneft shares, close to a market price.[6]

This growing state-controlled sector was acquired and managed through somewhat unorthodox methods. The state was just as complicit as the oligarchs in using shell companies, offshore banking and other nefarious manoeuvrings to conceal its economic activity from outside observers. This tradition extends back to the 1990s, and includes a broad spectrum of government and parastatal agencies, from the Orthodox Church to the Central Bank. But it has become even more entrenched under Putin. The initial sale of Yukos assets, for example, was laundered through a false intermediary company, Baikal Finance Group. One third of Russian oil is sold through a Swiss-based intermediary Gunvor (Nemtsov & Milov 2008, p. 14). Russia's gas sales to Ukraine have been channelled through a succession of intermediary companies (first Itera, and then RosUkrEnergo) that are registered through a shadowy network of internationally registered companies whose beneficiary owners are unclear (Global Witness 2006). The state's total shareholding portfolio was estimated to have a market value of $469 billion in 2007, equal to 40% of the capitalisation of Russia's stock market.[7]

Government oversight of the companies is achieved through the placement of currently serving members of the executive branch on corporate boards, in some cases as chairmen. Many of these are drawn from Putin's own retinue. For example, in July 2004 Putin's deputy chief of staff Igor Sechin replaced Economic Development and Trade Minister German Gref as chairman of Rosneft. Presidential aide Viktor Ivanov chaired Aeroflot and the Almaz-Antei arms firm; presidential aide Igor Shuvalov chaired Sovkomflot; and First Deputy Prime Minister Sergei Ivanov headed the United Aircraft Building Corporation. Guriev *et al.*'s (2007) survey found that 29% of the firms in the sample had a government representative on their board. One anonymous banker told a journalist that 'all big companies have to put people from the security services on the board of directors' (Mereu 2008). Even Arkady Dvorkovich, the head of the presidential analytical directorate, complained that the new state corporations were exempt from basic audit requirements (Novozhenina 2007). Putin assured leaders of the Chamber of Trade and Industry that: 'We

[6]By 2004, the largest companies by share of reserves were: Lukoil with 23%, Rosneft (including Yuganskneftegaz) with 14%, TNK-BP with 12%, Yukos with 11%, Surgut with 9%, Gazprom with 9%, Tatneft with 8% and Bashneft with 3% (EIA 2006; Grace 2005; Considine & Kerr 2002).

[7]*Vedomosti*, 6 February 2008.

don't want to create state capitalism', but his actions do not correspond to this sentiment.[8]

Russia as a global player

Russia made a dramatic about-turn in the Putin era, from one of the main problem cases in the global economy to a magnet for foreign investors. Russia alone was responsible for 48% of the rise in global oil supply between 1998 and 2004 (Tompson & Ahrend 2006). At the same time as Putin was building this new model of state–oligarchic capitalism, he remained committed to integration with Western economic institutions. And this was not merely a rhetorical commitment. There are at least four reasons for this engagement. First, Putin was aware that Russia was dependent on its energy customers in Europe. Second, he knew that Russia needed some Western managerial and technological expertise—but he preferred to tap this without conceding ownership or control over the Russian economy. Third, Putin wanted the political cover that he hoped would come with Western corporate involvement. The most blatant example was the appointment in 2005 of former German Chancellor Gerhardt Schroeder to chair the North European Gas Pipeline project (Nordsteam), a plan to lay a pipe on the seabed to Germany bypassing Poland. The same year former US Commerce Secretary Donald Evans was invited to chair the Rosneft board. Finally, Moscow is confident that the new state corporations like Gazprom and Rosneft, alongside private companies like Lukoil, will become increasingly powerful players on the international energy stage, through increasing acquisitions of assets in foreign countries.

Hence Western corporations are being allowed in as partners in energy projects, but on a minority basis. In 2004 ConocoPhillips bought an 8% stake in Lukoil, then raised this to 17%, and Conoco's Kevin Meyers was elected to Lukoil's board. Royal Dutch Shell was forced to sell a majority stake in Sakhalin II to Gazprom, for $7.45 billion, in December 2006; and BP-TNK was forced to sell a majority stake in its Siberian Kovykta gas field to Gazprom in June 2007. A new law regulating 33 'strategic' sectors of the economy was introduced to bar foreign companies from more than 50% ownership of any oil field over 70 million tons, and government approval would be required for even a 10% stake (Gudkov 2008). In July 2007 Gazprom announced that it had selected France's Total as a partner in the development of its giant Shtokman offshore field in the Arctic. Total was granted a 25% stake, and in October 2007 another 24% stake was awarded to Norway's StatoilHydro. The winners would be expected to allow Gazprom to acquire a share in their assets overseas. Recent years have seen a dramatic surge in cross-border acquisitions in both directions. In 2007 foreigners bought $26.6 billion of assets inside Russia, while Russian firms spent almost as much—$23.3 billion—in foreign acquisitions.[9]

Ironically, Western bankers have played an active role in financing Putin's re-nationalisation programme. In 2005–2006 Rosneft borrowed $8 billion, Gazprom $13 billion and Rosneftegaz $7.5 billion. The banks have been keen for this business

[8]AFP, 11 December 2007.
[9]*Vedomosti*, 13 March 2008.

because they expect it to lead to lucrative fees with upcoming stock offerings. In December 2005 Putin signed into law the lifting of the 'ring fence' which had limited foreigners to 20% of Gazprom shares. In July 2006 Rosneft sold off 15% of its stock in a public offering (IPO) on the London stock exchange, raising $11 billion. Russia introduced full convertibility of its currency in July 2006. Also striking has been a surge in foreign borrowing by Russian corporations both state-owned and private. In the first nine months of 2007 non-bank corporations took out a net $72 billion in foreign currency loans, roughly equal to the amount of capital that is being exported.[10] This curious pattern of capital circulating out of and back into Russia testifies to the inability of Russia's financial institutions to play an intermediary role. But other factors may be involved, from tax evasion to a deliberate strategy to promote Russia's integration with the West.

Can Russia escape the resource curse?

> We know that one of our main tasks is the diversification of the economy. That it is essential to depart from a model based on raw materials is obvious. (Vladimir Putin, speaking in Novosibirsk, 11 January 2005)[11]

Oil and gas played an important role in the Soviet economy, and the collapse of oil prices in the 1980s is now widely cited as one of the main factors precipitating the collapse of the USSR in 1991 (Kotkin 2001). The eightfold increase of oil prices in the 1970s provided a boost to the Soviet economy, and helped the Soviet system stagger on for another decade. However, prices dipped in the mid-1980s, and the resulting $7 billion shortfall in the Soviet budget forced Gorbachev to borrow from the West to finance long-overdue economic reforms (Gaidar 2005, 2007). Resource curse advocates argue that the resulting liberalisation in the 1990s was just a temporary phenomenon, and that Russian democracy was doomed to fail once the oil price went back up again (Nemtsov & Milov 2008).

Global experience strongly suggests that oil is bad for democracy and bad for sustained economic growth. Carles Boix (2004, p. 85) argues that there are zero examples of a successful transition to democracy in a country where oil generates more than one third of its export earnings, which sounds like a death sentence for Russian democracy.[12] Morton Halperin *et al.* (2005, p. 19) contend that only eight countries in the past 20 years have enjoyed sustained growth under authoritarianism, while 60 authoritarian regimes saw sub-par growth.[13]

Stephen Fish concludes from cross-national analysis that Russian democracy is indeed blighted by a variant of the resource curse (Fish 2005, ch. 5). However, he is not able to find clear evidence that the curse works in Russia through the three vectors identified by Michael Ross—the tendency of oil revenues to delay

[10]Central Bank of Russia, available at: http://www.cbr.ru, accessed 20 April 2008.

[11]Available at: http://www.kremlin.ru/eng/speeches/2005/01/11/2349_type82915_82564.shtml, accessed 20 April 2008.

[12]See also Kim (2003) and Ellman (2006). A country which was already a democracy when it discovered hydrocarbons, such as Norway, does not count.

[13]The eight are Bhutan, China, Egypt, South Korea, Singapore, Taiwan, Tunisia and Vietnam.

modernisation; their use to buy off social protest (the rentier effect); or their use to fund a repressive state apparatus (Ross 1999, 2001). Russia is clearly a modern society, as measured by urbanisation, education and industrialisation, so the resource curse had not prevented modernisation. Evidence for a rentier state buying off of social discontent is not strong: Russian state spending as a share of GDP (32% in 2007) is low by international standards. There is partial evidence for the repression hypothesis, since Russia does have above average levels of military spending, but Fish did not find this factor particularly decisive. (After all, Russia's bloated military long predates the discovery of oil.) Instead Fish traces the causal chain through the impact of oil and gas on corruption and economic liberalisation—boosting the former and distorting the latter. Fish concludes that there were insufficient funds 'to play the role of the Kuwaiti rulers, showering the people with services without taxing them. But [in Russia] there is more than enough money to corrupt the state apparatus' (Fish 2005, p. 134).

However, Russia is different from other resource-cursed economies—both in the structure of its political economy and in the path it took to arrive where it is today. Russia in 2006 is more dependent on resource exports than was the Soviet Union of 1985, yet it is also somewhat more democratic, even by Freedom House measures. There are at least four ways in which the structure of Russia's political economy diverges from the resource curse model.

First, in contrast to other resource-dependent economies, Russia's post-Soviet privatisation resulted in a pluralistic ownership structure in the oil industry. The oil ministry was split into a dozen independent corporations, along the lines of regional oil fields or packages of oil refineries (Kryukov 2001; Kim 2003). In addition to these production companies, there were hundreds of small independent companies created as middlemen for oil operations—typically to hide earnings from the tax authorities and creditors. This plurality of ownership is highly unusual in an international perspective. Only the US and UK have significant competition among oil producers—and neither of those countries is resource-cursed. In all the other major producers (even Norway), oil production is controlled by one or two state-owned companies.[14]

This pluralisation led to intense political bargaining in Russia, both 'vertically' between the federal centre and regional bosses, and 'horizontally' between rival companies. The federal government had to bargain with regional oil barons, such as the Presidents of Tatarstan and Bashkortostan, who won tax exemptions in the bilateral treaties they negotiated with Yel'tsin in 1994. Putin was able to claw back some of these concessions after 2000, but it was a slow and gradual process, and the bosses themselves (Presidents Mintimer Shaimiev and Murtaza Rakhimov) were still in power in 2008.

'Horizontal' bargaining refers to the fierce turf wars and takeover battles that erupted among the Russian oil majors. These battles spilled over into regional politics,

[14]Whereas in most countries it is the oil producers who build and own the pipelines, in Russia the state retained control over the pipeline system, through the state-owned corporation Transneft, which handles 71% of Russia's crude exports. A total of 14% go by rail, 3% by the Caspian Pipeline Consortium, and the remainder by sea (EIA 2006).

with each oil company acquiring one or more regional bases, notably the provinces where their production facilities were located. They also opened offices in regions which offered them tax shelters, such as Sibneft descending on distant Chukotka, or Yukos channelling some of its earnings through oil-free Mordova. These corporate battles culminated in the abortive merger of Sibneft and Yukos in 2003, and the subsequent state takeover of Yukos (Byanova & Litvinov 2003).

This pluralism in oil ownership did not extend to foreign companies. Russia introduced a limited system of production sharing agreements (PSAs) in 1995, but only three of 21 mooted projects were implemented before the regime was abolished in 2003.[15] The only major foreign acquisition that took place was the merger of BP and TNK in 2003. Foreigners have been allowed to take a minority stake in Russian oil companies, with Chevron acquiring 20% of Lukoil (Locatelli 2006).

A second distinctive feature is that Russia is equally endowed with both oil and natural gas: it is the world's number two oil producer and number one gas producer. Natural gas assets were kept separate from oil, and were privatised into a single nationwide corporation, Gazprom (Stern 2005).[16] Gazprom served as an important political resource for the state, domestically and internationally, and balanced out the aggressive profit-driven manoeuvrings of the oil companies. One example, from former presidential advisor Evgenny Yasin: 'Back in 1997 Yel'tsin told the federal government to cover regional backlogs in pension payments. Gazprom borrowed $1 billion for that purpose; otherwise Yel'tsin's order couldn't have been carried out' (cited in Dubnov 2006).

The gas market is quite distinct from the oil market, domestically and internationally. It is less volatile, depending on expensive long-term investments in pipeline systems or liquefied natural gas (LNG) facilities. While Russia's domestic oil prices were liberalised by the mid-1990s and rose close to world-market levels, the natural gas price remained heavily regulated. (Currently domestic consumers pay about $50 per cubic meter, while Gazprom's European customers pay over $300.) Through the 1990s Western officials pressed Russia to break up Gazprom, or at least allow private companies access to their pipelines, without success. IMF pressure for reform evaporated when Russia repaid its $3.3 billion outstanding debts to that organisation ahead of schedule in February 2006. The European Union gave up its insistence on the equalisation of domestic and export natural gas prices in March 2006, in return for a Russian pledge to ratify the 1997 Kyoto accord on climate change.

Third, Russia's resource endowment is not limited to oil and gas. It has a massive metals industry including iron and steel, non-ferrous metals such as copper and nickel, and precious metals such as gold and diamonds. The metal barons developed multi-billion dollar industries largely independent from the oil and gas companies. Their closest relations are with the coal industry and with the electricity monopoly, RAO UES, because of their reliance on cheap fuel. The metal barons' mines and

[15]These are Sakhalin-1 and Sakhalin-2 led, respectively, by ExxonMobil and Royal Dutch Shell, and the Kharyaga project in Siberia, led by France's Total. Exxon signed an agreement for Sakhalin-3 in 1993, but it lapsed and the license has been revoked.

[16]Independent gas producers account for 14% of Russia's output, nearly doubling their production from 2000 to 2005, but they are not allowed to export (*Moscow Times*, 23 June 2005).

factories are located in specific territories, typically far from Moscow, and they formed powerful alliances with local political leaders, providing another counter-balance to the federal authorities in Moscow (Fortescue 2007). Of the 33 Russians on *Forbes'* 2006 list of billionaires, only 12 are clearly identified as coming out of the oil and gas sector, while 15 were based in the metals industry (often merged with coal interests). Among the 87 magnates on the 2008 list, 15 originated in oil and gas, as compared with 22 in banking, 20 in mining and metals, 11 in real estate/construction, and eight in retailing. The Russian economy is far from a competitive environment as understood by Adam Smith or Joseph Schumpeter, but it is a more complex and differentiated political economy than the 'resource curse' label would usually imply.

Fourth, there is Russia's strong state tradition to consider. Putin was able to draw upon Russia's statist tradition to rebuild state power after 2000. He tapped into popular support for a strong leader to win election as president in 2000 and 2004. And he marshalled the police powers of the state to take down Russia's richest man, Mikhail Khodorkovsky, and dismember his Yukos corporation. Clearly, in that case national state power trumped international oil wealth. The 'Russian curse' of statism overlaps and supplants the 'resource curse', in complex and unpredictable ways that may diverge from predictions based on the experiences of other countries.

The Dutch and other diseases

Resource-dependent economies are prone to a variety of maladies: an over-valued exchange rate; fluctuations in revenues that lead to excessive state spending; increased opportunities for corruption due to the concentration of rents; and inefficiencies because of the prominent role of state-controlled enterprises, leading to lower capital productivity and hence slower long-term growth. Russia is certainly showing signs of many of these ailments (Luong Jones & Weinthal, 2001, 2006). On the other hand, the recovery since 1998 has been strong and sustained, and Russia's resource endowment and the state of the global energy market give no reason to imagine that it must end any time soon.

Many economists worry that Russia is succumbing to the 'Dutch disease': an over-valued exchange rate. The influx of oil and gas revenues has driven up the value of the ruble, which has appreciated by 80% in real terms since 1999. This makes Russian manufacturing and farming uncompetitive—unable to find export markets, and unable to compete with foreign imports. This comes at a time when Russia is moving towards joining the World Trade Organisation (WTO), which will further limit its ability to defend domestic producers with tariff and non-tariff barriers. The impact of the Dutch disease is not confined to the exchange rate. High returns on investment in the energy sector drive up the cost of capital and lead to increased wages for skilled workers, putting further pressure on domestic manufacturers in other sectors.

Specialists disagree over the proportion of Russia's GDP that can be attributed to energy, due in part to accounting practices that hide oil and gas receipts in other reporting categories (Tabata 2005). According to the official statistics agency Rosstat, energy accounts for 9% of the Russian economy, while the World Bank put it at 25%. These are high figures, but not as high as in Saudi Arabia or even Venezuela. Energy has clearly been driving the post-1998 economic recovery, accounting for about half of the growth in GDP[17] (World Bank 2006). But unlike most oil exporting countries, Russia has a developed manufacturing sector, so a high proportion of its energy output is used domestically, especially in energy-intensive sectors such as metals and chemicals. Only 56% of Russia's crude oil, 34% of its natural gas, and 42% of refined oil products have been exported in recent years (Tabata 2005), while the remainder has been consumed domestically. Manufacturing actually crept up from 17.0% of GDP in 2003 to 20.7% in 2006, leading Troika Dialog to argue that 'the rather high percentage of the manufacturing sector in GDP means that the Russian economy cannot yet be diagnosed as having the so-called "Dutch disease"' (Troika Dialog 2008b, p. 15). This illustrates how the political economy of Russia's energy dependence is more complex than in the typical 'petrostate'. There are more trade-offs to be made than in other resource-dependent countries, involving a broader range of political and economic actors.

Exactly how does oil revenue affect growth? Higher oil prices *per se* have zero impact on a country's reported annual GDP growth rate.[18] GDP growth is a measure of the increase in goods and services produced within a country in a given year. So if oil output is constant but the price doubles in year B, the value of the GDP in year A would be adjusted *ex post* to reflect the shift in the price of oil. For rising oil receipts to show up in reported GDP growth, they have to be spent on domestically produced goods and services. This might occur through an increase in government spending, if the state has captured some of the oil revenue in higher taxes. Alternatively, oil and gas companies might invest more and hire more workers to maintain or expand production. The higher earnings of workers, managers and owners in the oil sector could be spent on consumer goods and services.

Services, transport and the public sector are all fairly immune to the Dutch disease, being non-tradable. All three sectors are underdeveloped in Russia compared to more mature market economies, leaving plenty of room for non-oil growth. According to the World Bank, as of 2006 services had grown to 56% of GDP, while manufacturing accounted for 19% and agriculture had shrunk to 5% (World Bank 2007). As the Dutch disease scenario would predict, growth is concentrated in non-tradable sectors such as construction and retailing, which rose by 24% and 14% respectively in the first nine months of 2007. Manufacturing rose 10% in that period, concentrated in machinery for transport and power generation.

Specific challenges arising from the Dutch disease

Sterilising the surplus

Assuming that the Central Bank and Finance Ministry are competent enough to sterilise the capital inflows, the Dutch disease should be manageable. It did not prove fatal to the Dutch, after all. Russia has been following cautious fiscal and monetary

[17] Astaf'eva estimates that changes in the oil price alone accounted for an estimated 27% of the growth over 1998–2007 (Astaf'eva 2007, p. 38).

[18] I am grateful to Francisco Rodriguez for this point.

policies since 2000. Its fiscal policy has been closer to Norway than that of Nigeria or Venezuela (Bousseni & Locatelli 2005).

Between 2000 and 2006 the overall terms of trade moved 100% in Russia's favour (World Bank 2007). The price of Urals blend dipped from $27 per barrel in 2000 to $23 in 2001, then rose to $34 in 2004 and $69 in 2007 (Troika Dialog 2008b). Oil accounted for 33% of exports in 2006 and gas another 15%. These beneficial external developments helped drive government receipts from $40 billion in 2000 to $153 billion in 2005, while spending increased from $34 billion to $130 billion. The government has run a substantial fiscal surplus each year, and has not rushed into unsustainable spending projects.[19] The federal budget ran a surplus of 4.1% of GDP in 2004 and 7.5% in 2005, with revenues at 23.6% and spending 16.2% (World Bank 2006). In 2006 government revenue (regional and national combined) was 39% of GDP and spending 28%, leaving a budget surplus of 11% (World Bank 2007). The surplus means that the government is able to improve public services, pay off its international debts, and avoid financial crises.

In addition to the Central Bank buying up foreign exchange earnings, in 2004 the government created a Stabilisation Fund, into which are paid excess taxes from oil exports when the price exceeds $20 a barrel (raised to $27 in 2006). The Stabfond went from $4 billion in 2004 to $50 billion in January 2006 and $168 billion in January 2008. In 2008 Russia switched from an annual budget to planning three years out: the budget through 2010 assumes oil at $74 a barrel. The consultancy group UralSib estimates that the country will begin eroding its surplus if the price dips to $64 (Elder 2008).

Between the Central Bank and the Stabfond, Sosunov and Zamulin (2006, p. 9) estimate that the government was sterilising 16% of all export earnings from 1998 to 2005. Also easing the pressure was the oligarchs' predilection for stashing their earnings in foreign accounts and acquisitions. Capital exports were running at $20 billion a year in the late 1990s, rising to $42 billion in 2006, $81 billion in 2007, and $23 billion in the first quarter of 2008. On the other hand the enthusiasm of Russian companies for borrowing abroad is increasing Russia's exposure to a possible future payments crisis. Private sector interest payments last year rose to $65 billion—half of the $132 billion trade balance—while the external debt rose to $385 billion by June 2007 (Shishkin 2008; World Bank 2007). State-owned companies held 30% of the $350 billion corporate debts (Dokuchaev 2008). Deputy Prime Minister and Finance Minister Aleksei Kudrin said that external debt was a comfortable 33% of GDP by January 2008, down from 50% a year earlier, and of that only 4% is state debt.[20]

Despite a decade of appreciation, in 2008 the ruble was still only 72% of its PPP level, roughly similar to Mexico, Brazil and South Korea although significantly ahead of China (20% of PPP) or Ukraine (25%) (Troika Dialog 2008a, p. 61). The evidence for a Dutch disease impact on the competitiveness of Russia's non-energy sector,

[19]Spilimbergo estimates that without oil windfall revenues (i.e. with oil at $20 a barrel), the budget would have been in surplus in 2000–2001, but sliding into deficit reaching 2.6% of GDP by 2005 (Spilimbergo 2005, Table 3).

[20]*Itar Tass*, 30 January 2008.

therefore, is far from clear-cut. The main concern is focused on the domestic price level, and this is mainly because of its political rather than economic salience.

Spending the surplus

The record of stabilisation funds in other countries is mixed: their creation is no guarantee that they will be immune to politically motivated or corrupt spending.[21] From February 2008 the Stabfond was split into two: the Reserve Fund held in secure foreign investments (such as US treasury bonds) and the National Welfare Fund, which will take revenue once the Reserve Fund reaches 10% of GDP and invest it inside the country. The question of how to spend the surplus has led to some bickering among government ministers. The Finance Ministry argued that it should be used to pay off Russia's foreign debt, while the Health and Social Welfare Ministry wanted it to plug the $3 billion deficit in the Pension Fund, and help regions compensate citizens for the monetisation of social benefits. The latter, implemented in January 2005, involved the elimination of some social benefits and the conversion of in-kind benefits to a cash payment (Zaiko 2005).

The Finance Ministry won the argument. Most of the revenue that was spent was used to pay off the state's foreign debts, which fell to $53 billion, 9% of GDP, as of January 2008, down from a peak of $150 billion and 150% of GDP in 1998.[22] In 2005–2006 for example Russia paid the $45 billion owed to the Paris Club of official creditors, a move that saved an estimated $12 billion in future interest payments. Four high profile 'national projects' in housing, education, health and agriculture were launched in 2005. But these were modest schemes, costing less than $4 billion in 2006, just 3% of total spending (Butrin 2005). Spending on the projects rose to $10 billion in 2007 and under an October 2007 plan the spending was to increase to $40 billion per year (2.8% of GDP). The revised plan also created a new Development Bank and the Nanotechnology Corporation. Meanwhile, spending on domestic security went from $4 billion in 2000 to $39 billion in 2008 (Nemtsov & Milov 2008, p. 45). One worrying development was the November 2007 arrest of Kudrin's deputy Sergei Storchak, who supervised the Stabfond, on vague corruption charges.

Inflationary anxiety

The fact that despite its best efforts the government cannot bring inflation below 10% per year, nor prevent the steady appreciation of the ruble against the dollar, signals that Dutch disease pressures do pose a continuing challenge. Despite the government's successes in capturing and sterilising oil and gas receipts, they have not been able to prevent the inflationary pressures caused by the inflow of private capital.

For the first time in Putin's presidency, consumer price inflation rose in 2007 to 11.9%, against 9.0% in 2006. Producer prices rose even faster, at 17%, and the money

[21]Such funds have been created in Kuwait, Norway, Colombia, Venezuela, Azerbaijan, Chad, Alaska and Alberta (Birdsall & Subramanian 2004).

[22]Federal State Statistics Service (Rosstat), available at: http://www.gks.ru, last accessed 20 April 2008.

supply (M2) rose 28% (World Bank 2007). Milk and bread prices rose by more than 20%, and anxiety over rising food prices led the government to introduce informal price controls in October 2007, to last through March 2008—not coincidentally, the month of the presidential elections. The government also cut import tariffs on dairy products from 15% to 5%, and increased the export tariff on wheat by 10% and barley by 30%. The share of imports in food consumption increased to 37% in 2007, making Russia vulnerable to the global increase in food prices. (Imports accounted for an even higher proportion—54%—of non-food consumer purchases.)[23]

The second most sensitive price is that of housing utilities, which rose by an average of 33% a year between 2000 and 2007, climbing from 4.6% to 9% of average household spending (Nemtsov & Milov, 2008, p. 50). The price of many assets not covered in the consumer price index was also rising. The average price of a square metre of housing has risen from 21,000 rubles to 45,000 rubles in the past two years (Nemtsov & Milov, 2008, p. 47). Consumer price inflation climbed to a 12.7% annual rate in February 2008.[24] Most analysts agree that the government's target of 8.5% for 2008 is unrealistic. Still, against the backdrop of global shockwaves emanating from the subprime mortgage crisis in the United States, Deputy Prime Minister Kudrin could with some credibility talk about Russia as an 'island of stability' in April 2008.[25]

Inequality

One aspect of the resource curse which has arisen in Russia is the tendency of resource-dependent economies to see increased inequality, including spatial inequality. GDP per capita in the regions is one third of that in the city of Moscow, and is still only one half when cost of living differences are taken into account (that is, in terms of purchasing power parity) (Troika Dialog 2008a). GDP ranges from $8,000 per head in the Southern Federal District to $28,000 in Moscow. The city of Moscow, with 10 million inhabitants (7% of the population), accounts for 25% of Russia's GDP in ruble terms, and 16% in PPP terms. The top fifth of households in the capital have disposable incomes of over $5,000 a month. Through the whole economy, Russia experienced a lurch towards inequality in the early 1990s, and income distribution pattern has changed little since then. The Gini coefficient (a standard measure of income inequality on a 1–100 scale) went from 0.26 in 1991 to 0.41 in 1994, and stayed at around that level for the next decade, standing at 0.41 in 2006.[26] In January–September 2007, the top quintile accounted for 47% of all income, and the second quintile 23%, while the poorest fifth received only 5%.[27] This inequality is keenly felt by Russian citizens. According to the results of the Russian Longitudinal Monitoring Survey, the vast majority of the sample felt that they have become poorer relative to others. 'Only 19% of Russians think that the economic and

[23]'Russian Economy: Trends and Perspectives', Moscow, Institute for Economy in Transition, December 2007.

[24]Rosstat, available at: http://www.gks.ru, last accessed 20 April 2008.

[25]*Russian Business Monitor*, 4 April 2008.

[26]Federal State Statistics Service (Rosstat), available at: http://www.gks.ru, last accessed 20 April 2008.

[27]Bank of Finland, *BOFIT Weekly*, 2, 11 January 2008, available at: http://www.bof.fi, accessed 20 April 2008.

social changes of the last 15 years improved their life, while 49% think that transition worsened their life' (Denisova *et al.* 2007, p. 2).

Long-run sustainability

Another concern about Russia's oil dependency is its long run sustainability. Will demand persist if the price of oil stays around $100 a barrel? And even at that price, does Russia have sufficient reserves that can be extracted and brought to market at cost that would make it a profitable enterprise? Russia is confident that its role in world energy markets is secure. It provided 48% of the increase in world oil supply in 1998–2004 and has 72 billion barrels of proven reserves, 6.1% of the world total (Tompson & Ahrend 2006). Investment in the Russian oil industry was $12 billion in 2004, 70% up on 1998, and which can be compared to the $65 billion invested globally by the Big Five oil majors in that year. Investment in resource extraction accounted for 30% of total investment in the Russian economy in 2006 and refining another 27% (World Bank 2006).

Over the past decade each spike in world oil prices has led to a surge in new drilling, with a three–six-month time lag, as companies drill in the marginal, high cost corners of existing fields. So output has been rising in response to the higher price level, at 8–11% a year in 1999–2004 and 6–7% thereafter. Meanwhile cash-rich energy companies have attractive price–earnings ratios and suck in foreign portfolio investors. However, it is true that the newly accessed fields are increasingly expensive, while the general rising price level (including sharply increased costs for steel and other inputs) causes some problems for Russia's capacity to expand production. Troika Dialog estimates that: 'The break-even oil price (the price at which the budget remains balanced) will next year jump up to $58.59/bbl (in stark contrast to 2001–03 when it was well below $20/bbl)' (Troika Dialog 2008b, p. 5). In the next two years Russian oil production is expected to rise by 2.6% per year—the rate of increase in 2007.[28]

The politics of subsidies

Some of the rents from energy exports are used to keep other domestic sectors afloat. The main vehicle for cross-subsidisation is the maintenance of artificially low prices for domestic consumers of gas and electricity. (Refined oil products have generally been allowed to rise to near world-market levels.) Under pressure from the government, Gazprom uses export revenues to subsidise domestic consumers, creating a mini-planned economy based on cheap energy. Gas accounts for 60% of electricity production. The biggest beneficiaries have been the energy intensive metals producers who have enjoyed an export boom thanks to electricity prices which are one quarter of those in Europe. Gazprom is allowed to charge just $60 to domestic industrial customers and $50 for households, while export prices were reaching $370 per thousand cubic metres by March 2008.[29] The government's plans since 2000 for a

[28]'FSU States Set for Solid Oil Growth', *Petroleum Intelligence Weekly*, 30 July 2007.

[29]Putin meeting with Gazprom Board Chairman Aleksei Miller, 14 March 2008, available at: http://www.kremlin.ru, accessed 20 April 2008; http://eng.gazpromquestions.ru/index.php?id=5, accessed 20 April 2008.

gradual increase in domestic prices have been outstripped by booming global oil and gas prices.

The electricity generating and transmitting monopoly, United Energy System (RAO UES), has been one of the main casualties of this policy. The Federal Energy Commission has held the annual rise in electricity prices well below the rate of domestic inflation since the late 1990s. UES claims that the selling price is below the cost of production, and it is certainly below the level needed to replace out-dated generating plants. UES has to pay close to market prices for many of its inputs (fuel oil, coal, rail transport) but faces strict price controls over its sales to industrial and domestic consumers. Unlike Gazprom, UES does not have many export earnings of its own, and it bears the main burden of the scissors between domestic and export energy prices. Political pressure prevents UES from cutting off electricity to large categories of non-payers such as communal housing services and military installations.

Efforts to raise electricity prices in 2004–2005 produced street demonstrations and protests from regional and municipal leaders. Even some parliamentary members of the pro-government United Russia (*Edinaya Rossiya*) party, sensing their political vulnerability, started to denounce the reforms. Full price liberalisation was postponed until the completion of the five-year plan to reform the sector, unveiled in 2000 by UES head Anatolii Chubais. That plan has proceeded slowly, with Chubais brokering complex bargaining between regional governors, local industrialists, and UES shareholders. But the privatisation cannot really proceed until prices have been increased, since investors do not want to buy loss-making regional utilities. After Putin brought in Mikhail Fradkov to replace Mikhail Kasyanov as prime minister in February 2004, the pace of liberalisation slowed even more. In June 2004 Fradkov announced a six-month freeze in the ongoing privatisation of UES. Since then privatisation of the regional utilities has resumed.

This situation has left the energy sector facing some perverse incentives. Energy companies have incentives to expand the export infrastructure, but not to expand domestic production. It is easier for them to divert supplies from domestic to foreign buyers than to expand output. And the persisting uncertainty over the future division of rents gives them less incentive to expand the size of the rents in the immediate term.

Conclusion

Putin himself told a State Council meeting on 8 February 2008 that 'we have still not yet succeeded in breaking away from the inertia of development based on energy resources and commodities. . . . The state system today is weighed down by bureaucracy and corruption and does not have the motivation for positive change'.[30] But the resource curse is not a law of nature. Well-designed state policies can mitigate its most damaging effects. It's still an open question whether Putin's state corporatism may succeed in avoiding the dire consequences for Russia that the resource curse model predicts.

[30]Presidential Administration, available at: http://www.kremlin.ru, accessed 20 April 2008.

Critics of the Putin strategy propose an economic development model whose chances for success are just as hypothetical as the government's strategy. Throwing open Russia's oil and gas industry to majority-stake foreign investors would probably lead to a surge in investment that would boost their earnings and lower global oil prices. But would it benefit Russian workers and consumers, or lead to lower levels of corruption? Neighbouring Azerbaijan and Kazakhstan have pursued such a path, but are hardly models of democratic accountability. And in any case, the Russian government has rejected such a development model and seems determined to stick with its chosen strategy.

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