

## **Challenges of Russian economic policy in the context of structural change and integration with EU (Policy recommendations)**

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## **1. Introduction**

The aim of INDEUNIS project was “to provide a comprehensive and up-to-date analysis of the recent experience with transition, industrial restructuring and integration in both EU New Member States (NMS) and selected Newly Independent States (NIS)”- that is the following CIS countries: Belarus, Kazakhstan, Moldova, Russia and Ukraine. The main topics of investigation were such as:

1. patterns of industrial restructuring in NMS and NIS,
2. effects of WTO accession and EU enlargement,
3. EU-NIS integration problems and prospects.

## **2. Patterns of industrial restructuring in NMS and NIS**

Concerning the first topic the main conclusion is that notwithstanding fast restructuring and productivity catching-up in the NMS and NIS, productivity levels are still very low: 60% of EU-15 (NMS), less than 30% in the NIS. Except that the industrial structure did not change notably as productivity growth resulted largely from growth within individual sectors, less from inter-sectoral shifts. **(P.Havlik).**

Trying to analyze this undoubtful fact deeper to identify competitive strengths and weaknesses of the subjects in the draft version of this report we gave a concise comparative analysis of the Russian and EU economies. In terms of statistics, Russia and EU-15 countries really have different status in the world economy. By level of economic development measured by per capita GDP (PPP adjusted) Russia lags the EU-15 by a factor of three and is behind the states that joined the EU in 2004 only by one third.

It is important to remark that a dynamic view on the situation reveals Russia's overshooting growth over the last 7 years as compared to the EU countries, and the conditions are in place to maintain and even widen the gap, mainly due to much higher growth in gross capital formation in Russia versus EU-15 countries (overshooting by a factor of four) and versus EU newcomers (overshooting by a factor of five). With the latter group Russia has comparable levels of gross fixed capital formation, which volumes versus private and public sector savings spell out a 10 p.p. GDP gap, allowing to assume that gross capital formation may grow 1.2-1.4 times (considering the need of growing Russian transnational corporations to invest into foreign real assets). But on the other hand, although recently Russia demonstrated one of the highest growth rates in the manufacturing sector (9% annual average), ceding leadership only to China (9.2%) and dependence of these rates on oil price movements is not so obvious, the growth rates are not yet stable. This is evidenced by mounting volatility of growth rates in the manufacturing sector and a short two year cycle of high (8-9%) and low (3-5%) growth in the entire industry and its manufacturing segment.

Our investigation for the INDEUNIS WP-1 showed that though the growth of the Russian economy that followed after the financial crisis of 1998 was driven by industries that are oriented towards local markets (such as food, beverages and construction materials) their contribution into gross value added is relatively small as the main share of value added is generated by heavy and resource-based industries. The latter still form the “core” of the Russian economy and ensure its stability. Except that a two negative trends became apparent: unit labor costs in manufacturing reached their pre-crisis level while price-competitiveness demonstrated significant deterioration.

So, further development of the Russian economy depends now on the industry’s ability to gain control over costs and productivity improvement which is impossible without further restructuring. Acceleration of Russian economic growth from the current 6–7% to the levels of the world’s fastest growing economies, will only be possible if the manufacturing sector boosts its contribution to growth, because the long-term growth prospects in the extractive industries are limited by the rate of reserve expansion, and, most importantly, by how fast demand for commodities from the national and the world’s economy will rise. The extractive industries’ prospective growth is estimated at 2–3% a year. But as some INDEUNIS authors remark «CIS countries covered by the INDEUNIS project, regardless their differences in size, resource endowments, and progress in reforms, share many common problems in foreign trade». Among them: resource-based export orientation that has even increased during the recent years due to rise in commodity prices, prevailing in export of goods with a low degree of processing, geographical disparities in trade, when manufacturing products with relatively high degree of processing are usually exported only at the CIS market (*O. Pindyuk*). She concludes: «NMS have been significantly more successful in trade restructuring than the CIS countries (including Russia-V.M.), and their experience can bring important lessons for the latter».

But simultaneously some experts arise another important question saying that though “the current state of low-quality exports is evident, but to what extent it is a problem” May be Russia is «more like Canada than Saudi Arabia, with a dual comparative advantage in resources and manufactures» (*O. Havrylyshyn*) In such a case «care must be taken to avoid Dutch-Disease effects in the oil exporters, but there should not be an automatic jump to the notion that only sophisticated manufactured goods are “good”, all else is not worthy of a country. Forced diversification by oil-exporters can be very costly, as the example of wheat in the Saudi deserts testifies» (*the same author*).

Diversification is usually understood as the faster development of the manufacturing industries (primarily high-tech ones) and the services sector versus other sectors, a higher degree of primary commodities processing, and the reduction of the manufacturing and services sectors’ dependence on the commodity industries and the rate of commodity export growth. In report for INDEUNIS WP-1 we proposed using a new technique for measuring risk levels and diversification of industry’s sectoral

portfolio<sup>2</sup>, Based on this approach, we started a series of complex calculations making it possible to estimate the dynamics of Russian industry's sectoral portfolio diversification in 1999–2004.

The analysis of growth characteristics of the sectoral portfolio showed the following:

Risk dynamics of Russian industry's sectoral portfolio are wave-like – a reduction in 2000 to the lowest level for the entire six-year period, a sharp rise in 2002, a drop in 2003-2004.

The level and contribution of systemic risk was lower in 2003–2004 than that in 1999 and afterwards, suggesting a decreased relationship between individual industry's growth and a rise in the economy's diversification. In 2004, the level of the sectoral portfolio's non-systemic risk remained almost the same as in 1999, suggesting that the total risk level of the sectoral portfolio is generally more closely related to processes occurring within individual industries than to dependence of these processes on some external factors such as a rise in commodity exports and demand by commodity exports. If these assumptions are accurate, then economic policy seeking to maintain high growth rates in industry should focus on addressing the intra-industry restructuring problems, which make the largest contribution to the sectoral portfolio's total risk.

In this context, without denying the importance of “horizontal” policy measures aimed at stimulating diversification and providing incentives for developing all sectors of the economy, the Russian government could start phasing in “vertical” measures, which would be more specific in enhancing the stability of individual sectors of the economy. Whether these should be the manufacturing or extractive sectors is the question that could be answered as part of further analysis. Vertical measures of government economic policy aiming to promote diversification may include tax and tariff measures, establishment of special economic zones, export supporting measures, provision of incentives to achieve a higher degree of primary commodities processing (above all for exportable commodities) within commodity sectors (not only in the fuel and energy industries but also in the woodworking/paper and chemical and petrochemical industries as well as agriculture).

Another discussing point (*O.Havrylyshyn*) is what is the reason for the low quality of the Russia's exports that are manufactures (and for Ukraine, Belarus - where manufactures dominate but are shown to be at a much lower end of the comparative advantage ladder than in the NMS) - the insufficiency of market reforms or the lack of state support for high tech and priority sectors as proponents of a new Industrial Policy (IP) argue. Some INDEUNIS authors in this context write that in Russia «the policy's

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<sup>2</sup> Under this approach, a set of industries can be represented as an asset portfolio (similarly to a financial asset portfolio in a classical G.Markowitz analysis ) with a structure that depends on individual sectors' shares in total output, and a “return” that depends on individual sectors' growth rates. In this case, the standard indicators of the portfolio's variance decomposable into non-systemic and systemic risks serve as a quantitative measure of sectoral portfolio diversification. Under this technique, non-systemic risk means risk related to the variance of individual sectors' growth rates. Systemic risk means is the part of the aggregate variance of industry's sectoral portfolio which is related to co-variance of growth rates of individual sectors. In a sense, an increase in the contribution of non-systemic risk to the sectoral portfolio's total risk and, accordingly, a decrease in the contribution of systemic risk, suggests a rise in sectoral portfolio diversification. In addition, an absolute change in the portfolio's variance is a measure of economic growth sustainability, which is in itself an important measure of competitiveness.

tools have hardly changed since the 1990's; they are still too politicized and short of healthy pragmatism" (*R. Grinberg*). For example, as we write in the draft DC report for WP-6 export support measures devised by the Russian government since 2003 do not bring noticeable successes either. It follows not only from objective statistics on the export trends and structure, but also from the fact that already proposed mechanisms do not enjoy business demand. In 2005 state guarantees for export support were offered in the amount of \$ 214 million (to support supplies of aircraft building products and atomic power) having an officially affirmed limit of \$500 million. In 2006 state guarantees, due to procedural bureaucracy, were not given at all (as at 1 October 2006). The same organizational barriers prevent timely refund of VAT to the exporters. Actually, the period of refund 2-4 times exceeds a legally established 3 month period. In all evidence, measures aimed at enhancing the volumes of non-raw materials exports lack comprehensive approach and leverages of its support that have absolutely no relation to control over financial flows. New approaches, on the one hand, can aim to use purely organizational mechanisms – for example, massive political lobbyism of Russian exporters and preventive creation on the basis of industrial unions of Russian exporters' consortiums participating in international tenders to stave off price reduction, and on the other hand, to provide for clear communication by federal authorities to the regions of prospects and timeframe of export transport infrastructure development projects.

In my opinion, the problem of IP does not lie in the fact that direct government industry support policy based on identifying priorities has become outdated. Today we should think about new concepts creating the mechanism of economic self-development, for instance the concept of innovation, although two important processes make successful use of selective interventions more problematic than earlier. First, because of spiraled competition among the governments of the developing markets, which increasingly strive to support selected industries in the economies<sup>3</sup>. Second, cheapening cost of information, higher capital mobility, creation of global supplier chains and permanent technological changes lead to rapid changes in industrial development patterns and competitive advantages<sup>4</sup>.

We believe that development of traditional industries and innovation are inseparable interrelated processes and transition to innovation phase is impossible to pull off though a spurt, it is an organic consequence of traditional industries development.<sup>5</sup> The problem is to reshape traditional industrial policy conducted at the macro-level. First, to mitigate the risk of government interventions' failures (although

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<sup>3</sup> Starting from 1962, when countries of South-East Asia were successfully experimenting with the so-called "industrial policy" aimed at supporting exports, the number of countries exporting electric equipment trebled and the number of countries exporting components for motor vehicles more than doubled (2005)

<sup>4</sup> See World Development Report 2005 by World Bank

<sup>5</sup> High level of R&D expenses is typical for developed market economies, where the bulk of expenses is borne by private companies. In less developed economies private businesses are often not motivated to engage in innovation activities, as demand of production companies for innovation depends on the quality requirements of the end-use products consumers (domestic and international) and is therefore contingent on successes in development of traditional industries, traditionally measured by investment growth in the Russian economy.

they cannot be avoided<sup>6</sup>), they should be undertaken in line with basic measures aimed at improving the investment climate (non-selective measures) to assure clear and reasonable goal setting, exercise tough control over the recipients of government subsidies and regularly monitor the effectiveness of government programs<sup>7</sup>.

Understanding the drawbacks of selective industrial policy, the started effort in this direction should not be yet abandoned and the existing gaps in the Russian regulatory base should not be ignored. For example, the report of the Development Center under WP5 has shown that the Russian auto market is most open to import of foreign brand cars due to low 25% import duty. Besides, the terms of industrial assembly of automobiles in Russia – close to duty-free import of auto components given the annual output is at least 25 thousand cars and the volume of auto components produced in Russia is brought to 30% of the total used auto components within 6-7 years – are actually a gateway for foreign car manufacturers to Russia.

As a result, the existing legislative environment does not sufficiently motivate foreign car manufacturers to set up fully-fledged (in terms of output and production of components) production capacities in Russia and does not contribute to building respectable status of Russian subsidiaries within foreign automotive concerns.

It should be understood, that often the process of industrial policy development is more important than the result. The sectoral policy, according to some specialists, should be viewed as a research process, in the course of which the company and the government become aware of the key costs and opportunities and get involved in strategic interaction. A hypothesis is offered that this interaction can be targeted at solving two kinds of problems:

- support of imitating quasi-innovations<sup>8</sup>;
- solving problems of coordinating complementary types of activity (clusters and so on).

Industry restructuring policy does not sufficiently reflect *regional specifics and the risk of regional disintegration*. It is true that the session of Presidium of Russian State Council on 19 February 2007 addressed the issue “On measures to support industry development in the Russian Federation” pointing out that functions of federal authorities first of all consist in fostering favorable conditions for implementing effective focused measures at the regional level aimed at realizing competitive advantages of the respective territories. In this respect, a decision was made to set up a legal framework for

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<sup>6</sup> The failures may be illustrated by lame efforts of state support to aircraft building industry in Japan and production of liquid crystal monitors in the USA.

<sup>7</sup> See World Development Report 2005 by World Bank

<sup>8</sup> At the current stage of development we should not overlook support not only to new operations and industries but also to the types of products new to a particular country – the so-called discoveries (terminology of Dani Rodrik, Harvard University). «Indeed, we showed how whole industries often arise out of the experimental efforts of lone entrepreneurs. Garments in Bangladesh, cut flowers in Colombia, IT in India, and salmon in Chile. For such innovations the entrepreneurs need the guarantee of receiving a rent which is possible through subsidies, credits to venture capital». (Dani Rodrik, INDUSTRIAL POLICY FOR THE TWENTY-FIRST CENTURY, Harvard University, article available at [www.opec.ru](http://www.opec.ru)).

concluding investment agreements between development institutions (Development Bank, Rosselkhozbank, Rosagroleasing, Investment Fund, and Venture Fund), federal authorities, regions and investor companies. In addition, it was decided to develop a legal base allowing to subsidize interest rates on investment loans aimed at implementation of high-tech projects in priority sectors of the economy. To conduct a cluster policy aimed at bringing out the competitive advantages of the regions, a decision was made to develop the Concept of territorial and production clusters. A crucial step, even disregarding regional specifics, was approved by the State Council to liquidate staff deficit in the industry to satisfy the requirements of industrial development in the regions and create a special system of mortgage crediting oriented at educational personnel, engineers and qualified workers.

At the same time, in our opinion, the relationships between the regional and new industrial policy need to be further elaborated and require new approaches. As empirically shown in a number of research papers, the revenue base of the RF regions is far more volatile (sensitive to regional revenue shocks) than that of US and EU country regions (EU-15)<sup>9</sup>. The volatility stems from uneven concentration of natural resources on the territory of Russia and the legacy of the Soviet economic policy hinged on centralized selection of the region specialization. Besides, a much lower than in the developed market economies level of labor force mobility also affects the ability of the regional economy to respond adequately to recession (deflationary) or inflationary shocks. These facts spell out for Russia the importance to develop and implement a regional policy that would, on the one hand, facilitate fast growth of regions acting as the locomotives of the economic growth, and on the other, eliminate the most odious manifestations of regional economic differentiation, avoiding traditional Russian slant towards equalization, and contribute to realization of the “constructive inequality” principle in the regional policy.

Following the old perception of the regional policy, two systems of state governance should work in parallel and independently with actually duplicated functions. The objectives to level off regional lopsidedness so critical in the period of restructuring slump should now give way to development tasks. Currently, the regional policy and region development policy should become different although inter-related processes. Region development is the task of regional authorities and the regional policy pursued by federal authorities should seek and maintain the equilibrium of regional interests by various directions, adjusting them so as to assure maximum realization of their potential and overall economic growth in the country.

Resolving of the national tasks should not lead to centralization of all powers, both managerial and financial, at the federal level. The ideal option is to track shaping trends in the development of companies, population migration, etc, to subject them to analysis and form the policy above these trends that will be used either to accelerate these trends or to iron them out, depending on a situation.

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<sup>9</sup> Russian Federation: Selected Issues, September 2004, IMF Country Report # 04/316, p.75-88



An additional grasp of problems the resolution of which would contribute to overcoming the competitive weaknesses of the Russian economy and enhance the chances for diversification of Russian export deliveries to the EU maintaining the necessary for the EU volumes of exported hydrocarbons and other raw materials is provided, firstly, by INDEUNIS authors (*J.Chojna*) who compare conditions for doing business in the NIS and in CEEs and Central Asia and, secondly, by studying the IMD competitiveness indices by DC<sup>10</sup>.

The first one (*J.Chojna*) analyses a set of basic business environment indicators for the analyzed group of NIS as compared with the averages for the region of Central and Eastern Europe and Central Asia. The indicators illustrate: process of starting a business; dealing with building licenses; employment regulations; foreign trade procedures; court efficiency; taxation burdens. Governance quality and conditions for doing business are generally poorer both in the NMS and the NIS than in the EU-15 and in the other highly developed countries and regions and amelioration of them on my opinion is the first task in priority for the NIS governments (including Russian) and the IP is only the second one.

Our studying of the IMD competitiveness rating shows that Russia is lagging behind, ranking the 50<sup>th</sup> in the recent years versus 35-40<sup>th</sup> ratings of the EU-10 countries and 20<sup>th</sup> ratings of the EU –15 countries (Annex 1). However, analysis of ratings assigned to Russia, EU-15 and EU-10 countries by main indices and the respective sub-indices shows their uneven allocation. So, from the perspective of economic policy it is important to pay special attention to the sub-indices of Government Efficiency and Infrastructure. By Government Efficiency, Russia is ahead of the EU countries in such areas as quality of public finance and fiscal policy (according to IMD ratings) and seriously lags in such areas as development of the economy institutional framework, business legislation and social interaction infrastructure. By Infrastructure, Russia is ahead of the EU countries in the area of science and education infrastructure development and lags by such parameters as development of technological infrastructure, health and environmental protection.

These spheres of activity may be further examined to enable technological and institutional transfer from the EU to Russia in exchange for the resources and developments needed by the EU economy to raise its competitiveness versus USA, Japan and South East Asia countries, as set forth in the respective EU documents, for example, the Lisbon program providing for creation in the EU of the most dynamic and competitive economy in the world based on this knowledge. Therefore additional priorities for cooperation between Russia and the EU may be identified apart from those set out in the Road Map to

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<sup>10</sup> There two most respectable world competitiveness ratings developed by (World Economic Forum, WEF and International Institute for Management Development, IMD). Country competitiveness indices are calculated by IMD on the basis of 4 factors: economic performance, government efficiency, business efficiency and infrastructure (Annex 4). Each of the factors is further broken down into five sub-factors aggregating the statistical data (over 314 criteria). Altogether 20 sub-factors are used in the calculations (Annex 5). Unlike the WEF ratings, where the share of surveyed criteria is over 50%, the survey data in IMD research represent a weight of one third. Another difference in approach applied by IMD is that each sub-factor has the same weight in the overall consolidation of results.

general economic environment developed in Moscow in May 2005: information and communication technologies, electric machinery and equipment, medical products, automotive, textile and pharmaceutical industries<sup>11</sup>.

### **3. Effects of WTO accession and EU enlargement**

In INDEUNIS debates devoted to WTO accession *O.Pindyuk* argues citing de Cordoba that «it is the timing and sequencing of trade liberalization steps, which to a large extent determine their efficiency. On the one hand, gradual introduction of reforms has its benefits as it allows labor and capital to adjust by natural attrition. ... On the other hand, gradual reforms mean bearing the cost of protectionism for a longer period and possible creation of incentives to invest into uncompetitive sectors». Except that the WTO accession, on her opinion, “should not be regarded as a panacea to all economic problems in an accessing country... In order for the WTO accession to stimulate economic development of new members, it should be accompanied by significant behind-the-border reforms (including institutional adjustments)».

Some contradictions after trade liberalization (on my mind WTO accession is some sort of trade liberalization too) arises because in some cases, as *E. Kaliszuk* writes, “initially causes a strong imbalance in trade flows. There is a strong correlation between an inflow of direct investments and value of imports (import-driven investments). In a longer period when the economy has adjusted to the stronger competition exports may grow faster”.

In debates about WTO accession, EU enlargement and trade liberalisation some authors (*G.Hunya*) remark that “as a result of maintaining various entry barriers, FDI penetration in Russia (FDI stock per capita or per GDP) is much lower than in NMS. The question arises whether the liberal or the protectionist approach has been more conducive to development and restructuring, for building up modern competitive industries and attracting manufacturing jobs?” This author writes that “expected impact of FDI on foreign ... differs according the maturity of subsidiaries. In the early period of a project’s life-cycle imports increase as most components and services are imported. In this stage fears of losing domestic suppliers are justified. Local linkages may disappear, as they are often unable to meet the high quality standards of foreign companies. But experience of the NMS proves the emergence of a domestic supplier industry later on. As a result, those countries which have relied heavily on FDI have a positive foreign trade balance with the European Union – the Czech Republic, Hungary and Slovakia already since 2000 and Poland since 2005. Countries with low FDI or later start, like Slovenia, Romania and Bulgaria have negative trade balances with the EU. Foreign trade deficits have of course multiple reasons but the strong export sector of the NMS is certainly the result of FDI.”

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<sup>11</sup> This document is published in: V.N. Sumarokov, N.V. Sumarokov, “Expansion of the European Union and Russia’s foreign economic ties”, Moscow, 2006, pages 208-224.

For Russia very optimistic looks the policy conclusions of an UNCTAD study (2003), cited by **G.Hunya**: “Russia’s greatest untapped potential lies in efficiency-seeking FDI. With its technological capabilities and labour skills, Russia could become a major international engineering hub. Under exclusively local ownership, however, most of its industries have failed to link up with technology and knowledge flows in the world economy. Changing that situation will depend partly on the success of measures aimed at improving the business environment, the stability of the economy and the rule of law. But such measures may in themselves prove inadequate under a scenario of intense global competition for FDI project”

Polish experience of trade liberalization is of great interest for Russia and all NIS too because “Poland has been an exhibit case of minimal state intervention in this field for the majority of analyzed period. Under such circumstances trade restructuring was overwhelmingly a playground of market forces. The strongest players have been foreign-owned companies (FOC) and they are responsible for most substantial changes in Polish foreign trade structure” (*Krzysztof Marzewski and Ryszard Michalski*). These INDEUNIS authors identify in this context such tendencies:

- process of replacing low-skilled labor with medium-skilled workers,
- a general fall in labor intensity of exports,
- a gradual decrease of exports resulting from intensive use of natural resources,
- a rise in exports which exploit economies of scale,
- no progress in knowledge intensive exports share,
- product differentiation confined to industries characterized by high segmentation of production,
- a gradual decline in an export share of industries characterized by low fragmentation of reduction which deliver relatively homogenous goods,
- a shift from low-technology products to medium-technology products (medium-low and medium-high technology groups), FOC have led the process,
- practically no change in export share of high-technology products which remains very low (2-3%).

Basing on these findings they conclude “on one hand a positive role of non-activist attitude of state authorities in accelerating the substitution of modern factors of production for natural resources and labor, but on the other hand we can claim that market forces have proved insufficient to make progress in knowledge intensive and high technology exports from Poland. Therefore dependence solely on foreign technology transfer seems to be very short-sighted policy which can be tolerated only temporarily”. Polish authors also write that “there should be a room for policy interventions to prevent – at least to some extent – elimination of inside-economy cooperation networks by foreign investors who prefer to make use of their own international networks of supplies. Such a replacement is highly detrimental to

domestic production and labor market because it causes a sort of diagonalization of national economy input-output structure reducing this way magnitude of potential multiplier effects”.

They also write that “records of many emerging markets - including Poland - show that export-led growth strategy is much more effective at changing economic structure of a country than import substitution.” The Polish authors oppose severely the idea “that one can decree from above a domestic production structure. It turns out quite often that forced out import substitution leads usually to copied, costly, small scale production. Paradoxically, import substitution happens to be import intensive because it requires imported technologies, machinery equipment and procurement.”

Analyzing positive aspects of Special Economic Zones (SEZ) creation these Polish authors also write about negative aspects: “the surge in exports supported by the public aid has contributed to a zloty appreciation during 2000-2001 what has caused a serious competitiveness challenge to exporters operating outside SEZ. Sudden appearance of highly effective producers provided a shock to the rest of Polish manufacturers what can be interpreted as a sort of Dutch disease”. On my point of view, to mitigate such adverse effects of FDI inflow is also an important policy recommendation for Russia and other NIS.

Policy recommendations by *Gabor Hunya* for Russia looks rather adequate:

- “Based on the experience of the NMS and the expert opinion of several international organizations outlined above, one can conclude that under a liberal regime more FDI would flow into Russia than it is the case today.

- FDI would improve productivity and stimulate exports. On the longer run it may even diminish import dependence.

- Due to more FDI and integration into multinational corporate networks rapid technological upgrading could take place in manufacturing especially in the car industry.

- Russia by its market-size and skills level would be a perfect location for full-fledged FDI companies and may not need to apply costly promotion. But it is essential that conditions for FDI are not restrictive and regulations for doing business are predictable and transparent”.

But from my point of view danger of dualisation may be a reasonable threat for Russia and other NIS. As INDEUNIS author *Chojna* writes “ both the growth based on exploitation of natural resources and the successful restructuring with active participation of foreign direct investors endanger with dualisation of an economy, in which cutting-edge sectors integrated into world markets would coexist with sectors (other than raw materials or with exclusively domestic equity) characterized by low competitiveness. The lack of catching up effects and, consequently, a growing gap between the two types of the sectors should become an issue of particular interest for policymakers.” So “economic policy should be more effective at supporting especially small and medium-sized enterprises, in transferring

incomes from exports of raw materials to other sectors, especially by supporting investment and modernization processes. In this context, investment in infrastructure may be of essence”.

Speaking about useful lessons from NIS experience of industry restructuring for FDI attraction we can not agree with INDEUNIS authors *Ferto and Soos*, who try to link quality of privatization, corporate governance and foreign direct investment. From their point of view «give-away mass privatisation schemes» resulted in insider ownership and such corporate governance practices, which deter the development of outsider ownership and borrowing. They also write that such give-away mass privatization schemes had no economic but an important political appeal, and only from this point often have been unavoidable.

From my point of view<sup>12</sup> the give-away mass privatization schemes had not only political but profound economic base in the structure of the Russian industry. Proceeding from the main features of the Russian industrial monopolism substantially connected with narrow specialization of production units, during privatization it was necessary to transfer solving influence during decision-making to the economic subjects aimed at minimization of investment risks and, hence, on diversification of capital investments. Among the most probable candidates for this role we have deduced heads of the enterprises (top managers) and labour collectives as a whole. Deeper analysis of this question reveals, however, one more interesting problem which we considered necessary to consider. The matter is that studying by psychologists of comparative value of individual, group and collective decisions in relation to risk has yielded ambiguous results. Thus for our research of problems of formation of mechanisms of the property and control in process of privatization it was important to consider non-identity of risk value of group and collective decisions. At studying acceptance of the group decision of the so-called "the small group" (in five-seven person here is meant) in 1961 the American researchers found out interesting phenomenon which has received the name " shift of risk ". It has been proved, that the small group decision includes the moment of risk in a greater measure, than individual decisions though before was considered, that the group acts some kind of "moderator" of individual opinions and judgments of its members, rejects the extreme decisions and accepts original average of individual decisions. But experimental checking by the American psychologists of this process of averaging has not confirmed it for cases when the decision included the moment of risk.

The nature of «shift of risk " in small group was discussed by psychologists at that moment, but, in our opinion, economists had to consider greater propensity of small group to risk in comparison with the individual, accepting it as empirical fact.

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<sup>12</sup> My point of view on the subject of privatization in Russia is not theoretical, but practical too because I was a participant and one of the authors of the privatization schemes and laws in Russia in 1989-1991(I worked at that time at the Institute of Economy of the Russian Academy of Sciences and in the group of economic experts for the Supreme Soviet of Russia guided by Pyotr Filippov)

For our problem from this followed a conclusion, that if one wish to reduce a risk degree of accepted decisions at a corporate level he should be guided by transfer of the solving rights not to small group, but exclusively to individual person, for example, to director of the enterprise (in some cases to so called oligarch). At the same time it is necessary to consider, that decision-making by collective, greater on the size, than the small group, also was characterized by aspiration to avoid risk and to diversify the economic activity. Materials of the international conferences testified to it, in particular, at the Oxford University at the beginning of 90s.

Thus, the conclusion followed, that the individual and collective as subjects of decision-making are more inclined to decrease in risk, and a small group being between them (for example Board of Directors), on the contrary, is more inclined to acceptance of risk decisions in investment activity. Hence, aiming investments at diversification should be expected both from individual (director) - the individual proprietor, and from labour collective as a whole, possessing a control share holding, but in no way from small group of heads of the enterprises

Proceeding from these factors, and also from the world experience widely shared in the literature showing efficiency of the working property only on small firms with the size no more of several hundreds person, it was necessary to project, in my opinion, algorithm of the Russian privatization in view of its antimonopoly orientation in conditions of prevalence of narrow specialization of the basic industrial parts<sup>13</sup>. These subjects played their role by creation in 1990 powerful diversified financial-industrial groups in Russia that included manufactured enterprises and financed them by raw materials' export revenues. In some senses it helped to maintain the Russian manufacturing sector in the beginning and middle of 1990s and served as a base for quick economic recovery of Russian industry later- in 1999-2007. But now the new stage of restructuring is coming to an edge. Capture of oligarchs by Russian state is on my opinion only an intermediate stage of transition to new privatization of the state actives with the aim to diffuse property rights among wide layers of the population.

With some degree of doubt I also look at argument of *Gabor Hunya* that “the structure and development of the Russian car industry contrasts with world-wide trends and also deviates from the experience of the NMS”. He continued: “Today’s car manufacturing is a highly internationalized industry, national brands can hardly survive.... All larger national car companies in the NMS have become foreign subsidiaries. The best of them, Skoda in the Czech Republic is one of the most successful brands within the VW group. Also Romania’s Dacia has become a successful Renault subsidiary.” He

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<sup>13</sup> See in details in:

1. Валерий Миронов: Хочешь избежать риска – доверься «олигарху»: [http://opec.ru/comment\\_doc.asp?d\\_no=59884](http://opec.ru/comment_doc.asp?d_no=59884)
2. “Антимонопольное регулирование отраслевых промышленных рынков в экономике западного и советского типа (сравнительный аспект анализа), препринт доклада, Москва, 1992, Институт экономики РАН;
3. Валерий Миронов, РОССИЙСКИЙ МОНОПОЛИЗМ И ПРИВАТИЗАЦИЯ анализ индустриальной базы накануне радикальной реформы, научный журнал «Новое поколение», Москва, №2, том. 1, зима 1996;

writes later: “Therefore it is questionable that AvtoVAZ will be able to keep its production level in the coming years as foreseen by Russian analysts (Berezinskaya, DC, 2006) - if it stays under local ownership.”

On my opinion, it is very important to consider some empirically revealed feature of the large national automobile markets which does not undertake in calculation by the honorable author quoted above, - as shows the world experience generalized in particular in researches of company McKinsey, those transition countries which had in past their own automobile manufacture, have kept it in all circumstances. But naturally it concerns to markets larger in size, than the Czech Republic or Romania. Thus two objective tendencies are important, almost in all countries at the first stage the state rendered any support to a national car industry, but all the same a leading role in a survival of national automobile manufacture played energy of private business, and except that practically there is no case, that survived just that national brand or the manufacturer which existed at the beginning, during period of protectionism. But necessarily in all cases the new national brand arised and it found adequate solvent demand of customers.

#### **4. EU-NIS integration problems and prospects**

In the recent years Russia’s economy underwent serious changes. Net of the market conditions reviewed above (strengthening of the ruble, rising of ULC), such newly emerged factors as deficit of equipment, competent staff and escalating competition with imports begin to play a weightier role as economic growth constraints alongside traditional growth limiting factors (insufficient domestic demand and equipment).

Concurrently, radical change was observed in approaches to economic policy targeted at industry restructuring and overcoming de-industrialization of the Russian economy manifest in industry underperforming of GDP growth. In this context, the former strategic focus of foreign trade is now being revised, and a new strategy is still in the making (several scenarios are being developed), which contains and is likely to continue to hamper business development at least up to 2009 – the start off of new government formed after presidential elections .

As INDEUNIS author **R.Grinberg** writes “selection of structural priorities depends on the general economic development strategy in terms of economy positioning within the evolving global economic system. The key question in need of a sound answer is whether these countries position themselves as independent subjects of economic growth or implement a scenario suggesting their integration with other centers of economic power”.

The Central and East European nations by joining the EU chose the second way and became a part of the economic space of this powerful economic alliance. This way may be named as **R.Grinberg** writes, “exchange of economic sovereignty for foreign investments”. But on his opinion “this scenario

puts certain constraints on the economic development prospects in these countries”. “First, the prospects of their participation in the innovation process are not clear. ...The situation in CEE countries is radically different from that in, say, Finland and Sweden which both have world level national corporations capable of capitalizing on technological achievements. In terms of the current division of labor in the EU, the CEE countries will hardly play the role of independent agents of innovative development, they will rather act as EU assembly shops”. Except that “the economic development prospects in these countries will be a function of economic growth in leading EU countries. The current estimates of economic development prospects in the new EU member-states for 2015-2020 stand at 4-4.5% of GDP annual growth rates, which is roughly 2% higher than the economic dynamics in “old Europe”. Given this faster rate of economic development, the current gap between the per-capita GDP in old and new EU member-states can be bridged within 40-50 years. At the same time, it is difficult to imagine as to how the economic growth rates can be speeded up given the limited economic sovereignty”. Should the above problem of choice be referred to Russia, then two development scenarios lend themselves readily.

*“The first scenario*, when Russia with its resources builds in other centers of global economy, playing the role of energy and raw materials supplier with quite obvious constraints for economic development. Given *the second scenario*, Russia shall develop an integration space on the bulk of post-Soviet area and regenerate the multisectoral economic structure aimed, in the first place, at domestic market across the entire space”.

And really - as I observe - the recent years saw a change in the Russian government objectives as regards further course of foreign economic operations. One of the key priorities identified in the program of social and economic development of the Russian Federation for the medium-term (2005-2008) published in early 2005 was to complete accession to the multi-facet system of regulation on terms acceptable to the Russian Federation and transition from bilateral contractual base of trade to multilateral. Now, against the background of foiled talks on multilateral investment agreement and protracted Doha round negotiations under the aegis of WTO, more experts root for bilateral, and first and foremost, regional agreements based on the “free trade zone+” principle (trade liberalization with partial liberalization of capital flow). In this context, the task considered as first priority several years ago moves to the forefront again - to expand a list of trading partners, seek new merchandise and services markets based on bilateral treaties and more active participation of Russia in regional and political blocks. When the above development program was devised in 2005, its respective section mentioned primarily CIS countries, Evrazes, Common Economic Space, but not the EU.

Possible foreign trade development scenarios are linked with four core alternative scenarios – Asia-reorientation strategy, US cooperation strategy, creation of a single energy transit system “European Russia – Far East” to be able to exercise operational management of supply volumes by different



geographic zone, using the unique transcontinental location of Russia, and, finally, traditional loyalty to cooperation with the EU.

*The first scenario* requires creation of large specialized trade terminals on the Pacific coastline and development of infrastructure for rail deliveries to China and Republic of Korea, as well as entering into long-term contracts on economic cooperation with the countries of this region aiming to facilitate access of goods produced by the Russian manufacturing sector to this market.

*The second scenario* – orientation towards the USA – is primarily based on spurring exports of energy-producing materials and expanding cooperation in the area of production and exports of high-tech services requiring investments in the development of the respective infrastructure.

*The third scenario* is targeted at diversifying exports of energy-producing materials and taking advantage of the transcontinental position of Russia as a bridge between Europe and Asia.

*The final fourth scenario* provides for development of infrastructure for energy deliveries to Europe with the aim to exclude unreliable transit countries and ensure supplies oriented towards energy-saving and diversification of imports under the new EU Energy strategy (2007 draft). Due to low growth rates in the EU economy (Section 1 of the Report) and predominantly resource-driven Russian exports to European countries (Section 2 of the Report), this option have prospects only if agreement is in place on creation of a single economic environment with the EU, stipulating removal of barriers to Russian non-raw materials exports. In any other case, materialization of this scenario is not likely to resolve the piled up problems. Some of these problems were addressed in our report under WP (3+4) of this project. For example, one of our assertions was that the short-term result of the EU expansion in 2004 was a certain increase, in real terms, in raw materials exports from Russia to EU-10 countries against the background of a more considerable growth in finished goods exports from EU-10 to Russia. In future a number of institutional issues related to prospects of fulfillment by new member states of the EU Energy policy provisions and transition of the EU-10 countries to EU technical standards and similar certification procedures may potentially contain the growth in the Russian exports of machinery and equipment, industrial goods and end-use products. With further diversification of the Russian economy and rising demand for ecologically clean agricultural products on the European market, these problems may be become of crucial importance to the Russian enterprises operating in the manufacturing sector and agribusiness.

One of the ways to materialize the fourth scenario may be a course towards cooperation with the EU in the framework “free trade zone +” (trade liberalization with partial liberalization of capital flow) or a course towards “more profound” integration with the EU entailing conclusion of the agreements aimed at creating a single legal framework for economic activity. In the current political setting that would mean for Russia to accept the basic “playing rules” adopted in the EU. The second course would allow substantial cuts in investment costs associated with development of the transport infrastructure through

attraction of European investors and providing Russian companies with access to the EU transport infrastructure. At the same time, inevitable inclusion of the Transit Protocol to the Energy Charter will impose tight constraints on the freedom of choice for the Russian government.

Alongside problems arising from variances in the legislations, the poll conducted by our experts under WP3+4 of INDEUNIS project to find out the opinions of Russian top industrialists about implications of the EU enlargement mentioned above, allowed, inter alia, to identify organizational, economic and political factors impeding the expansion of Russian trade with EU member states.

According to the group of enterprises involved in foreign trade, among the main depressants (in the order of priority) were the drawbacks of the Russian economic policy and complicated taxation being, to a certain extent, one of the consequences of this policy. The following two problems – low quality goods and insufficient information about EU merchandise legislation - can be resolved by top managers of these enterprises themselves. A sizable share of managers from this group indicated that one of the significant problems for them is state support of the competing firms in the EU.

The problems challenging domestic-oriented producers are revealed in their responses to the questions on factors hindering expansion of trade with the EU countries. Thus, a much larger share of the respondents named a language barrier (almost 12% versus 2% in the export-oriented group and 4% in the entire sample) and low quality of their products (over 20% versus 14% in the export-oriented group).

We also note a higher percentage of the respondents (comparing to the entire sample and the export-oriented group) who have no or very vague idea of the EU merchandise legislation (over 20 % against 14%), and a very low percentage, evidently due to the lack of the relevant practical experience, of the respondents who pointed to visa regimes and government support of the competing firms.

## **5.In conclusion**

As *Janusz Chojna* – INDEUNIS author from Poland - writes and on my opinion there are profound reasons to agree with him, “The process of restructuring in the NMS was shaped to a large extent by external factors, namely the conditions for the membership in the OECD and in the WTO, and, especially, the EU association and accession agreements, which settled goals and a timetable for changes. The lack of strong external obligations and changed international environment make the restructuring process more difficult in the NIS than it was in the NMS. However, in view of long term risks and development challenges they should regard the commodity boom as a chance for restructuring and not as an opportunity to suspend it”.

The year 2006, on my opinion, bucked the multi-year uptrend in oil prices now set on a downward path. The Russian economy forecasts put together by Development Center for 2007-2010 with respect to different oil price levels indicate that in the short-term the Russian economy can withstand any change on the oil markets, maintaining GDP growth rates in 2010 at 4-4.5%, even if the URALS grade oil price

drops to \$35 p/bbl. In the medium-term, however, the influence of the international economic environment will be much stronger, although a possibility of crisis (GDP contraction) in the coming seven years is estimated as «remote» or «unlikely», albeit the consensus forecast regularly compiled by the Development Center points to a cyclical growth deceleration in 2011-2012.

In these circumstances a logical question will be what economic policy is more important for the Russian economy: restructuring at meso and micro levels or competent macroeconomic monetary policy. Judging by the poll conducted by IMD experts, the Russian economy has more room for resistance to cyclical fluctuations, including price movements on the world commodity markets, than for improving quality of the monetary policy as an instrument to underpin the competitiveness of national producers (the respective scores in 2006 were 4.3 and 5.5, respectively, using a 10-grade scale). As stability of the Russian economy substantially depends on raw materials exports, these assessments may be interpreted as a chance for Russian authorities to upgrade their course in the eyes of the international expert community through purposeful action aimed at diversifying the economy by developing sectors that are not directly exposed to the effect of oil price movements, primarily, the manufacturing sector.

Against the background of serious shifts in the world economy brought about, among other things, by restructuring and international migration of manufacturing industry sectors, the Russian economy faces a challenge to sustain high growth and strengthen its stability in the manufacturing industry for further economy diversification and adaptation to falling growth in raw materials exports. In the context of rapidly declining price competitiveness of Russian commodities on the domestic and world markets pulled down by appreciation of the real ruble, special focus is placed on such economic growth factors which refer to non-price competitiveness factors, for instance, expansion of international economic cooperation, including deepening cooperation with EU member states for mutual benefit.

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**Annex 1. Changes in IMD world competitiveness rankings of Russia and EU countries: sub-factor breakdown of Economic Performance, Business Efficiency, Government Efficiency and Infrastructure**

Table 1. Economic Performance – sub-factor breakdown of Russia’s and EU countries’ competitiveness (rankings assigned by IMD)

	2002	2003	2004	2005	2006
Domestic Economy					
EU-15	16	19	22	25	28
<i>EU-10</i>	30	41	41	44	34
Russia	26	45	21	30	23
International Trade					
EU-15	24	23	22	20	26
<i>EU-10</i>	19	23	31	23	25
Russia	6	10	5	7	17
International Investment					
EU-15	14	18	16	24	28
<i>EU-10</i>	34	30	24	30	24
Russia	4	21	30	33	33
Employment					
EU-15	22	27	31	34	31
<i>EU-10</i>	38	42	46	47	47
Russia	38	37	48	46	39
Prices					
EU-15	18	20	32	32	35
<i>EU-10</i>	28	30	31	34	32
Russia	48	58	59	60	61

*Note:* Competitiveness factors by which the Russian economy outperforms the economies of EU-10 and EU-15 countries are marked by yellow color. Competitiveness factors by which Russia outperforms only one of the EU-10 or EU-15 countries are marked by green color.

*Source:* IMD statistics, 2007

Table 2. Business Efficiency - sub-factor breakdown of Russia's and EU countries' competitiveness  
(rankings assigned by IMD)

	2002	2003	2004	2005	2006
<b>Productivity and Efficiency</b>					
EU-15	16	21	20	22	21
<i>EU-10</i>	23	35	35	34	29
Russia	33	46	14	47	51
<b>Labor Market</b>					
EU-15	27	32	37	38	35
<i>EU-10</i>	26	30	29	35	35
Russia	48	54	56	49	42
<b>Finance</b>					
EU-15	15	17	19	20	21
<i>EU-10</i>	37	42	48	42	43
Russia	36	58	57	59	56
<b>Management Practices</b>					
EU-15	19	22	26	28	26
<i>EU-10</i>	38	46	50	45	44
Russia	45	57	49	54	54
<b>Attitudes and Values</b>					
EU-15	22	26	30	34	32
<i>EU-10</i>	34	40	44	38	43
Russia	42	55	49	52	49

*Note:* Competitiveness factors by which the Russian economy outperforms the economies of EU-10 and EU-15 countries are marked by yellow color. Competitiveness factors by which Russia outperforms only one of the EU-10 or EU-15 countries are marked by green color.

*Source:* IMD statistics, 2007

Table 3. Government Efficiency - sub-factor breakdown of Russia's and EU countries' competitiveness  
(rankings assigned by IMD)

	2002	2003	2004	2005	2006
Public Finance					
EU-15	25	30	32	32	35
EU-10	26	35	31	29	28
Russia	26	17	3	3	2
Fiscal Policy					
EU-15	37	42	43	43	44
EU-10	35	39	39	40	40
Russia	23	28	21	18	23
Institutional Framework					
EU-15	17	20	24	26	22
EU-10	32	38	40	37	36
Russia	42	51	48	52	50
Business Legislation					
EU-15	18	19	21	25	24
EU-10	35	40	39	34	34
Russia	46	55	55	58	57
Societal Framework					
EU-15	17	19	21	22	21
EU-10	27	32	36	33	31
Russia	43	55	50	54	51

*Note:* Competitiveness factors by which the Russian economy outperforms the economies of EU-10 and EU-15 countries are marked by yellow color. Competitiveness factors by which Russia outperforms only one of the EU-10 or EU-15 countries are marked by green color.

*Source:* IMD statistics, 2007



Table 4. Infrastructure - sub-factor breakdown of Russia's and EU countries' competitiveness (rankings assigned by IMD)

	2002	2003	2004	2005	2006
<b>Basic Infrastructure</b>					
EU-15	19	22	23	23	23
<i>EU-10</i>	23	28	33	32	32
Russia	48	52	56	55	58
<b>Technological Infrastructure</b>					
EU-15	17	18	23	25	22
<i>EU-10</i>	30	39	38	39	39
Russia	48	58	54	55	57
<b>Scientific Infrastructure</b>					
EU-15	17	21	22	22	22
<i>EU-10</i>	33	43	43	43	44
Russia	10	12	12	21	24
<b>Health and Environment</b>					
EU-15	14	17	17	18	17
<i>EU-10</i>	38	44	44	43	42
Russia	47	58	59	59	59
<b>Education</b>					
EU-15	18	20	21	22	20
<i>EU-10</i>	25	29	31	31	31
Russia	23	29	26	27	37

*Note:* Competitiveness factors by which the Russian economy outperforms the economies of EU-10 and EU-15 countries are marked by yellow color. Competitiveness factors by which Russia outperforms only one of the EU-10 or EU-15 countries are marked by green color.

*Source:* IMD statistics, 2007