Is Russia Still a BRIC? Some Observations on the Economy and Its Potential for Diversification

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Is Russia Still a BRIC?

Some Observations on the Economy and Its Potential for Diversification

Aleksandr Gevorkyan

Can Russia break its dependence on oil and diversify its economy (its so-called resource curse)? Aleksandr Gevorkyan argues that it has the potential and may be well on the way to doing so—that is, beating the curse and becoming a full-fledged global player again.

IS RUSSIA STILL A BRIC (Brazil, Russia, India, China) economy as defined by Goldman Sachs (O'Neill 2001) and suggested elsewhere (Keohane 2011)? In other words, is it one of the future star economies, along with the other members of this group? The answer is "yes" because, having undergone profound transformation in an extremely short period, Russia is emerging as a qualitatively new economy with strong potential.

The economy appears to be set on a course of industrial diversification that in time has the potential to break its perennial energy "re-

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source curse." Despite persistent institutional challenges, the Russian economy has gone through several key changes. This article reviews some of the relevant trends that can lead to sustainable development. The new dynamic comes from domestic market operations, but the change is only just becoming visible.

New Landscape

Russia's economy is set on a very different foundation from the rapidly growing Asian economies to which it is often compared. Russia is emerging from the postsocialist, liberalization, and macro-stabilization shocks of the 1990s. While some aspects of the previous model are influential, a new one is also developing. Some of the characteristics of that earlier period were destabilizing—for example, volatility in a still dominant energy sector and impacts from foreign exchange flows, as well as domestic inefficiencies.

Russia is the largest member of the Commonwealth of Independent States (CIS) in terms of foreign investment and cross-border mergers and acquisitions (M&As) and has some impact on international markets. Capitalist-type consumerism has developed deep roots, with all the consequent individualism and property dynamics. A gradually evolving institution of corporate management and growth in new, innovative industries are real and gaining dominance, along with, though somewhat minimal, yet relative, a decline in the energy-sector dominance. For the business community, this means access to new markets that, aside from growing numbers of eager middle-class consumers, offer the determination of a well-educated labor force.

Where there was once economic chaos, there is now a new landscape, which requires a fresh new approach. The macroeconomic momentum for a proactive economic diversification drive appears to be just right. But such a transformation is not taking place and cannot take place overnight.

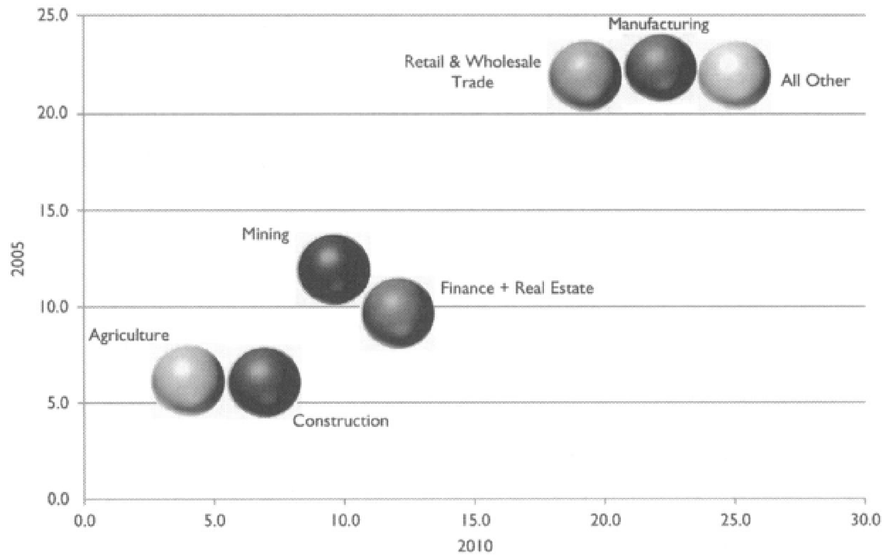

Figure 1. Russia's GDP by Top-Tier Sector Composition

Source: FSSS 2012.

Some Stylized Facts on the Economy

Domestic Macroeconomic Performance

Russia does not lend itself to "straightforward" analysis. To begin with, its institutional base continues its transformation as the society and economy evolve, while its economy appears to be often characterized as simply oil-exports dependent. At a bare minimum, this postsocialist market has developed some operational experience with concepts of private property, contractual agreements, taxation regulation (e.g., an expanded tax base), corporate financial reporting, and the institution of a formal administrative system for business operations. We should not be under any illusions, as Russia may not yet have achieved the highest scores on all benchmarks (e.g., it has risen only four points in terms of its rank on the scale of perceptions of business conditions, from 124 to a still low 120 position, according to the World Bank [2011]). Gaidar (2007) notes the strong, positive development of Russia's emerging and evolving institutional structure. However, he also rightfully points out the lack of a foundational tradition for the newly established institutions in the postsocialist context, suggesting that a solid institutional base and economic diversification would come in time.

In terms of industrial sectors, Russia's economy remained relatively static through the 1990s and early 2000s: slow to adjust and only partially diversified. The core sectors (e.g., mining) reduced their average share of the gross domestic product (GDP) only slightly between 2005 and 2010 (Figure 1).

Figure 1 can be explained as follows. New sectors have been slow to establish a significant presence in the early transition era under the new institutional system, and the economic collapse ended the period of a finely tuned and complex planning system. Facing a newly open economy and the foreign-exchange needs to support a growing consumer imports market (Gevorkyan 2011), Russia relied on its mining industry for growth. This dependence on exports of primary commodities (epitomized in oil exports) has been dubbed Russia's "resource curse."

Strong economic growth, no matter the source, is undoubtedly a good thing, and, even if concentrated in isolated sectors, early reformers hoped that it would eventually spread throughout the economy. The timing, as Gaidar (2007) notes, was the main unknown. Today there may be cause for cautious optimism.

Russia's economy, after taking a sharp dive in 2009, is now recovering to pre-crisis levels, with growth likely to average around 4 percent over the next five years (IMF 2012). Together, the four BRIC member countries will achieve over $14 trillion in combined GDP in current prices (compared to a combined $2.6 trillion in 2000), according to the International Monetary Fund (IMF).

As of 2012, Russia ranks third among BRICs, following China and Brazil, in terms of GDP, at an estimated $2 trillion, and its GDP per capita is projected to reach $14,300—the highest in the group. At the same time, consumer price inflation is expected to stay low at 6.5 percent on average, compared to 14 percent in 2008 and around 12 percent in 2009. Gross national saving is expected to rise to nearly 28.4 percent of GDP in 2012, and gross investment is expected to reach about 24 percent of GDP (compared with an expected 18 percent, 50.6 percent, and 31.4 percent in gross national spending, and 21.2 percent, 48.4 percent, and 34.6 percent in investment for Brazil, China, and India respectively for 2012).

Manufacturing productivity has rebounded to pre-crisis 2007 levels, reaching annual growth of 8.3 percent in 2010. However, industrial-sector growth in 2011 was a modest 3 percent. The export-oriented energy sector, challenged by new industries domestically, has also contracted from previous highs, due to volatility in global oil demand and lower prices. At the same time, labor productivity across all sectors increased 3 percent in 2010, a post-crisis comeback (FSSS 2012). Consumer goods and services production gained momentum in the first quarter of 2012. General government revenue as a share of GDP is projected to gradually decline to approximately 33 percent, from earlier highs of around 40 percent. This list of positive macro data also includes projections for lower unemployment (a steady 6 percent in 2012 and forward vs. an average 7.9 percent for 2000–2010) and other indicators (see IMF 2012). These indicators are the best macroeconomic indicators on Russia to date.

But is this performance sustainable? If this means continued reliance on the volatile and uncertain energy sector as the main driver of growth, then the answer is "no." However, this generally positive macroeconomic record offers an opportunity to jumpstart the diversification process, in which expanded business activity, reviewed below, is pivotal.

Advancing Cross-Border Business Activity

Let us consider cross-border business deals first, simply because being an open economy is still a new reality for Russia. According to Russia's Ministry of Finance (MF), total exports grew 30.4 percent between 2010 and 2011, with an upward trend forecast into 2012, on the rebound from the post-2008 crisis slide.

Exports to the CIS economies (a regional organization whose membership comprises postsocialist states including Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan) reached $84.1 billion in 2011, an increase of 34 percent over 2010, and grew 8 percent year on year in the first quarter of 2012. Not surprisingly, non-CIS exports, mainly to

Western Europe, reached $438.2 billion for 2011, an increase of 29.7 percent over 2010. Perhaps even less surprising is that over the past two decades, energy products on average grew to comprise nearly 50 percent of Russia's total exports, making the country a regional net exporter, along with Azerbaijan, Belarus, Kazakhstan, and Ukraine (Gevorkyan 2011).

Further, a somewhat optimistic illustration of increasing economic maturity is Russia's increasing outward foreign direct investment (OFDI) in the economies of the CIS and other developed markets. Evidence is abundant of Russian-based companies participating in large-scale M&As (Kalotay and Sulstarova 2010). These initiatives appear to be the dominant strategies in the foreign market access by Russian companies (Panibratov 2010). The United Nations Conference on Trade and Development (UNCTAD) (2012) notes a rise in cross-border M&As from $4.5 billion in 2010 to $33 billion in 2011, due primarily to a few large transactions. Russia is both an originator and a receiver in M&A transactions (e.g., KazakhGold Group's $6.3 billion acquisition of Russia's Polyus Gold). The report also notes an increasing proportion of M&As in Russia's consumer market, non–natural resource sectors, particularly with the participation of the members of the European Union (e.g., Russian-based enterprises active in retail trade and auto and textile industries, discussed below).

Russia is the key player in the postsocialist bloc as the major investor and trade partner. Investing in construction, energy, precious metals, and metallurgy, Russian companies rely on existing physical facilities from the Soviet era and count on access to a relatively skilled labor force. The pattern complicates cross-country comparisons, especially with other emerging markets (e.g., BRICs), where such preexisting relationships are less developed or nonexistent. For some of the smaller CIS countries, such investment has been a significant addition to their GDP (e.g., Armenia or Belarus; see data and trends in Gevorkyan 2011).

Large Russian multinational corporations (MNCs) also participate in M&As outside the CIS, including in financial services (e.g., Sberbank's acquisition of some of the Austrian Volksbank's European operations). Such actions follow the general demand of the Russian banks' corporate customers, who expect access to their banks while running business operations abroad. UNCTAD (2012) cites as another example the Russian TNK-BP's acquisition of a 45 percent stake in Brazilian Amazon oil exploration (from Brazil's HRT Particiapoes, worth $1 billion) and Russian technology firms' sizable investment in large firms in developed countries (e.g., Sky Technology's purchase of 10 percent of Twitter).

According to the Central Bank of Russia (CBR 2012). at the end of 2010 total OFDI reached the pre-crisis (2007) level of $370 billion for the year. This is eighteen times more than in 2000. Much of this growth was driven by a handful of large Russian MNCs in energy, technology, defense, and telecommunications. The firms involved include Aeroflot, Alfa Group, Evraz, Gazprom, Lukoil, Norilsk Nickel, Severstal, Kaspersky, Abbyy, MTS, VimpelCom, and Yandex. This trend may well be a strong contributing factor in Russia's economic diversification.

Commenting on the outward dynamic, Kalotay and Sulstarova (2010) observe that in the reforms of the 1990s, the main driver of OFDI was the search for the safety nets in developed countries as a hedge against domestic uncertainty (Oleinik 2005). Only a few privately owned financial and energy sector companies were able to capitalize on this strategy at the time, as magnates in state-owned enterprises were among the first movers.

Even in Russia's state capitalism, strategic business drivers are at the forefront. This is due in part to ongoing privatization efforts (EBRD 2011; UNCTAD 2012). Kalotay and Sultanova (2010) suggest that domestic macroeconomic performance and policies, as well as host-market size, access to resources, and longer-term ownership advantages in the nearest foreign markets, are also strongly correlated with the recent growth of Russian OFDI.

Access to regional markets by larger conglomerates, though they retain a substantial Russian presence, is often followed by efforts to expand in new, nonenergy or heavy industry sectors by smaller Russia-based businesses. For both the large and the small firms, control of the final product's entire value chain and profits is critical. This seems to be consistent with earlier suggestions by Andreff (2002) highlighting the minimal role in OFDI determination of the short-term variables (e.g., domestic currency volatility and short-term GDP growth fluctuations) or prevailing access to technology (either at the firm level or in target markets).

These trends contribute to the Russian economy's entrepreneurial dynamic, human capital, managerial capacity, and profit diversification strategies. But the trends are operating in an environment of fundamental uncertainty, so we need to explore two types of structural agents in the Russian market.

Inward Investment and Two Types of Structural Agents

Both domestic and foreign investors in the Russian market can be categorized as either strategic or speculative.

Strategic players see a unique opportunity in the Russian market (Iyer-Ahrestani 2012), which has two advantages: (a) it offers an opportunity to capitalize on relatively low-cost resources and skilled labor and (b) it has a new and underserved consumer market. The first option can be subdivided as: (i) re-establishing business or production facilities within existing sectors and (ii) establishing a new enterprise in a new industry.

The consumer market has boomed in recent years—an early spillover from the energy sector's burgeoning profitability (e.g., on consumerism, Aris 2010). It is also driven by growth in new financial services (e.g., consumer credit, mortgage, and small business loans—more on this below).

By the end of 2010, household expenditure as a proxy for consumer demand, given lower-cost utilities and health care compared to those in other countries, has recovered and surpassed 2008 levels, averaging 49.4 percent of GDP for the year. More recent data from the IMF (2012, 4, 5, 27) elevates that estimate above the 50 percent mark for the 2011 average. As seen in Figure 2, relative annual growth has increased from single digits in 1990s to double digits in more recent

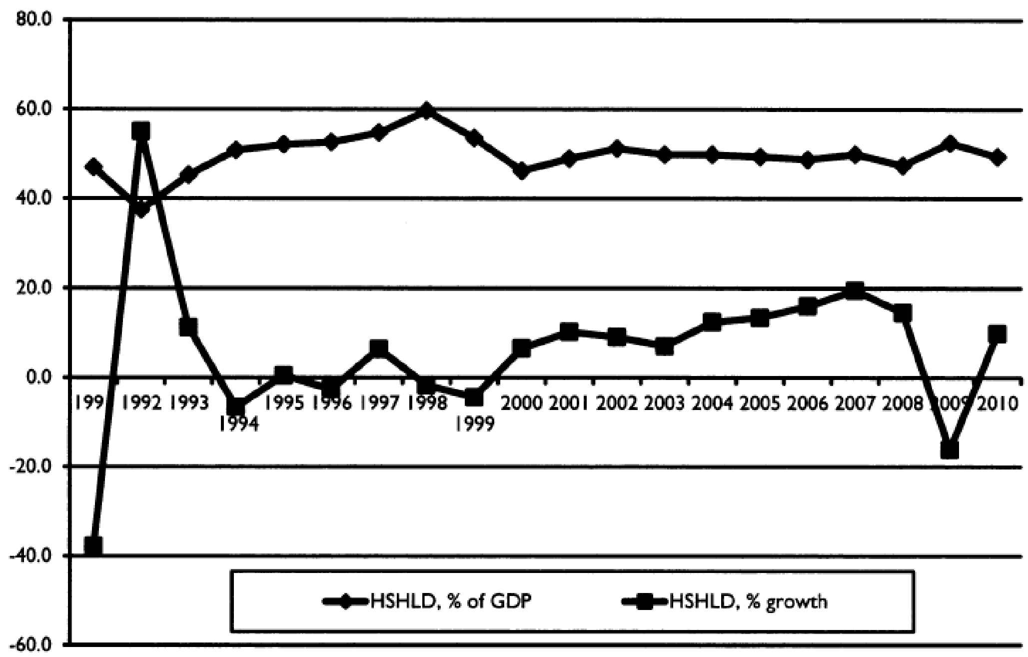

Figure 2. Household Consumption in Russia

Source: IMF 2012 and World Bank 2012.

years. Growth in real consumer demand is also fed by annual real wage growth of 15 percent, declining private savings, and substantial growth in consumer credit.

Early in the transition period, entry by strategic foreign investors was, predictably, in raw materials and energy. Recently growing business cooperation in IT, retail, auto, and large-scale construction, including partnerships with large foreign conglomerates, has been gaining momentum as well. Almost every known brand has a presence in Russia, from Mercedes-Benz to Ikea, Chanel, and certainly Coca-Cola. Some (like automakers such as Hyundai, Daewoo, Renault, and GM) have established individual domestic assembly lines (for an early report, see Kramer and Brooke 2005) or partnered with the Russian auto industry to develop new vehicles. Some foreign corporations in Russia have only a retail presence for now. And certainly the economy has attracted some of the biggest global players in finance.

The leading brands' production capabilities, regardless of the industry but focused on Russia's domestic consumer market, show a positive trend. As noted, there is a growing positive perception of

Box 1. Example: Russia's Leading Private Enterprises in Consumer Goods (selected companies).

Gloria Jeans (light textile production; designer fashion) now operates 33 factories and 435 retail stores, employing 12,000 people with average revenue growth of 34 percent between 2005 and 2011; Evrodon (turkey meat producer) has grown its revenue at 134 percent for the same period; while Sady Pridonya (juices, baby food, fruit and vegetable production) has grown 120 percent, employing 1,500 people; Polyplastic (tubes and engineering plastic) operates 11 factories, several large retail spaces, and a research facility, has revenue growth of 31 percent annual average between 2005–2011, employing 5,000 people (Krasnova and Matveeva 2012).

the Russian market potential (for evidence, see Iyer-Ahrestani 2012). Simply put, the opportunity costs of not entering the Russian market at this point are greater than ever before.

Russia's homegrown "new" industries have also been growing. This trend is more significant in the context of economic diversification, as it can create the basis for a successful industry takeoff, even if the primary focus is on the domestic market. The trend is driven by both companies established early in the transition period and those that are more recent entrants. In either case, being able to satisfy domestic industrial and consumer demand has been key to the success of these companies' operational models.

For example, indicative of an overall trend, medium-size companies such as Gloria Jeans, Sady Pridonya, Polyplastic, and Evrodon directed significant shares of their early profits and borrowed funds to invest in capital investment and branch expansion. They boldly incorporated new technologies, thus enhancing the internal resources and operational foundations. Their goal, as suggested by a recent study, is to meet the market needs using "super-production" methods that effectively combine technology and modern management techniques (Krasnova and Matveeva 2012). Their ambitious plans include competition with cheaper imports (mainly from China) in a struggle for Russia's massive market in textile, beverages, meat, plastic, and other products.

The valiant efforts of these and similar companies are still insufficient to reach the entire expanse of the Russian market, though some results are promising. Setting high internal standards and adopting strict corporate accountability standards have yielded near-absolute control over the full production chain as well as an opportunity for those companies to satisfy the demand of the domestic market at least in part with higher-quality products on a mass scale and at competitive prices.

While individual examples are illustrative, an overall view of the economy helps to show the context. One revealing proxy for expanding economic activity has been steady growth (with the exception of the 2009 crisis period) in overall capital investment, in absolute terms. In terms of the share of GDP, the average has remained around 20 percent in the 2000s (rising to 24 percent in the first quarter of 2012)—a significant achievement for a relatively young economy (MF 2012). Another important indicator of the growing cross-sector potential is the evolution of corporate revenue (see Table 1).

Table 1 shows growth in annual revenue for a selection of real-sector activity, excluding the financial sector, and is sorted in descending order between 2009 and 2011 (see FSSS [2012] for a complete sector list). This data is indicative for our purposes of tracking individual segment progress, because revenue growth here is due to the Russian-based firms.

Three immediate observations are of interest upon initial review: (a) steady growth in revenue between 2006 and 2011 across all sectors, with a downslide in 2009 due to the global economic crisis; (b) robust recovery in each sector in the two years after the crisis peak; and (c) strong average growth in non-energy-oriented industries in the observed period.

Building on the data in Table 1, Figure 3 then connects the first two points visually, showing sectors with revenue growth of more than 45 percent in 2011. The top three leading sectors are rubber and plastic production, chemicals, and general manufacturing.

Figure 4 relates to the average growth rate observation, with winning sectors being, in addition to the three mentioned, transport and equipment production, real estate, construction, retail trade, and others.

The pattern is too persistent to deny that Russia's economy has made

Table 1

Revenue Growth by Core Sectors, % Year on Year

Industry	2006	2007	2008	2009	2010	2011	2005–2011	2008–2011	2009–2011	Average
Oil refinery	3.0	−16.7	29.2	2.3	47.2	40.0	133.9	110.9	106.2	17.5
Transport vehicles and equipment production	22.6	31.9	17.0	−28.8	37.6	40.2	159.9	37.3	93.0	20.1
Rubber and plastic production	37.5	45.7	14.5	−13.6	36.7	31.0	254.7	54.7	79.1	25.3
Chemicals production	24.5	19.5	38.7	−12.1	30.5	31.9	212.6	51.4	72.2	22.2
Raw materials	15.9	13.4	21.7	−4.6	28.4	32.9	160.5	62.9	70.7	18.0
Metallurgy	29.3	22.1	14.8	−29.8	39.4	22.3	116.8	19.6	70.4	16.3
Manufacturing	21.5	17.4	23.0	−16.3	30.1	28.0	144.5	39.4	66.5	17.3
Electronic and optical equipment production	42.5	23.9	16.9	−21.4	30.9	20.1	155.3	23.6	57.2	18.8
Wood	14.9	30.2	7.0	−20.4	20.6	25.4	92.5	20.3	51.2	12.9
Paper production	33.7	16.4	37.5	−22.3	20.4	23.8	147.7	15.8	49.0	18.2
Equipment production	21.6	35.8	24.2	−19.8	17.8	25.2	142.4	18.2	47.4	17.4
Textile	35.7	1.2	12.7	−5.1	21.7	20.1	114.7	38.7	46.1	14.4

(Continues)

Table 1 *(Continued)*

Industry	2006	2007	2008	2009	2010	2011	2005–2011	2008–2011	2009–2011	Average
Retail and wholesale trade	37.8	34.8	22.8	−14.3	19.2	22.5	185.4	25.1	46.0	20.5
Hotels and restaurants	20.6	31.8	26.1	−2.8	20.4	21.1	184.2	41.8	45.8	19.5
Leather	17.8	20.2	−1.4	5.0	22.8	16.6	110.0	50.3	43.2	13.5
Natural gas and water production/distribution	31.4	32.7	15.3	20.1	19.3	17.6	239.2	68.6	40.3	22.8
Real estate	23.2	34.7	44.0	−2.7	20.7	12.7	216.0	32.3	36.0	22.1
Agriculture	13.1	28.6	19.2	2.6	14.2	16.5	136.5	36.4	33.0	15.7
Utilities	40.5	68.0	−20.3	−24.0	14.2	14.4	86.8	−0.7	30.7	15.5
Construction	38.4	39.6	35.3	−18.8	14.5	12.9	174.1	4.9	29.2	20.3
Food and beverages	18.2	24.3	27.0	2.3	11.9	15.2	145.8	31.7	28.8	16.5
Health care	24.2	27.6	17.5	23.1	6.8	18.2	189.2	55.3	26.2	19.6
Transport and communications	20.6	22.2	24.2	8.0	9.1	15.4	149.0	36.0	25.9	16.6
Education	25.2	22.2	17.0	8.7	8.9	15.2	143.9	36.3	25.4	16.2
Fishery	57.2	24.0	−14.4	13.4	5.2	18.2	135.3	41.0	24.3	17.3
Total	28.7	28.0	23.2	−9.9	20.9	22.5	170.9	33.5	48.1	18.9

Source: FSSS 2012.

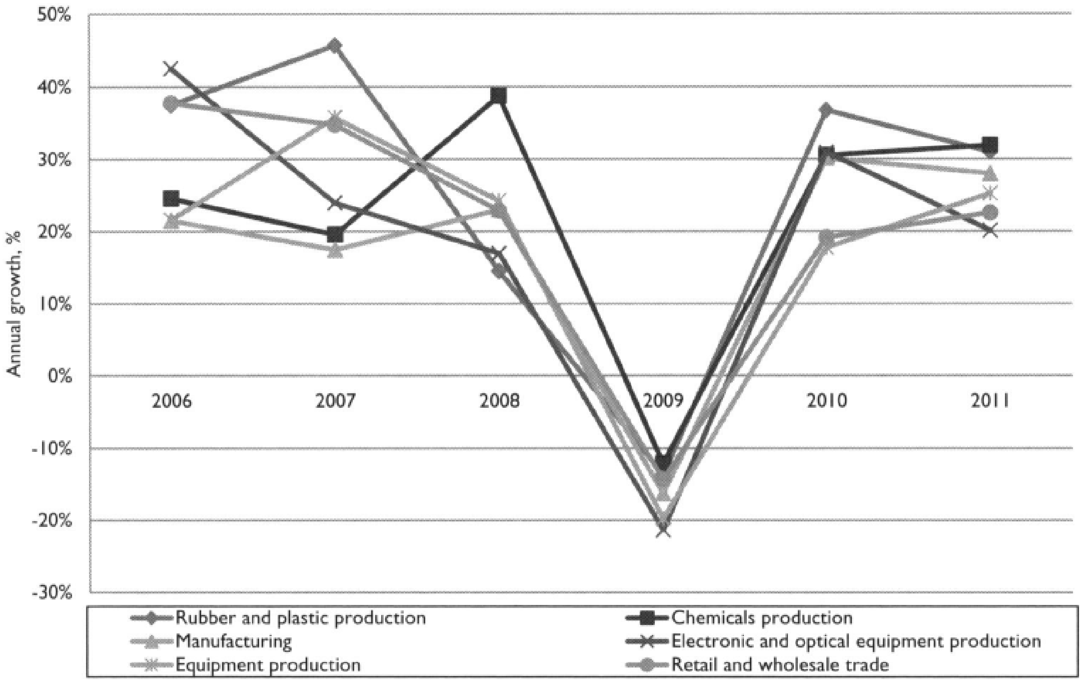

Figure 3. Selected Sector Revenue Growth, % annual change

Source: FSSS 2012.

at least some progress away from absolute energy-sector dependence. At a minimum, this general potential is now more visible.

The "Gazelle" Factor

Before we move on to the second type of inward investment (speculative) in the Russian economy, a few words should be said about the gazelle factor, which adds a strong impetus to the diversification model. First introduced in Birch (1979) in the analysis of U.S. business and job growth, the gazelle company concept is now widely discussed in the Russian business media (Expert 2012).

In short, any rapidly growing, private, medium-size company with 30 percent revenue growth over four years is considered a gazelle. In reality, as noted in Polunin and Udanov (2012), average revenue growth rate for the rapidly growing small private companies between 2007 and 2010 was close to 79 percent! At the same time, a typical Russian company showed revenue growth around 19 per-

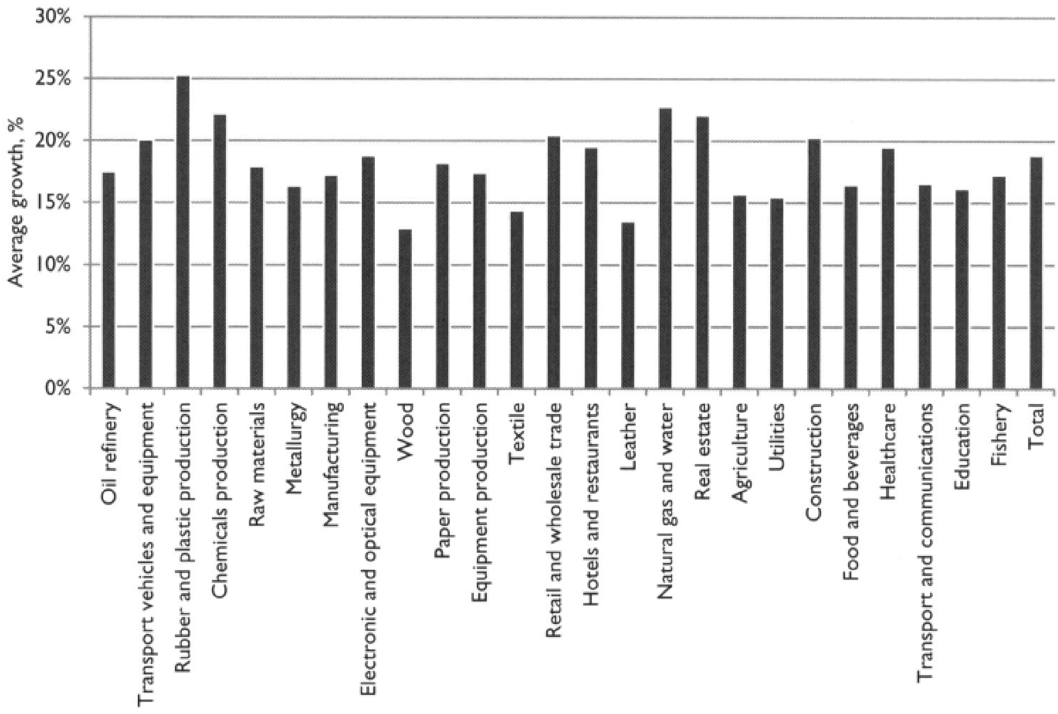

Figure 4. Average Growth in Selected Sectors, Revenue, 2006–2011, % annual change

Source: FSSS 2012.

cent, according to reported data (confirming our earlier cross-sector observation).

Specific to the Russian gazelles (for a full list of companies by sector, see Expert 2012) is their absolute private ownership and reliance on their own funds (Vinkov 2012). The group is not static and changes over the short term as some new companies enter and others leave, based on their business performance. But as a group, they exhibit continuous growth while retaining (and multiplying) their physical and human capital potential.

Estimates suggest that these companies range between 1 and 6 percent of Russia's pool of business entities, privately and semiprivately owned (extrapolated from FSSS [2012] and Expert [2012] data). The wide range is due to varying measurements (before, during, and post-crisis peak), lack of a common standard, and complexities with financial information filing—new for postsocialist Russia and thus developed in real time.

Finally, these companies are penetrating less-traditional sectors of the Russian economy: information technology, pharmaceuticals, nanotechnology, real estate, food processing, telecommunications, construction, infrastructure, shipbuilding, and small-scale manufacturing. In 2009 Russia ranked fourth in the world in total private investment in nanotechnology, largely thanks to advancements by the Skolkovo Innovation Center project (*Rossiiskaya Gazeta* 2010). Another growing gazelle sector in recent years comprises software and call-center outsourcing from foreign companies to smaller-scale Russian firms that offer high-level skilled professionals at significantly lower cost.

The IT sector, for example, led by the larger telecommunications and software giants (e.g., mobile network MTS and Kaspersky Labs), has been one of the most dynamically developing industries. Early in 2006, Russia's outsourcing industry was valued at nearly $1 billion (Satinsky 2006). A typical Russian IT software/outsourcing company has a very low (10 percent vs. 50 percent in India) attrition rate and is usually a small private business whose operational platform targets a particular niche and has customized software and individual client collaboration projects. Various industry reports and client testimonials indicate that Russian software engineers have a competitive edge over their counterparts, such as those in India, due to Russia's strong technical background and flexible approach in the search for complex solutions to problems (SoftwareRussia 2012). Although the crisis inevitably reduced the sector's profits (which led to personnel cuts of as much as 30 percent), total sector valuation is still expected to rise to nearly $3 billion in 2011 when balance sheets are finalized.

It is important to keep in mind that not all companies in the "new" sectors qualify as gazelles, and the latter flock to industries with lower barriers to entry or capital investment requirements—for example, as much as 30 percent of those that do qualify are in the retail and wholesale trade, with another third in construction. Yet observers see the general trend, including in IT, as a foundational stage en route to economic diversification (Expert 2012).

Moreover, the majority of the gazelles are mostly oriented toward the domestic market. If anything, the data on household consumption growth suggest a need for home-bred companies to satisfy the domestic market, which cannot be served adequately by imports.

The newcomers appear to have caught the wind in their sails, but will the conditions last? Stable finance appears to be necessary.

Russian Financial Stability

To gain a complete understanding of the current Russian economy's dynamic and explain the second, speculative type of inward investor, we must review recent developments in the financial market. At the peak of the crisis, despite experiencing a severe capital outflow (in late 2008–early 2009), Russia managed to avoid the most negative impacts of the global economic decline. Tapping into accumulated stockpiles of international reserves, monetary and fiscal authorities acted on a blended macro policy mix (Gevorkyan 2011). More than $300 billion in international reserves was spent to support the domestic (mainly financial) market (see Figure 5). The scale of intervention in the medium term compensated, at least partially, for the foreign exchange withdrawn and repatriated by the investors.

Although the Russian ruble depreciated more than 40 percent in relation to the U.S. dollar from pre-crisis August 2008 levels to mid-2009, it has since regained some of its strength. Immediate forced devaluation was averted. The exchange rate stabilized within the CBR's defined currency band. The depreciation was one of the largest compared to similar actions in other countries (EBRD 2011; Hanson 2009). Russia avoided an economic collapse of unprecedented proportions, providing much-needed financial stability to the existing and expanding new sectors in the real economy.

From an analytical standpoint, Russia's dealing with this crisis and its aftermath emphasized the distinction between the structural problems in the global economy and those in the Russian economy. Specifically, Russia's frictions originated not in the subprime market investment in toxic assets—but in the speculative actions of large

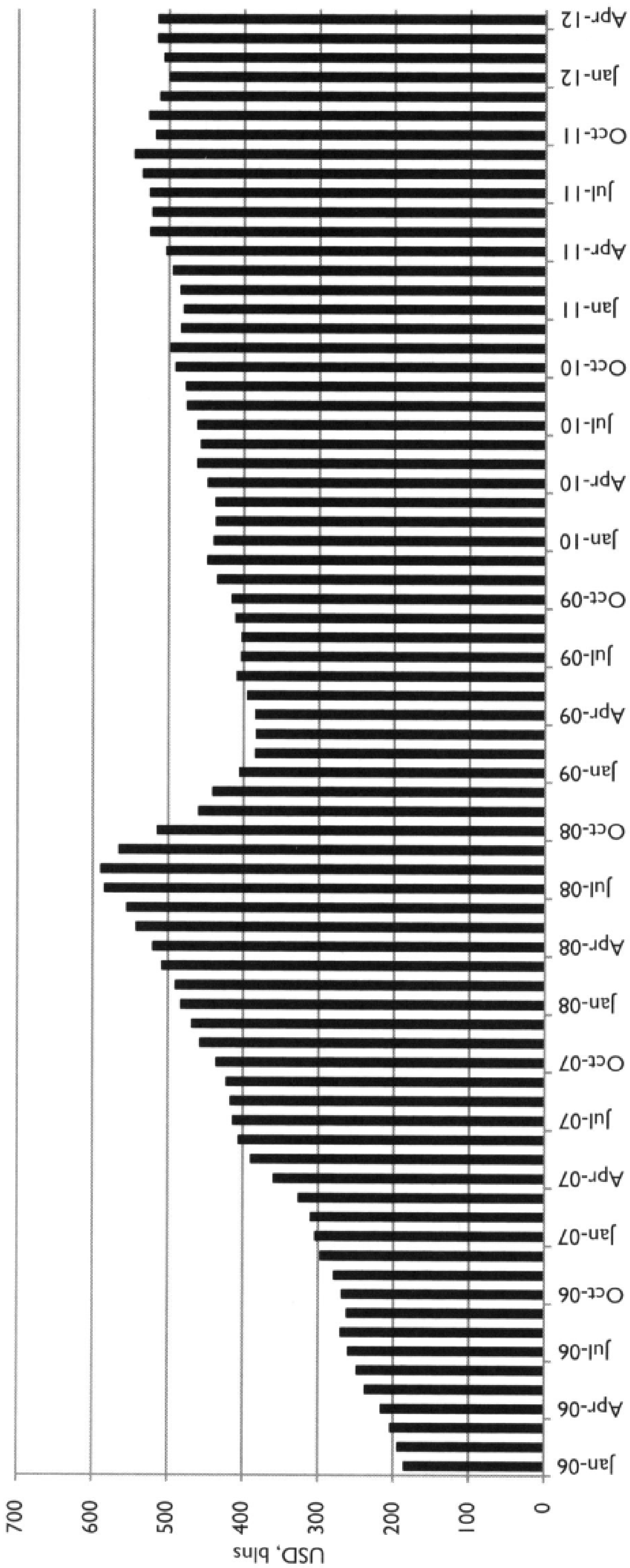

Figure 5. Russia's Foreign Exchange Reserves (in $ billions)

Source: Central Bank of Russia, 2012.

institutional and private actors in the broader domestic financial market and their simultaneous decisions to pull out as a precaution against potential losses elsewhere. For Russia, a significant portion of such transactions was denominated in foreign currency (e.g., the Russian financial system's debt was valued at more than $500 billion at the time [CBR 2012]).

Russia's private banking sector rapidly swelled during the transition period, and the battle for survival was intensified by the global crisis. The number of banks fell from a high of 1,300 in 2004 to 1,060 in 2009, as state-owned banks continued to command a significant share of assets (as much as 40 percent). Note also the rising number of foreign-owned banks since the crisis (110, according to EBRD [2011]), as their share of assets grew from 7.6 percent in 2004 to 18.3 percent in 2009. In addition, new banking services (e.g., credit provision to the private sector—more than 45 percent of GDP; and to households—more than 9 percent of GDP, including rising provision of mortgages and associated banking services) have contributed to a rapid maturity of the Russian financial system, which now serves as the main conduit for a range of loans and investment initiatives.

Figure 6 traces foreign portfolio and direct investments in Russia's banking sector in the first decade of the 2000s. Following a jumpstart in late 2005 and peaking in late 2007, portfolio investment reached its low point (declining to 2006 levels) in mid-2009. It then began to increase again, only to begin yet another falling trajectory in the second quarter of 2010, with a sharp rebound to pre-crisis levels in the second quarter of 2011. Although the absolute levels are impressive for Russia's maturing financial market (i.e., inward portfolio investment accounts for roughly 40 percent of the total, and FDI flows into the banking sector, which accounted for 21 percent of inward FDI in 2010, according to the CBR [2012]), one problematic factor is the significant fluctuation in capital flows that are denominated in foreign currency. This is where an individual, speculative (as in seeking a high and rapid return) investor's portfolio diversification strategy can work against a country's development path.

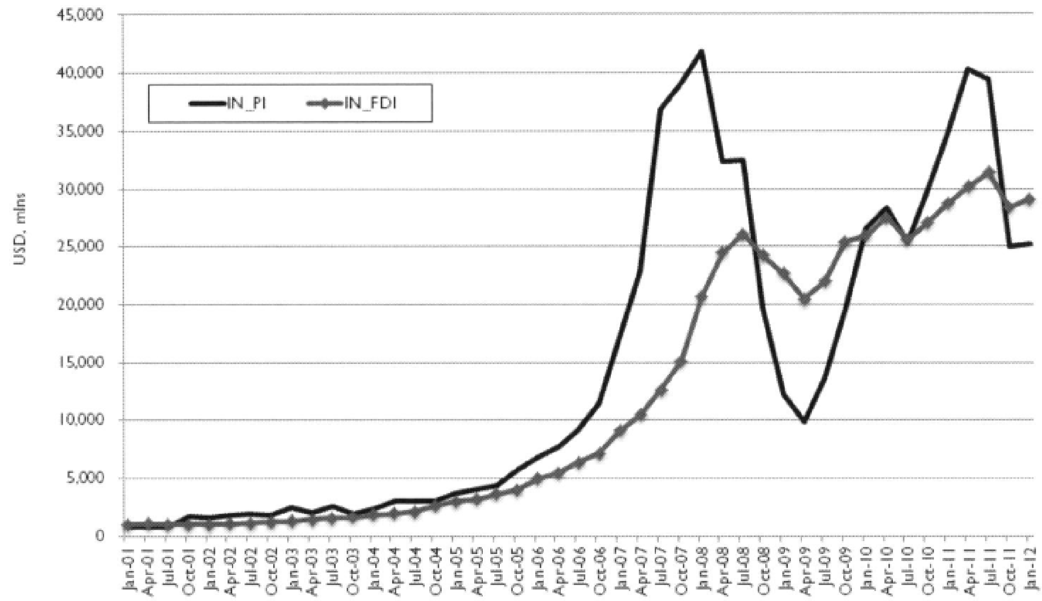

Figure 6. Russia's Banking Sector's Portfolio and Foreign Direct Investment (in $ millions)

Source: Central Bank of Russia, 2012.

For an economy that relies on hard currency—USD, EUR, GBP, and so on—as an asset, this can be a problem that moves from the financial sector into the real economy, which is what happened in Russia. The problem is common in postsocialist countries but is particularly relevant for Russia, where on average 70 percent of short-term debt in the banking system is denominated in foreign currency (approximately $27.5 billion as of January 1, 2011, according to the CBR [2012]). For private Russian banks that do not have FDI, short-term debt comprised 34 percent of total debt obligations at the beginning of 2011.

This trend is also speculative as financial flows in and out of the Russian economy seem to roughly follow the fortunes of the energy sector (i.e., rising oil prices and the expectation of increased borrowing by energy-sector firms) and are hence unstable. Similar trends can be observed in the larger corporate sector, which has a clear-cut dominance of foreign currency–denominated debt obligations. For a partially diversified Russian economy, these types of abrupt movements pose a high risk of triggering a currency crisis and then a financial crisis (Semmler and Gevorkyan 2011), leading to a relatively familiar scenario of real sector decline.

Note here that during the initial crisis in late 2008, larger (too-big-to-fail) private corporations and those with some state participation, seeing disruption in their financial flows, cut their commercial orders and downsized production, leading to overall economic decline, or they relied on state-funded bailouts to withstand the crisis. As mentioned, a larger effort to prevent a more severe crisis, support the currency, and avert wide-scale loan callbacks and bankruptcies was made by tapping into reserve funds.

But the top-performing gazelles that faced fewer orders and declining consumer spending had less room for maneuver. Only a quarter of the pre-crisis gazelles survived. The old top-performers relied on their own capital or short-term loans to finance their operations—the model that led many to shut down during the crisis. In fact, their precrisis overall indebtedness was lower than that for medium-size enterprise businesses overall (21 percent vs. 25 percent of revenues).

The majority of the surviving and new additions to the gazelles were those that proactively obtained business loans, contributed to capital formation, and developed (new for Russia) consumer credit programs for weathering the crisis (Expert 2012). The new gazelles' strict financial accountability (as in above-mentioned examples of Gloria Jeans and others) raised their overall indebtedness post-crisis, up to 41 percent of revenue in 2010. During and immediately after the postcrisis peak, they "borrowed to build" their businesses and customer base (Polunin and Udanov 2012).

Outside the gazelle sector, small and medium-size businesses now depend on reliable banking-sector and financial flows. Furthermore, the Expert (2012) study suggests that a more effective managerial pool in the Russian-based companies emerged from the wreckage of the crisis. But the future remains somewhat uncertain.

Challenges Now and Challenges Ahead

What is happening in Russia at present perhaps can be characterized by a nuanced reading of the early capitalist history of Western

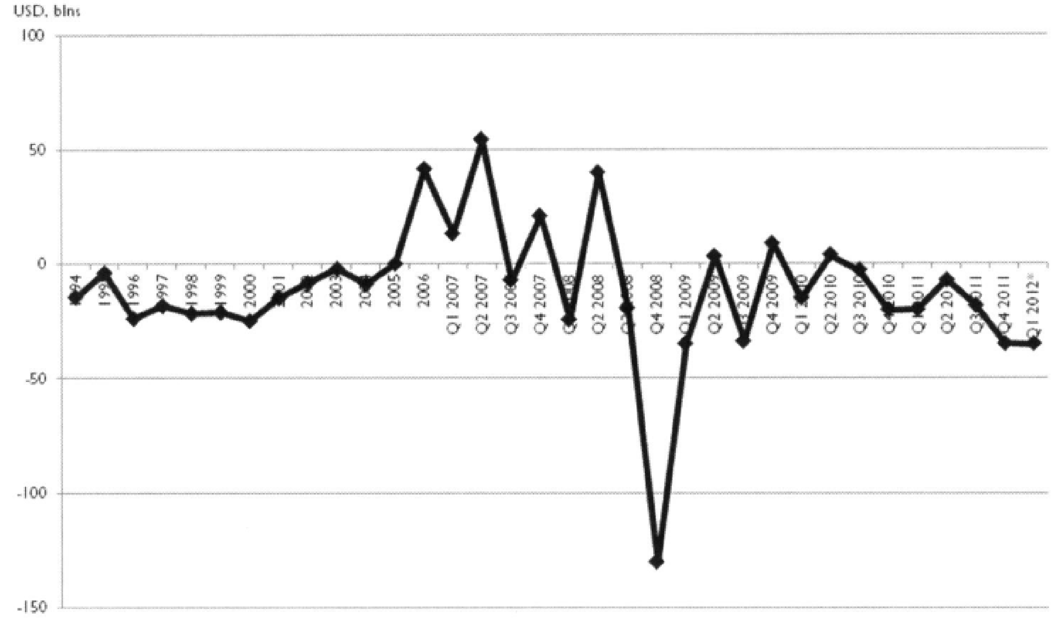

Figure 7. Russia's Net Private Capital Flows (in $ billions)

Source: Central Bank of Russia, 2012.

Europe. Clearly, the old model of reliance on energy exports as the driver of growth, though dominant in real terms, is losing its appeal in analytical perspective as a sustainable strategy. This is due in part to volatility in world oil demand and prices, especially in late 2011 and early 2012. The bigger problem is the evident inability of the energy sector to provide for the entire economy for a prolonged time and the indirect impact on stability of the financial system. New industries and the involvement of large segments of the population in new activities are evolving over time.

The nascent and rapidly growing sector (e.g., gazelles, but others, too) requires a strong and efficient financial system. The two must go hand-in-hand in establishing a new economic framework. Recent capital flows into and out of Russia offer just one such indicator of how uncertain this tandem arrangement may still be (Figure 7). Reinforcing our point above, capital outflows occur on short notice and vary in scale quite dramatically.

Yet the immediate solution seems to be clear. Already mentioned international reserves can offer some stability to the economy, as the "tailwind" that business leaders in Russia are seeking (Vinkov 2012). In this situation, the blended monetary and fiscal policy mix mentioned earlier becomes a norm for the medium term. In fact, gazelles that operate in new technology niches, specialized construction, engineering, and mass-scale food processing (hundreds of new companies that entered the market after the crisis peak) depend on these macroeconomic conditions' fostering their organic growth. One can engage in a proactive fiscal policy given current beneficial macroeconomic conditions with a reasonable prospect of developing a responsible fiscal balance.

One proposal recently popularized by the Russian government is to adjust calculation of the average price of oil, which is part of annual budget estimates, on a flexible annual scale (expanding the range each year) and to use the reserve fund to compensate for any fall in anticipated hard currency revenues. If actual revenues (from the energy sector) are higher than expected (based on the average oil-price estimate), the surplus would flow into the reserve fund or National Wealth Fund (for details, see Kommersant 2012).

Furthermore, the current 2013 national budget has allocated RUS343 billion in "anti-crisis" measures. The provision has invited some discussion in the business press, but what is critical here is the specific definition of "anti-crisis," leaving the window open for support of nascent non-energy-sector industries. The 2008 Russian government's Concept for Russia 2020 development set explicit investment (private and public) targets for moving the country's industrial base to a more innovative, non-energy-dependent economy (RF Government 2008). Funding for education should reach 6.7 percent of GDP, health care 6.2 percent, and science 2.7 percent—for Russia, that is doubling of current expenditures across all sectors.

There is still a unique opportunity to capitalize on Russia's diverse human capital and intellectual resources, including its legacy scientific infrastructure and scientific capacity. This outcome includes growth in nano-, bio-, info-, and cognitive technologies, with the expectation of 17 percent natural growth by 2020 and the capturing of as much as 1 percent of the global export market in these sectors (RF

President 2011). The consensus is an expectation of growth in private enterprises and technological sectors, referred to as "modernization" (Gorbatova 2012). Large state-owned corporations (e.g., Rosnano, Russian Railways, Vneshekonombank) are beginning to develop partnerships across sectors via either direct funding or, more often, business collaboration with gazelle-linked companies, projects, and sectors (e.g., software design).

Eventually, that can help address the problem of spreading capacity across Russia's immense market and raising labor force participation in the new sectors. The data assembled by Polunin and Udanov (2012) suggest that more than 50 percent of Russian companies saw average annual revenue growth exceeding 30 percent (25 percent experienced revenue growth of more than 75 percent) from 2002 to 2007. In 2010 the corresponding figure was 46 percent (with 23.9 percent growing more than 75 percent a year). There is indeed a significant potential, as the gazelle-linked industries have a rapid launch and become more prevalent. Yet the uncertainty of a still largely one-sector economy, problems in the labor market mobility, lack of infrastructure, and administrative inefficiencies, coupled with instability in financial flows, can upset this fragile chessboard.

An extension to current proposals should incorporate a defined target level of international reserves (or a ratio of net foreign currency borrowing in the banking system) to mitigate financial risks. These stockpiles offer a ready source of reserves, accessible for projects implemented via public policy and traditionally perceived as having a low return. The stimulation of infrastructure investment, human capital development, and greater labor force participation is achievable through a pragmatic fiscal policy mix (e.g., see Gevorkyan [2011] on Infrastructure Development Fund) and international reserves targets as part of a policy mix.

It follows, then, that for the economy in general, relieving dependence on the energy sector (though it be difficult to argue for a complete shift), along with other institutional factors, will clearly be profound structural economic shifts, for which developments in gazelle-like (i.e., new) sectors act as proxy. More substantively, such

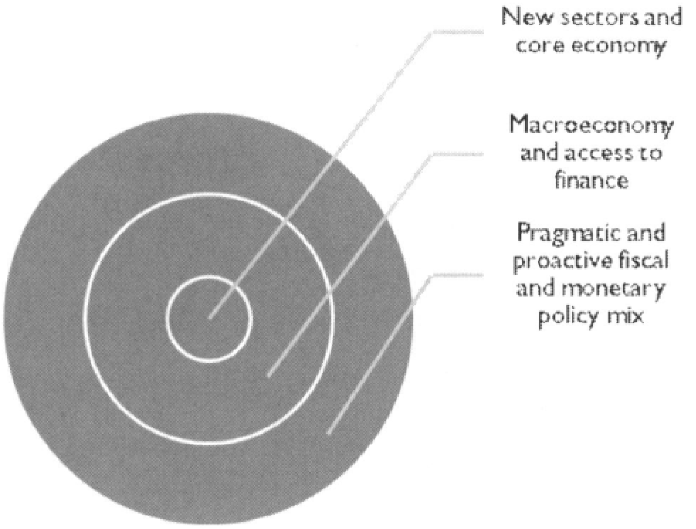

Figure 8. The Core of Russian Economic Diversification

changes include the evolution of business practices, stabilization of capital flows, wider access to and comfort with credit, a confident consumer market, the emergence of domestically produced competitive consumer goods, and the continuation of sustained business growth in nonenergy sectors. In turn, those changes rely on an improved macroeconomic domestic environment. And fiscal and monetary authorities still have the strategic capability to fine-tune that dynamic (see Figure 8).

As the experience with the early market reforms illustrates, attempting to synchronize economic and social change can be perilous. Yet until the new sectors acquire a solid footing in the Russian market, albeit focused on the domestic consumer—with uncertainty implied—some traditional sectors have to remain the way they are (e.g., oil prices as one of the primary determinants of export tax revenues in the Russian budget). A contributing factor to the traditional sector's efficient growth and spillover into new industries is the improving record on privatization, as well as recently announced determination to sell off some of the key stakes in remaining state-owned enterprises (UNCTAD 2012). Finally, added to the mix is the government's explicit assumption of certain social responsibilities through the provision of public goods and accommodating pro-business policies of economic activity. It helps that formation of a strategic approach and discussion of these tendencies is taking place at the highest levels of Russia's government (Vzglyad 2012). Combined with external factors, this diverse mix of dynamic tendencies defines the country's postsocialist context—a consideration that matters.

Final Remarks

Clearly, it is premature to declare victory in the struggle to reduce the Russian economy's dependence on the energy sector. In fact, the energy sector might retain a dominant share of Russia's exports for some time to come. Instead, the important dynamic, often omitted in popular commentaries, is elsewhere.

The focus should instead be on Russia's domestic market and its potential, despite persistent inefficiencies and risks. Regardless of which industry is the leading one, Russia is ready to capitalize on its human and physical capital and technological base for further diversification. The wheels of change are turning. Recent financial gains help boost new, innovative sectors, leveraging its vast intellectual capacity and newly formed managerial pool. Another component is streamlining the financial and technological activities of the proliferating Russian MNCs to benefit the development of domestic economic and institutional bases. The rapidly expanding market offers abundant opportunities for foreign ventures that target newly emerging sectors and form a foundation for regional expansion. Sustaining this progress in the medium term requires pragmatic state participation, the "tailwind" of the new sectors described above (e.g., efficient bureaucracy and accommodating economic policy) of the sort seen at the peak of the global financial crisis and in its aftermath. In such conditions, the current modestly diversified and mature growth in Russia's internal market can lead to equally diversified exports of significant proportions, finally mitigating the infamous "resource curse."

Adjustment to a structurally new economy will be rough, unsteady, and not immediate, but the benefits will be self-evident. Russia is no longer a static environment. It is dynamic and, as might be expected, does not conform to the standard economic models because of its experience. It is a BRIC, if that matters, and is open for business. Realizing its potential demands a pragmatic and responsible effort from all involved. This article is an effort to emphasize Russia's gradually growing and versatile economic potential.

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