

Considering Russia's Future



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It would appear that the world in which we live has entered an age of a US-China battle for hegemony. Glancing back over global affairs over a quarter of a century, little doubt remains that the enlargement of the Chinese economy is the major driver of this transformation. Looking at the ratio of the global economy made up by China in terms of GDP dollar volume, it has increased sixfold in the two decades between 1997 to 2016, from a trifling 3.0% to 17.9% (IMF World Economic Database), making it only second to that of the United States. In the 70 years since World War II, China has transformed into an unwavering global power.

On the other hand, the decline of Russia's economy is clear. Having transitioned through the collapse of the Soviet Union and the ensuing period of pandemonium that constituted a life-or-death situation for the nation, Russia was buoyed by rocketing crude oil prices and seemed to be steadily recovering at one point. However, with the crash in crude oil prices following the Lehman Shock, Russia faced a sudden transformation into a deep recession. In the last few years, it has been decidedly lacking in vigor and, as a result, by 2016 its GDP had fallen back to a mere ninth of China's. Seen in contrast to China, the sense of a setting sun is already strongly pronounced.

And yet China is poised for further growth to an extent that is unfathomable. In contrast, Russia cannot escape from the "trap of resource-rich countries" (the health of economies of resource-rich countries, generally speaking, is highly contingent upon prices for crude oil and natural gas), and is currently floundering in a global

whirlpool of long-term stagnation of oil prices, which is a global structural shift. China continues to rail ahead into the distance, leaving Russia stuck in the dust kicked up by what was once its kid brother, a late-starter country run by the socialist camp. The dissimilitude between a major power on the rise and one on the wane could not be more evident (*Chart 1*).

In a world where China and the US vie for supremacy, the path that forms Russia's very way of life is in question. The future of Russia depends upon the next six years of the regime of President Vladimir Putin which commences in May 2018.

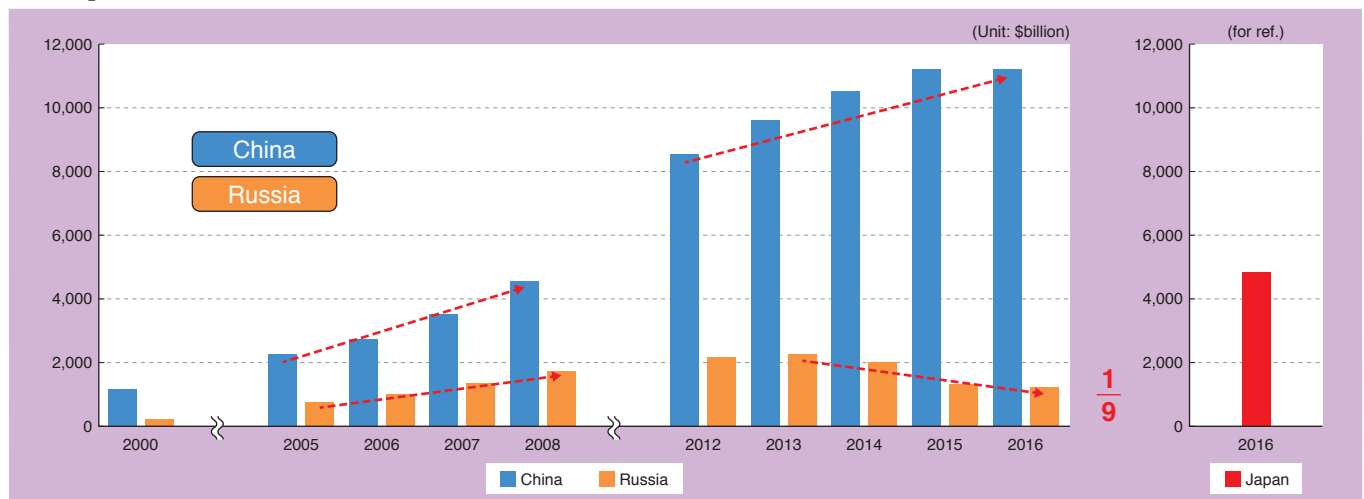
Darkening Economy of a Waning Power

Russia is a global front-runner for energy resources. Any recovery in crude oil prices constitutes a tailwind, and in 2017 its economy went from minus to plus growth for the first time in three years. However, the pace of recovery seems to be limited. The range of plus growth fell short of the expected value, lingering at 1.5% and well below the growth rate of leading nations that are in good shape (Russian Economic Development Ministry).

What can explain the lack of dynamic growth despite an economic upswing? In my view, seen over a long timeline, Russia would seem to be unable to break free from the slow-motion degradation process that began with the collapse of the Soviet Union (which might be more accurately described as having already started during the final throes

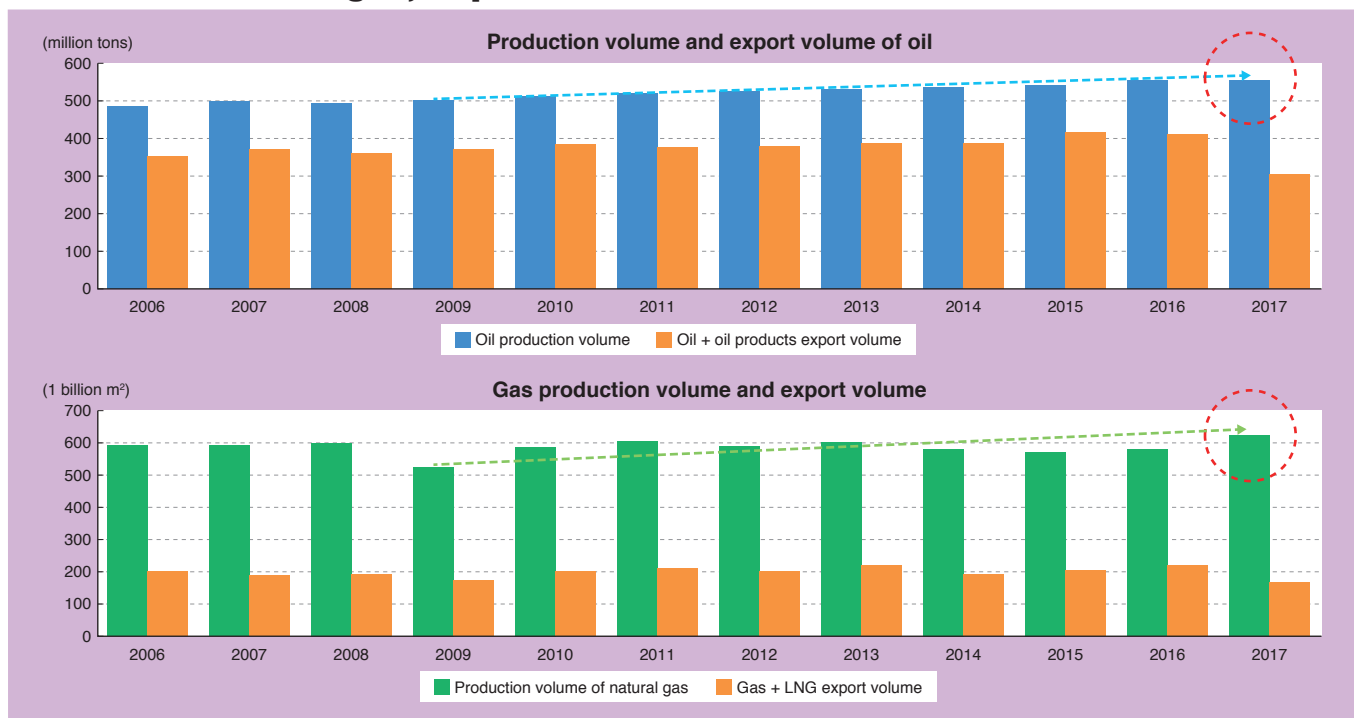
CHART 1

Comparison of China's & Russia's nominal GDP



Source: Compiled by the author in reference to IMF World Economic Outlook Database (2017)

CHART 2

Production of oil & gas, export trend

Source: Compiled by the author in reference to BP Energy Outlook 2017, Russia Central Bank data (N.B., 2017 export volume is for Q1-Q3)

of the Soviet Union).

Ever since the era of Ivan the 4th (“Ivan the Terrible”) during the second half of the 16th century, Russia has expanded its land over several centuries. It ended up presiding over one-sixth of the total land on planet Earth, becoming a gigantic nation spanning the Eurasian landmass from east to west, akin to an eagle spreading its wings. At the same time, it went from being a small and backward country in the remote regions of the Northern Hemisphere to a great imperial power on a level footing with the great powers of Western Europe. However, at the beginning of the 20th century, the Russian Empire collapsed. The nation faced defeat in the Cold War, which in turn triggered the collapse of the Soviet Union, and the loss of a vast amount of territory easily greater than all of that of the current 28 European Union countries. While Russia continues to possess the world’s biggest tract of land, its domain itself is shrinking.

More recently, Russia seized the opportunity in 2014 during political change in Ukraine to annex the Crimean Peninsula, and made substantial efforts to absorb the Donbass region in Eastern Ukraine. This in fact caused many Ukrainian citizens to distance themselves from Russia. Although they may have won the war, Russia could be said to have lost Ukraine itself.

The Curse of Oil & Delayed Structural Reforms

On top of this, the long-term decline of the economy continues unabated. Dynamism for growth has weakened, and the outflow of mainly young talented personnel has not ceased. Since 2000, some 2 million people have emigrated (Russia Immigration Office). Furthermore, an economy dependent on bountiful supplies of natural

resources has long since been stuck in a rut with no apparent exit. If the price of crude oil remains in the doldrums, the economy will inexorably follow suit. Russia has followed this pattern for a long time; the collapse of the Soviet Union was no exception.

This is commonly referred to as the “curse of petroleum”. Possessing vast territory full of fertile earth and being one of the world’s pre-eminent natural resource countries has resulted in Russia lagging far behind advanced nations of the West in modernizing its industry. The backwardness of Russia’s economy could even be a predestined issue. Thus, since Peter the Great who appeared at the end of the 17th century, Russia’s statesmen have favored top-down economic development led by the state. The same could presumably be said of President Putin.

Incidentally, in an unexpected development last year, Russia’s production of crude oil reached 554.9 million tons, a record amount since the collapse of the Soviet Union (Central Bank of Russia). As for what became of the promise made at the end of 2016 with OPEC to cooperate in reduced production, while the reduction amount was fixed for the production quantity for the single month of October 2016, in expectation of this Russia increased production all at once in October. Thus, the production amount “after reduced production” still maintained a level in excess of that of 2016.

Last year also, the production volume for natural gas reached 625 billion cubic meters, the highest ever. Put simply, the engine of this resource-rich nation is on full tilt. Despite this, traction for growth remains elusive. It goes without saying that this is due to the low price of crude oil. Russia cannot escape from the structural recession wrought by crude oil prices remaining at a low level (*Chart 2*).

Russia’s structural reforms are lagging. Although nearly 10 years

have already elapsed since the Lehman Shock, its dependency on exporting energy resources remains as high as ever. The ratio of the value of exports made up by crude oil and natural gas in 2017 (and their products) was 54% (in the 11 months from January to November), remaining at a high level despite the price of crude oil going south (Russia Customs Office).

On another front, following the shale revolution that began in the US, the mechanism for determining prices in the global crude oil market is changing profoundly. If the price spikes, production of shale oil will commence immediately, evening out the supply and demand balance. Accordingly, the price of crude oil is expected to remain at a steady low level in future. The era of resource-rich nations (in other words, producing nations) holding sway over the price is over. Nevertheless, Russia is still dragging around an economic structure that relies upon mineral exports, like a weight (Chart 3).

An Economy That Cannot Nurture Private Enterprises

Meanwhile, I am surely not the only one who feels that of late, the rule of governance in Russia is significant, and administrative power is growing gradually stronger. Government and corporations have gained from natural resource export money, invigorating investment and consumption which have in turn caused the economy to grow. But now it is not the private sector but the government budget that leads investment in the economy (examples of state projects sponsored by Putin include the Kerch Strait Bridge project which links the Russian mainland with the Crimean Peninsula, and infrastructure projects for the FIFA World Cup this summer).

In the background to this, Russia, in addition to the peculiarities of an economic structure where the ratio of government and state-managed business divisions account for 30% to 40% of GDP, may be feeling the impact of financial sanctions by the EU and US. While on the one hand corporations are reluctant to use funds in hand, the government is currently issuing Eurobonds instead of the large banks

subject to sanctions, in what is considered to be an attempt to make up for a lack of funds in the overall economy by way of government financing (the Russian Finance Ministry procured a total of \$6.9 billion from international capital markets on two occasions last year in June and September).

However, in any case, the flip side to government dominance is surely that private enterprises cannot flourish (or find it hard to flourish). Also, whether an extension of this or not, one hears that many young people are not attracted to corporations and instead seek employment with the government.

All the same, the elite in Moscow believe that wielding the power to be able to vie neck-and-neck with the developed countries of the West will guarantee Russia's position and existence. It is already apparent, however, that they will not be able to expedite this as things stand at present.

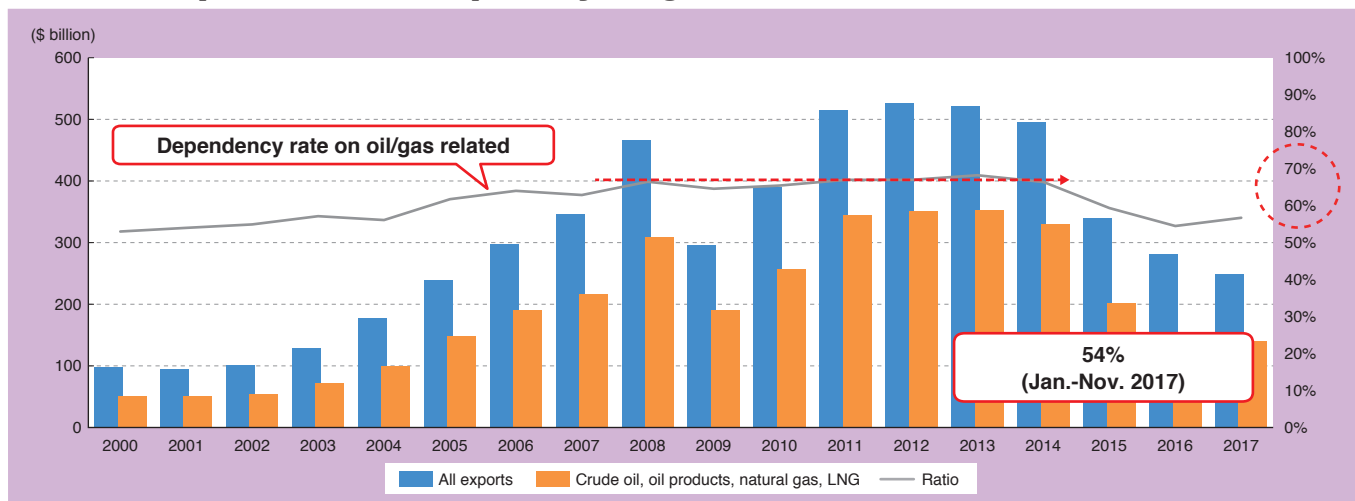
Eurasia's New Center of Gravity

Shifting the focus onto Eurasia, meanwhile, China has in the last two decades etched itself onto the canvas as a major power leading the global economy. In my view, one of the key changes that befell Eurasia following the end of the Cold War was the fact that freedom of movement became possible for people and goods over this vast continent. As a result of the loosening of political shackles that was the Cold War, Eurasia in its entirety was reborn as a singular physiographic space in close proximity due to the contiguity of its land.

China is currently focusing on constructing a very long land transportation network encompassing an expressway (locally called track burn) that runs from the Chinese mainland into Central Asia, then into Europe through Southwest Asia or Russia, as well as a high-speed railway network and a mineral pipeline that connects the mainland with the Caspian Sea, Persian Gulf and the Siberian Plain. President Xi Jinping first publicly announced this new concept of a "Silk Road economic belt" back in September 2013. Actually, since the mid-2000s China had set about constructing a transport network to span the

CHART 3

Ratio of export value occupied by oil/gas-related



Source: Compiled by the author in reference to Russian Central Bank data (N.B., Q1-Q3 for 2017)

Eurasian landmass, founded in the new geopolitical requirements that materialized following the collapse of the Soviet Union.

Eurasia is currently buoyed by the large groundswell of China's economy. For countries in Central Asia, China constitutes the largest trading partner in place of Russia which was up until now seen as the "colonial master" (in 2017, the trade volume between Kazakhstan and China exceeded that with Russia). Eurasia has become the supply base for energy resources and food supplies to China, which is its export destination not just for everyday sundries, but also electronic/communication devices such as computers and smartphones, and metallic resources including iron and steel, and copper wire.

Waves from China's economy are permeating westward inland with tremendous dynamism. Russia is also banking on China, and is exporting energy resources for China to use (Russia was the largest oil exporting country to China for two years consecutively in 2016 and 2017). It could be said that Eurasia's center of gravity is gradually shifting eastward, as if enticed towards the Chinese mainland.

Linkage with China Is Precisely the Path for Russia to Tread

The construct of Eurasia has changed significantly over the last 20 years. This current is now set to integrate the contiguous landmass that has its center of gravity in China. The extent to which China exerts its influence upon the domain that is Eurasia – and indeed at what pace and in what shape or form – is a momentous issue. Above all else, it will be central to the fate of Russia as a nation.

Which path should Russia take? In his foreign policy paper of March 2013 (released when he reverted from prime minister to president), Putin demonstrated his recognition that rather than seeing China's economic growth as a threat, Russia should leverage it for its own economic development, stating: "This is a chance for the sails of Russia's economy to harness the wind of China." The title of the paper was "Russia in a changing world".

Putin is in fact a realist. I believe that Russia will not fight with China. First, given that Russia's easternmost area has a 4,300-kilometer border with China, it faces the threat of intense population pressure from the northeastern region of China (6.7 million people vs 190 million). Secondly, I take the view that Russia has already overcome its appetite for competition with an ever-mightier China. This is because whatever Russia thinks, there is simply no way of fighting the difference between the economic powers of the two nations, and above all is the fact that for Russia, China is the most important buyer of their natural gas and oil which forms the mainstay of the economy. Third, from the point of view of diplomacy, in opposing the US, China is an indispensable sworn ally.

In fact, in future Russia could well become a global power by dint of its linkage with China. In this sense, I would venture that a linkage with China will constitute Russia's way of life as a Eurasian nation.

What Did the Yukos Affair Signify?

On the other front, breaking free of an economic structure dependent on resource exports remains a major issue. How can this be reconfigured and changed into an industry structure capable of

competing with the developed countries of the West?

The Yukos Affair took place in 2003. At the time, Yukos was the second-largest oil company in Russia, and Putin arrested the owner, Mikhail Khodorkovsky, and proceeded to dismantle Yukos. Khodorkovsky was an oligarch, a businessman with strong ties to the political community, and is considered to have conducted conspicuous lobbying activities by using the Siberian oil field assets as a revenue source, and trying to have politicians in his pocket.

Besides that, he had ExxonMobil and Royal Dutch Shell buy Yukos stock, attempting to use them as a shield to shore himself up with. Put simply, he tried to enlist the might of Western oil giants to face off against Putin. For Putin, this was nothing less than a showdown between the nation and capital. Thus, in the interest of the nation, Putin arrested Khodorkovsky on a separate issue, in an attempt to rein in the unbridled activities of these influence peddlers. This is my understanding of the Yukos Affair.

While this incident sent ripples through Western political and financial circles, Putin used it as a starting point to cease conforming with the free capitalist economies of the West and to turn the rudder towards nationalism. In short, this was an attempt to become an energy resource superstate, stewarded by the nation. And after this, Putin gradually returned oil and natural gas production companies privatized during the era of Boris Yeltsin back under the control of the Kremlin, one by one. In this way, Russia's economy was rebuilt (be it due to the fortuitous spike in crude oil prices at an opportune moment), and its pride as a powerful nation restored.

Conversely, however, a calm retrospection at subsequent events suggests that this shift was nothing more than people from the military-security establishment (known as *siloviki*) making a grab for the enormous concessions offered by resources, in place of the oligarchy. It could also be said that the Russia of today exists atop the balance of this new elite cluster formed due to this transformation. Surely another case of the "curse of oil".

Streamlining the Market Environment & Nurturing Private Companies

In early March, right in the middle of the presidential election, Putin delivered his customary annual message. Among several remarks regarding the economy, he highlighted the importance of streamlining the market environment. I am convinced that along with improving the business environment, it is the repudiation of the improper intervention by government and public order authorities into economic affairs and the assurance of a free and fair competitive environment for corporate activities – as well as the protection and nurturing of corporations that this allows – that will mark the resurgence of dynamism for growth in Russia's economy.

It goes without saying that Russia is a country with endless possibilities. Putin's last term which begins in May 2018 should be a period for laying out the sea-chart that Russia should follow post-Putin. It is thus fair to say that the future of the Eurasian nation of Russia rests upon these next six years. **JS**

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