

Competitiveness at the Crossroads: Which Way for the Russian Economy?

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as published in *Vedomosti*, November 26, 2007

<http://www.vedomosti.ru/newspaper/article.shtml?2007/11/26/136711>

There are few topics on which opinions are so diverse as the competitiveness of the Russian economy. Many Russians see high recent growth rates and solid public finances as a sign of a resurgence in their country's competitiveness. Many foreigners instead see the exuberance of an oil-based economy and an increasingly activist government as a sign of weak competitiveness. Our study on behalf of the Center for Strategic Research reveals the common logic behind these seemingly divergent observations.

Russia has since 1998 experienced strong economic growth that has improved the standard of living for many citizens. But Russia's competitiveness is not growing in line with its prosperity; over the last four year's Russian competitiveness has even deteriorated. Competitiveness, the level of productivity that companies can reach in a given location, determines the level of prosperity that countries can create. Russia creates much less prosperity than it currently enjoys; it relies on consuming its abundant natural resources. In fact, our recent analysis in the Global Competitiveness Report indicates that even accounting for natural resource exports, Russia's current prosperity is above its economically sustainable level.

Natural resources finance prosperity above its sustainable level. But they carry significant costs: natural resource dependency weakens government institutions, focuses the economy policy debate on the use of public funds, and undermines efforts to upgrade competitiveness. Without higher competitiveness, diversification of the Russian economy is not going to succeed, further cementing the dependence on natural resources. Russia can live off its resources, but will then remain a country of significant political and economic risks.

Unfortunately, Russia's current economic policies fail to move the country on a different path. After 2000, the government achieved clear progress on fiscal policy and on general political stability. Together with a benign global economic environment, especially rising oil prices, and free production capacity this paved the way for strong economic growth. Until 2004, the government also tried to improve the legal context and the general business environment in the country. Since then, however, legal reform and efforts to curb corruption increasingly lost power and business environment upgrading became tangled up with increasingly interventionist economic policies. In addition, Russia's relations with many of its neighbors, its most natural economic partners, have deteriorated.

Russian economic policy needs to be criticized because it fails to strengthen Russian competitiveness, not because it violates some abstract 'western' model of market economy. Ironically, current policies favor foreign consumer product companies experienced to deal with a challenging business environment, while small- and medium-

sized Russian companies suffer the most. Russian economic policy has created an environment where Russian companies make few long-term investments in capabilities, continue to compete largely on access to natural resources and captive markets, and fail to create more productive industry structures.

What are the root causes for the problems haunting Russian economic policy? First, Russia has not made any real progress in addressing fundamental weaknesses in its administrative and legal system. These weaknesses seriously undermine the effectiveness of sensible economic policies to succeed. Too often, Russia chooses policies that only work in the context of a highly effective administrative and legal system while that is one of its biggest weaknesses.

Second, Russia has made policy choices harmful to competitiveness. Government has reigned in the power of private 'oligarch' business groups. While reducing the power of these private interests might have been a logical step, using intransparent measures of different government agencies have undermined the creation of a transparent legal system. Government has taken an active role in many companies and industries. While a strong government role might have been inevitable to achieve restructuring, exerting strong government influence on the way companies are run has harmed competition and efficiency. Government has taken steps to increase its share of oil and gas revenues. While the rebalancing of profit shares might have been legitimate, the methods used further eroded trust in due process and the legal and administrative system.

Third, policies set by different Russian government ministries continue to work at cross-purposes. While some in government want to create a more competitive business environment, others want government to micromanage through regulation and create powerful companies with political as well as economic missions. These differences in opinion go beyond the usual policy disagreements present in many governments, and strike to the heart of the goals of the nation itself. Is the goal a powerful state or prosperity for citizens? Without a mechanism to resolve these incompatible aspirations, conflicting signals cancel each other out and raise uncertainty about future policies.

What would a Russian economic policy agenda look like that could put the country on the path to higher competitiveness? First, Russia needs an action agenda of consistent, mutually reinforcing steps to upgrade its competitiveness. Creating an efficient and independent legal system is a pre-condition for many of these efforts to have full impact. Opening up all parts of the Russian economy to effective competition is another critical priority. To make progress in this direction the role of government in the economy needs to be streamlined, clarified, and limited.

Second, Russia needs to define a growth path based on its existing capabilities that sets the direction for diversifying the economy. Natural resources will remain important, but only if policy changes dramatically they will also become the launch pad for efficient companies that sell knowledge and specialized services in addition to oil and gas. The significant legacy assets in research can become the basis for knowledge-driven clusters, but only if research institutions are fundamentally reformed and changes in the Russian

business environment make competing on innovation attractive. More opportunities exist, but only if Russia gets serious about consistent competitiveness upgrading.

Finally, Russia needs a strategy that outlines the country's economic direction: What role does it want to play in the global economy, what economic value does it aim to provide, and what purpose does it want to pursue? These are decisions only Russians can take, not foreign analysts. But the experience of other countries can help to fully understand their implications. Right now, Russia unfortunately confuses foreign criticism and using the experience of others with a lack of self-confidence. The opposite is true: Strong countries are able to identify problems and act up them. If Russia comes to that realization, it will have made a big step towards becoming the strong nation it aspires to be.