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New Government Faces Old Problems

By Martin Gilman

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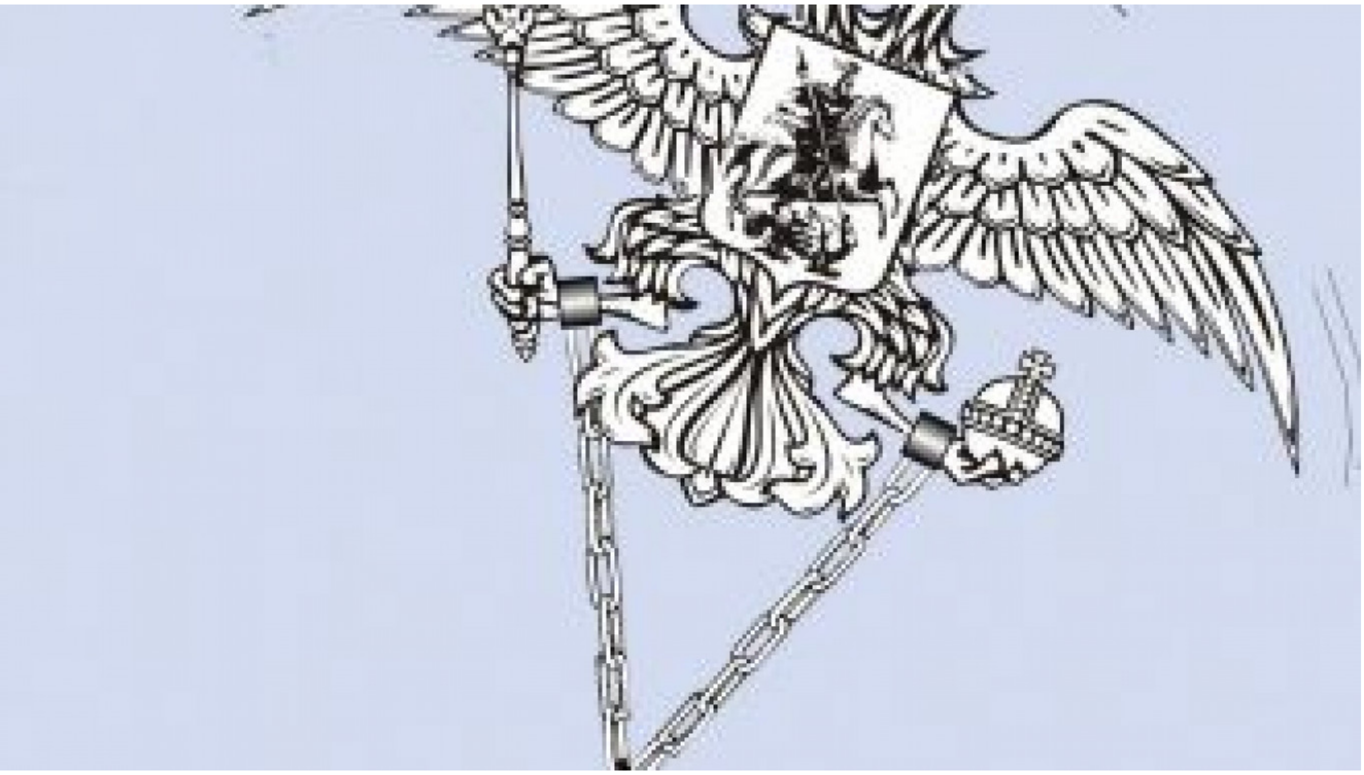

A longstanding platitude shared by both the Kremlin as well as domestic and foreign analysts is the need for Russia to diversify its economy away from energy dependence and reduce its non-oil budget deficit. The unfortunate reality is that this self-evident orthodoxy has languished on the shelf as frothy oil prices have continued to buoy the Russian economy and as the federal budget remains in balance despite expenditures rising by about 20 percent from last year. Arguably, the government is no different from those in Europe or the United States in terms of trying to postpone socially and politically difficult decisions if there is some more palatable alternative.

In what could be perceived to be remarkably awkward timing, the recent decline in oil prices — if it continues — may imply that Russia's traditional recourse to simply muddling through a crisis is hitting a dead end. Plummeting oil prices in recent weeks are an ominous sign for Prime Minister Dmitry Medvedev's new government, announced Monday. This means that the Cabinet will have no time to lose in pursuing policies that should finally start to decouple the economy's dependence on oil prices.

Since its recent peak on March 13, the price of a barrel of Urals blend has fallen by almost 14 percent. In fact, the price is right back to where it was a year ago. Ironically, the price assumption in the 2012 federal budget, originally set at $100 per barrel, was revised upward to $115 in mid-April. (The current price is $109.) With its high level of budget spending, as former Finance Minister Alexei Kudrin has warned repeatedly since October, and the budget's reliance on energy taxation for 60 percent of its revenue, public finances and its contribution to the gross domestic product could quickly deteriorate if a gloomier world outlook prevails in upcoming months.

Some quick backpedaling, including the continuing ratcheting-up of public spending, seems to be appropriate, even if prices don't sag much further. Global circumstances will determine what happens next, and it does not look promising. Remember how unexpectedly and abruptly oil prices plummeted in the second half of 2008 — from a peak of $144 per barrel in July to $34 per barrel by late December.

Even if no one expects this particular piece of history to repeat itself, Russia's financial Achilles' heel is obvious. Diversification is more than overdue. It is this excessive budgetary dependence on oil prices that differentiates Russia from most other countries. Understandably, global markets view the country as riskier from a macroeconomic standpoint, not to mention the lack of rule of law, poor property rights and an unpredictable legal framework.

Privatization of state assets is a key element of the government's strategy to diversify the economy. Strongly endorsing privatization during his presidential campaign earlier this year, Vladimir Putin wrote that the goal of privatization was "not fiscal but structural in character" and should proceed quickly — unlike in late 2008, when an ambitious privatization program was brought to a screeching halt by the collapse in financial markets. Putin said that by 2016 the state should sell all of its shares in enterprises that are outside of natural resources or those that are not considered natural monopolies or part of the defense sector. He added that the state should cut its equity in companies in those strategic sectors to that of a strategic-investor level in the same timeframe. Igor Shuvalov, in his role as first deputy prime minister, just last week repeated the mantra, emphasizing the government's determination to proceed with an ambitious program of privatization.

This much-needed structural policy has been repeatedly delayed since it was announced in 2008. In large part, the Kremlin backed off because of the legacy of the 1990s, when state assets were seen as almost a giveaway to corrupt and powerful business interests.

Why is this collective memory so poignant that it impedes the state from doing what is needed? Why is it that so many Russians and foreign investors still have such an overwhelmingly negative view — especially of the infamous loans-for-shares backdoor privatizations in 1995-96 — that it casts such a long shadow over what needs to be done now to transform the economy away from energy dependence?

As Putin said in February in an address to business leaders, "It is time to put the 1990s behind us once and for all." Unfortunately, his suggestion was that those who acquired state assets unfairly should pay a one-time windfall levy.

It may be worthwhile to recall how UCLA political science professor Daniel Treisman in his recent book, "The Return: Russia's Journey from Gorbachev to Medvedev," analyzed the myth of the loans-for-shares scheme: that a few well-connected businessmen bought stakes in major Russian companies through manipulation at bargain basement prices. While he concurs with the critics that the scheme's execution appeared corrupt, in most other regards the conventional wisdom was wrong. The stakes involved represented a small fraction of the market, the pricing in most cases was in line with international practice, and the loans-for-shares program only explains a small part of the country's large wealth gap. The biggest beneficiaries were not the oligarchs but Soviet-era industrial managers.

Having raised this specter during a political campaign, it will hopefully be quietly dropped. After all, there are other, much bigger skeletons lurking in that closet of the 1990s. It would be enough on its own to ask what happened to ownership stakes in Gazprom and its subsidiaries and other energy companies. At a time when oil prices may be going into a soft patch and economic diversification is so vital, it may be high time to finally close the chapter on the 1990s privatizations, as Putin himself asserted back in 2000.

Looking forward, it is going to require considerable political will to pursue a meaningful privatization agenda. The last thing that Russia can afford is to revisit the past, as Tony Blair's Labour government did in 1997. It would be a recipe for paralysis by postponing public support for privatization at a critical juncture and further undermining Russia's battered investment climate.

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