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Predicting the Future With Russia's Economic Nostradamus

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Mikhail Dmitriyev was responsible for major reforms in Putin’s first term.

Mikhail Dmitriyev, president of the New Economic Growth consultancy, is often described as "Russia's top brain."

He studied in Leningrad in the '80s and took part in economics discussion clubs with the people who transformed Russia into a market economy, including Anatoly Chubais, the architect of Russia's privatization program, and Alexei Kudrin, Russia's longtime finance minister from 2000 to 2011.

Some of those people who were discussing the future of the country's economy at a time when nobody imagined that the Soviet Union would collapse now occupy government posts. Others, including Alfred Koch and Andrei Illarionov, have turned critical of the country's current government.

Dmitriyev, 54, is somewhere in the middle. After serving as deputy economy minister in 2000-04, during which he was responsible for some of the most important reforms of President Vladimir Putin's first term in the Kremlin, he became head of the Center for Strategic Research, the country's top think tank on economic policy.

In reports produced by the think tank, Dmitriyev showed an uncanny ability to correctly predict the future, forecasting, among other things, the rise of political protests in Moscow and other big cities in 2011-12 and the current Russian economic downturn. This earned him fame among other analysts, but also latent irritation from the authorities. A year ago, he was forced to leave the Center for Strategic Research together with his team after his contract was not extended. Around the same time, he was beaten up at the entrance to his apartment block. The attackers took his computer, but did not touch his wallet or other valuables.

"Chronologically it coincided with the decision of the CSR's board to appoint a new president. No other clues are available," he told The Moscow Times in an interview.

Dmitriyev, who now heads the New Economic Growth consultancy, believes Russian society is undergoing fundamental changes that will become visible before the 2016 State Duma elections.

The economist met with The Moscow Times to share his views on the current economic, political and social situation in Russia.

Q: It is now clear even to the government that sanctions do affect the Russian economy. But how do they affect Russian society and support for President Vladimir Putin?

A: The foreign policy agenda, Ukrainian conflict and the economic crisis go hand in hand. We have observed a dramatic evolution of public attitudes toward the Ukrainian crisis throughout the last year. At the beginning of 2014, the whole issue was considered through the perspective of foreign policy achievements. Back then, the approval of what people saw as the restoration of Russia's status as a great power got maximum ratings: It [Putin's electoral rating] increased from 36 percent to more than 50 percent at that time, according to Levada Center surveys. The majority of respondents singled out this issue [Ukraine] as Putin's main achievement.

By the end of the year, that attitude had changed. Russia's ambitious foreign policy began to be considered not as an achievement but as a source of the threat of military conflict. The perception of a real threat of war has increased almost three times from the beginning of last year: Now almost 40 percent of respondents consider the risk of Russia being engaged in a military conflict as one of the key issues.

People have also begun to see Western powers as an enemy and a threat. Only a year ago, less than 20 percent of Russians considered the United States Russia's enemy. By August, that figure had increased to 82 percent, the highest ever recorded.

This situation means people can still approve of Putin, but the nature of the approval has shifted from positive motivation — approval of achievements — to negative: approval due to the perception of foreign threats. The acquisition of Crimea was considered a positive achievement, but now Russia's isolation is considered to be a threat. This threat can also

consolidate [people], but only from a negative perspective.

If the Ukraine conflict escalates further, then this negative consolidation could turn against the authorities. People could get tired of military confrontation, which will no longer motivate them to support the government.

In our focus group studies, we first discovered last December that it was difficult to stimulate respondents to talk about the Ukraine conflict in a rational way. They were often giving very normative, emotional answers.

On such sensitive issues, people tend to say what they feel they should say. In order to avoid this we used projective tests: We asked respondents to compare Russia with any animals they considered appropriate. At the time of Crimea's incorporation into Russia, respondents compared Russia with bigger and stronger animals, such as the bear. At the end of the year, shortly before the ruble's deepest dive, many respondents compared Russia to a smaller animal, such as a wolf or hedgehog.

What this means is that Russia was perceived as stronger at the beginning of the year than at the end. This became particularly clear when we looked into the standard average physical weight of each animal. We found that Russia's average weight had declined by 36 percent from the beginning of the year.

It was interesting that this decline correlated with the ruble's devaluation, which depreciated by 39 percent in the same period. This means that people began to associate Russia's economic might with the country's ability to achieve foreign policy goals.

This may also imply that if the foreign policy crisis escalates, sanctions are strengthened and the economy suffers, then it is likely that the approval rating of the president will go down.

Q: Over what sort of timeframe could these developments take place?

A: The economic sentiment [how positive people feel about the country's economy] of Russians is going down fast. Sberbank's financial sentiment index, which measures popular demand for financial services, is already at its lowest point ever. Usually presidential approval ratings follow attitudes to the economy with some lag. In the last 15 years, there has never been a case when a decline in economic sentiment was not followed by a decline in approval ratings.

After the previous economic crisis, approval ratings declined by 25 percent from the peak level of 2008, but it was a stop and start process.

This time we see that high ratings are underpinned by boosted patriotic sentiment among Russians. The propensity for protest is much lower now in 2015 than it was in 2011-12, when mass political protests took place in Moscow. The public's attitude toward the political protests of Russians on Bolotnaya and Sakharova squares has gone from generally positive to strongly negative. That happened during this last year, when the public reflected on the latest Ukrainian revolution and its implications for Ukraine and Russia.

Now such large-scale protest events are associated with the risk of destabilization, economic

decline and even the disintegration of the country. Therefore, it looks quite unlikely that large-scale political protests could happen in Russia in the near future.

Q: Is that a long-term or a short-term prediction?

A: That depends on how strong the memory of the Ukraine crisis turns out to be.

Economic protests, on the other hand, are a different story. The propensity for such protest activity is already in the red zone. The decline in incomes, high inflation and raising utility tariffs greatly contribute to this situation. These issues could cause major concern this year. Last year was the first one in the 21st century when the real incomes of Russians declined, and this trend will continue this year. January inflation was the highest since 1999.

Therefore, we can expect that these economic protests will intensify this year.

There is a big differentiation between political and economic protests in Russia. The latter are usually scattered among the Russian regions. Moscow and St. Petersburg are much less vulnerable to an economic crisis than provincial towns. In 2010, there were 34,000 protest events, according to our data, but most of them were outside Moscow and St. Petersburg.

Political protests, on the other hand, are concentrated in the capitals, the last wave in particular. These protests were very different from the economic protests.

Q: Could economic protests affect Russian foreign policy?

A: Economic protests are less challenging in terms of retaining political control. In my view, such protests are unlikely to force the authorities to change their policy on Ukraine.

Q: Do you believe it is possible for Russia to achieve economic growth while it is in confrontation with the West?

A: There are two challenges in terms of achieving higher levels of growth for Russia. Given the current economic policy mix, the potential growth rates are 1-2 percent a year in the longer term. This means that the gap between Russia and advanced economies will widen.

Russia is currently in the middle-income trap [meaning it is stuck at a certain level of development], making it similar to Argentina, Venezuela and Iran.

If the Ukrainian crisis ends in the political, financial and trade isolation of Russia from Western economies, growth will be perpetually limited. The largest market for Russia is still the European Union, because the European market is the closest to the geographic center of the Russian economy, which is somewhere around Moscow.

In contrast, the Chinese center of economic growth is very far from Moscow, while the EU economy is still larger and more technologically advanced than that of China. In 2010 Russia's combined exports to Germany, the U.K. and France were almost 1.5 times higher than Russia's exports to China. This will change, but only in the long run. According to HSBC bank's latest projections, by 2050 China is set to become Russia's largest trading partner and Russia's exports to China will be three times higher than Russia's exports to Germany, the U.K. and France combined.

In the short term, any disruption in cooperation with the EU will bring economic slowdown. Because of the size and distance of the Chinese economy, Russia's trade with China will not compensate for the decline in its trade with Europe. Russia's Far East will benefit from more trade with China, especially as the security concerns have been eased there. At the same time, regions such as St. Petersburg and Kaliningrad [near borders with EU countries] will suffer from the disruption of trade with Europe.

Q: Who do you think loses more from sanctions, Russia or the EU?

A: The EU losses are minimal at this stage. Further escalation — for instance if all gas supplies from Russia stop — would change that.

Russia's economic losses from sanctions and Russian anti-sanctions [retaliatory measures] are much more significant. So far, the main damage comes from financial sanctions against Russian companies.

For instance, the ruble has lost about 50 percent of its value under the combined impact of foreign policy risks, sanctions and the decline of oil prices. There is no [other] oil exporting country that has seen its currency devalue by more than 20 percent.

Further escalation of sanctions may cause much heavier losses, in particular if Russian banks are disconnected from the SWIFT system.

Q: How strong are the conservative and progressive elements of Russian society in relative terms?

A: In larger cities, many people are concerned about human development issues, such as education, health or civic and political rights. At the same time, the relative strength of these priorities has declined. Crimea's incorporation into Russia was considered even by socially advanced middle-class groups as a manifestation of the country's achievements.

Despite being achievement-oriented in some sense, such sentiments do not correspond to what we believe are modernist values. They reveal an obsession with territorial claims, which for the time being are placed above any other social and economic matters. So there was a certain setback from the modernist agenda to more traditional values, even among the middle classes in Russia. This does not mean that the middle class completely lost interest in the development agenda. But now the economic crisis has begun to work against these values too.

What we see is that as current consumption becomes affected by the crisis, the intentions of the middle class are refocusing on immediate survival above getting a better education or career advancement. In short, priorities have shifted to minimizing risks at the cost of achievement and development objectives. This shifts society's overall priorities back toward more traditional values.

By 2014, over 40 percent of the Russian population could be considered middle class, according to the classification of prominent sociologist Natalya Tikhonova. More than half of that middle class holds relatively modernist values, while among other groups the traditionalists prevail.

What we discovered in 2012 was that for the first time even the less advanced social groups outside Moscow and St. Petersburg suddenly turned to developmental priorities, with current issues of everyday consumption and risk minimization receding. This shift was taking place among all social groups, our study revealed. But outside Moscow this shift of priorities proved to be short-lived because it was not underpinned by a fundamental change in behavioral models and institutions. Social norms could not adjust so quickly to dramatic improvements in current consumption.

Our next survey in the middle of 2013 revealed that the majority in Russian provinces had slid back to survivalist mentality. Only in Moscow did there still remain a much bigger concern for human rights, environment, and education, while in the provinces these matters seemed much less important.

This is not the end of social modernization in Russia, but rather a temporary transitional setback. The new priorities are not yet embedded in new behavioral models and institutions. That is why such wide swings in public opinion have become possible. Public attitudes during transition have become more volatile.

Q: You were part of the modernization team of the Russian government, implementing German Gref's program during Putin's first term in 2000-04. Do you think the government will be forced to go back to the reform agenda, given that real incomes are falling and the economy is contracting?

A: Today, I do not see any decisive indications of a long-term policy shift toward successful development. There is a long way to go before this agenda becomes a priority for the current economic administration in Russia.

First, there is the issue of isolationist economic policy. If Russia follows Venezuela, Argentina or Iran, any attempts to accelerate long-term economic growth — even with institutional reforms — will be hopeless. It will also make any attempts to introduce a new set of policies irrelevant.

The second issue is that mere institutional reforms are not enough to achieve long-term economic growth in Russia. The previous reform package was very instrumental for a country that was still relying on energy-driven economic growth. Basic liberalization helped to translate growing export revenues into higher consumption for the vast majority of Russians.

At that time, non capital-intensive sectors were among the fastest growing in Russia: telecommunications, retail trade, retail banking and so forth. IT was the only exception, when the high-tech services sector became a booming export industry. All the other booming industries were driven by domestic consumption.

That was the easy part of the task, but today this model is completely exhausted. Housing, infrastructure and human capital now come to the foreground. The World Bank assesses that two-thirds of potential productivity growth in Russia could be delivered by simply improving the quality and quantity of infrastructure.

The Russian economy has already outgrown its energy sector. There are clear natural ceilings

in energy export growth in current dollar terms, and energy exports will continue to decline as a percentage of GDP. The world does not need more energy from Russia. Export can no longer drive the Russian economy, and it is clear that we should find non-resource-based solutions for further economic growth.

In this regard, the policy mix that the Russian government and elite is trying to put forward — import substitution in industry and agriculture — is irrelevant to future economic growth. There is some room for import substitution, but manufacturing and agriculture contribute less than 20 percent to Russia's GDP. In addition, real exchange rate appreciation will in the long run undermine short-term gains in manufacturing competitiveness due to the recent devaluation of the ruble.

If we aim to achieve average economic growth of 4 percent, which would enable Russia to bridge the gap with advanced economies in the next 20-30 years, then the import substitution strategy would require completely unrealistic growth rates of 10-20 percent in manufacturing and agriculture.

The solution to this requires a much more complex strategy that would aim at accelerating a far broader range of non-energy sectors, mainly in services. This policy agenda would go far beyond simply reforming public administration or the overall deregulation of the economy.

Q: Is the answer in the rule of law and democracy?

A: These concepts are relevant and important, but are not sufficient to secure high economic growth. The next major long-term drivers of economic growth in Russia are in the services. They include some of the traditional sectors, such as construction, logistics and transport infrastructure. But Russia also badly needs further advances in modern business services. In Russia, the proportion of business services in employment is still 1.5 times less than in Germany, while it [the proportion of people employed] in retail is higher than in Germany.

What do business services really mean? This is design, marketing, engineering, IT, legal services, architectural services, financial intermediation and others. These are very varied industries, but they are skill-intensive and highly productive. In addition, these services are no longer linked to the location where they are consumed. There is also a similar or even higher potential for growth in health, education, culture and entertainment.

If Russia wants to reduce its dependency on energy exports, it has to focus on the modern and productive segments of services. This requires a very different policy mix from the previous economic leap of the 2000s.

Q: In this regard, Russia does have several success stories: Yandex, Kaspersky, Mail.ru, which have developed in the last 15 years under not very developed governance in the country.

A: These individual successes indicate that the combination of skills of the Russian workforce is conducive to such industries. There might be many more successes in these areas with the right set of policies.

One of the main challenges is that these sectors need large economies of scale and require a large concentration of people, knowledge, skills and similar companies in one location. Most

of them develop in the world's largest agglomerations. Russia's problem is its spatial inefficiency. The proportion of the population living in major metropolitan areas in Russia is only 20 percent; for the Organization for Economic Cooperation and Development it is 50 percent. This problem is aggravated by the fast decline of the working-age population in Russia.

This means that a vast pool of skilled and potentially productive workers is trapped in inefficient locations, where business services are unlikely to be competitive. The productivity gap between Russia's large agglomerations and small towns is enormous. An enterprise in a small town of less than 50,000 people is 30 percent less productive than the same enterprise in a city with a population of more than one million.

In Russia, wages and real estate prices fall much more quickly than in developed countries as you move away from the core of a major agglomeration. This means that the areas of higher productivity around Russian agglomerations are also much smaller.

Connecting big cities with the surrounding areas by more efficient transport networks and encouraging labor mobility will make it possible to gradually shift 20-30 percent of the working population within the economy into major metropolitan areas. Russia could create an environment that is much more conducive to the faster growth of productive non-oil economy.

Q: How could the government do that?

A: We have very few efficient agglomerations and only a small fraction of the workforce is located there. This needs a comprehensive redesign of housing policy, which must remove the unacceptable barriers for developers and diversify supply, particularly toward rental housing. Supply of modern office space should also be radically enhanced.

Regulations must become conducive to the knowledge economy. These are issues of intellectual property rights, easier entry and exit of companies, better enforcement of minority shareholder rights to facilitate the capitalization of startups, and the effective protection of small and medium-sized companies from fraudulent hostile takeovers.

The urban environment must become more friendly for learning, leisure and socialization. It should provide cultural and recreational activities that are associated with upper middle class lifestyles. It should become more environmentally friendly and better connected by modern mass transit systems. In all these areas Russian policy-makers face enormous challenges.

This new development agenda affects very diverse areas and requires many new policy competences. It must be a comprehensive and coherent strategy: When implemented, it cannot fail in some aspects and still be successful as a whole.

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