Natural Resources and Their Implications for Russia's Economic and Political Development

https://www.e-ir.info/2012/07/08/natural-resources-and-their-implications-for-russias-economic-and-political-development/

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Russia is a country that is well endowed with a variety of naturally occurring minerals and is thus subject to both the benefits and disadvantages associated with significant resource wealth. However, the country occupies a unique position when compared to many other emerging markets in the same naturally rich position and, as a result, needs to be assessed on the basis of its distinct situation. Its position opens the Russian economy to a number of detrimental effects that, if not dealt with effectively, could mean disaster for the country's economy and its long term growth. The importance of efficient macroeconomic management is second to none, with the role of political economy in Russia's development and sustained growth playing a crucial role. This essay will look at the effects of state control, rent seeking and the government's fiscal policies, in an attempt to discover the nature of Russia's resource dependency, and whether or not the country's future success is jeopardised by the existence of natural wealth or political weaknesses.

One of the major issues associated with the presence of abundant natural resources such as oil, gas and other natural deposits, is the potential negative effects it can have on the rest of an economy. In other resource focused economies, a notable decrease in the manufacturing productivity has been noted as a direct result of the increased importance of resource exploitation in a nation's exports (Dobrynskaya & Turkisch, 2010). This effect is present in a number of emerging markets that place an emphasis on the development of their natural resource sectors. The impact was most prominently noted in Holland after the discovery of natural gas deposits in the 1950s and 60s, leading to the development of the concept of 'Dutch Disease' (Powell, 2008). As a result, many economists have rejected the assumption that the presence of natural resources is beneficial to a nation's growth, with the existence of raw materials becoming increasingly considered as an obstacle to successful future development (Ahrend, 2005). This is combined with an increasing amount of empirical work suggesting that resource rich countries are more likely to fall behind in terms of long term growth, leading to the syndrome frequently known as the 'Resource Curse' or 'Paradox of Plenty' (Ahrend, et al., 2007). However, in the case of Russia, economists are divided over whether or not the country is currently suffering from 'Dutch Disease', if it will suffer from the economic ailment in the future, or, if the theory is still in fact relevant considering the concept is just as frequently absent as it is present from resource rich countries (Powell, 2008).

Arguments suggesting that the country is currently in the grips of a severe case of 'Dutch Disease' (Sapir, 2005), are largely founded on Russia's apparent dependence on oil for its economic growth from 1998 onwards, as well as the presence of a number of symptoms associated with the disease. Russia has suffered from the appreciation of the rouble due to high energy exports, a decrease in employment in the manufacturing sector and a rise in the country's service sectors, all of which point to a country currently suffering from the effects of resource dependency and 'Dutch Disease' (Dobrynskaya & Turkisch, 2010). However, unlike the theory suggests, in many instances industrial sectors have grown and experienced increased levels of productivity (Ahrend, 2005). Until the financial crisis of 2008, there were two main factors supporting the strong development of Russian industry, booming internal demand and the good performance of Russian products on foreign markets, such as the Euro area and the Commonwealth of Independent States (CIS), regardless of their increasing prices (Dobrynskaya & Turkisch, 2009). Despite this, it has been suggested by Rüdiger Ahrend, that the growth achieved in the non-resource based sectors was a result of 'passive' restructuring, with its apparent growth only possible due to the high inefficiency experienced by industry during the Soviet period (2005).

As Ahrend suggests, much of Russia's increased manufacturing productivity can be associated to the poor productive environment under communism and the de-industrialisation that occurred during the economic difficulties in the 1990s. There was a rapid process of recovery during the early 2000s which explains the increase in manufacturing despite the decrease in employment, with evidence to suggest that demand from China and the CIS for Russian goods also acted to prevent the decline of Russian industry (Dobrynskaya & Turkisch, 2010). Dobrynskaya and Turkisch (2010) argue that the apparent symptoms of 'Dutch Disease' could also be explained by other factors, such as the Balassa-Samuelson effect in relation to the rouble's appreciation, and the rapid growth of services due to their under-development during the Soviet period (Dobrynskaya & Turkisch, 2010). Whilst economists may highlight the reasons for the continued industrial growth and competitiveness, despite the country's dependence on oil exports to fund much of its development, the continued long term growth of Russia's economy is dependent on the creation of sound monetary and macroeconomic policies as growth in the future will be significantly harder to attain. If the Russian government meets the challenge of resource dependency with good macroeconomic development, it will undoubtedly reduce the vulnerability of the country's economy to external factors (Anon., 2006). It could be argued, that the future of Russian development is dictated by the government's ability to manage the natural resources of the country, with effective administration ultimately negating the effects associated with an abundance of natural materials. It is therefore crucial that we recognise the role being played by the Russian authorities in resource management, if any kind of prediction is to be made regarding Russia's future long term growth.

The Russian government has attempted to control the situation emerging in the country through a number of fiscal policies, with some being more successful than others. Attempts by Vladimir Putin to control the appreciation of the rouble against the Dollar in 2004, thus protecting domestic producers from growing imports, was largely unsuccessful, resulting in inflation, revived capital outflow and a liquidity crisis that affected several banks causing an almost complete halt in the economy (Aris, 2005). Russia has experienced significant difficulty with the appreciation of the rouble and it has led to some conflicting monetary policy, with Putin admitting in 2004 that the economy was struggling to maintain competitiveness due to the strong upward pressure on the rouble caused by the resource dependant nature of Russian exports (Anon., 2006).

However, the creation of the stabilisation fund, designed to provide a buffer against the inflow of 'petrodollars', protects the Russian economy from a decline in the price of oil and acts to sterilise the effects of excessive inflow when prices are high (Aris, 2005). Whilst providing financial security against fluctuating oil prices, the stabilisation fund is also the most efficient means for controlling inflation, playing a pivotal role in sustaining budgetary expenditure, growth and exchange rate stability in the event of developing 'negative terms-of-trade' (Gianella, 2007). The stabilisation fund partly controls the country's money supply and, whilst not completely preventing it, goes some way to reducing the increase of inflation (Dobrynskaya & Turkisch, 2010). The structure of the tax system is critical in controlling the input of resource revenues, with the development of an effective taxing system ensuring that any excess profits are redirected into the stabilisation fund up to the value of 500 billion Roubles. The direct taxing of the resource sectors will allow the Russian authorities to relieve the tax burden on manufacturing, thus helping to ensure the continued competitiveness of industry (Gianella, 2007).

Despite this, a number of issues surrounding the stabilisation fund have become apparent. Initially it appears that the limit of 500 billion Roubles is likely only enough to offset the countries short falls for no more than a year at most. Neither is the fund indexed against inflation rates and, as a result, is falling in value relative to Russia's GDP by around 15-20% per annum (Ahrend, 2005). Yet, the most notable issue and prominently debated question in the Russian government is, what should be done with the excess windfall? As there is no legislative mechanism to control the rapid spending of the stabilisation funds above the value of 500 billion Roubles, there is a real danger of 'fiscal slippage' (Gianella, 2007). Some have suggested the reinvestment of oil revenues into infrastructure, health services and education. However, the dangers of such reinvestment include pro-cyclical financial loosing and inflationary pressures, with former minister of finance Alexei Kudrin warning against such measures and encouraging the government to use the windfalls to pay off external debt, thus avoiding a pro-cyclical policy that would make the risk of 'Dutch Disease' more severe (Gianella, 2007). Thus far Russian authorities have taken account of this advice and used the excess cautiously to write off the country's foreign debt (Anon., 2006). Without the creation of tough yet flexible restrictions on the use of the stabilisation fund[1], the endless speculation within the Russian government could in itself be enough to effect the management of the exchange rate, with expectations of a lapse in government discipline reinforcing pressure on the appreciation of the rouble (Gianella, 2007).From this it is clear, that the continued usefulness of the stabilisation fund in protecting the economy from the excessive input of resource revenues, is almost completely dictated by political will. As a result, Russia's future financial stability and the maintenance of long term economic growth is vulnerable to changes in political goals, opinions and governments; making its position, without a significant increase in legislative restrictions, tenuous at best. The political danger is clear. The incentives for rulers who are unsure of the security of their tenure are more likely to manipulate and aggressively spend resource revenues in an attempt to secure their future political authority, asserting their position through tax cuts and public spending, as well as using such windfalls to appease social protest if it should occur. The temptation is to use the funds for immediate consumption rather than to support forward thinking reform (Tompson, 2005).

The implications of political economy are potentially one of the toughest obstacles faced by resource rich nations, as rent seeking and the negative effects associated with it play a prominent role in resource dependant countries' development. In this respect Russia is no different. The allocation of talent to areas in the resource sector is commonplace, as individuals often chase the rents provided by Russia's natural wealth rather than engaging in entrepreneurship in other non-resource based industries (Ahrend, 2005). Both the private and publics sectors in Russia are highly focused on securing rents created by resources rather than creating new wealth. As a result, contest over the control of the means of resource production has generated significant problems for the diversification of the Russian economy, acting as a major point of political conflict and causing economic production to suffer due to the unproductive nature of the struggles (Tompson, 2005). Such conflicts have resulted in the domination of resources by fewer, larger firms, increasing the political incentive to nationalise these companies, especially when they constitute a large proportion of the economy, due to the government's fears of large and politically unmanageable enterprises. The reason for such intensive rent seeking in Russia is largely due to the general weakness of property rights and a legal system ill-equipped to deal with the contests that arise, rather than the nature of the natural resources. In this environment agents will be more likely to pursue prospects of short term profitability, rather than establishing uncertain long term enterprises (Tompson, 2005). It is clear that whilst rent seeking is a major issue for the Russian economy, it is not directly caused by the presence of abundant natural resources. The appeal of rent seeking will continue in Russia until there is some form of legislative intervention that drastically strengthens property rights and creates a legal system capable of effectively defending an individual's right to ownership. It can thus be summarised, that the political issues in Russia are not caused by oil, gas or other mineral deposits, but by a flawed and inconsistent judicial system and weak legislature. So, it could be argued, that rent seeking in Russia and its political fallout are not the result of economic factors, but the consequence of a weak legal system that makes such economic activities viable.

Traditionally, resource dependant states suffer from under developed extractive institutions due to their ability to secure significant revenues from their primary sectors, thus reducing incentives for the development of elaborate fiscal institutions (Tompson, 2005). Such a scenario is potentially very detrimental for Russia's political development, with their ability to fund activities without the need to tax the population reducing the government's accountability to its people. However, this situation does not appear to represent or explain the conditions in Russia. Extremely weak extractive institutions after Communism meant that the government had to develop a system in which it could effectively tax all areas of society. Initially a policy of general taxation was pursued and little attention was devoted to securing resource rents, suggesting that until the tax changes in 2000-2003 the country's political development was not negatively affected by resource rents (Tompson, 2005). In 2003, the Russian government's tax revenues for export duties and resource taxes (20%) were lower than both social (22.2%) and consumption taxes (29.5%), clearly showing that the tax revenue collected from the resource sector is not the Russian government's main source of revenue, with VAT in Russia acting as the single most important tax, accounting for 35.8% of the country's tax revenue in 2004 (Tompson, 2005). Although there has been a distinct authoritarian shift in Russia's governance since Vladimir Putin's presidency, it cannot easily be linked to the development of a resource rent seeking tax system or fiscal policy. Instead, the contribution of resource rents to the erosion of political accountability has not taken place via the fiscal system, but is the result of growing direct state control of the fuel orientated resource sectors, seen prominently in the acquisition of Yukos' assets in 2006 (Tompson, 2005). Whereas the tax system has developed in a transparent and efficient manner, government companies have not. It is unclear who is accountable within these organisations, with many suspecting their use to fund activities those in power would prefer not to appear on the budget (Tompson, 2005). The continued state control of the resources sectors will continue to have a detrimental effect on democratic and positive political development in Russia, as well as many negative economic ramifications.

One of the problems facing resource rich countries and threatening poor economic performance is not necessarily the presence of abundant natural resources, but instead the structures of control and ownership that these nations often choose to govern their resource sectors (Ahrend, 2005). It is commonly agreed that private enterprises are more efficient than state owned operations, and this contrast can be clearly seen in Russia between the largely state owned gas sector under Gazprom and, until 2005, the almost entirely privately owned oil companies (Anon., 2006). As a result, much of Russia's development between 2000 and 2005 was largely due to the export of oil, with the oil industry experiencing significant growth of almost 70% compared to the stagnation taking place in the gas sector (Ahrend, et al., 2007). The Russian Government's involvement in the certain strategic areas, especially the energy and financial sectors, has had a number of detrimental effects on the development of the resource production. In publically owned companies the state's management of foreign investment has been poor due to excessive restrictions and unclear legislation surrounding foreign investment. This has resulted in discouraging outside investors from participation in Russia's energy industries and ultimately inhibited the area's potential for growth. The government's reinvestment policies are also highly flawed, with the focus on the acquisition of assets abroad rather than the development of resource extraction within the country, undermining the sectors prospects for possible growth in the future (Dobrynskaya & Turkisch, 2009).

However, manufacturing industries were not subject to the same constraints due to the large proportion of privately owned companies. As a result the investment environment in the manufacturing industries improved, as did the perception of foreign investors who were attracted by the relatively moderate cost of production and the highly skilled Russian labour market (Dobrynskaya & Turkisch, 2009). It is clear from this that most state enterprises were under-achievers and subject to the often politically motivated goals of the government. However, ironically, the unattractiveness of the Russian energy sector to foreign investors, despite the potentially high profitability, allowed manufacturing industries to take advantage of this, achieving significant growth where the theory of 'Dutch Disease' predicted an erosion in manufacturing and eventual de-industrialisation. The privatisation of the oil industry is one example of how Russia was in a better position than most other resource dependant emerging markets, but it is also clear that the country is not without state management and has the potential to forsake productivity in favour of state control. Despite this, the mismanagement of public sectors has in many ways aided in the short term prevention of 'Dutch Disease'. Nevertheless, it is unlikely that any such future mishandling will have any feasible future benefits, with the continuation of such policies probably resulting in economic stagnation, resource dependency and an inability to develop a fully accountable political system. It could be suggested, that many of the issues experienced by Russia are not the result of a 'Resource Curse', but are in fact the effect of the 'State-Ownership Curse' (Tompson, 2005).

It is very difficult to use the conventional explanations to understand the impact that natural resource abundance has had on both the Russian political system and economy. This is largely due to a number of distinct differences between Russia's circumstances and those traditionally seen in other resource dependant emerging markets. Firstly, Russia is not a typical resource based economy as it did not suffer a 'resource shock' as the result of resource discovery, such as in the United Kingdom or the Netherlands, but instead it resulted from the adjustment of relative prices at the beginning of the country's post-Soviet transition (Tompson, 2005). Secondly, the legacy of communism in Russia meant that there was a significant industrial base, infrastructure and bureaucracy within the country, thus removing one of the most significant obstacles hindering the development of resource dependant nations starting from scratch. Despite having some of the symptoms of 'Dutch Disease' and the obvious importance of resource exports in the country's real GDP, the inheritance of an established industrial sector has gone some way in negating the potentially harmful impacts on the country's growth, protecting Russia from the de-industrialisation commonly associated with 'Dutch Disease'. It is clear that the effects of resource dependency on Russia can easily be exaggerated and, whilst there has been some good macroeconomic management of the system, with the creation of the stabilisation fund and an effective system of taxation, much of the economic difficulties being experienced in Russia are the direct result of the country's political orientation and not the presence of natural resources. Weak legislative foundations, a lack of meaningful property rights and an ineffective judicial system have led to rent seeking, corruption, growing nationalisation and a decrease in the government's accountability. However, much like the country's economy, much of these political factors are not developing in the same way as other resource dependant nations. Nationalisation has not been outright, but is continuing to grow, rent seeking is the result of poor property rights rather than the nature of the resources, and the diminishing accountability of the Russia leaders is not the result of their freedom from the need to consult society or to negotiate the terms of resource production, but a result of the state's growing control over the fuel based resource industries. Presently the country is not suffering from 'Dutch Disease', but the without the reform of legislature surrounding the country's macroeconomic policies, the strengthening of property rights and the improvement of the judicial system, Russia's economic future is unclear, not because of the presence of abundant natural resources, as when looking at Russia's resource poor neighbours it appears that Russia would suffer from the same kind of political problems regardless of their resource wealth, but because of the fickle and potential self-destructive nature of the country's political economy.

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[1] As overly tough constraints are more likely to be overlooked in times of financial uncertainty than those with a degree of flexibility (Gianella, 2007).

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Date written: January 2012