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BACKGROUNDER

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Russia's Economy Continues to Underperform

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Abstract

Nearly three decades after the collapse of communism, Russia increasingly abuses individuals' economic and property rights, thereby reducing the attractiveness of the country at home and its global competitiveness abroad. With time, these developments may have serious and long-lasting economic, political, and social consequences, including civil unrest and unpredictable political upheaval. Absent reforms to spur stronger and more widespread economic growth, Russians are likely to continue losing hope and faith in the future of their country.

Summary

More than a quarter-century after the disintegration of the U.S.S.R., the Russian government has still not introduced the structural economic reforms the country needs to make its economy truly competitive. Combined with the severely negative economic impact on the country resulting from slumping global oil prices and international economic sanctions imposed by the West, the result of that failure has been sadly predictable—continuing economic underperformance.

Those areas in need of reform are clearly illustrated in the analysis of Russia's performance in The Heritage Foundation's 2017 *Index of Economic Freedom*.[1] Russia is ranked 42nd of 44 countries in the European region, and its overall score is well below the world average.

The reasons for the country's low rank are many, including government officials' disdain for the rule of law and for the concept of limited government; continued marginalization of the private sec-

Key Points

- Ultimately, only the Russian people can solve Russia's problems. Nevertheless, the United States and its Western allies can and should continue to generate indirect pressure on the Russian government to encourage better behavior.
- For example, Western governments can counter Russia's ongoing campaign aimed at undermining Western unity and popular support for NATO.
- The West should actively combat not only conventional military threats, but also new "alternative" threats, such as cybercrime and subversive propaganda outlets in Europe and the U.S. aimed at igniting U.S.–EU and intra-EU political differences.
- The West should also continue to isolate Russia internationally through political and financial sanctions, leaving it with less money to buy off much of its population through welfare.
- Until the reforms described in this report are implemented, the economic prognosis for Russia will remain bleak.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3264**

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tor through structural and institutional constraints caused by ever-growing government encroachment into the marketplace; rising inflationary pressure that jeopardizes macroeconomic stability; and increasing domination of large, state-owned institutions in the financial sector at the expense of private domestic and foreign banks.

As the 2017 *Index* reported, the inefficient public sector dominates the economy. The risk of state meddling in the private sector remains high in Russia's repressive political environment. The judiciary is vulnerable to corruption, and the protection of property rights remains weak, undermining prospects for dynamic long-term economic development.

Ultimately, only the Russian people can solve these problems. Nevertheless, the United States and its Western allies can and should continue to generate indirect pressure on the Russian government to encourage better behavior. For example, Western governments can counter Russia's ongoing campaign aimed at undermining Western unity and popular support for NATO. This should occur not only in the area of conventional military threats, but also by actively combating new "alternative" threats such as cybercrime and subversive propaganda outlets in Europe and the U.S. aimed at igniting U.S.–EU and intra-EU political differences.

The West should also continue to isolate Russia internationally through political and financial sanctions, leaving it with less money to buy off much of its population through welfare. To counter Russia's covert financial influence in the media in the U.S. and the EU, strengthened trans-Atlantic cooperation should help European countries identify and draw public attention to Russia's financing of fringe politicians, political parties, and media outlets in the West.

The Russian business environment does not provide favorable conditions and a level playing field for small and medium businesses (SMEs) to develop and operate effectively. The situation in the country has created a maelstrom of vicious cycles, where the people do not trust the government and the government is afraid to make the courts independent, open up political processes, and liberalize the media due to fears of being overthrown by a wave of discontent.

Until the reforms described in this report are implemented, the economic prognosis for Russia will remain bleak.

Introduction

In 2014, The Heritage Foundation published a background paper on the state of the Russian economy,[2] detailing the persistent systemic and institutional problems that were halting a country otherwise abundant in resources and human talent from achieving greater growth and prosperity. The paper warned that Russia would continue its economic decline if the country did not tackle these problems. Unfortunately for the people of Russia, that paper proved to be prophetic.

Russian support of Ukrainian separatists in the regions of Donetsk and Lugansk and the annexation of Crimea in 2014 triggered a new wave of sanctions against Russia by the European Union, the United States, Canada, and other developed countries for what constituted the first violent takeover of another country's internationally recognized territory in Europe since the end of World War II. Similarly, Russian interference in Syria, while not a serious financial drag on the economy (the campaign is estimated to have cost around $1 billion per year[3]), has pushed Russia into the unenviable status of "pariah state," further distancing it from the very international partners it needs for inward investment.

This near-simultaneous involvement in hostilities in Ukraine and Syria coincided with an abrupt plunge in global oil prices that led to a wave of redistribution of global income from oil-rich exporters to net oil-consuming advanced economies. Russia was among the hardest hit: Oil revenues dropped, the ruble plummeted, and living standards deteriorated.

Russia Is Falling Behind

Although the International Monetary Fund has predicted robust global economic growth in 2017–

1. Terry Miller and Anthony B. Kim, "Russia," in *2017 Index of Economic Freedom* (Washington, DC: The Heritage Foundation, 2017), http://www.heritage.org/index/country/russia.

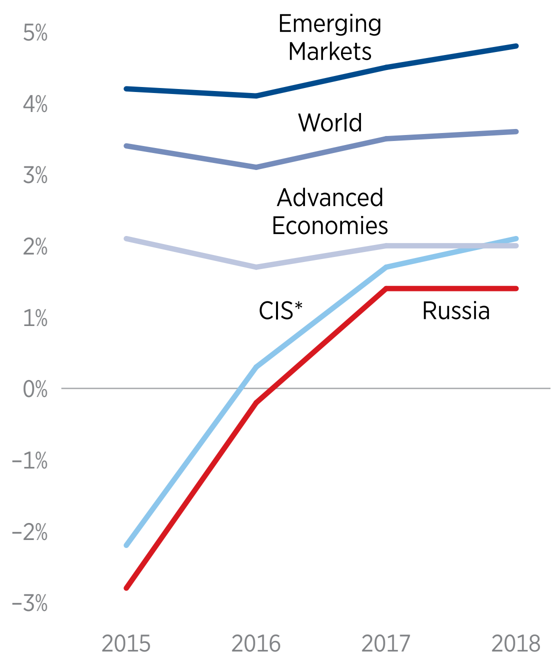
2. Ariel Cohen, Ivan Benovic, and James M. Roberts, "Russia's Avoidable Economic Decline," Heritage Foundation *Special Report* No. 154, September 17, 2014, http://www.heritage.org/europe/report/russias-avoidable-economic-decline (accessed August 2, 2017).

3. Anton Bayev, "God v Sirii: Vo Skolko Rossii Oboshlas Voyennaya Operatsiya" (A Year in Syria: How Much the Military Operation Has Cost Russia), RBK, September 30, 2016, http://www.rbc.ru/politics/30/09/2016/57ebb7199a7947db5bb2b309 (accessed August 2, 2017).

CHART 1

Russian Economy Faltering

REAL GDP CHANGE



* Commonwealth of Independent States

SOURCE: International Monetary Fund, "World Economic Outlook: April 2017," April 2017, pp. 198 and 202, http://www.imf.org/~/media/Files/Publications/WEO/2017/April/pdf/text.ashx?la=en (accessed October 7, 2017).

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2018,[4] Russia is projected to expand only 1.4 percent in both years and is thus bound to lag behind both advanced economies and emerging markets. After a decline of 2.8 percent in 2014 and another 0.2 percent in 2016, the country is gradually emerging from the 2015–2016 recession. However, without systemic structural economic and governance reforms, Russia is unlikely to improve tangibly in the long run and is unlikely to grow faster than the 1.5 percent to 2 percent per year needed to keep pace with global growth.[5] There are three principal financial reasons for Russia's underperformance for the past couple of years and for its bleak outlook—low oil prices, a domestic credit crunch, and a bad investment environment.

Problem One: Impact of Low Oil Prices on Russia and Its Government Finances

The end of 2014 saw a sharp fall in global oil prices. While, in the middle of 2014, one barrel of Brent crude was selling for around USD $110, at the beginning of 2015 that price had already dropped to between $50 and $60. With a still largely oil-dependent economy, the decreased inflow of foreign currency into the Russian economy led to a rapid decrease of the ruble's exchange rate, with speculators and a worried population adding extra volatility. After a bumpy 2015, the exchange rate stabilized in early 2016 at around 60 rubles to USD $1—from its previous long-term average of around 30 rubles to $1 since the 2008 financial crisis.

Contrary to expectations based on economic theory, the sharp Russian ruble depreciation in 2014 and 2015 did not lead to an increase in Russia's exports. The Russian non-commodity exports (such as equipment and machinery) are simply not competitive enough against foreign analogues, even at lower prices due to the currency depreciation.

As a result of the decreased inflow of foreign currency due to low energy prices and lower transfers from the proceeds of exporting oil and gas, the Russian government budget balance has also worsened in 2015 and 2016. Although in 2011, the Russian federal government budget recorded a surplus of 442 billion rubles (around USD $7.32 billion or around 0.7 percent of gross domestic product (GDP)), it has since fallen into deficit.

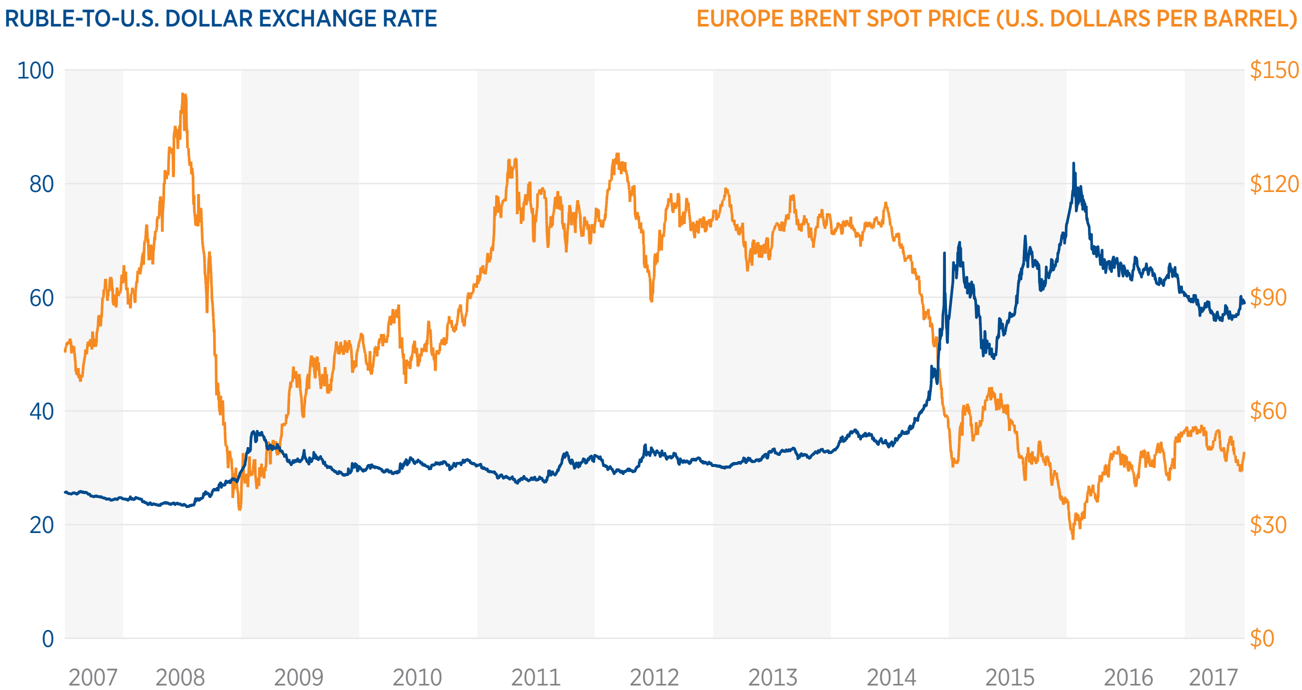
Persistently lower oil and gas prices combined with largely unchanged government expenditures have also led to the gradual depletion of the Reserve Fund of the Russian Federation. While in Septem-

4. According to the International Monetary Fund, the global economy is expected to grow 3.5 percent in 2017 and another 3.6 percent in 2018. The advanced economies are projected to grow 2 percent in both years, and the emerging-market economies should expand by 4.5 percent and 4.8 percent in 2017 and 2018, respectively. See "World Economic Outlook: April 2017," International Monetary Fund, April 2017, p. 2, http://www.imf.org/~/media/Files/Publications/WEO/2017/April/pdf/text.ashx (accessed August 2, 2017).

5. "Bank Rossii Prinyal Resheniye Snizit Klyuchevuyu Stavku Do 9,00% Godovykh" (The Bank of Russia Has Decided to Decrease the Key Interest Rate to 9.00 Percent Per Annum), Central Bank of Russia, June 16, 2017, http://cbr.ru/press/PR/?file=16062017_133001keyrate2017-06-16T13_21_27.htm (accessed August 2, 2017).

CHART 2

Low Oil Prices Hurt Russian Government Finances



SOURCES: Central Bank of Russia, "Dinamika ofitsialnogo kursa zadannoy valyuty" ("Dynamics of the Official Exchange Rate of the Selected Currency"), http://cbr.ru/currency_base/dynamics.aspx?VAL_NM_RQ=R01235&date_req1=01.01.2007&date_req2=07.10.2017&rt=1&mode=1 (accessed October 7, 2017), and U.S. Energy Information Administration, "Europe Brent Spot Price FOB (Dollars per Barrel)," https://www.eia.gov/dnav/pet/hist_xls/RBRTEd.xls (accessed October 7, 2017).

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ber 2014 the fund balance was $91.72 billion, by June 2017 it had fallen to as little as $16.5 billion[6] (barely enough to cover a fortnight of the country's average monthly imports of more than $22 billion[7]).

Over the past two decades, each "crisis" stemming from lower oil prices had been successfully weathered thanks to the Reserve Fund because oil prices jumped back up soon enough that the government could continue its spending policies without significant adjustments. Today, however, with increasing shale gas and oil production turning the United States from a net oil importer to net oil exporter (as well as the world's "swing producer" for marginal oil prices), the likelihood of oil prices rising back to around $100 per barrel seems low. Therefore, it is no longer a question of whether, but when, the Russian government will have to adjust its spending and make other necessary reforms.

Russia's negative macroeconomic climate has translated into hardships in the everyday lives of ordinary people, lowering their living standards and increasing poverty. The official poverty rate has

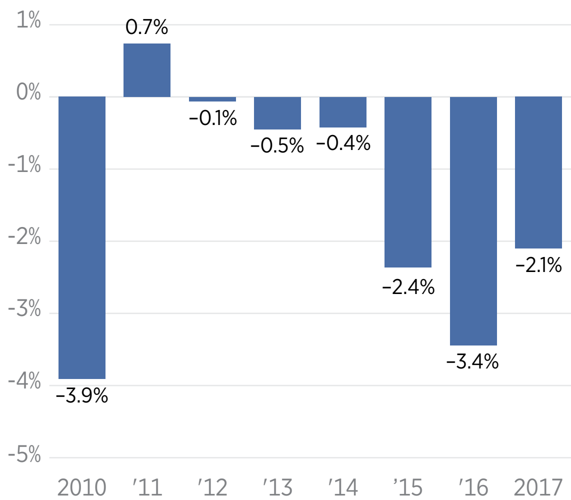
6. "Obyom Sredstv Rezervnogo Fonda" (Volume of Assets in the Reserve Fund), Ministry of Finance of the Russian Federation, https://www.minfin.ru/ru/perfomance/reservefund/statistics/volume/ (accessed August 2, 2017). The other government fund, the National Welfare Fund, has retained a broadly stable balance. However, this fund is intended to be a part of the Russian pension insurance system and should not normally be used as a cushion to weather temporary economic hardship.

7. "Platezhnyy Balans Rossiyskoy Federatsii Za 2016 God" (Balance of Payments of the Russian Federation in 2016), Central Bank of Russia, July 4, 2017, http://cbr.ru/statistics/credit_statistics/bop/bop_np-mc_2016.xlsx (accessed August 22, 2017).

CHART 3

Russia Facing Annual Deficits

AS PERCENTAGE OF GDP



SOURCES: Russian Federal State Statistics Service, Russian Budget System Portal, http://budget.gov.ru (accessed October 6, 2017), and authors' calculations.

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CHART 4

Russian Reserve Fund Quickly Depleting

IN BILLIONS OF U.S. DOLLARS

SOURCE: Ministry of Finance of the Russian Federation, "Obyom sredstv Rezervnogo fonda" ("Volume of the Reserve Fund"), https://www.minfin.ru/ru/perfomance/reservefund/statistics/volume/ (accessed October 7, 2017).

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increased slightly, from 13.1 percent in 2015 to a projected 13.7 percent at the end of 2017 and 13.9 percent at the end of 2018.[8] However, as Russian Deputy Prime Minister Olga Golodets admitted, Russia now has extensive "working poor" poverty—in which even having a job is not enough to ensure a decent living standard.[9]

The subjective feeling of poverty among the people is tangibly higher than indicated by the official government statistics, which are based on an artificially low poverty threshold that is not indexed to inflation.[10] According to opinion polls, the income-per-member-of-household that is informally accepted as the poverty threshold is 15,500 rubles per month (or about USD $250). That means that about 43 million Russians (or roughly 30 percent of the population) with monthly incomes below this level are informally considered to be poor. As recently as 2015 this subjective poverty threshold stood at 11,500 rubles per month (around USD $190), so the speed of public perceptions of the ruble's lost purchasing power has clearly outpaced the official figures.

Problem Two: Credit Crunch and Lack of Domestic Investment

Russia's investment climate never stabilized after the break-up of the Soviet Union. Nevertheless, an expectation developed that the Russian Federation was slowly but steadily evolving—moving towards greater openness to outsiders and more internal political and economic stability. That illu-

8. "Chislo Bednykh v Rossii Vyroslo Do 23 Millionov Chelovek" (The Number of the Poor Has Risen to 23 Million), June 17, 2016, https://lenta.ru/news/2016/06/17/poverty/ (accessed August 2, 2017).
9. "Golodets Nazvala Bednost Rossiyan Unikalnoy" (Golodets Has Called the Poverty of the Russians Unique), March 14, 2017, https://lenta.ru/news/2017/03/14/ruspoor/ (accessed August 2, 2017).
10. Anastasiya Bashkatova, "Realnaya Bednost v Rossii v Dva Raza Vyshe Ofitsialnoy" (Real Poverty in Russia Is Twice as High as the Official One), *Novaya Gazeta*, April 12, 2017, http://www.ng.ru/economics/2017-04-12/4_6973_real.html (accessed August 2, 2017).

sion was shattered, however, after the Ukrainian crisis began in late 2013. In the wake of the events in Ukraine, the continued arbitrary actions of President Valdimir Putin's government toward private business, along with cronyism, forced takeovers of successful businesses, and similar actions have since become endemic and given rise to the sharpest increase in capital outflow in Russia's post-Soviet history.

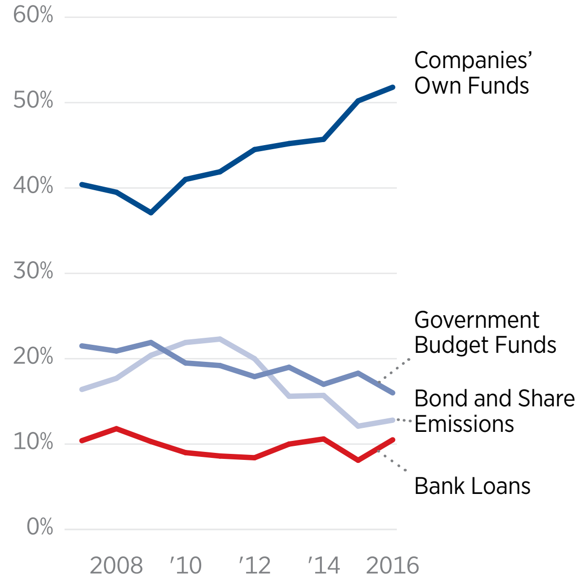
Investment growth has *de facto* stalled and led to what the government calls an "investment break" that the Russian government says should last until 2019.[11] In constant prices, fixed capital investment in Russia was broadly stable from 2012–2014, but then it fell sharply in 2015 (10.1 percent Year-over-Year [Y-o-Y]) and further in 2016 (0.9 percent Y-o-Y).[12] In 2016, total fixed capital investment amounted to 14.6 trillion rubles (17 percent of GDP, or around USD $241 billion according to the RUB/USD exchange rate as of December 31, 2016).[13]

There has been a structural shift in the composition of the investments, too, from economically productive non-residential construction and equipment to mainly residential construction and other lower value-added sectors.[14] Still, Russia's investment is largely import-dependent, so the weakened exchange rate of the Russian ruble has been another drag on investment, especially on equipment investments. Other obstacles include the usual suspects: a bad investment climate; an unwillingness of Russian banks (with a combined nonperforming loan [NPL][15] ratio of 9.4 percent[16]—versus the IMF-calculated world average of 3.925 percent in 2015[17]) to expand their real sector investment portfolios; the cautious approach of foreign markets towards Russia; and poor domestic project management.

CHART 5

Sources of Fixed Capital Investment

PERCENTAGE OF ALL FIXED CAPITAL INVESTMENT IN RUSSIA



SOURCE: Russian Federal State Statistics Service, "Investitsii v osnovnoy kapital v Rossiyskoy Federatsii po istochnikam finansirovaniya" ("Fixed Capital Investment in the Russian Federation by Source of Financing"), http://www.gks.ru/free_doc/new_site/business/invest/Inv-if.xls (accessed October 7, 2017).

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The lack of available external financing from both Russian and foreign financial institutions has

11. "SMI: Minekonomrazvitiya Sokhranilo Prognoz Po Rostu VVP na 2017 god" (The Ministry of Economic Development Maintains the Forecast of the GDP Growth for 2017, Media Say), *RIA Novosti*, October 19, 2016, https://ria.ru/economy/20161019/1479521588.html (accessed August 2, 2017).
12. "Dinamika Investitsiy v Osnovnoy Kapital v Rossiyskoy Federatsii" (Investment Dynamics in Fixed Capital in the Russian Federation), Russian Federal State Statistics Service, March 21, 2017, http://www.gks.ru/free_doc/new_site/business/invest/Din-inv.xls (accessed August 2, 2017).
13. "Investitsii v Osnovnoy Kapital v Rossiyskoy Federatsii" (Investment in Fixed Capital in the Russian Federation), Russian Federal State Statistics Service, March 21, 2017, http://www.gks.ru/free_doc/new_site/business/invest/Inv.xls (accessed August 2, 2017).
14. Olga Berezinskaya, "Investitsionnaya Pauza v Ekonomike Rossii: Strukturnyye Kharakteristiki i Perspektivy Eyo Preodoleniya" (Investment Break in the Russian Economy: Structural Characteristics and Turnaround Perspectives), *Ekonomicheskaya Politika*, 2016, https://cyberleninka.ru/article/n/investitsionnaya-pauza-v-ekonomike-rossii-strukturnye-harakteristiki-i-perspektivy-ee-preodoleniya (accessed August 2, 2017).
15. "Nonperforming Loan–NPL," Investopedia, http://www.investopedia.com/terms/n/nonperformingloan.asp (accessed August 22, 2017).
16. "Bank Nonperforming Loans to Total Gross Loans (%)," World Bank, http://api.worldbank.org/v2/en/indicator/FB.AST.NPER.ZS?downloadformat=excel (accessed August 22, 2017).
17. Ibid.

led to an extraordinarily high share of companies being forced to self-finance their investment projects. Business owners cite high interest rates and the poor availability of credit as the main barriers to investment.[18] Moreover, Russia's private businesses now seem to be operating mostly in an ultra-cautious survival mode, while Russia's state-owned enterprises (SOEs) feel more freedom to act thanks to a greater availability of credit from state-owned banks—lent without regard to the lower efficiency of Russia's SOEs.[19]

In 2009, companies self-financed 37.1 percent of investment projects in Russia. By 2016, that number had risen to 51.8 percent, in part due to shrinking government financing of investment projects and also because of lower levels of new bond and equity issuances.[20] The overall share of investment projects financed by banks (both Russian and foreign) has been relatively stable, but low, for the past 10 years—at a level of only about 10 percent.

Problem Three: Bad Investment Environment and Lack of Foreign Investment

In the years prior to 2014, a large amount of foreign direct investment (FDI) into Russia came from countries such as the U.K., Ireland, the Netherlands, Luxembourg, and France. Since 2013, however, FDI has increasingly originated in tax havens such as the Bahamas, Bermuda, and the British Virgin Islands.[21] This shift in the composition of the countries that provide FDI to Russia suggests that the true level of foreign investment in Russia may be even lower than the officially reported statistics. That is because these officially recorded FDIs were, in fact, most likely investments by well-off Russian entrepreneurs hiding their profits from Russia's tax authorities and subsequently reinvesting them domestically via global tax havens.

The reason for the sudden drop in true FDI was likely the rapid rise in Russia's risk profile. Foreign direct investors, especially those investing in core capital and acquiring a long-term stake in a company, require long-term stability of the country in order to be able to predict the return on their investment. Russia did not have that stability after 2013.

Extensive Corruption

Corruption in Russia continues to be deeply entrenched in both political and everyday life. In the ranking compiled every year by Transparency International, Russia scores persistently in the range between 27 and 29 (ranking from 119th to 136th worldwide),[22] suggesting that little is being done to curb this scourge. As a result, the population is increasingly resentful of the political and business elite's luxurious lifestyles.

For instance, Russia's most prominent anti-corruption activist, Alexey Navalny, issued a report in March 2017 that unveiled an intricate network of fake NGOs established for the sole purpose of managing ownership of posh real estate properties on behalf of their true owner—Russia's Prime Minister Dmitry Medvedev.[23] Those revelations kindled only modest media interest. Nevertheless, there were protests—widespread by Russian standards. Tens of thousands

18. "Doklad o Sostoyanii Konkurentsii v Rossiyskoy Federatsii Za 2016 God" (Report on the State of Competitiveness in the Russian Federation), Federal Antimonopoly Service of the Russian Federation, p. 53, http://fas.gov.ru/upload/aboutfas/Доклад%20о%20состоянии%20конкуренции.doc (accessed August 2, 2017).

19. Ekaterina Mereminskaya, "Gosudarstvo i Goskompanii Kontroliruyut 70% Rossiyskoy Ekonomiki" (State-Owned Companies Control 70 Percent of the Russian Economy), *Vedomosti*, September 29, 2016, https://www.vedomosti.ru/economics/articles/2016/09/29/658959-goskompanii-kontroliruyut-ekonomiki (accessed August 2, 2017).

20. "Investitsii v Osnovnoy Kapital v Rossiyskoy Federatsii Po Istochnikam Finansirovaniya" (Investments in Fixed Capital in the Russian Federation by Source of Financing), Russian Federal State Statistics Service, August 1, 2017, http://www.gks.ru/free_doc/new_site/business/invest/Inv-if.xls (accessed August 2, 2017).

21. "Pryamyye Investitsii v Rossiyskuyu Federatsiyu Po Stranam-Partnyoram v 2007–2016 (Uchastie v Kapitale, Reinvestirovanie Dokhodov i Dolgovyye Instrumenty)" (Direct Investments in the Russian Federation by Partner Countries in 2007–2016 [Equity Participation, Reinvestment of Earnings, and Debt Instruments]), Central Bank of Russia, May 22, 2017, http://cbr.ru/statistics/credit_statistics/inv_in-country.xlsx (accessed August 2, 2017).

22. "Corruption Perception Index: Overview," Transparency International, https://www.transparency.org/research/cpi/overview (accessed August 2, 2017).

23. "On Vam Ne Dimon" (Don't Call Him Dimon), Anti-Corruption Foundation, March 2, 2017, https://www.youtube.com/watch?v=qrwlk7_GF9g (accessed August 22, 2017).

of people took to the streets demanding that authorities explain the source of Medvedev's vast holdings.[24]

In a 2016 crony capitalism index compiled by *The Economist*, Russia was ranked worst in the world. The index noted that the country's economy is more controlled by kinship and personal ties than any other country and that the share of billionaire wealth coming from crony sectors[25] in Russia was around 18 percent—the highest in the world.[26]

Other Structural Issues Leading to Long-Term Economic Underperformance

The Russian economy continues to suffer from a range of the same issues that have been left unresolved for a very long time. First, there is a dire lack of economic dynamism and competition. In 2016, the share of Russia's GDP produced by SMEs was only 19.9 percent,[27] compared with about 50 percent in developed countries. The number of sole entrepreneurs fell abruptly (by around 13 percent) in 2013 and has not recovered.[28] In addition, only around 25 percent of employed Russians work for an SME, versus 60 percent to 70 percent in most Organisation for Economic Co-operation and Development (OECD) countries.[29]

Second, the role of the state in the economy is growing. According to the Federal Antimonopoly Service of Russia, while the share of the government and SOEs in Russia's GDP in 1998 was around 25 percent, by 2008 it had already reached 40 percent to 45 percent. In 2016, it was nearing 70 percent—an astounding and disheartening deterioration.[30] While the pace of privatization in Russia has slowed to one-third of what it was in 2010, the speed of the Russian state's penetration into the competitive spheres of the Russian economy has sped up.

Moreover, Russian officials in government agencies and SOEs tend to aggravate the damage from this trend by participating in and actively promoting anti-competitive cartel agreements, often in exchange for bribes or embezzlement opportunities.[31] Vladimir Milov, a friend and ally of opposition political leader Boris Nemtsov (who was murdered in downtown Moscow in February 2015) has asserted that the Russian "state capitalism" model steadily tightening its grip on the country has resulted in wasted human and financial capital, a strangulation of competition, lower labor productivity, and a "necrosis of capital."[32]

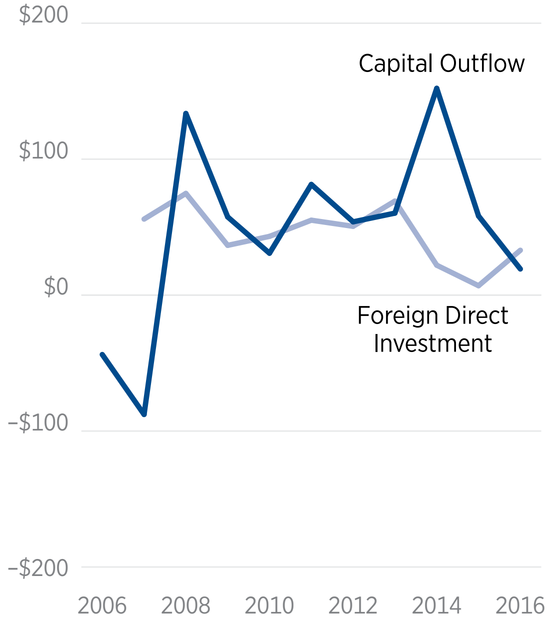
Third, Russia's labor productivity remains low as a result of the outdated technologies and technological processes used in domestic production.[33] According to the OECD, Russia's PPP-adjusted[34] GDP per hour worked was only 37.35 percent of that of the United States in 2015.[35] Russia's 2015 PPP-

24. "Massovyye Protesty Protiv Korruptsii: Chto Budet Dalshe?" (Mass Protests Against Corruption: What Will Happen Next?), *BBC Russian Service*, March 27, 2017, http://www.bbc.com/russian/features-39405229 (accessed August 2, 2017).
25. Industries especially vulnerable to cronyist rent-seeking by corrupt, bribe-seeking government officials include telecommincations, natural resources, real estate, construction, and defense.
26. "The Party Winds Down," *The Economist*, May 7, 2016, http://www.economist.com/news/international/21698239-across-world-politically-connected-tycoons-are-feeling-squeeze-party-winds (accessed August 2, 2017).
27. Olga Kuvshinova, "Malyy i Sredniy Biznes Sokratili Ekonomike Spad" (Small and Medium Enterprises Have Lowered the Economic Downturn), *Vedomosti*, March 30, 2017, https://www.vedomosti.ru/economics/articles/2017/03/30/683339-malii-srednii-biznes (accessed August 2, 2017).
28. Sergey Borisov, "Maloye i Sredneye Predprinimatelstvo v Rossiyskoy Federatsii: Tekushcheye Sostoyaniye i Perspektivy" (Small and Medium Entrepreneurship in the Russian Federation: Current Situation and Prospects), Higher School of Economics, 2016, http://tinyurl.com/y8sm8suj (accessed August 22, 2017).
29. "Small and Medium-Sized Enterprises: Local Strength, Global Reach," OECD, June 2000, http://www.oecd.org/cfe/leed/1918307.pdf (accessed August 29, 2017).
30. "Report on the State of Competitiveness in the Russian Federation," p. 9.
31. Ibid., p. 15.
32. Vladimir Milov, "Slony Goskapitalizma" (The Elephants of State Capitalism), *Profil*, May 30, 2017, http://www.profile.ru/economics/item/117563-slony-goskapitalizma (accessed August 2, 2017).
33. Yelena Platonova and Olga Khokhryakova, "V Rossii Ne Umeyut Rabotat" (In Russia People Do Not Know How to Work), *Gazeta.ru*, August 10, 2015, https://www.gazeta.ru/business/2015/08/10/7679837.shtml (accessed August 2, 2017).
34. Adjusted for Purchasing Power Parity (PPP). For more information on PPP, see https://stats.oecd.org/glossary/detail.asp?ID=2205 (accessed October 17, 2017).
35. "GDP Per Hour Worked," Organization for Economic Co-operation and Development, https://data.oecd.org/lprdty/gdp-per-hour-worked.htm (accessed August 2, 2017).

CHART 6

Foreign Direct Investment and Capital Outflow in Russia

IN BILLIONS OF U.S. DOLLARS



SOURCES: Central Bank of Russia, "Pryamyye investitsii v Rossiyskuyu Federatsiyu po stranam-partnyoram v 2007-2016 godakh i 1 kvartale 2017 goda (uchastie v kapitale, reinvestirovaniye dokhodov i dolgovyye instrumenty)" ("Direct Investment in the Russian Federation by Partner Countries in 2007–2016 and the First Quarter of 2017 (Equity Participation, Reinvestment of Revenues and Debt Instruments)"), http://cbr.ru/statistics/credit_statistics/ inv_in-country.xlsx (accessed October 7, 2017), and Central Bank of Russia, "Chistyy vvoz/vyvoz kapitala chastnym sektorom v 1994–2016 godakh i yanvare-iyune 2017 goda" ("Net Inflow/Outflow of Capital by the Private Sector in 1994–2016 and January–June 2017"), http://cbr.ru/statistics/credit_statistics/bop/ outflow.xlsx (accessed October 7, 2017).

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adjusted GDP, however, was 45.70 percent of that of the U.S.,[36] a discrepancy that indicates the average Russian in the formal sector works more hours than his U.S. counterpart. OECD data records the average Russian worked 1,974 hours in 2016, compared to 1,783 in the United States and 1,363 in Germany that same year.[37] The chief explanation for why Russian employees must—and do—work more than their occupational counterparts in the West is the lack of modern capital equipment.

Improving labor productivity would require a tangible upswing in investment. The volatile track record of the Russian economy and persistently elevated geopolitical risks, however, make increased investment unlikely. Foreign investors are not willing to take the risk, and risk-averse Russian banks are not, either.

The Government's Myopic Response: Back to the Soviet Future

Faced with this new reality, the Putin government has tried to turn Western sanctions to its political advantage. The government has revived the old, discredited, and Marxist-influenced "import substitution" model—which fell out of favor even among global leftists in the 1970s—with the aim of replacing the higher valued-added agricultural and manufactured goods that had been imported during the commodity boom with their domestically produced equivalents. In the Soviet era, Western economists typically referred to them as "inferior goods," because they were almost always inferior to best-in-class global standards.

As part of the policy, the government has decreed counter-sanctions prohibiting the importation of a wide range of agricultural products, such as beef, fish, salami, milk and other dairy products, fruits, vegetables, and nuts from the U.S., the EU, and other countries that have imposed sanctions on Russia.[38] Not surprisingly, this policy has produced mixed results.

36. "GDP Per Capita, PPP (Constant 2011 International $)," World Bank, http://api.worldbank.org/v2/en/indicator/NY.GDP.PCAP.PP.KD?downloadformat=excel (accessed August 2, 2017).

37. "Average Annual Hours Actually Worked Per Worker," Organization for Economic Co-operation and Development, https://stats.oecd.org/Index.aspx?DataSetCode=ANHRS (accessed August 2, 2017).

38. "O Merakh Po Realizatsii Ukaza Prezidenta Rossiyskoy Federatsii Ot 6 Avgusta 2014 g. # 560: 'O Primenenii Otdelnykh Specialnykh Ekonomicheskikh Mer v Tselyakh Obespecheniya Bezopasnosti Rossiyskoy Federatsii'" (On the Measures to Implement the Decree of the President of the Russian Federation of August 6, 2014 No. 560: "On the Introduction of Separate Special Economic Measures Aimed at Ensuring the Security of the Russian Federation"), Official Website of the Russian Government, http://government.ru/media/files/41d4f8cdfeeb731522d2.pdf (accessed August 2, 2017).

While the Russian president has praised the results of the import-substitution policy in the military area,[39] in other sectors the results have been modest.[40] Some sectors, mainly in agriculture, have recorded some positive results from the new policy. According to the Federal Antimonopoly Service of Russia, however, inadequately considered import-substitution policies may limit competition and impede the functioning of Russia's goods markets.[41]

Russia's Grim Prospects

While the economic tumult of 2014 and 2015 seems to be slowly calming down, the fact remains that Russia has not made sustainable progress in its economic development since 2013. To the contrary: The sudden drop in oil prices that coincided with Russia's military adventurism in Crimea and eastern Ukraine has succeeded only in pulling back the curtain at home—revealing an ossified government bureaucracy, an unfavorable business environment, unresolved economic rigidities, and other economic vulnerabilities hidden in plain sight.

On the other hand, those same sharply lower oil prices—coupled with Western economic and political sanctions in response to Russia's geopolitical bullying—have hit Russia hard, with the long-term effects to be seen in the near-term future. With modest levels of investment in productive areas, the country is now like a car rolling forward in neutral gear, lurching ahead thanks to momentum from the past. Without a recovery and growth in productive investment, be it domestic or foreign, the country may soon see a more rapid deterioration of its existing economic and human capital, putting a further drag on its economic prospects.

How the West Can Help Russia

Given Russia's position in the global economy and political order, as well as the differing national interests of the U.S., EU, and Russia, Western governments have little room for maneuver to influence directly the behavior of the Russian government. Therefore, they should try to encourage change in Russia indirectly, leading by example and helping to counter Russia's destabilizing behavior in Eurasia, Eastern Europe, and beyond.

The U.S. and EU should pursue domestic policies that enhance long-term economic resilience and political strength—and urge other countries around the world to do the same. That will make it more difficult for Russia to weaken Western democratic institutions. It will also demonstrate to the Russian people—especially the well-educated and well-traveled elites—that Russia's future is bleak unless it is reformed. The elites must also be encouraged to practice and preach patience within Russia, since the beneficial effects of reforms will be slow to appear.

More specifically, Western governments should:

- **Demonstrate and maintain NATO unity.** To counter Russia's actions aimed at undermining Western unity and popular support for NATO, there should be a continuing emphasis placed on strengthening NATO unity. This should focus not only on conventional military preparedness but also in combating new "alternative" threats—especially cybercrime and subversive propaganda outlets in Europe and the U.S. aimed at aggravating U.S.–EU and intra-EU political differences.

- **Continue to isolate the Russian government internationally.** By isolating Putin's regime politically and financially, it will have fewer resources with which to buy off the population through paltry welfare schemes. At the same time, however, Western governments should refrain from steps that could be perceived by ordinary Russians as trying to undermine the Putin government. Change in Russia must come from within, not from outside. Direct attempts at democracy promotion in Russia, especially cooperating with the domestically discredited liberal opposition to Putin, are likely to generate backlash and provide Putin with yet another alleged proof of unfriendly Western activities in the country.

39. "Putin Otmetil Khoroshiye Rezultaty Importozameshcheniya v Voyennoy Sfere" (Putin Has Noted Good Results of Import Substitution in the Military Area), *RIA Novosti*, May 17, 2017, https://ria.ru/defense_safety/20170517/1494503767.html (accessed August 2, 2017).

40. "Vsemirnyy Bank Ne Zametil Rezultatov Importozameshcheniya v Rossii" (The World Bank Has Not Noticed Results of Import Substitution in Russia), *Interfax*, November 9, 2016, https://www.vedomosti.ru/economics/news/2016/11/09/664189-vsemirnii-importozamescheniya (accessed August 2, 2017).

41. "Report on the State of Competitiveness in the Russian Federation," p. 50.

- **Help counter Russia's covert financial influence on the media in the U.S. and the EU.** As part of strengthening trans-Atlantic cooperation, the U.S. should help European countries identify and draw public attention to Russia's financing of fringe politicians, political parties, and media outlets in the West. Propaganda originated in Russia or supported by the Russian government (whether directly or indirectly) may in the long run lead to a gradual erosion of support for the democratic institutions that underpin the West's political and economic stability. Such erosion is already apparent, for example, in the increasingly polarized political landscape of Hungary. To combat this threat, it is vital for American and European voters (and their governments' leadership) to distinguish between truthful arguments and outright propaganda in the many forms of media today.

Conclusion

Nearly three decades after the collapse of communism, Russia increasingly abuses individuals' economic and property rights, thereby reducing the attractiveness of the country at home and its global competitiveness abroad. With time, these developments may have serious and long-lasting economic, political, and social consequences, including civil unrest and unpredictable political upheaval. Absent reforms to spur stronger and more widespread economic growth, Russians are likely to continue losing hope and faith in the future of their country.

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