Conference report

Dialogue with Russia: A new prosperity – aspiration, innovation, participation

Sunday 20 – Wednesday 23 March 2011 | WP1086

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Introduction

1. The conference engaged government, business and other actors to develop the British-Russian Knowledge Partnership launched by Foreign Secretary William Hague and President Dmitrii Medvedev in Moscow in October 2010 with the aim of promoting co-operation on education, technology and science and harnessing innovation; and of sharing best practice in combating climate change and ensuring sustainable energy supplies.

2. David Willetts, Minister of State for Universities and Science at the UK Department for Business, Innovation and Skills (BIS), stressed that Russia and Britain share strong traditions in science and education. He highlighted space, chemistry, energy efficiency, climate change and nuclear physics as fields in which there is good potential for further cooperation. UK firms are already investing in Russia, and not just in the energy sector, but in the knowledge economy also; he cited an example of two Russian Nobel Prize winners working at Manchester University, while stressing the historical tradition of academic independence in Britain.

3. Vladimir Mau, Director of The Russian Presidential Academy of National Economy and Public Administration, and one of the leading economic architects behind the modernisation agenda laid out by President Medvedev in 2010, set the framework for discussion highlighting the following priorities: Modernisation of political institutions; the budget system and financial systems; economic diversification and development of human capital; a new privatisation programme, incentives to competition and de-monopolisation.

"Diversification and productivity are the main challenges"

Russia's modernisation agenda

4. The Russian leadership's current drive to modernise the economy stems from the global economic crisis of 2008. Recession hit Russia hard. Falling oil prices illustrated the degree to which heavy dependence on energy exports made the country particularly vulnerable to price swings. Russian leaders' confidence that the recession would prove a "Western" phenomenon, with their country as an "island of stability" underpinned by steady economic growth, was soon proved wrong.

5. The crisis showed up inefficiencies in the model of state capitalism adopted by Russia over the past 20 years and revealed the degree to which the process of dismantling the Soviet legacy remains incomplete, even though it is clear that Russia's traditional industrial policy – top-down government prioritisation by sector via the state budget – is totally obsolete.

6. Economic diversification and labour productivity are the main economic challenges, just as privatisation was 20 years ago. Russian manufacturing cannot compete with cheap, imported products, in its own boosted consumer market, and fluctuations in energy and natural resource prices have shown that diversification is essential: The energy sector accounts for 68% of exports; metals 11%; chemicals, 6%; machinery; 5% and all other

activity for only 10%.

7. Russia's energy wealth provides it with an enviable source of income but the revenues from raw materials need to be deployed more efficiently and strategically to ensure long term benefit. There is a risk of relying on energy alone which will not be enough to close the gap with the developed economies.

8. Key reforms are underway, such as moves to stamp out corruption and a drive to promote research and development by establishing a scientific and technological innovation centre at Skolkovo near Moscow, known as Russia's Silicon Valley. But serious doubts remain, over whether an overall strategy exists to effect the modernisation of Russia in the wider sense, with the concept not seen to extend far beyond the economic sphere.

9. Further, deeper structural reforms are needed, including in the fields of property rights, institutional development, personal and commercial security, support for small and medium-sized businesses (SMEs), tax and budget policies, banking and monetary systems, and to further the rule of law. The welfare system also needs a radical overhaul, with regard to health and pensions in particular.

10. Russia may be drawing on the wrong models. For reasons of national historical pride, the Russian *elite* prefer to compare themselves to North America or to the European Union, which they consider their international equals, rather than looking to the experience of other emerging economies in the BRIC grouping (Brazil, India and China) or Turkey, that could prove more relevant.

11. The progress of Russia's economic development has been consistent. China has succeeded in narrowing the gap with Western Europe but Russia has maintained a lag of some 50 years behind the level of the French economy, to take one example. This gap has remained constant, regardless of the system of government in place, and dates as far back as the time of Peter the Great.

Challenges faced

12. Shortly after he was elected president in 2000, Mr Putin said that it would take the country 15 years to reach the per capita GDP level of Portugal or Spain at that time. Russia's per capita GDP of $1,800 was then about one-sixth that of Portugal and one-eighth that of Spain. In 2009, Russia's per capita GDP, measured, as before, at the dollar exchange rate, was $8,683, two-fifths that of Portugal. Part of this increase in dollar GDP can be attributed to exchange rate appreciation but it reflects genuine economic progress also. In "real" purchasing power parity terms, Russia's GDP in 2009 was about two-thirds that of the Portuguese level. Russia's growth prospects have been dented by the economic crisis however. A realistic aspiration may be not so much to close the gap with others, as to ensure it doesn't widen any further.

13. Russia is one of very few countries in the world for which the UN Human Development Indicator has fallen over a number of years consecutively. By comparison with Western countries, the middle class remains small (estimated at some 20% of the population) and has grown very slowly, if at all, over the past decade.

14. Russia's demographic structure poses a particular threat to modernisation plans, compounded by the exodus of the *elite* super rich, taking their money with them, and a brain-drain of qualified professionals. The population has fallen by two million in the past decade, and the country faces a decline in the overall number of males of working age that can be countered only by strong growth in in-migration which brings its own social tensions.

15. This demographic trend is particularly unfavourable to knowledge-based development as it will lead to a decline in the number of young people over the next 20 years. Russia also has a relatively high percentage of population older than 65 (the proportion would be even larger if life expectancy among Russian males were higher).

Accordingly, pensions will place a mounting burden on the budget. To meet Russia's modernisation agenda, moreover, immigration needs to be of skilled, rather than unskilled, labour.

16. Mutual mistrust between Russian business and the state is high, as shown by the continued high outflow of capital. Equally, the state mistrusts the population. There is an urgent need for more fluid dialogue between the state, the regions and society. With economic and political systems heavily centralised, few of the regions are in a position to develop their own initiatives. While there are some notable exceptions -- Kaluga, Tomsk, Perm and Sverdlovsk -- most regions continue to depend on the centre to drive reform.
17. Investment in human capital -- education and training -- has been a key factor allowing emerging economies to catching up with developed countries but it was stressed that, rather than register improvement, the standard of Russia's education system has actually deteriorated.
18. Corruption is another major concern -- an issue that was emphasised throughout the conference.

"The external view of Russia is often far more positive than the internal"

Russia in the global economy

19. The external view of Russia is often far more positive than the internal, certainly as far as economic and business potential is concerned. In areas such as private equity, Russia could prove to be the Ugly Duckling, and emerge in a few years as a beautiful swan. As a private equity market, Russia is one of the best performing - but worst perceived.
20. Growth rates of 4-5 %, forecast for 2011-12, provide grounds for optimism. Russians are living better than ever, even if serious levels of poverty persist and wide disparities in wealth could give rise to discontent. (The sheer scale of change in the global economy is way beyond that of the industrial revolution, in terms of the numbers of millions affected. The UK's share of world GDP is declining rapidly, but Russia's is growing, from 0.5% of world GDP in 1992, when it was in 35th place, to a probable 4% in 2015, in 6th place, according to IMF figures.)
21. Russia may lag behind the other BRIC economies, which enjoy the significant demographic advantage of younger populations, but it is not as weak as it is often portrayed. Foreign direct investment per capita in Russia is higher than in the other BRICs; Russia is the treasure house of the world in terms of raw materials and water resources; and, once it joins the World Trade Organisation (WTO), its relative weakness in trading across borders should be eliminated.
22. While Russia scores highest among the BRICs in corruption ratings, it outstrips India as far as labour productivity is concerned. Its share of world GDP is rising strongly. And, with 100 million consumers, Russia represents a major investment opportunity. "Never before have Russians lived as well as they do today," said one speaker. "Nowadays, there are traffic jams even in small towns!"
23. Analysts and business people consider Russia a relatively stable environment with considerable growth potential and inward foreign direct investment (FDI) has shown a steady rise, especially over the past five years. Many Russian firms see developing partnerships with foreign companies as the most effective way to compete in world, and sometimes even their own, markets. But government bureaucracy, which tends to the secretive and heavy-handed, can present considerable obstacles.
24. Ease of doing business in Russia is rated low in global surveys. Often the only fixes that work are an appeal to the top leaders, which is not a systemic, but merely an ad hoc solution. Individual firms may succeed in solving their particular difficulties this way but the overall problem remains. Some experts say that it could take more than a generation to raise Russia's economic and societal development to that of most

Western countries.

"Russia has rule by law, but not rule of law"

The rule of law

25. Strengthening the rule of law, and law-based transactions, is a vital component of Russia's economic modernisation. Russia's relatively poor ratings as a place to do business are due, in large part, to a perceived lack of respect for the rule of law. A number of surveys indicate that Russians consider the concept alien to their culture. According to one speaker, "Russia has rule by law, but not rule of law". Existing laws are used as levers of power. The judiciary is always subtly aware of the wishes of the executive. This creates a semblance of legality but leads, in effect, to selective application of the law. Prospects for sustainable development are seriously impaired when a potentially strong economy operates in the absence of the rule of law. (Argentina is another good example of this.)

26. The results of arbitration cases over business disputes show that the litigant wins in a majority of cases – especially, but not always when the state is the litigant. Where disputes involving foreign companies are concerned, in 2010 these won 59% of cases, whereas CIS companies won in 63% of cases they contested. In 1997 the equivalent figures were 52% and 61% respectively. Despite these relatively encouraging outcomes, foreign companies still mistrust Russian courts.

27. Criminal courts present a much worse picture: There the bias is towards the accuser, and the prosecutors have considerable influence over judges, since they can appeal against an acquittal to a higher court. In 2010, only 1.02% of criminal cases resulted in acquittal. A further factor is that many judges were previously in the procuracy or police, unlike the UK, where they are drawn from senior barristers.

28. Areas in need of attention are anti-corruption legislation; increased transparency of judgements; the use of precedent in cases; and equal rather than selective enforcement. The absence of these is evident from the practice in Russia whereby companies try to intercede to avoid having to pay bribes using their "departments for government relations" Neither the public nor business sectors consider that the law treats everyone equally.

29. International surveys show that, compared with other emerging economies, Russia is rated low for ease of doing business, and high for corruption, and does poorly by comparison with countries such as Turkey. The most blatant forms of corrupt behaviour such as extortion ("dinosaur practices") are not particularly widespread today, but lesser zoological evils remain prevalent – such as "rat practices" (siphoning money out of your own business), and "penguin practices" (long-term business relationships based on friendships).

30. The writer Viktor Pelevin, an acerbic chronicler of the vicissitudes of life in post-Soviet Russia, remarked in 2008 that, for Russia, true modernisation would come "when the trains ran on time; bureaucrats stopped taking kickbacks; Russian money no longer ended up in London; judges acted independently, and big-time gangsters ended up in prison". One might add to this wish list that Russian business disputes be settled in Russian and not English courts.

Partnerships for modernisation

Parallel Session: Innovation, Science and Technology

31. UK experience shows that working with Russian partners is different – but no more difficult -- than with other countries such as the USA or India. Russian partners are characterised by dedicated teams, while strong personal trust built up over years enables practical problem-solving. At the same time, senior managers still display "Soviet-style" attitudes that ignore customer's commercial realities and pressures while observing unpredictable timescales. Russia is hampered, moreover, by its aging

workforce.

32. As regards government-to-government cooperation, restrictions remain that hamper the development of better trading relations. The UK and Russia did not replace until 2010 the Memorandum of Understanding (MoU) on trade with the Soviet Union – and the new MoU was described as very weak. This has had a negative impact on UK firms. For example, UK exporters and Russian importers cannot predict with any certainty how much import duty will be levied by the Russian authorities. As a result, UK bids are often uncompetitive by comparison with their European and other international competitors. It is also impossible to predict possible transit delays as goods travel through Russia to their ultimate destination; this leads to uncertainty and fuels corruption.

33. One clear and low-cost recommendation for the UK and Russian Governments is therefore to negotiate a new MoU that would include taxation agreements: this could have an immediate and significant impact on UK-Russia trade.

Parallel session: Energy – markets, sustainability and climate change

34. Despite Russia's vast energy resources, developments elsewhere in the world raise questions about future markets for them. The recent agreement between BP and Rosneft shows confidence in the future of oil extracted from remoter reserves, and in Russia as a supplier, particularly given recent upheavals in the Middle East. Several other international oil companies operate in Russia. They have become accustomed to the Russian business environment.

35. At the same time, unconventional gas is a major development, with not only North America but Northern Iraq, Turkmenistan, Azerbaijan and Europe looking to the extraction of shale gas in particular, and licences already obtained. Transport is also diversifying. In addition to liquefied petroleum gas (LPG), it is also turning to compressed gas. In 2008-9, Russia's share of gas exports fell, because international prices dropped and Russia failed to lower its prices. Many Russian gas fields are reaching the end of their life, and European countries are looking to diversify their sources. This could have an impact on prospects for the Shtokman field and pipelines such as Nordstream and Southstream.

36. With both oil and gas increasingly in demand in the domestic market, as the economy grows, energy efficiency is becoming more important. Many in the Russian *elite* still do not believe in climate change as a threat, but businesses are beginning to see energy efficiency as a way of saving in production costs and maintaining competitiveness. A number of projects have been launched, the largest number in the food sector, but also in energy, metals and wood processing. There can be very short payback times, making this a potentially attractive option. Mr Putin has called for 20% energy efficiency gains by 2020. This is unlikely to be accomplished in the domestic sector, as the municipalities, which provide power and heat, are unable to obtain credit at present.

37. Other areas for modernisation and efficiency gains are the creation of an internal market for gas, and the use of flared gas, especially to provide regions without piped gas supplies with small scale power stations. But, given Russia's huge coal reserves the issue is not considered urgent. Whereas unbundling gas production from the pipeline system is seen by some as desirable, it is not considered useful by all experts in economic terms in Russia where the companies involved would also be state owned. In any case, to do this it would be necessary first to allow the domestic gas price to rise, something that seems unlikely at present. Nevertheless, new gas producing companies should be allowed access to the pipeline network.

Parallel session: Education and developing human resources

38. Given Russia's challenging demographic trends – in particular, the shrinking proportion of young workers -- Russia must ensure that its educational system can provide the

training essential to support knowledge-based development. The higher-educational system will play a central role in this. It needs to generate the high-level skills appropriate to the demands of an economy undergoing modernisation and diversification. This will require research-led teaching, with university lecturers actively engaged in research. The higher- educational system would then become a major component of the national innovation system of the country. The commercialisation of its research findings can contribute directly to innovation and modernisation. This is not just an issue of scientific and engineering skills. For a modern diversified economy, highly trained specialists in the social sciences and humanities have an equally important role to play.

39. As a result of the dominant role of the Russian Academy of Sciences (RAS) -- an extremely conservative institution -- Russia's higher-educational sector at present plays a limited role in R&D, but there is now a policy commitment to enhance its contribution and provide competition to the RAS. This is a welcome development. By international standards, Russia is atypical in having a small proportion of R&D performed in universities and a small share of researchers in the higher-educational sector.

40. One serious problem is that there are relatively few younger-generation researchers in Russia. The share of researchers under the age of 30 is gradually rising, but it is still very small. Moreover, many young people entering research do not stay long, either emigrating or switching to better paid, and perhaps more satisfying, alternative occupations.

41. For its scale and level of per capita income Russia does not perform well in international rankings of universities. The issue here is not one of money, although rates of pay in Russian science are not good. Above all, it is a question of research culture and freedom to work creatively. Research activity is bureaucratised, with hierarchical, paternalistic relations. Young researchers are rarely free to apply for, or manage, their own grants. Obtaining equipment or research materials is made difficult by extraordinary levels of bureaucracy. Freedom of travel to international conferences, or to have contact with foreign scientists, is at times limited. There is still an obsession with "security" – scientists with foreign contacts risk attention from the secret police (FSB). Finally, corruption is not unknown in the university sector. (There are exceptions -- institutions making serious efforts to develop vibrant research cultures, such as Moscow's Higher School of Economics, now with the status of a National Research University.)

42. Russian science needs fundamental modernisation and rejuvenation. It may be easier to make progress first in the university sector. But improving university education and its research potential is only part of the story. Universities need excellent students, trained to a high level by the country's schools. Here Russia now does not rate so well as in the Soviet period; school education has not adequately adapted to present-day requirements and expectations.

43. The conference also discussed the applicability of the concept of "Big Society" (and, by implication, "Small Government") for Russia and the UK. There was agreement that forming a "Big Society" should entail the participation of all citizens in society. At the same time, one speaker strongly argued, a "Big Society" cannot be built without a general awareness and acceptance of the common moral values that underpin society as a whole. This is hard to achieve in today's world but, unless it can be done, it will not be possible to build a "Big Society" in either Russia or the UK.

Parallel session: New Media – society, law and the economy on the Internet

44. Mobile phones, the Internet, blogging, social networking – in short, the "new media" -- are big success stories in Russia. Starting from a low base, internet penetration has grown from 3% in 2000 to around 43% of the population and is rising fast. The Internet is a massive "kitchen table" for discussion, and its users are difficult to control. The

majority of the population watch television and most trust it more than the Internet. However, internet users trust the internet as much as TV; and they like it because they can express their own opinions.

45. Unlike China, Russia has not (yet) tried to control Internet access. The downside is that there are dangers, such as nationalist and extremist websites, which the law does little to deal with. Russia is not, of course, unique in this regard; many governments struggle to manage such problems.

46. The "new media" allow people to participate and become personally involved in ways that TV, radio and newspapers cannot. Use of the English language on the internet can enable a wide range of debate and bring in people from outside Russia. The new media facilitate communication between isolated communities and between those who share similar views but are separated by geography. The example was cited of a platform for bloggers on climate change whose use of the Internet afforded them a global presence. Moreover, new media act as an equaliser; people can answer back in real time.

47. There is a big gap between the generations, with many younger Russians being avid Internet users and the older generations relying on TV for their news. Those in towns and cities are also more likely to use the Internet than rural dwellers. This creates a gap between the media-savvy Internet-users, many of whom are believed to support President Medvedev, and older audiences whose loyalty tends to lie with Prime Minister Putin. But, while its use is growing rapidly, Internet penetration outside Moscow and St Petersburg remains relatively low. Therefore, the real impact still remains to be felt.

48. Internet usage can be a tool for economic growth, rendering remoteness of location an issue no longer. As Internet penetration deepens, the Russian government will not be able to ignore the Internet. The presidential election of 2012 may be a test case. In this way, Russia might echo the US experience of 2008, where President Obama's election campaign served to mobilise the population, including some who do not generally turn out to vote. Russia is not there yet, but the situation could develop very quickly.

49. Some participants saw the Russian Internet (aka Runet) as a safety valve. It is a mistake, they said, to think of Runet as a dominated by the opposition. Oppositionists are certainly present, but so are nationalists and there is a good deal of cross-communication between the various groups. But the Internet is already having an impact on how the Russian population views the government. President Medvedev is Russia's No 1 blogger (unlike the older Prime Minister Putin) and this might have implications for the 2012 presidential election, since it would enable Medvedev to reach audiences who do not rely on television.

Reports from Working Groups on Developing Effective Partnerships for Modernisation

50. The conference broke up into three **working groups**, and discussed action points on how to develop effective partnerships for modernisation. At the outset, one of the speakers made the following general recommendations:

   - Any UK attempt to assist Russia's modernisation should be based on a sound understanding of the actual situation in Russia and of the priorities for action that will genuinely assist modernisation;
   - UK involvement needs to be approached with realism, with a recognition that any impact is likely to be modest;
   - Measures must be geared to Russian reality, avoiding the temptation to promote current UK policy concerns that may have little or no relevance to Russia's situation;

- Measures taken should be pragmatic, relatively small-scale, with limited resort to UK budget funding.

Working Group 1: Innovation, Science and Technology, and Education

51. It was suggested that, of the possible avenues of UK engagement with Russian modernisation, universities perhaps offer the most promising arena. The following steps should be encouraged:

    - Increased partnerships between UK and Russia universities leading to networking, academic conferences, joint research projects and workshops in Russia and the UK;
    - In particular, Russian scientists working in the UK should be encouraged to reconnect with Russian scientists working in Russia, e.g. through joint appointments;
    - Dialogue between UK and Russian institutions to advertise the advantages of the UK practice of peer review both to assess university research nationally and as a basis for the allocation of core research funding;
    - Sharing UK experience of assisting university lecturers in active research engagement;
    - Sharing positive experience of UK university science/technology parks;
    - Easing the visa regime for academics in both directions; and reducing the costs by granting multiple-entry visas.

52. It was pointed out, however, that one major obstacle would be the fact that UK universities lack the funding to develop and maintain such links and to promote transfers. A modest facilitation fund could be highly cost effective here – the Department for Business, Innovation and Skills could be a source of support.

Working Group 2: Energy

53. Focussing on gas, the group made the following proposals:

    - Easier access to gas pipelines would encourage gas production companies to develop and would complement the liberalisation of the electricity industry;
    - A price-setting mechanism in the domestic market that more closely reflects export prices (at least 75% of international price, though domestic customers might need to be subsidised);
    - At least some access to the export market -- without undermining Gazprom;
    - Reduce gas flaring by facilitating the development of small energy generation plants in close proximity to the gas fields.

Working Group 3: New Media

54. The group agreed on the vital importance of the new media in encouraging communication across social barriers and international borders. In both the British and the Russian context, the new media can and are being used to increase the influence of civil society over the state; to provide the state with often uncomfortable but nonetheless very valuable feedback from the population as a whole; and to encourage the authorities to find the right voice to communicate with the population. A note of caution was however sounded, warning that the new media should be used with care since their openness can render politically dissatisfied individuals vulnerable to identification by the state authorities. The group proposed in particular that:

    - The UK should share its positive experience of televised debates between candidates during general elections.

Next Steps: Where now for Russia and the West?

55. The final session drew the following conclusions:

- Western policy-makers should encourage Russian modernization in whatever form – technocratic or comprehensive, economic or political;
- However, there are severe limits to the West's capacity to assist modernization; Endogenous factors will be far more important than exogenous influences in determining the success or failure of modernisation;
- It is critical to moderate expectations in both Russia and the West about partnerships for modernization: the UK must be "modest and realistic" and "adapt to Russian reality";
- Unless the political will exists in Russia to implement far-reaching reforms, no amount of outside assistance will help. Indeed, in some cases, it may even have a detrimental effect. Despite the recent warming of Russia-West relations, a climate of mutual mistrust remains, characterized by anti-Russian sentiment in America and Europe, and anti-Western feeling in Russia;
- The guiding principle behind the West's approach should be to encourage Russian self-interest to take its logical (if slow and uneven) course. It is futile and counter-productive to lecture the regime;
- What is required is a mix of concrete assistance – "pragmatic, relatively small-scale measures" -- and moral support, including:
    - Increasing trade and investment outside the energy sector;
    - Relaxing visa restrictions;
    - Facilitating Russia's accession to the WTO;
    - Providing political support for a more receptive business environment in Russia;
    - Encouraging serious steps towards combating corruption;
    - Encouraging Russian participation in international financial and trade governance;
    - Fostering educational and scientific exchanges.

56. Russia's choices are stark:

- Emerging modernization *or* a slide into atrophy;
- Sustainable economic growth *or* economic stagnation;
- Good governance, the rule of law and some democratization *or* political and social stagnation;
- A globalized and influential Russia *or* growing marginalization in a changing world order.

57. While it is easy to be pessimistic about the future of modernization in Russia, the conference also heard strong arguments in favour of systemic change and "liberal modernization with Russian characteristics." Russia is not "a basket case". It has decent prospects. It has time (although not as much as it thinks it has). The West has every interest in the emergence of a strong, stable, prosperous and democratic Russia. Ultimately, the most promising driver of modernization is Russia's anxiety about its place and relevance in the 21st century international system. There are compelling strategic and security, as well as economic and psychological, reasons for Russian leaders and Russian society to undertake serious modernization.

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Wilton Park | May 2011

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