

Research Paper

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Import Substitution and Economic Sovereignty in Russia



Summary

- Russia's economic policy is being progressively subordinated to security concerns, with the ostensible aim of insulating the country from internal and external threats. The geopolitical conflict with the West that intensified after the annexation of Crimea in 2014 has resulted in the authorities accelerating their efforts to enhance Russia's economic sovereignty.
- A high-profile import-substitution campaign is one of the most important components of this drive. The legislation on import substitution began before the West's sectoral sanctions were announced. The arrangements are institutionally elaborate and indicate a strategy rather than a short-term expedient.
- One way for Russia to become more sovereign would be to diversify its economy away from oil and gas exports. It is one of the world's largest manufacturers, with a wide range of manufacturing capabilities. However, much of its manufacturing output is not competitive on global markets and is consumed domestically. Activity levels are therefore strongly correlated with export revenues from hydrocarbons. The rest of the economy nosedives when commodity prices drop. Real diversification will occur only if new industries are export-oriented.
- The relatively modest volume of financial resources allocated to achieving import substitution is dwarfed by the magnitude of the ambition. Russia is in the grip of a wider economic downturn that is proving intractable. How the issue of scarcer resources is managed will be of crucial importance. If resources are allocated to already protected and globally uncompetitive industries at the expense of policies designed to support entrepreneurship and strengthen property rights, the prospects for Russia's long-term prosperity will be bleak.
- The nation's commitment to import substitution will be tested if the price of oil rises. The strength of the rouble is bound up with the price of oil. The currency's depreciation since 2014 provides an opportunity for Russian producers to benefit from price competitiveness. However, given the Central Bank's apparent commitment to a 'free float' exchange rate policy, it is unclear whether this price competitiveness will survive any future rise in oil prices. The possible lifting of sectoral sanctions might also weaken the Kremlin's resolve to pursue import substitution.
- The authorities desire a change in the nature of Russia's integration with the global economy, in order to boost the domestic economy and national security. In this respect, it is perhaps more accurate to describe the current trajectory not as 'de-globalization' but as 'conditional re-globalization'. The Russian authorities appear intent on changing trade and investment relations where it is desirable for economic and/or security reasons, and where it is feasible given prevailing physical and financial constraints.

Introduction

A preference for greater freedom from internationally imposed constraints – i.e. for sovereignty – is nothing new for Russia. But the geopolitical conflict with the West that intensified after Russia's annexation of Crimea in March 2014 has resulted in the Russian authorities accelerating their efforts to enhance the country's economic sovereignty.

One of the most important components of Russia's efforts to increase its economic sovereignty is a high-profile import-substitution (*importozameshchenie*) campaign that is already well established. At a meeting of the State Council on 25 November 2015, Minister of Industry and Trade Denis Manturov reported that 570 import-substitution projects were under way.¹ The plan envisages the implementation of 2,059 projects across 19 branches of the economy between 2016 and 2020.² This rather Soviet-style communication raises doubts about the reality that lies behind it. It is clear, however, that the intentions of Russian policy-makers are real enough.

The ministry had earlier prepared a draft government directive forbidding the use of foreign bulldozers, graders, buses and trucks by companies supplying state contracts, and has more recently drafted an extension of this list.³ 'Foreign' here applies to goods supplied from outside the Eurasian Economic Union (EAEU). On 11 August 2015 the Government Commission on Import Substitution met for the first time. It regulates the ordering of equipment by state companies and large private companies receiving state support, with a view to restricting their use of imported machinery to items for which no locally made (i.e. EAEU-produced) analogue is available.⁴ It was agreed that specific rulings would be made from 10 January 2016, after preparatory work.⁵

It would be easy to dismiss this import-substitution campaign as merely a short-term response to Western sanctions, likely to be shelved when those sanctions are withdrawn. It would also be easy to dismiss it as doomed to failure like the import-substitution strategies that were fashionable in Latin America until the 1980s. On both counts, however, it might be unwise to rush to judgment. Policy-makers have a real concern about Russia's 'economic sovereignty', and this may be more durable than the immediate problem of sanctions. Russia's economic sovereignty is fragile above all because of the country's heavy dependence on oil and gas exports, however. Import substitution would reduce this dependence only if it were successful to a degree that seems unlikely. Successful import substitution and an increase in economic sovereignty ultimately hinge on whether policy-makers can engineer a substantial and, to date, elusive diversification of economic activity.

¹ Yedovina, T. and Shapovalov, A. (2015), 'Gossoviet sobral plody importozameshcheniya' [The State Council has collected the fruits of import substitution], *Kommersant*, 26 November 2015, <http://www.kommersant.ru/doc/2862090>.

² Dzis'-Voynarovskii, N. (2015), 'ZAO "Rossiya"' [JSC "Russia"], *Novoe Vremya*, 13 April 2015, <http://www.newtimes.ru/articles/detail/97063/> (accessed 2 May 2015).

³ Mereminskaya, E. (2015), 'Minpromtorg pytayetsya zastavit' gospodryadchikov ispol'zovat' rossiiskoe oborudovanie' [The ministry of trade and industry tries to force state contract suppliers to use Russian equipment], *Vedomosti*, 6 September 2015; US-Russia Business Council (2016), 'USRBC Daily Update', 14 March 2016.

⁴ Government of the Russian Federation (2015), 'First meeting of the Government Commission on Import Substitution', 11 August 2015, <http://www.government.ru/en/news/19246> (accessed 12 Oct. 2015).

⁵ Butrin, D. (2015), 'Kak predki zameshchali' [As our forebears substituted], *Kommersant*, 12 August 2015, <http://www.government.ru/news/19246/> (accessed 12 Aug. 2015).

The first part of this paper is a brief review of Russia's concerns about economic sovereignty: what is at stake, the reasons for those concerns, and their influence on the import-substitution campaign. The rest of the paper is an assessment of that campaign, its rationale and its limitations.

Russian views of economic sovereignty

In the public discourse of the Russian political elite an explicit emphasis on 'sovereignty' came first from Vladislav Surkov, when he was a deputy head of the Presidential Administration. In 2006, introducing his label of 'sovereign democracy' to an audience of United Russia party members, he said, 'We wish to be an open nation among other open nations and to cooperate with them according to just rules and not to be managed from outside.'⁶

As a label, 'sovereign democracy' has had its day. The aspiration not to be 'managed from outside', however, has become a dominant theme in public discourse. This is the case with respect to economic policy as well as foreign policy. In a speech to members of the government in January 2015, President Vladimir Putin said: 'We were naive to think that international economic rules would not be eroded by politics. This must encourage us to increase our sovereignty in the economic sphere while remaining of course a natural, organic part of the world economy.'⁷ Three months later, speaking to journalists, he said that 'the first task today is the raising of [our] economic sovereignty and the development of our economy as a high-productivity and high-technology [economy]'.⁸

What is at stake here? It may help to think of economic sovereignty as the ability of a state to influence the terms on which its citizens do business with those of other states. This ability is limited in several ways. In highly competitive international markets such as those for grain or basic steel products, all firms are 'price-takers', not 'price-makers' – that is, unable to dictate the prices they can charge and thus vulnerable to being undercut by cheaper foreign competitors. By deploying tariff or non-tariff barriers, a state can seek to protect local firms from foreign competition in its home market. Yet membership of the World Trade Organization (WTO) limits, in principle, this sort of protection. A state's influence is also diluted by the ability of some firms to choose freely or at a low cost the national jurisdiction where they pay taxes.⁹

From the Russian perspective sovereignty – or the lack thereof – also has a broader meaning beyond the economic context. Economic sovereignty can reduce vulnerability to political pressure from foreign powers. For instance, the new National Security Strategy highlights dependence on imported high-technology products as a threat to national security.¹⁰ It also stresses that foreign

⁶ Surkov, V. (2006), 'Nasha rossiiskaya model' demokratii nazyvaetsya "sverennaya demokratiya" [Our Russian model of democracy is called "sovereign democracy"], briefing to Yedinaya Rossiya officials, Moscow, 28 June 2006, <http://web.archive.org/web/20080430012854/http://www.edinros.ru/news.html?id=114108> (accessed 13 Nov. 2015).

⁷ Presidential Administration of the Russian Federation (2015), 'Soveshchanie s chlenami Pravitel'stva' [Meeting with members of the Government], 21 January 2015, <http://kremlin.ru/events/president/news/47497> (accessed 28 Nov. 2015).

⁸ Presidential Administration of the Russian Federation (2015), 'Mediaforum nezavisimyykh regional'nykh i mestnykh SMI' [Media forum of regional and local mass media], 28 April 2015, <http://kremlin.ru/events/president/news/49358> (accessed 28 Nov. 2015).

⁹ The classic statement of states' economic influence being challenged by international organizations and by the rise of multinational enterprises is Vernon, R. (1968), 'Economic Sovereignty at Bay', *Foreign Affairs*, 47(1), <https://www.foreignaffairs.com/articles/1968-10-01/economic-sovereignty-bay> (accessed 9 Nov. 2015).

¹⁰ Security Council of the Russian Federation (2015), *Strategiya natsional'noi bezopasnosti Rossiiskoi Federatsii do 2020 goda* [National Security Strategy of the Russian Federation up to 2020], section iv.56, <http://kremlin.ru/acts/bank/40391> (accessed 2 Feb. 2016).

powers, such as the United States and its allies, have threatened and may continue to threaten Russia with a range of economic instruments, such as sanctions, in order to contain it.¹¹ As a result, enhancing economic sovereignty and security is considered part of a wider effort to mobilize all domestic resources to deal with the growing range of threats perceived by officials in the Kremlin.¹²

Reducing Russia's import dependency can be seen, therefore, as fulfilling two ostensibly economic objectives that in fact have a broader political purpose. First, building new and (usually) high-technology industries will help Russia in its seemingly perpetual quest for modernization. If successful, this would result in higher incomes and better jobs for the population, a goal explicitly outlined by Putin in his 'May Decrees' of 2012 and foreshadowed in a programmatic article published when he was still a 'candidate' for the presidency.¹³ Second, reducing import dependency in strategic areas would insulate Russia from the possible threat of economic sanctions and trade embargoes by geopolitical competitors.

This import dependency is quite high, according to one study, and uncomfortably so in areas such as machine-building, which are vital to defence-industrial capabilities.¹⁴ The study showed that Russia's dependency on imports in the economy as a whole nearly doubled between 2006 and 2013, with imports as a share of producers' total costs rising from 8.5 per cent to 14.7 per cent. In machine-building, import dependence rose from 13.4 per cent in 2006 to 36.5 per cent in 2013. From the perspective of those in the Kremlin, these figures illustrate the scale of the problem that import substitution is intended to address.

Whatever the limitations on every state's economic sovereignty, it is clear that the economic influence of states is not evenly distributed. One issue is that supposedly weaker, developing countries are ill served by international organizations whose rules are manipulated by dominant, developed countries to the latter's advantage. The dispute about economic sovereignty, the argument goes, is 'a hidden power struggle on the world stage'.¹⁵ Such complaints may be partisan, but they are not wholly misleading. The United States, to take an obvious example, is clearly a powerful economic sovereign. Beside it – and that is where the Russian leadership wants its country to be – Russia looks weak.

Business analysts routinely note the pervasive influence of American interests. For example, on the Trans-Pacific Partnership: 'Washington's foremost goal [...] is to establish norms of global trade and investment on terms that benefit US business.'¹⁶ In establishing and implementing international sanctions against Russia, too, US influence has been apparent. Fear of incurring American displeasure has held banks and investors in many countries back from Russian deals, including perhaps even those in China.

¹¹ Ibid., section ii.12.

¹² Monaghan, A. (2016), 'Facing an Arc of Crisis', *Russia in Global Affairs*, No. 1, <http://eng.globalaffairs.ru/number/Facing-an-Arc-of-Crisis-17980>.

¹³ Putin, V. (2012), 'O nashikh ekonomicheskikh zadachakh' [On our economic objectives], *Vedomosti*, 30 January 2012, http://www.vedomosti.ru/politics/news/1488145/o_nashih_ekonomicheskikh_zadachah (accessed 3 Feb. 2012).

¹⁴ Berezinskaya, O. and Vedev, A. (2015), 'Proizvodstvennaya zavisimost' rossiiskoi promyshlennosti ot importa i mekhanizm strategicheskogo importozameshcheniya' [Production dependency of Russian industry on imports and the mechanism of strategic import substitution], *Voprosy Ekonomiki*, 1: 104, http://www.vopreco.ru/rus/archive.files/n1_2015.html.

¹⁵ Zhenying, P. (2005), 'Globalization vs. Economic Sovereignty', *China Daily*, 2 December 2005, <http://yaleglobal.yale.edu/content/globalization-vs-economic-sovereignty> (accessed 10 Nov. 2015).

¹⁶ Oxford Analytica (2015), 'TPP will unsettle East Asia's regional relations', Daily Brief, 7 October 2015,

<https://dailybrief.oxan.com/Analysis/DB205843/TPP-will-unsettle-East-Asian-regional-relations> 7 October 2015 (accessed 7 Oct. 2015).

The Russian leadership's concern about comparative economic sovereignty is understandable in an ex-superpower and a country whose economy was not so long ago insulated from the outside world by an inconvertible currency, the exclusion of foreign investment, and centrally planned foreign trade. One must not forget either that after those impediments to international economic integration had been removed, it took Russia more than 17 years to negotiate its accession to the WTO, in the process accepting rules on intellectual property rights that suit Hollywood and Silicon Valley and making farm subsidies lower than those in the United States and the EU.¹⁷

Over and above an immediate response to Western sanctions, these concerns seem to influence current Russian policy. In his address to the parliament on 3 December 2015, Putin argued that Russia was competitive, broadly speaking, only in natural-resource sectors, and that the country needed to develop competitive firms in a range of other sectors. To that end, the state had to offer support for exporters and programmes of import substitution. Firms engaged in these programmes (the 19 branches referred to above), Putin said, should be supported by exemption from profits tax and by having 30 per cent of their output open to purchase by the state without competitive tendering. There was no need, he added, to make support under such programmes conditional on the producers demonstrating success in exports. The state would check that the output in question was competitive in quality.¹⁸

These arrangements are institutionally elaborate. They indicate a strategy rather than a short-term expedient. They seem to be part of a more general national movement that Silvana Malle calls 'militant Russia'.¹⁹ She describes this as an organization of society reflecting patriotic sentiments, aiming at independent governance and provoked by the leading powers' 'ostracism' of Russia. This is a contentious interpretation, but the relevant point is clear: a tendency to stress national security and national standing in the world rather than international economic integration; it is a tendency that goes back at least to the early 2000s.²⁰

Russia's concern about economic sovereignty, then, is understandable in the light of its recent history. And this seems to have contributed to the development of the import-substitution programme, the scale and structure of which go beyond what might be expected of a tactical response to recent Western sanctions. The question, however, is whether that concern is a sound foundation for a long-term strategy of import substitution.

If the strategy could help to create a highly productive, technologically advanced economy, as Putin implied in a discussion with journalists in April 2015,²¹ it would serve its purpose. Such an economy would be diversified, internationally competitive across a range of industries, and no longer heavily reliant on its natural resources. The next section addresses whether this is plausible.

¹⁷ Not that Russia spent or aspired to spend as much on trade-distorting farm subsidies as the United States and the EU. See Connolly, R. and Hanson, P. (2012), 'Russia's Accession to the World Trade Organization: Commitments, Processes, and Prospects', *Eurasian Geography and Economics*, 53(4), p. 484.

¹⁸ Putin, V. (2015), 'Poslaniye Prezidenta Federal'nomu Sobraniyu' [Presidential Address to the Federal Assembly], 3 December 2015, <http://kremlin.ru/events/president/transcripts/messages/50864> (accessed 19 Dec. 2015).

¹⁹ Malle, S. (2015), 'Znakom'tes': Voinstvennaya Rossiya' [Get acquainted: militant Russia], *Rossiia v global'noi politike*, 624, <http://www.globalaffairs.ru/number/Znakomtes-Voinstvennaya-Rossiia-17829>.

²⁰ See, for example, Bacon, E. and Renz, B. (eds) (2006), *Securitisating Russia: the Domestic Politics of Putin*, Manchester: Manchester University Press; and Gorenburg, D. (2010), 'Russia's State Armaments Program 2020', Policy memo 125, PONARS Eurasia, Washington, DC: George Washington University, https://www.gwu.edu/~ieresgwu/assets/docs/pepm_125.pdf (accessed 9 Dec. 2015).

²¹ Presidential Administration of the Russian Federation (2015), 'Mediaforum nezavisimyykh regional'nykh i mestnykh SMI' [Media forum of regional and local mass media].

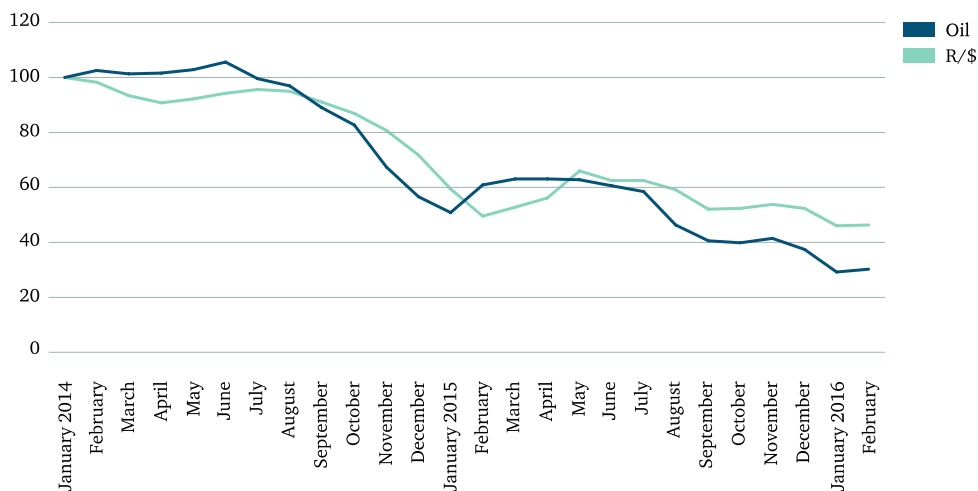
Can a natural-resource exporter achieve economic sovereignty?

One of the main channels through which Russia is acutely sensitive to external influences is its exports of oil and gas. Whereas hydrocarbons exports were a source of rapidly rising income for most of the 2000s, when oil and gas prices, as well as the volume of production, were rising, this sensitivity is now more obviously a problem. Russia, like all major oil exporters except Saudi Arabia, is a price-taker, not a price-maker, on world oil markets. Even in the selling of pipeline gas under long-term contracts, Russia's price-making ability is limited in the medium and long term. One way for Russia to become more sovereign might best be described therefore as 'export substitution': in other words, diversification of output and exports away from oil and gas.

The extent of Russia's economic sensitivity to the world oil market is striking. The strength of the rouble is bound up with the price of oil. Figure 1 illustrates the close correlation between the two variables. While this says nothing about causation, and there may be other influences acting in a similar way on both the oil price and the exchange rate, it is at least suggestive of a powerful link between the two. And the further consequences over this period have been striking: the rapid fall in the rouble has triggered a burst of inflation, which has eroded real incomes.

Figure 1: Brent oil prices per barrel and the dollar/rouble exchange rate (US cents per rouble)

Monthly data, January 2014 to February 2016 (indices, 1 January 2014 = 100)



Source: Indices derived by authors using data from investing.com, Central Bank of Russia.

The oil price strongly affects the level of Russian economic activity. Other things being equal, a fall in the oil price of \$10 per barrel exerts, over a year, a downward influence on Russian GDP of 0.8 per cent. The decline in the oil price between mid-2014 and mid-2015 was of the order of \$50, which in this analysis would largely account for the fall in total output.²²

²² Chakarov, I. and Vlasova, E. (2015), 'Prichinoy sokrashcheniya VVP Rossii stala neft, a ne sanktsii' [Oil, not sanctions, has been the cause of the reduction of Russia's GDP], *Vedomosti*, 26 October 2015.

The volatility of oil prices is a familiar phenomenon. Oil-exporting states, including Russia, built up reserve funds in the fat years to provide a cushion for public spending and, indirectly, for the economy as a whole in the lean years. But recent Russian experience suggests that creating such a buffer is not easy. For most oil producers, the inability to control international oil prices means that their economies are vulnerable to external developments beyond the control of their governments. Their economic sovereignty, in other words, is weak.²³

The weakness of Russia's economic sovereignty caused by its dependence on hydrocarbon exports is exacerbated by the tectonic shifts taking place in the global oil and gas industries, as well as within Russia itself.

At the global level the rapid expansion of unconventional oil supplies in North America – along with production increases in Iraq, and potentially now in Iran, after the lifting of sanctions – has contributed to the emergence of a global oil glut. At the same time, weak economic recovery in Europe and a slowdown in Asia have reduced growth in oil consumption. The resultant large and growing imbalance between supply and demand threatens to keep oil prices low for the foreseeable future.²⁴

Domestically, the hydrocarbons industry suffers from rising costs associated with the geographic and geological structure of existing reserves.²⁵ Much of Russia's future oil and gas production will need to take place in regions that are more costly to exploit, which is likely to cause the profitability of extraction to decline. This will reduce the volume of revenues that the government is able to tax and manage. However, representatives from the oil and gas industry claim that they are currently paying too much tax.²⁶ As a result, they are not investing in future production. The debate in Russia is currently focused on ensuring that the tax burden on the hydrocarbons industry is not lowered, while simultaneously ensuring that sufficient investment takes place to ensure future production.²⁷ It is unlikely that both goals can be achieved simultaneously. Whatever course of action is chosen, the growth in future revenues generated by the hydrocarbons industry will not reach anything like that observed in the past 10–15 years, irrespective of what happens at the global level.

Taken together, these two trends suggest that the growth model based on rising oil prices and production volumes that served Russia well between 1999 and 2012 is fraught with danger. This means that one way for Russia to achieve a greater measure of economic sovereignty is by diversifying the economy. A key test of the success of import substitution is that it should lead to diversification away from production closely tied to natural resources.

²³ It can be argued that Russia's specialization in hydrocarbons is not the problem: that the country's main exports reflect its comparative advantage, and that the real problem is an 'addiction' to wasteful spending of oil and gas rents. See Gaddy, C. and Ickes, B. (2010), 'Russia after the Global Financial Crisis', *Eurasian Geography and Economics*, 51(3), pp. 281–311. The trouble is that Russia, like other emerging economies, probably lacks the governance to handle natural-resource rents efficiently.

²⁴ International Energy Agency (2016), 'Oil Market Report: World Oil Demand', Paris: International Energy Agency, <https://www.iea.org/oilmarketreport/omrpublic/> (accessed 18 Feb. 2016).

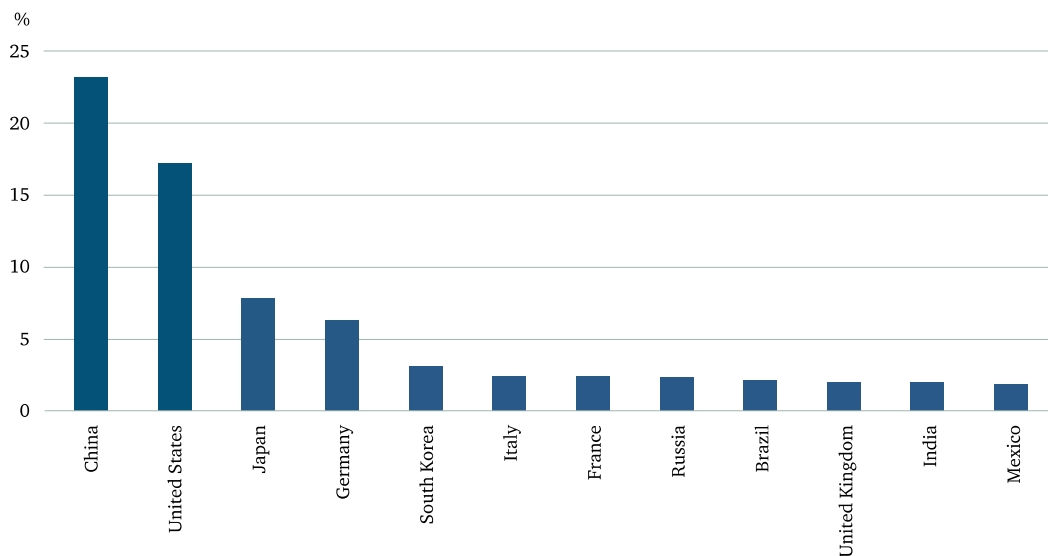
²⁵ Gustafson, T. (2012), *Wheel of Fortune: The Battle for Oil and Power in Russia*, Boston, MA: Harvard University Press.

²⁶ The minister for natural resources, Sergei Donskoi, cited Russia's 'imperfect' taxation of the hydrocarbons sector as the most serious challenge confronting the industry. See Interfax (2014), 'Sanctions against Russia already affecting production of tight reserves, could impact shelf', 10 September 2014, <http://www.interfax.com/newsinf.asp?id=535345>.

²⁷ Henderson, J. (2015), 'Key Determinants for the Future of Russian Oil Production and Exports', Working Paper, Oxford: Oxford Institute for Energy Studies, April 2015, <http://www.oxfordenergy.org/wpcms/wp-content/uploads/2015/04/WPM-58.pdf> (accessed 22 Aug. 2015).

The sort of diversification that will enhance Russia’s economic sovereignty is therefore one that results in GDP growth that is *not* correlated with performance in the hydrocarbons industry. This is not a trivial point. A common misconception is that Russia does not possess a sizeable manufacturing sector. In fact, as illustrated in Figure 2, Russia remains one of the world’s largest manufacturers. This is also a sector of the economy characterized by diversity, encompassing a wide range of manufacturing capabilities.

Figure 2: Share of global manufacturing valued-added, 2013 (%)



Source: United Nations (2015), 'National Accounts Main Aggregates Database', <http://unstats.un.org/unsd/snaama/introduction.asp> (accessed 17 Feb. 2016).

The problem is that much of this manufacturing is not competitive on global markets, is consumed domestically and is correlated with performance in the hydrocarbons industry.²⁸ Hydrocarbons revenues are transferred across the economy to maintain output and employment in non-hydrocarbons industries.²⁹ While this ensures growth across sectors when hydrocarbons prices and production volumes are rising, it also ensures that the rest of the economy nosedives when commodity prices drop.

The challenge from an economic sovereignty point of view is to develop sectors whose performance is relatively resilient to fluctuations in natural-resources industries. In practical terms, this means that simply building industrial capabilities that can supplant imports will not be enough. After all, fluctuations in hydrocarbons prices will continue to exert a strong influence over domestic demand. Instead, real diversification will occur only if new industries are export-oriented.

Research suggests that successful economic diversification occurs when there is a substantial and sustained investment in activities that are close to a country’s existing areas of comparative

²⁸ Cooper, J. (2006), 'Can Russia Compete in the Global Economy?', *Eurasian Geography and Economics*, 47(4), pp. 407–25; Connolly, R. (2008), 'The Structure of Russia’s Industrial Exports in Comparative Perspective', *Eurasian Geography and Economics*, 49(5), pp. 586–683.
²⁹ Gaddy, C. and Ickes, B. (2014), *Bear Traps on Russia’s Road to Modernisation*, London: Routledge.

advantage.³⁰ This is what Justin Yifu Lin describes as a ‘comparative advantage following’ strategy of industrial diversification.³¹ In Russia’s case, such a strategy might involve investment in areas further up the value chain within the wider natural-resources sector in which it currently specializes. This might see resources allocated to the development of oil refining, petrochemicals, and even the oil and gas extraction equipment industry.³²

By contrast, Lin suggests that industrial diversification policies that are ‘comparative advantage distorting’ – i.e. where policy-makers allocate resources to new sectors in which a country does not possess any existing capabilities – might be expensive, unlikely to succeed and ultimately result in the misallocation of increasingly scarce resources. In Russia’s case, this might mean that attempts to stimulate industries such as nanotechnology or beef herds are likely to fail.

The insights from the research cited here suggest that whether Russia’s import-substitution strategy ends up being comparative advantage ‘following’ or ‘distorting’ could shape the prospects for its success.

Assessing the import-substitution campaign

Origins

An officially stated desire to achieve import substitution in selected industries is not altogether new for Russia. In recent years, numerous official policy documents – including, but not limited to, the National Security Strategy of 2009,³³ the Energy Strategy to 2030 (produced in 2009),³⁴ the Food Security Doctrine³⁵ and the Strategy for the Development of the Pharmaceutical Industry to 2020³⁶ – have clearly asserted the desirability of increasing Russian production of strategically important goods and services. However, steps to move beyond vaguely defined and abstract desires to creating well-funded, concrete institutions intended to promote import substitution have appeared only in the last two years. Indeed Putin himself, in his then role of prime minister, said in May 2009: ‘If we

³⁰ As stated by one of the authors previously: ‘This is because the production of certain goods demands the provision of certain institutional features (such as property rights regimes, specific forms of public goods, etc.) that can then be used in the production of a wider range of goods than is already in production. In addition, some goods produced by countries have higher levels of asset specificity than others. Higher levels of asset specificity tend to constrain economies in making the jump to producing other goods by reducing the product space – i.e. the number of products that can be produced employing similar technologies or practices to those already in use. However, other goods, with denser product spaces, facilitate a more rapid leap towards the production of a wider range of goods. Thus, while producing more manufactures of higher technological intensity can help promote the expansion into similar activities, it can also lay the foundations for further structural transformation in the future.’ Connolly, R. (2012), ‘Climbing the Ladder? High-Technology Industrial Exports in Emerging Europe’, *Eurasian Geography and Economics*, 53(3), pp. 356–79. See also Klinger, B. and Lederman, D. (2004), ‘Discovery and Development: An Empirical Exploration of ‘New’ Products’, World Bank; and Hidalgo, C., Klinger, B., Barabási, A. and Hausmann, R. (2007), ‘The Product Space Conditions the Development of Nations’, *Science*, 317, pp. 482–87.

³¹ Lin, J. (2012), *New Structural Economics: A Framework for Rethinking Development and Policy*, Washington, DC: World Bank.

³² Atnashev, M. (2016), ‘Chto Rossiya mozhет i ne mozhет proizvodit' vmesto nefti’ [What Russia may or may not produce instead of oil], Carnegie Moscow Center, 26 February 2016, <http://carnegie.ru/commentary/2016/02/26/ru-62888/iiij>.

³³ Security Council of the Russian Federation (2009), *Strategiya natsional'noi bezopasnosti Rossiiskoi Federatsii do 2020 goda* [National security strategy of the Russian Federation up to 2020], <http://www.scrf.gov.u/documents/99.html> (accessed 22 Nov. 2009).

³⁴ Ministry of Energy of the Russian Federation (2009), *Energeticheskaya strategiya Rossii na period do 2030 goda* [Energy strategy of the Russian Federation up to 2030], <http://minenergo.gov.ru/node/1026> (accessed 21 Sep. 2014).

³⁵ Security Council of the Russian Federation (2010), *Doktrina prodovol'stvennoy bezopasnosti Rossii Federatsii* [The food security doctrine of the Russian Federation], <http://www.scrf.gov.ru/documents/15/108.html> (accessed 17 Feb. 2016). The desire for self-sufficiency in food production goes back to the early 2000s. See Wegren, S. (2014), ‘The Russian food embargo and food security: can household production fill the void?’, *Eurasian Geography and Economics*, 55(5), pp. 491–514.

³⁶ Ministry of Industry and Trade of the Russian Federation (2009), *Strategiya razvitiya farmatsevticheskoy promyshlennosti Rossiyskoy Federatsii na period do 2020 goda* [Strategy for development of the pharmaceutical industry of the Russian Federation up to 2020], <http://www.pharma2020.ru/> (accessed 14 Jun. 2012).

talk about the economy in general, it makes no sense to opt for import substitution if you can buy [imports] cheap.³⁷

As a declared policy, import substitution began with three presidential instructions (*porucheniya*) on 14 May 2014.³⁸ They were part of a list of 21 instructions for stimulating national economic growth and are addressed to the government.

- Instruction 1159 p1i required the government to assess by 1 August 2014 the ‘possibility of competitive import substitution in industry and agriculture’.
- Instruction 1159 p1k told the government to compile by 1 September 2014 a list of goods and services that can be purchased by national and subnational government exclusively from suppliers in the countries of the EAEU.
- Instruction 1159 p1l ordered the government to work out by 1 October 2014 plans for facilitating import substitution in 2014–15.

Putin issued these instructions after the asset freezes and visa bans put in place by the West in the wake of the annexation of Crimea. They came, however, before the imposition of the economically more significant sectoral sanctions. The Russian leaders may have seen the sectoral sanctions coming. With that proviso, it cannot be argued that import substitution was simply a response to sectoral sanctions.

It is hard to find clues to the origins of the campaign in the official records of meetings preceding the import-substitution instructions. When problems of slowing economic growth were discussed at a 19 March 2014 meeting of the president with members of the government, there was no mention of sanctions as a source of difficulty and no reference to import substitution in the proposed countermeasures.³⁹

That meeting identified the key problem as a lack of investment, which was blamed on low profits and high interest rates. The solutions were to be sought in tax breaks, state-subsidized cheap credit via Vneshekonombank and the establishment of a fund for the development of industry (FRP in its Russian acronym). Minister of Industry and Trade Manturov reported on fulfilment of the 2012 programme of industrial development, and it is his ministry that is responsible for the FRP.

There is a reference to import substitution in the report of another meeting of the president with members of the government (this time with military and military-industrial leaders as well) on 9

³⁷ We are grateful to Elizabeth Teague for this reference. Interfax (2009), ‘Russia’s Putin warns against becoming obsessed with import substitution’, 27 May 2009.

³⁸ Presidential Administration of the Russian Federation (2014), ‘Perechen’ poruchenii o dopolnitel’nykh merakh po stimulirovaniyu ekonomicheskogo rosta’ [List of instructions about additional measures for the stimulation of economic growth], 14 May 2014, <http://www.kremlin.ru/acts/assignments/orders/23900> (accessed 10 Dec. 2015).

³⁹ Presidential Administration of the Russian Federation (2014), ‘Soveshchanie s chlenami Pravitel’sstva’ [Meeting with members of the Government], 19 March 2014, <http://www.kremlin.ru/events/president/news/20612> (accessed 30 Dec. 2015).

April 2014.⁴⁰ But this is solely in relation to the risk of the halting of supplies from Ukraine. Putin remarked that ‘we must be prepared’, including with arrangements for import substitution.

Threats to the supply of military items were the main theme of the April meeting. This was evident not only from the reported discussion but also from the attendance. Of the deputy prime ministers, Dmitry Rogozin, who oversees the defence-industrial complex, was present but Igor Shuvalov, who oversees the ‘economic bloc’, was not. Within the economic bloc, the pattern of attendance was tilted towards the more micro-activist ministries. Attendees from the Ministry of Industry and Trade, including the minister, outnumbered those from the Ministry of Economic Development by a ratio of three to two, while the Ministry of Finance had a deputy minister as its sole representative.

Implementation

Once the presidential instructions were issued, their implementation was widely advertised. Support for import substitution in 2015–16 was the first of a list of measures in a government ‘Plan of priority measures to ensure the steady development of the economy and social stability in 2015’.⁴¹ The Ministry of Industry and Trade prepared subsequent decrees on the basis of this document. For example, it prepared a decree of 30 November 2015 banning the state purchase of medicines where at least two analogues were available from suppliers within the EAEU.⁴²

It is difficult – and it may at present be impossible – to estimate the scale of this support. In his speech at the 19th St Petersburg International Economic Forum in June 2015, Putin said: ‘We intend to allocate 2.5 trillion roubles to it [import substitution].’⁴³ He did not say over what period this amount would be spent.⁴⁴ It is the equivalent of some 3 per cent of GDP in 2015, so it is likely that the intended spending period is more than one year.

Putin also did not say precisely who ‘we’ referred to. The large sum he quoted may be a conflation of public soft lending and linked non-state expenditure in government-assisted projects. The FRP reportedly allocated R20 billion (\$328 million)⁴⁵ to 59 import-substitution projects in 2015, but their total value was cited as R162 billion. The terms of the FRP loans were certainly costly for the state. Individual credits ranged from R50 million to R700 million over seven years at 5 per cent, well below the double-digit rate of inflation in the year they were offered.⁴⁶

⁴⁰ Government of the Russian Federation (2014), ‘Soveshchanie y Prezidenta Rossii s chlenami Pravitel’sstva’ [Meeting at the President of Russia’s residence with members of the Government], 9 April 2014 <http://www.government.ru/news/11606> (accessed 30 Dec. 2015).

⁴¹ Government of the Russian Federation (2015), ‘Plan pervoocherednykh meropriyatii po obespecheniu ustoychivogo razvitiya ekonomiki i sotsialnoi stabil’nosti’ [Plan of priority measures to ensure the steady development of the economy and social stability in 2015], <http://government.ru/docs/16639/> (accessed 1 Jan. 2016).

⁴² Government of the Russian Federation (2015), ‘Ob ustanovlenii ogranichenii dopuska inostrannykh lekarstvennykh preparatov pri gosudarstvennykh zakupkakh’ [On the establishment of limits on the admittance of foreign medical preparations in state purchases], 2 December 2015, <http://www.government.ru/docs/20833> (accessed 1 Jan. 2016).

⁴³ Presidential Administration of the Russian Federation (2015), ‘Plenarnoe zasedanie Peterburgskogo mezhdunarodnogo ekonomicheskogo foruma’ [Plenary session of the St Petersburg international economic forum], 19 June 2015, <http://www.kremlin.ru/events/president/news/49733> (accessed 12 Nov. 2015).

⁴⁴ For example, it has been suggested that R235 billion will be supplied by the federal budget, with the remaining funds to be generated from unspecified private sources. See Dziz’-Voynarovskii (2015), ‘ZAO “Rossiya”’ [JSC “Russia”].

⁴⁵ Using an average annual exchange rate in 2015 of R60.9:US\$1, Economist Intelligence Unit estimate.

⁴⁶ Kryuchkova, Y. (2015), ‘Promyshlennyye stavki sdelayany’ [The industrial wagers have been made], *Kommersant*, 1 December 2015.

There are 570 investments under 19 branch programmes that have been labelled as import-substitution projects.⁴⁷ All, presumably, are labelled in this way so that officials can report more boxes ticked and the project promoters can at least hope for some state funding. Support other than from the FRP seems to consist mainly of tax breaks, some of them from regional governments.

Other channels for promoting import substitution rely more on restriction than on incentives. Restrictions are in place on state procurement of many items of equipment.

To sum up, the legislation on import substitution began before the West's sectoral sanctions. It creates substantial institutions and has been the basis for a significant commitment of state resources. It has every sign of being intended to last. It might not do so, but it does not resemble a temporary expedient, designed to be quickly cancelled.

Criticism

Before reviewing the problems that have arisen in implementing the import-substitution programme, it is worth noting two critical commentaries that are of particular interest for their provenance as well as for the light they shed on these problems. They highlight the fact that Russia's import-substitution policies can be damaging when pursued as more than a temporary expedient, and when directed at a wide range of industries or at industries in which productivity is far below internationally competitive levels.

An October 2015 article under the name of Prime Minister Dmitry Medvedev, who also chairs the Government Commission on Import Substitution, suggests that part of the political elite still wishes to see Russia pursuing integration with the global economy.⁴⁸ It starts with the proposition that the main aim of economic policy is to enable the country 'to enter the group of countries with the highest level of well-being'. But, it continues, Russia lags behind these countries in labour productivity and needs to become more competitive. Most countries that make a breakthrough into the leading group use the advantages of free trade: '[I]t is hard to name countries that have made continuing, steady progress by prolonged self-limitation in trade.' The article concludes that sanctions will sooner or later come to an end, that a return to cooperation with the West is inevitable, and that import substitution must not become the 'slogan of the day'.

Meanwhile, the economist Sergei Guriev has argued that the origins of the campaign to 'de-globalize Russia' are to be found in the leadership's need to justify the isolation that its policies cause. Therefore 'de-globalization' policies have been presented as though economic isolation were good for the country and had been the plan all along. If there can be an economic case for import substitution, it comes from the 'infant industry' argument. According to Guriev, the protection of infant industries may pay off if it is temporary, and if the industries in question cover a narrow

⁴⁷ Yedovina and Shapovalov (2015), 'Gossoviet sobral plody importozameshchaniya' [The State Council has gathered the fruits of import substitution].

⁴⁸ Medvedev, D. (2015), 'Novaya real'nost': Rossiya i global'nye vyzovy' [The new reality: Russia and global challenges], *Voprosy Ekonomiki*, No. 10, pp. 5–29, <http://www.vopreco.ru/rus/redaction.files/10-15.pdf> (accessed 19 Nov. 2015).

range of activities in which initial productivity levels are not far behind those of successful exporters. He implies that this does not look like being the case for the Russian campaign.⁴⁹

Implementation problems

Several problems have arisen in implementing the import-substitution policy, which in places suggest some support for the Medvedev-Gurieiev critique.

Measurement

To begin with, there is a problem of measurement. If a car assembly plant, for example, gets all its sub-assemblies from local suppliers, its management can claim that its production has wholly substituted domestic supply for imports. But these local suppliers may be relying to some degree on imported components. Therefore, if the reporting system relies on claims from the assembly plant and not on the identification of local value added in the whole production chain, there is a potential problem of ‘concealed imports’. Reportedly, the import content of Russian car production has long been subject to this sort of game-playing, but now that import substitution has become the ‘industrial ideology’, efforts to conceal import content have increased.⁵⁰

Breadth

There is also the issue of the coverage of the campaign. At the first meeting of the Government Commission on Import Substitution on 11 August 2015, Medvedev defined its aim as being ‘to create the conditions for our own production in those branches, those sectors, where there is still a high level of dependence on imports’.⁵¹ He then gave a long list of such sectors: machine-tool production, most sub-branches of machine-building, radio-electronics, light industry, pharmaceuticals and the medical industry. Medvedev went on to say that complete self-supply was not possible or desirable, but he made it clear that, in addition to agriculture, most of industry except oil, gas, metals and timber would be targeted. This broad coverage is at odds with Guriev’s argument about infant-industry policies.

The breadth of coverage in the current import-substitution plan is likely to stem from the lofty ambitions of policy-makers to enhance economic sovereignty and provide a new source of employment growth in knowledge-intensive industries. Laudable as such aims might be to those in the Kremlin, the relatively modest volume of resources allocated to achieving them is surely dwarfed by the magnitude of ambition.⁵² Spreading scarce resources so thinly does not augur well.

Competition

There are also problems to do with competition. By definition, protection of domestic producers reduces competition, but any damage to incentives for efficiency might be mitigated by creating the expectation that the period of protection will be limited and by maintaining as far as possible

⁴⁹ Guriev, S. (2015), ‘Deglobalising Russia’, Moscow: Carnegie Moscow Center, 16 December 2015, <http://carnegie.ru/2015/12/16/deglobalizing-russia/in6d> (accessed 16 Dec. 2015).

⁵⁰ Popov, Y. (2015), ‘Pravila igry’ [The rules of the game], *Kommersant*, 23 December 2015, <http://www.kommersant.ru/doc/2815446>.

⁵¹ Butrin (2015), ‘Kak predki zameshchali’ [As our forebears substituted].

⁵² By way of comparison, it is useful to consider that the sum of R2.5 trillion (i.e. derived from public and as yet unspecified private sources) envisaged for import substitution in 2016–20 is not much greater than the R1.88 trillion allocated by the federal government to the annual state defence order (*gosudarstvennyi oboronnyi zakaz*, or GOZ) in 2015. Data on GOZ from Cooper, J. (2016), ‘Russian military expenditure, 2014, 2015 and 2016 federal budget: a research note’, unpublished paper, cited by permission of the author.

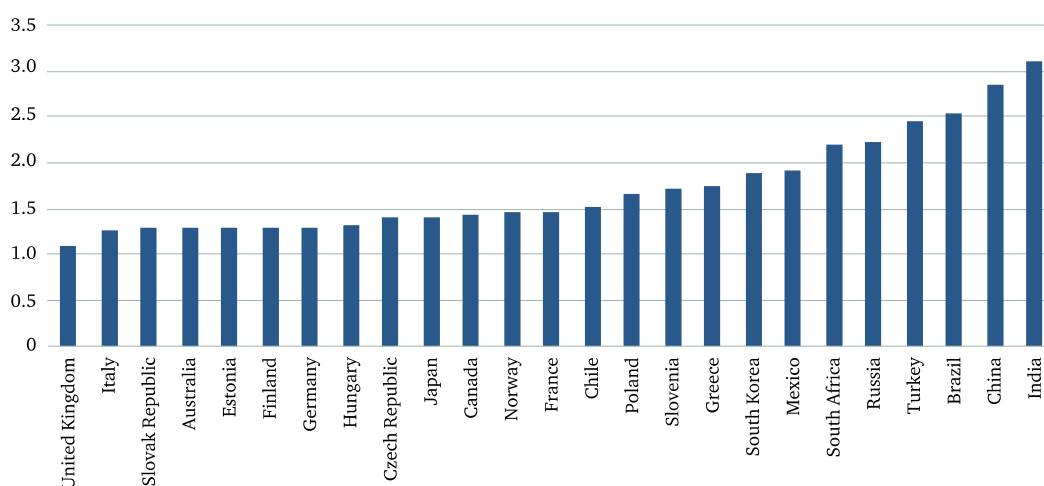
competition among domestic producers. The duration of the policy is not clear, however, and the work of the commission is to be facilitated by reducing requirements for competitive tenders in state procurement.

Putin’s December 2015 address to parliament illustrated these complications. He said that the state should be able to purchase 30 per cent of the output from specially supported projects without competitive tenders. He noted that in some countries state support for producers was made conditional on a certain proportion of their output being exported, but that Russia’s circumstances were ‘a bit different’. Russian producers would be guaranteed a home market.⁵³ There is some early evidence of import-substitution policies pushing up prices, allegedly because of reduced competition from imports. In state procurement contracts in 2015 the prices of road graders, minibuses and trailers went up by 55 per cent, 59 per cent and 82 per cent respectively.⁵⁴

That the import-substitution plans may reduce competition in the economy is made even more worrying by the fact that the intensity of competition across the Russian economy is already low by global standards (see Figure 3). (The OECD product-market regulation measure is an assessment of the extent of barriers to competition in markets for products.) This is important because of the role that competition plays in stimulating productivity and innovation.⁵⁵ A higher degree of competition can generate the type of technological or organizational innovation that is needed if Russia is to build successful, globally competitive industries of the sort envisaged by proponents of import substitution.

There is, though, a tension between the logical implications of the import-substitution strategy as currently stated and the recent emergence of a vigorous rhetorical commitment by senior officials –

**Figure 3: OECD economy-wide regulation indicator for selected countries, 2013
(0 = no regulation)**



Source: Koske, I., Wanner, I., Bitetti, R. and Barbiero, O. (2015), *The 2013 update of the OECD product market regulation indicators: policy insights for OECD and non-OECD countries*, Economics Department Working Papers, Paris: OECD.

⁵³ Putin (2015), ‘Poslaniye Prezidenta Federal’nomu Sobraniyu’ [Presidential Address to the Federal Assembly], 3 December 2015.

⁵⁴ US-Russia Business Council (2016), ‘USRBC Daily Update’, 16 March 2016.

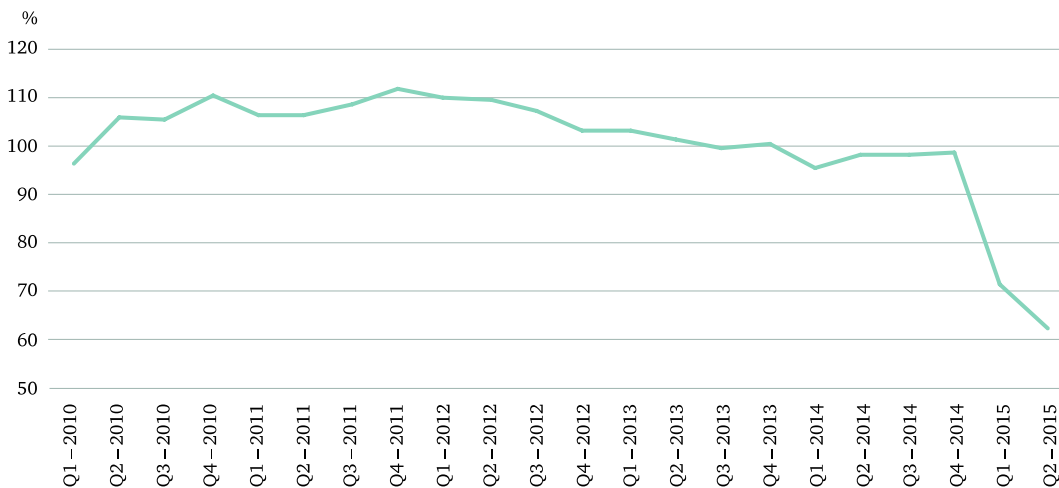
⁵⁵ Aghion, P. and Bessonova, E. (2006), ‘On Entry and Growth: Theory and Evidence’, *Revue de l’OFCE*, 97bis.

not least the president – to helping boost entrepreneurship in Russia. For instance, in his December 2015 address to parliament, Putin emphasized the integral role that a vibrant cohort of small and medium-sized enterprises (SMEs) should play in Russia’s economic development.⁵⁶ Whether this shift in rhetoric is matched by practical support is another matter. After all, repression of competition is an essential component of the existing social order and import substitution threatens to repress that competition even further.⁵⁷

Investment

A low level of investment afflicts the Russian economy. This is a chronic problem that is only getting worse.⁵⁸ Whereas a middle-income country might expect to channel 25–30 per cent of GDP towards investment to generate rapid industrial development, the rate in Russia has hovered around 20 per cent. To compound matters, investment in Russia has declined since mid-2013 (see Figure 4).

Figure 4: Gross fixed capital formation in Russia, 2010–15
(% of corresponding period in previous year)



Source: Rosstat (2016), ‘Investment in fixed capital’, http://www.gks.ru/bgd/regl/b15_15/Main.htm.

If it is to achieve its objectives, the import-substitution campaign will need to reverse the recent investment slump, at least in those branches of industry that are earmarked for state support. But the choice of instrument to effect such a turnaround reveals a lot about the direction of economic policy in Russia. Those of a more liberal persuasion may favour policies to improve the business

⁵⁶ Putin (2015), ‘Poslaniye Prezidenta Federal’nomu Sobraniyu’ [Presidential Address to the Federal Assembly]. Silvana Malle has noted a number of instances where the president has, in conjunction with the All-Russian National Front, highlighted the importance of stimulating entrepreneurship in the SME sector: Malle, S. (2016), ‘The All-Russian National Front – for Russia: a new actor in the political and economic landscape’, *Post-Communist Economies*, 28(2).

⁵⁷ On the role of repression of competition in the relationship between state and business, see Yakovlev, A., Sobolev, A. and Kazun, A. (2014), ‘Means of Production versus Means of Coercion: Can Russian Business Limit the Violence of a Predatory State?’, *Post-Soviet Affairs*, 30(2–3), pp. 171–94; and Connolly, R. (2015), *Troubled Times: Stagnation, Sanctions and the Prospects for Economic Reform in Russia*, Research Paper, London: Royal Institute of International Affairs, https://www.chathamhouse.org/sites/files/chathamhouse/field/field_document/20150224TroubledTimesRussiaConnolly.pdf.

⁵⁸ Gaddy and Ickes (2014), *Bear Traps on Russia’s Road to Modernisation*; and Connolly, R. (2011), ‘Financial Constraints on the Modernization of the Russian Economy’, *Eurasian Geography and Economics*, (52)3, pp. 428–59.

environment – such as the strengthening of property rights or credible efforts to rein in predatory state officials – that in turn will ignite private investment.⁵⁹

But, despite some change in official rhetoric, such market-friendly solutions so far have been eschewed in favour of an increasingly introverted and *dirigiste* approach to economic policy. Indeed, for some there is a fear that an even greater emphasis on the centralized allocation of resources will be made to ‘encourage’ investment in strategically important sectors of the economy.⁶⁰ Such an acceleration of investment could lead not only to a misallocation of resources but also to a macroeconomic crisis.

Historically, perhaps the most important incentive to stimulate investment in import substitution has been a supportive exchange rate.⁶¹ For much of the past two decades, the strength of the rouble has worked against the emergence of Russian manufacturing industries that are competitive on global markets. However, the recent depreciation of the rouble provides an opportunity for Russian producers to benefit from price competitiveness. Given the Central Bank’s commitment to a ‘free float’ exchange rate policy, it is unclear whether this renewed price competitiveness will survive any future rise in oil prices. In the event of any nominal appreciation, the government’s commitment to either import substitution or the current rouble policy will be tested: realistically, both cannot be pursued simultaneously.

A return to Soviet practices

Putin has also said that the growth of exports is important and could be used to appraise the performance of ‘branch departments’ (*otraslevye vedomstva*). The wording here, like that of Medvedev’s list of industries, is strikingly Soviet. *Otraslevye vedomstva* were entities like the Soviet Ministry of the Chemical Industry or the Ministry of Machine-tool Production. Now they are departments of the Ministry of Industry and Trade, with names that echo the names of the former Soviet ministries.⁶² In this and some other ways the import-substitution campaign is a return to Soviet practices. The requirement to demonstrate in state procurements the absence of domestic analogues to any imported machinery included in the bid is reminiscent of Gosplan’s screening of applications to import foreign licences and machinery.⁶³

Information technology

Information technology (IT), in one way or another, dominates modern production across all branches of the economy – and here Russia lags behind other countries. Communications Minister Nikolai Nikiforov has said that ‘75–95 per cent’ of all software in use in Russia is foreign.⁶⁴ At a

⁵⁹ A good summary of this type of thinking can be found in Ministry of Economic Development of the Russian Federation (2008), *Kontseptsiya Dolgosrochnogo Sotsial’no-ekonomicheskogo Razvitiya Rossiiskoi Federatsii do 2020* [Concept for the Long-Term Socio-economic Development of the Russian Federation to 2020], <http://www.economy.gov.ru/wps/portal/e-russia> (accessed 24 Mar. 2012).

⁶⁰ See, for example, Mau, V. (2016), ‘Vspomnit’ 1980-ye i ne povtorit’ oshibok’ [Do not repeat the mistakes of the 1980s], *Vedomosti*, 16 February 2016, <http://www.vedomosti.ru/opinion/articles/2016/02/16/629725-krizis-vspomnit-1980-e> (accessed 17 Feb. 2016).

⁶¹ Rodrik, D. (2007), ‘Industrial development: Some stylized facts and policy directions’, in United Nations Department of Economic and Social Affairs (2007), *Industrial Development for the 21st Century: Sustainable Development Perspectives*, New York, NY: United Nations, http://www.un.org/esa/sustdev/publications/industrial_development/full_report.pdf.

⁶² See <http://minpromtorg.gov.ru/ministry/dep/> (accessed 2 Jan. 2016).

⁶³ USSR State Planning Committee (1974), *Metodicheskie ukazaniya k razrabotke gosudarstvennykh planov razvitiya narodnogo khozyaistva SSSR* [Methodological guidelines to the working out of state plans for the development of the economy of the USSR], Moscow: Ekonomika, pp. 9–20.

⁶⁴ Cited in US-Russia Business Council (2015), ‘USRBC Daily Update’, 20 November 2015. The range of percentages probably refers to a range of fields of application.

meeting of the Maritime Board on 2 July 2015, with Deputy Prime Minister Rogozin presiding, it was said that ‘up to 95 per cent’ of all electronic components in Russian ships were imported.⁶⁵

Weaknesses in IT show up in more obvious ways in the state’s efforts to move all storage of Russians’ personal data onshore and to develop domestically based bank-payments and credit-card systems. For example, the Central Bank’s payment system, now available for use by companies, is reported to be cheaper than SWIFT but less efficient.⁶⁶ The domestically sourced Mir payment card, on the other hand, is reported to cost banks 50 per cent more than international cards.⁶⁷ Visa and MasterCard continue to dominate the Russian market but have been obliged to shift to using the Central Bank’s settlement system.⁶⁸ On 1 September 2015, the law obliging companies to store personal data on servers located in Russia came into effect. The depreciation of the rouble had made the use of Russian servers financially attractive, and many foreign firms operating in Russia had made the change. Overall, however, compliance was initially only at about 10 per cent.⁶⁹

An infant industry is by definition not competitive with its foreign counterparts to begin with. A limited period of protection is supposed to enable it to acquire the know-how, experience and long production runs that will bring its costs down and allow it to compete. Perhaps these early reports should not be taken as evidence of failure.

However, given the importance of IT to weapons systems, it might be supposed that these are not early days in the development of Russian electronics and software. There may be another way forward for Russia: localization by foreign firms, as in the motor industry. It was reported in late 2015 that a number of German IT firms were discussing with the Ministry of Economic Development the possibility of competing for Russian state contracts, despite the import-substitution campaign, through the transfer of some of their production to sites in Russia.⁷⁰ There does not appear to be a current Russian doctrine on the role – if any – of inward foreign direct investment (FDI) in the import-substitution effort.

Agriculture

The farm sector illustrates a final problem: uncertainty about time horizons. Import substitution in agribusiness has been presented as a success story. The counter-sanctions adopted in the summer of 2014 against imports of food from countries sanctioning Russia provided a clear opportunity for domestic producers to supplant foreign ones and enhance national food security. Increasing food security by reducing the share of imports in total consumption is a long-standing policy objective.⁷¹ The imposition of sanctions by Western countries gave Russian policy-makers the opportunity to support domestic producers to make this objective a reality.

⁶⁵ McDermott, R. (2015), ‘Russia Faces a Mismatch in Threat Assessment and Defense Capability’, Jamestown Foundation, *Eurasia Daily Monitor*, 7 July 2015,

[http://www.jamestown.org/programs/edm/single/?tx_ttnews\[tt_news\]=44127&cHash=a1dc9c420439272087c58abd1919fd2d#.VxpgIXp1yC4](http://www.jamestown.org/programs/edm/single/?tx_ttnews[tt_news]=44127&cHash=a1dc9c420439272087c58abd1919fd2d#.VxpgIXp1yC4). The government website gives none of this sort of detail in its brief record of the meeting. McDermott’s source is Fontanka.ru of 2 July 2015.

⁶⁶ Shestopal, O. (2015), ‘TsB zaimetsya bol’shim biznesom’ [The Central Bank will engage in big business], *Kommersant*, 20 July 2015.

⁶⁷ Shestopal, O. (2015), ‘“Mir” udarit bankam po karmanam’ [“Mir” will hit banks in the pocket], *Kommersant*, 17 November 2015.

⁶⁸ Bank of Finland (2016), ‘Russia’, BOFIT Weekly, 8 January 2016,

http://www.suomenpankki.fi/bofit_en/seuranta/viikkokatsaus/Documents/w201601.pdf.

⁶⁹ Kolomychenko, M. (2015), ‘U personalnykh dannykh plokhaya perenosimost’ [Personal data have poor transferability], *Kommersant*, 1 September 2015.

⁷⁰ Kolomychenko, M. (2015), ‘Importozameshchenie s nemetskim aktsentom’ [Import substitution with a German accent], *Kommersant*, 20 November 2015.

⁷¹ See Security Council of the Russian Federation (2010), *Doktrina prodovol’svennoy bezopasnosti Rossii Federatsii* [The food security doctrine of the Russian Federation].

Agriculture did well in 2014–15, when most other sectors were in trouble.⁷² How different its development might have been if the rouble had not fallen sharply, and if the weather had been less favourable, is a matter for conjecture.

However, beef and dairy herd numbers have fallen while almost all the rest of the sector has seen increased levels of activity. Natalya Zubarevich argues persuasively that the difference is due to uncertainty about the duration of the counter-sanctions, since crops, pigs and poultry have relatively short payback periods whereas investing in cattle requires a five- to seven-year horizon, and nobody can be confident that the counter-sanctions will last that long.⁷³

This illustrates the complexity facing the import-substitution campaign. On the one hand, there is the danger that protecting too many infant industries for too long will turn them into state pensioners with no more ability to compete than they began with. On the other hand, there can be circumstances in which productivity gains may come only if there is a lengthy, assured period of protection.

Import substitution in a shrinking and increasingly securitized economy

The import-substitution campaign is not taking place in a vacuum. It is simultaneously shaped by and proposed as a solution to two broader trends: a wider economic slowdown and moves towards a more ‘securitized’ economy.⁷⁴

First, Russia is in the grip of an economic downturn that is proving intractable. Falling oil prices, sanctions and a slowdown dating back to the end of 2011 have caused a period of deep and protracted stagnation (see Figure 5).⁷⁵ This stagnation – and, in 2015, recession – has made much scarcer the resources available to the Kremlin to pursue state objectives.

In 2015, the depth of the recession compelled policy-makers to formulate a revised federal budget for that year. The nominal rouble value of budget spending shrank by 5.7 per cent from that planned only a few months earlier. However, spending cuts were not applied evenly. Housing and municipal services (-10.8 per cent), environmental protection (-16.1 per cent), the national economy (-8.8 per cent) and health (-8.3 per cent) saw spending slashed, while ‘national defence’ and

⁷² Agriculture has done so well that the Ministry of Agriculture has declared that the country should be self-sufficient in milk, meat and vegetables by 2020. See Bol'shakova, N. (2016), 'Importozameshcheniyu produktov meshayut probely v zakonodatel'stve' [Gaps in legislation are impeding import substitution in [food] products], *Vzglyad*, 19 February 2016, <http://www.vz.ru/economy/2016/2/19/795182.html> (accessed 19 Feb. 2016).

⁷³ Zateychuk, M. (2015), 'Natalya Zubarevich: "Svini moloka ne dayut"' [Natalya Zubarevich: "Pigs don't give milk"], *Economy Times*, 17 December 2015, <http://economytimes.ru/kurs-rulya/natalya-zubarevich-svini-moloka-ne-dayut>.

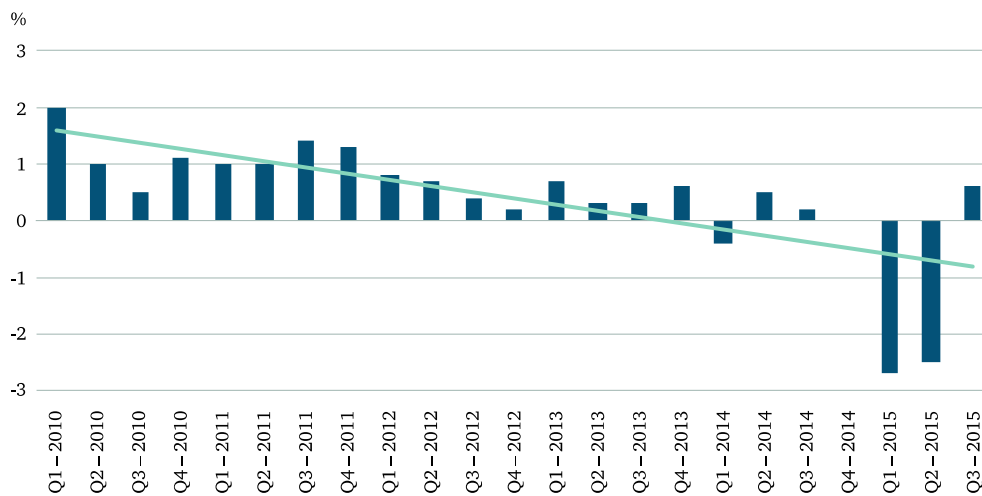
⁷⁴ The word 'securitized' is used here not in its financial sense but in the political sense of being made subject to considerations of national security.

⁷⁵ The causes of this slowdown are discussed in Zamaraev, B., Kiyutsevskaya, A., Nazarova, A. and Sukhanov, E. (2013), 'Zamedlenie ekonomicheskogo rosta v Rossii' [The slowdown of economic growth in Russia], *Voprosy Ekonomiki*, No. 8, pp. 4–34; Mau, V. (2014), 'Challenges of Russian Economic Policy: Modernisation or Acceleration? (Perestroika or Uskorenie)', *Post-Communist Economies*, 26(4), pp. 437–58; and Kudrin, A. and Gurvich, E. (2015), 'Novaya model' rosta dlya rossiiskoi ekonomiki' [A new growth model for the Russian economy], *Voprosy Ekonomiki*, No. 12, pp. 4–34.

‘national security and law enforcement’ were subjected to much lighter cuts (-4.8 per cent and -3.7 per cent respectively).⁷⁶

The distribution of these spending cuts reveals a lot about priorities. Spending on the military and social welfare has proven more resilient than that on areas essential to Russia’s plans for high-tech industrial development. Put simply, a system of political economy that prioritizes weapons and pensions over education, healthcare and infrastructure does not seem conducive to economic modernization.

Figure 5: Real GDP, 2010–15, percentage change from previous quarter



Source: Rosstat (2016), ‘Quarterly GDP data’, http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/accounts/#.

This points to the second trend, which is that government policy has become increasingly securitized. This term is used to describe the phenomenon when ‘a political actor by the use of the rhetoric of existential threat [...] succeeds in justifying the adoption of measures outside the formal norms and procedures of politics’.⁷⁷ In the Russian context, this has resulted in economic policy that emphasizes self-reliance justified in the name of security.⁷⁸ Thus economic policy is subordinated to security policies that are ostensibly designed to insulate Russia from a growing array of internal and external threats.⁷⁹

There is now a proliferation of official documents that stress that import substitution – along with the sovereignty of the financial system, technological security and natural-resource security (water and energy) – is a vital component in Russia’s capacity to deal with external threats.⁸⁰ The importance of economic security is underlined by the fact that in July 2015 the Security Council

⁷⁶ Ministry of Finance of the Russian Federation (2015), ‘Prilozheniye № 8 k poyasnitel’noy zapiske k projektu federal’nogo zakona “O federal’nom byudzhete na 2015 god i na planovyy period 2016 i 2017 godov” [Appendix Number 8. Explanatory note to the draft federal law “On the Federal Budget for 2015 and the planning period of 2016 and 2017”], [http://asozd2.duma.gov.ru/work/dz.nsf/ByID/1F4B4A870CEEDFBB43257D6300510063/\\$File/Приложение%20№%208%20%28новое%29.pdf](http://asozd2.duma.gov.ru/work/dz.nsf/ByID/1F4B4A870CEEDFBB43257D6300510063/$File/Приложение%20№%208%20%28новое%29.pdf) (accessed 12 Oct. 2015).

⁷⁷ Bacon and Renz (2006), *Securitising Russia*, p.11.

⁷⁸ Connolly, R. (2016), ‘Security Above All’, *Russia in Global Affairs*, No. 1, <http://eng.globalaffairs.ru/number/Security-Above-All-17981>.

⁷⁹ Monaghan (2016), ‘Facing an Arc of Crisis’.

⁸⁰ See footnotes 33–36.

instructed the Ministry of Economic Development to draft an Economic Security Strategy that will presumably seek to bring these disparate elements together under a single umbrella strategy.⁸¹ According to the Interdepartmental Commission of the Security Council responsible for security in the economic and social spheres, the new strategy should help insulate the ‘country’s economy from the political and economic decisions of other states [aimed at] preventing the effective dynamic development of the Russian economy’.⁸²

Taken together, these two broader trends in the wider political and economic environment may lead policy-makers to construct a new system of political economy in Russia. In a shrinking or stagnant economy, in which scarce resources are allocated to achieving economic security, import substitution may take on even greater political meaning. If this were to occur at the expense of policies designed to support entrepreneurship and strengthen property rights, the prospects for Russia’s long-term prosperity would be bleak.

Conclusions

Import substitution has become a buzzword in Russia over the past two years. The fact that the resources allocated to import substitution are significant – in pecuniary and institutional terms – signals that the authorities see it as a core component of economic policy in an increasingly turbulent geopolitical environment. The evidence so far suggests that the import-substitution campaign may suffer from several weaknesses. None the less, a more active industrial policy is being applied to a wide array of sectors that are now considered vital to national security. This is surely a sign of official commitment to the project.

Several wider considerations may shape the prospects for the success of import substitution in Russia.

The first is the impact of the ongoing recession. A revised budget for 2016 is being drafted that will be based on considerably lower projected revenues. As the government scrambles to protect politically important areas of spending (e.g. the military, social welfare), it is likely that spending on economic development, including import substitution, will suffer, notwithstanding the implementation of another set of anti-crisis measures. If spending on import substitution is cut, it is conceivable that a more focused application of resources on a smaller set of sectors may prove beneficial. It is, though, equally plausible that dogged lobbying from industrial interests may result in less spending being spread more thinly. How the issue of scarcer resources is managed will be of crucial importance.

⁸¹ *Pravda* (2015), ‘Nikolay Patrushev: Nuzhno razrabotat’ strategiyu ekonomicheskoy bezopasnosti Rossii’ [Nikolai Patrushev: We need to work out a strategy for the economic security of Russia], 3 July 2015, http://www.pravda.ru/news/politics/03-07-2015/1265776-sovbez_RF-0/ (accessed 12 Jul. 2015).

⁸² Security Council of the Russian Federation (2015), ‘Dopolnitel’nyye mery po neytralizatsii ugroz ekonomicheskoy bezopasnosti Rossiyskoy Federatsii obsuzhdeny na zasedanii Mezhdedomstvennoy komissii Soveta Bezopasnosti Rossiyskoy Federatsii po bezopasnosti v ekonomicheskoy i sotsial’noy sferakh’ [Additional measures to neutralise threats to the economic security of the Russian Federation discussed at the Interdepartmental Commission of the Security Council of the Russian Federation on security in the economic and social spheres], 2 October 2015, <http://www.scrf.gov.ru/news/962.html> (accessed 29 Oct. 2015).

A second question relates to the role of inward FDI. The current Russian practice of import substitution seems not to be hostile in principle to inward FDI. Instead, there is a shift in emphasis: foreign firms in targeted sectors are now directed towards ‘localizing’ their production in Russia rather than exporting their products to Russia. To that extent, Guriev’s ‘de-globalization’ term is misleading. There is little inward FDI forthcoming at the moment, but that could change.

What is clear is that the authorities desire a change in the nature of Russia’s integration with the global economy to boost both the domestic economy and national security. In this respect, it is perhaps more accurate to describe the current trajectory not as ‘de-globalization’ but as ‘conditional re-globalization’. This indicates that the authorities prefer a change in the role of inward FDI where it is deemed to be desirable (for economic and/or security reasons) and where it is possible, given prevailing physical and financial constraints.

The third issue can be put quite simply: what happens when sectoral sanctions are eased, probably by the EU and possibly as soon as this summer? Will the Russian authorities remain committed to protecting agribusiness or to producing indigenous high-technology oil and gas extraction equipment when analogous imported goods become readily available again? The answer to this question will show just how seriously Russia is committed to import substitution and economic sovereignty.

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German Gref, CEO and chairman of the executive board at Russia's Sberbank, Anatoly Aksakov, president of the Association of Regional Banks of Russia, and Deputy Prime Minister Arkady Dvorkovich cooking a dish from Russian food products at Metro Expo 2016.

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