Sergei Guriev, Rector of the New Economics School in Moscow, and President of the school’s Center for Economic and Financial Research, discussed the state of the Russian economy at Columbia University last Thursday. The talk: “Political Economy of (Non-) Diversification in Russia and Other Resource-Rich Transition Economies,” was co-sponsored by the Harriman Institute and the Center for Energy, Marine Transportation, and Public Policy. Guriev summarized chapter four of the Transition Report 2009, co-authored with Boris Ginzburg, Alexander Plekhanov, and Konstantin Sonin. He provided a comprehensive analysis of the importance of economic diversification and the obstacles faced by oil-rich countries during attempts to diversify. “The main message is Russia and other resource-rich countries have failed to diversify,” Guriev said, noting that Russia has fared the best.

The presentation was geared to answer several key questions: Is diversification a good idea? How can countries escape the resource curse? What have hydrocarbon-rich transition countries actually done in the past ten years? What are their policies?

“Why would you need to think about diversification?” asked Guriev. “If you look at the last ten years, then the growth has been especially high in resource-rich countries because oil prices have been high.” He was referring mostly notably to Russia, Turkmenistan, Azerbaijan, and Kazakhstan. Despite high growth, diversification is necessary because of the long-term problem of the “resource curse,” Guriev continued. He quoted Alexsey Kudrin, the Russian Minister of Finance, who said: “Russia is stuck in the resource curse.”

Why are resources a curse? Research by Guriev and others shows that strong performance by the resource sector typically depresses investment in other economic sectors and in human capital. This corresponds to the “Dutch Disease,” which predicts an inverse relationship between resource prices and manufacturing sector productivity in resource-rich countries: when resource prices are up, manufacturing productivity tends to go down.

Resources provide countries with “a nice pile of cash to invest, giving the economy a push,” Guriev said. Unfortunately, when governments have a “nice pile of cash” from resources and their institutions are struggling to begin with, there are no institutional checks to oversee how this “large pile of cash” is spent.

Guriev noted that a lack of spending oversight dulls the motivation to develop institutions: “Institutions aren’t good for politicians because they provide checks on how much they can appropriate.” This phenomenon is called the “institutional trap.” If institutions are bad to begin with in a resource-rich country, they are not likely to improve because they benefit those with the power to change them.

With shoddy institutions, the development of non-resource sectors becomes tricky and the economy depends on volatile oil prices, hindering long-term economic growth. While it appears logical that politicians should favor economic growth, it is often the case that politicians care more about the share of GDP they can appropriate as rents rather than the rate of growth. The term resource rent refers to the surplus after all expenses and normal returns have been attributed. “If you have resource rents you can grab cash and aren’t interested in developing institutions for the long run,” noted Guriev.

While the “institutional trap” has long been observed in oil-rich transitional countries, it is difficult to prove. “It is very hard to unravel causality and build a good empirical model,” Guriev said, “Looking at countries with good and bad institutions, countries with bad institutions and resource rents suffer more. But this empirical evidence is difficult to evaluate.”

There are, however, tangible phenomena that support the hypothesis of the “institutional trap.” When comparing non-resource-rich transition countries, like Poland, the Czech Republic, and Ukraine, to resource-rich transition countries like...
Russia, Kazakhstan, Uzbekistan and Azerbaijan, the non-resource rich countries show a trend of decreasing corruption and improved institutions over the past ten years, while resource-rich countries have not improved. “Russia is as corrupt as countries that are four times as poor,” Guriev remarked.

Guriev demonstrated these trends with a graph, showing that the gap, in terms of levels of corruption, has been growing wider between resource-rich countries and those without significant natural resource wealth. Guriev also noted an inverse relationship between oil prices and media freedom in non-democratic countries. For example, Iran had its first competitive debates between presidential candidates at a time when oil prices were low.

Guriev suggests that in order to overcome the “institutional trap” countries need to diversify. Diversification is good in the long run for two reasons: it helps reduce volatility and promotes investment in non-resource sectors. Resource prices are volatile, and reliance on commodity exports leads to high-terms-of-trade volatility. Even if diversification is costly, and you want to specialize in industries that are not yet developed, it is still better in the long run to develop non-resource sectors.

There are two types of diversification policies: vertical and horizontal. Adopting a vertical industrial policy requires that you “pick winners,” showing preferential treatment to certain non-resource industries. This type of policy only works with a “smart and benevolent” government.

Investment in state corporations is an example of a vertical industrial policy. In 2007 Russia dedicated something like 3% of its GDP in cash to state corporations and a percentage of its assets to technology. This is a small number and while it is too early to evaluate the success of these investments, they do not seem to be doing much good. Russia has little to show for in terms of technology and there are continuous scandals over the corporation that is building the facilities for the Olympics in Sochi.

If governments are corrupt, then most likely non-resource sector institutions are bad, and investment into any one firm will lead to negligible improvements. In adopting a horizontal industrial policy the government invests in all non-resource sectors (reserve accumulation, infrastructure, education, agriculture, and financial development). If the government invests across the board, there should be some improvement in all areas.

Reserve accumulation is crucial. If governments invest surplus revenue into stabilization funds instead of charging resource rents, they will insure that there is money for times when oil prices are down. “Once you convince your government that reserve accumulation is a good policy, you don’t need a smart and benevolent government,” Guriev said.

However, in corrupt governments reserve accumulation is difficult to achieve. Countries that have sovereign wealth funds have not invested enough for these funds to influence macroeconomics in any major way. Russia’s Finance Minister, Aleksey Kudrin, has been the driving force behind Russia’s Stabilization Fund. While he has managed to preserve some fiscal discipline in Russia, there has not been enough investment in the fund to make a real difference. In order for them to be successful, these funds should be at least three times the annual GDP. None of the resource-rich transition countries have invested even close to this amount.

Guriev suggests that to achieve the most tangible diversification results, governments should focus on financial development and education before reserve accumulation and infrastructure. Infrastructure development, he said, is important, but very susceptible to corruption. Projects like roads and airports can cost as much as four times more than they do in developed democracies because the money channeled towards these projects is misappropriated. Education is also susceptible to corruption and less likely to improve from investments than the financial sector; however, it fares better than infrastructure.

Financial development “helps to smooth the effects of price volatility,” Guriev said, and can also benefit non-resource sectors that are more dependent on external finance, allowing for horizontal industrial policy. Guriev noted that financial development may help to reduce inequality.

The financial sector can succeed in corrupt regimes because it relies on the private sector rather than the government. “Financial reforms have been quite successful in countries where governments aren’t so benevolent,” Guriev said. He noted that when examining the financial sector as a share of GDP in resource-rich transition countries, it has gone up in all of them. These countries have also performed well in terms of loan-to-deposit relations, bringing a lot of stimulus to the non-resource sector. Russia’s financial reforms however, are the only ones to outperform the non-oil-rich transition country average.

Unfortunately institutions are still bad in resource-rich transition countries and economies remain undiversified. A year and a half ago Putin said: “If Russia continues to develop along these lines, this may threaten its very existence.” Guriev concluded that as long as oil prices stay where they are, resource-rich transition countries will be okay in the short term. In the next ten to fifteen years, they will face serious problems.

*Reported by Masha Udensiva-Brenner*