

Russia's import substitution and the pivot to Asia

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Accelerated by Western sanctions, import substitution aimed to safeguard Russia's economic and technological sovereignty. Over the last five years, it descended into selective protectionism with political undertones, favouring state-controlled firms in the capital-intensive sectors. Striving to securitize the economy, the state significantly increased its involvement in import substitution, providing lavish public funds and limiting access to critical information. Due to the lack of domestic capabilities, poor inter-sectoral cooperation and rent-seeking the progress on substitution was protracted and weighed down by uncompetitive prices and low quality. As a result, import diversification to non-Western markets and localisation of foreign products and technology has gradually replaced Russian-made import substitution. The pivot to Asia has proved to be crucial, but remained largely contingent on backing from Asian governments to avoid sanctions risks.

Safeguarding economic sovereignty

The idea of import substitution was floated well before the geopolitical rift between Russia and the West, but it is Western sanctions, triggered by Russia's wrongdoings in Ukraine, that have accelerated the launch of an institutionalized and well-funded programme. The imposed restrictions on Russian energy, defence and financial sectors exposed the country's severe dependence on foreign goods and technology and mobilized the country's drive to enhance its economic security. With the mounting geopolitical tensions between Russia and the West, the import-substitution strategy was viewed through the lens of security concerns. Both National Security Strategy and Economic Security Strategy called for building domestic capabilities in order to reduce the country's vulnerability and to enhance its economic sovereignty.¹ Import substitution was perceived as a way of shielding itself from external threats, including the 'discriminatory measures' used manipulatively by hostile foreign powers.² Originally designed as a strategy for spurring economic growth and stimulating competitiveness, after sanctions import substitution became a strategy for the securitization of the economy.³

Launched in 2015, the Government Commission on import substitution created an institutional framework for the replacement of over 2,000 products and technologies across 19 branches of the economy. The lofty ambitions of the government were supported by equally generous state support. Nearly 375 billion rubles were allocated to the programme, including some 105 billion rubles of government support from the federal budget and the Industrial Development Fund (IDF). The government offered comprehensive support, ranging from tax breaks, state-subsidized credit lines, special investment contracts to favourable procurement regulations. It was projected that the programme would help to reduce dependence on imports in the targeted sectors to 50-60% by 2020.

¹ Richard Connolly and Philip Hanson, "Import Substitution and Economic Sovereignty in Russia," *Chatham House*, June 2016, 3.

² Security Council of the Russian Federation (2015), *Strategiya natsionalnoi bezopasnosti Rossiiskoi Federatsii do 2020 goda* [National Security Strategy of the Russian Federation up to 2020], <http://kremlin.ru/acts/bank/40391>; Ministry of Energy of the Russian Federation (2014), *Energeticheskaja strategija Rossii na period do 2035 goda* [Energy Security of the Russian Federation until 2035], <https://minenergo.gov.ru/system/download-pdf/1920/69055>.

³ Richard Connolly, *Russia's response to sanctions: how Western economic statecraft is reshaping political economy in Russia* (Cambridge: Cambridge University Press, 2018), 69.

High dependence on Western goods and technology

Prior to sanctions, the overall dependency on imported goods and technologies ranged from 70% to 90%, while the Russian financial system was closely intertwined with the European and American financial markets. Western sanctions targeted the country's most vulnerable areas – lack of homegrown modern technology and reliance on Western financing.

In the energy sector, Russian majors were highly reliant on foreign capital and technology. In particular, in unconventional projects, the share of foreign technology reached 80%, while dependence on foreign software was up to 90%. The domestic analogues for technically advanced LNG and offshore projects were largely absent. In the defence industry, although the exposure to foreign capital was comparatively limited, the dependence on foreign machinery, components and advanced equipment was still critical, as Russian analogues were non-existent. Prior to sanctions, Russia imported some 860 different types of products and components from NATO countries.⁴ It relied on foreign suppliers for 90% of its electronic components. The Russian military-industrial complex was highly dependent on Ukrainian-made diesel engines and gas turbines for the production of Russian ballistic missiles, submarine cruisers and air fighters.⁵ The Russian financial sector strongly relied on borrowing from Western capital markets. The share of dollar-denominated external debt remained high, particularly in the non-financial sector.⁶ Reaching nearly 80%, the greenback dominated Russia's currency settlements, as commodities-based exports prevail in the country's trade structure.⁷

Pivot to Asia

While import substitution was seen strategically as a long-term goal, the pivot to non-Western states was envisioned as a short-term tactical measure. The turn to the East was particularly instrumental for the replacement of Western technology and equipment in order to buy additional time for the development and production of homegrown analogues.

Russia's pivot to Asia opened the door to new export markets and technology transfer providers. Russian energy and defence companies gradually embraced the reorientation to the Asian markets. The Energy Strategy for 2035 envisioned the increase of hydrocarbon exports to Asia to 20-25%, with Novatek planning to ship 80-85% of its LNG to Asia. The military exports to Asia gradually increased with China's share growing from 39% in 2013 to 45% in 2016. In the last few years, Russia has become the largest arms exporter to the region, supplying missile defence systems, tanks and fighter jets to India, Laos, Vietnam, Myanmar and Indonesia.

The Asia-Pacific region has emerged as Russia's strategic partner in its efforts to secure its own financial and technological resilience. As none of the Asian countries imposed impactful sanctions on Russia⁸, the bilateral cooperation between Russia and China, South Korea, Japan, India and Vietnam intensified. Navigating through Western sanctions, these countries provided more advanced equipment, technology

⁴ Andrey Frolov, "Defence technologies and industrial base," in *Defence industries in Russia and China: players and strategies*, by Richard A. Bitzinger and Nicu Popescu, *ISSUE*, Report No. 38, December 2017 (Paris: EU Institute for Security Studies), 13.

⁵ Frolov, 13-14.

⁶ Evsey Gurchikov and Ilya Prilepskiy, "The impact of financial sanctions on the Russian economy," *Russian Journal of Economics* 1:4, December 2015, 362.

⁷ Henry Foy, "Can Russia stop using the US dollar?" *Financial Times*, 3 October 2018, <https://www.ft.com/content/a5187880-c553-11e8-8670-c5353379f7c2>.

⁸ With the exception of Japan, none of the Northeast and Southeast Asian countries imposed sanctions on Russia. Japan introduced merely symbolic sanctions on Russia, excluding the energy sector.

transfer, and financial support. For example, Chinese oilfield services became a notable alternative supplier of drilling rigs, while the share of equipment from South Korea and Singapore is expected to grow in the next years. South Korean and Japanese engineering companies provided expertise for the construction of LNG carriers and LNG modular plants for Russia's Arctic projects. In the defence sector, China replaced engines previously produced by Ukraine for small missile ships and anti-saboteur boats. Southeast Asia became a crucial supplier of electronic components for the Russian space industry.

Strapped for cash, Russian banking institutions and energy companies turned to the East. Asian credit organisations linked to governments became the main financial vehicle for the provision of financial support to sanctioned Russian banks and energy majors. Decoupled from Western financial systems, Chinese Export-Import Bank, Japan Bank for International Cooperation (JBIC) and Export-Import Bank of Korea mitigated the sanctions risks and signaled the guaranteed state support to the private sector. For example, JBIC provided several loans to Novatek, Sberbank and Transneft – all of which are sanctioned by the US, while the Japan Oil, Gas and Metals National Corporation (JOGMEC), a government agency, agreed to cover 75% of investments to encourage Mitsui & Co, a private Japanese trading house, to acquire a 10% stake in Novatek's Arctic LNG-2. As an alternative to traditional borrowing, prepayment arrangements and equity participation were practised in order to raise capital. The mutual investment funds established with Saudi Arabia, Kuwait, China, Japan, India and South Korea amounted to \$40 billion and were used to promote the inflow of foreign capital, in particular to Russia's Far East. The de-dollarization of the economy became another way to alleviate the reliance on Western institutions. Local currencies for wire transfers, alternatives to Brussels-based SWIFT and bonds denominated in foreign currency were considered to reduce exposure to the US.

Increasing state involvement and non-transparency

In a dirigiste fashion, the Russian state held a significant grip over import substitution. It controlled the allocation of resources and funds and the distribution of power in order to insulate the sanctions effects on targeted entities.⁹ The strategic firms designated by the Russian government were shielded from the negative impact.¹⁰ They enjoyed privileged access to state resources and were awarded a lion's share of state contracts. The state-controlled companies considerably increased their presence in the sectors affected by sanctions, while small and middle-sized companies were effectively sidelined. At the same time, the growing involvement of the state did not necessarily result in the obedient execution of its orders. Generously funded, the programme of import substitution created a negative stimulus for both state and private actors. Lacking the monitoring control over implementation, the programme suffered from Russia's inherent problem – rampant corruption. The government authorities and strategic firms were ready to exploit the state resources, by inflating the costs and failing to meet the targets in order to receive more state funding. Both prioritized their personal gains even while safeguarding economic security. Similarly, despite the establishment of government-initiated competence centers, the Russian majors were reticent to share their in-house expertise with their domestic competitors.

Gradually, the securitization of the economy resulted in the increase of non-transparency. To protect the strategic firms, the Russian government allowed the sanctioned companies to conceal crucial information on their shareholders and management structure as well as on financial reporting. The access to the state register entailing public information on the targets, in particular those based in Crimea, became classified.

⁹ Connolly, *Russia's response to sanctions*, 195.

¹⁰ Daniel P. Ahn and Rodney D. Ludema, "The sword and the shield: the economics of the targeted sanctions," *CESifo Working Papers* No. 7620, April 2019, 4.

An amendment to the Criminal Code was even tabled to introduce penalties for disseminating and disclosing information on sanctioned individuals and entities to the media.

Limited success of import substitution

Despite the government's constant reports on the fulfilled targets and implemented projects, overall, the progress on import substitution has been a partial success. Russian energy majors, defence companies and banking institutions managed to slightly reduce dependence on the West. While self-sufficiency for low-tech products and technology improved, the substitution of high-tech goods and advanced equipment largely failed. For years, the scientific-technological base remained chronically underfunded, leading to a glaring lag in innovative developments between Russian R&D and their foreign counterparts. Restrictions on technology transfer did not, however, foster Russian companies to invest in their in-house R&D – in 2015 only 9% of Russian energy companies were prepared to do so.¹¹ High domestic production costs combined with poor quality disincentivized the companies to do so. Outlined in a Soviet style, the programme's timeline was overly optimistic, leading to many unfulfilled or postponed targets. For example, in the defence industry the plan envisioned to replace 90% of foreign components by 2019. In 2015, however, roughly a half of the imported items from Ukraine and NATO countries were substituted, triggering the postponement of the final deadline to 2025.

The low quality of homegrown analogues put the breaks on the production capacities. It resulted in project delays and technical adjustments, as Russian analogues often did not fully match companies' technological requirements. For example, Novatek limited the operational capacity of its third LNG plant due to the failure to substitute high-powered gas turbines. The lack of domestic capabilities and expertise resulted in the costs for local substitutes ballooning, putting additional strain on the state budget. Zvezda Shipyard was awarded the contract for the construction of Novatek's Arctic fleet, with the estimated costs to be 70-80% higher than those ordered abroad.

The protracted progress on import substitution forced the Russian government to adjust its strategy. On the one hand, the re-orientation to non-Western markets was no longer viewed as a short-term plan and the pivot to Asia remained crucial. The replaced analogues from China were of a lower quality than those from Western countries, but they were still favoured over Russian analogues, offering higher performance and better reliability at a lower price. On the other hand, localisation of foreign imports and technology became a quintessential solution to the lingering import substitution. Localisation proved to be an excellent opportunity to supplant advanced equipment while preserving high quality and avoiding sanctions. As Russian subsidiaries were exempted from sanctions, both Western and Asian companies were eager to partake. For example, Rosneft localised the production of drilling wells with Schlumberger, a French-American leading oilfield services firm and the construction of LNG vessels with South Korean Daewoo Shipbuilding & Marine Engineering and Hyundai Heavy Industries. The slow progress of substitution and low quality of domestic analogues compelled the Russian government to relax its protectionist requirements and encouraged Russian majors to lobby foreign participation. Being unable to produce local high-powered gas turbines, Power Machines lobbied laxer requirements for localisation. Gazprom Neft, Rosnano, Roscosmos, Rostec, Rosatom, Russian Railways and VTB welcomed the localisation of foreign software with SAP, Oracle and other IT leaders in order to overcome 'the problem of imposed import substitution.'

¹¹ Deloitte, Opros rukovoditelei i specialistov neftegazovogo sektora [Expert survey in the oil and gas sector], 2016, <https://www2.deloitte.com/content/dam/Deloitte/ru/Documents/energy-resources/Russian/2016-russian-oil-gas-outlook-survey-ru.pdf>.

In the financial sector, the de-dollarization of the Russian economy showed only partial success too. The dollar-denominated total external debt slightly decreased, while the share of euro, yuan and gold increased in the Russian international reserves.¹² Despite the failure to promote local currencies in bilateral trade with China, the euro gained traction in the payment currency. The established national card payment system managed to alleviate the risks for Russia-based transactions and allowed Visa and MasterCard to preserve their market shares in Crimea. At the same time, the compliance of Russian payment processing companies with US sanctions undermined the independence of Moscow's payment system. It raised serious concerns among Russian officials, increasing pressure on credit agencies to defy sanctions. Alternatives to SWIFT did not find wide support, however, the EU-initiated special purpose vehicles could become a convenient payment system for Russia to avoid the US nexus in the future.

After five years, Russia's import substitution programme has failed to achieve full economic sovereignty. The lack of domestic capabilities, poor inter-sectoral coordination and rent-seeking impaired the programme's progress. Import diversification to non-Western states and localisation of foreign products and technology have incrementally been replacing the efforts to secure self-sufficiency and to develop domestic analogues. Russia's pivot to Asia proved to be instrumental in supplanting Western items and technology. The participation of Asia's private sector was, however, contingent on support from their respective governments. With expanding US sanctions, governments' backing has been crucial for the mitigation of reputational risks and avoidance of sanctions penalties.

¹² Maximilian Hess, "Geopolitics, Sanctions and Russian Sovereign Debt Since the Annexation of Crimea," Russia Political Economy Project (Philadelphia: Foreign Policy Research Institute), 6, 10.