



CHATHAM HOUSE

Chatham House, 10 St James's Square, London SW1Y 4LE  
T: +44 (0)20 7957 5700 E: [contact@chathamhouse.org.uk](mailto:contact@chathamhouse.org.uk)  
F: +44 (0)20 7957 5710 [www.chathamhouse.org.uk](http://www.chathamhouse.org.uk)  
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## Russia and Eurasia Programme Seminar Summary

# Agents of Russia's Modernisation

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## Panel One: Key Challenges to Russia's Modernization

### Julian Cooper

This is not the first time modernization has been on the agenda in post-communist Russia. In 2000 German Gref, Minister for Economic Development produced a 'Strategy for Socio-Economic Development to 2010' which set out key reform proposals. A recent study by the Centre for Strategic Research suggests that ten years on

36 per cent of the Gref Plan has been carried through, mainly in Vladimir Putin's first term as president. During his second term, the pace of reform diminished and state involvement in the economy started to increase. 39 per cent of the recommendations relating to the modernisation of the economy, 39 per cent relating to reform of power, 31 per cent relating to reform of the social sphere were fulfilled. The best results were in reform of the tax system (73 per cent), policy for capital flows (69 per cent), reform of inter-budgetary relations (69 per cent), budget policy (55 per cent) and credit-monetary policy (55 per cent). The worst results related to spheres such as competition conditions (25 per cent), property rights (20 per cent), customs policy (18 per cent), deregulation of the economy (15 per cent), and integration into the world economy (13 per cent).

There have been various formulations of the modernisation challenge by Russia's leadership. Dmitry Medvedev, when first deputy prime minister, declared at the Krasnoyarsk Economic Forum in February 2008 that 'four i's' were key to Russia's economic development: institutions, infrastructure, innovation and investment. He later added a fifth 'i', intellect. In his programmatic 'Russia Forward!' article on 10 September 2009, Medvedev provided the following overview of present-day Russia: 'an inefficient economy, semi-Soviet social sphere, fragile democracy, negative democratic trends and unstable Caucasus'. He presented modernisation as a comprehensive renewal of Russia's economy and society, with a key role to be played by five priority spheres within science and technology: nuclear technology, space technology and communications, medical technology and pharmaceuticals, energy saving and new energy sources, information technology. There was, thus, a dual understanding of modernisation as either an all-round process of renewal, or as a technocratic project, reminiscent of Soviet-style programmes to promote technological progress in selected sectors.

In reality, the technocratic approach has dominated over the socially transformative definition of modernisation. In May 2009 Medvedev created a Presidential Commission for the Modernisation and Technological Development of the Russian Economy. The Commission has met 12 times, chaired by the President with Vladislav Surkov (first deputy head of the Presidential Administration) and Sergei Sobyenin (head of the Government apparatus) as deputy chairs. Other members include Elvira Nabiullina (Minister of Economic Development) and Anatoly Chubais (General Director of Rosnano).

Putin has his own Commission for High Technologies and Innovations, which includes a number of scientists, as well as Sobyenin, Nabiullina, Kudrin and Anatoly Serdyukov, Minister of Defence. Putin's approach to modernisation is even more narrowly technocratic and more in line with the United Russia party, which favours 'conservative modernisation'. The central issue for the ruling party is the maintenance of social stability, although this is clearly a concern of the entire ruling elite.

There are radical modernisers, such as the authors of the Institute for Contemporary Development (INSOR) report 'Russia in the 21<sup>st</sup> Century – image of a desirable tomorrow'. This is a bold vision of a liberal, democratic Russia, at peace with the world and capable of joining the EU and NATO. It may be politically useful for Medvedev to have advocates of a more radical form of modernisation, allowing him to pose as a moderate.

Surkov, Chubais and others have shifted discussion away from modernisation to innovation – the creation and adoption of new products and processes advancing the technological frontier. This is a bigger challenge and it is debatable whether this is what Russia needs at this time.

Experts such as Pekka Sutela of the Bank of Finland and Viktor Polterovich have pointed out that modernisation of the economy does not require, at least in the early years, the creation of new technologies but the application of what is already available, tried and tested. This is the path successfully adopted by China and many other emerging economies. It requires openness to learning from abroad, a welcoming environment for foreign investors and an institutional framework conducive to rapid learning. The resources of this early stage of innovation can then be harnessed to build an effective 'National Innovation System'.

However, Russia lacks a National Innovation System in the sense of a coherent set of inter-related institutions promoting innovation as a natural outcome of their day-to-day functioning. The number of R&D scientists has

fallen from 1.2 million in 1990 to 375,000 today. Many young scientists are now working abroad and many in Russia are approaching retirement. Spending on R&D is just over 1 per cent of GDP. In the Soviet period it was around 2.5 per cent. Three-quarters of all R&D facilities are in the state sector, there is weak provision at company level. The role of higher education in R&D is very modest, making up around 4 per cent of R&D spending. Basic research is still concentrated in the Russian Academy of Sciences. However, the work is far less prestigious than it used to be and the pay relatively low. There is very modest grant provision and research remains highly militarised. Over half of all scientists are employed in the defence industry, which accounts for probably 50-55 per cent of total R&D funding.

The government is seeking to imitate the success of Silicon Valley by building its own innovation town in Skolkovo. A working group has been formed chaired by Vladislav Surkov. The goal is to create a centre devoted to innovation and commercialisation. Projects will be in line with Medvedev's five priorities, to be proposed by Russia's largest private and state companies. The town is expected to employ 35,000-40,000 people, including, it is hoped, many top foreign specialists. The right of residence will be strictly controlled. There will be generous tax breaks, including a complete VAT holiday, the town will have its own administration and special subdivisions of the MVD, migration, tax, customs, patent serve etc. The government has chosen not to base the centre in one of the existing science cities (Zelenograd, Dubna, Obninsk, Novosibirsk, Tomsk), perhaps because the site is easily accessible from Moscow and new elite residential zones.

The Skolkovo project has many critics, and some basic issues remain unresolved. Silicon Valley originated from research initiatives of a world class university – it is not clear where Skolkovo innovations will come from. It is envisaged that there will be substantial budget funding for Skolkovo (110 billion roubles from the federal budget, 2010-15), but, as critics point out, it will not undertake basic research - the aim of its activity is commercialisation, so the rationale for substantial budget support is not clear. There is a lack of clarity about ultimate control of the Skolkovo 'Innograd' – Vekselberg seems to think he is the overall leader, but 'Rosnano'/Chubais and the Ministries of Industry and of Communications also have claims. There is a strong bias towards large companies – SMEs do not appear to have a role. It will take several years to establish the 'Innograd', which will have priority resource allocation - other science cities, innovation zones, research parks, etc fear that they will have second class status.

According to Medvedev and Surkov, Skolkovo will be a model to be reproduced if successful. It is not at all clear that this 'town of the future' will have much impact on modernisation, even narrowly conceived. It will take 5-7 years before it will be fully operational, but for Medvedev it clearly has significant symbolic value. However, it may not achieve positive outcomes unless Medvedev, as President, remains actively involved. For this, of course, he will need a second term.

There are several obstacles to the realisation of modernisation in Russia, whether broadly or narrowly conceived:

- The economy is highly dependent on resource extraction and export. The global financial crisis alerted the country's leadership to the depth of the problem but there is now an awareness that recovery of the global economy could reduce the urgency of change and make modernisation less likely. Medvedev said in May 2010: "To speak frankly, \$140 per barrel (for oil) – this is a catastrophe for Russia, this destroys all stimuli to development."
- The poor state of Russia's research system and the very low level of innovative activity in industry, in part because of the structure of the economy and the very low level of competition.
- The institutional underdevelopment of the Russian economy, including a still weak domestic capital market, poor protection of property rights (including intellectual property), a seriously underdeveloped small business sector, and ineffective and corrupt public administration. Medvedev seems to understand this, but it will take time for the modest measures so far adopted to take effect.
- The nature of the institutions of power – lack of political competition; limited, if not absent, division of powers; ineffective legal system, subservience to power at all levels; weak and 'managed' civil society; limited media freedom. These conditions have generated an all-pervasive lack of trust – potentially fatal to any meaningful innovation and modernisation.

Another major obstacle is the predominant understanding of the relationship between economic and political change amongst the political elite, which sees economic development as pre-eminent, and not contingent on political reform.

In the media there has been considerable scepticism about the prospects for genuine modernisation, which has increased as the Skolkovo project has been promoted. There is profound scepticism about the value of injecting public money into modernisation projects, with 30 per cent of people believing it will have little effect, 9 per cent believing it will be completely ineffective, and 23 per cent confident the money will simply be stolen.

There are also economic constraints to modernisation. The optimistic 2020 socio-economic scenario approved by Putin just before the crisis in 2008, has not been amended. The growth forecast it set out of 6.5 per cent per year (2008-2020), with investment rising from 19 per cent of GDP in 2007 to 30 per cent by 2020 is not feasible. The global financial crisis will have an impact on future growth prospects and the state of the federal budget, with the budgetary situation made worse by a rapidly growing pension burden and a larger-than-previously-envisaged commitment to spending on defence and security. A growth rate of 4-5 per cent is now more likely.

The financial crisis and the events of August 2008 have confirmed the urgent necessity of modernization, but will make implementation difficult. The vested interests in the existing order are so strong that comprehensive modernisation is unlikely. However, piecemeal, 'enclave', technological modernisation is possible, although it is not easy to identify actors strong enough to secure its realisation. The deep underlying problems of Russia's economy, society and polity will remain. Genuine modernisation will remain a task for a future leadership.

### **Philip Hanson**

There are serious obstacles to any near-term modernization in the sense of Russia becoming a net exporter of high-tec products. First, the business environment is not favourable. Second, scientific research and development in Russia is fundamentally in a poor state. This was highlighted recently by a letter signed by leading expatriate scientists, who described the state of science in Russia as catastrophic. Third, there is the problem of product space. Countries historically diversify by moving gradually from production of one set of goods to those requiring similar skill-sets and technology. Russia is at a disadvantage here, because in terms of product proximity, the centre of gravity of Russian industry is a long way from high-tec industries. The oil and

gas sector does not demand a great deal of advanced technology and is not a good driver of innovation.

In a recent article, Clifford Gaddy and Barry Ickes argue that Russia may perform better by not trying to diversify. Russia has done very well from exporting metals and hydrocarbons, and if it had diversified sooner, it might now be poorer as a result. They argue that the resource curse will not necessarily befall a country if the right institutions exist to manage the economy. The real problem is not structural dependence on oil and gas per se, but addiction to rents from these industries which support unprofitable dinosaur enterprises. This creates waste in the economy. The notion of rents includes excessive costs in the production of oil and gas, caused by industrial inefficiencies as well as corruption, price subsidies to support domestic producers and informal and formal taxes. They conclude by arguing that Russia should focus on overcoming its addiction to these rents, rather than trying to transform the structure of the economy, since future oil and gas prices are expected to be high.

However, there are problems with this analysis. The extent to which rents from oil and gas support value-subtracting business is overplayed. In addition, low domestic energy prices are shared by all, not just old Soviet enterprises. If one looks at 2008, oil and gas revenues amounted to 6 per cent of GDP, but just 1.8 per cent of expenditure (through price subsidies etc). Thus, a large proportion of oil and gas rents are going to other things.

There are clear advantages to encouraging foreign investment in the oil and gas sector. If Russia limits FDI, the risk of low oil prices falls on Russia. If prices are high and foreign investment is high, output will be greater, so even if profits are shared they will be cut from a bigger pie.

Even if Gaddy and Ickes are right regarding modernization, ultimately the same policy advice follows. Successful management of a resource-based economy requires strong institutions – to protect foreign investment, to encourage long-term development of new fields, and to reduce corruption. Equally, any modernization or diversification agenda will require robust institutions to encourage enterprises in new sectors.

### **Alena Ledeneva**

The first presentation identified two different definitions of modernization – a politically and socially transformative modernisation, and a more narrowly understood technocratic-scientific modernisation. The gap between these two

definitions is large, and it is in the grey area between the two that we have to look at the capacity for development. Modernization can be understood technically, as the ability to produce knowledge-intensive goods. This is a teleological interpretation, whose endpoint is linked to a desire to synchronize with the West. The desire to imitate, or leap ahead of Western models has driven modernization projects in the past, and we can see elements of it again here.

However, modernization is not linear. The study of informal practices reveals that what is happening at the margins of institutions is more important. It should be asked also in what sense is Russia pre-modern? It is hard to see it when you walk around Moscow. Viktor Pelevin in *P5: Farewell songs of the political pygmies of Pindostan* suggests modernity will have come to Russia when the trains run to time, businessmen don't take their money to London, the traffic police live on their salaries alone and bureaucrats don't take kick-backs. Modernization is the set of policies which could close the gap between how Russia is and should be, that would bring together formal and informal practices. Medvedev has begun this by looking at the judicial system and addressing the problem of telephone justice.

Ultimately, however, modernization has to be looked at from a bottom-up perspective, because that is where things are really happening, and the capacity to change working practices really exists.

### Questions and Discussion

In response to a question about the likelihood of Russia joining the WTO, it was argued by one speaker that the business elite are committed to accession. The banking sector was initially sceptical but has come round. Medvedev is also in favour. The main obstacle is Putin. He wants to protect various industries, such as car production, which is why the Customs Union with Kazakhstan and Belarus was seen as attractive. We can see the hand of Sergei Glazyev in the creation of the Customs Union. He was never in favour of WTO and now sits on the Custom Union's commission. He produced a report using very primitive analysis which overstated the benefits of the Customs Union for Russia. However, the Customs Union doesn't really exist and seems to have run into a wall. If Russia wants to join the WTO, it can do so pretty quickly. All the major powers are keen. The problem lies in Moscow.



Another speaker said he had a certain sympathy for Putin's position on the WTO. Russia's accession negotiations have run longer than for any other country. There are still outstanding disputes on intellectual property rights, which are partly due to China. China was admitted on the understanding that it would tighten up control in this area and failed to do so. As a result, countries are now more wary of admitting Russia without tougher intellectual property rights law being enforced.

One participant asked how the consensus amongst the speakers that top-down modernization could not succeed squared with the Asian/China experience. It was argued that what happened in China has given confidence to Vladislav Surkov that reforms can be delayed. However, it is much easier to modernize from a low base than a higher one. There are important differences. China is keen to learn from abroad and import new technology. Much Russian industry is focused on the defence sector and is security obsessed. In the case of Singapore, the state is authoritarian, but it is not corrupt. Another speaker argued that corruption operates in different ways in China and Russia. In the former, it is much easier to predict the forms it will take. *Guanxi* is much more ritualized than the informal practices in Russia, which are individualistic, opportunistic and less predictable. Businesses therefore find it easier to work within the Chinese system.

What is the role of the outside world in modernization? A programmatic document written by the Ministry of Foreign affairs which was "leaked" to Russian *Newsweek* called for increased technical and academic exchange between Russia and the EU. This should be encouraged, but the EU has to try to go beyond this, it was argued. In all negotiations between the EU and Russia, the EU starts with a wide agenda and then allows Russia to whittle the items down to technical agreements. The EU needs to resist this. Another speaker argued that there are medium-term project links between the EU and Russia which make a lot of sense. The Sukhoi jet is an example of a successful joint venture with European countries, and almost all the innards of the plane come from the EU. Russian business has an interest in improving ties with EU states. Vekselberg also has business interests in Sweden.

One participant argued that one of the dangers of the modernization agenda was that it could lead to social unrest. Innovation and efficiency improvements imply that few workers will be needed. Concerns about unemployment are one of the factors holding back the modernization agenda in government. Both Putin and Medvedev believe redundancies are impermissible; they are very concerned about social stability. Another problem is that modernization is best done on a local level, through the devolution of responsibility. But the

government believes it can only drive such an initiative from the centre, which is ineffective.

Another expert argued that the employment issue is a temporary one. As the Russian economy picks up the issue of redundancies will become less serious. Indeed, there will be a need for labour-saving innovation.

It was argued that resource-dependence and modernization are not mutually exclusive. In the oil and gas sectors, cost competitiveness is a big issue. At present, oil and gas fields in the Russian Far East are only viable because of tax holidays. The industry has a long way to go to increase efficiency. FDI and innovation are required to reduce costs, even within a rent economy. Vested interests coincide with 'national' interests in this area, since Putin and Gendady Timchenko, through their involvement in Novatek, have a great deal to gain from deregulation.

One expert pointed out that during Chubais' presentation to Medvedev on innovation he argued that the low demand for research and development in Russia is due to the nature of the oil and gas industry – there is no great demand for innovation here. However, another participant pointed out that Russia could benefit greatly from modernizing the industry to allow it to move up the value chain in the resource sector. One example is titanium. The processing of titanium is a very knowledge-intensive, industry which is not done in Russia but could be. It is odd that there is not more discussion of this. Likewise, Russia mainly exports crude oil, when it could also process it and sell higher end products.

### **Andrei Yakovlev**

The research of the Higher School of Economics (HSE) on Russia's agents of modernisation is based on the comparison of two surveys of over 1000 Russian firms across eight sectors conducted in 2005 and 2009.

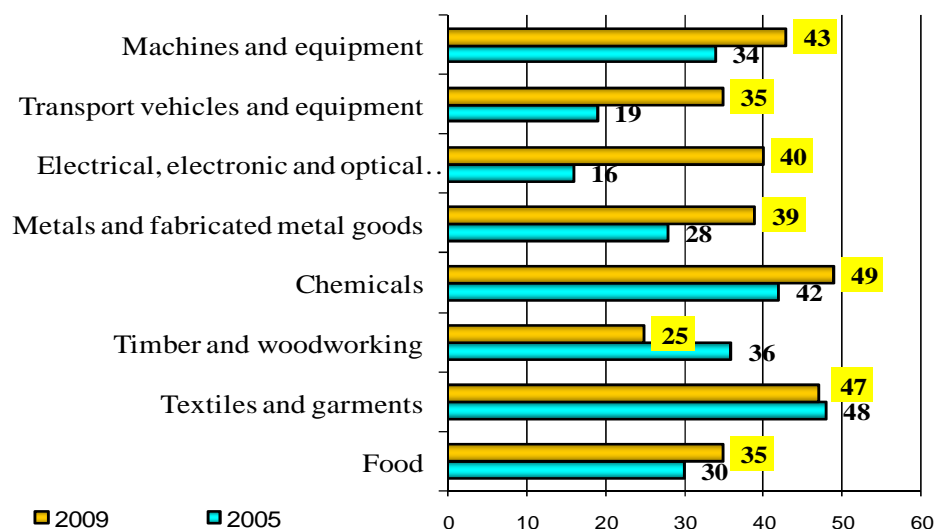
There are some well established stereotypes about the nature of Russian business and the key actors within it. It is assumed in the West that the principal possible agents of modernisation are firstly, oligarchs dominating the resource sectors of oil, gas and metal extraction – people like Abramovich, Vekselberg, Potanin, Deripaska and Mordashev – and, secondly, *de novo* firms in IT and retail run by people like Karachinsky and Khasis. Traditional (ex-Soviet) manufacturing is seen as outdated, inefficient and resistant to modernisation. To some extent, this is true; the average level of productivity of Russian manufacturing lags behind that of other countries. In 2005

productivity was three times lower than South Africa, two times lower than Poland and 1.5 times lower than Brazil. However, the HSE survey in 2005 indicated that there are very strong differences between the best and the worst performing firms in the same sectors. In the chemicals industry, for example, the top 20 per cent of firms are ten times more productive than the bottom 20 per cent.

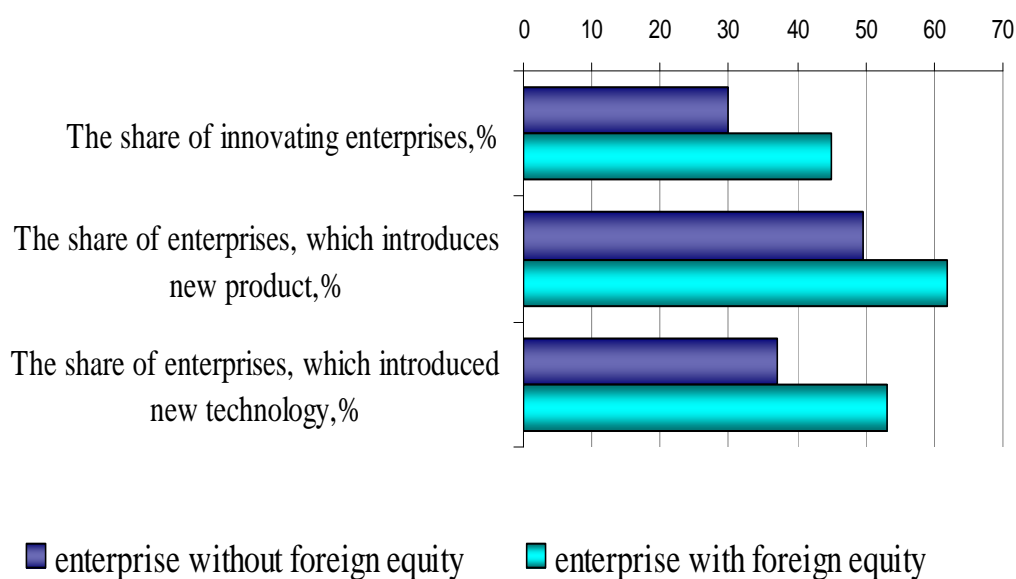
What is clear from the surveys is that the Russian economy is far from homogenous. There are “zombie” companies which add no value, and there are also competitive firms with global ambitions. One example which challenges the assumptions is UralChimPlast. This is an old enterprise, founded in 1938, producing oil for industrial consumers. The CEO is what would classically be viewed as a ‘red director’, having been at the company since 1968. Despite this, since the mid-nineties the management has sought to upgrade the enterprise, bringing in outside participation from Austria. Before the financial crisis, investments of approximately half a billion roubles were being made in the business yearly, allowing the company to successfully weather the crisis and increase productivity in 2009 by 40 per cent. The company has plans for an IPO which were postponed in 2008, but not cancelled. This is an example of a company which has undertaken real modernization under old ownership, driven by competitive pressures.

Looking at the macro level, the level of foreign investment in the manufacturing firms surveyed increased three times between 2005 and 2009. In 2005, \$6 billion was invested. In 2008 this had risen to \$18.6 billion. The number of firms with foreign participation also increased substantially, particularly in sectors relating to chemicals, metals and fabrics, electrical and electronic equipment, transport vehicles and equipment. The share of firms facing significant competition from Russia-based foreign producers between 2005 and 2009 increased substantially too, as the graph below shows:

**Share of firms facing significant competition from Russia-based foreign producers in 2005 and 2009**



In the sample, the number of firms exporting their products increased between 2005 and 2009 from 29 per cent to 55 per cent; however, the majority of this was focused on CIS markets (75 per cent). The group of big exporters increased significantly. Amongst companies with foreign capital, the number of exporters is much higher (70-75 per cent). These firms also show a higher volume and better regional structure of exports (39 per cent to the 'far abroad', 61 per cent to CIS). Firms with foreign participation are more likely to be innovating enterprises, to introduce new products and use new technology, as the graph below shows. However, Russian firms without foreign investment are also innovating and adopting new technology. Given the general investment climate, it is clear that many firms are making an effort to modernize and innovate, though it may take time to change structures of companies.



Even during the financial crisis, Russian firms were trying to adopt a more strategic approach and lengthen their planning horizons. The HSE concludes that there are significant changes in firms' behaviour in the manufacturing sector. Advanced firms and their owners are thinking about the future. They are seeking to improve the quality of management attracting foreign investment and aiming to move into global markets. Since the turn of the century, Russian enterprises have faced competitive pressures from the global market which have forced companies to increase efficiency. However, this is not an easy task. The grass is growing under asphalt. The Business Environment and Enterprise Performance Survey (BEEPS) conducted by the EBRD and World Bank shows that between 2005 and 2009 the business climate has worsened in almost all areas.

### Alexander Landia

Turning from the macro analysis of the state of Russian industry and prospects for modernisation, this speaker provided a view of how one successful Russian company, the Siberian Coal Energy Company (SUEK), approaches modernisation.

When SUEK was formed, the coal industry was in terrible shape. The miners were on strike, there were familiar scenes from the eighties and early nineties of coal workers outside the mines banging their hardhats against on the ground. Wages were not paid and the company was not profitable. SUEK turned the fortunes of the company round, it managed to achieve

modernization. Of course, modernization does in part involve streamlining. 10,000 people were made redundant. This took place without demonstrations or strikes because it was conducted in a socially acceptable manner.

For business leaders, the modernity debate, when it becomes a political slogan, can be distracting. Modernisation is about creating an environment in which people can enjoy the benefits of modernity, have jobs which use modern machinery, which allow you to be creative and free in your actions. SUEK is, in this respect, a strong agent of modernization. The company brought together a mix of assets and developed it into one of the largest coal companies in Europe. The biggest challenge to modernization is in the minds of people. Modernisation depends on people's ability, and willingness to plan forward. It was only in 2005 that the company was in a position to formulate a five-year investment plan. This was a big turning point. The company had to alter how people think about the enterprise and how they relate to it. It involved sending people abroad to learn new skills and develop an understanding of new technology. The broad political debate on innovation and modernization seems remote from the reality of the day-to-day and even longer-term challenges which an individual business faces. The broader question of innovation is not a question of intellectual capacity but capital location. Boeing designs most of its software in Russia, for example.

On the micro-level, modernization does not presuppose huge technological leaps or innovation. SUEK, for example, has developed a GPS location system which is embedded in a miner's helmet, so that the dispatcher knows where all the miners are at any time. This did not require any technological breakthrough; the technology has existed for some time. It was about deploying the technology in new ways, and to our knowledge no one else does this. The Ipad and Ipad are symbols of innovation, but the technology they use is not innovative. What is new is the application and the marketing which makes it so desirable. At Russia's stage of development, major technological breakthroughs are not needed. If Russian companies are allowed to make decisions in a commercial environment, in response to open competition, they will provide the engine for modernization. Thus, the big debate over whether a resource-based economy can modernize is misplaced. The oil and gas industries are not a brake on modernization- they are themselves modernizing industries.

If they are allowed to, market forces will do most of the work of modernizing Russian business. Currently, the price of electricity is so low that innovation is not stimulated. There will be no push for modernization whilst a domestic consumer pays only \$5 per month for electricity. There will be no stimulus to

invest in new, more efficient machinery or heating. SUEK has long pushed for an increase in electricity prices, but we felt isolated because foreign investors did not support these calls. Thus, foreign investment is not a panacea which necessarily brings innovation. Foreign investors have their own specific interests, which may be short term and not orientated towards long-term development. The key is to create market conditions to encourage business to do what it does best – compete, and use all possible means to compete.

### **Stanislav Shekshnia**

Business is not interested in the debate on modernization, or what kind of path Russia should take. Business is concerned with very specific questions, such as the price of electricity, and the mechanisms and decisions which drive this.

The impression one has is that the current modernization drive is like Brezhnev's food drive, or Gorbachev's housing campaign. In other words, a grand, top-down initiative which will flounder like those before it. However, this does not mean that business can't take advantage of the current modernization debate to lobby on specific issues.

There is a paradox: Russian business is both a major block and the major driving force of modernization. Some Russian businessmen are very ambivalent about the modernization agenda. Oleg Deripaska has no interest in the situation changing, or the strengthening of open market conditions. He wants electricity prices to remain low. His factories are an interesting case of non-modernisation. They have a big problem recruiting people to operate certain pieces of machinery, because some weigh in excess of 35 kilograms. There are not many people who can handle such heavy equipment properly. This machinery was developed at the start of the twentieth century and could be updated, but the current system protects Deripaska from competition. As a result he uses outmoded technology but still enjoys huge profits. All businessmen have a choice – one can invest profits in new technologies, in expansion or modernization, or you can put the money in your pocket. Russian businesses, on average, invest 12-18 per cent of profits; in China, this figure is 40 per cent. A lack of transparency in the business climate allows companies to maintain uncompetitive practices and discourages long-term investment.

However, Russian business people are also the major driving force behind modernization. In the 1980s, Gorbachev supported a campaign to install fixed lines in all residences. Yet at the end of the decade fixed-line penetration was only 25 per cent. There are now 200 million SIM cards in Russia, for a population of 140 million. The telecommunication problem was solved by private business. The investment banking and insurance industries in Russia are advanced. People have managed to create successful business in this area because there was a total vacuum. The state was absent and they were free to create a new sector.

Innovation is a way of life for business. If you don't innovate, you don't survive. Russian business is innovative. But we need to consider what we mean by innovation, and therefore modernization. 95 per cent of successful start-ups don't innovate, they redesign a pre-existing service to run more efficiently. In that respect, the potential for modernization in Russia is immense. As Mikhail Fridman of Alfa Bank has observed, we don't need to worry about the next twenty years – we just need to look abroad and bring it all to Russia.

Modernisation needs leaders. Russian business is taking the development of human capital seriously. Higher Education has collapsed in Russia, but business has recognized this and is developing future leaders itself. INSEAD runs a management programme with TNK-BP, for example. SUEK also supports a university. The aim of these and other initiatives is to create a modern way of thinking. The graduates of these courses will become the agents of modernization.

### **Questions and Discussion**

One participant argued that it was clear from the presentations that the major challenge to modernization was not technological development but the legal and economic system in which business operates. How, then, do firms operate in a non-transparent system, where the rule of law is uncertain?

In response, one of the speakers conceded that it is not easy to conduct business in Russia. It is clearly an advantage to be a big company. One of the major areas of vulnerability is tax payments. This is why SUEK voluntarily goes to the Supreme Court every year in order to agree its tax bill, even if no legal case is raised against it by the state. After this, they consider the matter closed and the tax bill has never been subsequently challenged by the authorities. The speaker argued that the regulators in Russia are willing to engage with business and listen to suggestions. Big companies get access



and can engage in debate on issues such as labour law, tax and legal regimes. Companies are able to point out to the government that if it wants low cost electricity, there is a price to be paid in terms of efficiency. This does not mean political decisions will also go the right way, but there is certainly an openness to debate these issues.

Another speaker argued that it was a positive thing that the business environment was tough, because if you are successful, the returns are huge. TNK-BP is just one example; the joint-venture has been very profitable for BP. It was argued that foreign companies often do not approach Russia in the right way. They start off by jumping into business, and only later reflect on what they're doing and how. Before moving into Russia, one needs to think carefully about a number of issues, in particular, corruption. You need to listen to experts; start small, limit your exposure, and slowly increase your presence. You need expatriate staff who are willing to stay in-country longer than is the norm. You need to get local people involved. And, importantly, you need to get your ethical position clear and stick to it. However, it was pointed out that the issue of corruption is a complex one. It is often discussed by experts, but if you ask most business leaders, with the exception of mid-sized service industries, corruption comes only eighth or ninth in their list of concerns. This is because established firms already know how to deal with regional and central elites.

One analyst, asked about the factors which determined why some companies innovate more than others. The speaker argued that in general, those with a consolidated structure were most efficient. However, some firms were compact but inefficient. In these cases, the problem is industrial poverty. The enterprise, typically, is the dominant business in its sector in a small town, and because the logistics are poor there is no stimulus for competitors to move in and drive up efficiency. The government thus needs to give incentives to companies to move into depressed regions and increase the level of competition.

One participant asked what constraint, if at all, the availability of finance was to business in Russia. A speaker argued that there is a problem that certain companies enjoy a privileged position because they have access to the bond market. Again, it helps to be a large company. Smaller enterprises find it much harder to raise capital. Another speaker pointed out that the problem that old Soviet banks, such as Sberbank, are still dominant.

One analyst asked why Russian companies export so little. It was argued that Russian companies are interested in developing some level of export as a

mark of competitiveness. They can be particularly keen to export abroad, as competition starts to increase at home and margins are squeezed.

Responding to a question about disinvestment and capital flight, the speaker from SUEK argued that investment is a question of capital allocation. SUEK currently invests a large amount of money every year in its business because it has identified projects worth developing. If they did not exist, that money would be paid out as a dividend. The key issue is thus to create opportunities in which investment projects look attractive. Whether a top-down, state-led approach is helpful or harmful in this context is irrelevant. Another speaker said that the state is trying to push processes in the business sector, when it would be more rational to concentrate on reforms in the state's natural domain – social care, education, road building etc.

Asked about concerns that reform of business would lead to large redundancies, it was argued that this is highly exaggerated. The paranoia of the ruling elite is often over-stated. In reality, changing jobs is part of the process of modernization –reskilling and reforming