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## The Promise and Peril of Russia's Resurgent State

RUSSIAN PRIME MINISTER VLADIMIR PUTIN, RIGHT, AND GAZPROM CEO ALEXEY MILLER, DURING A VISIT TO GAZPROM'S MAIN CONTROL ROOM IN MOSCOW.

The Putin-led government has rescued capitalism, but the biggest threat to business is the Kremlin's renewed appetite for centralization. *by Rawi Abdelal*

In Saint Petersburg's Senate Square stands a statue of Peter the Great, facing west. On a huge piece of red granite carved into the shape of a cliff, the Russian czar rides a horse whose hind legs are trampling a snake, representing the opponents of Peter's reforms and his enemies. More than 200 years after it was unveiled, the *Bronze Horseman* aptly symbolizes the challenges facing Russia and another reformer leader, Vladimir Putin.

After Putin became Russia's president in 2000, Goldman Sachs predicted that

Brazil, Russia, India, and China would soon be among the world's most important economies and coined the term BRIC. However, Russia's economic growth, which averaged a healthy 7% from 1998 to 2007, has been undermined by the global economic crisis. Russia's economy was projected to contract by 6.8% in 2009, according to the OECD, and Brazil's by 0.8%, while India's and China's were projected to grow by 5.9% and 7.7%, respectively, despite the global recession.

Is Russia in danger of falling out of the BRIC grouping? Would companies be better

off entering other emerging markets, particularly given the complexities of doing business in Russia? How do companies craft successful Russia strategies?

I have been studying Russia's politics and economics for more than 15 years. Over the past 10 years, during which time Putin has led the country as president or premier, he has strengthened Russia's nascent capitalist economy and institutions. However, in the process, he has stoked the Kremlin's apparently infinite appetite for power. That, I believe, represents a growing threat, not only to Russia's development but also to companies that wish to do business there. Instead of looking solely at growth rates, CEOs should come to grips with Russia's still-evolving capitalism, particularly the tensions between the state and business, to craft an effective Russia strategy. In the following pages, I will explain why that's critical and use three cases to illustrate the central role the Russian state plays in business.

### Russia's Lure

Russia isn't a falling economic power, as it was during the early 1990s, but it isn't rising in the same way that Brazil, China, and India are. That's because, unlike its peer group, the country is—unhappily—dependent on exports of commodities such as oil and natural gas, whose prices are volatile. For instance, between 2007 and 2009, oil prices fluctuated wildly, from a high of \$132.55 a barrel in July 2008 to a low of \$41.53 a barrel in December 2008, before climbing above \$70 in October 2009. Russia took advantage of the high prices to bolster its finances, but its growth rate has tumbled recently, as stated earlier. Energy prices will continue to be volatile in the future, as will Russia's growth.

Provided that the world economy starts growing again in 2010, however, Russia

may not have much to worry about externally. Oil prices could increase to stabilize at well over \$80, and the rising tide of petrodollars should lift the economy. Energy companies—particularly those based in Europe, where imports of Russian gas will surely surge for several decades—have no choice but to invest in Russia. Capital inflows, which reached \$80 billion in 2008 (a quarter came from foreign investment; loans and portfolio investments made up the rest), will pick up.

The Russian nouveaux riches will again devour Western luxury products, and, as employment rises, companies catering to the middle class will find millions of ardent consumers with an average income of around \$16,000 (adjusted for local purchasing power). Russia's infrastructure needs modernization, so government spending has risen in recent years; and for political reasons, it won't be cut anytime soon. There's a great deal of money to be made in Russia as the economy recovers slowly but perhaps more quickly than the U.S. economy.

### The Past as Prelude

This scenario may tempt companies to rush into Russia. But CEOs who don't fully comprehend how capitalism took root in the country in the 1990s are unlikely to succeed.

Russia was home to the two grandest social experiments of the twentieth century. The first, creating a socialist state, began in 1917 and had failed by December 1991. The second, Russia's initial attempt to develop a capitalist democracy, was similarly disastrous. Between 1991 and 1999, output in Russia tumbled by nearly 50%. Deindustrialization intensified the nation's dependence on exports of oil and natural gas, which traded at ruinously low prices for much of the 1990s. The central govern-

ment was unable to perform such basic functions as protecting property, enforcing laws and contracts, maintaining monetary order, collecting taxes, and providing public goods. Regional authorities kept the taxes they collected and introduced local currencies when it suited them.

Privatization, particularly of Russia's oil, gas, and mineral resources, was a corrupt fiasco that created a small group of wildly rich and influential individuals. These oligarchs were clever businesspeople who took advantage of the weak state and lived above the laws they paid the politicians to write. Without effective laws and courts, companies resolved disputes by turning to what Russian sociologist Vadim Volkov calls "violent entrepreneurial agencies," or private legal enforcers. More than half the population fell below the poverty line. In August 1998, the downward spiral culminated in the Russian government's defaulting on its domestic debt, devaluing the ruble, and imposing a moratorium on the repayment of foreign private debt. By that time, Russians associated democracy and capitalism with deprivation. Who could blame them for wondering if the new political and economic structures would ever create prosperity?

For Russia's political elite, the experience was humiliating, and it left a deep scar. When Putin won the presidential contest in March 2000, the previous decade of anguish had left him in no doubt that Russia's problems stemmed from the state's weakness. The government's ability to perform its duties had to be strengthened to kick-start economic development. He had lamented a few months earlier in an open letter: "You are not sure of the stability of your business because you can't rely on the force of law or the honesty of the officials. So you are dissatisfied with the services offered by the state and you refuse to pay all the taxes due. What's more, you can live pretty comfortably while doing this. The state fails to get sufficient revenues to keep an impartial judicial system, it pays small salaries to its officials, and they take bribes. The result is a vicious circle."

There is money to be made in Russia, as long as companies play by the rules imposed during Putin's tenure as president.

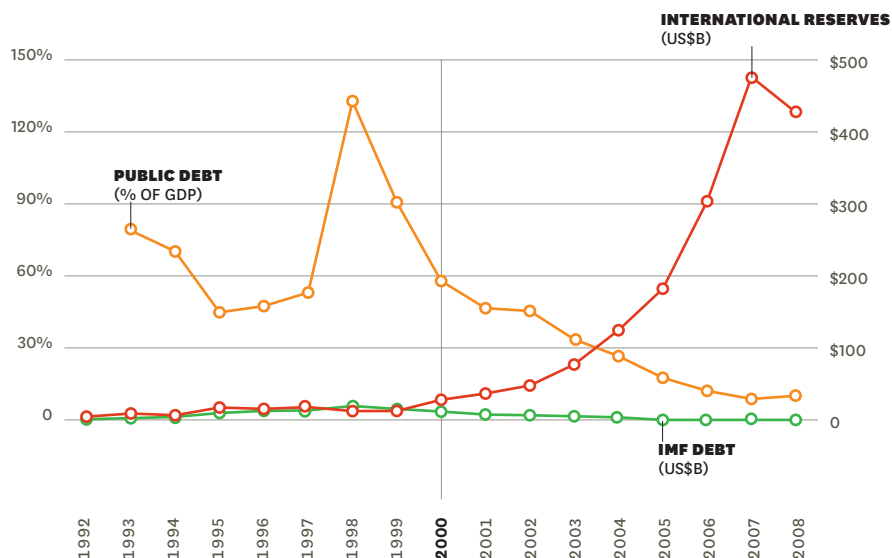
## Stronger, but Hurt by the Recession

Yet Putin's focus on rebuilding state power didn't mean he wanted to stop developing a market system or integrating Russia into the global economy. He wanted to strengthen the state to ensure that capitalism took root in Russia. In his eight years as president, Putin did everything he could to reinforce the Kremlin's power. He filled the administration with people he trusted from his days in the KGB and Saint Petersburg's city government, and he instituted policies that increased the power of the center at the expense of the provinces.

Putin recast the state's relationship with the oligarchs, forcing some, such as Boris Berezovsky, into self-imposed exile and sending others, notably Mikhail Khodorkovsky, to prison. Other oligarchs quickly learned to play by Putin's three rules: Do not get involved in politics; do not buy politicians; and pay your taxes. Putin created a government that would work without the oligarchs' meddling, but he didn't outlaw the rich or condemn the desire to make money. While the state did gain control of some companies in strategic industries, such as energy and defense—Gazprom acquired Sibneft from Roman Abramovich, albeit for a hefty price; and after a bitter legal battle, Rosneft annexed the oil-production units of Khodorkovsky's Yukos—fears of an all-out campaign against big business proved to be unfounded.

Throughout his two terms, Putin was helped by rising commodity prices worldwide, which fueled rapid growth and generated budget surpluses. Tax collections improved after the reforms of 2002, which reduced and simplified taxpayers' obligations. The government followed conservative fiscal policies and, from 2004, channeled some of the profits from energy exports into a stabilization fund that could be used to prop up its finances if prices suddenly fell. There's a remarkable contrast between the ways the Russian state tackled the crises of 1998 and 2008. When the recent financial crisis erupted, the government used the stabilization fund to prevent a sharp depreciation of the ruble; launched a \$200 billion fiscal stimulus package to

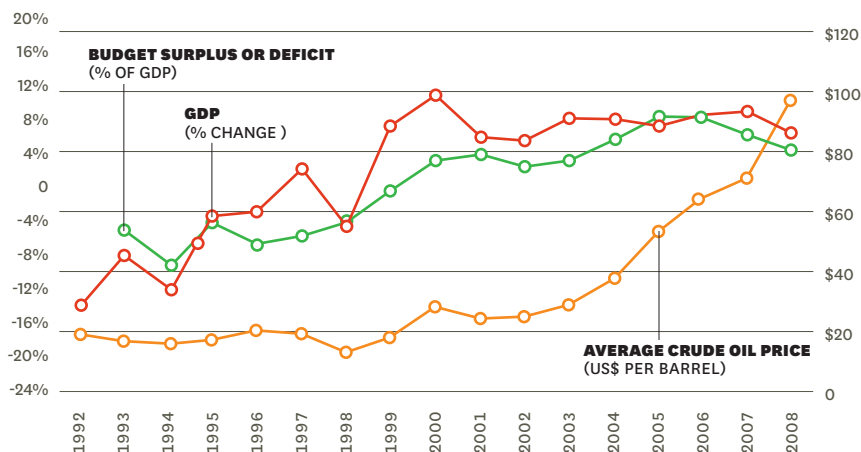
Since Putin came to power in 2000, Russia has amassed significant foreign exchange reserves and pared down its debts. Although the Russian economy has felt the impact of the recent global recession, it is performing better than it was a decade ago.



SOURCE ROSSTAT, IMF, WORLD BANK

## A Richer State

High oil prices have helped propel economic growth in Russia, but more important has been the combination of levying taxes on the profits of energy companies and improving tax administration. The resultant fiscal surpluses are an indicator of the state's growing strength.



SOURCE ROSSTAT, IMF, WORLD BANK

## Rising and Slipping with Oil

Russia is largely dependent on exports of commodities such as oil and natural gas, whose prices are volatile. From 2007 to 2009, for instance, oil prices fluctuated wildly, from a high of US\$132.55 a barrel to a low of \$41.53.



SOURCE IMF

counter the recession and unemployment; injected liquidity into the banking system through public sector banks; and bailed out some key companies. (Sound familiar?) None of this was possible in 1998 because the state, which was then drowning in debt, had no savings, no budget surpluses, and no capacity to raise revenues. The current crisis has been dislocating, but its impact has been mitigated by eight years of prudent macroeconomic management by Moscow.

The government's everyday functioning has improved, too. Some of that is because of its fiscal health. Public officials who receive regular paychecks may still succumb to temptation, but those who don't get paid at all have little choice but to be corrupt. Corruption continues to be a major problem, but the kind that prevails today is more tractable than the practices in the wild days of the 1990s. Putin's handpicked successor, president Dmitry Medvedev, has repeatedly said that tackling corruption is his top priority, and he is trying to establish legal authorities to combat extortion. Medvedev has often said, "Corruption must not simply be illegal. It must also be indecent." His goal is to change social attitudes, which will take persistence and patience.

### Doing Business in Russia

As the Russian state has become more powerful, greater clarity has slowly emerged for both domestic and multinational companies that want to operate in the country. There's no longer any doubt about who is in charge or what the state wants. There is money to be made in Russia, as long as companies play

Russia is just as promising a bet as the other members of BRIC; it is no more corrupt, violent, or prone to institutional upheaval.

by the rules imposed during Putin's tenure as president. Consider the examples of three multinationals that adopted very different approaches to enter the energy sector and met with varying degrees of success. In each case, the Russian government helped decide the company's fate.

**Shell loses.** In the 1990s, Royal Dutch Shell wanted to build and operate a mammoth oil and gas project, Sakhalin II, on Sakhalin Island. A Shell-led consortium of four foreign companies floated the Sakhalin Energy Investment Company (SEIC) in 1994 and signed a production-sharing agreement with the Russian government that would allow Shell and its partners to recover their investment in the project before the Russian government accrued significant financial benefits. Shell's interests and those of the Russian state were aligned at the time for two reasons: One, political and economic decision-making was decentralized, so Shell worked to gain the unqualified support of local authorities. Two, Russia needed investments by foreign companies because oil and gas were inexpensive then.

However, after Putin became president, he decried the "colonial method of exploiting Russian resources" and was determined

to wrest more power for state-owned companies. That shifted the ground underneath Shell's feet. By 2004, Sakhalin II stood out like a Fabergé egg because Shell had no Russian partner in the project. Realizing that, the multinational negotiated an alliance with the state-controlled gas monopoly, Gazprom, but it resisted giving the Russian company control. In June 2005, after protracted negotiations, Shell agreed to bring Gazprom into the project with a minority stake. Those negotiations were based on Shell's insistence that the project would come in on budget.

A week or so later, Shell announced that the cost of developing Sakhalin II would double to \$20 billion. The central premise of the negotiation with Gazprom was therefore flawed. Shell's negotiators either did not know about or decided not to disclose the cost overruns. Gazprom was furious, and the Russian government was not amused. The state struck back: Officials soon announced that SEIC had caused \$50 billion worth of ecological damage and that it would have to make amends. The claim put Shell on the defensive; Sakhalin II languished; and eventually, the multinational caved to the state's implicit wishes. In December 2006, Gazprom acquired

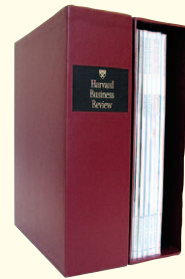
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the majority stake. It compensated Shell fairly, but Gazprom now leads all phases of Sakhalin II's development—as the Kremlin desired.

**BP gets even.** BP entered Russia in 1992 by investing \$500 million to buy a 10% equity stake in a privately owned Russian oil company, Sidanco. It then watched helplessly as a rival, TNK, manipulated the bankruptcy courts to seize several of Sidanco's prized assets. After years of complaining to Russian authorities, courts, and the press, BP finally announced in 2003 that it would invest \$6.15 billion for a 50% stake in a new oil company in Russia, TNK-BP. Although it isn't clear how that happened, it's possible that the state had decided that Russian companies shouldn't interfere with foreign corporations and ended the embarrassing squabble by forcing TNK into an alliance with BP.

**Enel makes friends.** Enel, an Italian electricity company, wanted to create a business in Russia by buying parts of RAO UES, Russia's electricity monopoly, when they became private entities. The Italian company believed that its investment would be safe only if it could demonstrate that it was interested in Russia's economic development. To the Kremlin's delight, Enel volunteered to develop natural gas fields in partnership with Gazprom and to generate electricity for the local market. Investing around €5.5 billion, it has purchased a minority stake in a hydrocarbons field; a controlling stake in OGG-5, one of Russia's biggest power-generating companies; and a near-majority stake in the electricity sales company RusEnergobyt. Enel is among the first foreign energy companies to create a vertically integrated business in Russia, and its prospects appear bright.

The implications for companies doing business in Russia today are clear. In the 1990s, the objective was to find the right oligarch to partner with—someone who would not defraud you and who could protect you from other oligarchs. Now the state must be the partner of choice, and its agenda must help define your company's strategy. Multinational companies in particular must

fit in with the prevailing definition of Russia's national interest; they cannot hope to succeed in spite of it. Fortunately, because Russia's leaders need companies to make profits and pay taxes, they are happy to let multinationals ally with state-owned and state-connected corporations.

**WITH THE RISK** of institutional collapse behind it, the biggest danger facing Russian capitalism today is the infinite appetite for centralization within the Kremlin. As the state becomes stronger, it could easily succumb to the temptation of full-fledged authoritarianism. It is unlikely to turn into a socialist economy again, but it could become a corporatist state run by public and private sector leaders who work together to make money. This would thwart the long-term goal of developing a broad-based, innovation-centric economy. Medvedev has time and again warned that Russia is doomed unless both the economy and the society modernize. Russia's political elite understands this, and continues to prefer a distinctively Russian model of capitalism—a middle ground between too much and too little government. That's the only check on the undercurrents that threaten to make Russia too authoritarian and statist to promote economic development.

Russia is just as promising a bet as the other members of the BRIC quartet; it is no more corrupt, violent, or prone to institutional upheaval. In fact, dealing with Russia's state-led capitalism is often easier than coming to grips with China's single-party, multilevel authoritarianism or India's multiparty, chaotic democracy. Today, as opposed to other periods in the past two decades, the Russian state has the autonomy, capacity, and legitimacy to continue reorienting the economy toward the market. It is safer to invest in Russia today than it was in December 1991 or December 1999—as long as you understand the political dynamics and choose the right partner, which is the state or a corporation closely connected to it. Ignoring the state now—as has been the case historically—is imprudent and dangerous in Russia. ♥

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