THE END OF THE PUTIN REFORM ERA

Alexander Bim and Kim Iskyan

The vigorous reform program of President Vladimir Putin's government has been experiencing an extended interlude. The prevailing -- and very wishful -- conventional wisdom holds that once the election season is over, Putin will rediscover his inner reformist self, and continue the reform process that marked the first two years of his presidency.

But the consensus is wrong: The Putin reform era appears to be over.

The Putin government's initial reformist focus was, for many, a pleasant surprise. In contrast to the policy paralysis that characterized the second half of the Yeltsin era, the Putin government developed and engineered the passage of a wide range of measures -- including tax, land, pension, judicial, corporate governance and labor reforms -- that have begun to alter the Russian economic environment fundamentally. Although the ultimate success of many of these efforts remains an open question, they have helped to lay the groundwork for sustainable macroeconomic growth going forward.

But the tenor of Putin's reign has since changed, as the president's well-documented authoritarian streak has steadily broadened. The rise of the siloviki, the Kremlin's favored faction comprising former KGB and law enforcement officials -- as evidenced by the continuing attack on Yukos and its CEO Mikhail Khodorkovsky -- reflects the ascendancy of forces within the Kremlin that are focused on increasing the state's control over the economy and society at large. The siloviki have even managed to dent the aura of irreversibility of the market economy experiment by raising the specter (albeit probably no more than that) of nationalization or the large-scale redistribution of privatized assets.

The aim of liberal reform -- to take power out of the hands of the government and bureaucracy in favor of independent economic actors -- is anathema to the siloviki and friends. The key reforms that have supposedly been deferred until Putin's second term, but which are likely to be ignored altogether, illustrate how the Kremlin's desire for control is trumping the need for reform.

The restructuring of Gazprom is critical to ending the Soviet legacies of super-monopolism and non-transparency, but it would also make it much harder for the company to be used as a slush fund for financing Kremlin-backed political parties and other projects. Attempts by government reformers to set the reform process in motion have been repeatedly blocked, and it is pretty clear that the message not to touch Gazprom is coming from Putin himself.

Contrary to high expectations following personnel changes at the Central Bank in March 2002, serious banking reform has also been deferred for years for the same reason -- despite the centrality of a functioning banking sector to sustainable economic growth. In addition, real and positive change in the electricity industry has been short-circuited by the entrenched interests that would stand to lose most from reform.

While the reforms that remain to be tackled require hand-to-hand combat with a range of vested interests, the reform accomplishments of the Putin government in 2000-02 only rarely involved taking on entrenched interests. No vested interests were threatened by tax reform. Fiscal centralization was only weakly opposed by the regional elite, which had already been stripped of power by the president. Corporate governance reform has made it only slightly more difficult for corporate Russia to engage in "business as usual."

Those efforts at reform that cut too close to the bone have subsequently been conveniently ignored or else allowed to sink into the bureaucratic muck -- such as serious administrative reform and the restructuring of Gazprom and the electricity sector. Often, those charged with carrying out the reforms have a vested interest in maintaining the status quo -- and Putin has done little in the way of wielding his enormous powers to tackle conflicts of interest for the sake of promoting reform.

The derailing of the Putin government's reform program has been facilitated by its ideological drift. At different times, Putin has been enraptured by different approaches to the tasks set, swaying from the radical liberalization advocated by economic adviser Andrei Illarionov, to the moderate liberalization tempered by state dirigisme prescribed by Economic Development and Trade Minister German Gref, to the go-slow approach of Finance Minister Alexei Kudrin and other technocrats -- and then back again.

The lack of ideological rudder and the president's apparent difficulties with grasping a broad conceptual framework have led to a loss of reform momentum.

Without serious efforts to undertake fundamental structural reforms, the long-term sustainability of Russia's economic growth will be severely compromised. The perverse incentives created by natural monopolies will continue to shred the country's economic fabric, and a dysfunctional banking sector will stand in the way of economic growth. The dependence of the economy on oil, gas and metals will only grow, and underinvestment will plague all other sectors of the economy. The lives of the vast majority of Russians (i.e. all apart from those who live in Moscow and a small number of oil-producing regions) will continue to deteriorate.

Another key consequence of the stalled reforms is its impact on Russian asset prices, which have risen dramatically across the board over the past few years. The bubble in asset prices in the mid-to-late '90s was caused in part by the anticipation of reform, as investors priced assets on the assumption of the full implementation of a wide-ranging reform program. To the extent that present asset prices have built in the expectation of dramatic and deep-cutting changes to the structure of the Russian economy, they are susceptible to correction as reality hits -- particularly once the unsustainably high commodities prices that have fueled economic growth and contributed to heightened expectations come back down to earth.

The PR-savvy Putin will continue to make the right reform noises when necessary -- particularly when foreign investors, who are investing despite Russia's structural problems, are within earshot.

But his much-touted aim of doubling Russia's GDP has clearly taken a backseat to other more self-serving concerns. Deputies in the State Duma (hardly a hotbed of reformist tendencies at the best of times) will likely be too preoccupied -- either with the Kremlin's efforts to extend the president's term in office or with positioning themselves for the post-Putin epoch -- to bother with reform.

Whither reform in Russia, then, given increasing authoritarianism on the part of a leader who is not interested in or not capable of taking on vested interests, a burgeoning bureaucracy and a Duma distracted by Putin's possible future power plays? The most likely scenario during Putin's second term involves increased state intervention, punctuated by periodic attacks on big business -- together with sporadic and half-hearted efforts at reform.

Many entertain the hope that Putin will revive the reform process after re-election. Under this scenario, after the elections, the Cabinet will be strengthened by an influx of outspoken reformers who will be allowed to push ahead with reforms --perhaps with the tacit support of the president.

Most likely, however, is that Russia's economic performance will continue to be tied to commodity prices, as the underlying post-Soviet structure of the economy remains largely untouched. Improvement in the business environment will grind to a halt, and the increase in investor confidence -- as reflected by the recent upgrade by Moody's rating agency of Russian debt to investment grade status -- will be tempered by reality as it becomes clear that reforms are on an extended vacation.

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