

## Pekka Sutela: The four i-words – and a fifth one

According to Vladimir Putin, Russia should be the fifth largest economy in the world by 2020, presumably after the United States, China, Japan and India. Thus, it would by then be the largest European economy. The country should also be "the best place for humans to live in". In a recent programmatic speech, Dmitry Medvedev presented four words, each beginning with i, as the keys to this bright future: institutions, innovations, infrastructure and investment. This speech has been warmly welcomed both because of these catchwords and because of the general content, which underlines respect for the law and liberal rules of the game. In fact, matters are not quite so simple, even on the level of general principles. The basics of modern economic growth theory help us see that.

### Front-runners and catchers up

Simplifying sufficiently, the economies of the world can be divided into two groups. Some of them – roughly, the OECD economies – are at what is called the global technological (or efficiency) frontier. We produce the most up-to-date commodities in the world, using state of the art technologies and the best organisational forms. Our economies function efficiently, our standards of living are the highest in the world and welfare is – in most cases – divided in a fairly equitable manner. Being on the frontier means that we are front-runners. Everything new to be introduced into practice must be invented, developed and tested by us. This is costly, cumbersome, slow and subject to error. Being good makes it difficult to be even better. Therefore, our economies grow sluggishly.

Economies inside the technological frontier – perhaps even very far inside – function inefficiently. They produce low standards of living and typically distribute the goods very unevenly. But at the same time these inefficient economies may enjoy the benefits of catching up. They have the possibility of adopting, from the efficient economies, the superior commodities, technologies and organisational forms that have already been developed, tested, introduced and found to be good in practice. If that is done, efficiency may improve and the economy grows fast. Naturally, this assumes both willingness and ability to utilise the potential for catching up. In some cases,

like China, India and earlier Japan, these conditions have been fulfilled. They are emerging or catch-up economies.

Well functioning economies thus grow slowly. Some badly functioning economies grow fast; others do not, as they fail to utilise the possibilities for catching up. Why they fail to do it is the key question in the modern economics of development. There is a wide literature and all too much practical experience addressing this question.

This division is of course extremely simplified. All economies are heterogeneous. Even the best of them leave room for further improvement. They may have sizable pockets of inefficiency. Emerging economies are typically highly heterogeneous. A look at Indian agriculture, in comparison with some of the technology companies of the country, confirms this. And yet the division is a useful one. One might hope that Medvedev's speechwriters had spent more time pondering it. Perhaps the underlying issue is that Russia is unique in its ways among the emerging economies. It has a unique geology. Natural resources kicked off Russian growth at the turn of the last decade. Russia's geography is also unique, as this country alone is in Central Europe, the Arctic and the Far East, and at the gates of Central Asia. Moreover, Russia is clearly the only emerging economy that used to be a superpower. The Soviet Union left a lot of luggage – bad and good. Russia inherited a population which is far better educated than that in other catch-up economies. It also inherited a mode of thought that makes it difficult to interpret the future through the challenges of an emerging economy.

### In many respects, Russia is still catching up

For several years, Russian economic growth has been driven by notable structural change. What was preferred by Soviet decision makers – military industries, say – has given room to what is preferred by a middle class that is growing wealthier, that is services and consumption in general. Ranging from financial services to cafeterias and restaurants to travel bureaus and filling stations, new activities have sprung up that were totally or almost alien to the Soviet economy. The economy, indeed the whole society, has opened up in thoroughly new way through imports, travel and the Internet. Growth of the middle class is a

process that would be virtually impossible to reverse. The same class of people both produces new commodities and consumes them. This is a self-supporting process. Many Soviet subjects have become consumers. That does not mean that they somehow automatically become citizens. But it does seem that this is more likely than the opposite.

Ignoring this structural dynamism is easy, because we take it for granted. In fact, this is the great engine of Russian growth, which will keep on running in the future. And this is part of the catching-up process, as regards the productive structure.

Russian research institutes have recently done a great deal of work on growth prospects up to 2020. The Center for Strategic Studies has applied the approach outlined above. They conclude that Russia still has a few years of catch-up potential. Therefore the country should already be preparing for life on the efficiency frontier. Among other things, the work should aim at creating an innovation system that would be in place on time.

This timetable may well be too ambitious. Russian industrial productivity is roughly on a par with those of China and India, just a few percentage points of the US level. The problem is that labour costs are about twice as high. Wages, as well as many other costs, are rising fast. When the Moscow-based Higher School of Economics concludes in a major study that across industrial branches some 10-45 per cent of companies are competitive, it adds that all too often the competitiveness is based on a cost advantage. That advantage is shrinking fast, and Russia will never be able to compete against cheap Asian production costs.

Another way to view the dilemma is to notice that not even two per cent of jobs are in energy extraction and transport. The key question for Russia's economic future is whether the other 98 per cent of jobs are competitive. The answer will also determine Russia's position in the world economy, not whether Russia accedes to the WTO sooner or much later.

Russia's economy is exceptionally heterogeneous. Some plants are globally state of the art, and so is some of the research. However, the average performance is unsatisfactory, as just noted, and variation across branches and regions is huge. According to reports by the Ministry for Economic Development and Trade, productivity differentials within branches, as between the best and the worst fifth, may reach factors of 20-25.

## Innovation vs. imitation

"One size fits all" solutions do not work in such an economy. Only a small part of the economy – especially when measured by jobs – is at the frontier or close to it. Mostly, the distance to the frontier is huge. Is relying on innovations then the right approach? Would not most Russian plants still have great potential to benefit from the fifth i-word, imitation? That, after all, is what catching up is about.

If the right path is imitation, not innovation, different kinds of institutions, infrastructure and investment are needed. To take an example: highly advanced top-to-bottom institutions may meet with meagre demand in the economy. Why would anyone invest in a Russian venture fund, when energy companies and retail chains bring in high revenue with relatively little risk? Venture funds, after all, are generally not money makers.

All five i-words have been imported into Russian from other languages. In this sense, Russian has always been an open language and Russia a society catching up. But most of Medvedev's voters probably do not understand what these words mean. Somewhat similarly, there may be grounds to assume that the Russian economy and society will reject many of the efficiency frontier solutions that are now being forced on them.

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