

**Conference on European Economic Integration (CEEI) 2011
“European Integration in a Global Economic Setting – China,
Russia and CESEE”**

Jointly organized by the Oesterreichische Nationalbank (OeNB)
and Suomen Pankki – Finlands Bank

Vienna, 21 November 2011

Dinner speech

Aleksanterinkatu 15B
00100 Helsinki, Finland
office@eastoffice.fi
www.eastoffice.fi

René Nyberg
CEO, Ambassador

rene.nyberg@eastoffice.fi
Mob: + 358 50 420 3840
Fax: + 358 10 841 4110

Stability or Reform?

At one of the better panels of the Sochi Investment Forum last September, Sberbank’s chief economist Xenia Yudayeva noted that Russian industrial policy is nothing but social policy cherishing myths. Stability has become an absolute value. She said the Russian economy has only three fortes: *Sirye i zemlya* that is, raw materials and arable land, as well as a good mathematical education, although, in her view, existing institutions prevent exploitation of this third potential.

The rector of the New Economic School, Sergei Guriev, quickly qualified Yudayeva’s observation, pointing out that the private sector had exploited Russian math skills with some success in the online world: Kaspersky Lab, the Russian search engine Yandex, explosive growth in the blogosphere, just to name a few. The Government, he argued, had overlooked regulation of virtual reality, leaving Russian entrepreneurs a market space in which to excel.

He could have added that the analytical skills of most of the early oligarchs from Deripaska to Khodorkovsky, not to forget Berezovsky, were also honed in that ideology-free part of Soviet academia, university science departments or “*fizmat*” as they are called in Russian.

This little exchange conveys something important; Russia still has intellectual critical mass in select areas. The efforts of Yegor Gaidar and Anatoly Chubais to introduce modern economic institutions in Russia after the collapse of the Soviet Union have also borne fruit.

To get some idea of just how bleak the start of Team Gaidar was, I would like to mention a passage in the biography of Anatoly Chubais, available unfortunately only in Russian and Finnish translation. The young economists led by Prime Minister Gaidar and his deputy Chubais were working day and night at the Staraya Ploschad premises of the former Central Committee of the CPSU when the phone rang. It was Gaidar’s wife, Irina. She said she knew Yegor was trying to save the country but wondered whether there happened to be any food in the old CPSU canteen, because she had nothing at home.

In his forthcoming book Gleb Pavlovski, a Kremlin spin-doctor out of grace, gives an unusual testimony of Gaidar's unique role: "Gaidar was a strange exception – the shadowy guru of any team that was in the Kremlin."

Fast forward to today. Moscow is the shining city on the hill. I moved back to Moscow just this fall and find it a truly amazing place, the dynamism and energy of Manhattan but with epic traffic congestion and aggressive drivers. Over ten per cent of the Russian population officially lives in and around Moscow; over 18 million people if you include the *gastarbaiter*, without whom this megalopolis would grind to a halt. Unemployment is virtually zero. It is the only air hub from which all Russian destinations can be reached. Moscow also generates about nineteen per cent of Russian GDP and monthly salaries for Muscovites average €1,000 a month, or double that of St. Petersburg. This extreme concentration of power and money makes Moscow unlike any place else in Russia.

St. Petersburg has come a long way, too. Its unique appeal is undeniable, even if it is only the moon that reflects the light of the Moscow sun. The renaissance of St. Pete as the "Northern Capital" is a major achievement with regional and international implications. But in fairness, it should be noted that the resurgence of St. Petersburg has coincided with the rule of Vladimir Putin and has been funded in part through political remittances such as taxes paid by firms like Gazpromneft, and soon Gazpromexport, too. ...In itself, a remarkable anti-Stalinist accomplishment remembering Stalin's suspicions of Leningrad.

As we know from history, the fate of France has often been decided in the streets of Paris. In Russia's case, the outcomes of revolutions were decided in the streets of St. Petersburg/Petrograd in 1905 and 1917. Today, of course, we expect the fate of Russia to be decided in Moscow, and hopefully not in the streets. But this has yet to be tested. The August 1991 *putsch* caused disturbances in Leningrad and a few other cities. A couple years later, the rest of the country remained passive while Yeltsin shelled the White House in Moscow in October 1993.

At first glance, the juxtaposition of stability and reform seems like a logical dichotomy. Stability at its extreme is synonymous with stagnation, while reform at its most violent implies revolution. But really they are two sides of the same coin. At the onset of the current election cycle, there is a palpable unease about the stability of Russian society, and Pushkin's famous comment on the propensity for "**senseless and pitiless Russian revolt**" is getting quoted a lot lately.

Economists would rather talk about growth, or at least "macroeconomic equilibrium," than stability, and would point out that the Russian government's preoccupation with stability is political. Where the concepts of stability and reform come together is in the high price of oil; it grants stability for Russia and in principle allows room for structural reform. The government is acutely aware of the problems that would emerge if the price of oil dipped. Recently in Helsinki, a leading Russian industrialist suggested over dinner that if the price of oil even drops to 70 dollars a barrel, Russia is in deep trouble.

Aleksanterinkatu 15B
00100 Helsinki, Finland
office@eastoffice.fi
www.eastoffice.fi

René Nyberg
CEO, Ambassador

rene.nyberg@eastoffice.fi
Mob: + 358 50 420 3840
Fax: + 358 10 841 4110

Stability can also be evanescent. For example, the authorities were caught totally off guard last December by spontaneous, violent demonstrations of thousands of young men on the Manege Square just outside the Kremlin walls. The unrest was triggered by a fatal shooting after a football match that turned into an ethnic riot against the Caucasians.

Aleksanterinkatu 15B
00100 Helsinki, Finland
office@eastoffice.fi
www.eastoffice.fi

René Nyberg
CEO, Ambassador

The upcoming elections for the Duma in December and the presidential elections next March, though not really expected to surprise, are nevertheless being keenly followed in the country. An opposition campaign to “Stop feeding the Caucasus” has stoked nationalistic sentiment and could be courting disaster. The Government’s budget proposals are a far cry from the prudent fiscal discipline that has characterized most of the Putin era. As pointed out by Alexei Kudrin before he was ousted as finance minister, the doubling of pensions and doubling of military spending (including wages for the officer corps, half of which are *siloviki*, members of different security services, internal troops etc.) was a nakedly populist and risky policy.

rene.nyberg@eastoffice.fi
Mob: + 358 50 420 3840
Fax: + 358 10 841 4110

The race between stability and reform cannot be a dead heat. If Russia fails to modernize, it risks being marginalized. Economic growth, in turn, enhances stability. As we speak, Russia is on the brink of WTO membership, which would open the path to OECD membership and ultimately a free-trade agreement with the EU.

To this day, Kudrin’s claim to fame remains his success in convincing Putin of the need to husband oil revenues prudently and build up sovereign wealth funds. These funds literally saved Russia’s public finances in 2008 and 2009. Yet Kudrin was sacked after publicly disagreeing with President Medvedev and choosing to air his laundry in Washington DC no less. Even so, his legacy in reforming Russian finances will not fade away.

Indeed, Kudrin was back with a scathing analysis of the Russian financial situation in the October 19 edition of Kommersant. He said the current budget proposal attempts to tackle all priorities at once, thereby endangering any chance achieving a balanced federal budget anytime in the near future. According to Kudrin, “... both the educational and the pension priorities pale in comparison with the military priority.” Kudrin points out that “...the defense industry’s ability to use the increased spending effectively to any extent had not been properly investigated and prompts great doubts. The considerably more modest levels of defense orders last year and this year basically suggests failure.” This is a serious reminder of how far Soviet-era industrial might has degenerated. Kudrin further warned against “switching the entire defense sector back to state funding.” Adding at another occasion that Russia cannot afford a defense budget of three percent of GNP.

The reform opportunities provided by the 2008 and 2009 crisis were basically squandered and have not resulted in needed reforms. The one thing the crisis did

change was the Government's attitude to investment – it now openly acknowledges the need for foreign investment.

At a conference last summer in Helsinki, Arkady Dvorkovich, President Medvedev's economic adviser, was asked about treatment of foreign investors relative to their Russian peers. According to Arkady, you don't really want to be treated like a Russian firm, because then you would have to deal with messy corruption, and so forth. Now you can rely on your embassies and Heads of State and Government who constantly lobby for you. And if you would like to be treated as our oligarchs, then you would have to shoulder social responsibilities, which means footing the bill whenever you are told to.

Aleksanterinkatu 15B
00100 Helsinki, Finland
office@eastoffice.fi
www.eastoffice.fi

René Nyberg
CEO, Ambassador

rene.nyberg@eastoffice.fi
Mob: + 358 50 420 3840
Fax: + 358 10 841 4110

Russia has come a long way since the early years of this century and Vladimir Putin's first term as president. The investment climate has changed, also reflecting the growing sophistication of the elite. My last trip outside of Moscow as Ambassador took me in June 2004 to Ryazan, where the business delegation I led was met by the Governor, General Georgy Shpak, the former commander of the airborne troops. The trip had been agreed with his predecessor, but at the time we got to Ryazan, 300 km south of Moscow, the governor had changed.

General Shpak entered the room and without saying a word fixed his eyes on me. Then, in front of the TV cameras, he declared: "The Chancellor is a friend of the President, how about you?" I put on my sternest look, fixed my gaze on the General, and responded calmly, "President Halonen is a friend of President Putin." *Peu-à-peu*, we got down to business. By evening, we were raising toasts at the birth home of the Russian poet Sergei Yesenin on the beautiful banks of the river Oka.

Finland has become a major investor in Russia and is today the largest investor per capita. The cumulative sum of all Finnish investments is already around nine billion euros. The most significant Finnish investment is a high-profile investment in the Russian energy market. Fortum's investment of 3 billion euros at present will reach 4.5 billion by 2014. Finns initially criticized this project, because its strategic nature was not fully fathomed. The scope of the Russian energy market reform had escaped many.

Yet this was precisely the situation. Russia had completely privatized the state assets in its electrical power sector by summer 2008 and fully reformed its electricity market by the end of 2010. It stands out as the most comprehensive and successful reform of a Soviet industrial legacy. Indeed, Russia now has opened up a lead over the European Union in deregulating and unbundling its electrical power sector.

The logic of the reform was very simple – attract critically needed new investment in generating capacity. In a meeting with captains of Finnish industry in 2009, Prime Minister Putin noted that Russia had allowed Fortum to invest in the heartland of Russia's oil and gas industry. He was referring to Fortum's acquisition of the utility TGC-10, now OAO Fortum, in the Urals and Western

Siberia. Putin might have added – because it is true – “We also allowed you to invest in one of the most important areas of Russia’s nuclear power industry.”

The sparseness of Putin’s remarks reflects both the significance and difficulty of opening up strategic sectors for foreign investment. Russia has come a long way.

Fortum entered the Russian market as an investor in 1998 when it acquired a stake in LenEnergo. In 2004, Fortum raised its ownership stake to 31%, buying up Eon’s shares. Today, Fortum owns 25% plus of the subsequent merger with Northwest Russia’s TGC-1.

Aleksanterinkatu 15B
00100 Helsinki, Finland
office@eastoffice.fi
www.eastoffice.fi

René Nyberg
CEO, Ambassador

rene.nyberg@eastoffice.fi
Mob: + 358 50 420 3840
Fax: + 358 10 841 4110

All this forms the background to my arrival from Moscow in summer 2004 to Berlin as Finland’s ambassador. One of my first jobs was to find a new honorary consul for Düsseldorf. Initially, I approached ThyssenKrupp on my own, but was rebuffed in Helsinki, suggesting that paths had been crossed with Finnish industry in the past. My mentor, the Honorary Consul General of Finland in Munich, Roland Berger, a well-connected industrialist and philanthropist, then suggested I approach his friend at Eon. Unfortunately, this plan did not work out either for similar reasons.

I don’t want to dwell on the travails of finding honorary consuls for Finland, but my four-year quest for Düsseldorf’s Honorary Consul proved such an exercise in bad timing that I think it might be worth sharing tonight.

Berger’s next candidate suggestion was, he hoped, a sure winner a well-known German banker, who had competed for the top spot at Deutsche Bank, only to lose out to DB’s current CEO Joseph Ackermann. Thomas Fischer, I learned, was a top guy, Chairman of the Westdeutsche Landesbank. Nobody in Finland had anything bad to say about this convivial man. I then lined up a speaker worthy of the official induction ceremony for our new Finnish Consul in Düsseldorf – Erkki Liikanen, Governor of the Bank of Finland. A small chateau on the Rhine was rented. Jürgen Rüttgers, *Ministerpräsident* of North Rhine-Westphalia was invited as our honorary guest. On the eve of the ceremony, Mr. Fischer called me with some bad news. A major speculation scandal has cost him his job as Chairman of WestLB. I again had no consul. Fortunately, I managed to reach Erkki on his mobile before he boarded his flight.

Back to Roland Berger. This time he suggested I might try the CEO of Vodafone Deutschland, Friedrich Joussen. This seemed ideal, given Finland’s prowess in the mobile phone industry. And I was sure I had the perfect speaker this time for that chateau on the Rhine – Sari Baldauf, former CEO of Nokia Networks. She served on a number of boards including Daimler and Hewlett-Packard, and is today the chairperson of Fortum.

Everything was arranged. The invitations were printed and sent. Then came the announcement that Nokia had decided to close its factory in Bochum, putting

the jobs of some 4,000 Germans on the line. All hell broke loose, and Jürgen Rüttgers let it be known that he could not attend the inauguration of the new Finnish Consul if Ms. Baldauf was the speaker. In the end, Friedrich Jousen's installation as Honorary Consul was postponed and more toned-down than what I had imagined, but we all remain friends to this day.

Stability or reform summarizes the Russian dilemma. A variation of the slogan of Bill Clinton's campaign provides the bottom line: "It's the oil price, stupid!"

Aleksanterinkatu 15B
00100 Helsinki, Finland
office@eastoffice.fi
www.eastoffice.fi

René Nyberg
CEO, Ambassador

rene.nyberg@eastoffice.fi
Mob: + 358 50 420 3840
Fax: + 358 10 841 4110



A Soviet memorial for a most un-Soviet man