Russia’s economic diversification potential: the untold story?

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ABSTRACT
Russia’s economic model is under a major sustainability test. Posting solid real growth in the early 2000’s it earned its “BRICs” designation. Later, surviving the worst of the crisis relatively unscathed, the economy unveiled its perennial structural flaw of energy exports dependence. Interpreting Russia’s macroeconomic troubles as the “bottle half-empty” analogy is tempting, while the “bottle half-full” dimension is challenging. Without diminishing significance of the real concerns, and refreshed with most recent data, this article attempts to analytically lay out Russia’s nascent economic diversification potential via evolving institutional business structure and new firm and sector developments.

KEYWORDS | Russian economy; BRICS; emerging markets; economy diversification; “gazelle” firms; fiscal policy.

INTRODUCTION
Approximately 16,000 books, articles, and other near-academic materials produced between 1991 and 2013 appear in Google Scholar for search phrase “Russian economy”. Compared to “American economy” result of 28,900—all scientific pretense aside in such comparisons—one might infer that the topic of Russia’s economic development may have been widely covered in recent academic and policy papers. Adding substantial non-English language literature, the volume of academic work increases even more. Yet, one should still expect a jump in new publications analyzing Russian economy as its sustainability and diversification potential are under much scrutiny these days.

To begin with, early in 2000’s Russia earned its BRIC[s] designation (e.g. O’Neill, 2001; Keohane, 2011), largely due to impressive post 1990s shock-therapy reforms turnaround. Real Gross Domestic Product (GDP) grew 10 percent in 2000 with...
subsequent pre-2007 growth oscillating around average 6.6 – 6.8 percent (IMF, 2013). The economy seemed to have avoided the worst of the 2008 global crisis impacts: preventing immediate severe real sector deterioration and forestalling currency fall and financial crisis. More recently growth has fallen below most projections and economy’s dependence on the energy market lacking significant industrial diversification has become more pronounced. Without the prior years’ fanfare, macroeconomic results for late 2012-early 2013 seem to reinforce the doomsday scenarios rhetoric. Yet, the negative verdict may not be that straightforward. Focusing on the institutional business structure transformation and without diminishing the macroeconomic concerns this article develops a somewhat alternative look that offers a glimpse of hope for the economy’s sustainable path.

It should be recognized that Russian economy is set on a rough foundation of post-socialist macro-stabilization shocks. The institutional legacy of the previous economic model is reinforced by emergence of state corporations and stronger fiscal factor, alongside robust adaptation to new content forms the contemporary political economy mosaic (Gevorkyan, 2011; Gaidar, 2007). Naturally, there is a host of destabilizing tendencies, from volatility in the energy sector, currency pressures, in part due to “uncensored” foreign exchange flows, to a multitude of seemingly limitless domestic inefficiencies. At the same time, there are significant appearances of institutionally new qualitative dynamics in the domestic market operations, though only just becoming visible.

Russia is the largest economy in the Commonwealth of Independent States (CIS) in relative and absolute terms. It is also the largest in outward foreign investment and cross-border M&A deals in the region. Private consumption, accompanied by a rise in a typical modern day consumerism has set its deep roots. This is then followed by too familiar individualism and property dynamics—an integral occurrence in modern capitalist society. Corporate management and growth in new innovative industries are real and are gaining dominance, though somewhat minimal. Despite some setbacks, for entrepreneurs those institutional factors open up yet untapped markets that aside from willing growing middle class consumers offer tenacity of well-educated labor force. The macroeconomic policy momentum for proactive economic diversification drive appears to be just right. But it is not and cannot be an overnight transformation.

The rest of the paper is structured as follows. The following section touches upon institutional development and some macroeconomics. Section II profiles domestic investor and outward investment activity. Section III challenges the skeptical assessments from an industry development view. Section IV deals with challenges in speculative financial sector and conceptually goes over relevant to economic diversification goal policy concerns. All across, the study is balanced at firm and sector level discussion within a larger macroeconomic context in sight. The paper ends with conclusion and references list.
THE UNBEKOWNST STORY OF INSTITUTIONS AND MACROECONOMICS

Modern day Russia is a post-socialist economy that has by now fully “tasted” the flavor of the 1990s shock-therapy and macroeconomic stabilization reforms. A reference to time limitation may not be valid, as legacy formations and institutions by their very definition necessarily remain visible in newly emerging formation that follows.

Why bring this up here? Institutional economics, as in the role of institutions in economic process (e.g. private property, private enterprise, functioning capital markets, housing market, labor market, public law, democratization, etc.), has grown in significance in mainstream and heterodox economic theory and policy over the past decades (e.g. North, 1991 and 1992). In the context of economic development (and transition—of which Russia is part), institutional development has been linked with progress in market reform and sustainability of emerging capitalist economies (e.g. Rodrik, 2004; Acemoglu et al. 2001).

Black and Tarassova (2003) in their comprehensive conceptualization of the institutional reform in transition, and Russia in particular, address these issues. The authors take a critical step back and propose a more gradual implementation framework as opposed to what appeared to be common anticipation of immediate change. The authors rightfully emphasize the complexity and interconnectedness of various reform elements that gradually become self-enforcing. Havrylyshyn and van Rooden (2003) find efficient institutional framework to have a significant positive effect on growth in transition economies, but they also stress the role of pragmatic macroeconomic policy for sustainable growth.

Commenting on the needed institutional change in the Russian economy, Gaidar (2007) suggested the effect of strong positive feedback of emerging and evolving institutional structure as it replaces outdated norms with new business and market culture. He also pointed to a lacking foundational tradition for the newly established institutions in the post-socialist context. Hence, a solid institutional base and economic diversification would only be possible in a longer term perspective. This seems to be in line with North’s (1991) general view of economy’s shape at any given time being the outcome of an evolving web of institutional tendencies. In that sense how long the longer term is for Russia, or any other post-socialist economy for that matter, would remain unclear. And it would be so, for economic development is necessarily a dynamic and self-regenerating social process the path of which is probably guided by a mix of pragmatic policy and endogenous macro and micro tendencies.

So at bare minimum, one sees the post-socialist markets slowly churning through concepts of private property, contractual agreements, taxation regulation (e.g. expanded tax base), corporate financial reporting, and the institution of formal administrative system for business operations. Russia is no exception, and in some cases is leading the pack. The European Bank for Reconstruction and Development (EBRD, 2013) tracks institutional reform in the post-socialist economies across six initiatives: Large scale privatization; Small scale privatization; Governance and enterprise restructuring; Price liberalization; Trade & Forex system; and Competition Policy. Figure 1 reports Russia’s
governance and enterprise restructuring index as higher than the CIS (with Georgia) average and the Net Exporter’s group (Russia’s peers based on current account position, see Gevorkyan, 2011 for detailed taxonomy).

One should beware, however, of overly optimistic view, as Russia is not really gaining top scores on all benchmarks seen for example in a six-point movement in the rank of doing business, from 118 to a 112 position per the World Bank Doing Business survey (2013). Still, as Figure 2 shows, by that benchmark, Russia is ahead of Brazil and India, yielding to China of the original BRIC group.

Are these and similar benchmarks accurate objective indications of the institutional change and healthier economy in Russia (or anywhere)? Actually, institutional measures are notoriously difficult to capture and track. They are necessary but probably are not sufficient if taken outside of general macroeconomic context. The analysis is less evident due to the vagueness of approximation and assumption made in such surveys, despite their directional use. So far the obvious conclusion seems to be that Russia has made dramatic progress over the past few years in some areas given its shaky foundation of the 1990s. If Gaidar’s (2007) proverbial assessment of self-reinforcing institutional base is right, there may perhaps be more ground for optimism than was previously thought.

Turning to more concrete discussion, Russian economy remains only partially

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**Figure 1**
Governance and enterprise restructuring, EBRD Index
Source: EBRD, 2013 and author’s calculations

**Figure 2**
The original BRIC ranking by county, 2012 vs. 2013
diversified. Decomposing value added to GDP by sector the weight of the traditional core sectors (i.e. mining and its subcomponents) remains dominant. Figure 3 compares proportions of each sector’s value added as percent of total GDP composition between 2005 and 2011.

The story here is quite interesting: mining has given way to stronger gains in government (positive 1.8 points change); construction (+1.2 points), finance and real estate (FIRE; +1.1 points), and other sectors (+0.9 points). There is a visible decline in trade, though later we point to the consumer factor in the economy. The curious aspect about the above results is that we are able to compare before and after crisis sector distribution. The rise in government services and FIRE corroborates the story of proactive fiscal policy during the crisis and solidifying position of the financial sector as well as expanding real estate market in the economy. New sectors, concentrated in tech-industries, are gradually rising as evidenced in the manufacturing improvement, though still slow in growth to establish a significant footprint. This was especially true in the early transition era with newly introduced institutional framework as the economic collapse ended the period of fine-tuned complex planning system. Reliance on the primary commodities exports drove much of the early economic growth in subsequent years. Concentrated in isolated sectors, growth may eventually pull other sectors across economy. Looking at the last decade’s firm and sector level data there may be some ground for conservative optimism.

Before we turn to sector level discussion, let’s address some stylized macroeconomic facts. Taking a sharp dive in 2009, the economy recovered to its pre-crisis levels, with real GDP CAGR likely to average around 3.1 percent over the next five years (IMF, 2013). The good news is that growth remains positive. The bad news is that it is significantly lower than what economy needs for a faster modernization and diversification (e.g. Yasin, 2012). Still, together the four BRICs (Brazil, Russia, India, and China) will climb over $15.6 trillion in current prices of combined GDP in 2013 (compare to the combined $2.6 trillion in 2000).

With slightly over $2 trillion estimated 2012 GDP, Russia is ranked third, following China and Brazil, while economy’s GDP per capita is projected to reach $15,700 in
2013—the highest in the group. At the same time, Russian CPI inflation is expected to stay low at 6.8 percent on average (between Brazil’s 6.1% and India’s 10.8%) compared to 14.1 percent in 2008 and around 12 percent in 2009. Gross national saving in Russia is expected to rise close to 28.8 percent of GDP in 2013 and gross investment to approach 26.2 percent of GDP (with expected 16.2, 49.7 and 30.2 percent in gross national saving and 18.5, 47.1, and 35.1 in investment for Brazil, China, and India respectively for 2013). All these indicators suggest a continuous improvement over the past decade.

In 2012, manufacturing productivity has rebounded to 8.3 percent annual growth in 2010 catching up to pre-crisis 2007 levels. The export-oriented energy sector, challenged by new industries domestically, has also declined from the previous highs, following volatility in the global oil demand and lower prices. Still, labor productivity across all sectors has grown 3.2 percent in 2010, and 3.8 percent in 2011—a post-crisis come back (FSSS, 2013). Overall, the data through 2011 and early 2012 seemed to have corroborated the general story of gradual improvement and impressive post-crisis recovery in the Russian economy. In fact, the list can go on and data available from the Russian and international sources simply says that these are good indicators and may be the best macroeconomic indicators on Russian economy yet.

But is Russia’s positive macroeconomic performance of the past years sustainable? Most economists in Russia are critical of that, blaming the current little diversified economic model (e.g. Yasin, 2012; Popov, 2011; etc.). In fact, adding to the perspective more recent macro-level data (see Figures 4 a, b, c, d) the answer to the sustainability question is a tempting “no.” The charts compare average indicators for the 2005-2007 with the 2011-2012 period.

It appears that after the initial upward pull immediately after the crisis the economy entered a period of macroeconomic decline as pre-crisis gains are being wiped out by the less so impressive performance in late 2012 and early 2013. This is seen across a range of macroeconomic indicators, most visibly in declines in current account, trade, incoming foreign direct investment (FDI) and others as proportions of country’s GDP. At the same time gross capital formation has improved between the two sample periods, despite the sharp (more than double) drop in annual growth between 2009 and 2012.

A bit of positive news can be seen in labor force participation (improving 1.6 points) with growth in services sector employment by 4.05 points. Additionally, total investment as a share of GDP increased 2.4 points as net outward investment went up approximately 0.1 points. These facts are well documented in available statistics and across few recent studies. For additional and comprehensive commentary on Russia’s current macroeconomic position the reader is referred to the most recent quarterly report by the World Bank (WB, 2013).

Moving on, much more nuanced is the business performance that has evolved as institution in itself quite significantly over the past decade in more recent years in Russia. The details of this development remain largely unknown to outside observers but, in our view, may play an important role in spearheading the economy’s diversification
Figure 4(a)
Changes in Russia's capital flows and services trade, % of GDP

Figure 4(b)
Changes in Russia's trade and business activity indicators, % of GDP

Figure 4(c)
Changes in Russia's labor market components, % of total

Figure 4(d)
Gross capital formation in Russia, % annual change
Source: WDI (2013) and author’s calculations
push. We address some of the key related concepts below.

**PROFILING DOMESTIC INVESTOR**

*Flexing Cross-Border Economic Pull*

Russia’s success in transforming as a market economy is often viewed in the context of the country’s tradable sectors’ export performance. According to the latest revised data from Rosstat (FSSS, 2013) and Finance Ministry (MF, 2013) total exports grew 17.4 percent CAGR between 2005 and 2008. Taking a steep dive in 2009, exports rebounded to 23.2 percent annual change between 2010 and 2011, only to slip again to mere 1.3 percent growth between 2011 and 2012. The downward trend has continued so far in the first half of 2013. This indeed is somewhat a different picture compared to similar reports through 2011 data.

Of the total volume, exports to the Commonwealth of Independent States (CIS) economies accounted for 15.7 percent shrinking 1.3 percent in 2012 compared to a 25 percent 2010 to 2011 growth. Perhaps not surprisingly, non-CIS directed exports, i.e. mainly to Western Europe, reached $446 billion in 2012, corresponding to a positive 1.7 percent growth in 2012 versus a more encouraging 23 percent growth in the year before. The dominance of energy products in the total exports has led to the economy’s net exporter title (along with Azerbaijan, Belarus, Kazakhstan, and Ukraine as in Gevorkyan, 2011). Still volume-wise Russia remains the largest exporter in the CIS space.

One finds a bit more optimism in increasing economic maturity of outward foreign direct investment (OFDI) from Russia into the economies of the Commonwealth of Independent States (CIS) and in some developed markets. Net OFDI has steadily grown over time as a share of GDP (approximately 3.2 percent between 2005 and 2012) outpacing inward FDI, sustaining high levels in recent years as well.

Capital flight considerations aside, evidence is abundant in examples of the Russian-based companies participating in wide-scale M&A projects (Kalotay and Sulstarova, 2010). These initiatives appear to be the dominant strategies in the foreign market access by Russian companies (Panibratov, 2010). UNCTAD (2012) notes a rise in cross-border M&A deals from $4.5 billion in 2010 to $33 billion in 2011, for now due primarily to few large transactions. Here Russia is the originator and the receiver in M&A transactions (for example, KazakhGold Group’s $6.3 billion acquisition of Russia’s Polymet Gold). Report also notes an increasing proportion of M&A deals in the Russia’s consumer market, non-natural resource based sectors, particularly with participation of the EU members (e.g. Russian-based enterprises active in retail trade, auto- and textile industries, discussed below).

In the post-socialist bloc of countries, Russian companies rely on existing legacy physical capital facilities and access to a relatively skilled labor force. The pattern complicates cross country comparisons, especially with other emerging markets (e.g.
BRICS) where such preexisting relationships are less developed or non-existent. For some of the smaller CIS economies, such OFDI coming in from Russia has been a significant factor in their GDP growth (e.g. Armenia or Belarus, see data and trends in Gevorkyan, 2011).

Large Russian MNCs also participate in the M&A deals outside of CIS, including in financial services sectors (e.g. Sberbank’s acquisitions of some of the Austrian Volksbank’s European operations). Such actions follow the general demand of the Russian banks’ corporate customers who expect access to their banks while running business operations abroad. UNCTAD (2012) cites as another example the Russian TNK-BP’s acquisition of a 45 percent stake in the Brazilian Amazon oil exploration (from Brazil’s HRT Particiapoes, worth $1 billion), and Russian technology firms’ sizable investment in large firms in developed countries (e.g., Sky Technology’s purchase of 10 percent of Twitter).

In numbers, according to Russia’s Central Bank (CBR, 2012) total OFDI at the end of 2010 reached the pre-crisis (2007) levels of USD370 billion for the year. This is 18 times more than the year 2000 levels. Much of this growth has been driven by a handful of the largest Russian multinational corporations (MNCs) in the energy, technology, defense, and telecommunications sectors. For example, Spigarelli (2011) offers a detailed case study analysis of recent scaling up of investments by Russian firms in the Italian economy across diverse sectors. Some other examples include such companies as Aeroflot, Alfa Group, Evraz, Gazprom, Lukoil, Norilsk Nickel, Severstal, but also Kaspersky, Abbyy, MTS, VimpelCom, Yandex, and a growing list of others. Could this trend be a strong contributing factor to Russia’s economic diversification?

Commenting on the outward dynamic, Kalotay and Sulstarova (2010), observe that during most of 1990s the push factor for outward investment was the search for safety-nets of developed markets (Oleinik, 2005). Only few privately-owned financial and energy sector companies were able to capitalize on this strategy at the time, as state-owned conglomerates were among the first movers. Kalotay and Sultanova (2010) also suggest that domestic macroeconomic performance and policies, as well as host-market size, access to resources, and longer-term ownership advantages in the nearest foreign markets are strongly correlated with the recent growth of Russian OFDI.

Access to regional markets by larger conglomerates, while retaining Russian presence, is often followed by relatively smaller Russia-based businesses seeking expansion in new, non-energy or heavy industry sectors. For both, control of the final product’s entire value chains and over revenue flows are critical. This seems to be consistent with earlier suggestions by Andreff (2002) highlighting the minimal role in OFDI determination of the short-term variables (e.g. domestic currency volatility and short term GDP growth fluctuations) or prevailing access to technology (either at firm level or in target market).

Today even in the Russia’s state-capitalism mode, strategic business drivers are at the forefront. In part this is due to ongoing privatization efforts (EBRD, 2011 and UNCTAD, 2012). According to the EBRD ranking Russia has scored top 4 points in
small scale and 3 points in large scale privatization (with 4+ being the highest). This roughly corresponds to 2,600 federal and municipal entities privatized between 2005 and 2012 according to FSSS, 2012. Interestingly, privatization in Russia has followed three stages, two of which were largely due to shock therapy-adopted policies during the 1990s with the third being more cautious and systemic over the first decade of 2000’s and recent reinitiating of the privatization debate at policy levels.

Above trends serve as positive contributions to Russian economy’s entrepreneurial dynamic, human capital, managerial capacity, and simply as profits diversification strategies. But as experience shows much of these happen under environment of fundamental uncertainty. Under these conditions different investors will assume varying positions vis-à-vis country investment.

A strategic investor

The above consideration leads us to two types of structural agents in the Russian market that require examination. Both domestic and foreign investors in the Russian market can be split between two categories:

- strategic
- speculative

Strategic players see a unique opportunity in the Russian market (Iyer-Ahrestani, 2012). Advantages are dual: a) opportunity to capitalize on relatively lower cost resources and skilled labor and b) possibility of entering new and willing consumer market. We can further break down the first option as: i) re-establishing business facilities within existing sectors or ii) establishing new enterprise in a new industry.

Complementary to such consideration is the boom in the consumer market in recent years mentioned above (e.g. on consumerism, see Aris, 2010). Importantly, the birth and maturity of the Russian economy’s consumer culture has also nourished new financial services (e.g. consumer credit, mortgage, and small business loans—more on this below), which in turn become integral in the country’s diversification agenda.

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**Figure 5**

Household consumption in Russia, % of GDP and annual % growth

Source: WDI (2013) and author’s calculations
By the end of 2010 household expenditure as a proxy for consumer demand, given lower cost utilities and healthcare compared to other economies, has recovered and surpassed 2008 levels averaging 49.4 percent of GDP for the year. Despite earlier forecasts of topping the 50 percent of GDP mark the actual data through 2012 shows a clear reduction in the more recent years. This is consistent with the overall story of the last two years slip across most indicators. The positive spillovers of crisis management policies are now exhausted and economy is readjusting to a new normal trajectory.

Nevertheless, as seen in Figure 5, relative annual growth in consumer expenditure has gone from single digits in 1990s to double digits extensive expansion in more recent years. Real consumer demand growth is also fed by a 15 percent annual real wage growth, declining private savings, and expansive growth in consumer credit. All these factors become relevant for a medium to long term entrepreneur, or what we refer to as strategic investor.

Early in the transition period, entry by strategic foreign investors was, predictably, in the raw-materials and energy sectors. Recently growing business cooperation in IT-, retail, auto-, and large scale construction industries, including partnerships with large foreign conglomerates has been gaining momentum as well. The geography is as widespread as the brands of the foreign companies operating in Russia these days. Almost every known brand is present in the Russian economy: from Mercedes Benz to IKEA and certainly Coca Cola. Some (like many automakers, e.g. Hyundai, Daewoo, Renault, GM, etc.) have established domestic assembly lines to promote unique makes (e.g. see Kramer and Brooke, 2005) or partnered with the Russian auto-industry to develop joint vehicles. Some foreign corporations in Russia are putting up retail presence for now (including all the brand names of retail to investment banking). Incidentally some of the first foreign companies to enter the Russian market were the big accounting and consulting firms (e.g. KPMG, Deloitte Touche, Pricewaterhouse, etc.).

In fact the number of Russia based firms with some degree of foreign capital increased 93.9 percent between 2005 and 2011 as new entities entered the market. The top five winners were quite predictable rapidly growing sectors of trade, real estate, transportation, construction, and manufacturing (see Figure 6).

**Figure 6**

Number of Russian companies with foreign capital participation, 2005 vs. 2011

Source: FSSS (2013) and author’s calculations
For Russia to attract such global heavyweights and continue to increase foreign capital presence in large and medium enterprises is an unprecedented — compared to the 1990s — achievement. It is unequivocally a positive trend as the improvements are seen what is typically characterized as real sectors of the economy offering real employment and feeding off real aggregate demand. For the large MNCs and similar companies, despite obvious and well-documented business risks, the opportunity costs of not going into the Russian market seem to largely outweigh the old business model alternative of simply feeding remainder produce as exports into Russia. Perhaps this also says something about growing sophistication of the Russian consumer, yet another component of a larger institutional change.

More significant is the growth in Russia’s homegrown “new” industries. That is driven by both companies established early in the transition period and those that are more recent entrants to the vast market. Being able to satisfy domestic industrial and consumer demand has defined success of these companies’ operational models. Looking at firms’ survival rates, we again find more positive story in the years before and immediately after the crisis (Figure 7).

In Figure 7 the pre-crisis and post-crisis years are colored in different tones to illustrate the magnitude of the conundrum when analyzing Russia’s enterprise performance. On the one hand there is a steady increase in firms’ formation, including as reported above a growing number firms with foreign capital. On the other hand the post-crisis years (2011 and 2012) have shown firms’ death rates at 86 and 93 percent of the birth rate respectively. This may be due, as is discussed below, to a changing structure of firms financing and inability of outright majority of firms to comply with stringent financing requirements of the banking system. Aside from some institutional barriers, it appears the process is quite evolutionary with a variant of natural selection being in place. There remains some core of businesses and those around them that are able to adapt to the changing environment.
The remainder of the year was pro-rated based on the first half of the year. Therefore 2013 growth rates should be treated with caution and as indicative only.

The table below presents the real revenue turnover in Russia, annual % change and CAR% for industry sectors.

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<td>Agriculture</td>
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<td>7.4%</td>
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<td>Construction</td>
<td>26.2%</td>
<td>28.1%</td>
<td>18.6%</td>
<td>-27.3%</td>
<td>71.1%</td>
<td>4.1%</td>
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<td>12.1%</td>
<td>2.5%</td>
<td>-2.7%</td>
<td>15%</td>
<td>6.2%</td>
<td>5.9%</td>
<td>-12.0%</td>
<td>8.6%</td>
<td>4.0%</td>
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<td>Equipment production</td>
<td>10.9%</td>
<td>24.5%</td>
<td>8.8%</td>
<td>-28.2%</td>
<td>10.2%</td>
<td>155%</td>
<td>11.1%</td>
<td>-20.7%</td>
<td>11.3%</td>
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<td>17.1%</td>
<td>3.0%</td>
<td>10.2%</td>
<td>-0.1%</td>
<td>9.0%</td>
<td>13.4%</td>
<td>23.3%</td>
<td>9.8%</td>
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<td>Manufacturing</td>
<td>10.7%</td>
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<td>7.8%</td>
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<td>21.8%</td>
<td>18.0%</td>
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<td>Raw materials</td>
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<td>20.2%</td>
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<td>Retail and wholesale trade</td>
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<td>7.7%</td>
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<td>11.5%</td>
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<td>-7.7%</td>
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<td>13.9%</td>
<td>10.7%</td>
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<td>-10.1%</td>
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<td>10.5%</td>
<td>-13.6%</td>
<td>-6.0%</td>
<td>14.9%</td>
<td>7.5%</td>
<td>-6.3%</td>
<td>10.2%</td>
<td>5.8%</td>
<td>0.2%</td>
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<tr>
<td>Wood</td>
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<td>19.4%</td>
<td>-6.3%</td>
<td>-28.8%</td>
<td>12.8%</td>
<td>15.6%</td>
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<td>6.3%</td>
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<tr>
<td>Paper production</td>
<td>21.9%</td>
<td>6.8%</td>
<td>20.5%</td>
<td>-30.4%</td>
<td>12.7%</td>
<td>14.1%</td>
<td>11.3%</td>
<td>-10.4%</td>
<td>9.2%</td>
<td>8.3%</td>
</tr>
<tr>
<td>Oil refinery</td>
<td>-6.1%</td>
<td>-23.5%</td>
<td>13.3%</td>
<td>-8.4%</td>
<td>37.8%</td>
<td>29.1%</td>
<td>6.1%</td>
<td>14.3%</td>
<td>10.5%</td>
<td>11.1%</td>
</tr>
<tr>
<td>Chemicals production</td>
<td>13.6%</td>
<td>9.7%</td>
<td>21.6%</td>
<td>-23.3%</td>
<td>22.2%</td>
<td>21.7%</td>
<td>1.9%</td>
<td>-3.8%</td>
<td>7.6%</td>
<td>7.4%</td>
</tr>
<tr>
<td>Rubber and plastic production</td>
<td>25.4%</td>
<td>33.6%</td>
<td>0.3%</td>
<td>-22.6%</td>
<td>28.0%</td>
<td>20.8%</td>
<td>5.3%</td>
<td>-16.3%</td>
<td>18.8%</td>
<td>8.4%</td>
</tr>
<tr>
<td>Metallurgy</td>
<td>17.9%</td>
<td>12.0%</td>
<td>0.6%</td>
<td>-37.3%</td>
<td>30.4%</td>
<td>12.8%</td>
<td>-5.5%</td>
<td>-12.2%</td>
<td>9.7%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Electronic and optical equipment production</td>
<td>30.0%</td>
<td>13.7%</td>
<td>2.5%</td>
<td>-29.6%</td>
<td>22.5%</td>
<td>10.7%</td>
<td>6.9%</td>
<td>-29.0%</td>
<td>13.9%</td>
<td>5.8%</td>
</tr>
<tr>
<td>Transport vehicles and equipment production</td>
<td>11.8%</td>
<td>21.0%</td>
<td>2.5%</td>
<td>-36.3%</td>
<td>28.8%</td>
<td>29.3%</td>
<td>13.7%</td>
<td>-3.0%</td>
<td>10.5%</td>
<td>13.7%</td>
</tr>
<tr>
<td>Natural gas and water production/distribution</td>
<td>19.8%</td>
<td>21.8%</td>
<td>1.1%</td>
<td>7.6%</td>
<td>11.7%</td>
<td>8.5%</td>
<td>-0.6%</td>
<td>1.4%</td>
<td>13.4%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>10.0%</td>
<td>20.0%</td>
<td>10.5%</td>
<td>-12.9%</td>
<td>12.2%</td>
<td>11.7%</td>
<td>31.6%</td>
<td>2.1%</td>
<td>10.0%</td>
<td>13.7%</td>
</tr>
<tr>
<td>Transport and communications</td>
<td>10.0%</td>
<td>12.1%</td>
<td>8.9%</td>
<td>-3.2%</td>
<td>2.1%</td>
<td>6.4%</td>
<td>9.5%</td>
<td>-3.8%</td>
<td>7.2%</td>
<td>5.2%</td>
</tr>
<tr>
<td>Utilities</td>
<td>28.1%</td>
<td>54.1%</td>
<td>-30.2%</td>
<td>-31.9%</td>
<td>6.9%</td>
<td>5.5%</td>
<td>-3.8%</td>
<td>0.7%</td>
<td>25.4%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Total</td>
<td>17.3%</td>
<td>17.4%</td>
<td>8.0%</td>
<td>-19.3%</td>
<td>13.1%</td>
<td>13.0%</td>
<td>6.1%</td>
<td>-13.5%</td>
<td>11.3%</td>
<td>6.2%</td>
</tr>
</tbody>
</table>
For example, indicative of overall medium-business trend are such Russia born-raised-operating companies as Gloria Jeans, Sady Pridon’ya, Polyplastic, Evrodon, and many others that have directed significant shares of their early profits and borrowed funds to capital investment and branch expansion from their modest beginnings. Incorporating new production and management techniques they were able to enhance and solidify their own internal resource and operational foundations. Their goal, as suggested by one study, is to meet the market needs using “superproduction” methods that effectively combine technology and modern management organization (Krasnova and Matveeva 2012).

Those companies’ ambitious plans included competition with cheaper imports (mainly from China) in a struggle for Russia’s massive market in textile, beverages, meat, plastic, and other products. Setting high internal standards, and adopting strict corporate accountability, has yielded near-absolute control over the full production chain but also an opportunity for those companies to fill the domestic market at least partially with higher quality produce on mass scale and at competitive prices.

In the context of the above, two factors are of interest. We addressed total capital investment earlier; additional more micro data may be pulled to illustrate the sector distribution of the dynamic. However, perhaps more indicative would be a view of revenue turnover by sector in the Russian corporate sector’s revenue evolution (see Table 1).

The story should by now be all too familiar. One sees an impressive growth in real revenues before crisis and a dramatic recovery immediately after the sizeable drop in 2009, followed by drop in more recent years. Similarly, real CAGR for the year groups inspire a strong degree of optimism right through 2012 only to reverse in estimated 2013. Another observation based on Table 1 data is the relatively strong average growth in non-energy sectors. Undoubtedly it is not sufficient yet to overtake the energy sector fully, but it cannot be denied that some sectors either organically or via various fiscal stimulus packages have been improving. This brings us to the next point in the strategic investor discussion: what are some of the types of companies that are expanding in Russia that may be unique to this market?

NURTURING DIVERSIFICATION

The Gazelles and How Fast They Run

Before we turn the discussion any further, few words must be said about the so-called “gazelle” firm factor. As argued below, that adds a strong impetus for the diversification model. The gazelle-firm concept was first introduced by Birch (1979) in the analysis of the U.S. business and job growth. The concept is now widely discussed in Russian academic and business media (e.g. Polunin & Yudanov, 2013; Expert, 2012; Yudanov, 2010; etc.).

Any fast growing private medium-size company with 30 percent revenue growth
over four years is considered a “gazelle”. Polunin and Yudanov (2012), based on the Russian firm level data, note that actual average revenue of the fast-growth small private companies between 2007 and 2010 increased an impressiv 79 percent. At the same time a typical Russian public company with reported data showed revenue growth around 19 percent.

Specific to the Russian “gazelles” (full list of companies by sector is available via Expert, 2012 or Polunin and Yudanov, 2013) is their absolute private ownership and reliance on own funds (Vinkov, 2012). The group itself is not static and changes in composition over the short-term as new companies enter and others leave, based on the business performance. But as a group they exhibit continuous growth retaining (and multiplying) their physical and human capital potential.

Approximated estimates suggest these companies range between 1 and 6 percent of Russia’s entire pool of business entities, private and semi-privately owned (extrapolated from FSSS, 2012 and Expert, 2012 data). Finally, these companies are penetrating less-traditional sectors of the Russian economy: information technology, pharmaceuticals, nano-technologies, real estate, food processing, telecommunications, construction, infrastructure, ship-building, and small scale manufacturing. Interesting results were obtained in the Polunin and Yudanov (2013) study based on privately accessible firm-level dataset. The authors compared middle-sized (with revenues between 200 million to 20 billion Russian rubles) enterprises’ wage share distribution by sector between 2007 and 2011, separating the gazelles in distinct category. The study finds an interesting reversal of fortunes between gazelle-type companies and all mid-size firms before and after the crisis (see Figure 8 a, b). Effectively gazelles transformed in four years from market underperformers to market leaders in every sector and especially trade (though yielding substantially more in finance and real estate).

Information Technology Sector and “Gazelles” Survival Tactics

A growing “gazelle” sector of recent years has been the Information Technology industry. There are three core segments within Russia’s IT market. Hardware leads the group with sales of 52 percent of the entire IT market, followed by 28 percent in services, and remainder allocated in services sales. Most expert reviews agree on continued positive growth in all three sectors, despite market’s clear geographical segmentation and dominance of few large companies in larger cities. In terms of proportion to the national GDP, Russia’s IT market is roughly 1 percent of the economy, forecast to reach $32.4 billion by 2016 (from current $21.4 billion).

As an example, the IT sector, led by the larger telecommunications and software giants (e.g. MTS and Kaspersky Labs), has been one of the most dynamically developing industries. Early in 2006, Russia’s outsourcing industry was valued close to $1 billion (Satinsky, 2006). With very low (10 percent vs. 50 percent in India) attrition rate, a typical IT software/outourcing company is usually a small private business with niche targeting operational platform, customized software and individual client
collaboration projects. Various industry reports and client testimonies indicate Russian software engineers holding a competitive edge over their counterparts, such as India, due to Russia’s strong technical background and flexible approach in search for complex problem solutions (SoftwareRussia, 2012).

Strong government backing and demand for IT infrastructure and services by various state-corporations provide a strong backbone support for the private IT market. There has been a rise in IT technoparks that have offered special tax treatments to new businesses (e.g. technopark expenditures in Moscow growing from $6.4 million between 2006 and 2007 up to $220 million between 2008 and 2010. However, demand comes from a diverse set of businesses niches, both private and semi-private organizations as businesses push to optimize their operations to remain competitive and under pressure of maturing consumer market. Experts place much hope on the growth in IT services sector, which may evolve as Russia’s competitive advantage in the global IT market due to an optimal balance of labor costs and developed human capital and professional skills. The leading companies include such staples in the global IT market as Abbyy, Kaspersky, R-Style, Sitronics, and others. Considering that Russia’s IT industry started from bare bottom of nothing, these are impressive achievements in business management, enterprise development, and institutional transformation of the marketplace. For a more rigorous discussion the reader is referred to Gevorkyan (2013) study.

Not every new company (or for that matter sector) qualifies for “gazelle”
designation. Most flock into industries with lower entry barriers and capital investment requirements—for example up to 30 percent of the qualified are in the retail and wholesale trade with another third in construction sectors. Yet the general trend and what appears to be existence of managerial and operational capacity is that necessary foundational stage in the economic diversification path. Moreover, in addition to tapping into new sectors, the gazelles (in particular the smaller ones) seem to be solely focused on domestic consumer. The newcomers appear to have caught the wind in their sails, but will the conditions last?

Note here that during the initial crisis shock in late 2008, larger (too-big-to-fail) private and those with some state participation businesses, seeing disruption to their financial flows, cut their commercial orders and downsized production leading to overall economic decline or relied on state-administered bailouts to withstand the crisis. But the top-performing “gazelles” facing drying-out demand orders and declining consumer spending had less room for maneuver. Only a quarter of the pre-crisis “gazelles” survived. The old top-performers relied on own-capital approach or short-term loans for their operations financing; the model that led many to shutdown during the crisis. In fact their pre-crisis overall indebtedness was lower across entire medium-enterprise businesses (21 percent vs. 25 percent of revenues). This could also partially relate to the point of improving own competitiveness by smaller private companies, as opposed to the larger enterprises (e.g. Kuznetsov et al. 2011).

Majority of the surviving and new additions to the “gazelles” were those that proactively procured business loans, contributed to capital formation, and developed (new for Russia) consumer credit schemes weathering the crisis (Expert, 2012). The new “gazelles” strict financial accountability (as in earlier mentioned examples of Gloria Jeans and others) raised their overall indebtedness post-crisis (up to 41 percent of revenue in 2010). During and immediately post-crisis peak, they “borrowed to build” their businesses and customer base (Polunin and Yudanov, 2012). Furthermore, Expert (2012) study suggests that surviving the peak of the crisis has led to a more effective managerial pool formation in the Russian-based companies. But the future yet still remains uncertain.

DEALING WITH CHALLENGES

The Speculative Investor

The speculative investor (or agent) in the Russian economy comes via the financial system. Russia’s financial market is open in terms of capital flows. There was a fear of a sudden capital flight at the time of the 2008-2009 crisis and the Central Bank of Russia dipped into foreign reserves pool, reducing the balance by 65 percent (from highs of $588 billion in August 2008 to the lowest $382.5 billion in March 2009). The events and the eventual monetary and fiscal policy interaction are captured in Gevorkyan (2011) among others. The action was one of the largest in relative scale compared to similar
fiscal boosts in other countries (Hanson, 2009 and EBRD, 2011).

Eventually, the Russian ruble depreciated over 40 percent in relation to the USD from pre-crisis August 2008 levels to mid-2009, though it later regained some of its strength, only to fall under devaluation pressures again in late 2012-early 2013. The latest episode was due to uneven capital flows (and mostly outflows) over the 2012. That might have more to do with uncertainties about the global economy and the U.S. Federal Reserve’s monetary policy direction. In fact Financial Times (FT, 2013) reported on a correlation between markets’ reaction to the policy advisements from the U.S. Federal Reserve and investors’ appetite for holding funds (albeit at higher returns) in emerging markets, the BRIC group specifically. Be it as it may, Russia escaped immediate, 1998-like, forced devaluation, averting sudden economic collapse and providing much needed financial stability to the economy.

Analytically, Russia’s latest economic and financial frictions originated not in the domestic subprime market dealing with toxic assets. Macroeconomic structural issues aside, instability in Russia’s financial system derived from decisions by foreign and domestic institutional and private investors to pull out of the market based on worsening risk perceptions at the time..

Russia’s total number of banks has fallen from highs of 1,300 in 2004 to 1,060 in 2009, as state-owned banks continued to command a significant share of total assets (up to 40 percent). Note also the rising number of foreign-owned banks since the crisis (110 according to EBRD, 2011), as their asset shares have expanded from 7.6 percent in 2004 to 18.3 percent of the market in 2009. In addition, new banking services (e.g. credit provision to the private sector: over 45 percent of GDP; and to households: over 9 percent of GDP, including rising provision of mortgages and associated banking services) have contributed to a rapid maturing of the Russian financial system that now serves as the main vessel for a range of loans and investment initiatives. Figure 9 traces quarterly total foreign portfolio (IN_PI) and direct investments (IN_FDI) in Russia’s banking sector over the first decade of 2000s.

Figure 9
Russia’s banking sector’s portfolio and foreign direct investment, $mns
Source: Central Bank of Russia, 2013
Following a jumpstart in late 2005 peaking in late 2007, portfolio investment reaches its low point (declining to 2006 levels) in mid 2009. It then begins to rise again, only to set on yet another falling trajectory in the second quarter of 2010 with a sharp rebound to pre-crisis levels in the second quarter of 2011, followed by even less stable recent quarters. While the absolute levels are impressive for Russia’s maturing financial market (i.e. inward portfolio investment accounting for roughly 40 percent of the total and FDI flows into the banking sector, itself accounting for 21 percent of the total inward FDI for the year of 2010 according to the CBR, 2013), a problematic factor is the significant volatility in foreign currency denominated capital flows. This is where individual, speculative (as in seeking high and fast return), investor’s portfolio diversification strategy goes head to head with country’s development path.

For an economy that relies on hard currency as an asset this can be a problem spanning from financial into the real sector, which was exactly the case in Russia. The problem is common for post-socialist economies, but is particularly relevant for Russia where on average 70% of short-term debt in the banking system is denominated in foreign currency (at approximately USD27.5 billion as of January 1, 2011, according to the CBR, 2013). For private Russian banks that do not have FDI, short-term debt comprised 34 percent of total debt obligations at the beginning of 2011. Hence, there is likely more instability in the financial sector in Russia than in the real sector, as the former attracts highly speculative and mobile investors that do not necessarily need to physically cross borders to establish or abolish their presence in the market.

Why All is Not Lost (Yet)

The nascent and growing sectors (such as “gazelles”, for example) require a strong efficient financial system. The two must go hand-in-hand establishing new economic framework. Recent capital flows in and out of Russia, offer just one such indicator of how uncertain this tandem may be.

Russian business leaders are looking for “tail winds” to sustain and develop their businesses (Vinkov, 2012). Despite macroeconomic successes, those results are unable to effectively spread growth across sectors, hence drawing criticism of the country’s economic model. Proposals for stronger transparency and improving competitiveness are just, but insufficient. There needs to be an additional push factor than own, organic, industry growth.

In this situation the blended monetary and fiscal policy mix (e.g. Gevorkyan, 2011) becomes a norm for an immediate term. In fact, “gazelles” operating in new technology sector niches, specialized construction, engineering, and mass scale food processing (hundreds of new companies that entered the market post-crisis peak) depend on these macroeconomic conditions, fostering their organic growth. This is evident in a 22.5 percent CAGR innovation spending by the Russian enterprises between 2009 and 2011, according to FSSS (2013). Yet, more is needed. It is probable to engage a proactive fiscal policy given current beneficial macroeconomic position with forward outlook of
developing a responsible fiscal rule balance.

At the official level (with all subsequent political risk aspects that are beyond the scope of this paper), proposals have varied from allocating surpluses above forecast oil price into the Reserve Fund or National Wealth Fund (Kommersant, 2012), to embedding specific “anti-crisis” policy in the annual government budget.

More generally, there is still a unique opportunity to capitalize on Russia’s diverse human capital and intellectual capacity, including legacy scientific infrastructure and scientific capacity. This includes growth in nano-, bio-, info-, and cognitive technologies and others. The consensus is one of expected growth in private enterprises and technological sectors, referred to as “modernization” (Gorbatova, 2012). Large state-owned corporations (e.g. Rosnano, Russian Railways, Vneshekonombank, etc.) are beginning to develop partnerships cross-sectors via either direct funding or more often business collaboration with “gazelle”-linked companies, projects, sectors (e.g. IT services and software design).

Eventually, that may help address the problem of spreading the capacity across Russia’s immense market and raising labor force participation in the new sectors. The data assembled by Polunin and Yudanov (2012), suggests that over 50 percent of all Russian companies saw average annual revenue growth of over 30 percent (25 percent experienced revenue growth of over 75 percent) between 2002 and 2007. In 2010 the corresponding figure was 46 percent (with 23.9 percent growing over 75 percent a year). There is no data for later yet, but if macroeconomic indicators reviewed above may serve as any guide, we are likely to see more modest results.

Still, there is indeed a significant potential, as the “gazelle”-linked industries emerge and maintain such entrepreneurial, professional, and skills capacity, solidifying their presence. In turn this has a direct effect on the positive institutional change, which to recall Gaidar (2007) may be self-reinforcing, paving the way for further improvement. Yet, the uncertainty of still largely one-sector economy, problems in the labor market mobility, infrastructure, and administrative inefficiencies coupled with financial flow instabilities, may upset this fragile chessboard.

An extension to current proposals, might incorporate a defined international reserves target level (or as a ratio of net foreign currency borrowing in the banking system), mitigating financial risks. These stockpiles offer a ready source of reserves, accessible for traditionally-perceived as low return projects implemented via public policy. Stimulating infrastructure (in the most wide definition of the term and not just roads and bridges) investments, human capital development and greater labor force participation is achievable via pragmatic fiscal policy mix (e.g. see Gevorkyan, 2011 on Infrastructure Development Fund in and international reserves targets as part of a policy mix).

It follows, then, that for the economy in general, relieving dependence on the energy sector (though it would be difficult to argue for any sizeable shift at the moment), along with other institutional factors, will clearly be driven by profound structural economic shifts, for which developments in gazelle-like (i.e., new) sectors act as
proxy. More substantively, among others these changes include evolution of business practice institutions, stabilization of capital flows, wider access and comfort with credit, a confident consumer market, emergence of domestically produced competitive consumer goods, and continuation of sustained business growth across non-energy sectors. In turn, those rely on improved domestic macroeconomic environment. And fiscal and monetary authorities still have the strategic capability to fine-tune that dynamic. Finally, added to the mix is the government’s explicit assumption of certain social responsibilities via provisions of public goods and accommodative pro-business policies of economic activity. Combined with external factors, this diverse mix of dynamic tendencies defines the country’s current post-socialist context.

CONCLUSION
It is premature to claim a victory over Russia’s energy dependence. Recent macroeconomic data may even suggest a much gloomier scenario. Still even if the energy sector may remain dominant in Russia’s exports for some time, the important dynamic, often omitted in popular commentaries, is elsewhere. It is more domestic oriented in nature and breeds positive institutional change, set to play out as a net benefit in the longer term.

Rather than absolute exports, the relative focus must be on Russia’s domestic market operations and potential, despite persistent inefficiencies and risks. Regardless of which industry is the absolute leader, Russia is ready to capitalize on its human and physical capital resources and technological base for further diversification. New sectors and businesses have sprung either out of natural evolution or benefiting from sizeable state contracts (e.g. IT services). The capacity that led to earlier successes is still there. The business structure change then stays in close interrelationship with innovation across sectors, as IT services sector seems to suggest by leveraging intellectual capacity and newly formed managerial pool.

Streamlining financial and technological activity of now proliferating Russian MNCs to benefit domestic economic and institutional base development is another component. Foreign ventures targeting newly emerging sectors and setting a platform for regional expansion continue to find abundant opportunities of a rapidly expanding market. Sustaining all this in the medium term requires pragmatic and new fiscal policy, the “tail wind” of the new sectors that spearhead economic diversification.

Russia’s new landscape is in sharp contrast to once economic chaos and demands a non-cliché, approach. It is still undergoing the structural transformation launched back in the early 1990s shock-therapy reforms. The path is filled with potholes, puddles, but also patches of dry, smooth land. The transformation is a socially dynamic process that does not necessarily conform to the standard economics. Capitalizing on the ongoing institutional change in the new sectors flanked by emerging domestic consumer and rising managerial talent requires a pragmatic, all-encompassing analytical approach in policy and research. Such perspective may offer some allowance for cautious optimism. And so, that is the untold story of Russian’s economy.
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