

## Anders Aslund

### The Folly of Renationalization

by Anders Aslund, Peterson Institute

Op-ed in the Moscow Times  
May 23, 2006

Something strange is happening in the Russian economy. Since 1999, it has delivered stellar growth numbers of almost 7 percent per year, with virtually all of the growth coming from the private sector, which has been led not only by the recovery in the oil and metals sectors, but also by retail and construction. It only took off a few years after privatization because other market reforms were lagging and new owners needed to consolidate their ownership.

The state, in contrast, has learned little, and continues to fail. Most branches of the state, including law enforcement, the armed forces, public healthcare and education, the bureaucracy and public infrastructure, are patently flawed. The common denominator in all of these problematic sectors is public ownership.

Under these circumstances, a rational and accountable government should pursue two related courses: accelerated privatization and comprehensive reforms in the public sector. Sensibly, the government was doing so until 2003. But the last three years have brought a halt to all reforms, and this situation is expected to continue until President Vladimir Putin has left office.

Incredibly, underperforming state corporations are swiftly gobbling up successful private firms on a major scale. According to the European Bank for Reconstruction and Development, the share of gross domestic product created by private companies fell from 70 to 65 percent last year.

The most spectacular renationalizations have been in the oil industry. From 1987 to 1996, the old state-owned corporations managed to halve output in Russia's oil industry through mismanagement and pervasive criminalization. Fortunately, insiders successfully privatized the LUKoil and Surgut oil majors, allowing for some economic recovery. In the other companies, however, the situation remained dire. The Russian government realized that drastic measures were necessary and succeeded in privatizing several of the most criminalized companies in sales to young outside businessmen.

By 1999, 90 percent of the oil industry was in private hands and, over the next five years, oil production rose exponentially, at an average annual rate of 8.5 percent, as foreign technology and expertise were brought in to revive Russia's old brownfields. Meanwhile, international oil prices rose, allowing the government to fill its coffers by means of ever-higher taxation of the oil companies.

By 2000, Yukos was paying \$6 billion in taxes, far more than anybody would have considered it worth when it was privatized in 1995, proving that legalization and a sensible taxation policy generate much larger state revenues than nationalization. Corporate governance improved in parallel. The stock market favored the newly privatized companies and was waiting for the

promised privatization of Rosneft and Zarubezhneftegaz.

Although the privatized economy was booming as never before, renationalization began in 2003. It wasn't failure or illegality that exposed the private oil industry to this danger, but its success and transparency. The first notable renationalization was Rosneft's purchase of a small oil company, Severnaya Neft, in early 2003. Remarkably, Rosneft paid \$600 million for assets that had been bought for \$7 million only a couple of years earlier.

The biggest renationalization has been Rosneft's seizure of Yukos, which is still being completed. It started in the summer of 2003 when the government began systematically destroying the company through lawless persecution and confiscatory taxation. Rosneft will soon pick up the remaining morsels of Yukos.

In a very different renationalization in September, state-owned Gazprom purchased Sibneft from Kremlin-friendly businessman Roman Abramovich, who wisely lives in Britain. Gazprom paid a high market price of \$13 billion for Abramovich's controlling stake.

Since government persecution made it impossible for the Yukos management to run the company effectively, its investment and output levels began to plummet. Likewise, the long delay in Sibneft's sale reduced its output. Rosneft, in turn, invested little in its operations, because it was spending all of its cash on acquisitions. The remaining major private producers—TNK-BP, LUKoil and Surgut—realized the danger of investing too much or boosting production excessively, so they moderated their production increases. In 2005, the increase in oil output growth dropped to 2.7 percent, with all of the growth coming from the three big private companies. This year, the government forecast growth of just 2 percent, but, after four months, output had risen by an annual rate of only 1.7 percent, and stagnation appears to be approaching.

The government could easily and swiftly bring a halt to this ongoing damage through renewed privatization. In particular, Russia needs private companies to develop the difficult new fields where state companies have long failed. Instead there is talk that Rosneft plans to purchase another private company, Surgut. Poorly performing Rosneft is preparing an international IPO to raise billions to repay loans, while the company's management will be handsomely remunerated in stock options.

Another key sector damaged by renationalization has been banking, in which five big state-owned banks are buying up smaller competitors. Their raids are sometimes accompanied by smear campaigns, bank runs, and accusations of money laundering. As a consequence, the banking sector remains state dominated, and the ratio of the broad money supply to GDP is about 10 percentage points lower than in less-developed Ukraine, where private banks dominate and flourish.

At Russia's current stage of development, its automotive sector should be taking off, but this will require major investment from international companies. Despite announcements by major manufacturers that they are opening production plants in the country, their projects are being impeded. Meanwhile, Rosoboronexport has taken control of yet to be restructured giant AvtoVAZ, which will receive huge state subsidies that will continue to block the modernization of Russia's automotive industry.

Some heavy machinery companies, notably Uralmash, have recovered, but last year its mother company, OMZ, was sold to Gazprom for inexplicable reasons. Another decent private corporation, Siloviye Mashiny, was similarly sold to Unified Energy Systems, thus diverting the latter from its core activities.

In the oversized Russian aircraft industry, a few small private companies have recorded success, but they are now to be merged with the big, dying state enterprises into a huge AiRUnion corporation, with three-quarters of its shares in state hands. There is no doubt that the big bad state companies will crowd out the promising upstarts with the help of state subsidies.

Transactions like these are proliferating throughout Russia's big business sector at an ever-increasing speed. Some owners are friendly with the Kremlin and are well paid. Others, having neglected their relations with the Kremlin, are paid little but sell in any case because they fear ending up like poor Mikhail Khodorkovsky.

As all of these examples demonstrate, structural effects are of no interest to the government. Renationalization is being driven by the interests of state officials looking to extend their power and wealth. The government does not even promote these moves until they have already happened, and there is no apparent socialist ideology behind nationalization.

In January, at his annual press conference, Putin said, "We have about 10 relatively large private oil companies. . . . Nobody is going to nationalize them; nobody is going to interfere with their activities. They are going to develop according to market conditions, like private companies. I think that this kind of balance is better for the Russian economy today, and this includes active participation from our foreign partners and shareholders." Meanwhile, a new draft law has named 39 strategic industries that the Kremlin wants to dominate, and renationalization proceeds on course.

Indeed, if no good argument can be found for renationalization, no positive effect is likely to materialize.