

## Analysis

### **“Putinomics” reaches a dead end?**

Donald Jensen

**Can the “Putinist” system in Russia survive the economic setbacks? What is the role and effectiveness of the Western sanctions against Russia? This article explores the consequences of the sanctions and the prospects for the Russian economy.**

Former Russian Finance Minister Aleksey Kudrin said in an address to the Federation Council on June 3 that the Russian economy is in a “full-blown crisis” fueled by capital flight, slow economic growth due to the war in eastern Ukraine, and low global oil prices. In 2014, Kudrin stated, capital flight was \$150 billion — more than a quarter of Russia’s reserves on hand at the end of the previous year. He predicted capital flight will be \$100-110 billion in 2015. Steadying the ruble at about 50 to the dollar also has drained the country’s hard currency reserves. Meanwhile, the European Bank for Reconstruction and Development predicts the overall economy will shrink by 4.5 percent in 2015. Other experts estimate that Russia will experience a decline in GDP this year of at least 10 percent. As long as these problems last, the Kremlin will find it difficult to sustain its current and planned levels of energy exports and its ambitious rearmament program.<sup>1</sup>

Middle- and lower-middle Russians have been especially hard hit by this downturn. The poverty rate has grown to more than 15 percent — about 23 million people — in the first quarter of 2015, the first substantial increase in the poverty rate since the economic crisis of 2008-2009 which helped usher in the end of the Yeltsin administration. About 500,000 people, according to Kudrin, will lose their jobs this year. Last year also saw an average drop in real income of 10 percent, and an increase in mortgage defaults to go along with rising food and utility prices. Inflation, moreover, is rising and is predicted to be more than 15 percent in 2015. For the first time in a decade the government recently announced it will be unable to raise pensions and other social benefits to fully match inflation. Nevertheless, polls show that Putin is even more popular now than a year ago. His standing has been helped by the public fervor the Kremlin has whipped up over the war in Ukraine and a successful propaganda campaign that has convinced most Russians the economic downturn is the result of foreign enemies seeking to undermine Russia. A central question facing the Russian regime, therefore, is whether, if this so-called “patriotic mobilization” over Ukraine wears off, Russians may begin to blame Putin or the regime for their deteriorating standard of living.<sup>2</sup>

#### **Behind the crisis**

Three factors are dragging down the Russian economy. First, structural problems limit growth in the near to medium term: the decline in the working-age population and restrictions the Putinist system places on competition, investment, and innovation. Government projections predict that the workforce will decline from 84 to 80 million between 2015 and 2020. The number of young entrants into the workforce will be only partly offset by immigration. The weak rule of law and poorly protected property rights inhibits competition, investment, and innovation. Business people without connections to

the authorities are vulnerable to attacks by law enforcement agencies, often backed by corrupt courts. Corrupt state officials interfere with what otherwise would be routine market activities.

Second, contextual challenges posed by the international system: the end of quantitative easing in the United States, which pulls investment away from emerging markets; the rise of shale oil and gas production in the US and Canada, which puts downward pressure on global hydrocarbon prices; the weaknesses in the Eurozone economies, which take a large proportion of Russian exports; the slowing of the Chinese economy; the fall in the oil price; and decline of the exchange rate against the euro and the US dollar.

Finally, geopolitical impediments: the war in Ukraine; Western economic sanctions; Russian counter-sanctions; Moscow's drive for import substitution; and the turn at home from liberal economic policies toward greater reliance on the law enforcement and security organs.

Western economic sanctions, although partial, gradually implemented, and with unclear objectives, nevertheless have helped squeeze Russia's liquidity and hard currency reserves. Although the Russian economy is more sensitive to changes in the oil price than other energy producers, experts differ about whether the sanctions or the drop in the oil price have had the greater effect on Russia's economic slowdown. In his address Kudrin said the Ukraine crisis and resulting international sanctions imposed on Russia for its involvement in the conflict were reducing Russia's GNP by between 1 and 1.5 percent per year. By themselves, however, EU and US sanctions are unlikely to produce such economic distress as to force Russia to withdraw from Ukraine. To the contrary, they provide the Kremlin with a convenient scapegoat for the country's economic problems. There are also signs the regime is beginning to adjust to the restrictions imposed so far. But the pressure on the regime resulting from the sanctions remains an important weapon in negotiations over a settlement even if they are unlikely to prevent Russia from advancing further militarily if it chooses to do so. The economic price for such aggression, however, would be severe — it could trigger the cutting off of Kremlin access to external financial markets, which is vital to the economy.<sup>3</sup>

Despite these concerns, the likelihood of a financial meltdown is low, barring another sudden and sustained decline in world oil prices. Although the large volume of scheduled external debt repayments has led to speculation that Russia's finances could experience a financial crisis comparable to the shock of August 1998, these vulnerabilities are less worrisome than they appear.<sup>4</sup> A large share of Russia's external debt is owed not to Western banks, but instead to Russian parent companies or holding companies registered abroad. Such debt is easily rescheduled, which means the country is less likely to suffer a currency crisis. Unfortunately, other indicators such as the decline of foreign investment — a key source of technology and expertise — are more worrisome. If this trend continues, the "effectiveness of Russia's aggregate investment will decline, productivity growth will slow, Russia's international competitiveness will slump further, and ultimately living standards will fall."<sup>5</sup>

## **Impact**

The state of the economy plays a major role in the durability and legitimacy of the regime. Putin's popularity during his early years in power was dependent in large part on the popular perception that he has made Russia richer and politically stable. But when the economy crashed after 2008 many Russians panicked. Since then many have returned to the idea that a crisis is the norm and maybe becoming inured to the situation.

The viability of the regime again has become a key question as the economy has slowed over the past year. With prosperity threatened, the regime may be in danger of losing its legitimacy and effectiveness. To preserve domestic stability, Putin largely has chosen policies that preserve jobs at the expense of real wages, even as inflation has grown. But in dealing with the financial troubles the government policy making process has had trouble functioning effectively. Power has been centralized in the Kremlin.

These developments, along with the intractability of Russia's economic difficulties, make it more likely Putin will rely on repression and hardcore nationalism to maintain his grip on society. Although the economic troubles create new problems for Putin, however, they are not likely to impede his ability to pursue an aggressive foreign policy. The risk of further military action in Ukraine or elsewhere is not so much affected by funding issues, but other factors.

Nevertheless, the economy's problems will make it more difficult for the Kremlin to carry out its ambitious plans for military modernization. The Russian government's published 2014 military budget is about 2.49 trillion rubles (approximately \$69.3 billion), the third largest in the world behind the US and China. The official budget was set to rise to 3.03 trillion rubles (approximately \$83.7 billion) in 2015, and 3.36 trillion rubles (approximately \$93.9 billion) in 2016. Unofficial estimates place the total amount of military spending for the Russian Federation higher. However, a collapse in the value of the ruble has greatly reduced the dollar-value of the Russian budget to around 50 billion USD as of February 2015, despite a 33% increase in the ruble-value of the budget.<sup>6</sup> As a result, the budget will be cut in 2016, with the navy the most likely victim.<sup>7</sup> The Russian military is failing to meet its plans in 2015 for re-equipping its armed forces with modernized weapons because of Western sanctions over Ukraine and the decline of domestic industries, according to a deputy defense minister.<sup>8</sup>

## **Prospects**

This picture suggests that the most likely prospect for the Russia's economy is a gradual winding down of the system Putin has built rather than an abrupt discontinuity, though nothing in Russia can be ruled out. The key driver of the country's economic course will be the oil price. If prices remain at their current level, \$50-\$60 per barrel — which many experts predict — Russia would stand to lose 5-8 percent of GDP, but would probably muddle through. Moreover, the built-in resistance of the Russian policy and business elite to radical reform of Putinism makes any fundamental change in the system unlikely in the medium term.

However, if a compromise were reached over Ukraine and sanctions were withdrawn, or if uncertainties over the oil price and the ruble were eased, demography and the Putinist system would still constrain Russian economic performance. The rate of growth of Russian GDP might then be about 2–2.5 percent a year. This might not be enough to satisfy the elite or popular appetite that Russia play the role of a global power, but should allow the regime to get by. If those conditions are not fulfilled and the international security environment remains tense, the prospects for the system are more uncertain. While external pressure to contain Russian ambitions is critical, a push for outright regime change would be at least as likely to result in an angry, sullen Russia that would try to push back than a country that would pursue a more pro-Western course.<sup>9</sup>

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