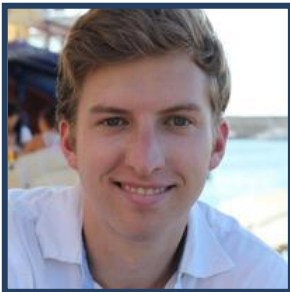


## RUSSIA'S FROZEN ECONOMY

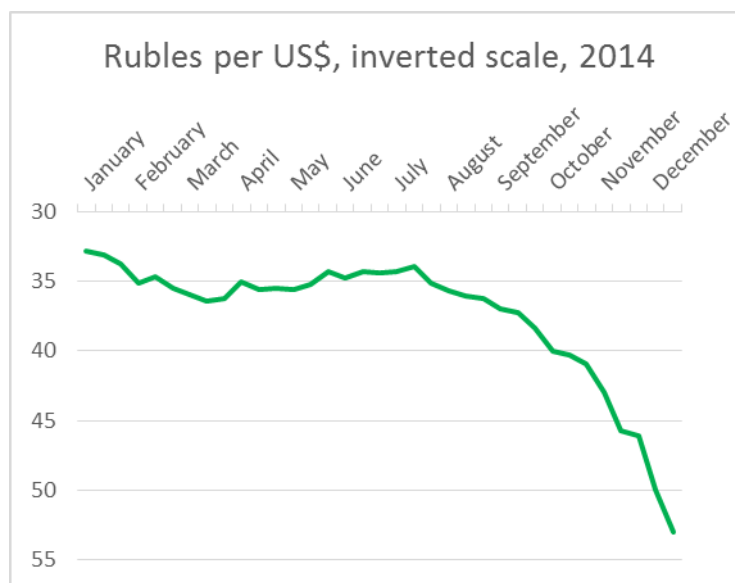
By Chris Miller



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December temperatures in Russia's Siberian cities often reach 40 below zero, but the freeze that threatens Russia today has nothing to do with the winter cold. Russia's economy is frozen. Western sanctions designed to punish Russia for invading Ukraine have deterred investment, while plummeting oil prices have substantially reduced Russia's main source of export revenue. GDP growth will be basically flat this year, and will be no better in 2015. The rise in living standards, the foundation of Russian President Vladimir Putin's popularity, has ground to a halt.

At the trough of the 2008-2009 crisis, Russia's economy performed worse, but it was clear that the financial crisis was caused by external factors. Today the opposite is true. Sanctions and a worsening business climate are direct consequences of Vladimir Putin's policies. Even the shock created by declining oil export revenues, which is caused by global supply and demand factors, reflects poorly on Putin, because despite the advice of many economists he has declined to diversify Russia's economy away from energy exports. That now looks foolish. The deep freeze gripping Russia is not simply an economic problem. The politics of austerity are restructuring the country's politics, too, and Russians are beginning to ask how—and whether—Putin will manage.



Source: Central Bank of Russia

## **Western Sanctions**

Russia's invasion of Crimea and Eastern Ukraine provoked a series of economic sanctions by the US, the EU, and allies such as Canada, Norway, and Japan. The first round of sanctions targeted individuals, but as Russia pushed further into Ukraine, Washington and Brussels levied sanctions on Russian businesses, too. The two most damaging restrictions have been the ban on transfers of oil drilling technology and on long-term lending to leading Russian firms.

Russia had been counting on Western technology to increase production in existing oil fields and to open new production sites in the Arctic. Sanctions put a halt to much of this work, and will stunt growth in Russian oil production over the medium term. The most pressing issue, however, is that many Russian firms, including energy giant Rosneft, state-owned bank Sberbank, and arms dealer Rostec, are now prohibited from raising funds abroad. These firms had come to depend on capital raised in London or New York, so sanctions will force them to find new sources of financing. Some will struggle to repay existing debts. In response, many Russian companies have turned to the government for assistance. The Kremlin is planning to use the \$80 billion national pension fund to provide long-term funding to firms hit by sanctions. Judging by the Russian government's investment record, many of these funds may never be recouped.

## **The Yevtushenkov Affair**

One of the harshest blows to Russia's economy this year has nothing at all to do with Ukraine or the international economy. . Vladimir Yevtushenkov, one of Russia's richest businessmen, was placed under house arrest on September 16 on charges of money laundering. Yevtushenkov controls a conglomerate called Sistema, which owns businesses ranging from toy stores to cell phones to—most recently—oil. In 2009, the company bought Bashneft, an oil firm in Russia's Bashkortostan region.

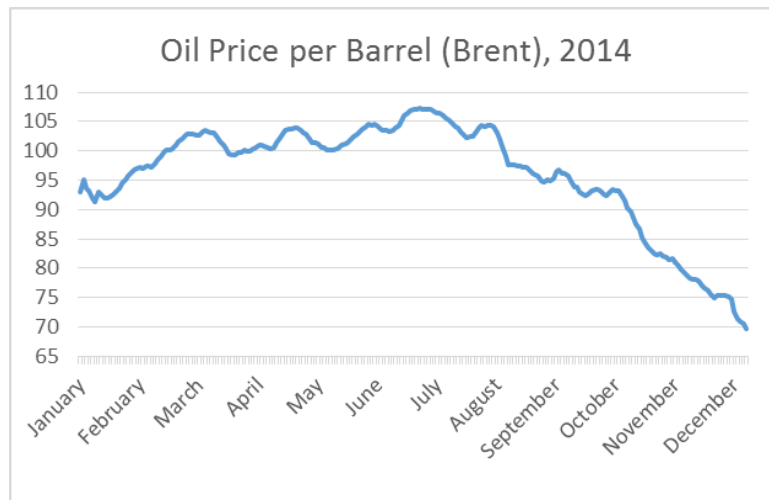
The Bashneft deal is the source of Yevtushenkov's legal problems. Few doubt that in the early 1990s, Bashneft was privatized by its previous owner in a dubious manner, as were many other Russian energy assets. Yevtushenkov is accused of money laundering in relation to the privatization, yet he bought the firm a decade after it was privatized. His real sin was his refusal to sell Bashneft to Rosneft, the state-owned oil giant run by Putin confidant Igor Sechin. In late October 2014, a court ordered Yevtushenkov to surrender Bashneft. In the first week of December, Yevtushenkov's firm Sistema received more bad news, as a court ordered the company to repay dividends it had previously received from Bashneft. Sistema's shares, which are traded in London, are down by 80 percent since September, and Yevtushenkov remains under house arrest.

Russia has seen high-profile expropriations before. Most famously, Mikhail Khodorkovsky, who had become the country's richest person through his ownership of energy giant Yukos, was jailed on fraud charges in 2003. Khodorkovsky had political ambitions that clashed with Putin's, and his arrest was widely seen as setting out a new deal between Russia's government and its oligarchs: businesses would be secure only if their owners stayed out of politics.

Unlike Khodorkovsky, Yevtushenkov was exceptionally loyal to Putin and was careful to avoid politics. His assets are being expropriated regardless of his loyalty, breaking the implicit deal Putin made with the Russian business community in 2003. Now, even loyal oligarchs are at risk of expropriation. Many of Russia's top businesspeople had already begun protecting their fortunes by investing abroad, in assets ranging from British soccer clubs to European energy firms. Yevtushenkov's arrest will accelerate this process, providing an additional reason for Russia's rich to move money abroad, and for foreign investors to avoid Russia in the first place. Russia's central bank is expecting capital flight of well over \$100 billion in 2014.

## **Oil Prices**

In mid-2014, oil sold for around \$100 per barrel, but today it sells for around \$70. Few analysts expected the sharp fall in oil prices, and the Russian government was no exception. Given Russia's deep dependence on oil revenues, falling prices create serious economic problems. Hydrocarbons make up about a quarter of GDP as well as 60 percent of exports. Moreover, roughly a third of government revenue comes from taxes on energy exports.

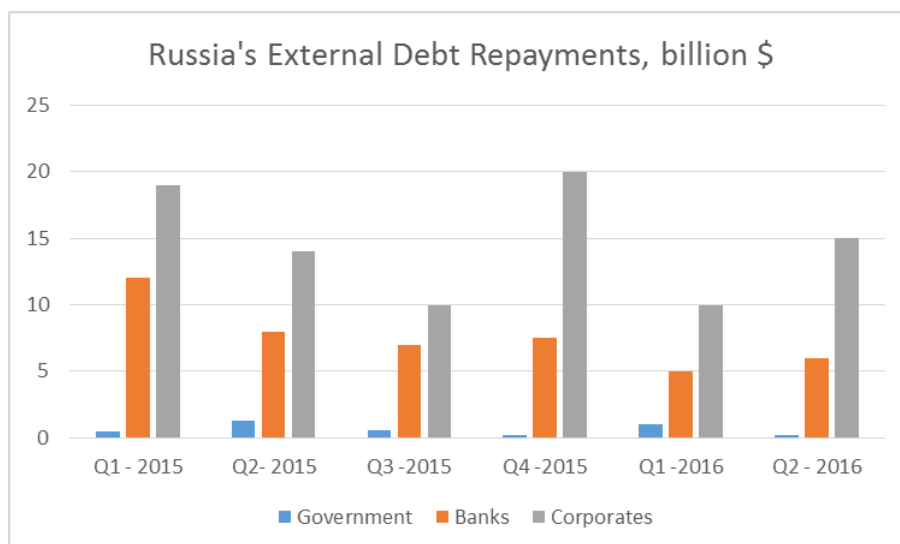


Source: Yahoo Finance

As the price of oil declined in recent months, the value of Russia's currency plummeted. The sharp decline in the ruble's price vis-à-vis the dollar was interpreted by many analysts as evidence that Russia's government was losing control of its ability to manage the economy. In fact, Russia's central bank—led by former Putin aide Elvira Nabiullina—embraces the ruble's decline because it acts as a shock absorber for government finances. In September a barrel of Russian oil sold abroad yielded about 3,700 rubles, because oil cost \$100 per barrel, and a dollar bought about 37 rubles. Today, a barrel of oil sold abroad yields only slightly fewer rubles, around 3,600 at current prices (\$70/barrel oil and 52 rubles per dollar). Most of the Russian government's expenses—pensions, salaries, and the like—are in rubles, so government finances are not much worse off today than when oil was at \$100 per barrel. The Kremlin deployed a similar strategy of devaluing the ruble in order to protect the government budget during the crisis in 2008-2009 and appears to be using a similar playbook this time.

The ruble's decline helps the government balance its books by shifting costs to individuals or institutions with expenses in foreign currency. Buying a foreign-made car, costs far more rubles today than a year ago, for example, which is one reason that car sales have slumped. The price of vacations in Europe have risen by two-thirds since the beginning of the year, leading to mass bankruptcies among Russian tour companies. Consumers who purchase many imported goods are now much worse off. The rich spend the most money on imports, though all Russians will feel the effect of the ruble's declining value through rising prices on food and clothes.

Many Russian firms, especially the country's banks, have large sums of debt in foreign currency. The ruble value of these debts has risen sharply, and many companies will need state help to survive. The Kremlin has no interest in seeing a state-owned firm default on its debt, and will take whatever steps are necessary to protect the banking system, even if it means raiding the country's \$80 billion pension pot.



Source: Central Bank of Russia

## **Bailouts, but for whom?**

Although the ruble's devaluation has shielded the government from lower oil prices, the Russian people have been made worse off, as their wages buy fewer imported goods and as businesses hesitate to invest because of sanctions and the Yevtushenkov affair. The main question the Kremlin faces is not economic, but political. Who will pay the price? In the short term, Putin appears to have decided to make Russian consumers pay by lowering their living standards. Prices for food, electronics, and other imported goods will increase, so consumers will have to buy less of them. Inflation may hit double digits, but wages will not rise accordingly. Taxes are already being raised.

In the medium term, however, the Kremlin faces a dilemma. Putin is popular in large part because living standards rose so rapidly during his first two terms as president, from 2000 to 2008. "It's the economy, stupid" was a concept that defined Putin's early years in office, but he now finds himself presiding over an economy that will stagnate in the near term. In his annual address to the Federal Assembly on December 4, Putin concluded by noting that "This year, as has been the case many times during crucial historical moments, our people have demonstrated national enthusiasm, vital endurance and patriotism." But Putin will struggle to convince Russians that he is a wartime president while denying that Russia is at war in Ukraine.

If national enthusiasm, patriotism, and the "Crimea is ours!" euphoria run out before growth resumes, Putin will face a perilous choice between squeezing the population and restructuring the Russia's elite. The first option, continuing to tolerate a weak ruble, high inflation, and lower living standards, may require more repression—and perhaps more foreign and internal enemies. Imposing costs on Russia's elite, such as the security service-linked businessmen who control much of Russia's energy industry and other state-owned companies, risks threatening Putin's personal power base. The Kremlin could save billions of dollars a year if it restructured Gazprom, for example, but the corruption that the company creates is the glue that holds Putinism together. The Kremlin cannot seriously reduce waste and corruption without compromising patronage networks and sparking a political crisis.

A rebound in the price of oil would resolve this dilemma by restoring the previous balance of resources between the populace and elite groups. So, too, would a burst of growth caused by reforms that encouraged investment. In his speech last week, Putin promised a series of measures to cut low-level corruption associated with bribe-seeking inspectors. Reducing corruption associated with health and safety checks is a fine idea, but the practical effect will be minuscule so long as the terrifying lessons of the Yevtushenkov affair haunt Russian businesses.

Indeed, Yevtushenkov's fate sums up the dilemma facing Russia today. Evidence is murky, but it appears that Rosneft moved to seize control of Yevtushenkov's oilfields in part because Western sanctions have imperiled the firm's ability to service its debt. Seizing Yevtushenkov's assets seemed an ideal solution, helping to resolve Rosneft's financing woes without a government bailout. In fact, expropriating Yevtushenkov's assets merely shifted the bill, onto Yevtushenkov personally, but also onto all Russians, who will suffer lower growth as businesses put off investment and shift funds abroad. Yet the poisonous cocktail of sanctions, expropriations, and low oil prices is not simply an economic problem. Stagnation degrades the social contract—mass prosperity plus elite corruption—that undergirds Putin's hold on power.