



## RUSSIA'S ECONOMY: SANCTIONS, BAILOUTS, AND AUSTERITY

By Chris Miller



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The news about Russia's economy keeps getting worse. The IMF predicts that the country's GDP will shrink by 3 percent in 2015. Other forecasters fear the recession will be even worse. Meanwhile, Russia's central bank has admitted that inflation might hit 15 percent this year. Unemployment is rising, too. The Kremlin has already spent \$100 billion—roughly a fifth of its reserves—fighting the crisis. Now, Moscow is seeking to apportion the costs of the recession, determining who will pay via higher taxes or lower benefits. In the face of the ruble's collapse, business groups are demanding bailouts and appear to be succeeding. The Kremlin is adopting a strategy of austerity, including swinging budget cuts and perhaps pension cuts, too. Given that Putin's rule has been predicated on steadily rising living standards, the Russian government's response to the crisis risks undermining the foundations of its own legitimacy.

### Causes and Consequences of Russia's Recession

Oil prices fell by 50 percent over the second half of 2014, and though they have recovered slightly in recent weeks—hitting \$60 per barrel—reduced energy export revenue is the main source of drag on Russia's economy. Indeed, the problem is not only oil: the price at which Russia sells gas to Europe, which is contractually linked to oil prices, will fall by a third in 2015.

If low energy prices were the only blow to Russia's economy, it would be painful but not a knock-out punch. Yet the economic effect of falling export revenue is compounded by the Kremlin's expansive—and expensive—foreign policy. The deployment of Russia soldiers to Ukraine is itself a costly undertaking, yet the Western sanctions that war provoked have proven more debilitating still. Many big Russian companies, from state-owned oil giant Rosneft to banks such as VTB, face restrictions on raising capital in US and European markets. Most of Russia's biggest firms had come to depend on Western investors for funding, and many have billions of dollars in debt that they are now struggling to refinance.

The combination of these factors will throw Russia into a painful recession in 2015 and perhaps beyond. The Kremlin's response thus far has been to redistribute the burden of the recession without addressing its fundamental causes. The country's dependence on energy exports cannot be eliminated overnight, of course, but Putin has decided to suffer through Western sanctions rather than withdraw troops from Ukraine.

To preserve his freedom of action in the short term, Putin has taken steps to shore up the government budget by letting the ruble fall sharply against the dollar. That has shifted costs on to corporations with foreign currency debts and on to consumers, all of whom import goods that now cost far more in ruble terms. Yet the depreciation of the ruble was just the opening move in a long-term chess game that will apportion the costs of the recession. Someone will ultimately need to pay the bill that is coming due. The Russian government has some capacity to borrow funds from international markets given its low debt levels, but the combination of war and low oil prices has left foreign investors skittish. S&P, a ratings agency, recently

downgraded Russia to junk status. Unless oil prices rapidly recover, spending will need to be cut, either by the government, businesses, or the population. Powerbrokers in Moscow are currently jockeying over budgets and bailouts, as each group seeks to force others to bear the brunt of Russia's recession.

### **Addressing the Cost of Sanctions**

The easiest way of dealing with the recession would be to remove some of the factors that are causing Russia's economy to contract—above all, the Western financial sanctions. Sanctions have not only cut off many of Russia's biggest firms from Western financial markets, the threat of further sanctions has forced the government and many companies to seek alternate suppliers to hedge against the risk that sanctions are deepened. *Kommersant*, a leading newspaper, has reported that Russia's government is considering bans on importing many types of machinery, in part as a sop to domestic industries, but in part to prepare for an expansion of sanctions. Individual firms have been forced to take action on their own, too. Gazprom, for example, is looking to find new suppliers for \$2.5 billion of its annual investment spending, replacing Western industrial groups such as Siemens and Caterpillar with partners from Belarus, Israel, India, and other countries that will not participate in potential future sanctions. Such a move may protect Gazprom from sanctions, but it will also raise the firm's costs—a further result of the war on Ukraine.

Despite the recent ceasefire deal in Minsk, the Kremlin looks unlikely to offer the type of concessions that would lead Germany or the US to consider lifting sanctions. This has not stopped Moscow from searching for ways to make its Ukraine policy less costly. One of the least noticed stipulations of the Minsk agreement was the call for “a full restoration of social and economic connections, including social transfers, such as payments of pensions and other payments” between the Donbass and the rest of Ukraine.

Ukraine's government had previously taken steps to cut the occupied territories off from the Ukrainian financial system and economy. Kyiv prohibited the payment of pensions to the occupied areas, officially on the grounds that the Russian-backed separatists might seize pensions to help fund their war effort. That presented serious financial risks to Russia, since it left open the possibility that Moscow would be forced to fund the Donbass separatists indefinitely. At the Minsk talks, Moscow insisted upon a resumption of economic ties between the Donbass and the rest of Ukraine in part to shift the financial burden back onto the Ukrainian government. This shows that the Kremlin is not unaware of the spiraling costs of its war effort, and will seek to economize when possible. But Putin so far appears willing to bear the burden of Western sanctions in order to achieve his aims in Ukraine.

### **Corporate Bailouts**

Moscow's response to the economic crisis has already involved bailing out politically-influential corporations. Some bailouts were inevitable, given that the devaluation of the ruble placed immense pressure on firms that had ruble income but dollar debts. Many of Russia's banks, for example, face insolvency as non-performing loans multiply and dollar debts become increasingly unserviceable. Like Western countries after the 2008 financial crisis, Russia also has banks that are ‘too big to fail.’ These banks will receive whatever government support they need to ensure they do not collapse and endanger Russia's broader financial system in the process.

Moscow is in the midst of a debate about what other businesses should receive bail outs. It is not only banks that are under financial pressure. Big industrials and petrochemical firms have sought state aid, too, and some have already received help. Russian Railroads, for example, benefited from a deal whereby a government savings fund invested in state-owned bank VTB, which in turn lent money, presumably at below-market rates, to fund Russian Railroads' long-term investment program. Whether these loans will actually get paid back is unclear. Even more controversial was the backdoor bailout of Rosneft, the state-owned oil firm which is lumbering under an enormous load of dollar-denominated debt. In December 2014, Rosneft received preferential regulatory treatment from the central bank to help it refinance debt, sparking a huge fall in the ruble once currency traders became aware of the shadowy deal.

Some in the Kremlin are trying to systematize corporate bailouts in an attempt to limit the overall cost and to prevent the anti-crisis program from becoming a feeding trough for the country's corporate titans. Early signs do not look good. Leading businessman Mikhail Fridman penned an op-ed in the *Financial Times* in early February pinning blame for the crisis on Russia's overdependence on state-owned energy firms. Fridman's implicit conclusion was that state-directed investment had not worked in the past, and it will not work now—so Russia's government should avoid handing out more funds to big firms. Yet a week after Fridman's op-ed, Rosneft head and long-time Putin ally Igor Sechin published a response, arguing that the fall in

the oil price was caused by “grotesque” market manipulation and speculation. Sechin’s conclusion was that only a strong state could overcome market speculation.

Sechin’s approach—which envisions large-scale state backing of business—appears to be winning out. At the beginning of February, the Ministry of Economic Development listed 199 firms that were eligible to apply for government aid, including not only banks, but also mining companies, airlines, a fertilizer producer, retail chains, and cell phone operators. Almost all of these companies will be hit by the recession, but it is hard to see how financial troubles at, say, a telecom firm would endanger the country’s economy. Instead, business interests are likely to take advantage of the anti-crisis program to gain access to low interest rate loans or other handouts, which would amount to a transfer of resources from taxpayers to corporations. That many of the firms that have received bailouts so far are run by former KGB colleagues of Putin’s—whether Russian Railroad President Vladimir Yakunin or Sechin himself—does not inspire confidence. As in the aftermath of the 2008 financial crisis, Russian firms are likely to receive a significant infusion of resources from the state budget, at taxpayers’ expense.

### **Austerity and Russian Politics**

For most of Putin’s time in office, high oil prices have made it possible to avoid tough decisions about distribution. Throughout the 2000s, Russia’s economic pie was growing so rapidly that everyone could have a slice. Wages rose sharply, benefiting average Russians, while windfall oil rents meant the state still had plenty of resources to distribute to political allies. The coming recession, however, will bring distributional questions to the fore. Who will pay the bill? Unwilling to reverse course in Ukraine or to restrain oligarchs seeking for bailouts, the Kremlin appears to have decided to make the population pay through austerity.

To some extent, this has already begun. Inflation has crept upwards even as wage growth has slowed, degrading the purchasing power of Russians’ incomes. Unemployment is increasing. The devaluation of the ruble will raise prices for imported goods, forcing Russians to cut back not only on luxuries such as European holidays, but also on basics such as clothes and food, much of which is imported.

Other measures to shift costs on the population are also being considered. In response to the crisis, Russia is cutting government spending by 10 percent across the board, except for the military’s rearmament program, which will be maintained at current levels. This will reduce the provision of education, health, and other social programs. At the same time, former Finance Minister Alexei Kudrin—a long-time influential advisor to Putin on economic questions—has joined forces with several current ministers to demand an increase in the age at which Russians receive state pensions. Russia’s current retirement age, at 55 for women and 60 for men, is low by European standards, though Russian life expectancy is lower than Western Europe’s. Yet this question is as much political as it is economic. Over the past 15 years, Putin’s government has been predicated on steadily increasing living standards, and the pension debate will be a test of whether Putin feels he can break this social contract.

That would be a risky move. Signs of discontent are already visible. Polls suggest that average Russians have not yet begun to register higher inflation, though there was a much-publicized scare late last year when supermarkets in several regions ran out of *grechka*, a buckwheat porridge that is a Russian staple. More worrisome for the Kremlin are complaints about public services. Doctors, who are state employees, attracted much support as they led mass rallies against cuts to health spending last fall. More recently, train ticket price hikes led to popular outrage that forced Putin to publicly criticize his ministers. Yet given the government’s decision to adopt austerity uncoupled with any attempt to improve efficiency, declining public services are inevitable.

The social tension that recession unleashes will create new challenges, but it is unlikely to threaten Russia’s political stability in the short term. By helping to raise living standards throughout the 2000s, Putin has accumulated a large reserve of popular trust that he can now draw on. And his ‘political technologists’ have honed their skills for ensuring that the opposition remains divided and under constant legal pressure. When opposition leader Alexey Navalny began attracting attention with calls for an anti-crisis protest on March 1, ten other groups, including the Communist Party, filed for permission to hold protests that same day, a classic diversionary tactic. Games like this have proven repeatedly effective over Putin’s 15 years in power. As wages stagnate and unemployment picks up, Putin’s core claim to economic competency will begin to erode. The longer the recession lasts, the more Putin will have to rely on nationalism and repression to sustain his rule.

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