

CAN “PUTINOMICS” SURVIVE?

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SUMMARY

- High oil and gas revenues in the 2000s stimulated consumption-led growth in Russia, with low investment and increasing dependence on imports. Government intervention in the economy crowded out private investment, and corporations came to rely on international financing.
- In 2014 Russia experienced a sudden fall in oil prices and Western sanctions. Devaluation helped to preserve currency reserves and to rebalance government finances, but also led to a drop in consumption.
- A drop in domestic production costs supported industrial output in the first quarter of 2015. Exports of raw materials increased but the import substitution effect was small, due to low domestic consumption and high prices for investment.
- Recent data show a fall in manufacturing output and continued drop in investment and retail turnover. A new phase of the crisis is starting: while many Russians expect a V-shaped crisis, they may face prolonged decline that could undermine trust in Putin's policies.
- Access to external financial markets is crucial for the Kremlin. If financial sanctions are reduced, it might stimulate capital inflow and permit an import substitution policy that could stabilise the economy. Combined with mid-level oil prices, this could allow a “demodernisation strategy” – a period of stagnation buttressed by an authoritarian political system with an anti-Western ideology.

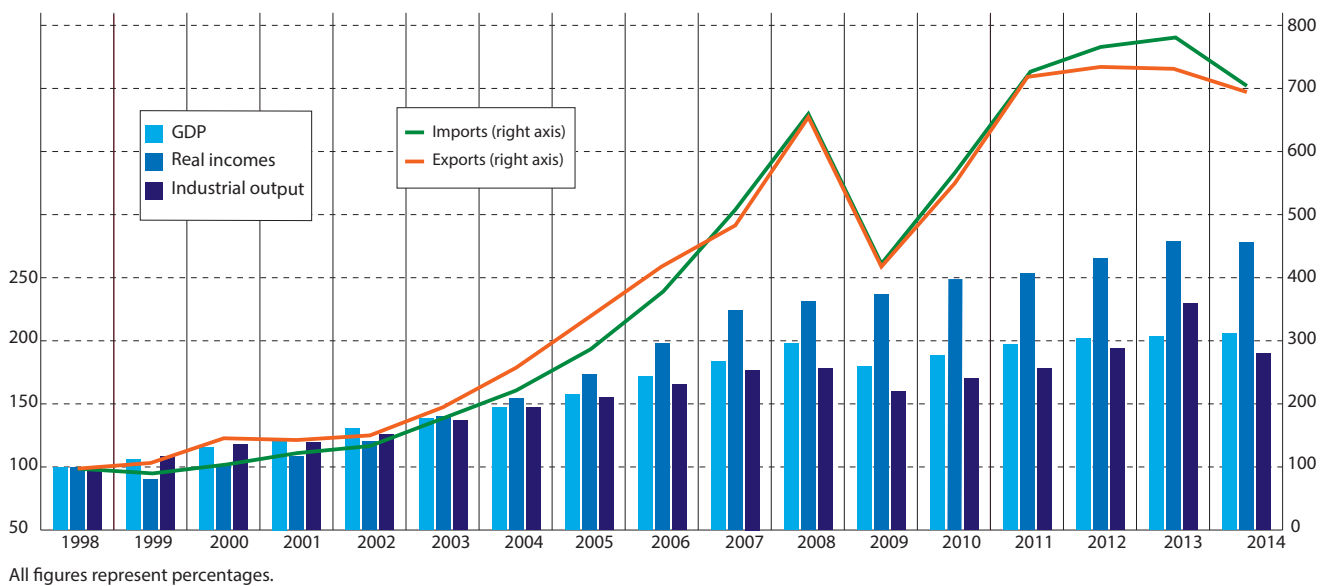
At the end of 2014, the Russian economy experienced a double shock: a sudden fall in oil prices and Western sanctions. The first shock is a standard challenge for any resource-rich country. In the long term (1992–2013), the share of resource rents in the Russian economy has averaged about 25 percent, and fluctuated between 17 and 35 percent.¹ The second shock – the sanctions imposed by the European Union and the United States in response to the annexation of Crimea and the destabilisation of eastern Ukraine – has substantially restricted Russian companies' access to international financial markets. In economic terms, this second shock resembles a sudden stop in capital flows, which in emerging economies usually leads to a decline in investment, output, and private spending.

This policy brief explores how that double shock will affect “Putinomics” – the economic system developed during the period of high and rising oil and gas export revenues under Putin's governance. How severely will the double shock hurt the economy and what political consequences might it cause? Will the effect of the sanctions, exacerbated by falling oil prices, be to undermine Putin's anti-Western and anti-Ukrainian crusade or boost it? Will sanctions reduce public support for Putin's policies? What effect will they ultimately have: a long period of isolation, as in Iran; a miserable existence, as in North Korea; or the collapse of the regime, as in the USSR? In short, will “Putinomics” survive and, if so, in what form?

The main argument of this policy brief is that the Russian economy will not collapse in the near future, assuming the price of oil remains at around \$60 per barrel; rather, it will

¹ The World Bank, Global Development Indicators: Total natural resource rents (percent of GDP); the share of total natural resource rents in GDP fluctuates depending on the production (and export) of mineral resources (by volume), global prices for resources, and nominal exchange rates.

Figure 1: GDP, real income, industrial production growth, exports, and imports indices (1998 = 100 percent)



Sources: Federal State Statistics Service; the Central Bank of the Russian Federation; author's own calculations.

start to sink into a gradual depression. The devaluation of the ruble cancelled out Russia's consumption-led growth model developed in the mid-2000s. While the ruble's depreciation rebalanced state finances after the fall in oil prices and increased the competitiveness of Russia's manufacturing sector, the economy requires additional capital for investment to lessen its dependence on imports and spur import substitution growth. State and quasi-state demand could support industrial production, but its impact would be limited because of Russia's shrinking money reserves and the external debt of its banks and companies.

The majority of Russians expect a V-shaped crisis – that is, a drastic drop and a quick recovery – and this explains their endurance of the current crisis. The rise in oil prices (up about 35 percent in April 2015 against January's figures) and macroeconomic stabilisation has added to this optimism. At the same time, the most recent statistics indicate that a new phase of the crisis, manifested by a serious decline in industrial output, has begun. And it could undermine people's trust in the government and Putin's policies.

That is why abolishing or even weakening the Western sanctions in the financial sphere has become a crucial issue for the Kremlin. While assets remain undervalued and domestic production costs are lower, the weakening of financial restrictions could promote capital inflow and an uptick in investment to launch the import substitution strategy. This would give the Kremlin the opportunity and legroom to strengthen authoritarian institutions and adapt both the economy and people's expectations to prolonged stagnation under a more autocratic and autarchic regime inspired by anti-Westernism and the ideology of isolation and self-sufficiency.

A brief history of "Putinomics": the rise of the rentier state

In the past 15 years – an era marked by soaring oil prices and Putin's rule – Russia has experienced intense growth. Exports increased sevenfold, from \$75 billion a year in 1999 to an average of \$515 billion between 2011 and 2014. Between 1998 and 2014, Russia's GDP expanded by a factor of 2.1, industrial output by a factor of 1.9, and real personal income by a factor of 2.8. The rapid growth of export revenues produced an inflow of foreign currency, which in turn led to the appreciation of the ruble and made Russia's GDP and income growth look even more impressive in dollar terms. Russia's GDP per capita rose from \$1,330 in 1999 to \$14,600 in 2013 and the average monthly salary leapt from \$60 in 1999 to about \$940 in 2013. This gave the impression that the economy was booming; in fact, average growth rates in Russia were lower than the average growth rate for the post-Soviet countries in the Commonwealth of Independent States.

Growing consumer demand stimulated by rising oil and gas export revenue was partly covered through an increase in domestic supply and in part through an increase in imports. Since 1999, the total value of imports has increased sixfold, from about \$50 billion to about \$315 billion in recent years.

However, as Figure 1 illustrates, the rate of this economic growth has varied, as has its quality. Between 1999 and 2004, while export and import growth remained moderate, industrial output was growing intensively through output expansion in the extractive and metals industries, as well as through the substitution of previously imported consumer goods. Between 2004 and 2007 – when oil prices rose dramatically – almost every sector and industry grew, including chemicals, electronics, automobile production, and machines

and equipment. And the real income growth rates during this period were much higher than those for industrial output as well as import growth.

The global financial crisis and short-lived drop in commodity prices led to a 7.8 percent decline in output in Russia. But, as oil prices began to rise again, the economy quickly recovered. However, since 2011, though oil prices remained above \$100 per barrel until the third quarter of 2014 and thus produced an even bigger inflow of petrodollars than during the first oil boom, the economy failed to respond. Growth has slowed – and stagnated since 2013 – and investment declined in 2014. The gap between real incomes and industrial output cumulative growth increased. In contrast with the pre-crisis years, capital continued to flee Russia: total capital outflow between 2011 and 2013 amounted to \$227 billion and peaked at \$151 billion in 2014. In 2008, Russia's GDP was 140 percent of the 2003 level, but by 2014 – five years after the crisis – GDP exceeded the 2008 level by only 6 percent.

Behind these numbers lies a set of structural changes that reflect the shifting balance of Russia's political system and the government's increased intervention in the economy. The Russian oligarchs of the 1990s lost most of their political influence in the 2000s – and some of them lost their assets too. Meanwhile, the government has increased its ownership of the oil and gas industry. It took over two major oil companies (Sibneft and Yukos), as well as some lesser ones, and it increased its interest in Gazprom and revised the terms of the Sakhalin production-sharing projects. As a result, a much larger chunk of Russia's oil rent is now under state control.

As Michael Rose argues in a recent book, the nationalisation of oil and gas assets is critical for the development of so-called “resource curse” effects. It leads to rising volatility in state finance, an increase in people's expectations of rent revenue distributions, and the crowding out of private investment.² This certainly seems to apply to Putin's Russia in the late 2000s and early 2010s.

The system that replaced the oligarchic one has led to even more uncertainty for businesses. Personal connections and an affiliation with Putin and his close circle have become the only guarantee of property rights. Not only has this discouraged private business owners from investing, it has also caused them to finance their companies through foreign loans. At the same time, the government has consolidated some of Russia's important industrial assets in state-controlled holding companies and enhanced its role in the banking system. In short, Russia's investment model has changed: private investment has been crowded out by government financing. When oil prices and export revenues were rising every year, it drove up consumption and provided resources for investment. But when oil prices stopped rising in 2012, the economy started to slow, as did the rate of investment.

Rising domestic costs have also contributed to the substantial decline in investment in recent years. Although GDP had by 2011 returned to the 2008 level, domestic prices were 10–30 percent higher. The share of labour costs (in terms of national

accounts) increased to 53 percent, which would be normal for an advanced economy but quite abnormal for an emerging or developing one. This reduced producers' profit margins and brought about an essential lack of investment.

However, thanks to high export revenues, this slowdown has affected neither consumption nor government spending. As real incomes continued to grow, Russia experienced a genuine consumer credit boom. Dozens of huge, sparkling shopping malls were built in major cities, their parking lots filled with foreign-branded cars. Russians felt rich while travelling abroad and bought real estate around the world. Meanwhile, even as the country experienced significant capital outflows, the economy was supported via massive foreign borrowing on the part of Russian banks and corporations. Russia's corporate sector debt went from \$490 billion in 2010 to \$730 billion at the beginning of 2014. Russia's central bank provided generous loans to domestic banks to help stimulate production and consumption growth. These loans reached 10 percent of the banking system's total assets.

The government also stimulated the economy through additional spending. Annual public spending accounted for about 33 percent of GDP between 2004 and 2008, but rose to almost 37 percent between 2011 and 2014. Abundant export revenues and increased spending enabled the government to finance increases in pensions and public sector salaries (especially for the army, the secret services, police, and law enforcement personnel) and to launch an ambitious military modernisation programme. Additional funds were provided to finance high-profile construction projects before the APEC summit in Vladivostok in 2012 and the Winter Olympics in Sochi in 2014. In short, “Putinomics” climaxed in 2013 and 2014 with an era of splendid and opulent stagnation.

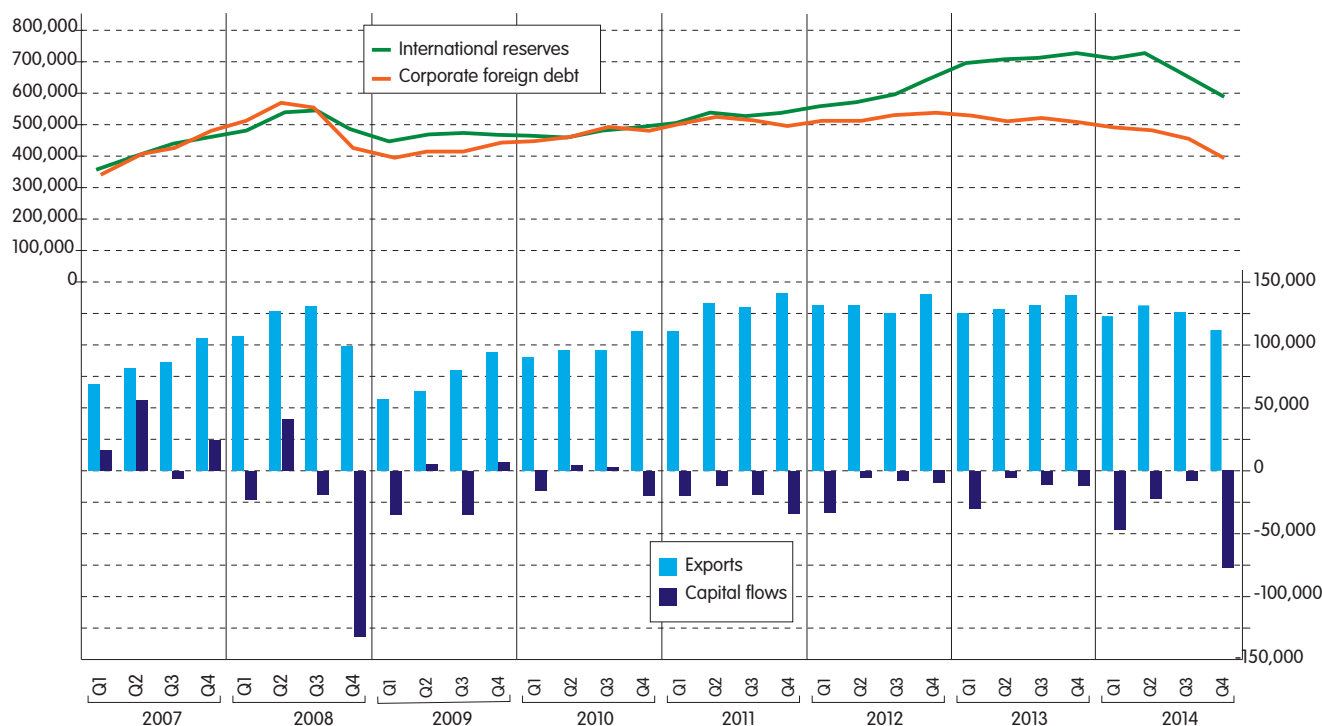
The first blow: the currency crisis and its consequences

The drop in oil prices, structural problems in the economy that were evident in increased capital outflows along with investment and output stagnation, and political tensions between Russia and the West over Ukraine which resulted in sanctions caused the fall in the ruble, culminating in the December 2014 currency crisis. The ruble's devaluation by 50 percent was the steepest among commodity currencies (that is, the currencies of countries that depend heavily on the export of commodities for income).

While the foreign debt of Russian banks and companies increased substantially between 2009 and 2014, it remained around 140 percent of central bank reserves and about 140 percent of the previous year's total exports. But the two new factors – sanctions and the fall in oil prices – radically changed the assessment of the macroeconomic risks. In 2014, Russian companies reduced their total debt from \$729 billion to \$599 billion, and central bank reserves fell from \$510 billion to \$385 billion. So, while the debt-to-reserves ratio increased to 155 percent, expected export revenues for 2015 (about \$300 billion) are now about half of Russia's current debt.

² See Michael L. Ross, *The Oil Curse: How Petroleum Wealth Shapes the Development of Nations* (Princeton: Princeton University Press, 2012).

Figure 2: Exports, capital flows, corporate foreign debt, and international reserves



All figures are in millions of USD.

Source: The Central Bank of the Russian Federation

The currency crisis also had political implications. A significant share of corporate foreign debt is owed by government-controlled companies and banks. For example, the oil company Rosneft had to pay about \$10 billion in the last quarter of 2014. As oil prices continued to fall in November and December, Rosneft and other exporters stopped selling foreign currency and started to buy it. Moreover, the central bank was forced to provide additional liquidity to Rosneft to help the company accumulate foreign currency for external debt payments. The expansion of the money supply coincided with a sharp new fall in oil prices and provoked panic in the currency markets. To stop the panic, the central bank had to raise its base rate to 17 percent. In other words, the bank first provided liquidity to one company and then blocked access to liquidity to others – what economist Paul Krugman called “macroeconomic cronyism”.³ This illustrates how authoritarian rule helps to redistribute the costs of crises and external shocks among economic agents.

However, cronyism was not the only factor behind such a severe depreciation of the ruble. Amid the confrontation with the West and a sharp fall in export revenues, the radical devaluation of the ruble served two main purposes: it arrested the decline in Russia’s international reserves that might have resulted from excessive demand for foreign currency; and it rebalanced the country’s revenues and spending. While reve-

nues from oil exports have halved in dollar terms, the 50 percent devaluation of the Russian currency means their value in rubles has remained the same.

There are two other standard consequences of devaluation. On the one hand, it decreases domestic production costs, making domestic industries more competitive. On the other hand, it triggers inflation as a result of the exchange-rate transfer into domestic prices for imports and brings the banking system to the verge of a full-scale crisis because of the extremely high base rate.

At the beginning of 2015, the government announced a plan to prop up the banking system with an injection of 1.5 trillion rubles. The central bank provided the three biggest banks (Sberbank, VTB, and Gazprombank) with subordinated loans. The formal and informal government control of the banking system provides room to prevent panic and bank failures. The second threat – inflation – is an even greater challenge, because it seems to be the heaviest price to pay for devaluation. Inflation eats away at people’s income and purchasing power, thereby undermining total demand and output.

After 15 years of consumption-led growth, the problem is even more acute. The main channel through which the external shock caused by the fall in oil prices is destabilising the Russian economy is almost the same as the one that induced the collapse of the Soviet economy 30 years ago: import dependence. In recent years, Russian imports reached around

³ Paul Krugman, “Macroeconomic Cronyism”, New York Times, 3 February 2015, available at http://krugman.blogs.nytimes.com/2015/02/03/macroeconomic-cronyism/?_r=0.

\$315 billion a year while Russia's total retail sales stood at around \$750 billion a year. According to various estimates, imports account for 35–45 percent of the Russian retail market. These figures give an idea of how a 50 percent devaluation affects domestic market prices.

Furthermore, it is not only the volume of imports that has changed but also their place in the Russian economy. During the last 15 years of economic growth, “import localisation” has developed as part of global supply chains. Today, a huge part of domestic production depends not only on imported machines but also on imported fittings, equipment and materials – so-called intermediate imports. The share of imported goods for final consumption in total imports is about 35 percent, with machines, plants, and equipment (designated as imports for investment purposes) accounting for 25 percent. The rest, about 40 percent, is represented by intermediate imports. In some industries and product groups – such as automobiles, clothing, textiles and footwear, household appliances, electronics, computers, and pharmaceuticals – the share of imported components and materials reaches 50–80 percent. This means that value added by domestic producers is comparatively small and appears to be another effect of consumption-led growth stimulated by oil rents: that is, intermediate import dependence is another consequence of underinvestment in the economy.

The depreciation of the ruble has caused prices to increase not only for directly imported goods but also for many “domestic” products that contain a larger or smaller share of imports. As a result, the economy's response to devaluation differs from that between 1999 and 2001, when import substitution was one of the drivers of the economic recovery. Then, imported goods for final consumption became too expensive for consumers and were replaced by worse but cheaper domestic substitutes. Now, the difference between imported and domestic goods is less obvious: the conversion of exchange rates into prices affects a huge number of domestic products. Meanwhile, import substitution requires the organisation of manufacturing components and materials that were previously purchased abroad, which requires major investment and takes time.

In short, the December 2014 currency crisis undermined the consumption-led growth model that had shaped Russia's economic development during the previous decade. At the same time, however, it helped to limit possible damage to the state's finances, allowing reserves to be saved and the budget to be balanced. The depreciation of the ruble also had contrasting effects on the economy in terms of demand and supply: on the one hand, it stimulated production by reducing production costs and making domestic producers more competitive; on the other hand, it cut real household income and consumption capacity, thus reducing demand and output. The big question in the first few months of 2015 was, how would these two factors play out?

Why the Russian economy didn't collapse, but won't recover

Despite a drastic decline in oil prices and the imposition of Western sanctions, Russia's economy failed to collapse in early 2015. In fact, statistics for industrial production output in the first quarter of 2015 appear to suggest that there is no crisis at all. In January 2015, industrial production performed even better than in January 2014 and in Q1 2015 the industrial production index was 99.6 percent of the level for Q1 2014. The decline in manufacturing was also surprisingly moderate: it fell no more than 1.5 percent.

These results contrast sharply with the situation in Q1 2009 when, after a similar decline in oil prices, the industrial production index was only 83 percent of the level for Q1 2008 and manufacturing had collapsed by about 25 percent. The encouraging industrial performance, accompanied by macro-economic stabilisation in March and April, led to a surge of optimism among Russian officials and citizens alike. The former announced that the worst phase of the crisis had passed. And, according to opinion polls, the latter's views on the state of the economy saw an intense recovery after a dramatic decline in January and February.⁴

There are two reasons for the reassuring economic results of Q1 2015. The first is that while the global financial crisis of 2008 saw a fall in demand (and therefore in price) for all resources and raw materials – including metals, chemical products, corn, and wood (these primary products comprise 20–25 percent of Russia's total exports) – this time the plummeting oil price wasn't accompanied by a fall in demand and prices for other resources on the global market.

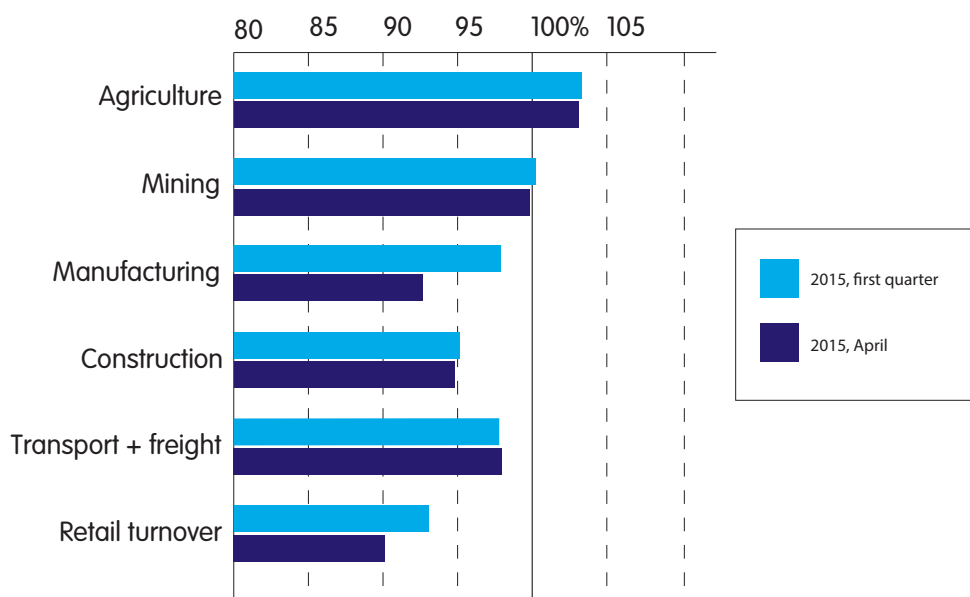
The other factor that ensured the stability of Russian industrial production was the devaluation of the ruble, which reduced domestic production costs. A closer look at Russian manufacturing in Q1 2015 shows that raw materials industries – such as oil refinery, metallurgy, and manufacturers of chemical products and fertilizers – were the ones that demonstrated output growth. While the effect of import substitution was in fact small because of decreasing consumption within Russia and the substantial lack of investment (though some import substitution was observed in food production and agriculture), industries that have a substantial share of exports benefitted from lower production costs after the ruble's devaluation and increased their output and exports.

In fact, though Russian exports in Q1 2015 reached only 75 percent of the level for Q1 2014 in dollar terms, exports grew in real terms (i.e. in tons and units). The physical volume of exports of oil and refined petroleum products, iron and base metals, chemical products and fertilizers, and even machines and equipment production increased by 10–40 percent.⁵ This partly compensated for export income losses caused by the oil

⁴ According to polls conducted by the Levada Center, the percentage of respondents who see Russia's economic performance as worsening fell from 36 percent in February and March to 26 percent in April; the percentage of respondents who think the current crisis will continue for at least one to two years (or longer) fell from 35 percent to 27 percent; and the percentage of respondents who shortly expect an uptick in the economy rose from 23 percent in February and March to 38 percent in April. See *Operativnyi monitoring ekonomicheskoy situatsii v Rossii*. 2015. No. 8 (in Russian).

⁵ See *Operativnyi monitoring ekonomicheskoy situatsii v Rossii*. 2015. No. 8.

Figure 3. Indices for the main types of economic activity in Q1 2015 and in April 2015 compared with the same periods in 2014.



Source: Federal Statistics Service

price drop and mitigated the negative influence of the crisis for industrial production.

But this is only part of the story. While some industries benefitted from devaluation and stable external demand, consumption and investment were both devastated by the ruble's devaluation, the macroeconomic volatility and political instability. In Q1 2015, investment fell by 6 percent compared with the same period a year ago, a fifth straight quarter of decline. The contraction in domestic consumption led to a fall in output in industries that are highly dependent on intermediate imports and are more sensitive to consumers' ability to pay, such as automobiles and transportation equipment, manufacturing, clothing and textiles, household goods, and digital devices. On average, output in these industries was 80–95 percent of the comparable figure for last year.

The decline in retail turnover reached 7 percent in Q1 2015, a reflection of rising inflation and the fall in people's purchasing power. As a result of this deterioration, as well as the decrease in construction and the financial sector's losses, Russia's GDP fell by 1.9 percent in Q1 2015.

Moreover, the new paradox of oil dependence and macroeconomic volatility has become evident in recent months. The rise in oil prices in March and April led to macroeconomic stabilisation. The value of the ruble rose while inflation started to come down (from 16.9 percent in March to 16.4 percent in April). At the same time, the ruble's current appreciation (in real terms it has risen 22 percent since December 2014) reduced the competitive advantages of the raw material-exporting industries, which also suffer from the high price of money. As a result, the figures for industrial production output in April were shocking: manufacturing industries fell by 7.2 percent compared to the level for April 2014, while the decrease in retail turnover hit 10 percent.

In contrast to official and public optimism, these results suggest that the crisis has yet to pass. Moreover, expectations of the crisis among both the public and experts were based on the experience of the two V-shaped crises the Russian economy went through in 1999 and 2009. Those crises were characterised by a sudden and drastic decline followed by a quick recovery. In that light, the economic performance at the beginning of 2015 looks promising if seen as evidence that the full force of the crisis will be followed by gradual economic improvement. But it seems increasingly plausible that the current crisis will radically differ from the previous one and that it is following the pattern of a depression – that is, step-by-step deterioration that gradually drags the economy deeper into a quagmire. In other words, shrinking consumption leads to output contraction, triggering a further drop in household income and a further decline in consumption.

During the crisis of 2009 the government supported consumption by preventing the ruble's devaluation, and then poured money into the banking system and industrial production, thereby maintaining the consumption-led growth model. This time, however, it has sacrificed private consumption to preserve state and government finances. But while the consumption-led growth model was destroyed by the ruble's devaluation, the drop in imports did not lead to substantial import-substitution growth because of the decline in consumption and high prices for investment.

That is why the Western sanctions against the financial sector now appear to be crucial for "Putinomics". The ruble's devaluation has provided a significant advantage to the economy and made up for the discrepancy between productivity levels and domestic costs which persisted in the period of high oil prices. The reduction of imports creates a possible opening for import substitution, but this requires investment. The central bank is going to decrease the base

rate while inflation slows and the ruble strengthens. But the Western sanctions against the financial sector and the problem of the banks' and corporations' external debt, which cannot be refinanced under sanctions, detract from the advantages of devaluation. If the financial sanctions were repealed or even weakened this summer, it might stimulate capital inflow and an increase in investment in Russia's mining and manufacturing industries and thus support the rebalancing of "Putinomics" – and its survival.

The strategy of demodernisation and the conditions for its success

There are two basic views on the Russian economy in its current mode. The first emphasises its deep integration into the global economy and its dependency on external markets. Revenues from the export of mineral resources have boosted domestic consumption, stimulating a rise in output and imports. As described above, this growth also essentially depended on funding from global capital markets. Former Russian Finance Minister Alexey Kudrin called this model "imported growth".⁶ This view stresses the dependence of "Putinomics" on external factors – oil and gas revenues, integration into international financial markets, and imports of consumer goods, materials, and machinery – and focuses mostly on rising private consumption as the main driver of economic growth and the main basis of Putin's political support.

The second view emphasises the Soviet legacy on the Russian economy, which was given new impetus in the late 2000s and early 2010s when the government started to play a more significant role in the economy through direct redistribution of resource rents. This legacy is associated with Russia's large government and quasi-governmental sector, its heavy machinery and metals industry, and the extractive sectors. It includes state-owned monopolies such as Gazprom, with its gigantic pipeline projects, railways, the power industry and electrical engineering, new state-controlled corporations, and the defence industry. All of them are interconnected through a network of redistribution chains.

Clifford Gaddy and Barry Ickes explain the way this economic system works: "Suppliers of material inputs (fuel and energy, metals, and components) and services (railroads and pipelines) are bound to serve machine building enterprises. The produced machinery and equipment are then shipped, predominantly to these very same input sectors."⁷ Commercial orders from the government and monopolies, as well as government subsidies and loans, produce demand for products, which secures not only the consumption of raw materials but also employment. Gaddy and Ickes argue that this old-fashioned rent redistribution network plays a stabilising role in an economy that is heavily dependent on min-

eral resource exports.⁸ The redistribution chains increase the economy's sustainability in the face of external shocks and create a basis for self-sufficiency.

Of course, this system needs additional resources to maintain its inefficiency and cover its losses. During the current period of shrinking rent from external markets, both the Reserve Fund and the National Welfare Fund will be used for that purpose. These funds reached \$166 billion at the beginning of 2015, of which between \$50 billion and \$55 billion are supposed to be used to finance the budget deficit under the new budget plan for 2015. An additional \$8 billion will be used to provide support for the banking system, though it may well need more. State-owned companies and infrastructure projects are claiming additional money from the National Welfare Fund too. It looks as if the Kremlin is going to spend about half of its total reserves (\$75–\$85 billion) to support the economy this year if the price of oil remains at about \$60 per barrel.

The new anti-crisis budget plan announced in March illustrates the Kremlin's real strategy and priorities. The only areas in which spending has been increased (or only marginally reduced) are social welfare, defence, and law enforcement. As a result, social welfare now accounts for 26 percent of total spending, defence and law enforcement accounts for 34 percent, while healthcare and education combined account for just 6.5 percent of total spending. While the consumption-led growth model and the industries most closely connected with it (automobiles, electronics, home appliances, and so on) have been hit by the severe depreciation of the ruble, Putin is prioritising the old-style industrial sector with its redistribution chains, pensioners (who are being supported through an increase in social expenditure), the repressive state apparatus, and the army and defence industry.

While consumption is mostly associated with the big cities, a huge part of Russian industry is concentrated in small and medium-sized towns, which have much lower income levels, few private savings, a smaller share of services in their economy and of imported goods in consumption, and a less vibrant social life. In this "second Russia", the main challenge is more or less to maintain employment and levels of income and consumption.⁹ The current strategy seems likely to produce stagnation for the Russia of the big cities, with their massive consumption and aspirations for modernisation. But the industrial Russia of small towns, with their predominantly conservative lifestyle, could stabilise and provide a source of support for Putin through the "lean years" that Russia now faces. Meanwhile, the "first Russia" will be neutralised by the new political agenda of confrontation with the West, political mobilisation in the face of external threats, and a crackdown on political and civic activism. It is quite remarkable that, while the government is cutting spending, it plans to increase its support for the mass media by 3 percent: propaganda is crucial to the Kremlin's crisis strategy.

6 Alexei Kudrin and Evsey Gurchik, "A new growth model for the Russian economy", Bank of Finland, BOFIT Policy Brief, 2015, No. 1, available at [http://www.eeg.ru/files/lib/Kudrin-Gurchik%20\(BOFIT-2015\).pdf](http://www.eeg.ru/files/lib/Kudrin-Gurchik%20(BOFIT-2015).pdf) (originally published in Russian in *Voprosy Ekonomiki*, No. 12, 2014).

7 Clifford G. Gaddy and Barry W. Ickes, "The Russian Economy Through 2020: The Challenge of Managing Rent Addiction", in Maria Lipman and Nikolay Petrov (eds), *Russia in 2020: Scenarios for the Future* (Carnegie Endowment, 2011), p. 171, available at <http://carnegie.ru/publications/?fa=46030>.

8 Clifford G. Gaddy and Barry W. Ickes, "Can Sanctions Stop Putin?", Brookings Institution, 3 June 2014, available at <http://www.brookings.edu/research/articles/2014/06/03-can-sanctions-stop-putin-gaddy-ickes>.

9 Natalia Zubarevich, an expert on regional economies and social development, argues that there are "four Russias" – different parts of the country that have very different levels of economic development and social set-ups. See Natalia Zubarevich, "Four Russias: Human Potential and Social Differentiation of Russian Regions and Cities", in Maria Lipman and Nikolay Petrov (eds), *Russia 2025. Scenarios for the Russian Future* (Basingstoke: Palgrave Macmillan, 2013), pp. 67–85.

As this analysis demonstrates, the contraction of the Russian economy's dependence on imports looks to be another fundamental condition for the rebalancing of "Putinomics" and the adaptation to mid-level oil prices. Ineffective in the long term, as the experience of many countries has demonstrated, the policy of import substitution can support industrial output and even provide economic growth in the short term, as well as serve the purpose of ensuring the survival of Putin's regime. So-called Latin American structuralism – the import substitution industrialisation (ISI) strategy implemented in some Latin American countries between 1950 and 1980, and widely discussed in academic literature¹⁰ – is predicated on protectionism, vertical integration, and wide government interventionism. It was originally developed as the ideology of self-sufficiency and would fit naturally with anti-globalism and anti-Westernism in the political sphere.

Together with the redistributive policies described above and focused on the redistribution of shrinking resources for the purpose of political survival, the renewed ISI strategy provides an appropriate framework for a mid- or even long-term demodernisation strategy for Russia under the current regime. However, as indicated by the data on the economic dynamics in Russia during the first few months of 2015, the ruble's steep devaluation (now about 35–40 percent) and the associated reduction of imports are still insufficient conditions to start the process of import substitution. The implementation of such a policy requires additional protectionist measures and additional financial resources. The effectiveness of protectionist measures was demonstrated by the food embargo Putin imposed on countries that joined the sanctions against Russia (the so-called counter-sanctions). As for additional resources, they can be obtained either through the rise in oil prices or through new external public or quasi-public borrowing.¹¹ The possibility of such borrowing now appears to be critical for the implementation of the strategy described.

The new phase of economic deterioration indicated by the continued decline in industrial production output and consumption in April could undermine the optimistic expectations of the first months of the year. If patriotic enthusiasm for Putin's anti-Western policies also falls, this is likely to reduce the time available to the Kremlin to modify people's expectations and reinforce authoritarian institutions for the purpose of prolonged stagnation maintenance.

¹⁰ See, for example, Werner Baer, "Import Substitution and Industrialization in Latin America: Experiences and Interpretations", *Latin American Research Review*, Vol. 7, No. 1 (Spring, 1972), pp. 95–122, available at http://www.jstor.org/stable/2502457?seq=1#page_scan_tab_contents; and the chapter on Latin America in Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: The Battle Between Government and the Marketplace That Is Remaking the Modern World* (New York: Free Press, 1998).

¹¹ While Russian corporate external debt is substantial, Russian public external debt is extremely low (about 2.5 percent of GDP).

About the author

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