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ISSUE BRIEF

The Russian Economy: Short-Term Resilience, Long-Term Stagnation?

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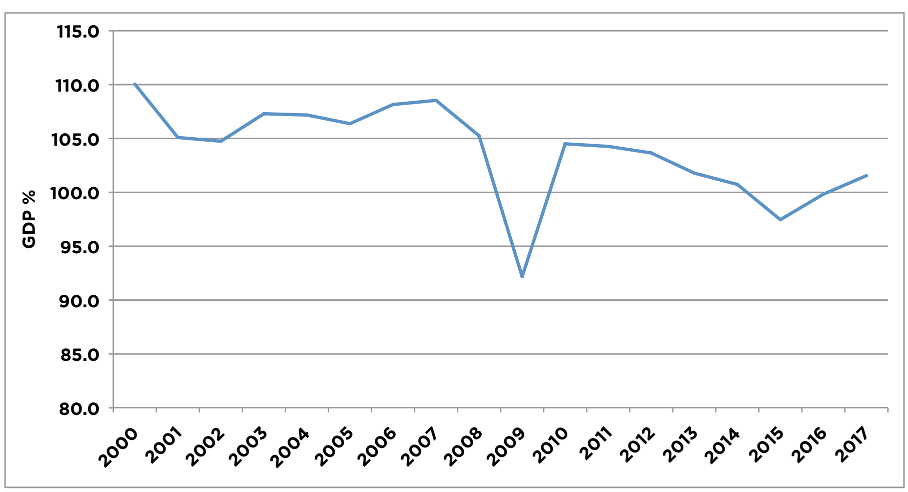
When, in September 2011, then Prime Minister Vladimir Putin announced his decision to run for a third presidential term, it seemed that the Russian economy was going to recover from the 2008-09 recession. As soon as the price of oil reached $100 per barrel (bbl) in the beginning of 2012, Russia's gross domestic product (GDP) returned to pre-crisis levels, but by the middle of that year, the economy was once again losing its momentum. Economic growth slowed down and, more importantly for the long term, the growth of investments came to a trickle. Although the average oil price was a high $108 per barrel in 2013, Russia's economic growth fell to 1.7 percent (see Fig. 1).

Figure 1. Russian economic growth, 2000–17



Source: "*Natsional'nyye Scheta,*" Russian Federal State Statistics Service, accessed April 23, 2018, http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/accounts/.

The Eurasia Center's mission is to enhance transatlantic cooperation in promoting stability, democratic values and prosperity in Eurasia, from Eastern Europe and Turkey in the West to the Caucasus, Russia, and Central Asia in the East.

As former Russian Deputy Prime Minister Alexey Kudrin and economist Evsey Gurvich noted, "The slowdown caught both the Russian government and [its] analysts off guard."[1] Nobody could accuse Putin of changing his economic policy or his economic team. Putin's economic reforms in the beginning of the 2000s were neither comprehensive nor radical, leaving many areas such as the gas industry, railways, and public administration untouched. In his first presidential term, Putin sponsored several laws that significantly changed the economic rules of the game. The tax code simplified the tax system and established a 13 percent flat income tax scale, which later became the benchmark for Serbia, Slovakia, Ukraine, and other Eastern European countries. The land code was adopted, which legitimized private ownership of land and spurred business activity in Russian agriculture. The reform of the electricity industry de-monopolized it and split power generation from distribution. The monetization of social benefits replaced benefits in kind by monetary transfer, allowing the consolidation of support for the poorest part of the population. Although pension reform was unsuccessful, it gave a substantial boost to the domestic corporate bonds market by creating pension funds managing long-term savings.

Despite the importance of these decisions, they did not constitute a full-scale agenda of reforms, as they were isolated parts of the so-called Gref program,[2] and played a limited role in the economic achievements of the first eight years of Putin's presidency, which were largely attributed to an increase in oil prices and massive foreign borrowing. Putin's economic policy in 2009–17 was not something different from his economy policy in 2000–08. In fact, the same group of bureaucrats known as the liberals occupied top positions in all economic ministries and agencies, where they promoted gradual reforms.

The reason for the decline in economic growth lies not in economic policies but in the political decisions made in Putin's era: the process of degradation of democratic governmental institutions that, among other things, led to the demolition of the country's property rights protection system. Lack of political competition resulted in the monopoly of the pro-Putin United Russia party in the parliament. The judiciary system was put under direct command of the Kremlin's administration and siloviki—an influential group of current and former military and security officials—and lost its independence. Freedom of speech was limited to a small number of newspapers and radio stations. Cases of state-sponsored racketeering spread all over the country, with thousands of companies coming under attack from bureaucrats, siloviki, and their relatives and friends. Business owners faced criminal charges and lost their businesses, though in less than 10 percent of cases those accusations resulted in court trials.[3]

Being deprived of property rights protection, the Russian private sector reduced its investment activity and intensified capital outflow. By the end of 2013, the Russian economy was close to stagnation.

A PERFECT STORM

In March 2014, Russia annexed Crimea and, starting in mid-April of that year, launched a hybrid war against Ukraine that led to the de facto occupation of part of eastern Ukraine. Responding to this aggressive policy, Western countries, led by the United States and the European Union (EU), imposed economic sanctions on dozens of Russian individuals, banks, and companies. The strongest of these sanctions was the ban on raising capital in Western markets; in 2014-15, it was virtually comprehensive: though only six Russian banks and five companies were sanctioned and banned from access to the Western capital markets, not one Russian entity was able to obtain new funding, while the old debts were due to be repaid on schedule.

According to the payment schedule, there was a peak in payments on external debt in the last quarter of 2014 and the first quarter of 2015—about 5 percent of

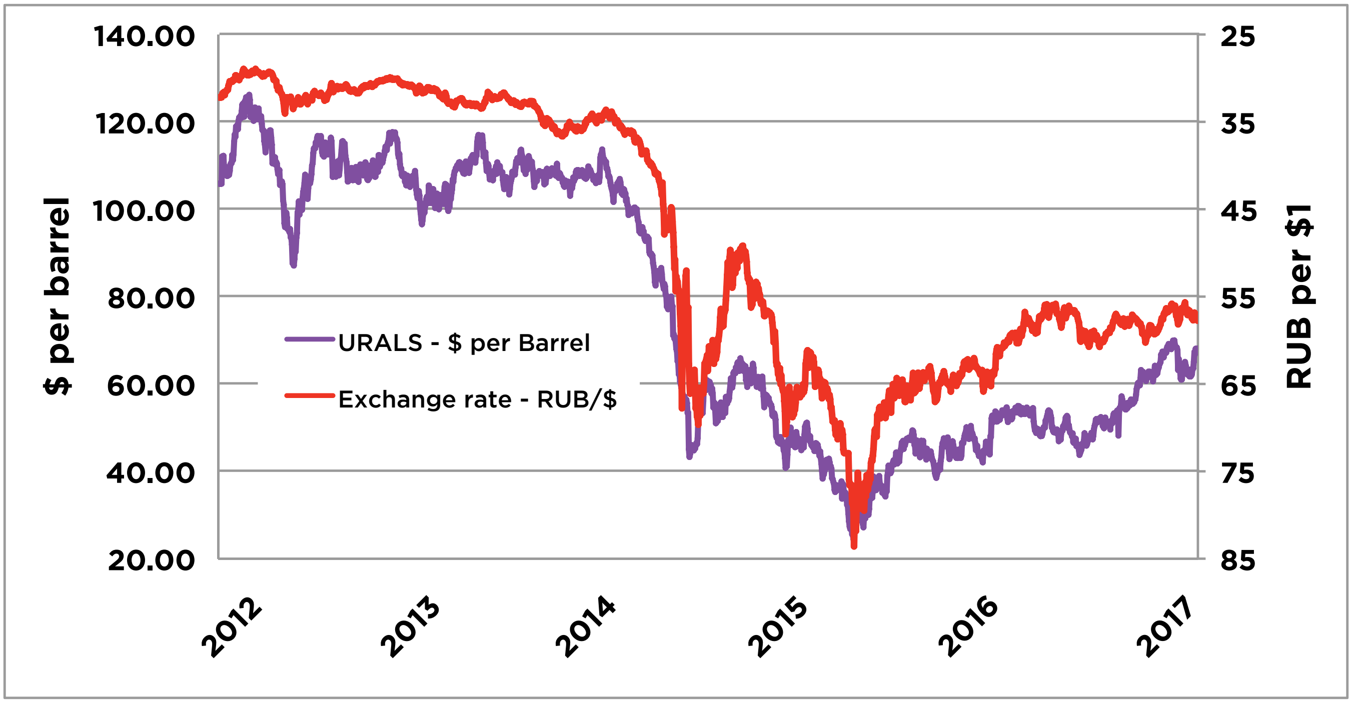
1 Alexey Kudrin and Evsey Gurvich, "A New Growth Model for the Russian Economy," Institute for Economies in Transition, Bank of Finland, Policy Brief 1 (2015), accessed April 23, 2018, http://www.eeg.ru/files/lib/Kudrin-Gurvich%20(BOFIT-2015).pdf.

2 The Gref program was an ambitious and comprehensive plan of liberal reforms prepared on the request of Vladimir Putin when he was acting president of Russia in January-April 2000. This plan was drafted by a task force headed by the future minister of economy German Gref and envisaged liberal and democratic reforms not only in the economy but in judiciary, state governance, and political competition.

3 "*Predprinimateley Stali Chashche Otpravlyat' pod Domashniy Arrest vmesto SIZO*," May 17, 2017, RBC, http://www.rbc.ru/economics/17/05/2017/591c4bea9a79473d6e88f1f8.

quarterly GDP in each quarter.[4] Paying such a debt using domestic resources is not easy for any economy, but, as late as the summer of 2014, it seemed that Russia could do it. However, it was then that a rapid decline in oil prices began. As a result, demand for foreign currency was much stronger than supply,[5] and the ruble collapsed in mid-December. By January 2015, oil prices fell below $45/bbl.[6] Many experts described this situation as "a perfect storm."[7]

Figure 2. Oil price and the Russian ruble exchange rate, 2012–17



Source: Dynamics of the official exchange rates, The Central bank of the Russian Federation, accessed May 23, 2018, http://cbr.ru/eng/currency_base/dynamics.aspx

The market situation was exacerbated by the mistakes of the Russian monetary authorities. In 2013, the new governor of the Central Bank of the Russian Federation (CBR), Elvira Nabiullina, tried to prevent ruble devaluation and authorized the sale of foreign exchange to support the ruble. By autumn 2014, the CBR had spent

4 For CBR's balance of payments statistics, see "*External Sector Statistics*," Central Bank of the Russian Federation, http://cbr.ru/eng/statistics/default.aspx?PrtId=svs.

5 Revenues from exports of oil and oil products in mid-2014 accounted for 56 percent of Russia's exports of goods and services. See "*Statistika Vneshnego Sektora*," Central Bank of the Russian Federation, accessed April 23, 2018, http://cbr.ru/statistics/?PrtId=svs.

6 "*Petroleum & Other Liquids: Spot Prices*," US Energy Information Administration, accessed April 23, 2018, https://www.eia.gov/dnav/pet/PET_PRI_SPT_S1_D.htm.

7 Andrew Ross Sorkin,"'*Perfect Storm' Pressures Russia's Economy: Sec. Lew*," CNBC video, December 14, 2014, https://www.cnbc.com/video/2014/12/11/perfect-storm-pressures-russias-economy-sec-lew.html;
Darya Korsunskaya, Lidia Kelly, and Katya Golubkova, "*Ex-Minister Kudrin Warns of 'Full-Fledged Crisis' in Russia*," Reuters, December 22, 2014, https://www.reuters.com/article/us-russia-crisis/ex-minister-kudrin-warns-of-full-fledged-crisis-in-russia-idUSKBN0K011920141222; Deena Zaidi, "*Russia—Caught in a Perfect Storm*," Economy Watch, December 19, 2014, http://www.economywatch.com/features/Russia-Caught-in-a-Perfect-Storm.12-19-14.html; Sergey Aleksashenko, "*The 2014 Ruble Devaluation: A Perfect Storm*," Kennan Institute, Wilson Center, Kennan Cable 2 (December 2014), accessed April 23, 2018, https://www.files.ethz.ch/isn/186552/2-Kennan%20Cable-Alekseshenko.pdf.

about $100 billion propping up the ruble,[8] actually provoking higher demand for foreign exchange to finance imports. This and other actions by the CBR's, such as non-stop currency interventions after the announcement of the floating ruble exchange rate, and the extensive ruble loans to banks at low interest rates, have greatly undermined the credibility of the institution and of its policy. The CBR's actions contributed to the collapse of the ruble,[9] causing a psychological shock in Russian society. In his January 2015 State of the Union address, then US President Barack Obama stated that Western sanctions left Russia isolated and characterized the Russian economy as being "in tatters."[10] However, it quickly emerged that the fall in oil prices and sharp devaluation of the ruble produced a much smaller effect on the Russian economy than many anticipated.

A RESILIENT ECONOMY

In the third quarter of 2014, the Russian economy went into a recession that lasted for eight quarters—the longest since 1996. The external shocks were strong: steep and long-lasting decline in the oil prices combined with intensive capital outflow caused by the private sector debt redemption resulted in a two-fold ruble devaluation (see Fig. 2). Although the fall of the ruble caused significant troubles for the financial sector, its effect on the economy was modest: GDP shrunk by 2.5 percent in 2015 and another 0.2 percent in 2016, which was low, especially when compared with minus 10 percent in 2008-09.[11] There are five reasons for this.

First, the Russian economy relies on production and export of raw materials and commodities. As the global economy continued to grow in 2014–16 at a healthy 3.2-3.6 percent, there was high demand for primary resources. Because of that, the production and export of key Russian exports—oil and refined products—recorded a robust increase. Although the direct share of extracting industries and commodities production is slightly above 15 percent of the Russian GDP,[12] the growth in those sectors provided for the stability of railway freight (commodities and raw materials are more than 70 percent of turnover),[13] pipeline transportation volumes, and wholesale trade and import operations. Some 45 to 50 percent of the revenues of the federal budget depend on taxes of oil and oil products,[14] another factor that makes production and export of hydrocarbons the backbone of the Russian economy. As was the case in 1998 and 2008, profits of all export-oriented industries boomed from the devaluation of the ruble, since local costs paid in rubles devalued in dollar terms. Growing external demand allowed the commodities sector to increase production, while growing profits meant that corporate investments in this sector were kept untouched.

Second, the federal budget is the main beneficiary of the increase in oil prices, absorbing 50-70 percent of the oil price increase in taxes, as well as the main loser if prices plunge. Although the federal budget lost a more than a half of its dollar-denominated revenues due to the ruble devaluation, the oil revenues' decline in ruble terms was much more modest – about 20 percent in 2015 increasing to 35 percent in 2016 (see Fig. 2a). At the same time, the government actively used its fiscal reserves, which it had accumulated in previous years, to avoid cuts in budgetary expenditures.

Third, in 2011, the Russian government launched a full-scale program to finance an ambitious military procurement and reinvestment in the defense industries that was de facto funded by the use of the fiscal reserves. Military production in 2014–16 grew by 12-15 percent annually,[15] which benefited the chemical industry, machinery building, and other adjacent sectors.

8 For CBR's statistics on international reserves, see "*External Sector Statistics*," Central Bank of the Russian Federation.

9 Chris Matthews, "*Russian Ruble's Fall: A Classic 'Currency Collapse*,'"Fortune, December 16, 2014, http://fortune.com/2014/12/16/russian-ruble-currency-collapse/.

10 Barack Obama, "*Remarks by the President in State of the Union Address*," Office of the Press Secretary, White House, January 20, 2015, https://obamawhitehouse.archives.gov/the-press-office/2015/01/20/remarks-president-state-union-address-january-20-2015.

11 "*Natsional'nyye Scheta*," Russian Federal State Statistics Service.

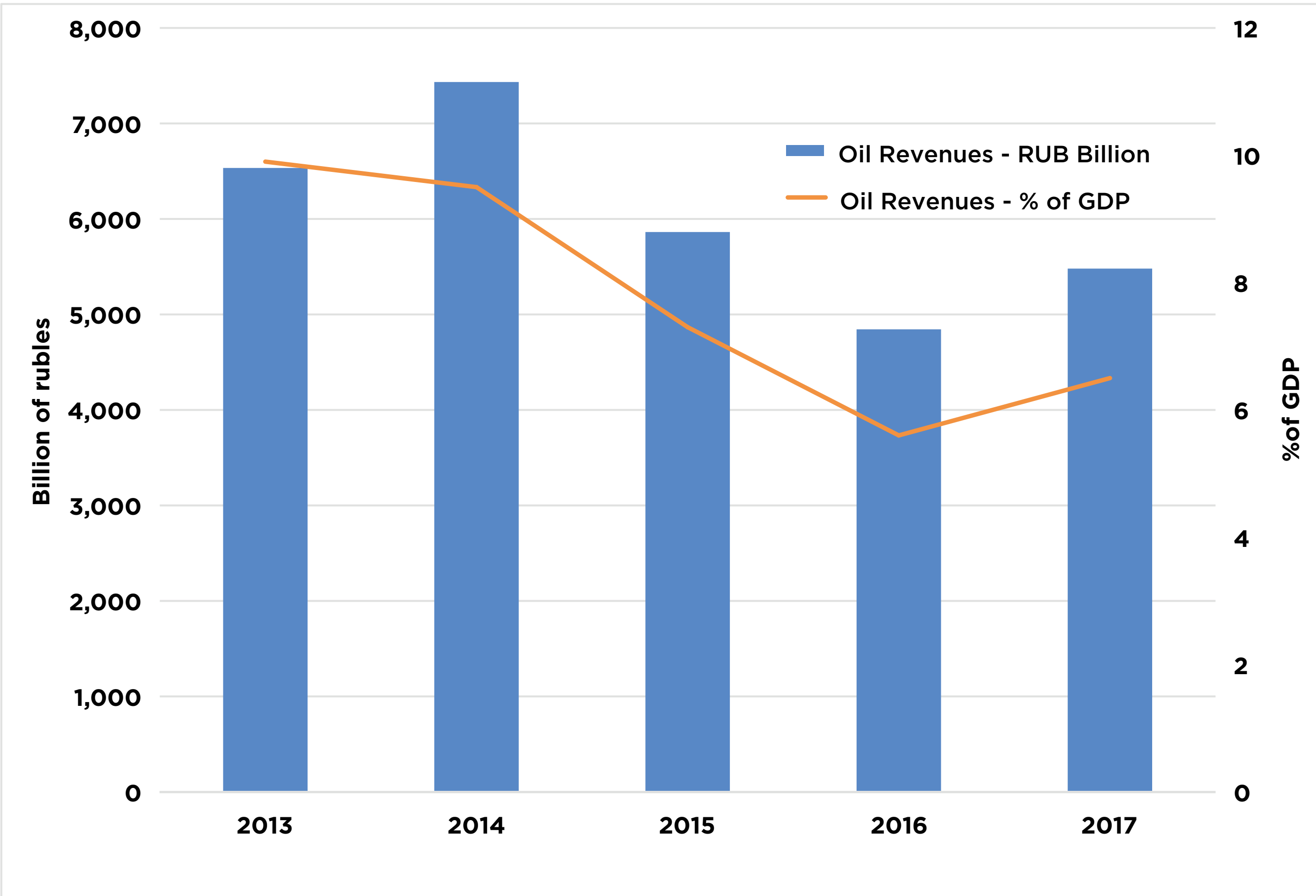
12 Ibid.

13 "*Railway Cargo Turnover*," VTB Capital, https://research.vtbcapital.com/Content/Search/Document.aspx?id=236493&lang=english.

14 Federal Budget Execution, Economic Expert Group, accessed May 23, 2018, http://www.eeg.ru/pages/148

15 "*Otschchet Pravitel'stva o Rezul'tatakh Raboty v 2014 Godu*," Russian Government, April 21, 2015, http://government.ru/news/17768/; "*Otschchet Pravitel'stva o Rezul'tatakh Raboty v 2015 Godu*," Russian Government, April 19, 2016, http://government.ru/news/22717/, "*Otschchet Pravitel'stva o Rezul'tatakh Raboty v 2016 Godu*," Russian Government, April 19, 2017, http://government.ru/news/27338/.

Figure 2a. Oil revenues of the Russian federal budget, 2013–17



Source: "Federal Budget Execution," Economic Expert Group http://www.eeg.ru/pages/148.

Fourth, although the share of agricultural sector in the Russian economy is not big (3.6-3.7 percent of GDP), since 1999, this sector has experienced stable growth at about 3.3 percent annually.[16] This growth was caused by two major decisions of the early 2000s: the implementation of land reform that legalized the sale of farmland, strengthening private land ownership, and the formation of a comprehensive system of budgetary subsidies for farmers. The annual growth of poultry and pork production peaked in some years above 20 percent, and, since the mid-2000s, Russia has been one of the top grain exporters in the world. The strong performance of the agricultural sector in 2014–16 was significantly supported by a record-high harvest.[17]

Last but not least, thanks to the reforms of the 1990s, the Russian economy has become a market economy—it is inclined to restore equilibrium using free prices and the floating exchange rate of the ruble. When inflation jumped, Russian authorities, to their credit, not only refrained from, but did not even discuss, a price freeze. By spring 2015, the CBR had finally moved to the floating exchange rate and explained to the Kremlin that continuation of the currency interventions to prop up the ruble was futile and would only worsen the economic situation.

As a result, the Russian economy relatively easily adjusted to both external (Western sanctions) and internal

16 For Rosstat's GDP statistics, see "*Natsional'nyye Scheta*," Russian Federal State Statistics Service.

17 "*Sel'skoye Khozyaystvo, Okhota i Lesnoye Khozyaystvo*," Russian Federal State Statistics Service, accessed April 23,2018, http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/enterprise/economy/#.

(the Kremlin's ban on food imports from Western countries) shocks. However, the price of this adjustment was the rise in inflation to 17 percent[18] in spring 2015, a 10 percent decrease in the level of private consumption,[19] and a 45 percent reduction in imports.[20]

THE RECESSION IS OVER BUT . . .

As early as autumn 2016, the Russian authorities declared the recession over and made very optimistic forecasts on the speed of the recovery. GDP started growing in mid-2016, and, by mid-2017, the official growth forecast exceeded 2 percent. Nevertheless, the recovery was not stable, economy shrunk in the fall, and the GDP growth resulted just 1.5 percent in 2017.[21]

The comeback of the Russian economy after two years of recession was not extraordinary. Since 1980, there have been no more than two dozen recessions of the economies with annual GDP exceeding $50 billion that lasted more than two years. The bulk of them were caused by very strong negative shocks, either wars or unconventional macroeconomic policy such as price and exchange rate control, giant budget deficit, and hyperinflation. None of this happened in Russia. Could maybe the favorable conditions have overridden mistakes made in macroeconomic policy?

Fast-growing oil prices consolidated the balance of payments: after being neutral in second and third quarters of 2017, the current account became strongly positive ($17.8 billion or 1.1 percent of annual GDP) in the last quarter of the year.[22] Since the beginning of 2015, Western countries de facto removed their sanctions' pressure on the Russian economy, allowing Russian banks and companies to intensively raise equity and debt capital from Western financial markets in 2016-17. Moreover, as fears of new sanctions emerged in the end of 2017, an intensive inflow of repatriated capital back to Russia was registered (1.1-1.2 percent of annual GDP) in the fourth quarter.[23] The CBR entered into forward financial transaction and increased as the inflow of the foreign currency to the country (0.5-0.6 percent of annual GDP).[24] All that, combined with the floating exchange rate regime, led to the nominal appreciation of the ruble by 4 percent in 2017. The appreciation of the Ruble could have been stronger if not restrained by the Ministry of Finance (MoF) with regular purchase of foreign currency for its reserves, according to the budgetary rule.[25]

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18 "*Tseny*," Russian Federal State Statistics Service, accessed April 23, 2018, http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/tariffs/#.

19 "*Uroven' Zhizn*i," Russian Federal State Statistics Service, accessed April 23, 2018, http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/population/level/#.

20 "*Statistika Vneshego Sektora*," Central Bank of the Russian Federation, http://cbr.ru/statistics/?PrtId=svs.

21 "*Valovoy Vnutrenniy Produkt*," Russian Federal State Statistics Service, accessed May 9, 2018, http://www.gks.ru/free_doc/new_site/vvp/kv/tab7.htm.

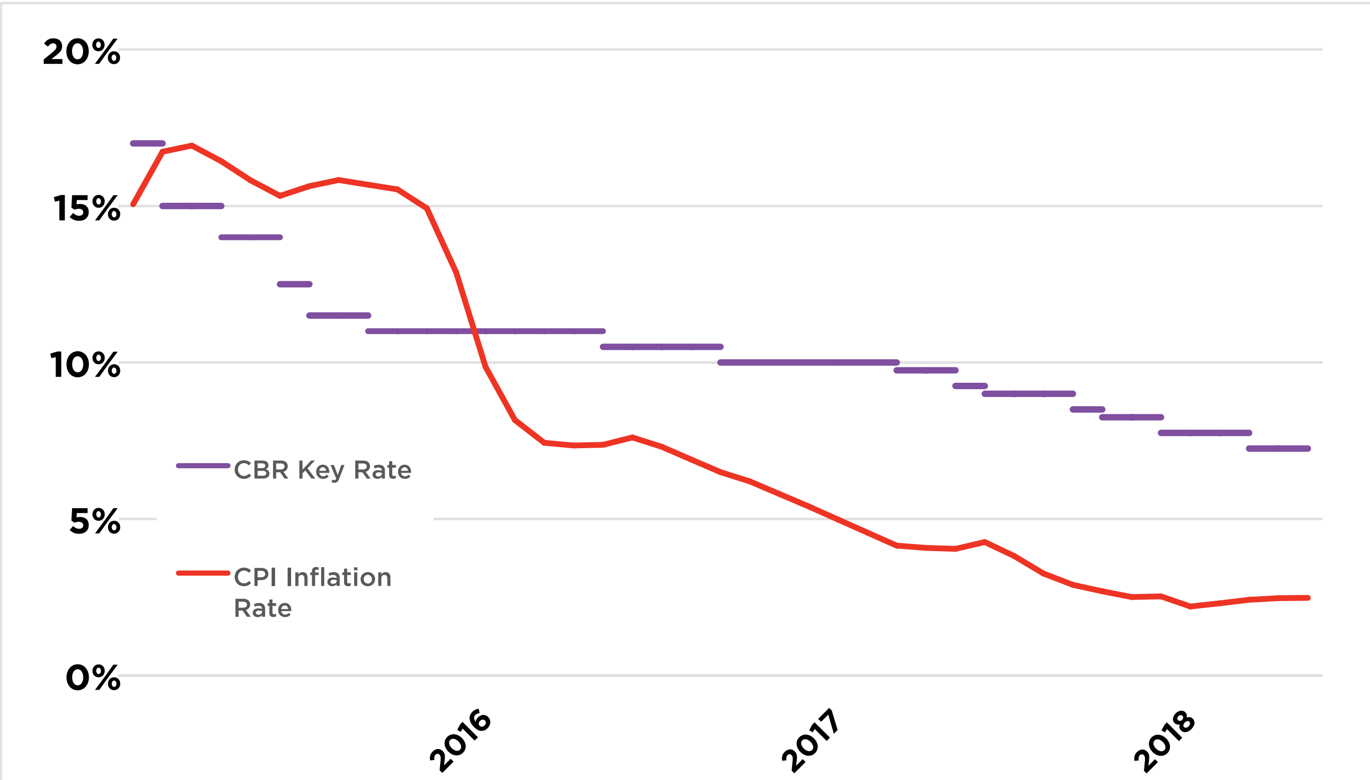
22 "*External Sector Statistics*," Central Bank of the Russian Federation, accessed May 9, 2018.

23 Ibid.

24 Ibid.

25 Starting February 2017, the Ministry of Finance publishes on a monthly basis its announcement on the future purchase of the foreign currency. See "*Informatsionnoye Soobshcheniye: O Neftegazovykh Dokhodakh i Provedenii Operatsiy po Pokupke/Prodazhe Inostrannoy Valyuty na Vnutrennem Valyutnom Rynke*," Ministry of Finance of the Russian Federation, February 3, 2017, http://minfin.ru/ru/press-center/?id_4=34613&area_id=4&page_id=2119&popup=Y). For consolidated data on Ministry of Finance's purchases, see "*Faktory Formirovaniya Likvidnosti Bankovskogo Sektora*," Central Bank of the Russian Federation, accessed April 23, 2018, http://cbr.ru/statistics/?Prtid=flikvid. The law on the federal budget in 2017 allowed the MoF to use only part of its revenues originating from the production and export of oil and gas for current financing. All those revenues accounted for by the excess of oil price above the $40/bbl level were used to purchase the foreign currency in the open market. As a result, the MoF was able to increase its reserves by $15 billon (0.95 percent of the GDP) by the year's end. See "*Factors Affecting Banking Sector Liquidity (Daily)*," Central Bank of the Russian Federation, http://cbr.ru/eng/statistics/default.aspx?Prtid=flikvid.

Figure 3. Russian inflation and the key rate of the Central Bank of the Russian Federation, 2015–18



Source: Key rates decisions, The Central bank of the Russian Federation, accessed May 23, 2018, http://cbr.ru/eng/DKP/dkp_press/; 'Inflyatsiya na potrebitel'skom rynke' , The Central bank of the Russian Federation, accessed May 23, 2018, http://cbr.ru/statistics/?PrtId=macro_sub

Since mid-2016, the CBR has declared the suppression of inflation as its primary goal, defining 4 percent level as its medium-range target. By keeping the positive real interest rate above 5 percent, the CBR reduced inflation to 2.5 percent by the end of 2017, though stating it was unexpected and to a certain extent caused by temporary factors (see Fig. 3).

Facing an economic recession and fall in budgetary revenues, Russian authorities, unlike in 2008, did not increase budgetary expenditures. On the contrary, wages in the public sector were frozen in 2015–17 while the indexation of pensions was well below the inflation level required by law. The rigid budgetary policy led to stabilization of nominal expenditures of the federal budget while their real level declined by 6.5 percent in 2018 compared to 2015 (see Fig. 4).

The recovery of economic growth in 2017 was caused, in part, by the improving external environment. Due to the effectiveness of the 2016 agreement between the Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC producers, including Russia, which limited oil production, the average price of the Russian Urals oil—the country's major export grade—increased by 25 percent, from $42/bbl in 2016 to $53.3/bbl in 2017 (see Fig. 2). Additionally, the acceleration of the global economy to 3.7 percent in 2017 led to growing demand for Russian commodities. One assessment by the Centre for Development Institute at Russia's Higher School of Economics argues that nearly all economic growth in 2017 originated from the 5.4 percent growth of Russian exports in physical terms (agricultural products, metals, gas, and related services).[26]

Except in the commodities sector, data point to stagnation in the Russian economy. Although investment increased (4.4 percent),[27] this result is dependent on methodological changes that occurred in the spring that increased the share of small- and medium-sized businesses. On the other hand, construction, which represents half of the overall investment, continued to decline (minus 1.4 percent); moreover, the slow recovery in residential construction in the second half of 2017 forces one to be even more pessimistic assessing the dynamics of investment in the real sector.[28] Similarly, the Russian Federal State Statistics Service (Rosstat) reports a 3.4 percent growth of private consumption, though the growth of the retail turnover (1.2 percent) and services (0.2 percent) do not support that estimate. At the same time, disposable household income continued sliding down in 2017 for the fourth year in a row.

Although the official forecast is rather optimistic, predicting accelerating growth in 2018–21 (from 1.5 to 3.1 percent),[29] it is well below Putin's goal of having a growth rate above that of the global economy, meaning, at least 4 percent, by 2020.[30]

SHORT-TERM CONSTRAINTS

Compared to 2000–08, when the Russian economy was growing 7 percent per year on average, 4 percent growth is not an ambitious target. Moreover, one has to take into account that 2008-17 is known as a lost decade for Russia: its economy grew only 9 percent in ten years while the global economy grew 27 percent during the same period.[31] However, given Russia's slow economic growth, the big question among experts is whether Russia can even deliver a 4 percent growth.

Growth-Hostile Macroeconomic Policy

Two main engines of the Russian economy have halted. First, due to the agreement with OPEC, Russia has frozen its oil production at least until the end of 2018. Second, military procurements will decline significantly in the years to come—19 trillion rubles for 2018–27 (20.5 percent of GDP in 2017)32 compared to 23 trillion rubles in 2012-20 (38 percent of GDP-2011).[33] On top of that, there are three macroeconomic policy issues that may prevent acceleration of the Russian economy.

The first concern is monetary policy. For the first time in Putin's tenure, the CBR declared its desire to fight inflation in 2015, deciding to keep a high real interest rate in the economy. To a great extent, that was a right approach at the initial stage when inflation exceeded 10 percent, but later on, as inflation started declining, the CBR refused to lower its key rate adequately. As a result, the decline of the real interest rate was going much slower, and despite the rapidly falling inflation, the real interest rate was increasing (see Fig. 3). A high interest rate is a proper anti-inflationary instrument, but it also constrains economic activity, making credit too expensive. The corporate sector's demand for credit in Russia

26 The effect of the commodities' production and export growth in the official statistics is dispersed between extracting industries, transportation (railways and pipelines accounting for 85 percent in this sector), and wholesale trade (where export trading and holding companies are gathered). See "*Kommentarii o Gosudarstve i Biznese*," National Research University Higher School of Economics, Centre for Development Institute Bulletin 148 (2018), accessed April 23, 2018, https://dcenter.hse.ru/mon/71896859/215207342.html.

27 Russian Federal Statistics Service, Sotsial'no-Ekonomicheskoe Polozhenie Rossii (Moscow: Russian Federal Statistics Service, 2018), http://www.gks.ru/free_doc/doc_2018/social/osn-03-2018.pdf.

28 Besides all above-mentioned, the investment dynamics in 2017 were affected by government-sponsored mega-projects, including the Kerch bridge that connects Russia's mainland with occupied Crimea, a gas pipeline to China, and construction related to the soccer World Cup 2018.

29 Ministry of Economic Development of the Russian Federation, Prognoz Sotsial'no-Ekonomicheskogo Razvitiya Rossiiyskoy Federatsii na 2018 God i na Planovyy Period 2019 i 2020 Godov (Moscow: Ministry of Economic Development of the Russian Federation, 2017), http://economy.gov.ru/wps/wcm/connect/2e83e62b-ebc6-4570-9d7b-ae0beba79f63/prognoz2018_2020.pdf?mod=ajperes.

30 "*Putin: Tempy Rosta VVP RF k 2020 Godu Dolzhny Prevyshat' Srednemirovye*," Tass, June 1, 2017, http://tass.ru/pmef-2017/articles/4303887.

31 "*DataBank*," World Bank, accessed April 23, 2018, http://databank.worldbank.org/data/home.aspx.

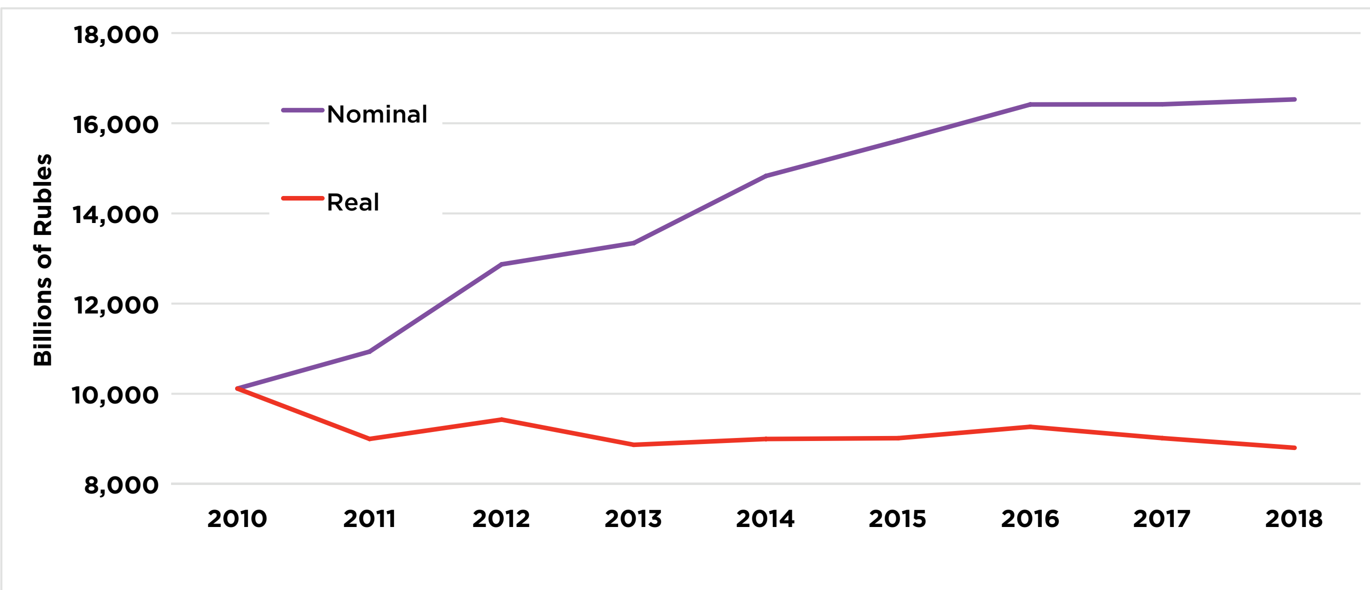
32 "*Putin Soobschchil o Prinyatii Novoy Desyatiletney Programmy Vooryzheniya*," Interfax, January 24, 2018, http://www.interfax.ru/russia/596927.

33 Some experts argue that the slowdown of the Russian economy in the fall 2017 was caused by the decline in defense spending. See Andrey Ostroukh and Darya Korsunskaya, "*Lower Defense Output Saw Russia Undershoot GDP Target in 2017*," Reuters, February 13, 2018, https://www.investing.com/news/economy-news/lower-defense-output-saw-russia-undershoot-gdp-target-in-2017-1235954.

is not growing, which is a leading indicator of sluggish economic activity in the short and medium terms. In 2017 the CBR became more aggressive in cutting its rate (see Fig. 3) but in 2018 became extra-cautious and refrained from rate cuts though inflation felt well below its target.

The second problem is budgetary policy. As oil prices collapsed, the revenues of the federal budget shrunk, and the Kremlin is facing a difficult choice between higher budget deficits and cuts in expenditures. Though, by all standards, the state debt in Russia is small, 11 percent of GDP, since 2015, the Ministry of Financetook an ultra-conservative approach, requiring significant budgetary consolidation in order to reach zero deficit.[34] Putin had accepted the MoF's position of gradually eliminating the budget deficit by 2019 by freezing and cutting expenditures, both in real and nominal terms. Despite the unpopular character of such a policy, public wages were frozen during 2015-17, though accumulated inflation was 20 percent for two years. In 2016, pensions were indexed by only 4 percent, although inflation the previous year was 12.9 percent. In 2016-17, many budgetary expenditures, including military procurement, were cut by 10 percent, and the MoF foresaw the need for further cuts.

Figure 4. Nominal and real expenditures of the Russian federal budget, 2010–18



Source: "*Federal Budget Execution*," Economic Expert Group http://www.eeg.ru/pages/148.

In the short run, budgetary consolidation is an effective tool of stabilization of public finances. However, as is the case with monetary policy, time does matter: the longer the consolidation process, the stronger the negative effect on economic growth. The tight fiscal policy contributed to the decline in household income in recent years. At first glance, this has not caused visible social unrest among the Russian population, thus making the

34 Initially, this approach was caused by fears of depletion of fiscal reserves. After a sharp decline in budgetary revenues, the Russian government relied heavily on the use of the Reserve Fund, set up to cover budget shortfalls during times of economic crisis. At a certain point, the Ministry of Finance projected that if the price of oil stayed low, the Reserve Fund as well as the National Welfare Fund, a separate fund designed to cover pensions, may have become devastated by the beginning of 2018. This scenario has not materialized, while the recovery of oil prices to above $65/bbl in 2017 meant a stop to reliance on the fiscal reserves. See "*Osnovnyye Napravleniya Byudzhetnoy, Nalogovoy i Tamozhenno-Tarifnoy Politiki na 2018 God i na Planovyy Period 2019 i 2020 Godov*," Ministry of Finance of the Russian Federation, last updated October 3, 2017, http://minfin.ru/ru/perfomance/budget/policy/?id_57=119695&area_id=57&page_id=523&popup=Y.

Kremlin believe that this policy is low risk.[35] However, in the long run, this approach will undermine any economic program that relies on human capital priorities, as it provides no room for any increase in expenditures, sometimes even making it impossible to keep them stable in nominal terms. This type of budgetary policy also does not allow the financing of any significant infrastructure projects, threatening degradation in the quality of public services.

In 2018 the budgetary forecast weakened: the sluggish economic growth did not generate enough revenues while the newly adopted "fiscal rule" made tough constraints on the use of revenues from production and export of oil and gas. After reelection president Putin ordered an increase in many areas of budgetary expenditures. Though MoF was forced to cancel its consolidation policy it did not accept to change the "fiscal rule" but to increase the VAT rate from 18 to 20 percent. According to estimates of the Ministry of Economics that will increase inflation by 1.3-1.4 percent and deduct 0.4-0.5 p.p. from economic growth in 2019.

The third macroeconomic issue is the Russian banking system. In 2013–17, the CBR, in its role as the banking supervision agency, implemented a purge in the banking system. In 2000–13, the CBR paid little attention to the banking supervision, resulting in massive fraud and emergence of zombie banks running illegal activities. The number of banking institutions declined from 978 in the end of 2012 to 561 in the end of 2017.[36] By itself, this would not have been a reason for concern. However, the CBR withdrew licenses from some of the one hundred largest banks in the country on the grounds that they had negative capital. The intervention demonstrated a lack of proper banking supervision and caused both macroeconomic and structural problems. On the one hand, the CBR and the MoF decided to spend enormous funds attempting to revitalize these bankrupted banks. The financial scheme was complex: the CBR provided loans to the ASV (Deposits Insurance Agency), a state corporation, while the latter provided long-term credits to banking institutions that sometimes required them to purchase the federal debt. In total, the CBR had spent more than 1.5 trillion rubles on financing these operations and another 800 billion rubles crediting the ASV, which together accounted for 2.8 percent of the average 2014–16 GDP. Such a massive increase in money supply forced the CBR to change its monetary policy instrument: it stopped crediting the banking system and instead concentrated on withdrawing excessive liquidity.

Nevertheless, the revitalization did not work. Many of the banks that were put in charge of these operations by the CBR used the funds received from the ASV to solve their own problems, including by taking good assets out of the banks they were supposed to be revitalizing. Ultimately, the CBR has recognized the shortcomings of its policy, but instead of stopping it, the CBR decided to take over the revitalization efforts. In 2017, a special law allowed the CBR to establish a special institution and made it possible for the CBR to acquire banks in trouble on the cheap and inject new capital in them via the newly established institution. In fact, this law greatly expanded the CBR's powers: the CBR is now not only in charge of banking supervision but may also become an owner of many banks. In the fall of 2017, the CBR used this law to acquire three big private banks.[37]

The previously mentioned factors led to further the rapid nationalization of the Russian banking system—by the end of 2017, the share of state-controlled banks approached 75 percent, as measured by assets.[38] The nationalization of the banking system may be a right way to prevent the banking system from total collapse. However, as the US government's bank bailouts in 2008-09 demonstrated, this may work with two preconditions: the state should avoid taking management of banks on itself and should not be a shareholder of the banks. The first precondition has been rejected by the Russian authorities: the CBR has nominated the management of all three banks and their boards, and ordered to merge two of them even before the new management was able to look into the banks. It remains to be seen how effective

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35 Meanwhile, polls show that the unrest may be growing: the majority of those comprising the 42 percent of the Russian population who think that radical changes are needed are people with low incomes. See "*Khotim Li My Peremen*," Levada-Center, December 28, 2017, https://www.levada.ru/2017/12/28/hotim-li-my-peremen/.

36 "*Informatsiya o Registratsii I Litsenzirovanii Kreditnykh Organizatsiy v 2012 Godu*," Central Bank of the Russian Federation, accessed April 23, 2018, http://cbr.ru/statistics/print.aspx?file=bank_system/inform_12.htm&pid=lic&sid=itm_43766.

37 The three nationalized banks were Otkritie Bank, BIN Bank, and Promsvyazbank.

38 "*Reyting Bankov po Ob"emu Aktivov na 1 Yanvarya 2018 Goda*," Rossiya Segodnya, January 5, 2018, http://vid1.rian.ru/ig/ratings/banki_05_01_18.pdf.

the management of the newly nationalized banks will be, but except for Sberbank, all other state-controlled banks—twelve out of the twenty largest banks in the country—have been requesting subsidies from the government on a regular basis.

The CBR promised the privatization of these banks in two to three years, but this scenario is unlikely. On the one hand, the government had nationalized two banks (Svyaz-Bank and Globex bank) during the crisis of 2008, and they are still state owned and suffering losses. On the other hand, the CBR declared that there should not be a strategic owner of those banks but dispersed minority shareholders. The problem, however, is that there is not one bank in Russia that has such dispersed ownership structure. By the end of 2017, the CBR had injected more than 1.2 trillion rubles (1.3 percent of GDP) in two of the nationalized banks,[39] which makes them very expensive for any potential bidder. Moreover, even if they find buyers, these banks will need some time to stabilize and become profitable.

The nationalization of the bulk of the banking system will lead to inefficient investment decisions, as the government may give banks orders on their credit policy, which would put Russian private banks in a disadvantageous position. If private banks will have to pay higher deposit interest rates and take higher credit risks, that may result in new bankruptcies.

LONG-TERM CHALLENGES

Investment Climate

In 2008, Putin, prevented from running for a third consecutive term by the Russian constitution, switched seats with Dmitry Medvedev to become Russian prime minister. In this new position, he not only faced many economic problems but also personally led the government's response to the economic crisis. At the time, he frequently heard from businessmen who complained about bureaucratic red tape and told him that the poor investment climate was the main obstacle to running a business in Russia. The country's drop in global competitiveness rankings, they argued, had alienated foreign investors and increased the cost of capital for Russian businesses. In 2011, Putin decided to address the problem, announcing the goal of putting Russia in the top twenty countries in the World Bank's Doing Business rankings by 2018.[40]

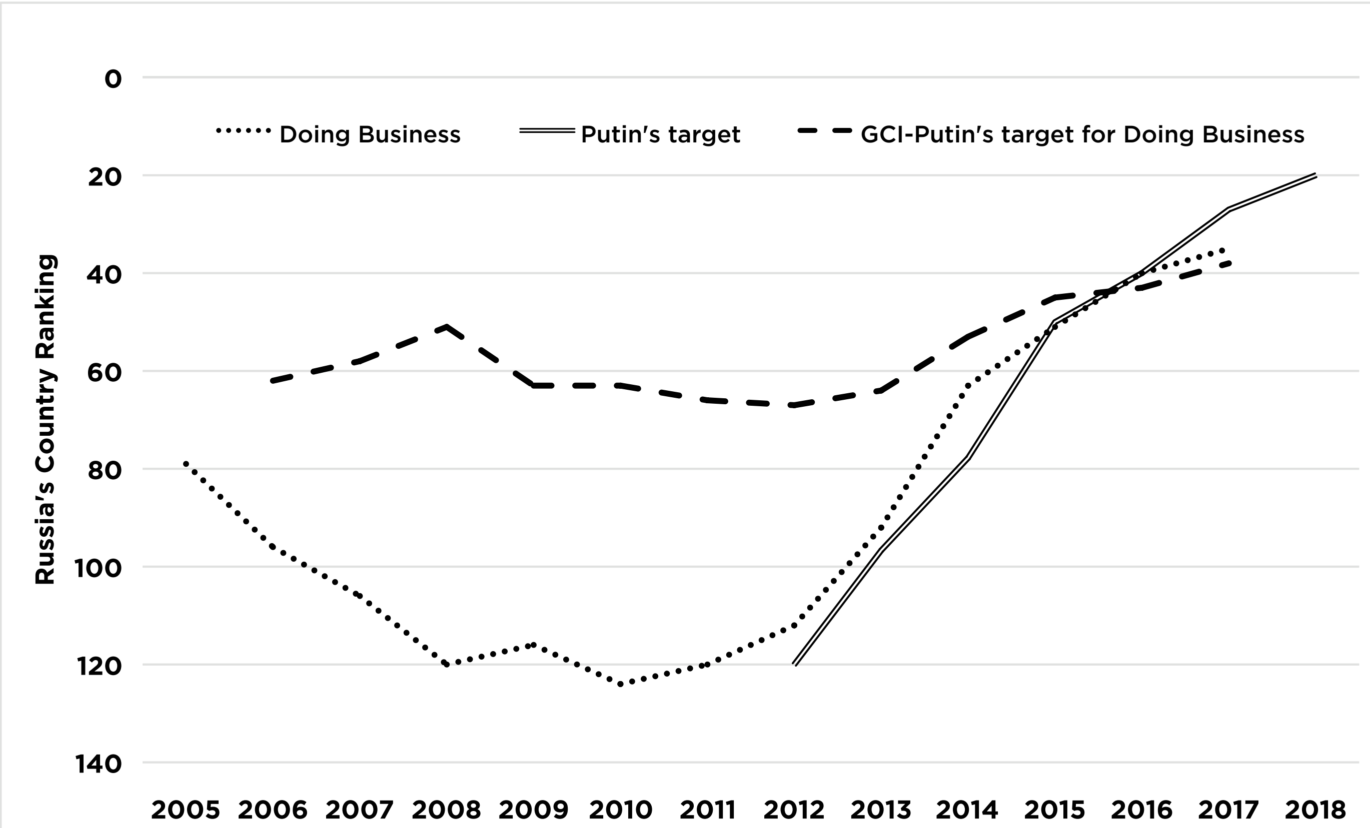
The fact that the World Bank's rankings take a quantitative approach to various bureaucratic barriers considerably simplified his task: businessmen and officials joined forces to single out the trouble spots that accounted for Russia's low ranking. They discovered that many bureaucratic processes in Russia were being slowed down either by the absence of time limits on decision-making in statutory documents, or by the fact that certain decision-making processes had been inherited from the Soviet era and still had not taken advantage of information technology and other modern technologies to speed up their processes.

Putin's efforts bore fruit: Russia began climbing up in the Doing Business rankings (see Figure 5). Russia's position in the "institutions" pillar of World Economic Forum's Global Competitiveness Index (GCI) also rose rapidly, thanks to improvement in reducing favoritism by government officials, burden of government regulation, and organized crime, and improving ethical behavior of firms and efficacy of corporate boards. However, this did not really change the investment climate in the country and did not lead to an increase in investments. The reason why it did not was quite simple: there were practically no changes in key areas of the relationship between business and the state.

39 For CBR's investments in Otkritie Bank and B&N Bank, see Central Bank of the Russian Federation, Godovoy Otchet Banka Rossii za 2017 God (Moscow: Central Bank of the Russian Federation, 2018), http://cbr.ru/publ/God/ar_2017.pdf.

40 The Doing Business ranking is based on technical criteria such as the number of days it takes to complete a certain bureaucratic procedure or the number of procedures one has to complete in order to obtain a permit or a license.

Figure 5. Russia's position in the World Bank's Doing Business and World Economic Forum's Global Competitiveness Index rankings



Sources: "*Doing Business*," World Bank, http://www.doingbusiness.org/; "*Competitiveness Rankings*," World Economic Forum, http://reports.weforum.org/global-competitiveness-report-2015-2016/competitiveness-rankings/.[41]

In its Global Competiveness Index, the World Economic Forum seeks to characterize the investment climate. And when one looks at indicators related to the protection of property rights, Russia has shown little progress in this important area to investors. It is thus not surprising that Russia continues to struggle to be seen as an attractive country for foreign investment.

Sanctions

Four years after Western sanctions were imposed on Russia, it became evident that they were not effective and could not force the Kremlin to change its foreign policy. By the end of 2016, dozens of Russian banks and companies that were not included in the sanctions lists

41 In both the World Bank's Doing Business and World Economic Forum's GCI rankings, the closer to the top a country is, the better its position. From 2005 to 2017, the number of countries evaluated in the World Bank's ranking increased from 155 to 190. From 2006 to 2012, the number of countries on the World Economic Forum's list first increased from 125 to 148 and later dropped to 138.

raised debt and equity in Western markets, thus nullifying the pressure of financial sanctions. Sanctions against Russian oil companies were initially extremely narrow (impacting oil and gas operations in the Arctic offshore) and covered the area where oil production is viable if the price exceeds $100/bbl,[42] which is far from today's market reality.

However, another effect of sanctions is playing a more serious role in undermining the competitiveness of many sectors of the Russian economy in the medium and long runs, as historically Russia was and is an importer of technologies and equipment. Western sanctions have dramatically increased the political risks of doing business in Russia and virtually blocked the inflow and transfer of Western technologies and innovations. The economic effect of this blockade cannot be captured by statistics, but it is significant because it leads to the isolation of the Russian companies from international production chains, resulting in a widening technological backlog and slower growth.

In April 2018, the US Department of Treasury's Office of Foreign Assets Control, in consultation with the Department of State, imposed a set of sanctions on Russian individuals and companies that demonstrated a new approach to dealing with Russia. For the first time, several of Russia's biggest companies were included in the Specially Designated Nationals (SDN) list that banned any type of economic activity with them. Previously, sanctions were imposed on non-publicly listed companies and banks that did not play a significant role in the Russian economy and were not connected with international markets. The new sanctions were imposed on, among others, the world's second-largest aluminium producer, Rusal, whose shares are traded on the Hong Kong Stock Exchange and which was the biggest trader on the London Metal Exchange. The company was also an active borrower in international financial markets. Just days after the announcement, the capitalization of the company fell by two-thirds, at least a quarter of its export contracts were frozen, and several of its suppliers stopped their deliveries. Prices for aluminum in the global exchanges jumped. RUSAL's Aluminum fell by 10 percent in May and by another 10 percent in June. The effect of sanctions seemed to exceed the forecast and their pressure on RUSAL was gradually relaxed. The US Treasury stated it may review sanctions if Deripaska yielded control of RUSAL, retaining up 48 percent ownership, by October 2018. Nevertheless, it should not be forgotten that another 26 percent of RUSAL belongs to Victor Vexelberg, who is on the SDN list together with Deripaska. From this, it seems that current US sanctions policy regarding Russia is more a show of force than an attempt to affect the Russian economy.

Demography

Unlike macroeconomic policy that may be changed in a matter of months, and even unlike the reestablishment of the rule of law that may take a few years, demography is a much longer-term and more difficult challenge for Russia. Rosstat's demographic forecast through 2050 demonstrates that demographics will play a more essential role in determining the future path of the Russian economy. The document describes three scenarios: a continuation of current trends, suggesting that Russia's population will shrink by 20 percent over the next thirty-five years; the population of Russia remaining at the current level; and the authorities' dream scenario, in which the Russian population increases by 15 percent.[43]

Besides limiting the country's economic growth, Russia's demographic challenges will provoke the growing pressure of pension expenditures on public finances. Since the Soviet era, the pension system in Russia has been a state-run solidarity mechanism.[44] In the last fifteen years, the government has made at least four attempts to modernize the pension system, but all of them were short-term oriented and did nothing to solve future problems. As a result, the pressure of the solidarity pension system on public finances increased and, for three years in a row, starting in 2014, the cash-strapped government confiscated all current mandatory pension savings of the Russian population in order to cover current

42 "*Chto Zamorozilo Proekty Rossii v Arktike: Sanktsii ili Tseny na Neft'?*" EurAsia Daily, February 22, 2018, https://eadaily.com/ru/news/2018/02/22/chto-zamorozilo-proekty-rossii-v-arktike-sankcii-ili-ceny-na-neft.

43 Mikhail Denisenko, "*Naseleniye Rossii: Demograficheskiye Prognozy,*" National Research University Higher School of Economics, accessed April 23, 2018, http://www.mfc-moscow.com/assets/files/2016/consumers/02-hse.pdf.

44 This type of the pension system was firstly proposed by Otto von Bismarck, the conservative minister president of Prussia, in 1881. This system envisages that the government takes responsibility for pensions and finances them by taxing the current labor force (payroll tax). This system does not have any saving/investment components, and the size of the pensions is determined by the government.

pension expenditures. In 2017, the saving/investment component of the pension system was eliminated completely. That policy has made the pension system rely on the solidarity mechanism only if the federal government balances its pension fund budget.

According to various scenarios in Rosstat's forecast, the ratio of people above working age to those within working age increases from today's level, of 0.4, to around 0.5, by 2022, where it should remain for about ten years, before going further, to about 0.6, by 2045.[45] These changes will inevitably increase the national pension fund's deficit, forcing the Russian authorities to accept either an increase in payroll taxes, an increase in the retirement age, a decrease in the real size of pensions, or some combination of these measures. None of these options is attractive. A rise in the retirement age and cuts in pensions will reduce the popular support of Vladimir Putin and his ruling group, while an increase in payroll taxes will break the growth of those labor-intensive sectors such as services, science, and information technology that the Russian government sees as an engine of the future economy. Thus, it was not surprising that the Kremlin decided to postpone its decision until after the 2018 presidential election.

Demography is an exogenous factor for any economy; it is virtually impossible to change its trends in the short run while any import of a new labor force may cause significant tensions inside the country. Still, as Putin begins his third presidential term, it is worth remembering that the presidential term in Russia is six years—a not insignificant period during which the negative economic consequences of Russia's demographic challenges will continue to be felt.

CONCLUSION

The Russian economy is not in danger of collapse. The 2014–16 crisis demonstrated that the Russian economy is resilient and is able to quickly restore equilibrium even after the most serious external shocks. However, the Russian economy may not be able avoid a long period of stagnation or sluggish growth. Being isolated from global economic cooperation and lacking the inflow of foreign investment, the Russian economy will continue to lose its competitiveness. The main hindrance to the Russian economy is the Kremlin's robust authoritarian system, which undermines property rights, stifles private initiative, and keeps Russia in isolation.

45 M.B. Denisenko, "*Naselenie Rossii: Demograficheskie Prognozy*," National Research University Higher School of Economics, 2016, http://www.mfc-moscow.com/assets/files/2016/consumers/02-hse.pdf.

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