The decline of the Russian economy

Effects of the non-reform agenda

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abstract

The objective of the article is to analyze the economic effects for Russia of pursuing political goals instead of reviving the economy and carrying out necessary reforms. The "non-reform agenda" since the mid-2000s means that for many years, the economy has been sliding due to structural problems and weak institutions. These tendencies were reinforced with the re-election of President Vladimir Putin for a third term in 2012 and his economic agenda. Since 2014 the additional problems of geopolitical tension, low oil prices and economic sanctions have resulted in the economy contracting. Despite the depressed economy the leadership keeps military expenditure at a high level. Import substitution as a means to mitigate the economic crisis is not convincing.

KEY WORDS: Russia, economic decline, political versus economic goals, institutions, rent addiction, rent management, sanctions, import substitution.

In 2014 the Russian economy showed almost zero growth and the forecasts for 2015 indicate a contraction of 3–4%. This stands in sharp contrast to the high growth rates of the 2000s but also compares poorly with the more moderate expectations of 3–4% GDP growth after the economic crisis in 2009. Nevertheless, instead of choosing the path of modernization after the crisis, the Russian leadership opted for more state intervention and more state control of the economy and it continued to support non-viable production by old state enterprises despite the decline in growth rates. The non-competitive environment where political ties and subsidies have been more important for survival than market performance has slowed the development of new private small- and medium-sized enterprises that represent the future of the economy. Weak institutions have been the trade mark of the economic order under Vladimir Putin and rule of law, effective governance, control of corruption and other governance indicators have deteriorated during his time in office. Why has the Russian leadership become so uninterested in promoting growth and further prosperity for the country?

The downgrading of economic goals is linked to the increased prioritizing of geopolitical objectives in Russian foreign policies. As early as in his speech to the Federation Council on April 25, 2005, President Vladimir Putin claimed that "the collapse of the Soviet Union was a major geopolitical disaster of the century".[1] In his speech to the Munich Conference on Security Policy two years later Putin described the unipolar world that developed after the Cold War, with the US as the only superpower, as "unacceptable" and that "[t]he United States has overstepped its borders in all spheres – economic, political, and humanitarian and has imposed itself on other states."[2] Thereafter, preserving its influence over the post-Soviet states became an overriding goal in Russian politics, taking precedence over other things such as economic growth. Likewise, the imperative of domestic stability and the anxiety over color-themed revolutions and a potential Russian Maidan[3] have decisively influenced the way Russia's domestic politics have evolved with significantly limited citizen rights, persecution of NGOs with foreign funding as "foreign agents," and repression of all political opposition. Thus it appears reasonable to state that geopolitical aspirations and the preeminence of maintaining the political status quo at home have become more important than economic growth in Russian politics. This article explores the effects of not reforming the economy and strengthening the market economy but instead letting political objectives overshadow concerns for economic development.

THE OBJECTIVE OF the article is to analyze the economic effects for Russia of pursuing political goals instead of reviving the economy and carrying out necessary reforms. The "non-reform agenda" since the mid-2000s that was reinforced with the reelection of President Vladimir Putin for a third term in 2012 has led to the economy sliding due to structural problems and weak institutions over many years.

Since 2014 with the additional problems of geopolitical tension, low oil prices and economic sanctions these weaknesses have been revealed and the economy is contracting.

The article is organized as follows. In the second section the foreign political background to the present crisis is described. In the third section the structural reasons for the economic decline are analyzed. In the fourth section Putin's economic policy since 2012 is investigated and in the fifth section the economic situation 2013–2015 is explored and effects of sanctions are discussed. The final section draws the conclusions of the article.

Political background of the crisis with the West[4]

The deterioration of the relationship between Russia and the West after Russia's annexation of Crimea reflects a deep disagreement over the post-Cold War security order in Europe that has existed over some time. In brief, Russia has become dissatisfied with the arrangements that developed after the collapse of the Soviet Union in 1991 and wants to preserve at least what is left of the former Soviet "sphere of influence," which includes the remaining former Soviet republics in Europe, Ukraine, Belarus, Georgia and Moldova, Armenia and Azerbaijan and Central Asia. Meanwhile the West regards these countries as sovereign states that are free to engage in any international cooperation and form the alliances they choose. Russia's former satellites in Europe and the three Baltic republics joined NATO in 1999 and 2004[5] and they acquired full membership in the EU in 2004 and 2007.[6] When Georgia and Ukraine pursued attempts to join NATO in 2008 and the alliance spoke positively of these countries eventually joining the alliance, this was too provocative for Moscow and resulted in the military conflict in 2008 with Georgia over South Ossetia and Abkhazia in which Western countries were not inclined to intervene.

After the Georgian war the EU launched the Eastern Partnership which was to include Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. This was mainly an economic initiative, offering the opportunity for economic reforms through increasing interaction and exchange with the EU; however, it also included goals of building a "common area" of democracy, prosperity and stability. The idea was thus to create stronger economic cooperation with the EU and strengthen the market economy in the Eastern Partnership countries and also to transfer Western values of democracy, rule of law and fighting corruption. Russia disliked this initiative and found the EU trespassing in its "sphere of influence".

In response, Russia announced that it intended to form the Eurasian Customs Union (ECU) by 2015. Belarus and Kazakhstan signed the agreement to establish ECU in 2011, but the union would be insufficient with only these two countries. In addition Russia opted to include Armenia, Moldova and Ukraine, and of these countries Ukraine mattered most to Russia because of its size and strong economic, historical and cultural ties with Russia. If Ukraine signed the Association Agreement with the EU, which was planned for November 2013, it could not join the ECU. For Russia it was vital to prevent any further expansion of "EU's sphere of influence" and especially to block Ukraine's accession to the Eastern Partnership. As is now known, the then President Yanukovych did not sign the agreement with the EU in November; instead he signed an agreement with Russia for a bail-out loan of USD 15 billion in December 2013. This was the last straw that triggered the still ongoing crisis in Ukraine.

Pro-European protests on Maidan, Independence Square, in Kiev started in November 2013. After the failure to sign an agreement with the EU, tension increased and the government tried to fight the uprising by force, resulting in many casualties. On February 22, 2014, the protesters ousted President Yanukovych who fled to Russia. On February, 27 Russia's "little green men"[7] took the airport in Simferopol' and occupied the Supreme Council of Crimea, enabling a pro-Russian government to be installed. By 18 March Russia's annexation of Crimea was a fact.

Factors behind the economic decline

Russia's current economic situation stems from multiple accumulating problems; it does not simply reflect the consequences of the international reactions on policies towards Ukraine or to President Putin's authoritarian domestic policies in his third presidency. First, despite a lot of discussions over the years and a serious modernization proposal by then President Dmitry Medvedev in 2009, Russia has not managed to escape its dependency on exporting hydrocarbons and there seem to be very few new up-coming innovative products "made in Russia" in view. Second, the inability to leave the extensive energy-export-driven path of development is explained by the power vertical's dependence on rents from the commodity trade and the distribution of rents that has evolved under Vladimir Putin.[8] Oil rents are used to subsidize economic actors that are not economically viable, so called "rent addicts", who support the regime in exchange for subsidies and further survival. Third, new private small and medium-sized enterprises that as a rule are outside Putin's rent distribution system find it difficult to attract investment and manpower in order to grow. Institutions are weak and the business climate is unfriendly for these market actors.[9]

These factors have been on the scene since the mid-2000s, long before more acute depressing factors were added in 2014. The new tendencies have seriously damaged the economic prospects and the economy has gone from a stagnating muddling-through to a meltdown. The confidence in the Russian economy declined as the Ukrainian crisis developed with a fall of investments and FDIs as a result. Economic sanctions have made it difficult for the Russian state banks and companies to access Western capital markets which has negative multiplier effects throughout the economy, and some specific exports to Russia were banned which has suppressed technology transfer from the West on which the Russian industry depends. In particular, this has caused problems for oil exploration on the Arctic shelf and the defense industry. The final blow was the dramatic fall in the oil price which appears likely to stay low at around USD 50 per barrel during at least 2015, which has decreased income to the federal budget. The value of the Russian ruble (RUB) was halved against the dollar, which has made imported goods expensive and has contributed to inflation. In response to the Western sanctions the Russian government imposed counter sanctions on certain food products that have further spurred inflation.[10]

The Russian economy has suffered from structural problems since the early 2000s and unfortunately the modernization program launched in 2009 by then President Dmitry Medvedev – which addressed the need for diversification from the heavy reliance on the export of hydrocarbons, too much state involvement in the economy, the weak business climate for small and medium-sized businesses problems and corruption – was too much of a challenge for the various political elites and never materialized.[11] Yet the popular protests in the fall of 2011 and early 2012 against electoral fraud and Putin's standing for president again showed that a considerable part of society wanted a change in the political sphere as well.

A major obstacle to any modernization program in Russia is that the economic system that has developed since the reforms in the 1990s still bears features of the Soviet command system. Despite the change of system from a command economy to a market economy, the institutions that normally support market allocation are weak and are overruled in many ways by informal institutions surviving from the Soviet era and new variants of manual management that have evolved during Putin's reign. That Russia's market institutions are deficient is reflected in the Worldwide Governance Indicators.[12] The WGI project constructs aggregate indicators of six broad dimensions of governance: political stability and absence of violence/terrorism; voice and accountability; government effectiveness; regulatory quality; rule of law; and control of corruption. When these indicators are studied over time it is found that in Russia they have generally been low, that they improved up to the early 2000s, but that since 2004 there has been a marked deterioration in vital institutions like "rule of law" and "control over corruption".[13] "Voice and accountability" shows a downward trend over the whole period of Putin's leadership since 2000. Weak institutions create scope for manual management of economic matters, which is also a reason why institutions need to be kept weak – so that political goals rather than economic goals can be pursued.

THE PRESENT RUSSIAN economic system may be characterized as a hybrid of the old Soviet heritage with inefficient state-owned or state-controlled subsidized enterprises and state intervention, on the one hand, and a market economy consisting mainly of the small and medium-sized business sector that evolved after the change of system, on the other hand. In Putin's power balancing system, the loss-making "Soviet-type enterprises"[14] are subsidized to ensure continuing support for the regime. Rents from high oil prices have been distributed in what Clifford Gaddy and Barry Ickes call a "rent management system" and economic behavior has been labelled "rent addiction," alluding to the fact that when rents from natural resources are invested in inefficient production by loss-making firms – "addicts" – they will continue to demand resources in order to save jobs and capital already installed.[15] This preservation of the old industrial structure and the resulting rent management system inhibits the growth of the private market-oriented sector. It provides an explanation for the weak institutional framework and poor business climate in Russia. The old industrial sector is not interested in institutional reform and more competition; more market and competition would upset the power balance. Thus, growth cannot be restored within this economic system.[16]

Nevertheless, liberal economists in Russia have argued for a renewed market reform in order for Russia to be able to compete in the global environment, overcome capacity constraints and support innovation. They have also emphasized the need for real democracy to enable modernization.[17] In fact, political reform would be necessary to reinstate the market as the main instrument in resource allocation. However, the regime under Putin has become more authoritarian and since he came back to presidential power in 2012, civil society has been repressed and civil liberties have been severely restricted. Tax policies and anti-corruption campaigns have had an adverse effect on the establishment and growth of new businesses and small businesses have shut down or become part of the informal economy instead of expanding and increasing their share in the formal economy.

Putin's economic policy

On the macro level the Russian economy performed well in the 2000s and its fiscal management won praise. Economic policy under former Minister of Finance Alexei Kudrin was commended for its restraint and low government debt. The crisis management during the 2009 economic contraction resulted in Russia recovering from the crisis, and growth in 2010 was 4.5%.[18] In connection with Kudrin's resignation in September 2011 the direction of economic policy became less consistent and the idea of Russia taking its own route with a "Russian economic model" seriously challenged the liberal paradigm. This idea matches the general nationalistic trend in Russian policy which is based on the notion that Russia is a special country with a special mission that should pursue its own path and not follow the "decadent West," ideas that have been developed after Putin's return as president in May 2012.

President Putin presented the main directions of his economic program immediately after his inauguration in May 2012. In his first decree on economic policy, he spelt out the economic improvements that should be achieved by 2018–2020.[19] These included: the creation of 25 million highly productive work-places by 2020; an increase in the share of investment in GDP to 27% in 2018; an increase of investment in state priority industries; an increase in labor productivity by a factor of 1.5; preparations for the privatization of state assets outside the commodity-energy sector; and an improvement of the rating of Russia in the World Bank Ease of Doing Business Index from 120th place in 2011 to 50th in 2015 and 20th in 2018.

Moreover, despite the negative Soviet experience and evidence from other countries that high military spending does not guarantee high growth, the increased role of the defense industry was stressed in Decree No. 603 and in the budget address 2012.[20] There the defense industry was named "a driver" in economic development. The government's economic program up to 2018 also stressed the importance of the defense sector in technological modernization and for generating economic growth.[21]

Several of Putin's goals appeared difficult to achieve even before the sharp decline in growth in 2013. Raising the investment ratio to 27% would have been a difficult task even before the surge in capital flight in 2013-2014. Creating 25 million highly productive workplaces would also have been difficult before the present economic stagnation since the rent-dependent companies hoard labor in order to motivate continuous subsidies and Russia is experiencing labor shortages due to the decline in the working-age population and the low geographical mobility of the workforce.[22] The labor market is tight and for new jobs to be manned old, inefficient "Soviet-type" jobs need to be scrapped and labor motivated and helped to move. As the reform economist Vladimir Mau remarked, there is no labor surplus to employ in these new jobs. Mau also notes that a large part of the educated middle class living in the big cities is ready to leave the country.[23] The trend in emigration supports this notion. According to Rosstat data, annual emigration has quintupled since 2010.[24]

The weak business climate has been a characteristic of the Russian economy despite years of reform aimed at improving it. Nevertheless, Russia's ranking in the World Bank Ease of Doing Business Index has improved since Putin's Decree No. 596. In 2013 it had improved to 92nd among 189 countries (from 120th place 2012). In 2014, Russia had reached place 64 in the ranking and in 2015, place 62. [25] The aspects in which Russia still has substantial disadvantages are "getting electricity", "obtaining construction permits" and "trading across borders". Moreover, between 2014 and 2015 the rank of the indicator "getting credits" has deteriorated. However, this index reflects performance with respect to six different indicators and it does not capture the balance between old, large enterprises with political influence existing outside market competition and small and medium-sized firms struggling to stay in business and expand. Nevertheless, it is worth noting that with respect to the business climate Russia has taken some steps in the right direction, although the credit crunch will probably continue for the foreseeable future.

Economic growth and policy 2014–2015

In 2013, Russian growth plummeted to 1.3% a year instead of the 2–3% forecasted. The confidence crisis following Russia's annexation of Crimea in March 2014 and its continuing aggression against Ukraine lowered growth expectations, and in October the IMF revised its forecast to 0.2% growth for 2014, 0.5% for 2015 and a recovery to 1.5% only in 2016.[26] In January 2015, however, the preliminary result for 2014 was 0.6% growth and the IMF now projected a contraction of -3% for 2015 and -1% for 2016.[27] Western sanctions, Russian counter-sanctions and the dramatic fall in the oil price added to the negative trend. In April 2015, the World Bank presented three scenarios with growth rates between – 2.9 and – 4.6 for 2015 and 0.1 to -1.0 for 2016; the baseline scenario is described in Table 1 and predicts -3.8% for 2015 and -0.3 for 2016.[28]

Table 1: Macroeconomic development 2012–2015 (World Bank baseline scenario 2015)

	2012	2013	2014	2015	2016
Oil price, USD/bbl	105	104	97.6	53.2	56.9
GDP growth, %	3.4	1.3	0.6	-3.8	-0.3
Consumption growth, %	6.4	3.9	1.5	-5.3	-1.9
Gross capital formation growth, %	3.0	-6.6	-5.7	-15.3	1.1
General government balance, % GDP	0.4	-1.3	-1.2	-3.6	-3.1
Current account, USD billion	71.3	34.1	56.7	73.7	62.9
Current account, % GDP	3.6	1.6	3.0	6.0	4.4
Capital and financial account, USD billion	-32.3	-56.2	-143.2	-122.1	-60
Capital and financial account, % GDP	-1.6	-3	-7.7	-10	-4.2
CPI, average, %	5.1	6.8	7.7	16.5	8.0

Source: "The Dawn of a New Economic Era? ", *Russia Economic Report*, 33 (World Bank, April 2015): 24. Accessed April 20, 2015, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2015/04/12/000333037_20150413141814/Rendered/PDF/956970NWP00PUB0B0WB0RER0No0330FINAL.pdf.

Impact of the economic sanctions imposed by the US and the EU

In July 2014 the US and the EU imposed economic sanctions on Russia affecting its financial sectors, energy sector and defense industry.[29] As a result, in 2015 six major state banks and major energy and defense companies in the listing can only apply for loans and issue debt not exceeding 30 days of maturity on EU and US capital markets. The defense and energy sectors have also been hit by the prohibition to export arms and dual-use goods and advanced technology for oil exploration to Russia.

There is still no comprehensive analysis on how the sanctions hit the Russian economy and even less on the magnitude of the effects because this cannot be separated from the impact of other factors. More time need to elapse before these matters can be fully investigated. Nevertheless, the World Bank argues that Western sanctions have hit the Russian economy through three channels: first they have caused volatility on the foreign exchange market and a significant depreciation of the ruble.[30] This has also led to capital flight and deterioration of international reserves. The second channel through which sanctions have hit the economy is the restriction on access to international financial markets. The tighter domestic and external credit conditions have negatively affected investment and consumption.[31] This is the sanction that has impacted the economy most in the short-run since it inhibits investments and refinancing of major state banks and other financial institutes. The third channel cited by the World Bank is the confidence crisis that has developed as a consequence of the geopolitical tension and sanctions that have

Table 2: Federal budget items as shares of GDP in 2012–2015 (percentage of GDP)

	2012 Actual	2013 Actual	2014 Actual	2015 FZ-384	2015 New budget
Federal budget as % of GDP	*20.6*	*19.8*	*20.9*	*20.0*	*20.8*
General state issues	1.3	1.4	1.3	1.4	1.5
National defense	2.9	3.1	3.5	4.2	4.3
National security and legal system	2.9	3.0	2.9	2.8	2.8
Support to the economy	3.1	2.7	4.3	3.0	2.9
Housing and utilities	0.4	0.2	0.2	0.2	0.2
Environment protection	0.0	0.0	0.1	0.1	0.1
Education	1.0	1.0	0.9	0.8	0.8
Culture	0.1	0.1	0.1	0.1	0.1
Health	1.0	0.8	0.8	0.5	0.5
Social policy	6.2	5.7	4.9	5.2	5.8
Physical culture and sport	0.1	0.1	0.1	0.1	0.1
Media	0.1	0.1	0.1	0.1	0.1
Debt service (state and municipal)	0.5	0.1	0.6	0.6	0.8
Inter-budgetary transfers	1.0	0.6	1.1	0.9	0.8
Deficit/surplus	–0.1	–0.8	0.5	–0.6	–3.7
GDP bn RUB	62,599	67,519	70,976	77,499	73,119

Sources: Data for 2102 and 2013: The information on the execution of budgets, Federal Treasury of the Russian Federation, July 2013, accessed 5 July 2014. http://www.roskazna.ru/en/the-information-on-execution-of-budgets/
Data for 2014 and 2015: Poyasnitel'naya zapiska k proektu Federal'nogo Zakona "O vnesenii izmenenii v Federal'nyi zakon 'O Federal'nom byudzhete na 2015 god i na planovyi period 2016 godov'" [Explaining note to the project "Revisions to the federal budget law for the budget 2015 and the preliminary budget for 2016], Ministry of Finance RF (2015) 8, accessed March 25, 2015, http://asozd2.duma.gov.ru/main.nsf/(ViewDoc)?OpenAgent&work/dz.nsf/ByID&04D187289DAC194943257D63004E6253. Prilozhenie No 5 k poyasnitelnoi zapiske k proektu FZ "O vnesenii izmenenii v Federal'nyi zakon 'O Federal'nom byudzhete na 2015 god i na planovyi period 2016 –2017 godov'" [Annex No 5 to the Explaining note to the project "Revisions to the federal budget law for the budget 2015 and the preliminary budget for 2016], Ministry of Finance RF (2015), accessed March 25, 2015. http://asozd2.duma.gov.ru/work/dz.nsf/ByID/1F4B4A870CEEDFBB43257D6300510063/$File/%D0%9F%D1%80%D0%B8%D0%BB%D0%BE%D0%B6%D0%B5%D0%BD%D0%B8%D0%B5%20%E2%84%96%208%20%28%D0%BD%D0%BE%D0%B2%D0%BE%D0%B5%29.pdf?OpenElement

resulted in great uncertainty regarding policy and economic development. Consumption growth slacked in 2014 and fixed investment contracted by 2.5%. Foreign direct investment (FDI) was halved in the first three quarters of 2014 compared with the same annual periods 2011–2013.

In addition trade flows have been impacted and imports have decreased mainly due to the weakened ruble and the Russian counter sanction banning certain food imports. Effects on Russia's oil and gas export volumes have not been too evident yet. This is due to the fact that oil and gas contracts are usually set for a longer period. Effects of the sanctions on targeted sectors such as the prohibiting the export of arms, dual-use technology and advanced technology for oil and gas exploration and the defense industry are still to come according to the World Bank assessment.[32]

The federal budget

In the initial three-year budget for 2014-16 there was an aim to reduce the federal budget as a share of GDP from 20 to 18% by 2016.[33] Social policy expenditure, which has had high priority since 2009, was to fall from 6 to below 5% of GDP. The shares of education and health were also to decline. Defense spending remained at a high level and was planned to rise from 3.1% of GDP in 2013 to 3.8% by 2016. Fiscal policy during 2013 remained restrained and actual budget expenditures were slightly lower than approved.[34] Table 2 shows the actual federal budget shares for 2012-2014 and here the austerity in 2013 is reflected: the federal budget's share in GDP dropped to 19.8%. However, in 2014 the share increased again to 20.9%. The increased priority given to defense and Russia's increasing security policy ambitions with Putin's return to power is reflected in that the share of national defense rose from 2.9% in 2012 to 3.1 in 2013 and to 3.5% in 2014 (Table 2).

THE BUDGET FOR 2015–2017 (FZ-384) was adopted by the Duma in November 2014. The Ministry of Finance had opted for a minimal budget deficit of less than 1% and fierce discussions had accompanied the budget process in the government on where the cuts should be made, not least on how far defense spending could be preserved at high levels when other public spending had to be reduced. The budget law implied a defense budget of 4.2% of GDP in 2015. However the Minister of Finance Anton Siluanov had already signaled that a new defense program needed to be developed that took into account the changed economic situation, even though the deputy Prime Minister Dmitry Rogozin in charge of the sector had ruled out any cuts in military spending.[35] "A new defense program will be prepared now, and in its framework we want to reconsider the amount of resources that will be spent from the budget in order to make it more realistic," said Siluanov. This was an echo of his veteran predecessor, Alexei Kudrin, who quit in protest when the rise in military spending was initially proposed under President Medvedev in September 2011. At that time, however, the funding of the military reform and the rearmament program were based on the assumption that Russia would maintain its unprecedentedly high growth rate of 6% per year throughout the decade. Now times had changed and Siluanov stated quite bluntly "Right now, we just cannot afford it".[36] The lower growth due to the dip in oil prices, the halving of the value of the ruble against the US dollar, and the Western sanctions impeding Russian banks' free access to Western capital markets and restricting exports of advanced technology to Russia, had clearly shattered the Minister of Finance's hopes of a quick recovery. It was time to tell the truth about the economic situation.

Since it became increasingly obvious that the oil price would drop from its high level of around USD100/bbl and that GDP would contract, the Ministry of Finance prepared amendments to the budget that were discussed during the first months of 2015. The new amended budget for 2015 was adopted by the Duma April 7, 2015 and has a much lower GDP estimate for 2015. As seen in Tables 2 and 3, forecast GDP is almost 6% below that in the original budget law (Table 3). The new law applies to 2015 only and the Ministry of Finance will introduce changes related to 2016 and 2017 in September 2015. The new law is based on the assumption of an oil price of USD 50/bbl and GDP contraction by 3%. Budget revenues are projected to decrease by 3.3% of GDP while expenditure decreases only marginally from 20.9 in 2014 to 20.8% of GDP in 2015. The deficit rises to 3.7% of GDP and the Reserve Fund will be the main source of deficit financing.[37] This means that in total RUB 3.2 trillion (about USD 50 billion) will be drawn from the Reserve Fund, which corresponds to about 60% of the whole fund (USD 85 billion).[38] This reduces Russia's fiscal maneuvering room for future years if the economy does not recover or Western financial markets do not open up for Russian state banks.

Table 3: Federal budgets 2014 and 2015 and proposed changes in 2015 (million RUB [current prices] and percent)

	2014	2015	2015	2015	Change %
	Actual	Budget law FZ-384	Proposed change	New budget April 2015	from FZ-384 to new budget
Total spending	14 830 601	15 513 079	–298 035	15 215 045	–1.9
State administration	934 741	1 113 735	–33 669	1 080 066	–3.0
National defense	2 479 074	3 273 991	–157 218	3 116 774	–4.8
National security and legal system	2 086 165	2 148 072	–80 423	2 067 649	–3.7
National economy	3 062 915	2 338 749	–205 897	2 132 852	–8.8
Housing and municipal services	119 609	144 606	–15 603	129 003	–10.8
Environmental protection	46 366	54 947	–8 868	46 079	–16.1
Education	638 265	632 976	–30 867	602 108	–4.9
Culture	97 832	99 008	–7 115	91 893	–7.2
Health	535 564	420 940	–34 730	386 210	–8.3
Social policy	3 452 374	4 010 082	203 639	4 213 721	5.1
Physical culture and sports	71 164	73 662	–1 818	71 844	–2.5
Media	74 832	69 971	2 152	72 124	3.1
Debt service	415 612	449 304	135 996	585 299	30.3
Transfers between budgets	816 090	683 037	–63 614	619 423	–9.3
Deficit		–431	–2 245	–2 673	
GDP billion RUB	70 976	77 499	–4 380	73 119	–5.7

Source: : See Table 2. Sources for data for 2014 and 2015.

AS SHOWN IN TABLE 3, the defense budget has been cut by almost 5% in nominal terms compared to the original FZ-384. National security – much less discussed but also an item that has had high priority and grown during the Putin era – also sees reductions. Support for the national economy is cut by 8.8%, which is quite courageous of the government considering the difficulties Russian companies are experiencing under present circumstances. Furthermore, spending on many of the items that affect the population most, such as the health sector, protection of the environment, education and culture, has been reduced and it may be interesting to see if this has any effect on public opinion. Nevertheless, social policy has been allocated increased funding, which will be devoted to pensions and social provisions for households.[39]

The anti-crisis program and import substitution

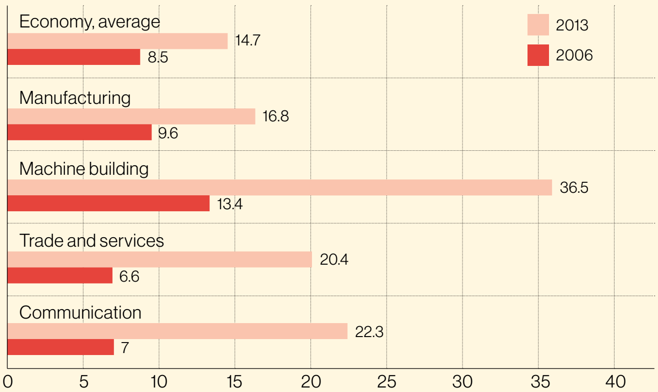
So what is the government doing to mitigate the poor economic prospects? The government has initiated an anti-crisis program worth USD 35 billion (about 1.5% of GDP).[40] The plan was rather vague as to what was to be cut in other public spending in order to afford this program since it was presented before the new budget that was adopted only in April. Some investments are to be financed through the National Wealth Fund and redistributions have been made from other unnamed projects. Most of the spending goes to the banking sector since Western sanctions impede Russian state banks' and big state companies' access to Western capital markets, thus hindering production.[41]

"Import substitution" is the new paradigm of Russian economic policy. The idea that the Russian economy should use the current situation to advance domestic industry and production also permeates the Russian counter-sanctions imposed August 7, 2014.[42] In April 2015 the Ministry of Industry and Trade presented a plan on how Russia should become more self-sufficient by implementing 2,059 projects in 19 branches of the economy up to 2020.[43] The cost is estimated at RUB 1.5 trillion, of which only RUB 235 billion will come from the federal budget (ibid.). Many observers point to the difficulty of this scheme given the relatively high import dependence of the Russian economy after almost 25 years as an open economy and that the funds available for necessary investments are too small. Olga Berizinskaia and Alexei Vedev highlight the fact that the general dependence on imports in production has almost doubled between 2006 to 2013 from 8.5 to 14.7% (Figure 1).[44] In machine construction the figure has risen from 13.4 to 36.5%. High shares may also be noted in communication and transport (Figure 1).[45]

The Russian counter-sanctions have to a large extent been geared towards banning food imports, which demands that domestic production of these goods is increased. However, here

Figure 1: Import dependence in the Russian economy 2006 and 2013

(import as percentage of producers' total costs)



Source: Olga Berezinskaya and Alexei Vedev "Proizvodsvennaya zavisimost' rossiiskoi promyshlennosti ot importa i mekhanism strategicheskogo importozameshcheniya" [Production dependence of import in the industry and the mechanism of strategic import substitution], Voprosy ekonomiki, 1 (2015: 103-124) 104.

too it is evident that there is a significant dependence on imports in Russian production. Apparently, in meat production there is a dependence of 20%. In fish and seafood production the corresponding figure is 28% and in the production of vegetables and fruits, 33%. In order to cope with the increasing demand, these sectors need to be modernized and to make that possible significant investment is required. In more advanced production there is a need for more advanced technology if Russia is to become more self-sufficient, e.g. in the production of food enzymes the import dependence is presently 68%.[46] At the moment the opportunity for getting necessary investments and acquiring the technology needed for this kind of production is small due to the weak ruble and the lack of equipment on the Russian market.

Can Russia change its economic orientation from the EU?

The EU has been Russia's most important trade partner since Russia introduced the market economy in the 1990s. In 2013, 53% of Russian exports of goods went to the EU and 46% of imported goods came from the EU. European banks hold 75% of foreign bank loans to Russia and substantial stocks of FDIs.[47] It follows that it will take time for Russia to change its trade orientation if it wants to replace part of the previous export and import activity to and from Europe with trade with Asia, BRICS or the post-Soviet space. In the 2010s, about 80% of its energy exports went to the West and 10% to Asia.[48] Cooperation with BRICS cannot solve Russia's major challenges of attracting investments and technology.[49] To expand the cooperation with the countries in the Eurasian Customs Union (ECU) is plausible but it would imply stressing Russia's "special route" away from the West, market economy and democracy; that is, going backwards rather than forwards.

Could Russia turn to China and increase economic cooperation? China is one of Russia's main trading partners – 6.8% of Russia's exports go to China and 16.4% of its imports come from China.[50] China has bought Russian oil since 2009, and in 2013, Rosneft agreed to double oil supplies to China in a deal valued at USD 270 billion. This means that 20% of Russia's oil exports will eventually go to Asia.[51] In May 2014, after relations with the West were upset, a gas agreement worth USD 400 billion was signed between Moscow and Beijing, under which Russia will supply 38 billion cubic meters (bcm) of gas to China over 30 years starting in 2018. If a second pipeline is built to China's western provinces this would expand Russia's annual gas sales to China to 61 bcm.[52] This is a large amount but still just a fraction of what Russia exports to Europe: in 2013 pipeline gas exports to Europe amounted to 162.4 bcm.[53] In addition to the oil and gas cooperation, China and Russia are partners in the nuclear energy field.[54]

The defense industry is a priority and the Western sanctions have closed Russia's access to Western defense technologies and technologies of dual use, which may become a problem for the defense industry that is not as self-sufficient as is sometimes claimed.[55] More importantly, however, Russia has lost its quite extensive arms cooperation with Ukraine and with it supplies of important arms components (in particular gas turbines and helicopter engines) which were essentially produced in eastern Ukraine. Also, Russia lacks production of electronics, but China has developed its indigenous production, and Russia could use Chinese electronics in its arms development.[56]

Conclusions

The third term of Vladimir Putin as president of the Russian Federation has implied that geopolitical aspirations and the precedence of maintaining the political status quo at home have become the overriding goals in Russian policies. Economics and economists have very little influence over the present political development, which stands in sharp contrast to Putin's first period and to Dimitry Medvedev's term as president. Presently, becoming a great power of the world is far more important than attracting investors, achieving high economic growth and increasing the living standard of the Russian population. During his third term Putin has given priority to the military sector, military spending has risen substantially as share of GDP, and the defense industry has been launched as a "driver" in the economy. As a result of these choices and a rent management system giving advantages to non-viable producers in exchange for loyalty to the regime, economic performance has been weak for several years and growth dropped to 1.3% and 0.6% growth in 2013 and 2014. Russia's annexation of Crimea and the subsequent war with Ukraine have added to the declining economic trend and created an economic meltdown. The currency was depreciated by half and on top of this Western sanctions have been imposed and the oil price has dropped from a level of USD 100/bbl to USD 50/bbl. Together these factors have led to that the economy will contract at least by 3% in 2015 and the prospects for the coming years are very bleak.

In response to the economic decline the government has launched an anti-crisis program that is small in comparison to the measures imposed during the crisis 2009 and which is mainly geared at supporting the banks and increasing social programs. The innovative policy initiative that has been launched to curb the negative development is "import substitution" meaning that Russia, like the USSR, should produce more domestically and become less dependent on the outside world. Unlike the USSR though, Russia is quite import dependent after having been integrated in the global economy for twenty-five years; to cope even with the restricted nomenclature of products presented by the Ministry of Industry and Trade does not seem realistic even in the medium-term. Of course, domestic production sheltered by the weak currency and import bans will imply low quality goods at high prices for the consumers.

Productivity growth occurred during the high growth years but Russia did not use the opportunity to invest and create an innovative economy. Instead of modernization and institutional reform the political leadership opted for a political resource allocation preserving rent addiction and non-viable economic actors that need constant state support and subsidies to survive.

THE WESTERN FINANCIAL sanctions have impacted the Russian economy severely and contributed to difficulties in refinancing debt and raising funds for investments. In addition, trade flows have been impacted and imports have decreased mainly due to the weakened ruble and the Russian counter-sanctions banning certain food imports. Effects on Russia's energy export volumes have not been too evident yet because oil and gas contracts are usually set for a longer time. The effects of the sanctions on targeted sectors such as prohibiting the export of arms, dual-use technology and advanced technology for oil and gas exploration and the defense industry are yet to be felt. Since the innovation capacity of the Russian industry is weak the lack of international cooperation in these fields will have long-term effects if Russia is excluded for a longer period. Russia may modify its trade patterns over time and seek more cooperation with other countries such as China, other BRICS countries or Latin America. However, this will take time and the EU remains Russia's major trade partner.

The present Russian leadership's political ambitions abroad and at home clearly have a price. Low and near-to-stagnation growth have been exchanged for a major economic contraction. Despite the depressed economy the leadership keeps military expenditure at a high level. The ideas on how to mitigate the economic crisis are not convincing. All these factors imply lower living standard for the population. ×

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