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"Muddling down": the economic crisis in Russia and its political impact

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In summer and autumn 2008 the Russian stock market showed signs of volatility and then collapsed, the rouble underwent a gradual devaluation against the dollar and euro and the real economy began to experience first a slow down, then accelerating decline. Over time, the Russian government's response to the crisis has been two-fold. At first, the leadership sought to portray Russia as a safe haven, and that the Russian economy had decoupled from the US and European economies. The leadership focused much of the blame for the crisis on the USA. At the same time, the government has adopted an active response including fiscal stimulus to support the banking system and the introduction of anti-crisis measures to identify "system forming" and regionally significant enterprises eligible for support. Subsequently, on 19 June 2009, Prime Minister Putin signed a programme of over 120 anti-crisis measures for

- social support
- retention and enhancement of industrial and technological potential
- support for specific branches of the economy, particularly the motor, defence and transport industries.
- reduction of administrative pressure on business

The stabilisation and then gradual rise in the price of oil has had a concomitant stabilising effect: the rouble began to appreciate in value from March and stock markets began a gradual recovery, which accelerated in May.

Despite this stabilisation, the real economic situation in Russia remains difficult, and there has been a growing realisation in the Russian leadership that the crisis has serious ramifications for Russia – the debate first centring on whether the "bottom" of the crisis had been reached, then on concern about a possible second wave of crisis later in 2009.

The difficult overall economic picture is reflected in

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- A dramatic drop in GDP, with an annual percentage change of -10% or -11% in 2009. 2010 and 2011 forecasts are very modest (2.5% & 3% respectively) and may be revised down.
- A collapse in industrial output of approximately 15% in Jan-May 2009 compared to Jan-May 2008 and forecast to be 9% overall in 2009
    - Compared to Jan-May 2008, natural gas production in Jan-May fell 19%, crude steel production fell 32%, cement production fell 33%
    - Output of many goods is now falling, particularly those related to the collapsing construction sector, such as excavators and trucks.
- The contraction of both imports and exports to approximately half the levels of 2008. Ministry of Economic Development forecasts suggest that even 2007 levels will be reached again only in 2012.
- Persistent double-digit inflation, forecast to be some 14% in 2009.

The Russian budget is under pressure, going from a surplus over the last 9 years to a deficit by the end of 2008 as demands for increased spending on anti-crisis measures have grown. Budget revenues are falling, but there is a reluctance to cut spending on social programmes and the military.

- The budget for 2009 was adopted in November 2008 but based on unrealistic assumptions of a surplus of 3.7% of GDP. It was amended in April 2009 with a deficit of 7.3% of GDP, to be funded mainly from the Reserve Fund.
- Russia has one of the largest financial cushions. However, Finance Minister Aleksei Kudrin has warned that the Reserve fund will be exhausted in 2010, or even by the end of 2009, and since a provisional budget deficit of 5% GDP is forecast for the 2010 budget, Russia may have to resort to borrowing or raiding the National Welfare Fund.

The Russian banking sector faces a number of problems:

- Transparency is limited in a banking system that is dominated by state owned companies and supervision is somewhat lax.
- The government ensured liquidity when the financial crisis first struck. But according to the Russian Central Bank on 1 May 2009 5.1% of the credit portfolio of the 30 largest banks by assets were problematic and a further 10.1% constituted dubious loans.
- Businesses and households are finding credit difficult to obtain – and often only at interest rates of 20-25% on borrowing roubles, resulting in investment plans being cut back.
- Companies and households are experiencing difficulties in repaying loans and there is a danger that later in the year bad loans could grow to a threatening scale (perhaps 20% of credit portfolios) leading to a second wave of crisis and renewed credit crunch in which smaller banks could go under. A further round of bank recapitalisation may be necessary, but it would strain the budget. Therefore, while the Government hopes for a “V” shape recovery, it may have to deal with more of a “W” shape.

The Government's response to the crisis has had mixed success. If the measures adopted have sought to deal with liquidity and support, little has been done to enhance trust in economic life – as Elvira Nabiullina, Minister of Economic Development and Trade, has pointed out, the scale of the crisis is not only the result of external shocks, but is also a result of domestic weaknesses of our economy, "above all, a crisis of trust". If specific sectors have been identified as eligible for support, industry has seen little of the designated funding. Moreover, the government funding has been made available to large enterprises only and small and medium enterprises are not benefiting. The crisis has therefore served to accentuate the tension between the state and small and medium business.

Government schemes to keep workers in employment, while socially positive in the short term, stall industrial reform – and in any case appear to be only partly successful given both the significant rise in unemployment (forecast to be over 10% in 2009) and the drop in living standards as reflected in the declining rate of growth of real disposable monetary incomes.

At the same time, the government faces a major problem with the impact of the crisis on monotowns.[2] The case of Pikalyovo, in which Prime Minister Putin became directly involved, has set an important but potentially difficult precedent for the government: citizens may deduce that they can demonstrate and the Prime Minister will arrive to bail them out. Senior Russian economists suggest that monotown problems are potentially explosive and the problem could become acute in late 2009.

The political impact of the crisis

The economic crisis renders more explicit the contradictions and choices the government faces. It clearly puts pressure on one of the government's main claims to legitimacy: economic success, and there appears to be concern in Moscow about the crisis generating instability through social unrest and federal collapse.

Nevertheless, despite the demonstrations in Pikalyovo and other cities, public opinion has so far not been volatile. Polls in June 2009 showed that 53% thought that Russia's leaders had been very or quite effective in dealing with the crisis, as opposed to 32% who thought the leadership to have been ineffective, and the economic decline has to date not directly equated to a decline in the popularity of either Medvedev or Putin.

The economic crisis has highlighted the lack of joined up government in Russia and flaws in the power vertical by emphasising the lack of mechanisms for articulating the problems and their solutions, or for coordinating corporate, regional and federal elite interests, or even for coordinating government Ministries and Departments. It has also generated some tension within the political elite, including pressure to replace Finance Minister Kudrin and criticism of how Prime Minister Putin has handled the government's response. Both President Medvedev and Putin have supported Kudrin so far. But there are clearly important differences in approach to handling the crisis: Putin's decision to

[2] There are three types of monotown: a monoprofile sputnik of a large multifunctional town, a monoprofile town with several town-forming enterprises and monoprofile towns with a single enterprise. Monotowns account for 25% of the total Russian population and some 40% of total gross regional product. Local budgets are almost totally dependent on the profits of a few, or a single enterprise and many monotowns are associated with industries that have been most affected by the crisis: metals, chemicals, machine building.

increase taxation on business to pay for increased pensions, for instance, was opposed by Kudrin.

In terms of political response to the crisis, the leadership has sought to enhance stability and continuity by attempting to appeal to a range of constituencies and seeking to co-opt them into the system, exemplified by Medvedev's interviews with opposition media, the establishment of the History Commission and the restatement by senior figures of the planned gradual move towards democracy and a two party system. Indeed, this might be considered the "Plan A", a long-term plan to modernise Russia towards democracy, albeit a "specifically Russian-style" "sovereign democracy". But this "Plan A" was made for a booming economy: spring 2008 represented the ideal conditions for its success. But under times of such economic strain – and with concerns about social instability prominent in the leadership's mind – it may be that the government avoids trying to make the leap and turns more towards a "Plan B", emphasising state strength and national unity from above.

The economic crisis has also had a number of ramifications for Russia's foreign policy. Initially, the leadership focused on blaming the West, particularly the USA for the crisis, and Russian domestic media has detailed the nature of the impact of the crisis in the West. This has tended to accentuate a shrill, nationalist tone to Russian statements and underpinned an anti-Western political narrative. Blaming the West, and particularly Western dominated international institutions for the crisis has also been at the root of Moscow's calls for a reconsideration of the international financial architecture.[3]

The financial crisis has created a dual international situation for Russia. First, although it has curtailed Russian ambitions to establish the rouble as a reserve currency, Russia has had a comparative advantage to its neighbours and provided some opportunity for Moscow to further its ambitions to be a Eurasian regional hub and power. This has tended to result in Russian financial assistance to neighbours in an attempt to gather together the remaining "loyal" members of the Commonwealth of Independent States (CIS), evident in the decision to form a $10bn Eurasian Economic Community anti crisis fund, loans to states to help them overcome the crisis and the formation of a customs union between Russia, Belarus and Kazakhstan.

The customs union may affect Russian WTO membership prospects, and there now appears to be little prospect of Russia acceding to the WTO in the next 5 years. Russian priorities in this regard remain somewhat unclear, illustrated by the conflicting statements given even by the President and the Prime Minister, but it appears that the Russian leadership has decided either to prioritise regional economic cooperation or that Moscow does not wish to be bound by WTO obligations at a time of economic crisis. Either, or indeed rather *both* of these options are likely to have foreign policy ramifications in Russia's dealings with the West, for example affecting Russia's negotiations with the European Union about an agreement to replace the Partnership and Cooperation Agreement (PCA), which are predicated on Russian membership of the WTO.

An important calculation in Moscow will be how Russia emerges from the crisis compared to other states. China appears likely to emerge strengthened, as will the US –

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[3] Moscow submitted a range of proposals for reforming the international financial architecture to the G20 Summit in London in April 2009. These proposals should be seen alongside Moscow's proposals to reconsider both the energy and European security architectures.

and this will pose the important question to Moscow of how to react to an international situation dominated by the US and China. The Russian economy is the worst performing of the BRICs and failing to emerge amongst the first few states is likely to undermine Russian global ambitions.

Conclusions

In sum, the crisis has served to underscore the widespread lack of trust in the economy and expose the serious institutional weaknesses of the economy itself, particularly emphasising the fact that growth over recent years has come too easily without institutional change and sufficient economic diversification. Recovery is likely to take longer than the government expects, and depends heavily on the oil price forecast. At the same time, there are also dangers that the measures adopted may threaten macro stability, the central policy success of post 1998-9 Russia.

Politically, the clearest feature of the government's response is stability and continuity, in effect "muddling through". This, however, appears likely to entrench the weaknesses in the economy. The consequences of "muddling through" are likely to be a greater interpenetration of ownership and governance underscoring the narrowness of the leadership club and concentration of wealth. This will raise the stakes of losing power yet further, which in turn may lead to a change in the nature of the regime towards more authoritarian methods in a more emphatic "anti-revolutionary" stance. Real reform appears unlikely, and the drive to co-opt all constituencies is contributing to high levels of corruption in the face of Medvedev's high profile effort to address this problem. Indeed, Russian policy appears to be locked into a status quo anti crisis effort, attempting to restore the conditions of spring 2008. "Muddling through" may be credible if the crisis is a short term one. But the longer the crisis lasts, the more pressure will build on the budget, in consequence affecting the implementation of the long-term development plans and creating the conditions for "muddling down".