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**C e n t r e f o r E a s t e r n S t u d i e s**

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# **OSW REPORT**

**RUSSIA IN CRISIS: YEAR ONE**

**WARSZAWA JANUARY 2010**

# **OSW REPORT**

## **RUSSIA IN CRISIS: YEAR ONE**

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## Executive summary

### Impact of the crisis on social and economic indicators

**Economic conditions which had favoured Russia's development suddenly changed** in mid-2008. The Russian economy was hit, on the one hand, by a **drastic slump in oil prices** (which fell from nearly US\$150 to US\$50 between July 2008 and January 2009), and on the other by the **outflow of investors** (a net of US\$130 billion of capital left Russia in the fourth quarter of 2008). Within several months, the financial crisis became an economic crisis affecting the entire economy. The financial reserves accumulated in times of prosperity (more than US\$162 billion in the stabilisation funds and nearly US\$598 billion in the currency and gold reserve) alleviated the negative impact of the crisis, although this failed to prevent the deep declines in macroeconomic indicators.

**Russia is one of the states most severely affected by the crisis.** In the first half of 2009, its **GDP fell by 10.4%** compared to the same period in the previous year, while **industrial production dropped by nearly 15%**, and a **decrease in investments of over 18%** was reported. The poor economic performance has strongly affected the Russian **budget**, which reported a **deficit** for the first time in ten years in 2009. During the first year of the crisis (August 2008 – September 2009), Russia's financial reserves **were seriously reduced as a result of the government's anti-crisis policy and interventions from the central bank**: the reserve fund decreased by nearly 45% to US\$76 billion, and the central bank's reserves shrunk by nearly US\$200 billion to US\$409 billion. Meanwhile, however, the money in the National Welfare Fund, which had been intended almost entirely to subsidise the Pensions Fund between 2010 and 2015, rose almost three-fold (to US\$90 billion). According to government forecasts, the money from the reserve fund is also supposed to be spent fully in 2010.

The financial crisis has triggered a dynamic **outflow of capital from the Russian market**. So-called speculative capital was the first to demonstrate the lack of confidence in the Russian market. In the first half of 2009, the growth rate of long-term investments also decreased noticeably, although no spectacular withdrawal of direct investments from Russia has been observed. The economic crisis has also halted **the foreign expansion of Russian private capital**, while state-owned capital strengthened its position as an investor. Russia's raw materials companies continue to be the main category of foreign investors; however, new technologies are gaining prominence as the second main direction of Russian investments.

**Standards of living in Russia have fallen as a result of the crisis.** Because of rising unemployment, decreasing salaries and overdue salary payments, combined with high inflation, real incomes in Russia have started to fall for the first time after ten years of dynamic growth. **In late 2008, Russia reported a rise in unemployment for the first time in ten years.** In the period of oil-driven prosperity, unemployment fluctuated around 5–6%, but in the first half of 2009, it rose **to 8–9%** nationwide; unemployment rates in more than thirty individual regions of Russia are much higher than this. However, the problem that has been affecting the Russian employees most in the first half of 2009 concerned **forced leave, part-time work and overdue salary payments**. Between December 2008 and June 2009, between 600,000 and 1.4 million people worked part time, and between 1 and 2 million were on forced leave (often unpaid). Outstanding salary payments oscillated around 7-8 billion roubles (US\$220–250 million) in the first half of 2009. **Private-sector employees** and workers with primary education in the production and processing sectors were among those most severely affected by the crisis. Employees in managerial posts also faced employment problems. **In the public sector, on the other hand, employees were only slightly affected.**

Because of the labour market crisis and rising prices, **real incomes in Russia started to decrease for the first time in eight years**, after having grown by more than ten percent a year on average since 2000. The deepest slump in incomes (by 11.6% compared to the same period in the previous year) was reported in December 2008. The reduced standards of living have resulted in an **increase in the percentage of poor Russians in the entire population**. According to Rosstat, the number of people living below the subsistence minimum (5083 roubles, corresponding to US\$159, in the first quarter of 2009) increased by **6 million** during the first three months of 2009 (24.5 million Russians currently fall into this category). The so-called **monocities**, built around large enterprises that employ most of the local active labour force, have become centres of economic and social problems; during the crisis many of these enterprises have found themselves on the verge of bankruptcy, which has drastically affected the population's standards of living.

### **The government's reaction to the deepening crisis**

The deepening financial crisis, which has quickly spread to the entire economy, has forced the Russian authorities to take action to address its negative consequences. However, **the objective of the Russian government's 'anti-crisis' strategy has been not so much to tackle the systemic problems of the Russian economy, as to overcome the temporary economic difficulties while at the same time reinforcing the ruling elite's economic and political power**. To implement this strategy, the authorities have been mainly using financial and propaganda instruments (welfare assistance and measures to reinforce Vladimir Putin's positive image, respectively), and have been preparing to use force in the event of any escalation of welfare problems and social protests.

The government's assistance plan envisaged spending 2.1–2.5 trillion roubles (around US\$80 billion) between October 2008 and December 2009. **The principal objectives of the government's anti-crisis program have been to maintain the banking sector's financial liquidity, stimulate internal demand, alleviate the negative impacts on society and support the enterprises of key importance for the Russian economy, many of which are controlled by members of the ruling elite**. The state-owned Vneshekonombank (VEB), a state corporation which was established in 2007 to finance large investment projects in Russia, has been the main distribution channel for public aid. **The government initiated these measures under high pressure of time and lobbying efforts by various interest groups, as a consequence of which the criteria for selecting the beneficiary sectors and enterprises have been arbitrary and untransparent, and state aid has been offered unconditionally (without imposing any requirement to restructure the inefficient companies)**. The anti-crisis measures have been accompanied by a large-scale propaganda campaign in the media, which was intended to channel the growing public frustration and to blame the regional authorities and businesses for the difficulties, while reinforcing Vladimir Putin's image as a politician capable of solving problems.

## Impact of the crisis on economic, social and political trends

### The economy

So far, the economic crisis has not triggered any thorough change in the Russian government's **economic policy**. On the contrary, it has accelerated the processes observed in the Russian economy since the final years of Vladimir Putin's presidency. **The governmental anti-crisis programme has enabled a continuation of the original policy, which involved strengthening the state's role in the economy, the ruling elite's appropriation of assets and the foreign expansion of Russian capital.** During the crisis, many Russian private companies which found themselves in financial difficulties had to turn for assistance to the state, which has been one of the few actors still in the possession of cash. They have established liens on their assets to secure new loans, which has led to the **renationalisation and marginalisation of large private businesses**. Meanwhile, state-owned holdings benefiting from state aid have strengthened their market positions. Consequently, the government's anti-crisis measures have stimulated a process whereby **the Russian economy has been abandoning the principles of free competition.**

During the crisis the authorities have been continuing the policy, which had already been launched before the current economic troubles began, **of opening up the Russian market, including the (most attractive) raw materials sector, in a controlled manner** to foreign investors. Since 2006, Russia has been privatising minority stakes in attractive assets (Rosneft, public banks) and selectively admitting foreign companies to the extraction sector.

### Russian society

At the level of the general public, the deteriorating living conditions have engendered some frustration and tension, although these have not transformed into **broader mobilisation of the public or massive, nationwide protests. Neither has popular discontent led to a revision of the traditionally positive assessment of the top members of the government elite.** Prime Minister Putin and President Medvedev have remained highly popular during the crisis. According to an August 2009 poll by the Levada Centre, up to 82% of Russians supported the actions undertaken by Vladimir Putin as PM, and 76% supported the activities of President Medvedev. Moreover, the propaganda campaign conducted by the authorities, combined with the traditionally passive attitude of the public and its habit of expecting others to solve problems, have led to a rise in hopes that the two politicians will tackle the most urgent social issues. The Russian people have blamed economic problems in the regions on the regional authorities, businesses and administration officials. At the same time, in the face of the deteriorating financial situation, the general public has devised **individual strategies for dealing with the crisis** through savings, taking extra jobs, taking loans, or growing fruit and vegetables in allotment gardens.

### Internal policy

Even though the crisis has had a severe impact on the Russian economy, it has not shaken the dominant position of Putin's ruling elite. **Given the current level of power concentration in the hands of the ruling elite, the economic factor seems to no longer have any direct impact on the elite's standing.** In some areas, the crisis has even strengthened of the elite's position, especially regarding economic matters. This has been made possible by the leadership's control of the state finance reserves, which are the greatest providers of financing in the times of crisis. By controlling these funds, the Russian leadership has been able to speed up its economic expansion at the expense of those private businesses which do not boast any closer connections with the authorities.

Despite the crisis and the presidential reshuffle that preceded it, the Russian system of government has remained unchanged – **the most important decisions are still being taken by the narrow circle of Putin's ruling elite** (which cannot be identified with any particular institution), and are not subject to any political or social monitoring. The Putin elite has kept a monopoly on political power and has been using it to strengthen its own economic position. The crisis has not brought about any change in the composition or structure of the elite. Vladimir Putin remains its leader and the arbiter in charge of preserving equilibrium between the individual groups. The structure of the elite is informal, and the main membership criterion concerns belonging to a certain community – the elite is made up of Putin's trusted aides from his time in the KGB and the St. Petersburg mayor office. **The crisis has not triggered any major conflicts among the elite members** – although some disputes with a financial background have taken place, no schism has occurred, and the elite's grip on power has remained firm. Neither have any divisions been created by the **presidential reshuffle**; despite his more liberal and pro-democratic rhetoric, President Medvedev's actions have in fact consolidated the Putin model of state governance.

### Forecast

The most likely course of events in Russia over the next two years seems to be the so-called **inertia scenario, which is based on the assumption that the oil price will remain at the current level** (US\$60–75 per barrel of Brent crude), as a result of which Russia will avoid a breakdown of its public finances. In 2010, these will be supported by the reserves amassed during the period of prosperity. The relatively stable financial situation will enable the authorities to maintain their current line of economic policy, including the further postponement of structural reforms, despite the fact that **the crisis has exposed the threats involved in the Russian economy's dependence on the raw materials sector**. This is because the ruling elite is firmly convinced that Russia's raw material resources will remain its main source of revenue for many years.

While the main trends in economic policy will remain unchanged, the government may decide **to adjust economic policy in selected spheres**. The authorities may make slight cuts to public assistance for the large state-owned companies, in other words, make assistance conditional on measures to improve efficiency. It is also possible that the Russian market will become more open to foreign capital and the new technologies it brings. The state is also likely to recommence privatising minority stakes in Russian companies, as long as it keeps control over the so-called strategic sectors of the Russian economy.

**Recovery from the crisis will be a slow process, and Russia will not regain its pre-crisis level of development until 2012.** It will continue to report a budget deficit in subsequent years as a result of extensive public spending. Some businesses will continue to cut employment, and some will face bankruptcy. As a result of the problems the companies experience, the difficult situation in the labour market will continue, **and living standards in Russia will keep declining**. More protests motivated by welfare issues will probably break out in the regions; however, the authorities will have instruments to control and neutralise them (by increasing welfare spending or by the use of force).

Despite the social and economic problems, the current ruling elite is expected to stay in power, mainly because **there is no real alternative**. The weak state institutions (parliament, courts) are controlled and used for political ends by the authorities and can offer no counterpoise. The regional elites and former oligarchs have lost much of their political influence and autonomy, do not participate independently in political manoeuvres and are not an autonomous political power. **The crisis**

**has not created any opportunities for any real anti-system opposition to emerge.** Anti-Putin opposition in Russia is weak and dispersed, and has been effectively marginalised by the authorities for years (opposition members have no access to the media, are excluded from elections, and so on). The authorities are determined to defend their privileged position. If necessary, they will use the appropriate financial and propaganda instruments to neutralise any threats that may emerge, which will probably suffice in conditions of a crisis of medium severity.

**The scenario of a deep and long-lasting crisis** that could result in the financial failure of the Russian state is less probable, mainly because economic trends both in Russia and worldwide appear to be improving. Should this scenario materialise, the authorities would be forced to cut budget spending drastically or, in extreme situations (such as mass social unrest) use force to restore order and keep control of the situation. However, even in the event of a drastic escalation of economic problems and social protests, **the likelihood of the current leadership losing power appears minimal.** The authorities possess the instruments they need to control the situation, and are able to impede the emergence of real political alternatives. The only real threat could come from an internal split within the elite, for instance caused by conflicts over the allocation of funds. However, it should be emphasised that the current leadership is interested in stability and in ensuring that potential change is evolutionary, because it controls the major assets acquired in recent years, and will strive to avoid any violent conflicts that could result in reshuffles and a re-distribution of property.

## **Introduction**

The global economic crisis has severely affected the Russian economy and triggered a rapid slump in macroeconomic indicators. It followed nearly a decade of prosperity brought about by high oil prices. During that period, Russia has become even more dependent on raw materials, and so the drastic oil price slump in the second half of 2008 has shaken its financial stability.

This report analyses the consequences of the global economic crisis for Russia's economic, political and social situation between August 2008 and August 2009. Its objective is to examine if, and to what extent, the crisis has triggered change within the ruling elite and prompted a revision of its economic and social policy.

Chapter One describes Russia's macroeconomic situation, including the condition of the budget and the status of the national currency reserves. Chapter Two discusses the impact of the crisis on the political situation in Russia (including the position and policies of the ruling elite), and on the social and welfare situation (including the standards of living and the attitudes of the general public). It also describes the anti-crisis measures the authorities have undertaken in the social and welfare spheres. Chapter Three presents the economic, political and social consequences of the first year of the crisis. Finally, Chapter Four offers a forecast of further developments in Russia in the next few years.

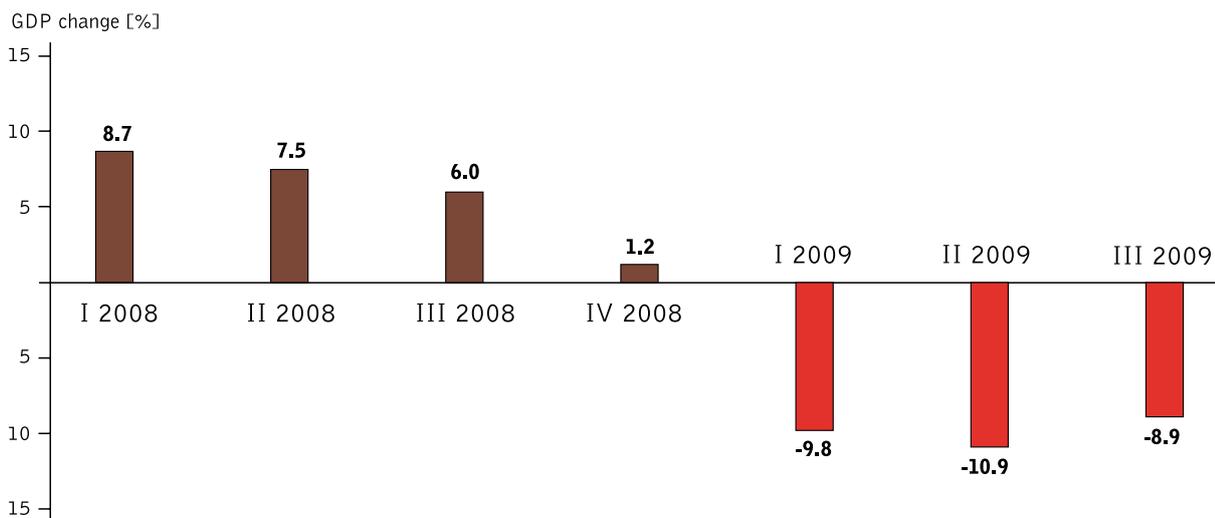
# 1. THE ECONOMY IN THE TIMES OF CRISIS

## 1.1. Macroeconomic indicators

The economic conditions which had favoured Russia's development since 2000 suddenly changed in mid-2008. The Russian economy was hit on the one hand by a **drastic slump in oil prices** (which fell from nearly US\$150 to US\$50 per barrel of Brent between July 2008 and January 2009), and on the other by **an outflow of investors** (a net of US\$130 billion of capital left Russia in the fourth quarter of 2008). Over several months, the financial crisis became an economic crisis affecting the entire economy. The financial reserves accumulated in times of prosperity (more than US\$162 billion in the stabilisation funds and nearly US\$598 billion in the currency and gold reserve) were a key instrument in combatting the crisis, although this failed to prevent deep declines in macroeconomic indicators. **Russia found itself among the states most severely affected by the crisis.**

### 1.1.1. Steep decline in Russia's GDP

**Chart 1. Quarterly GDP change over the same quarter in the preceding year in 2008–2009 (%)**



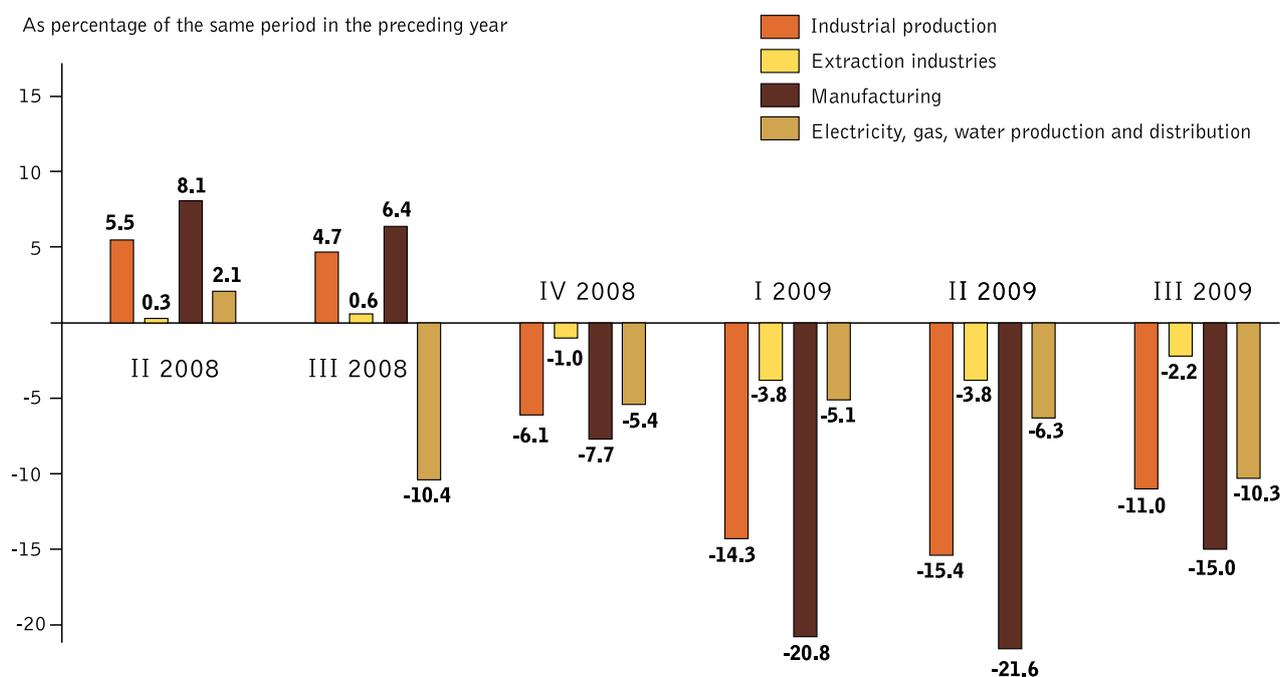
Source: Rosstat

Russia's GDP figures reflect the change in economic conditions. The rapid growth of GDP in the first three quarters of 2008 (7.7% on average) slowed to 1.1% during the last three months of the year (compared to the same period in the previous year; over the whole of 2008, the GDP increased by 5.6% compared to 8.1% the year before). Since the beginning of 2009, Russia's GDP has been decreasing. **In the first half of 2009, it fell by 10.4%** compared to the same period in the previous year, and the decline deepened in the second quarter of 2009 to reach 10.9% (Rosstat), compared to 9.8% in the first quarter. Unlike GDP data presented in a yearly perspective, however, the figures on the change in GDP over the preceding period are much more optimistic. In the second quarter, the GDP rose by 7.4% over the first quarter (although these figures do not take the seasonality factor into account). This may mean that the negative trends in the economy are gradually reversing. According to the government's forecasts, Russia's GDP for all of 2009 will decrease by 8.5%.

The decline in GDP was also caused by **suppressed demand**. This includes both domestic demand, especially investor demand, and external demand, which has driven down the prices of the raw materials Russia exports. According to Rosstat, the tempo of economic investments fell to 9.8% in 2008, compared to 21.1% in the previous year. A **decline in investments** (by more than 2%) was already observed in the fourth quarter of 2008, and the trend continued in the first half of 2009 when a fall in investments by up to 18.2% was observed (the deepest decline was reported in the construction market). Investment activity was lower because of the banking sector's liquidity problems and the strong suppression, or even halting, of lending. **Consumer demand did not decrease as steeply**; in the first half of 2009 it fell by only 3%. However, this decline has been deepening in the following months as people became increasingly affected by the crisis and started to economise by refraining from buying goods other than basic necessities.

### 1.1.2. Decreasing industrial production

**Chart 2. Industrial production (as percentage of the same period in the preceding year)**



Source: Rosstat

The economic crisis has strongly affected industrial production. Although a continued production growth (2.1%) was reported for the whole of 2008 thanks to the results of the first three quarters, industrial production has been declining ever more rapidly as of the fourth quarter of 2008. **In the first half of 2009, it fell by 14.8% compared to the same period in the preceding year. The worst results** have been reported for **the gas extraction industry**, where production decreased by 14.7% (by 20% in the first seven months), while oil production remained at the same level as the preceding year; **the iron ore sector** (26.9%); and the manufacturing, where production decreased by more than 21%. Declines have been reported in practically all branches of industry, with the sole exception of the military-industrial complex, which reported a 5% production growth during the period in question (largely thanks to unchanged levels of public procurement).

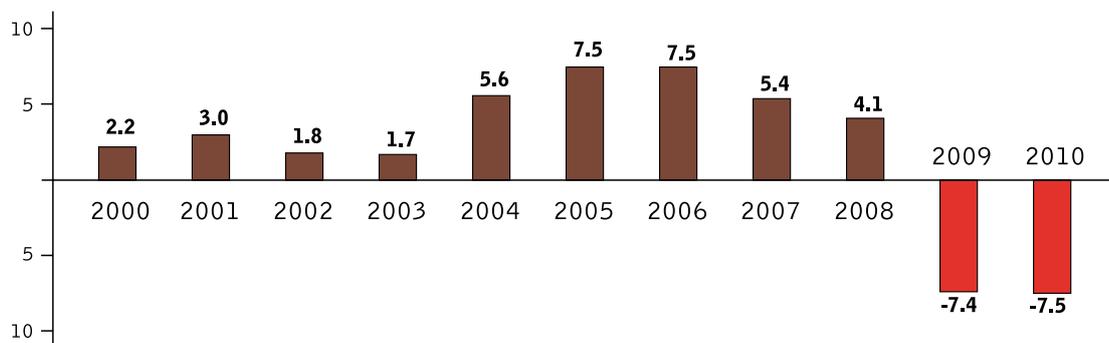
The main factors which influenced the industrial production results included **falls in demand, the low competitiveness of Russian industry, and strong intra-sector ties between companies** (for example,

decreasing production in the machine-building industry would affect the results of the metallurgy sector). These are the worst results to have been reported in a decade. According to forecasts, in 2009 production will fall by 10%, more than in the crisis year of 1998 (5.2%).

### 1.1.3. Russia's budget deficit

**Chart 3. Surplus/deficit of the federal budget of Russia**

Surplus/deficit as percentage of GDP



Source: Rosstat

In April 2009, the government decided to adjust the 2009 budget with a view to adapting it to the new economic conditions, mainly decreasing oil prices (the new assumption being US\$41 per barrel, compared to US\$95 previously), and the need to take anti-crisis action. The authorities decided to increase spending by around 30% in 2009 over the 2008 level (to around US\$270 billion) despite the 30% decrease in budget revenue compared to 2008 (to around US\$190 billion). As a result, in 2009 Russia **will report a budget deficit (7.4% of GDP) for the first time in ten years.**

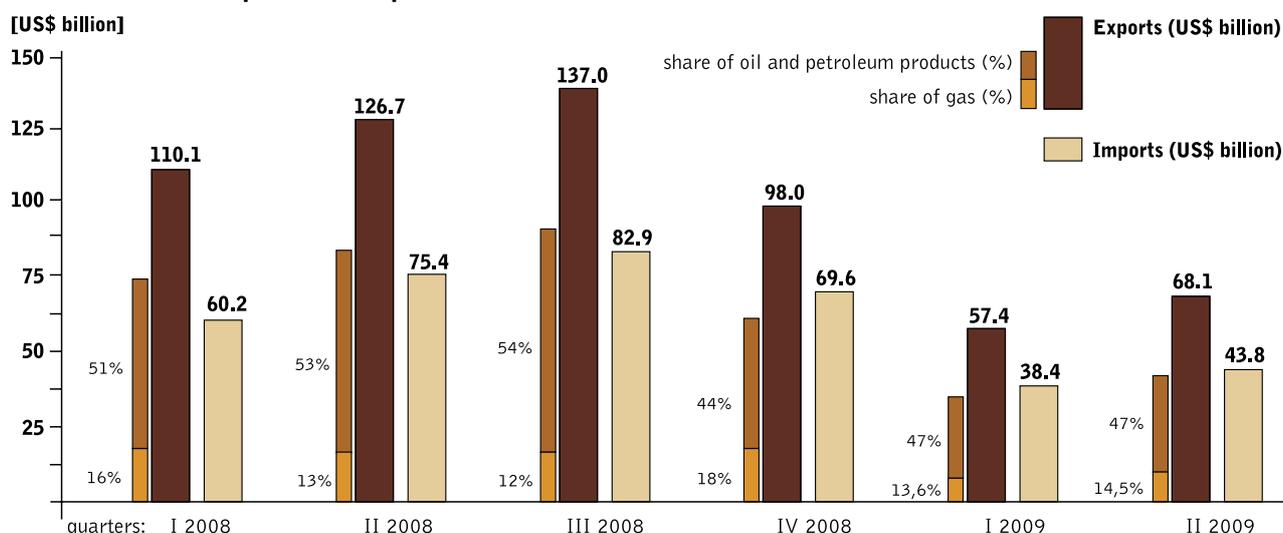
In order to raise funds to fight the crisis, the government has implemented savings and cuts under many budget spending headings (including federal programmes such as the development of the road network). Anti-crisis measures will consume one quarter of the entire budget. Most of these funds will be allocated to supporting the economy and to welfare policy. Despite those shifts, however, the original **budget priorities have remained unchanged: higher amounts have been allocated to defence** (an increase by 15% compared to 2008), **security** (22.3%), education (11%) and healthcare (20%). The resulting budget deficit (around US\$80 billion) will be financed from the Reserve Fund (worth around US\$177 billion in September 2009).

During the first seven months of 2009, budget revenue was as planned (56.5% of total for the whole year). Half of the previous year's amount of corporate income tax was collected (as a result of the difficult situation which many companies in Russia found themselves in, as well as the reduction of the tax rate by 4 percentage points), whereas oil and gas revenues fell below the planned levels, even though the average price of Russian oil was higher than expected at US\$52 per barrel.

While budget revenue shrank dynamically, the planned spending continued to rise as the government sought to stimulate demand for Russian-produced goods. However, the anti-crisis programme has been implemented only slowly (only 48% of the total spending planned for the year was realised during the first seven months of 2009). The failure to accomplish the plan should be blamed mainly on the Ministry of Finance, which has been delaying payments. Consequently, in order for the plan to be carried out, the payments of budget funds should accelerate in the final months of the year, which may in turn drive down the rouble's exchange rate.

### 1.1.4. Declining trade exchange

Chart 4. Russia's exports and imports in 2008–2009



Source: Central Bank of Russia, Balance of Payments

A decline in Russia's trade turnover was already reported in the fourth quarter of 2008, and exacerbated in the first half of 2009. However, even though **exports decreased at a higher rate than imports** (in the first half of 2009 exports decreased by 47%, and imports by 40%), Russia managed to maintain a positive trade balance.

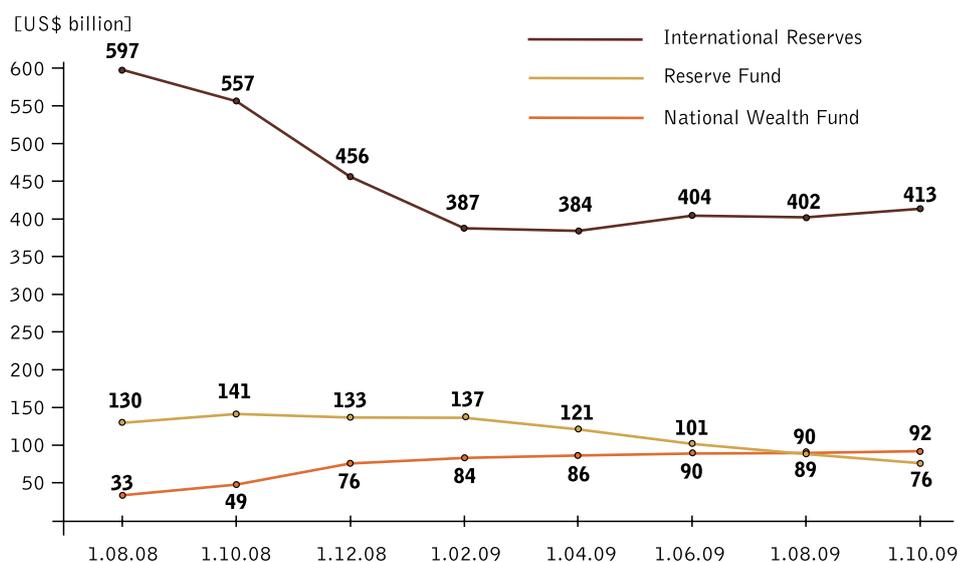
**The value of exports decreased because the global demand for the raw materials exported by Russia slackened** (raw materials account for more than 80% of the total value of Russian exports), and consequently, their prices decreased – this concerns oil and petroleum products in particular, as well as metals (changes in the price of gas follow the changes in oil prices with a delay of 6 to 9 months), and because smaller quantities were exported (this concerns gas in particular; in the first quarter of 2009, the volume of gas supplies to consumers abroad fell by 35%).

The decrease in imports, on the other hand, has been due mainly to the **relative rise of the prices of imported goods as a result of the devaluation of the rouble**, as well as the protectionist policy of the Russian government (which imposed higher duties on cars, combine harvesters, metal goods, etc.), and decreased demand in Russia.

### 1.1.5. Decrease in the currency and gold reserves held by the CBR

The Russian Federation's reserves had been building up dynamically until August 2008 thanks to the high revenues from the export of raw materials (oil, gas, metals). However, this trend reversed as the global crisis developed. As of 1 July 2009, the CBR held currency and gold reserves worth US\$365.4 billion, nearly US\$232 billion less than at the peak point on 1 August 2008. The **reserves stopped shrinking** in May 2009. The fastest rate of meltdown in the reserves was reported before February 2009, before the **central bank undertook heavy interventions in the currency market to stop the pace of the rouble's devaluation**. To this end, the CBR disposed of more than US\$200 billion. However, this failed to stop the process and consequently, the rouble lost around 40% to the dollar by February 2009 (compared to the maximum rate reported in July 2008). Further devaluation of the Russian currency was prevented by the fact that the price of oil stopped falling. However, even though Russia's reserves have shrunk, they remain at a high level by international standards (they are equivalent to more than two years of imports, whereas six months is considered to be a safe level for developing states).

**Chart 5. International Reserves of the CBR and the government's stabilisation reserves (US\$ billion)**



Source: Rosstat

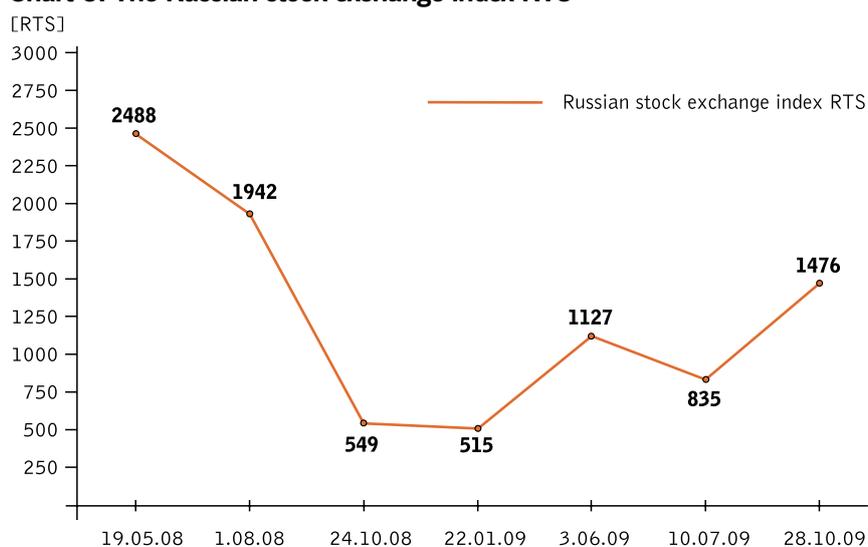
The government's reserves in the Reserve Fund and the National Wealth Fund<sup>1</sup>, which are deposited in foreign currencies and invested by the CBR, account for a large portion of the central bank's reserves. As of 1 July 2009, the Reserve Fund was worth US\$94.5 billion, and the National Wealth Fund another US\$94 billion. The former holds nearly 50 billion dollars less than it did in August 2008 (since then, it has been systematically shrinking), while the latter has nearly US\$60 billion more. According to the government's current forecasts, the remainder of the Reserve Fund will be used to finance Russia's budget deficit in 2010 (although it will not suffice to cover the entire deficit), whereas the National Wealth Fund will co-finance the government's pensions policy starting from 2010 (it will probably run out in 2015).

### 1.1.6. Difficulties of the Russian banking sector and stock exchanges

In August 2008, Russia started to be affected by the financial crisis unfolding in the West. The stock exchanges were the first to be hit as the investors started to massively withdraw capital (in late autumn 2008, stock exchange indexes returned to the December 2005 levels). The negative consequences of the slump in the stock markets spilt over to the interbank credit market; the price of capital increased, but still no banks were willing to lend money. Large banks such as Sberbank, Vneshtorgbank and Gazprombank suspended lending to other banks in practice. In addition, Russian banks were cut off from foreign sources of cheap credit. The problems of the banking sector exacerbated in autumn 2008 by massive withdrawals of deposits by citizens concerned about their savings. In September and October, the Russian public withdrew around 8% of their banking deposits (around US\$20 billion). The situation was worsened by outstanding loan repayments.

<sup>1</sup> The two funds were established in early 2008 when the resources of the Stabilisation Fund, created in 2004, were split between them. They are made up of revenues from the export of oil and gas, as well as taxes on the extraction of raw materials. A proportion of these funds (defined separately for each year; 5.5% of the GDP in 2009) is transmitted directly to the budget as the so-called oil and gas transfer, while the remainder is retained within the funds, and may be used to stabilise the state budget in the event of a slump in the prices of raw materials (in the case of the Reserve Fund), and to support the Russian pensions system (in the case of the National Welfare Fund). The monies of the Funds are deposited in accounts held with the Central Bank of Russia and managed by the CBR.

**Chart 6. The Russian stock exchange index RTS**



Source: Rosstat

The increasing problems in the banking sector forced the Russian authorities to provide assistance. State-owned banks, especially Sberbank and Vneshtorgbank, became the main distribution channel of anti-crisis public aid, public funds were deposited in their accounts, and in addition, state-owned banks became involved in state-run programmes aimed at sustaining domestic demand through measures such as subsidised loans for the purchase of Russian-produced cars. Private banks received considerably less assistance, as a result of which they faced a much more difficult task in competing with the state-owned institutions<sup>2</sup>. The government also decided to triple the limits of guaranteed deposits (to 150,000 roubles). These measures were successful in halting the withdrawals of deposits, although the banks remained reluctant to lend money.

Another problem of the banks concerned overdue loan repayments. According to the CBR, 4.4% of loans granted to companies and 5.5% of those granted to individuals were overdue as of 1 June 2009. It is predicted that the proportion of bad loans may rise to 12% of the total amount by the end of the year. This will create a serious burden for the banks, and may lead to major liquidity problems.

Despite the problems with the borrowers' creditworthiness, the Russian government has been pressing banks to step up lending, especially to selected sectors such as the military-industrial complex, agriculture, construction, the automotive industry, air transport and the state corporations, in return for the financial support provided to the banking sector. On 29 June Prime Minister Putin said he was dissatisfied with the slow increase in lending by the state-owned banks (Sberbank, Vnesheconombank, Vneshtorgbank, Rosselkhozbank and Gazprombank). Lending rose by 1.3% during the first five months of 2009, whereas the PM had called on the banks to step up lending by 2% per month (in February 2009) and in June, he had asked them to grant US\$16 billion in new loans within the following three months. The prime minister decided to discipline the bank CEOs by making their vacation leave conditional on the fulfilment of this task, which was fulfilled by the banks by late August.

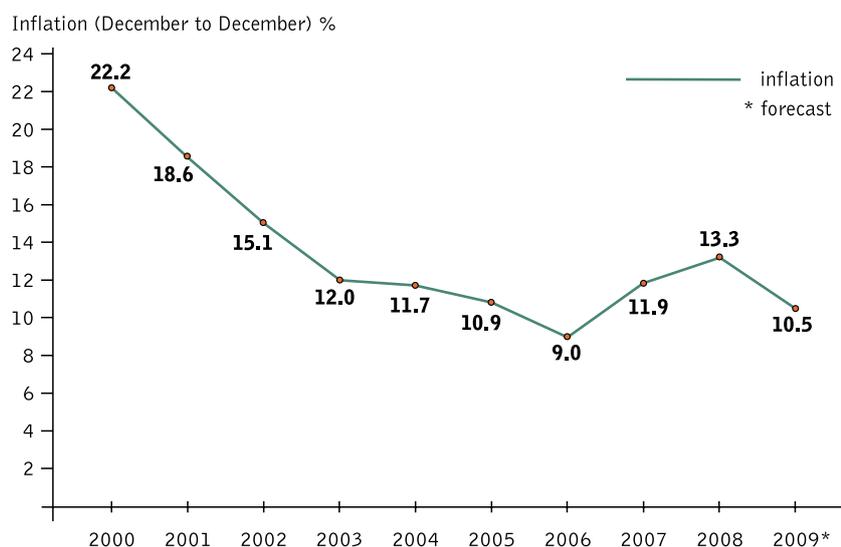
Many smaller banks went out of business during the crisis. Between 1 August 2008 and 1 July 2009, the CBR cancelled the licences of 37 private banks, some of which went bankrupt, and some of which merged with or were taken over by other banks. The crisis thus contributed to the further consolidation of the Russian banking sector, improving its stability. On the negative side, however,

<sup>2</sup> For example, Alfa Bank, the largest private bank in Russia, has been publicly reprimanded by PM Putin for demanding a loan repayment from the excessively indebted RusAl aluminium concern owned by Oleg Deripaska.

the share of state-owned institutions, which are subject to strong political pressure, has increased. In July 2008, state-owned banks accounted for 47% of the Russian banking system, compared to 53% in July 2009. The state-owned Sberbank, which holds half of the total amount of individuals' deposits, remains the largest bank in Russia.

### 1.1.7. Continuing high inflation

**Chart 7. Inflation**



Source: Rosstat

**Despite the crisis and the slackening demand, inflation remains high in Russia.** In 2008, the inflation rate increased to 13.3% (compared to 11.9% in 2007), and inflation remained high during the first seven months of 2009 (the consumer price index grew by 8.1% since December 2008), although this growth was lower than in the previous year (9.3%). The highest price increase was reported for services (10.5%; especially municipal services, the prices of which increased by more than 20%) and foods (7.3%).

In autumn 2008, as the crisis unfolded, inflation expectations were driven up by growing financial instability, decreasing economic activity and limited confidence in the banking system; consequently, the demand for money also decreased. The devaluation of the Russian currency, as a result of which goods imported to Russia became relatively more expensive (imported foods account for around 40% of the market in Russia, and even as much as 70% in Moscow) also contributed to the growth of inflation. In the months to come, the inflation rate will be restrained by decreasing demand, although this effect will be countered by the large amounts of money pumped into the market under the government anti-crisis programme (which will increase inflation pressure).

### 1.1.8. Limited capital flows in Russia

According to the CBR, the **private sector exported a net amount of US\$130 billion of capital from Russia in the fourth quarter of 2009.** Both foreign and domestic investors sought more certain and less risky investments. An outflow of net capital, albeit less dramatic (US\$34 billion), was also reported in the first quarter of 2009. However, thanks to the strengthening of the rouble and the increase in oil prices in the second quarter of 2009, this was stopped; the capital which had been exported

while the exchange rate of the rouble was declining started to return to Russia. Consequently, a net influx of US\$7.2 billion of capital was reported again, although for the most part, this was speculative capital rather than in direct investments or long-term deposits. The outflow of capital was also connected with the need to handle the Russian companies' high foreign debt, as well as with major difficulties with contracting new loans. According to the Central Bank of Russia, corporate debt exceeded US\$488 billion on 1 July 2008; this amount included US\$193 billion of bank debt and US\$295 billion of the non-financial sector's debt (for comparison, state debt amounted to only US\$35 billion). Under their credit agreements, Russian economic operators had to repay over US\$47 billion in the fourth quarter of 2008, and another US\$160 billion during the twelve months of 2009.

**Chart 8. Foreign direct investments in Russia and Russian direct investments abroad (US\$ billion)**



Source: Proprietary calculations based on the CBR balance of payments

**According to Rosstat, in the first half of 2009, the influx of foreign investments to Russia decreased by 30% compared to the same period in the previous year.** Direct investments accounted for US\$6 billion out of the US\$32 billion total investments; in other words, they had fallen by half compared to the previous year. Around 30% of total investments were made in Russia's manufacturing. The biggest investors included Luxembourg, the Netherlands and Cyprus. Figures from the Central Bank (whose methodology differs from Rosstat's) also confirm a downward trend in the influx of investments into Russia (according to the CBR, direct investments fell by 55% to US\$8 billion in the first quarter).

**Russian investors operating abroad have been much more active than foreign investors in Russia.** They invested a total of US\$43 billion in the first half of 2009, despite a 17% decrease compared to the same period in the previous year (in the first quarter of 2009, investments increased two and a half fold), and direct investments accounted for one-quarter of the total amount. For the most part, these investments were sent to tax havens, mainly Switzerland.

The decrease in investments in Russia has been one of the consequences of the global economic crisis and the suppressed investing activity of the global business (in 2008, direct investments worldwide decreased by nearly 15%, and in 2009 the slump is expected to continue to reach around 30–40%) as well as the economic slowdown which Russia's economic partners have also experien-

ced. Against this background, Russian activity abroad stands out. However, it appears that a **large proportion of these investments are in fact a way to secure capital abroad, rather than genuine investment projects** (many Russian companies have had to withdraw their investments in order to repay their debts).

## 1.2. The government's anti-crisis strategy

The deepening financial crisis, which has quickly spread to the entire economy, has forced the Russian authorities to take action to address its negative consequences. The government assistance programme provided for total spending of 2.1–2.5 trillion roubles (around US\$80 billion) between October 2008 and December 2009, although back in autumn 2008, the government had spoken of around US\$200 billion of support (some measures were subsequently scrapped). In autumn 2008, the government undertook *ad hoc* measures to address the most urgent problems, primarily to preserve liquidity in the banking system and prevent the devaluation of the rouble. In the first half of 2009, the government started implementing the measures provided for in the anti-crisis programme (although the programme itself was not officially approved until June 2009), on the basis of much more stable economic forecasts; before February 2009, forecasts had been changing on a weekly basis. At that time, support was provided to the sectors of particular importance for the Russian economy (the oil and gas sector, the automotive industry, the construction sector); in addition, massive financing was also allocated to welfare policy (as the public was being increasingly affected by the effects of the crisis). The state-owned Vnesheconombank (VEB), a state-owned corporation established in 2007 to finance large investment projects in Russia, became the main distribution channel for public aid.

### 1.2.1. Main objectives of the anti-crisis programme

The main aims of the government's anti-crisis measures<sup>3</sup> have been as follows:

- **support the finance sector** by sustaining its financial liquidity and promoting lending. The Russian exchange markets received support, as Vnesheconombank was granted around US\$7 billion for investments aimed at supporting the listings of the most important Russian companies<sup>4</sup> such as Gazprom and Rosneft; in addition, Russian credit institutions, mainly state-owned banks such as Sberbank and Vnesheconombank, obtained more than US\$75 billion; state-owned banks also became engaged in the programme of subsidies for the purchase of Russian-manufactured cars;
- **stimulate internal demand** through public procurement, advance payments, investment programmes for natural monopolies, protectionist measures, measures to stimulate consumer demand and preferences for domestic manufacturers, restrictions on imports, subsidised consumer loans (for example, for purchases of Russian-manufactured cars) or lease payments. Selected infrastructural projects received support; for instance, the state-owned Transneft (the owner of the oil transport network in Russia) received assistance from the state-owned institutions for the construction of the second branch of the Baltic Pipeline System (an oil transport route bypassing Belarus), and state-owned banks purchased Eurobonds issued by Transneft<sup>5</sup>. A loan was contracted from

<sup>3</sup> For more information on the Russian government's anti-crisis programme and its results, see 'Assessment of the anti-crisis support to the real economy sector in Russia', 4 July 2009, Higher School of Economics in Moscow, State University.

<sup>4</sup> Between June and November 2008, the RTS Russian stock exchange index fell by nearly 70%, as did the listings of Gazprom and Sberbank. Since October 2008, Vnesheconombank has purchased nearly 2% of Gazprom shares; 2.6% of LUKoil shares; 1.4% of Rosneft shares; 0.8% of Surgutneftegaz shares; 3.4% of Sberbank shares and 2.1% of Vneshtorgbank shares.

<sup>5</sup> In May 2009, Transneft issued 35 billion roubles worth of bonds (around US\$1.1 billion) which were purchased by Gazprombank, Vneshtorgbank and Uralsib. The monopoly is planning to issue another 100 billion roubles worth of bonds (around US\$3.2 billion) by the end of the year.

China under the auspices of the Russian government to support Transneft, especially in connection with the construction of the pipeline connecting West Siberia with the Pacific Ocean, and Rosneft (for the repayment of debts);

- **alleviate the negative social consequences of the crisis** by developing the labour market and measures to protect workplaces, stimulate employment, (through training, among other measures), and restrict the employment of migrant workers;
- **provide broader access to sources of financing for selected sectors and enterprises** through direct credits (also based on the government's recommendations – the government indicated which sectors ought to receive financial support from banks; these included the military industrial complex, agriculture, the construction sector, the automotive industry, air transport, as well as monopolies and state-owned corporations), subsidised interest rates, credit guarantees<sup>6</sup>, the provision of extra capital to some companies, and refinancing foreign debt;
- **reduce burdens on business** by cutting down the tax and duty burdens (reduced tariffs and a new procedure for setting export duties were particularly important in this respect), restraining the growth of charges for the services and products of natural monopolies, and simplifying administrative regulations;
- **support small businesses** through a programme of support for small and medium-sized enterprises, a credit programme implemented by Vnesheconombank, as well as the guaranteed participation of small businesses in tenders organised by regional authorities (through quotas).

### 1.2.2. Main instruments in the anti-crisis programme

Some instruments were designed to achieve several objectives simultaneously. The largest amount of funds was allocated to expanding the real economy sector's access to financing (1.1–1.2 trillion roubles, including US\$10 billion for refinancing Russian companies' foreign debt, plus 300 billion roubles (slightly under US\$ 10 billion) in state credit guarantees earmarked for 2009). Reducing the burdens on business cost the state budget 500–700 billion roubles; the welfare policy and measures to promote consumer credit and support business start-ups cost a further 250–300 billion roubles; measures to stimulate internal demand cost 180–200 billion roubles; and support for small and medium enterprises, 60–90 billion roubles<sup>7</sup>.

Broken down by sector, the industries that benefited most from the anti-crisis programme in 2009 included the oil and gas sector (200–250 billion roubles); the automotive and agricultural machinery industries (around 200 billion roubles), and the military-industrial complex (180 billion roubles including 100 billion in credit guarantees).

The medium-sized enterprises sector has been the biggest loser under the programme: it did not benefit from the aid offered to large enterprises because its lobbying power was too weak, and it was systemically excluded from aid for small businesses. Likewise, no specific aid offers were developed for light industry, the foods industry or the chemical sector. The high-technology sector did not obtain sufficient assistance either. Although the government introduced VAT exemptions for the import of technological devices for which no Russian-manufactured equivalents were available, it did not enact secondary legislation (such as a list of eligible devices) to enforce this decision, and consequently, the regulation did not come into force until September 2009.

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<sup>6</sup> In early 2009, the government established a limit at 10 billion roubles on credit guarantees to be granted to companies, but this guideline was not followed rigorously: Gaz Group received 20 billion roubles, Kazanorgsyntez 15 billion roubles, Metalinvest 29 billion roubles, and the Progress aviation plant 2.17 billion roubles.

<sup>7</sup> 'Assessment of the anti-crisis support...', *ibidem*.

### Value of the government's anti-crisis programme (October 2008/December 2009)

	billions of roubles
Expanding the economy sector's access to financing, including:	1100–1200
<i>Refinancing foreign debt of Russian companies*</i>	~ 345 (US\$11.5 billion)
<i>State credit guarantees</i>	300
<i>Issue of state-guaranteed securities by Russian Railways</i>	100
<i>Provision of additional capital to the Agency for Mortgage Housing Development</i>	75
Reducing burden on businesses, including:	500–700
<i>Shortening of the export duty calculation period</i>	below 150
<i>Increasing the amount exempted from the natural resources extraction tax</i>	100
Social policy, support for business start-ups	250–300
Stimulating internal demand	180–200
Support for SMEs	60–90

\* This support instrument has been suspended since early 2009.

#### 1.2.3. The main characteristics of the Russian anti-crisis programme

An analysis of the government's anti-crisis measures reveals several main characteristics:

- in the majority of cases, the **arbitrary selection of beneficiary sectors and enterprises** based on political decisions and unclear criteria, and a noticeable tendency to use this kind of instruments on an ever larger scale. An unprecedented interest-free loan has been provided to AvtoVAZ, Russia's largest car manufacturer and a member of the state corporation Rostekhnologii (25 billion roubles; this money has been used to repay half of the company's debt);
- **lack of transparency:** the terms of foreign debt refinancing were defined quite precisely (aid was to be offered only to those Russian companies or their foreign subsidiaries whose activities are of significant importance for the economies of the respective regions or strategic branches of industry, such as Gazprom, Rosneft and LUKoil). However, subsequently the procedure was made secret, and no official information was disclosed about whom Vnesheconombank had decided to support, and no comments were made about the press leaks claiming that RusAl had obtained US\$4.5 billion despite the fact that Vnesheconombank had previously set the limit for any single enterprise at US\$ 2.5 billion;
- **compensatory nature:** the measures undertaken were aimed at mitigating losses (of companies in temporary trouble and those chronically unprofitable); no instruments were implemented to motivate companies to pursue more active policies, diversify production or seek new markets;
- **unconditionality:** the government set practically no requirements for the aid beneficiaries;
- **support targeting the traditional sectors of the economy**, including the raw materials sector (the oil and gas sector benefited from changed procedures for setting export duties and collecting VAT, among other measures; and Gazprom, from the continually low rate of the gas extraction tax, which had not been raised for this company since 2006); the armaments sector (which was awarded guaranteed orders and received advance payments for their fulfilment); the machine-building

- industry, especially the automotive industry; as well as agriculture, construction and air and rail transport. Aid was visibly concentrated on big businesses, which received more than 60% of total assistance (while small businesses received around 5% of total public aid);
- **ineffective implementation of approved normative acts** (not to mention assistance pledges that have not been delivered on, such as in the case of Russian Railways, which had been promised 50 billion roubles as compensation for maintaining low tariffs but received only around 5 billion roubles by the summer 2009);
  - many instruments were developed under the pressures of **time and powerful lobbying by various interest groups**.

### 1.3. Economic trends

So far, **the economic crisis has not triggered any thorough change** or adjustment in the Russian government's **economic policy**. On the contrary, it has accelerated the processes observed in the Russian economy since the final years of Vladimir Putin's presidency<sup>8</sup>. The governmental anti-crisis programme has enabled the continuation of the original policy, which involved strengthening the state's role in the economy, the ruling elite's appropriation of assets and the foreign expansion of Russian capital. Although the crisis has demonstrated that Russia is exposed to enormous risks as a result of its dependence on the raw materials sector, it seems unlikely that the authorities will significantly change their economic policy in the nearest future. The ruling elite is firmly convinced that Russia's raw materials resources will guarantee high revenues for many years to come. One should therefore be very cautious about the declarations made in recent months by the highest-ranking Russian state officials concerning the need to modernise the Russian economy and fight corruption, such as those spelt out in President Dmitry Medvedev's programme article published this September on the Gazeta.ru web portal<sup>9</sup>. Such declarations have been made in Russia on many occasions before, by Vladimir Putin also (mainly in 2000–2003). However, the actual actions taken by the authorities have so far run counter to such postulates<sup>10</sup>. The Russian authorities will certainly remain interested in modernising the economy and importing new technologies to Russia, albeit on condition that this process does not undermine the state's control of the economy.

#### 1.3.1. Stronger state role in the economy

During the crisis, many Russian private companies which found themselves in financial difficulties had to turn for assistance to the state, which has been one of the few actors still in the possession of cash despite the deepening difficulties. This has enabled a further **re-nationalisation** of assets. The process was first observed in summer 2008 in the banking sector, where Vnesheconombank took over the private Svyazbank; and the KitFinance bank, which had found itself on the verge of bankruptcy, was taken over by the state-owned Russian Railways.

As part of the anti-crisis measures designed to prevent the bankruptcies of plants important for particular cities or regions, in August 2009 Vnesheconombank acquired 100% of shares in the Amurmetal metallurgy concern in the Russian Far East, which had previously owned by Duma deputy Alexander Shishkin. The deal stated that the original owners retained the right to buy out the shares.

<sup>8</sup> For more information on the pre-crisis trends in the Russian economy, see 'The invisible hand... of the Kremlin, Capitalism à la russe', Iwona Wiśniewska, Policy Briefs, February 2007.

<sup>9</sup> [http://www.gazeta.ru/comments/2009/09/10\\_a\\_3258568.shtml](http://www.gazeta.ru/comments/2009/09/10_a_3258568.shtml)

<sup>10</sup> For more information, see Iwona Wiśniewska, 'The invisible hand...', op. cit.

The financial difficulties experienced by the co-owners of Sibirneft (an oil company producing 3 million tons a year and the owner of the Moscow refinery) provided an opportunity for the Gazprom-owned oil company Gazpromneft to take over control of Sibirneft. Between April and June 2009, the Gazprom subsidiary company purchased over 34% of Sibirneft shares from minority shareholders and reached agreement concerning the acquisition of another 23% of shares currently held by Sberbank as a lien (securing a loan that should have been repaid by October 2009). Sberbank has also taken over some oil assets: 100% of shares in Dilisma (the owner of fields in the Irkutsk region with reserves of 15 billion tons) and 35% of shares in Tass-Yuryas Neftegazodobycha (the owner of fields in Yakutia with reserves of 59 million tons of oil and 154 million tons of condensate). The oil company Urals Energy had contracted a loan to purchase these assets from the state-owned bank, which should have been repaid in October 2008. The prosecutor's office was involved in enforcing Sberbank's rights<sup>11</sup>. The state-owned companies Rosneft and Gazpromneft have expressed interest in acquiring the assets currently held by Sberbank. The latter also holds a lien on 100% of shares in Russneft, which were forcibly taken from the previous owner, Mikhail Gutseryev, in summer 2008.

#### **Sergei Chemezov builds up his position in the power elite**

Sergei Chemezov is among the members of the ruling elite who have strengthened their position during the crisis. Chemezov belongs to the inner circle of Putin's trusted aides (they have known each other since the periods when they both worked for the KGB and served in Dresden). Since November 2007, Chemezov has been director-general of the Rostekhnologii state corporation which manages around 430 enterprises (with a total staff of more than 800,00 workers), mainly from the military-industrial complex, but also from the automotive industry (AvtoVAZ and Kamaz). Rostekhnologii's main task is to co-operate on the development, production and export of civilian and military high-tech industrial products. According to Chemezov's initial assumptions, the development of the assets Rostekhnologii took over was to be financed with loans from foreign and Russian banks, as well as the lease of the land owned by the member enterprises. These plans were thwarted by the change in economic conditions in August 2008. By October 2008, it turned out that Rostekhnologii's debt had risen to 625 billion roubles (and in May 2009, up to a third of its member enterprises found themselves on the verge of bankruptcy). Chemezov admitted that "if the crisis could have been foreseen, Rostekhnologii would have thought twice before undertaking to manage such a large number of assets."\* Since the very beginnings of Rostekhnologii, Chemezov has been actively seeking Russian government support and broader powers for himself, and stepped up the efforts in this direction when the crisis began. →

\* From Sergei Chemezov's interview for the Russian business daily *Vedomosti* on 27 May 2009.

<sup>11</sup> In early 2009, a special team was created in the prosecutor's office to co-operate with 'problematic' debtors. Apart from prosecution officials, it includes representatives of Sberbank, Vneshtorgbank, Vnesheconombank and Rosselkhozbank.

In recent months, Chemezov has succeeded in taking the following actions:

- **obtaining broader powers:** in May 2009, President Medvedev signed the amendments to the legislation in force, under which Rostekhnologii gained more autonomy. The amendments stated that this *goskorporatsiya* would take over the land occupied by its member enterprises under lease arrangements (at preferential prices). Rostekhnologii's director-general was granted additional powers. Chemezov is the only state corporation director who has the right of legislative initiative (he may present proposals to the president, the government and other state bodies). Under the amended laws, Rostekhnologii will gain property rights as soon as the government decides to transfer assets to this corporation, and not after the normal lengthy legal procedure. Finally, the *goskorporatsiya* enjoys protection from creditors;
- **establishing Rosavia**, a company comprising Rostekhnologii-controlled air carriers, which was established in October 2008 in the aftermath of the financial difficulties experienced by the private Russia air carriers belonging to AirUnion in July and August 2008. The concern is currently being formed out of what remains of AirUnion, which has been driven into bankruptcy. Rosavia member companies will receive 5 billion roubles in public aid under the state financial support programme. The decision to this effect was adopted by the government in December 2008;
- **obtaining financial support.** Rostekhnologii has already received 25 billion roubles in loans for AvtoVAZ (while the remaining automotive companies are only getting state guarantees), and 3.5 billion roubles for ASMPO-Avisma. In addition, the government has allocated 180 billion roubles to support to the military-industrial complex, most of whose companies are owned by Rostekhnologii;
- **making arrangements for close co-operation between Rostekhnologii on the one hand, and Sberbank, Vneshtorgbank and Gazprombank on the other** (Vnesheconombank is also expected to join). In April 2009, these three banks, the largest in Russia, signed a memorandum under which Rostekhnologii will gain cheap loans under simplified procedures. The banks will finance the AvtoVAZ investment programme (worth around 80 billion roubles) until 2013 under a recommendation from PM Putin. In return, Rostekhnologii will support the banks (by providing consulting, management, audit and monitoring services) in supervising the assets which the banks have found themselves owning as a result of liens established to secure the loans granted (including Norilsk Nickel, Grupa Gaz). Rostekhnologii will also be able to buy some of the assets which the banks took over.

It should be noted that the Rostekhnologii director had much higher ambitions, but not all of his plans could be implemented. Chemezov had applied for the post of chairman of Norilsk Nickel's board of directors, but was defeated by another candidate from the ruling elite, Alexander Voloshin, the former head of the Presidential Administration. Chemezov has also failed to obtain those powers under which he would manage and benefit from budget funding in the implementation of the Federal Target Programmes. Nevertheless, despite the presence of a strong group of opponents within the ruling elite and the inefficiency of the assets he manages (exposed by the crisis) his position in the elite has not eroded; on the contrary, it has been strengthened.

In parallel to the takeovers of assets, **state-owned companies continued to strengthen their positions.** This was particularly apparent in the finance sector, where the consolidation of assets progressed with state-owned companies (including Vnesheconombank, Sberbank and Vneshtorgbank) as the main players. The Rostekhnologii corporation received considerable financial support and broader powers (see the frame on Sergei Chemezov). Public aid was also provided to companies from the energy sector, including Gazprom, Rosneft and Transneft.

The government's anti-crisis programme has favoured the **managers of state-owned establishments** such as state corporations, oil companies, Gazprom and banks, and has assisted them in **building economic backup of their own**. In contrast to the 1990s, during this crisis state-owned assets rather than private property were guarantees of a strong position in the Russian economy and access to financing (see frame). Currently it has been the state, and not private businesses as in 1998, that has possessed the cash needed to avoid bankruptcy. Effective lobbying has been possible thanks to close ties with the ruling elite.

During the current crisis, **large private businesses have become progressively marginalised**. As they possessed only limited funds of their own, they had to turn to the government for support, and have consequently become increasingly dependent on the state. For example, Vnesheconombank has been granting loans on the condition that the beneficiaries appoint its members to their management boards, offer additional shareholder guarantees, or establish liens on their shares or export contracts (see the frame on *Difficulties of private businesses during the crisis*).

#### ***Difficulties of private businesses during the crisis***

**Vladimir Potanin**, the co-owner of **Norilsk Nickel**, the world's largest nickel company, is among those entrepreneurs whose business has been adversely affected by the crisis. While Norilsk Nickel formally remains in private hands, the state has taken over de facto control of the company. Following a conflict between the two shareholders, Potanin and Oleg Deripaska, in which the state had stepped in as a mediator, Vladimir Strzhalkovsky, a former aide of Vladimir Putin's from the St. Petersburg mayor office, was appointed as the company's director-general in August 2008, and in December 2008 another state official, Alexander Voloshin, was appointed as the chairman of the company's new board of directors\*. It is unclear what position the ruling elite has adopted with regard to **Oleg Deripaska**, one of the private entrepreneurs who have until recently been promoted most vigorously by the authorities. During the period of prosperity, his company **Basic Element**, which manages Deripaska's assets such as his shares in RusAl or Russkiye Mashiny, was one of the most Russian companies developing most dynamically, both domestically and abroad. It was active in sectors that were particularly sensitive from the Kremlin's point of view (the aluminium, machine-building and oil industries), for which reasons Deripaska's business successes were associated with strong support from the authorities. During the crisis, the enormously indebted company got into serious financial trouble. It was forced to transfer some of the foreign assets it had previously acquired for loans to the banks which had granted the loans (20% of shares in Canada's Magna automotive company and 10% in the German construction company Hochtief). The state backed Deripaska with a loan of US\$4.5 billion, as a result of which Vnesheconombank came into the possession of the shares in RusAl, on which foreign banks held a lien. Deripaska's Gaz automotive company also received assistance in the form of 20 billion roubles' worth of credit guarantees. Deripaska managed to restructure his debt to the Russian banks. However, these actions exposed his complete dependence on public aid.

\* Voloshyn was a grey eminence during Boris Yeltsin's presidency but kept much of his sway under Vladimir Putin (he has been associated with the current president Medvedev, among others).

The government's anti-crisis measures have stimulated a process whereby the **Russian economy has been abandoning the principles of free competition**. The anti-crisis programme, the financial support to individual sectors, and the tax and customs support measures were motivated by political decisions and strong lobbying by individual interest groups, and were arbitrary in nature. As a result, the tendency to steer the economy manually, without any regard to economic effectiveness, gained strength. State-owned enterprises were offered assistance based on unclear criteria, and were not required to restructure in order to be eligible. Enormous public procurement orders were awarded

to state-owned enterprises, irrespective of the actual quality of their products or services. Decisions to restructure debt and offer new loans to companies were politically dictated (of which PM Putin's decree on state-owned banks' lending is an example: see section 1.1.6). Consequently, the crisis has not led to any improvement in the efficiency of management; on the contrary, ineffective companies obtained aid and gained a competitive advantage over those which did not benefit from public aid.

### **1.3.2. Further expansion of Russian capital and a controlled opening-up to foreign capital**

#### 1.3.2.1. Russian expansion abroad

The economic crisis has suppressed the scale of **Russian private investors' expansion abroad**<sup>12</sup>, although Russian private capital is still quite active on foreign markets. However, it is state-owned capital that has stepped up its investing activity during the crisis. Russia's raw materials companies continue to be the main category of foreign investors; however, new technologies are gaining prominence as the second main direction of Russian investments.

Before the crisis, Russia's investments had largely been credited by foreign banks. The loans granted were usually secured with liens on the assets taken over by the Russian companies. When the economic situation deteriorated, some investors were unable to deliver on their commitments and had to dispose of the newly taken-over assets. Deripaska found himself in the most difficult situation as his company, Ruskiye Mashiny, had to dispose of his 20% stake in the Magna automotive concern (although it still declares it is closely co-operating with the Canadians), and Basic Element was forced to dispose of its 10% stake in the German construction company Hochtief. However, Russian entrepreneurs have not lost control of the assets they took over in sectors regarded by the Russian authorities as strategic – the Russian government developed an anti-crisis programme under which Vnesheconombank would refinance the foreign liabilities of Russian companies. Such refinancing was provided to Deripaska's RusAl (a lien on 25% of shares in Norilsk Nickel was established in favour of Vnesheconombank), and the iron metallurgy company Evraz, among others. Thanks to this programme, **strategic Russian companies remained in the hands of Russian capital.**

**A further expansion was observed in the raw materials sectors.** Russian oil companies took over 45% of shares in the Dutch refinery TRN (LUKoil), and over 21% of shares in the Hungarian petrochemical company MOL (Surgutneftegaz, which became the largest shareholder in MOL as a result). The crisis has also enabled the Russian extraction and metallurgic concern Mechel to take over 100% of shares in the US company Bluestone Coal at an attractive price.

The Russian state-owned companies have also been interested in foreign assets during the crisis: Vnesheconombank took over more than 50% of shares in Ukraine's Prominvestbank, and Russia's largest air carrier Aeroflot has placed a bid to purchase 91% of shares in the Czech national carrier Czech Airlines (however, the Russian company is unlikely to win the tender, because the transaction has been assessed negatively by the Czech secret services). Sberbank has participated in the tender for a stake in the German car manufacturer Opel, and the private company Renova owned by Viktor Vekselberg was authorised by Brussels in summer 2009 to take over control over the Swiss engineering and construction company Sulzer, having previously (in mid-2008) increased its shareholding in Oerlikon, a nanotechnology company producing semiconductors, vacuum devices and space electronics). The latter three investments are particularly important for the Russian market as they offer Russian capital access to new technologies that may be used on the Russian market.

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<sup>12</sup> According to Forbes' calculations published in April 2009, the wealth of the 100 richest Russians had decreased by US\$380 billion to US\$ 142 billion over a year. Vladimir Prokhorov, who managed to sell his shares in Norilsk Nickel before the crisis (thus avoiding the slump in the listings of raw materials companies) was the richest Russian in 2009, while the preceding year's leader Oleg Deripaska had fallen to tenth position (his wealth decreased by US\$25 billion to US\$3.5 billion over the year).

### 1.3.2.2. Foreign investments in Russia

The financial crisis has triggered a dynamic outflow of capital from the Russian market. So-called speculative capital was the first to demonstrate a lack of confidence in the Russian market. However, in the first half of 2009, those investors who had intended to build a permanent presence on the Russian market also drastically reduced their activities. However, no spectacular withdrawal of long-term investments from Russia has been observed. While many investors (especially the car companies strongly affected by suppressed demand) have been hit by the adverse economic conditions, they have been trying to wait out the unfavourable period, hoping to make profits in the future, especially since the government's protectionist policy has been making imported goods less attractive (with higher custom duties on cars, machines, foods or timber exports) and promoting domestic production.

During the crisis the Kremlin been continuing the policy, which it had already launched before the current economic troubles began, **of opening up the Russian market, including the (most attractive) raw materials sector, in a controlled manner** to foreign investors. Minority stakes in assets attractive for investors (Rosneft, public banks) have been offered for privatisation since 2006, and foreign companies have been admitted, albeit selectively, to the extraction sector. While opening the Russian economy up to foreign investors, Moscow has maintained control over the key sectors of the Russian economy<sup>13</sup>. Foreign investors have been much more active in industries other than the raw materials sector.

The process of admitting foreign investors to the Russian raw materials sectors has continued during the crisis. The French energy company Total has concluded a preliminary agreement to take over 49% of shares in the Russian gas field Termokarstovoye (with reserves of 47.5 billion m<sup>3</sup> of gas and 10 million tons of condensate) currently owned by the private gas company Novatek. The transaction has been personally endorsed by PM Vladimir Putin, and it seems to have been made possible by Total's earlier sale of shares in a Dutch refinery to LUKoil. This exchange of assets between Total and Russian companies was part of the Russian government's strategy of admitting foreign investors to the Russian raw materials sector on condition that Russian investors are granted access to foreign markets.

The crisis has also forced Russian companies to start closer economic co-operation with China. Russia's Rosneft and Transneft received US\$15 billion and US\$10 billion in loans respectively, in return for which Russia committed itself to supplying 15 million tons of oil a year between 2011–2030 to China, and to building a pipeline branch connecting the East Siberia–Pacific oil pipeline with China.

This process is expected to accelerate in the coming months<sup>14</sup> because it guarantees that Russia receives not only capital, but also the new technologies which the Russian economy greatly needs. In his programme statement published in September 2009 by the popular web portal Gazeta.ru, President Medvedev also announced broader co-operation with foreign investors. This new policy line has been confirmed by the deputy PM Igor Shuvalov who said that the government would resume the privatisation of Russian assets, including the oil company Rosneft<sup>15</sup>. However, it is unlikely that the ruling elite would concede control of those enterprises which are of key importance for the state<sup>16</sup>.

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<sup>13</sup> For more information, see 'Russia's controlled opening to foreign investors: The Kremlin's new strategy on foreign capital', Iwona Wiśniewska, OSW Commentary No 4, May 2008.

<sup>14</sup> On 21 September 2009, the Russian automotive company AvtoVAZ announced its plans to create a joint venture with France's Renault and Japan's Nissan. The company would produce spare parts in AvtoVAZ plants.

<sup>15</sup> From Shuvalov's interview for Bloomberg TV on 22 September 2009. For example, a 25% stake in the largest Russian oil company Rosneft could be privatised. The state currently holds 75% of shares in the company.

<sup>16</sup> During the first phase of the crisis in autumn 2008, the government granted multi-billion loans to Russian companies to enable them to repay their foreign debt and prevent them from being taken over by foreign creditors.

## 2. POLITICAL AND SOCIAL ISSUES IN TIMES OF CRISIS

### 2.1. Social and political situation

#### 2.1.1. Politics

The current system of power in Russia is a continuation of the system formed during Vladimir Putin's presidency (2000–2008). It could be referred to as **'soft authoritarianism'**, as its main features are the concentration of power in the hands of the ruling elite, tight control of the important political and economic processes exercised by this elite, arbitrary decision-making and a politicised economy (where political power is used to enable members of the ruling elite to appropriate assets), as well as instrumental use of the constitutional state bodies (the parliament, the courts, etc.), which are expected merely to sanction the decisions taken by the elite. There is hardly any public and political supervision of the government's actions. This system of power derives its legitimacy mainly from the high popular support for the elite's leader Vladimir Putin, who owes his popularity to the favourable economic situation during his presidency and the control he exercises over the popular media, which have been building up his positive image for years.

**The most important decisions are taken by the narrow circle of the Putin ruling elite, which cannot be identified with any particular institution**<sup>17</sup>. The elite comprises Putin's trusted aides from the times when he worked for the KGB (1975–1990) and from the St. Petersburg mayoral office (1990–1996). This group has no formal structure. Some of its members do not hold any public offices, and relations are based mainly on long-standing friendships. However, while most of the elite members have close relations with Vladimir Putin, they are seldom as closely related with one another. The Putin elite is inhomogeneous and comprises a number of competing interest groups. Their rivalry usually concerns financial and property issues (distribution of assets, access to budget funding) rather than differences of programme or ideology<sup>18</sup>. Nevertheless, despite this internal diversity and rivalry, this group has not seen any splits for years, and its composition and structure have largely remained unchanged.

The main representatives of the ruling elite include deputy PM Igor Sechin, who holds significant sway over the oil sector and controls the Rosneft company; Sergei Chemezov, director of Rostekhnologii, the largest state corporation comprising several hundred companies from the machine-building, automotive, aviation and other industries; the banker Yuri Kovalchuk, who controls the Rossiya Bank; and the oil trader Gennady Timchenko (see frame). Dmitry Medvedev, who has been Putin's close collaborator in the past, also belongs to the ruling elite (and before 2000, was a member of Putin's inner circle), although he did not play any pre-eminent role in this group before being elected president.

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<sup>17</sup> During Putin's presidency, when the leader of the elite also held the highest state office, the presidential circle (the president and the Administration) was the main decision-making centre. After leaving office following the 2008 presidential election, Putin retained his status as the elite's leader and arbiter, which strengthened the personalisation of power and undermined its institutionalisation.

<sup>18</sup> Battles for budget funding have been fought, for instance, between the finance minister Alexei Kudrin and the Rostekhnologii chief Sergei Chemezov (who was seeking major financial support for the companies he controls). The conflict over control of the oil sector, and especially of Rosneft (which had taken over Yukos assets), was the most prominent example of the fight for assets among the elite members; this occurred in 2004 and 2005 between deputy PM Igor Sechin, who had previously established control of Rosneft, and Alexei Miller, the CEO of Gazprom who tried to absorb Rosneft.

## Gennady Timchenko takes over successive energy assets

Gennady Timchenko is among those who have taken advantage of the economic crisis in Russia to significantly expand their possessions in the energy sector. Until recently, he was known primarily as the founder and main shareholder of the Gunvor company.

Gunvor was established in 1997 and within just a few years became the largest intermediary company trading Russian oil (it controls around 35% of Russian oil exports) and the third largest oil trader in the world in terms of sales volume (with US\$70 billion of revenue in 2008). For many years, only very scarce information was available about Timchenko. It is known that since the beginning of the 1990s, he has been engaged in the trade in Russian oil and petroleum products. His name appeared in the media for the first time during the 2004 presidential campaign when one of the candidates, Ivan Rybkin, said Timchenko was a friend of Vladimir Putin's and controlled key economic sectors in Russia. According to the Russian media, Timchenko has long enjoyed the Russian PM's deep trust; their acquaintance dates back to the 1980s, when they worked together for the KGB in East Germany.

Gunvor, which buys oil from all major oil companies in Russia except for LUKoil, has been presumably thriving thanks to Timchenko's excellent contacts with the highest-ranking members of the Russian ruling elite. The fact that a large part of the oil exports have been centralised has enabled the ruling elite to collect an unofficial 'oil premium', especially since the details of how Gunvor buys oil from the producers are secret.

In addition to Gunvor, it is believed that among the assets Timchenko has controlled since 2008, there are: 9.5% of shares in the Rossiya Bank, the Transoil rail operator and Estonia's Tarcona company (the latter two specialise in the transport of oil and petroleum products), Clearlake Shipping Ltd., one of the world's leaders in shipping oil with tankers, and 5% of shares in Novatek, the largest independent gas producer in Russia. The crisis has enabled him to expand and increase his holdings in the energy sector. In 2009, companies associated with Timchenko made the following acquisitions:

- In March, Gunvor purchased 100% of shares in the **Ust-Luga terminal** (now under construction, with a planned capacity of 25 million tons a year). In September, Vneshekonombank granted Gunvor a US\$545 million loan for the construction of the terminal;
- In May, Gunvor took 50% of shares in the company building the **Novorossiysk terminal for the export of heavy oil** (4 million tons a year);
- In April, Gunvor purchased 50% of shares (and the remaining 50% in November) in **Castor Petroleum**, a US oil trader specialising in the supply of oil from Latin America, Africa and the Persian Gulf to the West Coast of the United States (around 16 million tons a year);
- In May, Volga Resources, a fund registered in Luxembourg and controlled by Timchenko, increased its **share in Novatek to 18.2%** in exchange for 51% of shares in the Yamal LNG company, the holder of the licence for the **Yuzhno-Tambeyskoye gas field** (with reserves of 1.3 trillion m<sup>3</sup>). The transaction also revealed that Volga Resources had owned 74.9% of shares in the company since 2008. Timchenko's companies still control 23.9% of shares in Yamal LNG. In December Russian press reported that Volga Resources was to increase its share in Novatek to 23.49%;
- In June, the Volga Resources fund purchased **79.6% of shares in Stroytransgaz**, the second largest construction company operating in the energy sector. Stroytransgaz also holds 67% of shares in Uralneftegazprom, the holder of six extraction licences (for reserves of 25 million tons of oil and 25 billion m<sup>3</sup> of gas). In August, Stroytransgaz sold its shares in an oil field in Algeria (70 million tons) to Rosneft for US\$200 million;
- In July, the Russian press revealed that the Timchenko-controlled Stroytransgaz owned 50% of Petromir, the company holding the licence for the development of the **Angaro-Lenskoye gas field** (with reserves of 1.2 trillion m<sup>3</sup>);
- In September, Gunvor acquired **30% of shares in the Laganskoye oil field in the Russian part of the Caspian Sea** (with reserves of 15–65 million tons) from Sweden's Lundin Petroleum.

The transactions disclosed in recent months have considerably strengthened Gunvor's position in the Russian oil and petroleum product trade sector, as well as its share in the global oil trade (the acquisition of shares in Castor Petroleum). Timchenko has also started investing in the gas sector, where he took over two very large gas fields and a substantial share in Novatek, Russia's second largest gas company after Gazprom. Given the specificity of the energy business in Russia, which is regarded as strategic and is therefore controlled by the authorities, one may presume that the Kremlin approves of Timchenko's expansion, as it probably benefits the private interests of some sections of the ruling elite\*.

*Prepared by Wojciech Konończuk*

\* For more see Wojciech Konończuk, 'Making money on the crisis in Russia: the case of Gennady Timchenko', OSW Commentary 31, 28 November 2009, [www.osw.waw.pl](http://www.osw.waw.pl).

**Oligarchy** is still present in today's Russia, albeit in a different way than in the times of Boris Yeltsin, when billionaire entrepreneurs gained political influence due to the weakness of the state structures and the poor condition of the state finances. The former oligarchs of the 1990s have lost some of their influence since Vladimir Putin came to power in 2000. They were replaced by **'new oligarchs', Putin's close aides, who hold extensive political sway and control enormous, usually state-owned assets.** The most pre-eminent of these 'state oligarchs' include the already mentioned Chemezov, who controls the gigantic state-corporation Rostekhnologii, Igor Sechin, deputy PM and chairman of the board of directors of the state-owned company Rosneft, and Vladimir Yakunin, CEO of Russian Railways, who has been taking over assets in other sectors as well. The 'new oligarchs' have been using their close relations with Putin to take control over more and more assets (often state-owned), to ensure their companies receive steady flows of public aid, and to obtain lucrative contracts for the private companies associated with them.

**Vladimir Putin is the main decision maker and arbiter in the Russian elite.** He controls the key spheres such as the economy and security, and ensures that a balance is maintained between the different groups within the elite. While Dmitry Medvedev has held the highest state office for almost two years now, he has served to continue Putin's policy; Medvedev himself is a man without major personal ambitions and a loyal guardian of the ruling elite's interests. The pro-democratisation and pro-liberal declarations brandished by Medvedev during the election campaign and immediately after he took office as president have been put into practice to only a negligible extent, and have not influenced the shape of the system of power. Medvedev's critical statements on the economic and political legacy of Putin's presidency<sup>19</sup>, on the other hand, should be regarded simply as part of his rhetoric, as they stand in contrast to his actual actions, which have consolidated the Putin model of state governance.

**Medvedev's election as president in March 2008 illustrates the mechanisms employed by the elite to control public life.** Medvedev had been previously designated by the elite as the official presidential candidate, and his unquestionable victory was made possible by Putin's support, a positive campaign in the pro-Kremlin media, and substantial funding allocated to his campaign. His showing in the ballot (72% in the first round) illustrates how the ruling elite secures its interests: the decision taken by a narrow group was promoted to the public (being presented as the best choice possible, to which there is no decent alternative), while the people's consent in fact only legitimised the decision that had already been taken.

The main objective of the ruling elite seems to be to **develop and strengthen the members' economic assets**, most of which were acquired during Putin's second term as president, and to carry on their economic expansion. When they came to power, Putin and his team started off by building up and consolidating their political influence, but Putin's second presidential term was already marked by the appropriation of commercial and financial assets by the ruling elite<sup>20</sup>. Currently, members of the elite control enormous resources in the oil and gas sectors, finance and heavy industry, and their principal objective is to gain financial support and preferential conditions for the companies they control.

The concentration of mechanisms of influence over the political, economic and social spheres in Russia has enabled the elite to keep its leader (Vladimir Putin) highly popular and to impede the emergence of any potential alternative to the current leadership. At present, **there is no serious alternative to the Putin elite in Russia.** The weak state institutions (parliament, courts) are controlled by the autho-

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<sup>19</sup> See inter alia Jadwiga Rogoża, Medvedev's 'manifesto': political conservatism and economic adjustments, Eastweek 31, 16 September 2009, [www.osw.waw.pl](http://www.osw.waw.pl)

<sup>20</sup> The takeover of the assets held by the oil company Yukos (most of which became the property of the state-owned Rosneft controlled by the then deputy chief of the presidential administration Igor Sechin) was the most important event which triggered the appropriation process.

rities and can offer no counterbalance. The regional elites are not a major autonomous force, either, since during Putin's presidency the Kremlin managed to stop and reverse their centrifugal tendencies and effectively curtailed the ambitions of individual governors by making them financially dependent on the central government. Influential entrepreneurs ('oligarchs') have likewise lost much of their political influence and autonomy, and do not participate independently in political manoeuvres. The anti-Putin opposition in Russia is weak and dispersed, and has been effectively marginalised by the authorities for years (opposition members have no access to the media, are excluded from elections, and so on). The former Yukos chief Mikhail Khodorkovsky is the only person perceived by observers and the elite alike as a potential leader of anti-Putin forces with sufficient charisma to catch the public imagination. However, Khodorkovsky has been serving a prison sentence since 2003, and it appears that the Putin elite is determined to keep him in jail as long as it stays in power<sup>21</sup>.

The public, which for the most part remains passive, susceptible to media manipulation and tolerant of the authorities' behaviour (Putin's popularity has oscillated around 80% in recent years; cf. footnote 27), has not developed a serious alternative to the current leadership, either: independent civil organisations (NGOs) and trade unions not associated with the authorities are feeble in Russia.

## 2.1.2. Society

### 2.1.2.1. Situation on the labour market

#### - Growing unemployment

As a result of the economic crisis, **unemployment in Russia increased considerably in late 2008 for the first time in nine years**. According to the Federal Service of State Statistics (Rosstat), the unemployment rate in the Russian Federation had been decreasing steadily since the end of the 1990s. During the years of oil prosperity, it fluctuated between 5 and 6%, and reached a minimum of 4.2% in November 2007. However, in December 2008 unemployment in Russia suddenly increased to 7.8%. In the first months of 2009, the situation in the labour market deteriorated further. **The highest unemployment rate of 9.5% was reported in February 2009**. At that time, major layoffs were carried out after the holiday season (January in Russia) and the standstills experienced by employers. In the following spring months, the unemployment rate stabilised at **8–9%**.

**Unemployment levels differ greatly among the different regions of Russia**. In many parts of the country they are much higher than the national average. In May, **unemployment rates were above 10% in more than 30 regions of the Russian Federation, and in some of them, as many as 20% to 50% of people able to work were without jobs**. The situation is the most difficult in Ingushetia (50.3%), Chechnya (33.9%), Tuva (23.5%), Kalmykia (19.1%), Buriatia (19%) and Altai (16%), although unemployment in the former two republics is due mainly to the disastrous social situation with which these regions have been struggling for years, rather than the current economic crisis<sup>22</sup>.

According to Rosstat, 40,000 to 56,000 people lost their jobs each month between December 2008 and June 2009. The labour market forecasts for the coming months are also pessimistic. Russia may face another wave of layoffs in connection with the expected deterioration of economic trends. In September 2009, the managers of the Russian car maker AvtoVAZ (the manufacturer of Lada cars) decided to

<sup>21</sup> Khodorkovsky is currently on trial once more, as a result of which he may be handed another long sentence of imprisonment. When Medvedev was elected as president, many observers expected him to grant Khodorkovsky a pardon. Even today, many commentators maintain that such a decision would have been a serious signal indicating that Medvedev intended to build an independent position and become the elite's leader. However, the elite's position on Khodorkovsky has remained unchanged, which, along with other facts, demonstrates that Medvedev is a 'man of the system' and does not intend to dismantle the system Putin built.

<sup>22</sup> Figures from Rosstat, May 2009, [http://www.gks.ru/bgd/free/b04\\_03/lssWWW.exe/Stg/d02/123.htm](http://www.gks.ru/bgd/free/b04_03/lssWWW.exe/Stg/d02/123.htm)

make 5,000 employees redundant by 14 December 2009, and announced that another 31,000 people would lose their jobs later on. The situation in AvtoVAZ demonstrates that the new wave of the crisis will lead to an increase in mass layoffs, as a result of which unemployment in Russia will rise. According to the World Bank's forecasts, it may even reach 13% by the end of 2009.

**Chart 9. Unemployment in Russia in 1995–2009**

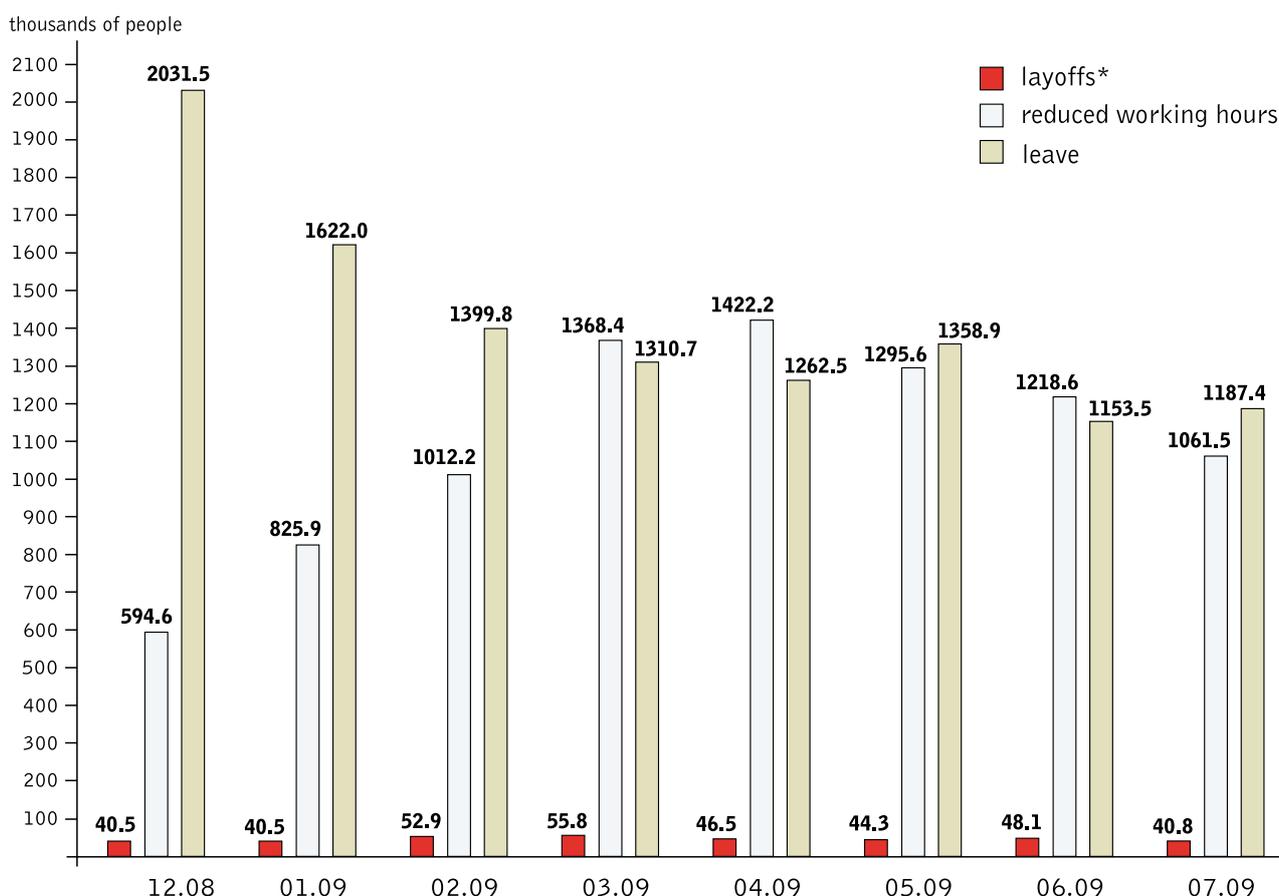


Source: Rosstat

### **- Forced leave and reduced working hours**

However, the problem which has been affecting the Russian employees most in the first half of 2009 did not concern employment reductions, but rather forced leave and part-time work. In an effort to manage the difficult financial situation, most employers decided to implement this form of saving as the first measure because it enabled them to avoid difficult decisions concerning layoffs while paying a much lower payroll. Formal layoffs were treated as a last resort, and were used less commonly than reduced working hours schemes. Between December 2008 and June 2009, **600,000 to 1.4 million people worked part-time each month**, and the number of those on forced leave (often unpaid) ranged **between 1 and 2 million** (during the holiday season between December 2008 and January 2009).

**Chart 10. Change in employment in Russia between December 2008 and June 2009**



\* Total number of people who lost jobs as a result of gradual reduction of workplaces and group layoffs, according to Rosstat. According to official data, 40,000-56,000 people lost their jobs each month between December 2008 and June 2009, including 5,000-10,000 as a result of group layoffs.

Source: Proprietary calculation based on Rosstat figures

### - Overdue salary payments

The employees' welfare situation was further exacerbated by the employers' failure to pay remunerations on time. The volume of outstanding salary payments increased rapidly in November and December 2008, when **this category of debt increased to 4 billion roubles (US\$125 million), and then to 7.7 billion roubles (US\$240 million)**, respectively (earlier in 2008, it had oscillated around only 2.5–2.9 billion roubles (US\$78.1–90.6 million)). **Throughout the first half of 2009, outstanding remuneration payments remained at a high level of around 7–8 billion roubles (US\$220–250 million)**. Statistics for 1 August 2009 reported a decrease in unpaid remunerations to 6.3 billion roubles (US\$190 million). It has been estimated that around 400,000 employees in Russia were affected by this problem in July 2009.

The main cause of the suspended remuneration payments is that **the crisis-affected employers do not have enough of their own funds** (97.5% of outstanding remunerations volume as of 1 August 2009). Delayed money transfers from the federal or regional budgets account for a very small proportion of outstanding remunerations (2.5%). Companies from the processing sector owe their employees the most (50% of total outstanding remunerations), followed by companies in the transport sector (15%) and in the construction industry (14%)<sup>23</sup>.

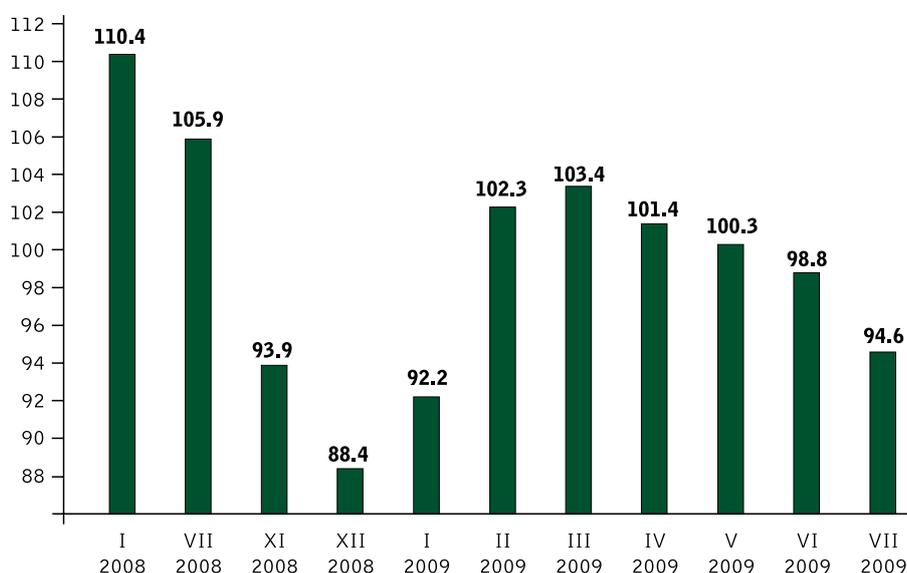
<sup>23</sup> Rosstat figures, 1 August 2009, [http://www.gks.ru/bgd/free/B04\\_03/IssWWW.exe/Stg/d03/152.htm](http://www.gks.ru/bgd/free/B04_03/IssWWW.exe/Stg/d03/152.htm)

### 2.1.2.2. Deteriorating standards of living

The economic crisis, the resulting labour market problems and the increased prices of goods and services have caused a decline in Russian standards of living. **Real incomes**, which had been increasing by more than 10% a year on average since 2000 (see Table 1 in the Appendix), **started to decrease for the first time in eight years**. The deepest decrease was reported during the first phase of the crisis: in November and December 2008, real incomes shrank by 6.1% and 11.6% respectively, compared to the same periods in the previous year, and in January 2009, they fell by another 9.2%. By May 2009, the situation improved and incomes rose slightly. However, the negative trend was back next month, when incomes started to fall again. In July 2009, real incomes were lower by 5.4% compared to the same period in the previous year<sup>24</sup>.

**Chart 11. Real incomes in Russia in selected months of 2008 and the first half of 2009**

As percentage of the same period in the preceding year



Source: Rosstat

The deteriorating standards of living are also illustrated by other Rosstat data, which demonstrate that **expenses have increased noticeably while the purchasing power of salaries and pensions diminished**. In the first half of 2009, the average real pension increased by nearly 10% over 2008 (reaching 4882 roubles, or US\$153), while the average real salary decreased by nearly 3% (17,875 roubles, or US\$559). Meanwhile, housing and municipal charges increased by 19.5% over the same period in 2008, according to figures available in June 2009; charges for healthcare increased by 16.1%, charges for kindergarten services by 19.1%, transport tariffs by 11.3%, and the cost of foreign tourism by 19.7%.

The economic crisis has resulted in an **increase in the percentage of poor Russians in the entire population**. According to Rosstat, the number of people living on less than the minimum subsistence level<sup>25</sup> (5083 roubles, or US\$159 in the first quarter of 2009) increased by 6 million during the first three months of 2009 (it currently stands at 24.5 million). This means that the proportion of the poor

<sup>24</sup> Rosstat figures, [http://www.gks.ru/bgd/free/B09\\_00/lssWWW.exe/Stg/d07/6-0.htm](http://www.gks.ru/bgd/free/B09_00/lssWWW.exe/Stg/d07/6-0.htm)

<sup>25</sup> The minimum subsistence level (prozhitochniy minimum in Russian) is defined in Russia under the 1997 Act 'O prozhitochnom minimumie v Rossiyskoy Federatsii'. According to the Act, the minimum subsistence includes a basket of goods (expenses for basic necessities, including foods, as well as services needed to satisfy basic needs) as well as other basic charges. For Rosstat's definition of the term, see: [http://www.gks.ru/free\\_doc/2007/metod\\_rus\\_fig/06-58.htm](http://www.gks.ru/free_doc/2007/metod_rus_fig/06-58.htm)

in the Russian population has increased from 13.1% in 2008 to 17.4% in the first quarter of 2009<sup>26</sup>. The June 2009 World Bank forecasts on this issue are not optimistic, as the World Bank expects the proportion of the poor to increase to 17.4% by the end of 2009 (compared to 15.5% in 2008)<sup>27</sup>.

### 2.1.2.3. Who has been affected most by the crisis?

**The groups most severely affected by the crisis in Russia include employees in the private sector, people with primary education and people working in the production and processing industries. Employment problems have also hit people in managerial positions.** According to Rosstat, in May 2009 the highest unemployment rate of 8.9% was reported for workers with primary education, in particular in the metallurgic and machine-building industries, trade, transport, the food industry and the production of construction materials. For employees with secondary and university education, the unemployment rates were lower at 6.3% and 4.5% respectively. In both groups, managers (including in the banking sector) as well as people in the humanities and educational employees faced the most serious employment problems.

**Employees in the public sector were only slightly affected by the crisis.** A survey by the Russian opinion poll institute FOM<sup>28</sup> indicates that public-sector employees have much better opinions of their situation in times of crisis and more optimistic assessments about the condition of their employers. Over 55% believe that the crisis has no or little negative impact on their respective sector. Private-sector employees have expressed the opposite opinion. Over half (54%) have observed the negative impact of the crisis on the condition of the companies they work for.

A separate, typically Russian, social group that has been affected most severely by the deteriorating economic conditions comprises the **inhabitants of the so-called monocities**. These are urban complexes built around large industrial establishments which employ most of the active workforce in the given area. The crisis has brought many such plants to the verge of bankruptcy by hitting their respective sectors. As a result, the living conditions of the hundreds of thousands of people in the monocities who depended on such plants have deteriorated immediately. According to a research by the Regional Policy Institute, there are currently 460 monocities in Russia (around 40% of the total number of Russian cities). Their inhabitants (around 35 million people) account for 25% of the population of Russia, and the monocities generate around 40% of Russia's GDP<sup>29</sup>. It is estimated that around 100 are currently struggling with serious financial and economic problems.

The welfare conditions of the monocities' inhabitants have been exacerbated by the fact that the plants around which those cities were built have for many years not only employed most of the local population, but also co-financed the welfare sphere in the region, including the maintenance of city infrastructures, healthcare, cultural events, holidays and transport services. Currently, the bankruptcy of such a company, or even its financial difficulty, trigger an immediate decline in the welfare situation of the entire city population. In times of crisis, social frustration has built up in the monocities, making them potential areas of social destabilisation in their respective regions of Russia.

**Labour migrants** are another social group adversely affected by the crisis in Russia. The problems on the Russian labour market and the restrictive immigration policy implemented by the Russian authorities have suppressed the numbers of migrants coming to the Russian Federation. The Federal Migration Se-

<sup>26</sup> *Niezawisimaja Gazieta*, 31.08.2009: <http://www.ng.ru/printed/230216>

<sup>27</sup> Russian Economic Report, The World Bank In Russia, June 2009, <http://siteresources.worldbank.org/INTRUSSIANFEDERATION/Resources/305499-1245838520910/rer19-eng.pdf>

<sup>28</sup> <http://bd.fom.ru/pdf/d27naemrab.pdf>

<sup>29</sup> [www.gazeta.ru](http://www.gazeta.ru), 24 December 2008.

vice has reported a 10–15% decrease in the number of incoming migrants in the first quarter of 2009 compared to the previous year<sup>30</sup>. Immigrants working in Russia have been earning less, their welfare situation has deteriorated, and it has become more common for employers seeking savings to hire the migrant workforce illegally. This has stimulated the development of a ‘grey economy’ in Russia: it is estimated that illegal employment has risen to 19.3% in November 2008, over 17.1% in November the preceding year<sup>31</sup>.

## 2.2. The government’s anti-crisis strategy

The objective of the Russian government’s ‘anti-crisis’ strategy has been not so much to tackle the systemic problems of the Russian economy as to reinforce the ruling elite’s economic and political power. To implement this strategy, the authorities have mainly used financial and propaganda instruments, and have been preparing to use force in the event of any escalation of welfare problems and social protests.

### 2.2.1. The PR strategy

Since the crisis began in autumn 2008, the authorities have been conducting an intensive media campaign to buttress their own position and blame the negative economic phenomena on foreign operators and the lower ranks of the Russian administration and businesses.

In the early phase of the crisis (spring to summer 2008), **blaming the United States as the main culprit responsible for the global economic crisis** was the leitmotif in the state-controlled Russian media (particularly television). In this context, the media would speak about the decline of the USA as a world power, and emphasise that Russia had enormous resources and a ‘stability reserve’, with which it was in a position to survive any crisis.

In the following months, when the crisis started to increasingly affect Russia, the propaganda campaign became dominated by the motif of ‘those to blame’ inside Russia. Economic problems such as bankruptcies of companies or rising prices were blamed on entrepreneurs (owners of companies and retail chains), bankers (for denying credit to the less profitable companies) as well as regional and local authorities. Against this background, **a positive image of Vladimir Putin was reinforced**; the prime minister was presented as the right man at the right time, concerned about the Russian people’s material situation and capable of solving all ‘irresolvable’ problems. In terms of media exposure during the crisis, President Medvedev has been overshadowed by Putin.

The media coverage of PM Putin’s June visit to Pikalevo, a monocity experiencing an acute welfare crisis as a result of the bankruptcy of a plant, is one of the best examples of this propaganda campaign. The prime minister met the city’s inhabitants in front of the cameras, ordered a state-owned bank to allocate funds to reactivate the bankrupt plant, and harshly reprimanded the plant owners and the regional authorities. Putin’s actions concerning the rise in food prices (inflation in Russia has been high at 13%) were similarly populist in tone. Several weeks after the Pikalevo intervention, the PM personally visited one of the Moscow supermarkets where, again in front of the cameras, he accused the supermarket managers of charging excessive margins on dairy products and meat, and ordered the Federal Antimonopoly Service to audit the price policies of retailers in the capital city. These propaganda measures have produced the expected results – while the regional authorities have been plummeting in popularity polls, both PM Putin and President Medvedev have maintained the high popularity they enjoyed before the crisis began (see section 2.3.1.1.).

<sup>30</sup> <http://www.iet.ru/files/text/trends/06-09.pdf>, p. 65

<sup>31</sup> <http://www.iet.ru/files/text/trends/06-09.pdf>, p. 63

The authorities have also been **taking propaganda measures to address the symptoms of popular discontent and anti-government protests**. The largest protests so far took place in December 2008 in the Far East, where entrepreneurs dealing with the import and maintenance of used Japanese cars (widely used in the region) staged a protest action. The protest became the subject of a State Duma report in which its organisers were accused of subversive activities, plans to separate the Far East from Russia and of 'implementing Orange Revolution scenarios'<sup>32</sup>.

### 2.2.2. The welfare strategy

**Neutralising the challenges of the welfare system** has been one of the priorities of the government's anti-crisis strategy. This has manifested itself mainly in the **welfare-centred character of the 2009 budget** (and the draft 2010 budget). Despite cuts in many other areas, welfare spending has been increased by 30% over 2008 in the 2009 budget. Additional funds have been transferred to the regional budgets, which are jointly responsible for financing welfare policy. Spending on the maintenance of public order has been kept at the previous high level (see section 2.3 for more information), as has spending on the media, the main instrument of propaganda. The deficit of 7.4% of GDP, caused by increased spending and lower revenues, is being financed from the reserve funds.

### 2.2.3. The strategy for the use of force

Since mid-2008, the Russian authorities have been taking measures which indicate that the government is considering that public frustration may escalate if the economic situation continues to deteriorate, and has been admitting that an option to forcefully pacify potential unrest may be necessary.

So far, the government has resorted to the use of force only on a couple of occasions: in December 2008 the OMON brutally suppressed anti-government protests in the Far East, and in July 2009, they prevented a highway blockade which the employees of the nearly bankrupt Gorno-Altai plant were trying to stage. Most of the measures the authorities are undertaking currently concern the creation of legal and financial instruments to improve the state's capacity to maintain public order. The most important measures of this kind include increased spending on the maintenance of public order in the 2009 budget (high pay rises have been implemented for the police, with priority given to police officers operating in the field). Another decision, announced in December 2008, has stopped the reductions in the Interior Ministry's troops and created a new department for combating extremism within that ministry. In 2010, a new act adopted in December 2008 will come into force, which will regulate the operation of private detective and security agencies, strengthening the Interior Ministry's supervision over those organisations and enabling it to use them as a reserve force. In January 2009, a draft act was tabled with the parliament, which provides for the creation of so-called 'popular squads' ('druzhinniki', voluntary citizen patrols which existed back in Soviet times) charged with protecting public order and endowed with broad competencies. Although the project has not yet completed the first reading, the Interior Ministry has reported that around 16,000 teams, composed of a total of nearly 200,000 volunteers, are already operating throughout Russia. Popular squads can be spotted in the streets of many Russian cities as they patrol the area during all kinds of events along with the police, interior troops and private security agencies.

Preventative actions intended to tighten the authorities' grip on developments in workers' communities, including in plants threatened with bankruptcy, are also part of the broadly understood 'forceful measures'. In November 2008, the pro-government United Russia party signed a protocol on co-operation and information exchange with the Sotsprof independent trade union, and in March, a similar

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<sup>32</sup> For more information, see Ivan Rodin, Alexandra Samarina, 'Nu, nachalos!', *Nezavisimaya Gazeta*, 16 January 2009, [http://www.ng.ru/politics/2009-01-16/1\\_dalniyostok.html](http://www.ng.ru/politics/2009-01-16/1_dalniyostok.html)

protocol was signed with the Federation of Independent Trade Unions of Russia (the largest trade union organisation in Russia, which remains loyal to the authorities). Trade union activists have been receiving secret orders to monitor the situation among workers and prevent protests from escalating. In addition, prosecutions have been made against representatives of independent trade unions which do not co-operate with the state, who bring the problems of employers or the volatile sentiments among workers to public attention.

## 2.3. Impact of the crisis on social and political trends

### 2.3.1. Russian society and the crisis

#### 2.3.1.1. Unshaken trust in Prime Minister Putin

The social problems triggered by the crisis **have not undermined the long-standing positive public image of the highest-ranking members of the ruling elite**. In times of crisis, the showings of PM Putin and President Medvedev in the opinion polls have remained high and stable. According to an August 2009 poll by the Levada Centre, up to 82% of Russians support the actions which Putin is undertaking as prime minister, and 76% support the actions of President Medvedev. A year before, the two politicians' showings were 83% and 73%, respectively<sup>33</sup>.

What is more, the ruling elite's propaganda strategy for the time of crisis **has strengthened Putin's positive image** in the Russian public, which now views the PM as the 'only effective politician for difficult times', and has led to a **rise in hopes that Putin will guarantee effective help and solve all the problems in crisis situations**.

The above-mentioned visit to Pikalevo monocity was a typical example of this kind of social reaction (see section 2.2.1.). Putin's intervention in the city resounded widely with the Russian public. Opinion polls carried out afterwards revealed a very clear picture of how the Russian public perceives the condition of the state and its institutions during the crisis. According to the respondents, **the state machinery is operating ineffectively and needs continuous interventions from the highest authorities**. In the crisis conditions, only Putin appears to be an energetic and effective politician concerned about ordinary people<sup>34</sup>.

Polls conducted after the events in Pikalevo and other surveys examining the popularity of various levels of the administration in Russia indicate that **the Russian public mainly blames the regional authorities, the government apparatus and the businesspeople for the frustrations caused by the crisis**. Up to 65% of Russians believe that the local authorities and businesses were responsible for the crisis in Pikalevo<sup>35</sup>. In July 2009, 41% of the Russians expressed negative opinions about the activities of the governors and the government, and the level of popular dissatisfaction with the work of these two levels of authority has risen by several percentage points over the last year<sup>36</sup>.

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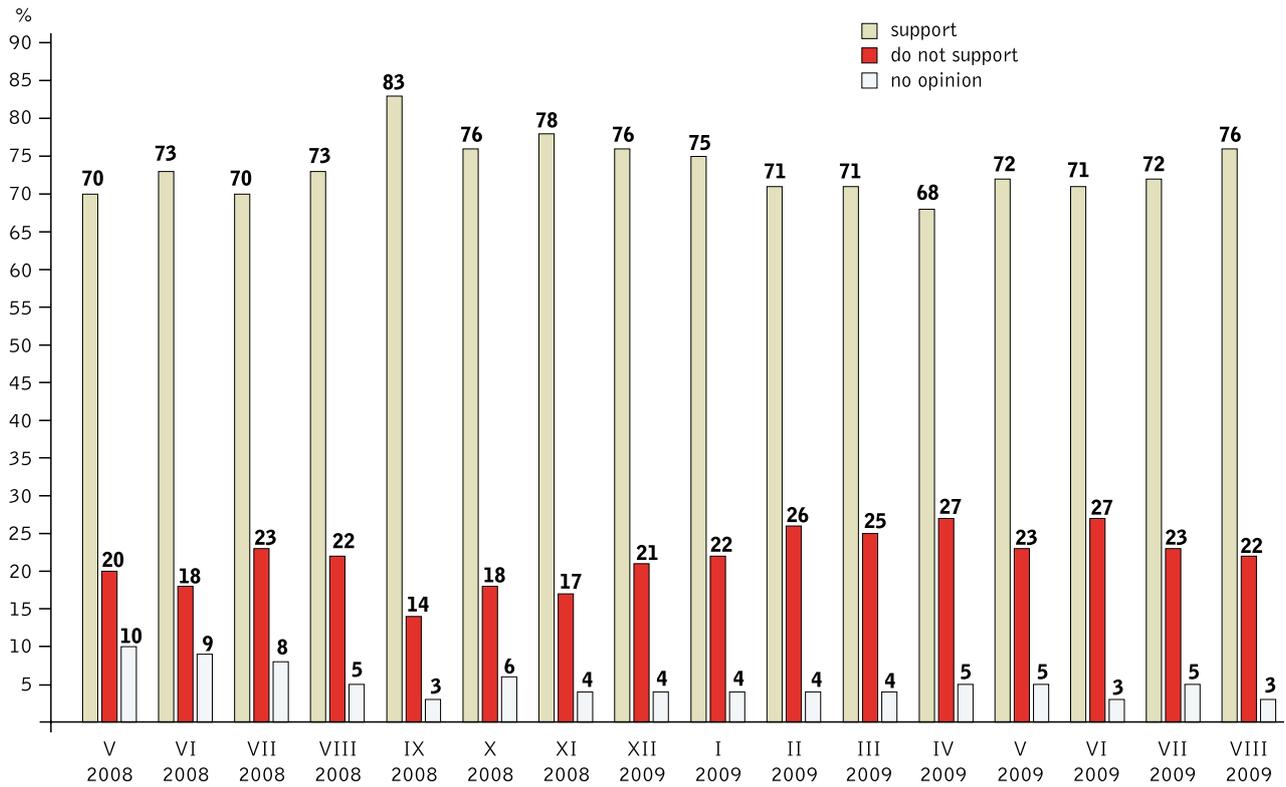
<sup>33</sup> Levada Centre Research: Lewady: <http://www.levada.ru/press/2009082001.html>

<sup>34</sup> Based on a survey by the Levada Centre on 19 June 2009: The most frequent answers to the question about the significance of Putin's visit to Pikalevo included: 1) Putin is an energetic and efficient politician who feels personally responsible for solving the difficult problems (21%), 2) The state operates ineffectively, and interventions of the highest-ranking state officials are necessary (16%), 3) Putin is concerned about the problems of ordinary people (13%).

<sup>35</sup> Data from the FOM public opinion institute: <http://bd.fom.ru/pdf/d25sobvpik.pdf>

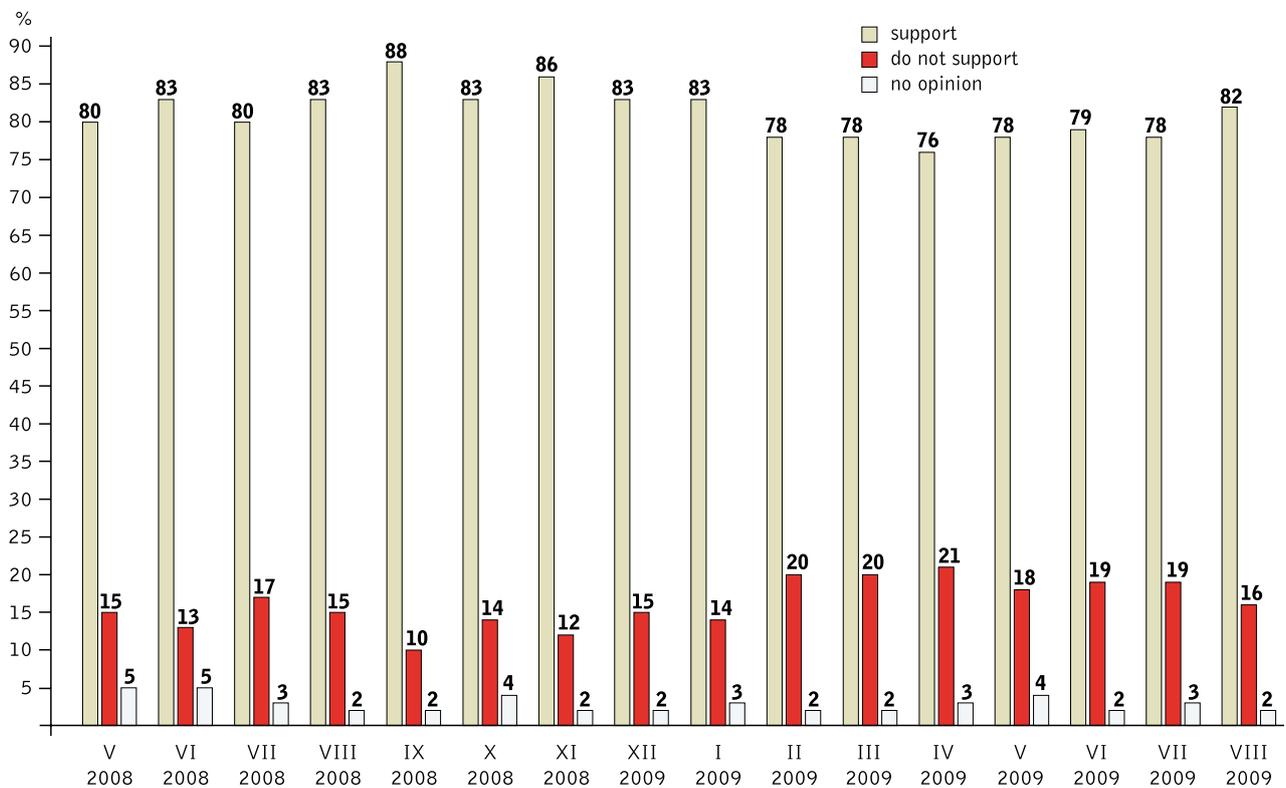
<sup>36</sup> Research by the Levada Centre: <http://www.levada.ru/press/2009072202.html>

**Chart 12. Popular support for President Medvedev's actions**



Source: Levada Centre survey from 20 August 2009, <http://www.levada.ru/press/2009082001.html>

**Chart 13. Popular support for PM Putin's actions**



Source: Levada Centre survey from 20 August 2009, <http://www.levada.ru/press/2009082001.html>

### 2.3.1.2. A passive and fragmented public

The financial problems experienced by employers have led to an increased number of protests in the regions, whereby the protesters usually demanded measures that would improve the economic situation of the given plant's employees. The protests were usually staged by people who had not much to lose, who had been receiving no remuneration for a long time, and whose families were living in very poor material conditions, in those cases where the given plant's bankruptcy threatened to entail a deterioration of the welfare situation in the entire region.

**However, such local outbreaks of heightened frustration have not entailed a broader social mobilisation in Russia or any massive, nationwide protest actions.** Public opinion polls suggest that at the national level, in practice **there has been no rise in feelings of protest.** During the period between June 2008 and June 2009, the number of those declaring readiness to take part in a protest ranged between 20% and 31%, depending on the month; this is around the level which has usually been observed in Russia since 2005<sup>37</sup>. When looking at those figures, one should take into account the fact that a declaration of a certain intention is not equivalent to its practical realisation. According to the FOM public opinion institute, only 2% of Russians are really prepared to participate actively in a protest action.

The fact that popular frustration has only manifested itself in local and short-lasting protests reveals the low level of Russian public activity. It seems that the inability to take collective action has been the main factor causing this political and social passivity in Russia at this time. It has been difficult for the public to mobilise not only because of the traditional attitudes of the Russians, who rather expect the authorities to solve the problems, but also because of the **weakness of the leaders of civil society and of any organisational structures that could exploit and co-ordinate popular frustration.** In Russia, there are no strong trade unions independent of the government, influential political opposition parties or authoritative non-governmental organisations (cf. section 2.1.1.). The authorities have been able to impede their development thanks to the mechanisms for regulating civil activity, such as the 2006 act imposing stricter state control over the NGO sector, or the competition for state grants in which it has been the organisations (such as human rights NGOs) loyal to the authorities or politically neutral projects (such as social and cultural initiatives) that have been given funding. In addition, **the authorities have been creating virtual civil-society organisations to imitate civil activity.** The Public Chamber established in 2006 is one such organisation: it was supposed to guarantee public participation in political life, although it has more often been engaged in propaganda functions aimed at legitimising the government's activities.

Finally, the fact that the Russian people have demonstrated a less-than-proactive attitude in organising protests seems to be also related to **their high tolerance for difficult living conditions and their skill in adapting to difficult situations.** For instance, such an approach to the Russian state's financial troubles is visible in the Levada Centre poll which states that up to 63% of the Russians believe they simply need to patiently wait until the crisis is over and life gets better again<sup>38</sup>.

### 2.3.1.3. Individual survival strategies

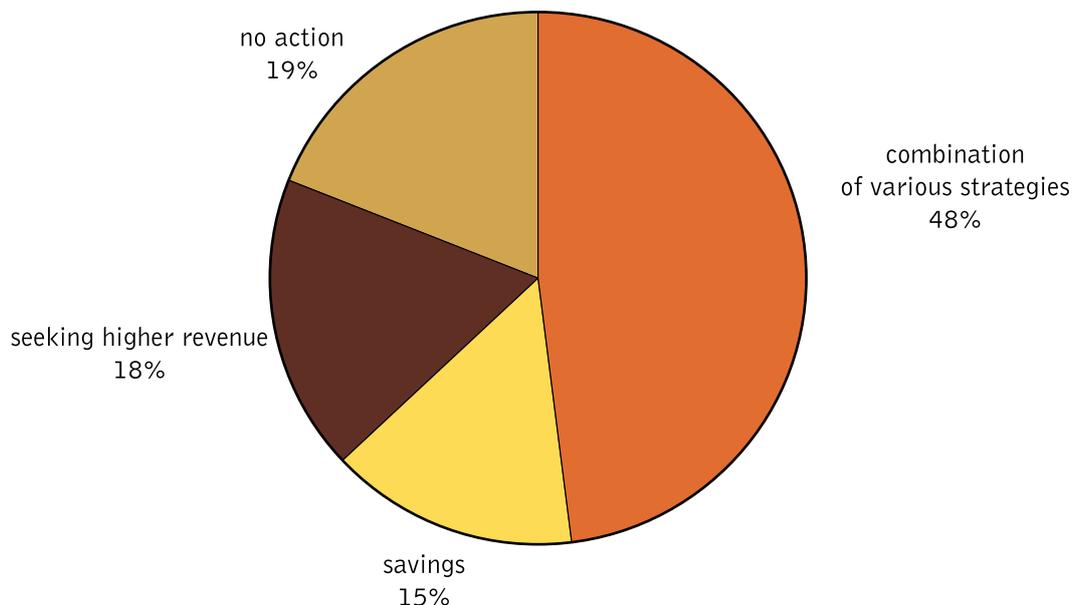
While the Russians are passive and apathetic at the level of general society, in private life they demonstrate much more active attitudes in developing their individual strategies to survive the crisis.

<sup>37</sup> Research by FOM, 09.07.2009.

<sup>38</sup> <http://vkzizis.ru/news.php?news=1199&type=rus&rub=soc>

According to the FOM opinion poll institute, there are at least **four distinct strategies for adapting** to the deteriorating material conditions. **The most popular** (declared by 48% of respondents) **is to respond to financial problems with a combination of several different actions** such as finding an additional job, saving, taking a bank loan, or growing fruit and vegetables in one's own allotment garden.

**Chart 14. Adaptation strategies employed by the Russian people to cope with worse material conditions in times of crisis**



Source: FOM research, June 2009.

Other declared ways of coping with the crisis include **saving** (declared by 15% of respondents) and **attempts to earn a higher income** by seeking a new, better-paid job, taking additional paid jobs, or acquiring new skills (18%). Fewer than one-fifth of Russians demonstrate complete passivity when facing financial problems.

The most common reaction to financial troubles during the crisis has been to tighten one's belt, in addition to any other action taken. **The Russian people have started to spend less on goods and services, and to save more.** According to the Deposits Insurance Agency, banking deposits of individuals have increased by up to 12% during the first seven months of 2009 and are expected to increase by further 20–24% by the end of the year, according to the Agency's forecasts<sup>39</sup>. The scale of savings is also visible in the Rosstat figures, indicating that consumption spending has dropped by 9.6 percentage points over last year (from 71.7% of income in June 2008 to 62.1% in June 2009), while the proportion of income set aside as savings has doubled (from 8.5% to 17.9%). The last time that consumption in Russia decreased was ten years ago, during the banking crisis of the late 1990s<sup>40</sup>.

The Russian people cope with financial troubles in different ways, often resorting to methods proven back in the Soviet times and during the crisis of the 1990s. The common and almost indispensable way to save money while prices are rising in the shops is to grow one's own fruit and vegetables instead of ornamental plants in the popular allotment gardens (dachas). The fact that Russians are

<sup>39</sup> *Kommersant*, 03.09.2009.

<sup>40</sup> Rosstat figures, source: [www.vedomosti.ru](http://www.vedomosti.ru) 31.07.2009

increasingly using their dachas to support the family budget in times of crisis is apparent in the increased demand for fruit and vegetable seeds (total sales of which rose by 40% last year, and by 200% in the case of potatoes for planting<sup>41</sup>), as well as in the opinion polls, according to which as many 81% of those who own a dacha or a home in the countryside treat their allotment gardens as a source of agricultural products for the family (compared to 72% in 2005).

### 2.3.2. The ruling elite and the crisis

The way the crisis has been developing in Russia demonstrates that **the stability of the current elite's power does not directly depend on the economic situation in Russia**. Despite the sudden deterioration of economic conditions, including that of the budget deficit (for the first time in ten years), the ruling class's economic and political standing has not been shaken; on the contrary, it has been consolidated.

Members of the leadership **have carried on their economic expansion** during the crisis. They have been assisted by two factors: on the one hand, the control they have been exercising of state funds held in the reserve funds and investment banks (for example, Putin chairs the board of directors of Vneshekonombank, one of the main lenders in Russia), and on the other, the weaker position of the many private companies which have been struggling with financial problems. By offering them financial assistance, key state officials (who are at the same time members of the ruling elite) have been able to increase state control over their businesses (see section 1.3.1.).

The biggest winners of this 'crisis expansion' include the Rostekhnologii state corporation chief Sergei Chemezov (see frame), the Gunvor oil trade company chief Gennady Timchenko (see frame) and the deputy PM for energy issues Igor Sechin (who controls the Rosneft oil concern, and has been using his post in the government to obtain financial support for the company, as well as favourable changes in the energy legislation). These men have been accumulating assets in a non-transparent manner, and their actual holdings have often been revealed only after a lengthy period of time. There has been hardly any social and political supervision of this economic expansion process.

Even though it has never been homogenous and has brought together representatives of different communities, the Putin ruling elite has remained relatively undivided, and has experienced no major conflicts or splits as yet. While the difficult economic situation in Russia and the budget problems have led to a stepping-up of the disputes over budget funding (which, for instance, have been a regular occurrence between the finance minister Alexei Kudrin and the Rostekhnologii chief Sergei Chemezov), those disputes have always been settled within the elite (partly thanks to the fact that there are sufficient funds within the budget to support individual elite members) and have never destabilised it.

The current ruling group has been progressively **consolidating its political power**. Loyal to the Kremlin and the government, the parliament amended the Russian constitution in late 2008, extending the president's tenure from 4 to 6 years (the change is to come into effect as of the next presidential election). Extending the president's rule is in line with the broader strategy of the current ruling elite, which has been seeking to consolidate its power and hold on to it as long as possible. The elite's position in the political scene is also illustrated by the fact that its actions to strengthen its grip on power have not triggered any open protests by the public, business circles or regional elites.

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<sup>41</sup> <http://www.newsru.com/russia/26jun2009/dachi.html>

## 3. CONCLUSIONS

### 3.1. Economic consequences of the crisis

The limited **public aid resources have been distributed by the ruling elite in a non-transparent manner, and used instrumentally to tighten the elite's control of the economy.** As Russian entrepreneurs have had only limited access to the international capital, the financial reserves of the Russian Federation, which were accumulated over the eight prosperous years, have offered the Russian ruling elite a huge advantage over those private businesses that have no direct links to the leadership. At the same time, the people in charge of the distribution of aid funding have been the main beneficiaries of the anti-crisis measures (such as deputy prime minister Igor Sechin, who is also the chairman of the board of directors of Rosneft, a company which benefits from that very same financial support).

The financial crisis has forced the authorities to resort to interventionism and use non-standard solutions to save those economic operators who are experiencing financial difficulties. Such measures have proved necessary to stabilise the economic situation in Russia. However, opportunities to develop effective assistance mechanisms have been limited: the public aid instruments were being developed under the pressure of time, and along guidelines dictated by those who would directly benefit from the assistance, in a situation in which total power in Russia has been concentrated in the hands of the executive authority which also controls the system of supervision over public spending. As a result, the **aid has often served as a way for the ruling elite to take over more private assets.** As a consequence, the **largest amounts of aid have been offered to ineffective state-owned establishments which have not made the slightest effort to restructure. The anti-crisis programme hardly includes any measures to promote exports, especially high-technology exports, or boost competition** (the programme to promote competition adopted in February 2009 has produced no results so far). Likewise, there has been no observable support for innovation or development, or to enhance the efficiency of the natural-resource monopolies and large corporations. Consequently, the anti-crisis policy has undermined the pro-innovation dimension of the government's policy (first introduced before the crisis). Vneshekonombank (the Development Bank) has become the main agent distributing public aid, instead of focusing on the tasks for which it was created, and the financial resources of Nanotekhnologii (a state corporation established to promote innovation in Russia) have been slashed due to the need to finance the government's anti-crisis programme.

When developing the anti-crisis programme, the Russian government acted on the conviction that the previously accumulated reserves would suffice to spare Russia from any major financial difficulties at least until 2010 when, it was predicted, the negative trends in the financial and raw materials markets would reverse. One year on, however, the Russian elite is increasingly aware that Russia's recovery from the crisis may be a costly and lengthy process, and may require financial assistance from abroad. For political reasons, Russia is reluctant to turn to the international financial institutions for loans (because such loans would be offered subject to conditions concerning reforms), and commercial loans could turn out to be quite costly for the Russian Federation. Therefore, deputy prime minister Igor Shuvalov **proposed** in September 2009 that the **privatisation process should be resumed**<sup>42</sup>, espe-

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<sup>42</sup> 'Russia's controlled opening to foreign investors', *ibidem*.

cially since the market values of Russian companies have been gradually returning to pre-crisis levels. **It is unlikely, though, that the authorities would concede control of the economy's so-called strategic sectors.** Russia's recovery from the crisis may be assisted by foreign investors; the Russian authorities wish to engage them in joint ventures in a hope of thus obtaining new technologies.

### 3.2. Social consequences of the crisis

The Russian general public has been experiencing the crisis mainly in terms of a **deterioration of the market labour situation.** Employers' financial problems have led to a rise in unemployment, reduced working hours and forced leave, all of which have driven incomes down. The labour market crisis has been one of the main causes of social problems in the regions, and has triggered tensions, which in many cases transformed into local protests by workers.

**However, the local outbreaks of discontent have not grown into a general social mobilisation or led to massive, nationwide protest actions.** Thanks to the effective pro-Putin propaganda strategy, the Russian people have blamed the economic problems experienced by their respective regions on the regional authorities, businesses and the government administration. Meanwhile, the strategy has built the **image of PM Putin** as an energetic and effective politician trusted by the Russians to solve the urgent social problems.

The way the Russian public have responded to the crisis and the government's anti-crisis strategy is a good characteristic of this society in general. The Russian society is politically passive and displays low social activity which signifies its **deep fragmentation and the lack of grassroots social structures**, such as influential independent trade unions, genuine political opposition or authoritative non-governmental organisations, that could co-ordinate the protests and coherently channel popular discontent. The absence of such mechanisms, however, does not mean that Russians are a completely passive society. In the private sphere, they have been displaying much more active attitudes in devising individual strategies to cope with the crisis.

### 3.3. Political consequences of the crisis

The current ruling elite built up its position during the period of prosperity when the Russian public, satisfied with improving standards of living, allowed then president Putin to concentrate power in his hands and restrict public and political supervision of the ruling elite's activities to a minimum. After eight years of this kind of policy, the current economic crisis has demonstrated that **given the present level of power concentration in the hands of the elite, the economic factor no longer has any direct impact on the leadership's political position.**

The control exercised by the elite over financial and propaganda instruments has enabled it to maintain its popularity (the main source of its legitimacy), especially the popularity of the 'nation's leader' Vladimir Putin. The political institutions, which have been turned into 'vassals' during Putin's presidency, can offer no counterpoise to the ruling elite. Nor has the elite been challenged by any serious opposition stemming from the liberal democratic, business or regional communities. The concentration of political and force instruments has enabled the authorities to keep any potential leaders in check and prevent them from consolidating anti-Putin forces.

In some spheres, the crisis has even helped to promote the strengthening of the elite, especially in economic terms. It has enabled faster economic expansion, at the expense of those private companies which do not have closer relations with the authorities but are experiencing serious financial problems; they are forced to seek public aid, and to concede some control over their enterprises in return.

Even though the economic situation and the condition of the Russian budget have deteriorated considerably during the crisis, no major conflicts have occurred between elite members vying for the shrinking financial resources needed to support their companies. Disputes within the leadership have not yet caused any splits in the elite, nor shaken the stability of its power. Nor have the composition and structure of the elite (including Putin's role as an arbiter ensuring equilibrium between the different groups in the leadership) changed as a result of the crisis.

Thus, the crisis has only solidified the ruling elite's conviction that its model of political and economic development is the right one. From the Russian leadership's point of view, this model has proved effective both in times of prosperity, as it has enabled the elite to gain a political monopoly and appropriate assets, and in times of crisis, when it has allowed it to neutralise the social, economic and political challenges and retain its dominant position.

## 4. FORECAST

Two general scenarios of developments over the next eighteen months appear possible at this stage: the scenario of inertia, and the scenario of a prolonged and deep economic crisis. The former seems to be the much more likely. As the world's economies gradually overcome the crisis, the demand for raw materials will probably grow; consequently, it is unlikely that the prices, especially of oil, will fall significantly below the current levels. The Russian economy has also been showing signs of improvement, and the government still has the financial reserves accumulated in prosperous times at its disposal.

### 4.1. The scenario of inertia

In the most probable **scenario of inertia**, oil prices will stay at the current level (US\$60-80 per barrel) for the next eighteen months; the second phase of the banking crisis triggered by the so-called bad loans (expected in 2010) will not be too severe, no serious liquidity problems will occur, and the government's anti-crisis programme will start to bear fruit; for example, consumption will stop falling and lending activity will halt the decline in production. In this scenario, **recovery from the crisis will be very gradual**. Even though Russia will probably report economic growth of around 1% in 2010, **it will not regain its pre-crisis level of development until 2012**. The economic problems will continue in the coming months, some companies will continue to make workers redundant and some will go bankrupt; others will keep receiving public aid despite their inefficiency, because the state's financial reserves, even though they are running out, will suffice for the government to selectively support the key economic sectors. **It is also possible that some adjustments will be made in the current economic policy**. Some conditions may be imposed on the large state-owned establishments receiving public aid, and improved efficiency may be required from the beneficiary companies. It is also possible that Russia will open its market more to foreign capital and the new technologies that come with it. It is also probable that the government will resume the privatisation process, initiated before the crisis, on condition that the state maintains control of the so-called strategic sectors of the economy.

As a consequence of extensive public spending, Russia will again report a budget deficit in the coming years (7.5% in 2010). Expensive foreign loans or privatisation revenues will most probably be needed to cover the deficit because the Reserve Fund runs out of funds in 2010, and the National Wealth Fund (which has been supporting the pensions system) does likewise in 2015. Nevertheless, this scenario will prove the efficacy of the state's current economic policy, which has been guaranteeing high revenues for the ruling elite and consolidating its conviction that thorough reforms and the regulation of the economy through free competition can be avoided. As a consequence, **the Russian economy will remain dependent on the raw-materials sector, and the crisis will be used as an opportunity for a further re-partitioning of property in Russia**, of which the current ruling elite will be the main beneficiary. New opportunities for re-nationalisation may be offered by Vneshekonombank's credit programme for Russian companies. Vneshekonombank may use the outstanding loans of private entrepreneurs to take over those shares on which liens have been established.

The problems experienced by companies will continue to create a difficult situation on the labour market. One should expect unemployment to increase further and employers to continue cutting back on working hours, as a result of which **standards of living in Russia will continue to deteriorate**.

More welfare-motivated protests in the regions may to break out, but the authorities have at their disposal the instruments needed to control and neutralise such outbreaks (through the use either of force, increased welfare spending, or both). The experience of the first months of the crisis has shown that the **Russian people have proved themselves able to gradually adapt to the deteriorating material conditions**, to fend for themselves and devise ways to manage their household budgets.

In spite of the social and economic problems, the current ruling elite is expected to stay in power, primarily because there is no real alternative. It is unlikely that such an alternative should emerge from the aftermath of the crisis. The authorities are determined to defend their privileged position, and so they will use the necessary financial and propaganda instruments to neutralise the threats as they appear, which should suffice in the case of a crisis of medium severity. **The present 'soft authoritarianism', whereby the current ruling elite holds a monopoly on the most important political and economic decisions and maintains its popularity with the people**, seems most likely to continue over the next few years.

## 4.2. The scenario of prolonged and severe crisis

**In the scenario of prolonged and deep economic crisis** the oil prices will drop below the current levels (US\$60-70 per barrel), the second wave of the banking crisis will be severe, many companies and banks will go bankrupt, the state will face difficulties in financing the budget deficit, and the Russian rouble will continue to depreciate. Such a deepening crisis could force the Russian authorities to revise their current economic policy, stop providing financial assistance according to political criteria, limit budget spending, carry out partial reforms to the system, genuinely improve conditions for small businesses, and open up the economy more to foreign investments. This would create opportunities for the development of industries other than the raw materials sector and of small and medium-sized enterprises.

**A lengthy and deep crisis could force the authorities to cut welfare spending.** If the government stops subsidising unprofitable sectors of the economy or indexing pensions and public sector salaries, the incomes of large numbers of Russians will decrease. **Such ongoing pauperisation may prompt the public to stage massive protests**, which will be unpredictable and difficult to control in the absence of structures such as trade unions or non-governmental organisations that could act as intermediaries in the negotiations between the public and the ruling elite.

However, even if the economic problems drastically worsen and social protests escalate, **the likelihood of the current ruling elite losing power appears to be minimal.** The authorities have the instruments of force needed to ensure public order. The concentration of power also enables them to prevent the emergence of any real political alternative. A real threat to the leadership could come from an escalation of conflicts within the ruling group over the shrinking financial resources. In extreme conditions, such rivalry could even lead to divisions in the elite and the emergence of a new leader and arbiter who would replace Vladimir Putin. Such a scenario, however, does not appear realistic, primarily because the economic trends seem to be improving, both in Russia and worldwide. Moreover, the current elite is interested in stability and in ensuring that potential change is evolutionary, because it controls the major assets it has acquired in recent years. For this reason, it will seek to avoid any violent conflicts that could result in reshuffles and a re-distribution of property, despite the financial difficulties.

## Appendix 1.

### Economic indicators in Russia between 2000 and 2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
<b>GDP, %</b>	9.0	5.1	4.7	7.3	7.2	6.4	6.7	8.1	5.6
<b>Industrial production, %</b>	11.9	4.9	3.7	7.0	7.3	4.0	3.9	6.3	2.1
<b>Inflation (December to December), %</b>	20.2	18.6	15.1	12.0	11.7	10.9	9.0	11.9	13.3
<b>Foreign direct investments, based on balance of payments (US\$ billion)</b>	2.7	2.5	2.6	8.0	15.5	12.9	29.7	55.1	73.0
<b>Russian foreign direct investments abroad, based on balance of payments (US\$ billion)</b>	3.2	2.7	3.5	9.7	13.8	12.8	23.2	45.9	52.6
<b>Currency and gold reserves of the CBR (US\$ billion, as of 1 January)</b>	12.5	28.0	36.6	47.8	76.9	124.5	182.2	303.7	476.4
<b>Federal budget surplus (% of the GDP)</b>	2.5	3.0	2.3	1.7	4.1	7.5	7.4	5.4	4.1
<b>Stabilisation Fund, and since 2008, the total of Reserve Fund and National Wealth Fund (US\$ billion, as of 1 January)</b>							82.1 (1 VIII)	89.1	156.8
<b>Commodity exports (US\$ billion)</b>	105.6	101.9	107.3	135.9	183.0	245.0	304.5	355.2	471.8
<b>Commodity imports (US\$ billion)</b>	44.9	53.8	61.0	75.4	97.0	125.0	163.9	223.1	292.0

Source: CBR; Federal State Statistics Service (Goskomstat/Rosstat); Ministry of Finance of the Russian Federation

## Appendix 2.

### Real incomes in Russia between 2000 and 2008<sup>43</sup>

	2000	2001	2002	2003	2004	2005	2006	2007	2008
<b>As percentage of the same period in the preceding year</b>	112.0	108.7	111.1	115.0	110.4	112.4	113.5	112.1	102.9

<sup>43</sup> Based on Rosstat data in Rossiyskiy Statisticheskiy Yezhegodnik 2008 and [http://www.gks.ru/bgd/free/B09\\_00/IssWWW.exe/Stg/d07/6-0.htm](http://www.gks.ru/bgd/free/B09_00/IssWWW.exe/Stg/d07/6-0.htm)

Appendix 3.

Industrial production (as percentage of the same period in the preceding year)

	II /08	III/08	IV/08	I/09	II/09	III/09	1 <sup>st</sup> half of 2008	2008	1 <sup>st</sup> half of 2009
<b>Industrial production</b>	5.5	4.7	-6.1	-14.3	-15.4	-11.0	5.8	2.1	-14.8
<b>Extraction industries</b>	0.3	0.6	-1	-3.8	-3.1	-2.2	0.5	0.2	-3.4
<b>Manufacturing</b>	8.1	6.4	-7.7	-20.8	-21.6	-15	8.4	3.2	-21.3
<b>Electricity, gas, water production and distribution</b>	2.1	-10.4	-5.4	-5.1	-6.3	-10.3	4.1	1.4	-5.6

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