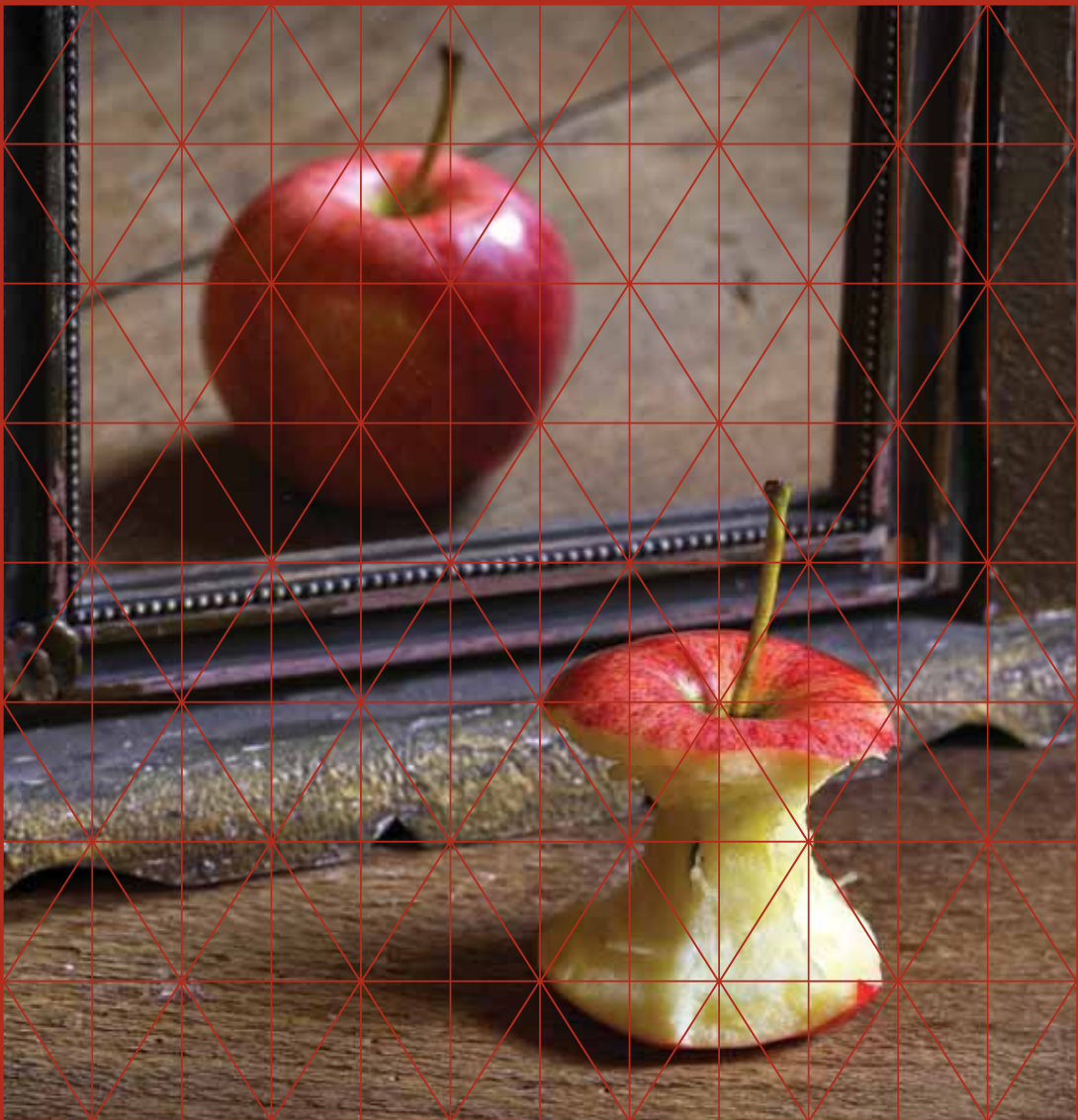


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CRISIS IN RUSSIA

THE DEGRADATION OF THE MODEL
OF ECONOMIC GOVERNANCE

Maria Domańska

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OF ECONOMIC GOVERNANCE

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THESES

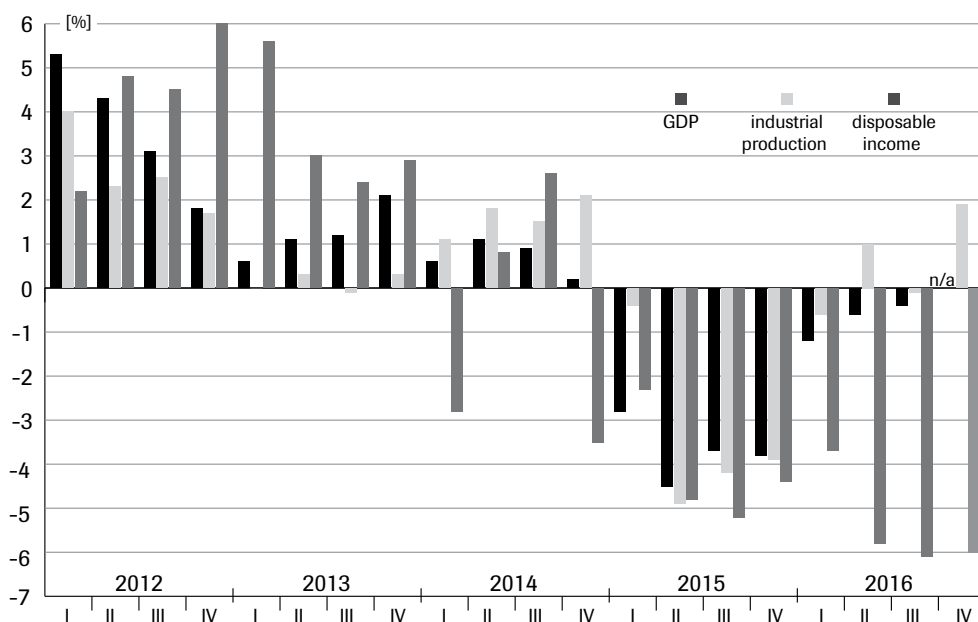
- Russia has been dealing with an economic crisis since the beginning of 2015. It has chiefly affected the Russian public who need to cope with the most serious decline in real incomes since 1998. Public finances have also been seriously affected: the worst problem for the government is the need to find sources for to plug the budget gap, with dwindling revenues from the export of raw materials and reserves, and limited access to foreign loans. In turn, the recession has relatively mildly affected the real sphere of the economy, according to data showing the dynamics of the fall of GDP and industrial production.
- The crisis is not so much a consequence of the current difficulties caused by the slump on international raw material markets as proof of a serious dysfunction of the model of economic governance adopted by the Russian government – a model skewed towards the individual interests of the power elite. The systemic nature of the crisis has been revealed in governmental forecasts: even though, according to them, the recession will end in 2017, it is expected to be followed by a long-lasting stagnation (perhaps even two decades-long).
- This means that the present crisis significantly differs from the economic crises which affected Russia in the past. The existing problems are not a transitional phenomenon; they determine ‘the new normal’ which will last for many years and will be characterised by a constant lack of development perspectives. **The formal end of the recession will thus not be equivalent to the end of the crisis of the economic model. Instead there will only be a transition from the acute to the chronic phase characterised above all by a gradual and unstoppable degradation of the Russian economy and the living standards of the Russian public. This is so because it is impossible to guarantee stable, economic growth of several per cent without extensive and painful system reforms.**
- However, the political nature of the sources of the crisis makes it significantly more difficult to overcome its consequences, because the government has no desire to overhaul the present model of state governance. Their priorities include maintaining control over political and social life and regaining Russia’s superpower status on the international arena. Economic development is thus given a lower priority, and the tactical anti-crisis measures taken by the government are predominantly for the sake of appearances and intended to serve political and propaganda goals.

- Paradoxically, this tactic has a great chance of success in the next 2–3 years: the economic crisis will not become an independent catalyst of a political crisis. The likelihood of massive public protests is very low, which is an effect of both the paternalistic mentality and atomisation of the Russian public, as well as their fear of repressions. A mutiny inside the elite, who strongly identify themselves with Putin’s system, is equally unlikely despite the limited opportunities to build their personal fortunes during a crisis.
- In the longer term, the Kremlin will face serious challenges resulting from both budget problems and possible errors in diagnosing and forecasting the social situation. However, if one assumes that the Russian government will refrain from hasty moves that might destabilise the socio-political situation in the country and that the international community will spare Russia serious turbulence, the probability of major threats to the government elite seems low. Russia’s most serious problem will be long-lasting stagnation and a worsening backwardness when compared to developed countries.

I. FROM RECESSION TO STAGNATION – THE COURSE AND THE DYNAMICS OF THE ECONOMIC CRISIS IN RUSSIA

Russia has been struggling with recession since 2015. This is the fourth serious economic crisis in this country in the past 25 years. Proof of the crisis include the macroeconomic results for 2015–2016: the fall in GDP and industrial production, the decrease in people’s real incomes and wages, and inflation. Consumer spending (this accounts for 50% of GDP) and investments (which cover a further 20% of GDP) have decreased, and the decline in foreign direct investment, which are essential for development perspectives, has been dramatic¹.

Chart 1. The dynamics of GDP, industrial production and real disposable income of the population year-on-year



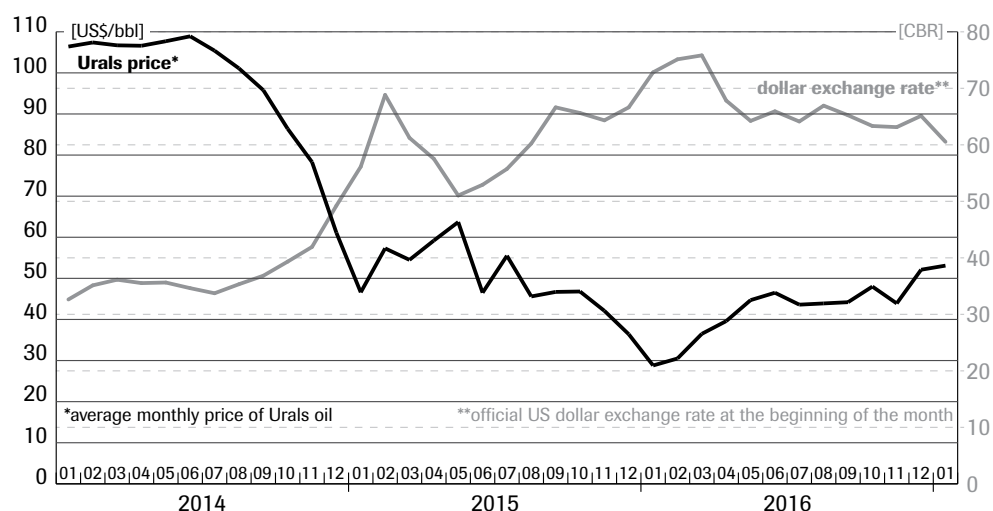
Data on GDP growth may be substantially revised due to the modification of the methodology applied by Rosstat.

Source: Author’s own analysis on the basis of data from Rosstat (www.gks.ru).

¹ According to UNCTAD, in 2015 (no data for 2016 is available) it fell by as much as 92% against 2014 figures. Furthermore, the influx of FDI to Russia in 2014 was more than three times lower than in 2013.

Although most of these phenomena suggest that the recession (in the strict meaning of the term) began in the first months of 2015, when Russia's economic problems were fully laid bare, **clear tendencies for crisis had been growing already from the second half of 2014**. They were above all an effect of: a significant drop in oil prices, the consequences of the Western financial sanctions imposed on Russia in July 2014 and the fall in the value of the rouble. Coupled with the mistakes made by the Russian Central Bank (including lengthy and unsuccessful attempts to maintain the value of the rouble at its previous level at the expense of a significant reduction of foreign currency reserves) and speculation on the Russian currency market, all this led to an accumulation of the negative phenomena observed in December 2014. This resulted in the collapse of the rouble which in turn led to the deterioration of the financial situation of Russian banks, companies and citizens².

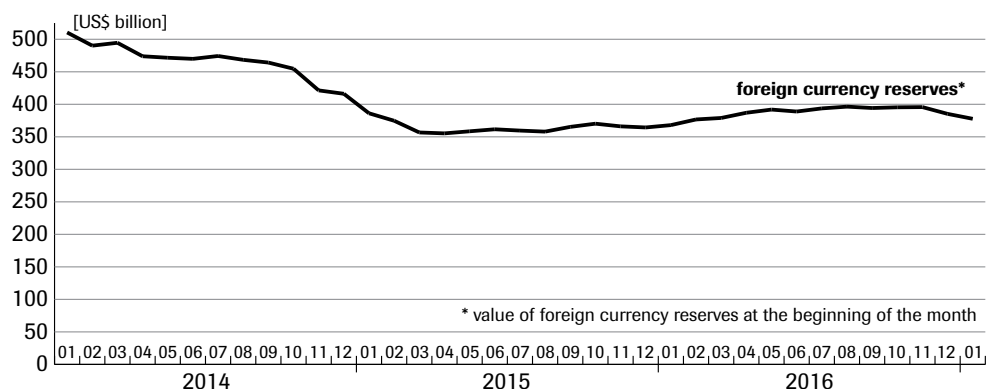
Chart 2. Dynamics of Urals oil prices and the dollar exchange rate (in 2014–beginning of 2017)



Source: Author's own analysis on the basis of data from the Ministry of Finance and the Central Bank of the Russian Federation (www.minfin.ru, www.cbr.ru)

² For more information on the crisis in December 2014 see: The economic and financial crisis in Russia – background, symptoms and prospects for the future, *OSW Report*, 6 February 2015, <https://www.osw.waw.pl/en/publikacje/osw-report/2015-02-06/economic-and-financial-crisis-russia-background-symptoms-and>

Chart 3. The Central Bank's foreign currency reserves (in 2014–beginning of 2017)



Source: Author's own analysis on the basis of data from the Central Bank of the Russian Federation (www.cbr.ru)

The major fall in oil prices has proven durable and it has had the strongest direct effect on the deterioration of the macroeconomic indicators leading to a reduction of revenues from oil exports and the depreciation of the Russian currency. This in turn increased the costs of both imports and the servicing of foreign debt³. **The situation worsened due to the Western financial sanctions** imposed on Russia in July 2014 in response to its military aggression in Ukraine. They weakened the rouble further still, but above all they significantly reduced the opportunities for Russian entities to acquire new foreign loans and to refinance their previous debts. Although the direct impact of the sanctions has diminished over time⁴, their indirect and informal effect can still be felt (this concerns even those Russian entities, including the Treasury, on which no direct sanctions have been imposed⁵). The international rating agencies

³ In 2015, revenues from oil exports fell by over 40% to less than US\$90 billion, compared to almost US\$154 billion in 2014. Between January and November 2016, they reached US\$66.4 billion (a 20.3% year-on-year fall). Incomes were falling despite the growing volume of oil exported every year (by almost 9.5% in 2015 and by 4.9% in January–November 2016). Data from the Federal Customs Service: www.customs.ru

⁴ For information on the impact of financial sanctions on the Russian economy see, Maria Domańska, Szymon Kardaś, The consequences of the Western financial sanctions on the Russian economy, *OSW Commentary*, 24 March 2016, <https://www.osw.waw.pl/en/publikacje/osw-commentary/2016-03-24/consequences-western-financial-sanctions-russian-economy>

⁵ In February 2016, the US government recommended American banks to be cautious about participation in the placement of Russian treasury bonds since they might be used as a channel to indirectly finance the entities on the sanctions list. A similar recommendation addressed to European banks was included in unofficial statements from representatives of institutions of the European Union in March 2016; <http://www.wsj.com/articles/u-s-warns-banks-off-russian-bonds-1456362124>; <http://www.rbc.ru/rbcfreenews/56e-8813a9a79472d1d86dbcf?from=main>

(S&P and Moody's) decided at the beginning of 2015 to downgrade Russia's credit rating to the 'junk' or non-investment level due to the deterioration of its economic situation and international image (Fitch was the only agency to leave Russia's rating at the lowest investment-grade level). Since the financial markets are globalised, **the government has limited possibilities to neutralise economic problems by way of the influx of money from other countries** (even from those which have not imposed sanctions on Russia).

As shown by macroeconomic data, a few characteristic features of the crisis in Russia can be distinguished that are especially visible in comparison with the recession in 2009.

First of all, the real sector has so far been affected to a much lower level. The fall in GDP and industrial production is much milder than in 2009 (then, as a consequence of the slump on international markets and lowering demand for Russian raw materials, these indicators fell by 7.9% and 10.8% respectively⁶). However, at the same time, the tempo of overcoming the crisis is noticeably slower; this time the recession will last for at least two years in aggregate (there was a decline in GDP in 2016 year-on-year).

In spite of the continuation of the negative tendencies in the economy, **the relatively mild impact of the crisis on the real sector facilitates** its gradual **adaptation to the new conditions**. In 2016, symptoms of a general improvement of the situation in the real sector were noticed: industrial production was falling at a slower pace and the losses incurred in 2015 were being made up for⁷. This happened both as a consequence of austerity policies adopted by companies (including the sale of foreign assets) and the government's moves: upholding the decision of 2014 to liberalise the rouble exchange rate and giving up ideas to regulate prices and to impose limitations on capital flow. There were also visible signs of moderate optimism among businesspeople and the general public as regards the evaluation of the economic situation. This, though, is not so much proof of the crisis being overcome, but rather of their getting used to living in crisis – this is facilitated above all by the lack of new serious market volatility⁸.

⁶ http://www.gks.ru/bgd/regl/b10_06/IssWWW.exe/Stg/1/0-0.htm

⁷ See Rosstat data, www.gks.ru

⁸ See data from VCIOM public opinion polls and the surveys conducted by Markit agency for August 2016. See <https://www.vedomosti.ru/economics/news/2016/09/05/655693-indeks-pmi-sferi-uslug-snizilsya>; <https://rns.online/consumer-market/Indeks-potrebitelskogodoveriya-v-Rossii-v-avguste-viros-do-36-punktov-2016-09-20>

At the same time, detailed statistical data indicate that the anti-developmental structure of the economy are becoming entrenched through adaptation processes; the chances for its modernisation are slim. The industrial production indicators are growing mainly owing to the constant slight growth in the primary sector resulting from the relatively stable (unlike in 2008–2009) demand for oil and gas on international markets and the unshifting share of Russian exports in the European oil and gas market⁹. In turn, a significant section of the processing industry is struggling with recession¹⁰. Although the depreciation of the rouble has improved the profitability of exports in some sectors which had been generating very low profits until recently (including the chemical industry¹¹), many other sectors are still in the high-risk group. This concerns for example the car industry, one of the technologically most developed sectors¹². The withdrawal from investment plans caused by the crisis along with the low rouble exchange rate are ruining the chances for modernisation of production by way of imports of goods and technologies. At the same time, the dynamics of foreign investments suggests that external investors are sceptical about engagement on the Russian market.

However, the consequences of the crisis have most of all affected the Russian public, especially the poorest sections of society¹³. Proof of this can be found in the dynamics of the fall in the real disposable incomes of the population¹⁴. Thus the recession seen in 2015–2016 radically differs

⁹ See data from the Ministry of Energy and the Central Bank concerning oil and gas exports; S. Aleksashenko, Is Russia's Economy Doomed to Collapse?, 1 July 2016, <http://nationalinterest.org/feature/russias-economy-doomed-collapse-16821>. The special construction of the fiscal system also helps the primary sector. This causes the decrease in oil and gas prices to adversely affect above all the revenues in the public budget, while companies' profits are affected to a lesser extent.

¹⁰ For example, the growth seen in the primary sector reached 2.5% in 2016. In turn, the output of the processing sector grew only by 0.1% (in the preceding year it fell by 5.4% as compared to 2014).

¹¹ С. Алекашенко, Потерянное дно: почему российская экономика не поддержала оптимистов, 28 June 2016, www.rbc.ru. There was growth in the chemical industry in both 2015 and 2016 (by 6.3% and 5.3% respectively).

¹² For information on this sector's problems on the example of Avtovaz see <http://www.rbc.ru/business/02/06/2016/5750012a9a79479c4b76a950?from=newsfeed>.

¹³ For more information on the social consequences of the crisis see: Jan Strzelecki, Painful adaptation. The social consequences of the crisis in Russia, *OSW Studies*, January 2017; <https://www.osw.waw.pl/en/publikacje/osw-studies/2017-02-06/painful-adaptation-social-consequences-crisis-russia>

¹⁴ After the 4% fall in 2015, incomes fell further in 2016 (by 5.9% year-on-year), while real wages remained on a level similar to the level seen in 2015 (their total annual reduction in 2015 reached 9.5%).

from the crisis in 2008–2009. Despite the economic slump, owing to support from the state budget, the real income of the population increased in 2009 by 2.3%¹⁵. By comparison, during the current crisis, starting from November 2014, their incomes have been constantly falling, which is the worst result since 1998. The crisis resulted in a significant increase in the number of poor people whose incomes are lower than the minimum subsistence level: from 16.1 million in 2014 to 20.3 million in January–September 2016 (13.9% of the population)¹⁶.

The public is feeling the consequences of the crisis in two ways. On the one hand, they need to face the consequences of inflation – both imported goods and domestic production have become more expensive as a result of the depreciation of the rouble. The factor which most determines people's living standards is the level of food prices: in 2015 it increased by almost 21% (while the prices of some food products, especially fruit and vegetables, rose by over 40%)¹⁷, and the noticeably slower price growth in 2016 was mainly an effect of the stabilisation of the rouble exchange rate and lowering consumer demand.

On the other hand, the public has felt the negative consequences of the real sector's adaptation to crisis conditions. The austerity strategies which companies have been applying include above all reducing working hours and wages, as well as functioning in the grey economy (informal employment covers between 25% and 40% workers in total¹⁸). Although more flexible employment rules led to a relatively low unemployment level (5.3% in December 2016), employees' sense of security is weakening. In mid-2016, more than 60% of respondents feared they could lose their jobs, while the number of people who have been unemployed for more than 12 months is growing, as is the average period of searching for a job¹⁹. This is one of the reasons for the increase in the

¹⁵ http://www.gks.ru/bgd/regl/b10_06/IssWWW.exe/Stg/1/0-0.htm

¹⁶ <http://www.interfax.ru/russia/540505>

¹⁷ <https://www.vedomosti.ru/business/articles/2016/01/13/623761-2015-podorozhali>

¹⁸ 11.7% of them work only in the grey economy. Data for April – May 2016. Н. Акиндинова, Я. Кузьминов, Е. Ясин, Экономика России: перед долгим переходом, апрель 2016; Bloomberg рассказал о желании Путина вывести из «тени» 30 млн россиян, www.rbc.ru

¹⁹ Data from RANEPА. <http://www.rbc.ru/society/05/07/2016/577bb8b69a79472d3a128a50>; <http://www.ranepa.ru/images/docs/monitoring/ek-monitoring/monitoring-march-2016.pdf>; Впервые за восемь лет расходы россиян на еду превысили остальные расходы, 19 April 2016, <http://www.vedomosti.ru/economics/articles/2016/04/19/638228-rashodi-edu>. For more information on the labour market's problems during the crisis see Jan Strzelecki, *op. cit.*

number of registered unemployed since 2015, which is proof of the loss of faith in the possibilities of finding a new job soon and of growing interest in receiving even small guaranteed benefits – especially given the widely shared conviction that the crisis will not end soon²⁰.

The situation is additionally complicated by the lack of budget funds for social welfare, which forces people to implement individual ‘survival strategies’ which envisage above all economising, sometimes radically (for example, around 45% of Russians are economising on food²¹). In contrast to the crisis in 2008–2009, the government is no longer able to combat recession through huge financial injections from the state budget.

The poor situation of the state budget is another essential feature of the crisis in 2015–2016. The federal budget entered the present crisis in a much worse situation than in 2008²². The consistently low oil prices forced the government to seriously amend the budget in 2015 and 2016, involving the adjustment of planned revenue and expenditure to the new price conditions. However, while in 2015 the adjustment did not upset the balance of the federal budget²³ and while the deficit turned out to be visibly smaller than planned (2.6% as compared to the expected 3%), the way the discussion on the budget in 2016 unfolded indicates that the state’s financial problems significantly deteriorated.

The Russian budget for 2016 was initially constructed with the assumption that the average annual oil price will be unrealistically high (US\$50 per barrel), which was a simple repetition of the assumptions from 2015, without taking into account the trends on the raw material markets. It was only the budget amendment in November based on the average annual oil price at US\$41 per barrel that reflected the market reality (the average oil price in 2016 reached US\$41.9). Budget revenues were also falling, to a great extent as a result of low

²⁰ Over 60% of respondents estimate that it will last for at least a year; <http://www.levada.ru/2016/09/26/krizis-i-ozhidaniya-uvolnenij/>. For information on the increase of registered unemployment see www.gks.ru

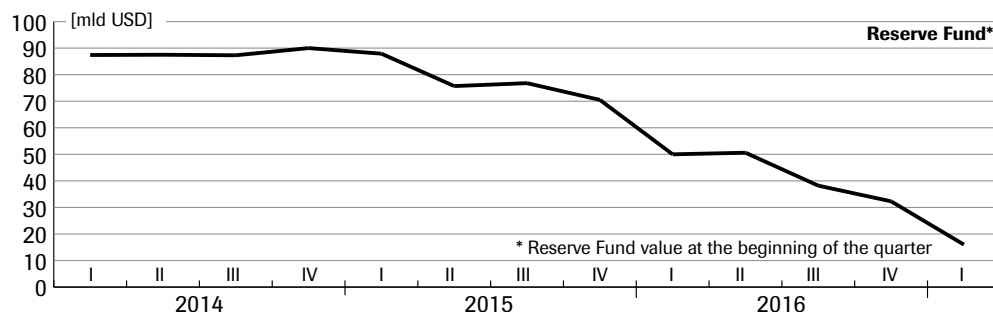
²¹ This indicator is three times higher than a year earlier. Survey conducted by Romir agency, data for April 2016; <http://www.rbc.ru/business/19/04/2016/57160a2b9a7947e599265f33>. Мониторинг социально-экономического положения и социального самочувствия населения, Май 2016. <https://isp.hse.ru>; Россияне сокращают покупки еды уже два года, 6 July 2016, www.ng.ru

²² In 2008, the budget surplus reached 4% of GDP, while in 2014 the deficit was at 0.5% of GDP.

²³ The average annual oil price initially assumed in the budget for 2015 (US\$96/bbl) was adjusted to US\$50, while the real average annual price was US\$51.2. By comparison, in 2014, the real average price was US\$97.6, and the one assumed in the budget was US\$93.

oil prices (in January-October 2016 they fell to 15.4% of GDP as compared to 17.3% of GDP in the analogous period in 2015)²⁴. The annual budget deficit in 2016 was 3.5%, according to the Ministry of Finance. The situation has been additionally worsened by the relatively low level of foreign currency reserves at the Central Bank, which is partly a consequence of unsuccessful attempts to stabilise the rouble exchange rate at the end of 2014, as well as the dwindling resources of the Reserve Fund – the main source of financing for the budget deficit²⁵.

Chart 4. Resources of the Reserve Fund (in 2014–beginning of 2017)



Source: Author’s own analysis on the basis of data from the Ministry of Finance of the Russian Federation (www.minfin.ru)

Russia’s economic problems thus seem to mutually fuel and exacerbate each other. The causes and the logic of this phenomenon are difficult to explain without examining the initial systemic sources of the economic crisis in Russia. These lie outside the economy.

²⁴ http://www.iep.ru/files/text/crisis_monitoring/2016_19-37_December.pdf

²⁵ Between November 2014 and January 2017, the Reserve Fund fell from around US\$90 billion to US\$16 billion. By comparison, Russia entered the crisis in 2008–2009 with over US\$142 billion in the Reserve Fund.

II. THE SYSTEMIC CAUSES OF THE ECONOMIC CRISIS – THE DYSFUNCTIONAL STATE GOVERNANCE MODEL

Russia's economic problems are to a great extent merely a manifestation of a crisis in the model of state governance. Its sources are *par excellence* political. The dysfunction of government institutions and the system of values on which the system of managing the public sphere is based has a huge impact on the economy as a whole.

Signs of this had become visible already in 2012, i.e. long before the present crisis and soon after the Russian economy made up for the losses caused by the recession in 2008–2009. Then GDP growth began to slow down even though oil prices remained high²⁶. As investments slowed down and investors' perception of the outlook for the Russian economy worsened, the capitalisation of Russian companies began to fall from 2011 – this process began a few years before the oil crisis and sanctions²⁷. The growth potential of the economic model which was formed in the first decade of the 21st century began to decline.

This model was based on the absolute dominance of the primary sector in the economy, budget revenues and incomes from exports. Incomes from sale of oil, petroleum products and natural gas in pre-crisis 2013 accounted for around half of budget revenue, two-thirds of export revenue, and 17% of GDP²⁸. **The influx of petrodollars to the country** (in the form of the so-called 'oil rent', i.e. the profits owed to extensive factors: the very fact of having and exporting oil) **ensured the constant growth of budget revenue and spending.** **The real incomes of the population were growing, too** (by even more than ten per cent in the record-breaking years²⁹).

However, the nature of the budget structure has been anti-developmental, and has remained so regardless of the annual economic results. Spending on defence and security (in aggregate, it reached around one third of total

²⁶ Even though the average annual oil price was at US\$110/bbl, GDP grew by 3.5% at that time, slowing down for the first time since the crisis in 2008–2009.

²⁷ Н. Акиндинова, Я. Кузьминов, Е. Ясин, Экономика России: перед долгим переходом, April 2016.

²⁸ <http://trubagaz.ru/issue-of-the-day/neft-nefteprodukty-gaz-rossijskie-bjudzhet-i-vvp/>;
<http://www.cbr.ru/statistics/?PrId=svs>

²⁹ <http://www.rbc.ru/economics/28/01/2015/54c8ed8e9a79476360df32f3>

spending in 2013³⁰) and on welfare policy (around 25–30% of total spending, the overwhelming majority of this is made up by financing the pension fund) have predominated. In turn, healthcare and education spending did not exceed 10% of total spending and were cut as part of the austerity policy adopted in the crisis years³¹. The important thing is that the relatively high share of spending on welfare policy has not resulted in a reduction of the number of people below the poverty level. In 2007–2014, despite the constant supply of budget funds for these purposes, the share of population with incomes below the minimum subsistence level remained similar, i.e. 11–13%³², which proves that the government's moves in this area have been ineffective.

However, what has had the most serious consequences is the fact that **the period of prosperity was characterised by constantly increasing state control of the economy** (the estimated share the state has in the economy was 35% in 2005 and 70% in 2015³³), excessive bureaucracy and the tightening grip on the public sphere. The strengthening redistribution functions of the state and the excessive development of the bureaucratic apparatus have weakened civil control of the way public funds are spent, making citizens and business circles dependent on budget funds. This resulted in the entrenchment of the characteristic 'rules of the game' both inside the Russian elite and in government-business and government-society relations. The most effective way of doing business in Russia is to seek support from groups of influence linked to the government in the increasingly complex and aggressive legal and institutional environment and in the context of a deteriorating business climate. The lack of respect for basic rights (including property rights) and the excessive development of the supervision apparatus and the repression apparatus³⁴ are an effect

³⁰ The share of defence spending in Russia's GDP visibly exceeds the level in developed countries. See <http://www.indexmundi.com/g/r.aspx?v=132>

³¹ In 2011–2016, federal budget expenditure on defence increased from 13.9% of total spending to 19.6%, while spending on healthcare and education fell by more than 25%, and will continue to fall until 2019. These expenses have also been reduced on the local level. <http://www.vedomosti.ru/economics/articles/2016/07/14/649141-tri-goda-minfin-mozhet-naiti-12-vvp-schet-rostadohodov-sokrascheniya-rashodov-schitaet-mvf#/galleries/140737492840570/normal/1>; http://www.iep.ru/files/text/crisis_monitoring/2016_20-38_December.pdf; <http://www.vedomosti.ru/opinion/articles/2016/10/25/662263-rossiya-latinskaya-amerika>.

³² Помощи нужен контроль и учет, 20 April 2016, www.kommersant.ru

³³ <http://www.rzd-partner.ru/news/different/otsenka-ieffektivnosti-masshtaba-uchastii-agosudarstvennykh-kompanii-v--iekonomike-rf/>

³⁴ For more information see, Maria Domańska, Piotr Żochowski, Business under supervision – pathologies serving the system of power in Russia, *OSW Commentary*, 1 June 2016, <https://www.osw.waw.pl/en/publikacje/osw-commentary/2016-06-01/business-under-supervision-pathologies-serving-system-power>

of the **absolute dominance of the executive power and secret services in the institutional system of the state**. According to government estimates, the operation of the supervision system leads to business losses that reach 5% of GDP annually³⁵. Small and medium-sized business, which have no links to political decision-makers, are the main victim of suppressing competition and the lawlessness of the increasingly strong secret services.

Furthermore, all levels and areas of the Russian state's operation – from big contracts as part of public procurement to education, healthcare and citizen's everyday contacts with public servants – **are permeated by the omnipresent systemic corruption** which is an effect of the historic legacy and the fact that a great volume of 'easy money' was until recently in circulation. The estimated losses to the state budget and business circles inflicted by corruption reach hundreds of billions of dollars annually (estimates have been made, for example, by Transparency International)³⁶. Russia has for years been far below the top one hundred countries covered by the survey in Transparency International's corruption perception rankings³⁷.

The activity of non-transparent lobbyists and the intensifying phenomenon of clientelism are manifested, for example, through lobbying the increasing financing of inefficient state-owned companies by particular groups inside the elite. This is often done under the pretext that the companies will be modernised or will implement extensive development strategies and expensive infrastructural projects³⁸. Public procurement is usually used to **misappropriate public funds by the oligarch lobby or people directly linked to Vladimir Putin**. While profits generated by such transactions are privatised, losses are nationalised (i.e. incurred by the state budget). As Tatyana Golikova, the Head

³⁵ Dmitry Medvedev's statement, <http://www.rbc.ru/rbcfreenews/58076f7a9a7947e97fdeela2>

³⁶ <http://vz.ru/economy/2009/11/17/349632.html>, 17 November 2009; <http://pasmi.ru/archiv/127691>, 25 August 2015

³⁷ According to Transparency International's report for 2016, Russia was ranked 131st of 176 states; <http://www.transparency.org/cpi2015#results-table> (by comparison Poland was in 29th place in this rating).

³⁸ The flagship examples of unreasonable building of fortunes on infrastructural projects include: holding the APEC summit in 2012 and the Olympic Games in Sochi in 2014 (the costs might have been overstated by more than ten billion roubles and US\$30 billion, respectively); <https://rg.ru/2012/11/12/stepashin.html>; http://echo.msk.ru/blog/nemtsov_boris/1009664-echo/. Well-known examples of wasting public funds also include the operation of the Russian Railways which until 2015 was managed by Vladimir Yakunin (a member of Vladimir Putin's 'inner circle') and the activity of Vnesheconombank (the bank's financial gap may reach as much as 1.5 trillion roubles).

of the Accounts Chamber of the Russian Federation, stated in April 2016, the financial losses caused by corruption and mismanagement each year are several times higher than the losses resulting from falling oil prices, reaching trillions of roubles³⁹. A great deal of the stolen funds have most likely been transferred to tax havens – according to some surveys, over one trillion dollars may have been siphoned off from Russia between the early 1990s and the end of 2014⁴⁰. This was done not only in order to evade taxes but also out of a desire to protect assets from Russian jurisdiction.

Two conditions needed to be met for the model formed this way to function smoothly: high oil prices and their constant growth. As long as the prices were growing, the government managed to achieve the main goal of the economic policy, namely the constant enrichment of the elite alongside relatively low social costs. The system's inefficiency was masked through constant injections of 'easy money' from the raw material rent addressed to the real sector and social transfers. This allowed the Russian elite to avoid the need of reforming the state and the economy and, regardless of this, to maintain production and employment levels, as a result of which all social groups benefited from the oil prosperity, though to different extents.

This mechanism began to malfunction when oil prices stopped growing in 2012. It failed completely after they fell, starting from 2014. The systemic problems became evident with double strength in the new reality, above all the elite's kleptocratic attitude to the state and society, as well as the fragility of the foundations of economic growth based on an unstable boom on the raw material market. **The state governance model in place so far** involved structural problems being masked through a constant increase in ineffective budget spending. In this model economic calculation was becoming increasingly irrational. **This resulted in the exhaustion of internal sources of long-term growth.** The falling oil prices entail a reduction of revenues from exports, but an adequate cut of import costs is impossible, given the fact that the economy is highly dependent on imported goods and technologies⁴¹. Domestic demand is falling as a result of the dwindling real incomes of Russian residents. The level of investments is also falling, above all due to the poor investment climate

³⁹ http://www.ng.ru/economics/2016-04-19/1_golikova.html

⁴⁰ <http://www.rbc.ru/economics/09/05/2016/572fc4839a79479bd682e3eb>

⁴¹ One proof of this dependence is Russia's foreign trade dynamics in January – November 2016. Within this timeframe exports fell by 19.2% and imports by 1.4% year-on-year; www.gks.ru

and distrust of the government's policy. All this means that higher government spending is the only possible source of stimulating economic development (and that only in the short run, anyway), which is unreal, given the increasing budget gap and the dwindling reserves.

III. THE ANTI-CRISIS SHOW – THE KREMLIN’S HELPLESSNESS IN THE FACE OF ECONOMIC CHALLENGES

The Russian government elite has sufficient knowledge of the condition of the economy and understands the key problems. This is proven, for example, by the analyses and forecasts published regularly by the Central Bank, as well as diagnoses from the Ministry of Finance. **Ready-to-use formulas are also present** – reform strategies have been developed several times (including the ‘Gref programme’ of 2000 or the ‘Strategy 2020’ developed in 2011), as are free funds, if one takes into account the scale of public money being wasted. According to the Russian Accounts Chamber, Russia’s problem is not so much the deficiency of funds but rather the lack of efficient fund management institutions⁴².

The government is clearly lacking the political will to change the governance model and to support those who want reforms with real competences. One proof of this is the fact that none of the development strategies developed so far has been implemented to a significant degree. This is caused by financial motives (**the elite is not ready to share its future income with the public**), **the political background, and the psychology of power.** The durable connection of power and ownership in Russia, the mutual distrust inside the elite and the awareness that their political influence will be at stake should the costly and socially painful reforms be implemented, effectively thwart any attempts to actually put them into effect. The key institutions that would have to be reformed are the foundation of the present government system which guarantees incomes and security to the elite. **Thus the ‘reform paradox’ is that the logic of the government’s response to the crisis is strongly conditioned by the logic of the existing ineffective and anti-reform oriented model focused on maintaining stability and control of socio-political life.**

As a result, the government’s anti-crisis tactic is concentrated on several basic directions of action which are intended to replace or mitigate the lack of real recovery plans. Those that need to be singled out among them are temporary measures (mainly economic) and extensive long-term actions, mainly in the area of politics and propaganda.

Temporary measures include above all support from the federal budget to selected sectors of the economy and regional budgets, as well as preventing

⁴² Tatyana Golikova’s statement at the International Economic Forum in Saint Petersburg in June 2016.

social tension in the regions. The overriding goal of these is to maintain a stable social situation in the country in the period preceding the presidential election (scheduled for 2018). Part of the problems which the government is trying to overcome by using funds from the public budget is a direct effect of the consequences of the erroneous decisions revealed by the crisis and many years of neglect from the government itself.

The especially bad situation in some sectors (banks, construction, and the car industry) **induced the government to launch a comprehensive financial aid programme in 2015.** There are visible signs of stabilisation in the banking sector mainly owing to strong government support—aid provided in 2015 (a total of at least 2.3% of GDP⁴³) helped stabilise the financial market and the rouble exchange rate and also made it easier for banks to implement adaptation strategies. As a result, the sector's profits were consistently growing in 2016 (formally reaching 930 billion roubles, i.e. almost five times more than in 2015) even though this sector still has serious structural problems⁴⁴. Support for selected industries from the real sector made it possible to reduce the scale of losses (including in the car and construction industries⁴⁵) and to prevent mass redundancies. The investments in the defence industry also had a positive effect. Its 13% growth in 2015⁴⁶ stimulated the branches linked with military production, which improves the situation in industry in general, at the same time maintains the level of employment.

Aid offered to regional budgets is also important. It is worth noting that their financial problems were previously generated artificially, already in 2013. Then, as a consequence of the populist decrees passed by Vladimir Putin in May 2012

⁴³ For more information on the strategy and scale of the government's support for banks see, Maria Domańska, Rosyjski sektor bankowy. Rok w kryzysie, *OSW Commentary*, 29 March 2016, <https://www.osw.waw.pl/pl/publikacje/komentarze-osw/2016-03-29/rosyjski-sektor-bankowy-rok-w-kryzysie>

⁴⁴ http://cbr.ru/analytics/bank_system/din_razv_16_12.htm. The sector's real profits are many times lower if one takes into account the scale of growth of the compulsory reserves which consume a huge part of the profits, as well as 'creative accounting' (banks hiding their financial problems) and unreliable audits applied on a massive scale – the problems this sector has been facing since the crisis in 2008–2009; Половина банковских аудиторов заверяли недостоверную отчетность – ЦБ, 26 July 2016, www.vedomosti.ru

⁴⁵ Total assistance for the car industry in 2015–2016 may have reached 180 billion roubles; <https://mf.ru/news/view/?id=2117495>; https://www.gazeta.ru/auto/2015/12/02_a_7930847.shtml. In turn, the governmental programme for subsidising mortgage loans is a great support for the construction sector.

⁴⁶ Estimates from the deputy prime minister Dmitry Rogozin, http://www.bbc.com/russian/news/2016/05/160530_rogozin_military

and despite the already visible slowdown of economic growth, the regions had to shoulder the burden of wage raises in the public sector without any additional transfers from the federal budget (they had to incur 70% of the expenses⁴⁷). To finance these liabilities, they took out expensive bank loans. As a result, both the regional debt (in many regions it exceeded the legally admissible level⁴⁸) and the regional budget deficit⁴⁹ were growing at a fast rate. The debt service costs became a real problem when recession came, as on the one hand the possibilities of financial assistance from the federal budget reduced, and on the other tax revenues accounting for two thirds of regions' own incomes began to contract.

Regional authorities attempt to reduce budget deficits mainly by cutting social spending (education, healthcare and welfare care). Their austerity policies have been aided by measures taken by the federal centre, such as replacing the expensive commercial loans with government loans with a symbolic interest rate⁵⁰. 160 billion roubles were allocated on loan support for the regions in 2015. This amount was nearly doubled in 2016. As a result, total deficit of the regions was reduced almost fourfold in 2015 when compared to 2013, but most federal subjects (over 70) had problems with a budget deficit in those years⁵¹. The financial situation of the regional budgets is exacerbated by the local social situation and the situation of companies, and this poses the risk that the regions' own incomes will continue to fall. The regional governments can also seek additional assistance from Moscow; this, though, often depends on their lobbying skills rather than on automatically functioning support mechanisms.

The government has also taken measures to better recognise the potential causes and areas of public protests. It appears that this is precisely the goal of the surveys commissioned by the Ministry of Economic Development which

⁴⁷ Н. Зубаревич, Регионы России и экономический кризис, <http://poistine.org/regiony-rossii-i-ekonomicheskij-krizis#.V5fCRbiLS71>

⁴⁸ The debt of the record-breaking region exceeded 180% of its own income in 2015. <https://www.vedomosti.ru/economics/articles/2016/07/15/649305-regioni-mogut-poluchit-dostup-kreditam-plavayuschei-protsentnoi-stavkoi>

⁴⁹ In 2013, the regions' total deficit tripled; 77 regions had budget gaps (57 in 2011). Минфин хочет сократить трансферты регионам на 15,5%, 25 July 2016, www.vedomosti.ru

⁵⁰ <http://tass.ru/ekonomika/3434632>

⁵¹ Even though the share of loans granted from the state budget have clearly increased in the case of regional debts (such loans currently predominate in the regions' debt structure, accounting for over 48%), this form of assistance will most likely be insufficient. <https://www.vedomosti.ru/economics/articles/2016/07/15/649305-regioni-mogut-poluchit-dostup-kreditam-plavayuschei-protsentnoi-stavkoi>; <http://iep.ru/files/RePEc/gai/monreo/monreo-2016-36-772.pdf>

are conducted to identify the potential threats to Russia's socio-economic security⁵². The secret services are also certainly probing public sentiment. However, it should be suspected that the government's main objective is not really to improve the situation in the 'trouble spots' but rather to take preventive and repressive measures to stamp out the protest potential before it happens. The characteristic manner of managing the Russian labour market (including pressure to avoid large-scale redundancies by large employers that might generate social tension) is intended to serve similar purposes⁵³. At the same time, a great deal of responsibility for the socio-political situation in the regions is placed on the regional governments. These are forced to cautiously manoeuvre between presenting the situation in their area as stable (to prove their effectiveness and usefulness for the system) and posing the threat of destabilisation in the case of a lack of additional budget transfers from the centre. There is also an increasingly strong tendency to require local business circles to co-finance regional expenses (one proof of this are the problems Renova, Viktor Vekselberg's firm, is facing due to being forced to sponsor the electricity supplies to residents of the Komi Republic)⁵⁴.

Another characteristic feature of Russian crisis management is seen in the attempts at 'manual control'—the selective extinguishing of existing and potential problems not through automatically functioning institutional mechanisms but by means of direct interventions by the most senior officials, frequently by the president himself. These interventions sometimes cause a real improvement of the situations, but sometimes seem to be merely a carefully stage-managed show⁵⁵.

Special attention needs to be paid to conscious, cynical moves from the government whose priorities include maintaining the loyalty of selected

⁵² <http://www.rbc.ru/economics/31/05/2016/574d9a319a7947224fa1789f>

⁵³ The mining and metallurgical company Mechel, which employs around 66,000 people, is an interesting example. Banks withdrew from launching a bankruptcy procedure against this company that would have caused mass redundancies most likely as a result of an intervention by the Kremlin (this move was also intended at sparing financial problems to the company's main creditor, Gazprombank, which is cherished by the Kremlin). Reuters рассказал о роли Кремля в спасении «Мечела», 14 July 2016, www.rbc.ru

⁵⁴ For details see <http://www.rbc.ru/business/05/09/2016/57cd91eb9a7947111e43a27b>

⁵⁵ Vladimir Putin's annual teleconference ('hotline with the president') is a textbook example of the ostentatiously demonstrated single-person rule of the country, for instance the one held in April 2016, when the president received complaints, for example, about the terrible condition of roads in the regions or a violation of employees' rights at the fish factory in Sakhalin (in effect, administrative measures were taken in both of these cases).

members of the elite by ensuring financial benefits for them – at the expense of the state budget and people’s living standards. The lucrative contracts offered to the Rotenberg family – who are close friends of Putin included in the Western sanctions list – are one example of this⁵⁶. Regardless of the scale of corruption and the very small reductions in spending on security and defence made so far⁵⁷, the budget cuts have affected social expenses in the first order. This includes freezing transfers from the state budget to pension funds as part of the open investment fund system, and manipulations concerning the indexation of pension benefits⁵⁸. Cuts have also been made in healthcare spending. The implementation of the flagship programme of import substitution has also turned out to be harmful to the public. This is presented as a recipe for independent long-term development⁵⁹ when in fact it has been temporarily used by local manufacturers, including members of the government elite, as another channel for fraudulently obtaining subsidies or public orders. The essence of this policy is manifested by the strictly politically motivated decision of the Kremlin to impose an embargo on imports of food from the West in August 2014 and then from Turkey (in November 2015)⁶⁰. This not only increased import costs as a result of importing food from more distant regions, it also encouraged local food producers to significantly raise food prices, while

⁵⁶ In 2015 Arkady Rotenberg’s firm, Stroygazmontazh, entered into contracts covering the implementation of governmental projects (including the construction of the Crimean bridge and the Power of Siberia gas pipeline) worth in total over 0.5 trillion roubles. Public procurement procedures were not conducted in most of the cases. One case which caused particularly strong public outrage (in the form of driver strikes across Russia) was the contract signed in 2015 with Igor Rotenberg’s firm covering the operation of the newly introduced controversial system of charging trucks for moving along domestic roads. For details see: <http://www.forbes.ru/rating-photogallery/313039-koroli-goszakaza-2016-reiting-forbes>; <https://www.vedomosti.ru/economics/articles/2016/07/05/647963-vladeltsi-gruzovikov-smogut-ignorirovat-transportnii-nalog-esli-plata-platon-okazhetsya-bolshe>

⁵⁷ See for example, <https://www.vedomosti.ru/economics/articles/2016/09/09/656321-min-fin-voennie-rashodi> In the amended budget for 2016, defence expenses even increased, thus widening the budget gap. See, Maria Domańska, Iwona Wiśniewska, Government expenditure in Russia increases despite the crisis, *OSW Analyses*, 12 October 2016, <https://www.osw.waw.pl/en/publikacje/analyses/2016-10-12/government-expenditure-russia-increases-despite-crisis>

⁵⁸ It was decided, for example, to replace the indexation of pensions for 2016 with a single payment of 5,000 roubles (less than US\$80) at the beginning of 2017 which, by lowering the base for indexation in the next three years is expected to bring as much as 850 billion roubles of budget savings. <http://www.rbc.ru/economics/09/09/2016/57d2b2d09a794727d6612c9d>

⁵⁹ See Sergey Glazyev’s lecture: Как обогнать Запад, не догоняя его, <http://www.business-gazeta.ru/article/144949>

⁶⁰ This was a response to Western economic sanctions imposed on Russia and the shooting down of the Russian military aircraft by Turkey over the Syrian border in November 2015.

its quality was falling⁶¹. The family of the minister for agriculture, Alexander Tkachov (who has a say on the future of the embargo) is among those who have benefited from the import substitution programme. They are able to benefit owing to the network of firms operating in the food and agriculture sector⁶². Similarly, attempts to replace foreign medicines with products of the Russian pharmaceutical industry ended up in shortages and an increase in prices⁶³.

These moves by the government are masked through a kind of twisting reality, something the former economy minister, Alexey Ulyukaev, was particularly good at. Since the beginning of 2015 the public has been regularly persuaded that Russia had already overcome or is overcoming the crisis and that economic growth should be expected soon⁶⁴. It is often concealed that the small economic growth expected in 2017 will not signify real development. These moves are accompanied by **aggressive anti-Western propaganda** aimed at convincing the audience that the causes of the crisis are mainly external. In addition to the falling oil prices which are dependent on the market situation, the government claims that these external causes include ‘undeserved’ and ‘groundless’ sanctions imposed on Russia aimed at ‘bringing it to its knees’. The overriding goal of anti-Western propaganda is to mobilise public support for the government despite the financial problems and deteriorating living conditions which are increasingly being felt by Russian people. Stoking the atmosphere of threat, even of a military nature (including the bitter criticism of ‘NATO’s Eastward expansion’) is intended to cause that—in the face of an alleged threat to survival of the Russian state and nation, any internal differences will melt away and any possible resentments which citizens have against the government will become pointless.

Along with the temporary moves intended at neutralising selected manifestations of the crisis by way of adequately applied propaganda, the government has also taken long-term action aimed above all at maintaining high public support levels for Vladimir Putin ahead of the presidential election. These actions are based on simulating the creation of a state development strategy,

⁶¹ One example of the negative consequences of the substitution is the large-scale addition of harmful palm oil to dairy products. Russian imports of palm oil have been consistently growing since 2015. Сыроделья паразитируют на продуктовом эмбарго, 20 June 2016, www.ng.ru; http://www.ng.ru/economics/2016-01-19/1_milk.html

⁶² <http://www.zagolovki.ru/daytheme/tkachev/21Apr2016>; <http://www.rbc.ru/business/11/11/2015/564329409a79473a0d551b24>

⁶³ <https://regnum.ru/news/economy/2066491.html>

⁶⁴ This thesis has also been put forward in public on several occasions by Vladimir Putin (including during the International Economic Forum in Saint Petersburg in June 2016).

the manifestation of which is the discussion on the desired direction of reforms seen among the government elite. It is intended at concealing the lack of a real anti-crisis strategy, above all to delude the public, including liberal circles, and also foreign investors.

In this context the simultaneous activation of several advisory and decision-making centres is symptomatic. According to the government's declarations, these are expected to work on reforms⁶⁵. Not only various ideas to overcome the crisis have been put forward so far, but also assurances of the desire to combat corruption, improve the business climate, and improve the competitiveness of the Russian economy can be regularly heard in such debates. These are nothing but propaganda slogans, if one takes into account the real sources of Russia's economic problems.

There is a clear difference of opinion in these discussions⁶⁶: the need to choose between boosting development by increasing budget expenditure and an austerity policy combined with a tough monetary and loan policy. This results both from an attachment to the various economic theories and the lobbying of certain business groups interested in the choice of anti-crisis instruments that would be beneficial to them.

The project of softening the monetary and budget policy for the sake of stimulating production and investments using public funds has been pushed for mainly by the presidential advisor Sergey Glazyev, and Boris Titov, the business ombudsman and the head of the Party of Growth established in 2016 with the Kremlin's support. The project envisages the activation of banks and governmental development institutions⁶⁷ by the state and controlled issues of money

⁶⁵ In April 2016, President Putin made the former minister of finance, Alexei Kudrin, part of the management team of the Centre for Strategic Research and entrusted him with the preparation of a development plan for the coming years. The presidential Economic Council has also resumed work after a two-year break, with the participation of representatives of the government, other decision-making centres and experts. At the same time, the government is working on a development strategy for Russia until 2030 as part of its statutory strategic planning obligation. Two other organisations have also been established: a commission for reform of the state administration chaired by the president, and a council for strategic development tasked with developing key projects aimed at introducing structural changes in the economy and the social sphere.

⁶⁶ For more information on proposals put forward during the discussion see, *Путину посоветовали, как вернуть экономику к росту*, 26 May 2016, www.vedomosti.ru

⁶⁷ There is an excessive number of developmental institutions in Russia (around 30). Even though their operation is ineffective (the country is not developing), the government is building this apparatus further. In May 2016, Dmitry Medvedev signed a decree establish-

(around 1.5 trillion roubles, i.e. around US\$25 billion annually)⁶⁸ to credit the real sector and investments in infrastructure.

The reindustrialisation proposal from the defence industry's lobby is an attempt to make the ideas for stimulating economic growth more specific.

Officially, this is intended to ensure a technological leap to Russia that will compensate for its backwardness when compared to other countries⁶⁹. The proposals for a 'new industrialisation' as a rule are limited to a general characterising of Russian industry's technological and modernisation needs, without seriously addressing the key challenges and systemic problems which adversely affect the economic sphere in general. A successful reindustrialisation would require a reversal of the trend that was formed over the past few years—in 2013, before the crisis, the share of high-tech production in Russian exports of industrial goods was at 23% (for example, in China it was 60%), and this share was reduced in the preceding decade, which was contrary to the trends seen in the other BRICS countries⁷⁰.

One of the most frequent reindustrialisation proposals is the idea of developing (with the help of state investment) the defence industry (with around a 15% share in industrial production⁷¹) as development leverage for the whole economy. This is in fact a reference to the logic of the militarised Soviet industry. This idea may seem appealing, considering the growth tempo of the military industry sector (estimated to have reached 13% in 2015). However, the development of isolated modernisation centres (there is no exchange of innovation between the defence industry and the civilian sectors in Russia) in the conditions of a modern economy is unrealistic. This would also most likely mean a further reduction of spending on other goals, including investments in education, which are essential for authentic modernisation, and a further weakening of the private sector, including small and medium-sized companies. This strategy

ing an Agency for Technological Development tasked with "modernisation, the substitution of imports, and improving the competitiveness of Russian firms". Куда дает деньги наблюдательный совет ВЭБа, обществу знать не положено; materials from the government's meeting on 26 May 2016, <http://government.ru/news/23181/>

⁶⁸ Путину на экономическом совете предложили запустить «печатный станок», 25 May 2016, www.rbc.ru

⁶⁹ Доклад Сергея Глазьева: «Как обогнать Запад, не догоняя его», <http://www.business-gazeta.ru/article/144949>

⁷⁰ UNIDO data, <https://iq.hse.ru/news/177669045.html>

⁷¹ С. Алексащенко, Дно (если не пройдено, то) обязательно будет пройдено!, 28 June 2016, <https://openrussia.org/post/view/16032/>

would only aggravate the backwardness of the Russian economy as a whole. It cannot be ruled out that it is being pushed through for social reasons and is intended to serve the basic needs of maintaining social stability during the crisis. Employees of the defence industry and related branches – the defence industry also partly works for civilian needs – and their families form a group of around 15 million people⁷².

The proposals to stimulate development by increasing spending also include the idea of boosting consumer demand through raising people's real incomes. The deputy prime minister for social affairs, Olga Golodets, has been calling for this⁷³. This is in fact a repetition of the solution that was successfully applied in 2008–2009, and thus in different macroeconomic conditions. Golodets also opposes the project put forward by the Ministry for the Economy envisaging a reduction of business costs by cutting labour costs⁷⁴.

These ideas are unanimously opposed by the Ministry of Finance, which takes care of the budget deficit level, and Putin's advisor, Alexei Kudrin. This brings them close to the stance adopted by the Central Bank (one of its goals is to reduce inflation to 4% in 2017, which requires strict control of the money in circulation). Representatives of the Central Bank and Kudrin openly say that thorough system reforms are necessary, including, as Kudrin pointed out: limiting the state's participation in the economy, a reform of the judiciary and law enforcement agencies, and limiting spending on ineffective state-controlled companies⁷⁵. The Central Bank has warned on several occasions of 'permanent stagnation' as a consequence of the lack of structural reforms; without these the Russian economy will grow at a maximum rate of 2% annually (i.e. below the forecasted global average)⁷⁶. According to Kudrin, institutional reforms would offer a chance to make economic growth based not on state investments but on

⁷² The sector which produces goods for the needs of the army alone employs, according to information from the Ministry of Defence, over two million people. Россия уходит в оборону, 26 January 2015, <http://svpressa.ru/economy/article/110934/>

⁷³ Заглянуть за горизонт: что предложили Путину на экономическом совете, 25 May 2016, <http://www.rbc.ru/economics/25/05/2016/5745c18c9a794703df6b5a6a>; Голодец призвала сделать ставку на потребление, 17 June 2016, www.rbc.ru

⁷⁴ <https://www.vedomosti.ru/opinion/articles/2016/06/09/644720-chto-delat>; Заглянуть за горизонт, *op. cit.*

⁷⁵ Заглянуть за горизонт, *op. cit.*

⁷⁶ For Elvira Nabiullina's opinion see, for example, Экономический совет при президенте должен найти рецепт роста ВВП на 4%, 9 May 2016, www.vedomosti.ru; Важно было вовремя перекрыть кран, 29 June 2016, www.vedomosti.ru

private investments (in his opinion, companies have accumulated as much as 12 trillion roubles of available funds on bank deposits⁷⁷).

Kudrin's proposals appear to be the most well-thought-out and consistent of the solutions presented so far, but they will be impossible to implement for political reasons because they would undermine the foundations of the existing model where the state is governed by a small group forming the elite. Furthermore, there is a tacit consensus among the participants of the reform debate that the proposals of strictly political reforms (free elections and respect for civil liberties and rights) remain a taboo. In this context, Putin's reaction to Kudrin's proposal of reducing tension in the policy towards the West for the sake of economic development was symptomatic. The president, justifying the present anti-Western policy, employed such categories as 'sovereignty' and 'Russia's thousand-year-old history'. This leaves no doubt about the real priorities of the government as regards governing the country⁷⁸.

One proof that the reform debates have a purely ritual nature is the way the transactions of sale of part of the shares in two oil companies (Bashneft and Rosneft) **were effected** in the last months of 2016. This officially generated a revenue of around one trillion roubles (around US\$16.5 billion) to the state budget. The Russian government has called these transactions privatisation, while in fact Bashneft was taken over by the state-controlled company Rosneft, and a 19.5% stake in Rosneft was sold in a very non-transparent way⁷⁹. In the latter case, most likely Russian state-owned banks supported by the Central Bank of Russia were engaged in financing the transaction; furthermore, it is unclear who the new real owner of the stake is. Officially, the main goal of these transactions was to generate budget revenues, but how much the state budget actually gained is difficult to assess (as a consequence, Rosneft's incomes have been reduced, for example, and it will thus pay less in tax and dividends to its majority shareholder, i.e. the state).

⁷⁷ http://www.ltv.ru/news/2016/05/29/303095-diagnoz_rossiyskoy_ekonomike_stavyat_spetsialisty_na_zasedanii_prezidiuma_ekonomicheskogo_soveta_obsudili_vozmozhnye_stsenarii_vyhoda_iz_krizisa. Potential investors are, however, discouraged by the uncertainty surrounding the further development of the economic situation and the directions of the government's economic policy, as well as the serious drop in domestic demand as a result of the falling incomes of the Russian public.

⁷⁸ <https://lenta.ru/articles/2016/05/31/kudrinwest/>; <http://politcom.ru/21170.html>

⁷⁹ For transaction details see, <https://www.osw.waw.pl/en/publikacje/analyses/2016-12-14/a-murky-deal-a-195-stake-rosneft-has-been-sold>; <https://www.osw.waw.pl/pl/publikacje/analizy/2016-10-12/pseudoprywatyizacja-rosneft-przejmuje-basznieft>

Rosneft and its CEO, Putin's close friend, Igor Sechin, are the undoubted beneficiaries of these operations. The company has strengthened its position as the leader of the Russian oil sector, and Sechin has demonstrated his strong position in the government elite. **The real goal of the 'privatisation',** which is traditionally associated with building a liberal market economy, is thus **in Russian conditions temporarily obtaining budget revenues without upsetting the state control of the assets, and strengthening the influence and increasing the incomes of the circles with close links to the Kremlin.**

President Putin's official stance on the desirable direction of change has not yet been fully formulated and will most likely depend on the programmes that will be presented in 2017 by the numerous advisory bodies. He has rather enigmatically appealed for "new sources of growth to be found" and for structural reforms, while macroeconomic stability is maintained⁸⁰, clearly opposing moves that could stimulate inflation. At the moment, Putin's preferences can be determined by the shape of the budget for 2017–2019, assuming significant cuts in government spending (to 16.2% of GDP in 2019 against 19.8% of GDP in 2016). This plan also assumes a gradual reduction of the budget deficit to 1.2% of GDP and financing the missing income above all by way of domestic loans⁸¹. This most likely will not only fail to improve the situation of most business circles in Russia, it may even adversely affect it. Banks will be more willing to buy treasury bonds rather than to grant loans to private companies, especially small and medium-sized ones.

The intensification of the discussion on reform and the fact that it is conducted on various platforms are intended to perform mainly a political function – to calm down public sentiment and to convince the public, including business circles, that government policy is not a cause of the crisis but rather a remedy to the economic problems. The debate is thus aimed at adding credibility to the Kremlin's pseudo-reformative ambitions and at preparing the widest possible spectrum of proposals to select content for Vladimir Putin's election manifesto in 2018. In turn, it is unlikely that the discussions are aimed at developing a comprehensive reform agenda that would upset the current governance model, though it cannot be ruled out that the government is ready to implement

⁸⁰ <http://kremlin.ru/events/president/news/51996>

⁸¹ According to the deputy president of the Central Bank, Ksenia Yudaeva (statement at the Gaidar Forum in January 2016), Russia's public debt – considering its service costs – should not exceed 25–30% of GDP (thus double the present level and half what is considered a safe level in developed countries).

selective partial changes, on the one hand to mask their lack of will to rebuild the entire model, and on the other to temporarily help alleviate the most severe signs of the crisis. This selection based on half measures has, however, more in common with wishful thinking than with a rational agenda. For systemic reasons the limited nature of pseudo-reforms may lead only to them proving ineffective.

IV. IS RUSSIA AT RISK OF A POLITICAL CRISIS? – AN ATTEMPTED FORECAST

As the crisis continues, it is becoming clear that – mainly due to the pessimistic forecasts concerning oil prices – **it is impossible to return to the extensive economic governance model** that would guarantee high incomes without development based on innovation. According to the forecast published in October 2016 by the Ministry of Economic Development, by 2035 average annual economic growth will not exceed 2%, while people's real incomes will reach 2013 levels only in 2021⁸². This poses the risk of a serious and durable deterioration of people's living standards.

However, the Russian elite will avoid comprehensive and politically risky reforms at any price, choosing instead temporary, feigned and selective tactical anti-crisis moves that will boil down to **neutralising the risk for the system in the period leading up to the presidential election** scheduled for 2018. This strategy has been adopted most likely due to **hope of a gradual increase in oil prices** which will be possible to capitalise on politically in view of the election and also due to **hope that the economic sanctions will be lifted** by the West (even though Russia has not made any concessions as regards the Ukrainian issue), which would cause a return of investors to Russia and an amelioration of the consequences of the crisis through the influx of cheap money. In case the situation develops in a way that is beneficial for Moscow, these two factors may slightly alleviate the economic problems but this will not help overcome their primary causes, and thus will not in themselves create the foundations for sustainable growth. **Focusing on temporary measures is clear proof of the Russian government's helplessness in the face of strategic challenges.**

Even though the government's tactic of preservation is unable to successfully reverse the stagnation trend in the Russian economy (which will in the long term adversely affect the interests of both society and the broad elite circles), **paradoxically, it stands a big chance of success in the socio-political dimension, at least by the time of the presidential election which is viewed as key for the stability of the system.** Neither the elites of various levels in the broad meaning of the term nor the public – though for different reasons – are interested in hard system reforms. Thus, despite the deteriorating socio-economic

⁸² <https://www.vedomosti.ru/economics/articles/2016/10/20/661689-20-let-stagnatsii>. By comparison, GDP grew by 4% and 4.3% respectively in 2010 and 2011 after the crisis, more than compensating for the fall in 2009.

situation, the Kremlin elite feels no pressure on the domestic arena. At the same time, there is no reform pressure on Moscow from the international environment, both due to the partial self-isolation policy the Russian government has been adopting since 2014, and the high resistance of the Russian public to discourse promoting so-called Euro-Atlantic values (democracy, pluralism and a liberal market economy). Furthermore, it seems that the West is increasingly prepared to accept the distinctness of the Russian political system and is focusing on limiting the negative effects of Moscow's aggressive foreign policy.

Above all, despite serious financial problems, the government has great possibilities to obtain money for the budget by the time of the presidential election (unless oil prices suddenly plummet or other serious external turbulences occur). According to the government's calculations made in mid-2016, total funds kept in both reserve funds (the Reserve Fund and the National Welfare Fund) will be sufficient at least until 2019. This will allow the government to finance the deficit, while simultaneously increasing the public debt. Priority expenses (temporary financial injections applied as needed to various spheres of the economy, while the austerity policy is maintained in general) will most likely be manually controlled. The government may resort to further cautious social cuts (for example, the future of pension indexation is uncertain) as well as cautious and selective improvements of the efficiency of disbursing budget funds, including a partial curbing of the scale of corruption (while maintaining financial support to the section of the elite closest to the Kremlin). It may also reduce spending on state investments, amend the fiscal law, and maintain the low rouble exchange rate, although this will make entrepreneurs' situation more difficult⁸³. **Although the austerity strategy may generate political risks in the period leading up to the election, apparently, it has been recognised – at least temporarily – as nevertheless less dangerous to the government elite than the implementation of structural reforms.**

The likelihood of a revolt among the elite or a 'palace coup' that might lead to a real reconstruction of the existing government and ownership model is low. Even though both the economic crisis and the Western sanctions have adversely

⁸³ The average annual rouble to dollar exchange rate assumed in the budget for 2016 was 63.3. Meanwhile, the budget for 2017-2019 assumes that the average exchange rate will be 67.5-71.1. In a survey commissioned by the Central Bank, 69% of businesspeople expressed an interest in a strong rouble to reduce the cost of the imports necessary for modernisation. Contrary to the government's opinion, none of them believed that the weak rouble exchange rate was beneficial. Укрепление рубля обеспокоило российские власти, 20 July 2016, www.vedomosti.ru

affected the financial situation of the Russian elite both directly (reducing the value of their assets) and indirectly (limiting their opportunities to further build their fortunes)⁸⁴, the kleptocratic style of exercising power preferred by it requires the existing model of governance to remain in place. Furthermore, Vladimir Putin is viewed by the elite as the only guarantor of balancing the influence between the various interest groups and – though to a lesser extent than before – of maintaining their personal fortunes⁸⁵. The supremacy of the law enforcement agencies in the system, which perform preventive and repressive functions in dealing with real and potential opponents of the Kremlin, along with the lack of an alternative leader and an alternative system that would guarantee that the elite would maintain their power and property, means that the elite still binds their careers to the centralised, paternalistic Putin model.

Even the austerity policy adopted by the government due to the crisis has not changed this attitude. It does not rule out that the existing lobbying system will remain in place. In this system, individual interest groups inside the elite are fighting for lucrative financial contracts financed by the state budget. The new financial reality is intensifying the rivalry for favours from the Kremlin, which ever more cautiously distributes them. However, this will most likely only induce the higher level elite to demonstrate loyalty to the presidential centre. At the same time, the intensifying rivalry for sources of income may lead to a further degeneration of the state governance model on the various levels of the bureaucratic machine.

The reasons for the low likelihood of public rebellion against the government are slightly different. The predominant need for stabilisation and the unwillingness to take risks are partly an effect of the memory of the traumatic period of transformation in the 1990s and they strongly dampen the desire for system reforms. People's behaviour is affected by **the high degree of economic and psychological dependence on the state.** Over 60 million people, and thus almost half of the population, directly financially rely on the budget

⁸⁴ For example, the 19 richest Russian oligarchs, according to Bloomberg agency, lost US\$8 billion in 2015 (in 2014, their losses exceeded US\$50 billion) to a great extent as a consequence of the Western sanctions (then the losses were partly offset owing to increasing oil prices); <https://life.ru/t/%D0%B7%D0%B2%D1%83%D0%BA/852187>, 29 December 2015.

⁸⁵ The state's difficult financial situation will most likely force the government to partly curb corruption and limit it to a selected circle of entities recognised by the Kremlin as necessary for stability of the system. One example of the partial reshuffle inside the elite under the slogan of combating corruption were the arrests of officers of the Investigative Committee and Federal Customs Service conducted by the FSB in the middle of 2016.

mechanisms of the redistribution of incomes (43 million pensioners and around 20 million people employed by the public sector, including employees of state-owned companies⁸⁶). This dependence becomes stronger during a crisis and when people's incomes are shrinking. This translates into a paternalistic mentality and approach. Over 70% of the population believe that society cannot function without state support, and only 9% believe that citizens should take care of themselves, show initiative. Even though people do see the defects of the system, 53% of them believe that personal interventions from the most senior state officials are the most effective method of crisis management. This means that the government itself is in fact the only instance to which complaints can be made against its own errors and negligence. Hence most likely the predominant belief that the country will cope with the crisis, and the government has a good action plan⁸⁷. People do not thus seem to notice the fact that the government itself has worsened Russia's economic situation (for instance, by bringing the country into international isolation as a result of the Kremlin's geopolitical ambitions). Nor do they seem to notice the many feigned anti-crisis measures taken by the government becoming separate sources of crisis phenomena, while the main beneficiaries of the budget support is the narrow elite circle and not the Russian public. This means that the awareness of the crisis and intensifying social and existential problems have no negative impact on public support levels for the government—in January 2017 over a half of the respondents were convinced that their country was heading in the right direction, and 85% praised Putin's activity as the president⁸⁸. The relatively mild way in which the present crisis is developing is also important (concerns about an economic collapse that appeared at the beginning of 2015 have proven to be unreasonable).

Furthermore, the real monopolisation of the public sphere by the Kremlin's discourse means that **there are no alternative platforms to the state for forming and demonstrating collective identity**, values and interests on a large scale. The identity vacuum after the collapse of the USSR, the political and economic turbulences in the 1990s, and the lack of an appealing project of a modern Russia have all made the Russian public retreat into the safe and familiar Soviet

⁸⁶ OECD data for 2011.

⁸⁷ Государство нам поможет, 2 July 2016, <http://politcom.ru/21251.html>

⁸⁸ <http://www.levada.ru>. Paradoxically, even the ostentatious destruction of Western food covered by the embargo in summer 2015 did not provoke a revolt. For details see: Maria Domańska, Katarzyna Chawryło, The Kremlin steps up the fight against contraband foodstuffs, 12 August 2015, <https://www.osw.waw.pl/en/publikacje/analyses/2015-08-12/kremlin-steps-fight-against-contraband-foodstuffs>

and superpower models affirmed by the state. Compensation myths (the revival of a 'great Russia' as a result of confrontation with the West)⁸⁹ make it easier to accept the financial and existential difficulties.

There are also strong **psychological and institutional mechanisms limiting the protest potential and processes of self-organisation to fight for group interests**. The fact that people are focused on survival in the conditions of crisis and their lack of faith that they could influence the government's policy discourage them from being politically active and facilitate populist moves. Another factor that discourages protests are repressive measures skilfully dosed by the government⁹⁰. Survival strategies are predominantly individual or limited to a narrow circle of the closest people (family, less frequently friends). They do not extend to local neighbourhood circles or professional groups mainly due to the historically conditioned atomisation of society. Along with the lack of an appealing alternative to the existing model, this means that **citizens' economic problems will most likely not be crystallised into political demands or even massive economic claims** addressed to the government. The widely shared belief that the crisis has mainly been caused by external factors additionally suppresses the need for change.

The economic crisis alone will not thus be a catalyst for any major political change in Russia. The way the parliamentary election was held in September 2016 proves that there are no threats to the system's stability. The deterioration of the socio-economic situation has not become a platform for mobilising the public against the 'party of power', United Russia, or the Kremlin. The lowest voter turnout in the Russian Federation's history proved the success of the government's strategy aimed at discouraging the public from participation in political life and convincing them that there is no alternative to the existing system⁹¹.

⁸⁹ One example of this mechanism is Russians' attitude to the food embargo, formed mainly by the propaganda in the mass media, which runs counter to the everyday experience of consumers. Although increasing numbers of respondents expressed a negative opinion on the embargo in the middle of 2016 (the percentage of negative opinions increased from 23% in 2015 to 31%), upholding the embargo as a response to Western sanctions was opposed by only 12%. Граждане устали от антисанкций, 11 July 2016, www.ng.ru

⁹⁰ For more information, see Jan Strzelecki, *op. cit.*

⁹¹ For more information, see Maria Domańska, The parliamentary election in Russia: a demonstration of the Kremlin's power, 21 September 2016, <https://www.osw.waw.pl/en/publikacje/analyses/2016-09-21/parliamentary-election-russia-a-demonstration-kremlins-power>

Despite the government's successes so far, **there are still some risks to the government elite, mainly linked to possible mistakes in diagnosing and predicting the social situation.** Official statistics fails to fully reflect the real picture due to the methodology used and defects in the information gathering system⁹², the significant scale of the grey economy (as much as 40% of GDP⁹³), and also the level of hidden unemployment⁹⁴. Nor can it be ruled out that regional elites intentionally conceal inconvenient information due to their particular political interests. This makes it more difficult to formulate a consistent diagnosis, especially given the fact that the macroeconomic situation in the Russian regions is strongly differentiated⁹⁵. The Russian public's attitudes and reactions are not fully predictable, either. They may be radicalised, for example, when the savings made at the time of prosperity (which are a kind of 'security valve' and decrease the level of public dissatisfaction in the face of the crisis) run out⁹⁶.

The risks may grow after the presidential election and will be linked above all with the exhaustion of budget reserves that have so far facilitated the neutralisation of the effects of the crisis through selective social measures and support for selected branches of the economy. When this happens, the likelihood of radical cuts in spending and the maximisation of budget revenues (partly through raising taxes⁹⁷) will be greater. This will lead to a significant deteriora-

⁹² For example, the statistics concerning the level of remuneration takes into account only large and medium-sized companies employing around 46% of all workers. In the remaining companies (the sector of small and micro companies), the wages might be 10–15% lower. Основная причина бедности – инфляция, <http://www.newizv.ru/economics/2016-03-17/235975-direktor-instituta-socialnoj-politiki-niu-vshe-lilija-ovcharova.html>. Furthermore, statistics might be distorted due to unreliable data provided by companies (partly resulting from their being unfamiliar with reporting standards). Depending on the methodology applied, conclusions concerning the country's socio-economic condition may significantly change. See for example, Промышленность выплеснула рост, 18 July 2016, www.kommersant.ru

⁹³ Н. Акиндинова, Я. Кузьминов, Е. Ясин, *op. cit.*

⁹⁴ According to experts' estimates, over 30% Russians are looking for a job or an opportunity to earn additional money, regardless of the officially low unemployment rate. Замаскированная безработица шагает по стране, 22 June 2016, http://www.ng.ru/economics/2016-06-22/1_job.html

⁹⁵ This concerns, for example, significant disproportions in the wages, costs of living, structure and size of regional GDP. Занятость, доходы и личное потребление: региональные различия, июнь 2016, <http://ac.gov.ru/files/publication/a/9465.pdf>

⁹⁶ At the beginning of 2016, only slightly more than 25% of Russians had any savings; this was the worst result over the past decade. <http://newsru.com/finance/31mar2016/ruhshldssavings.html>, 31 March 2016.

⁹⁷ In autumn 2016, President Putin announced a moratorium on raising taxes which is to be in force until 2019. <http://www.vedomosti.ru/economics/articles/2016/09/23/658241-putin-analogi>

tion of people's financial situation, which in turn will require the development and expansion of the competences of the repression and prevention apparatus to maintain the stability of the system.

Serious political consequences cannot be ruled out either if the government makes relatively small errors. These are highly likely in an excessively centralised and bureaucratised governance system, especially during a crisis when an intensified flexibility of reaction is required.

However, the strong 'deep structures' of the Russian state are an important 'trump card' of the government elite. They are formed by the network of informal co-dependencies based on the widespread penetration of the official institutional system by the secret services and bureaucracy. Both of them are strongly developed and want to maximise their scope of competences which would hinder any substantial reforms. Thus it should be expected that even if massive public protests linked to the crisis take place and even if formal changes in the state governance model are implemented and state institutions improve their effectiveness to a certain degree (for example, in the context of budget mobilisation), these hidden and durable mechanisms will contribute to a real reproduction of the system in place.

The dynamic of the international situation may affect Russia's condition in various ways during the crisis. There are many unknown factors that might destabilise its economic situation. These include above all the uncertainty surrounding the further trend in oil prices (the main factor determining the rouble's exchange rate and the position of Russian assets on international financial markets).

Remaining factors include: the condition of the Chinese economy affecting the attractiveness of emerging markets (including Russia) in investors' eyes and the level of global consumption of raw materials (the main export goods of the Russian Federation); decisions of the US Federal Reserve (the changes of the base interest rate affect the exchange rates of other currencies against the dollar and oil prices); and, finally, the economic condition of the European Union, the main market for Russian exports.

In turn, political factors will rather work for the benefit of Russia and its position on the international arena, which may tangibly expand Moscow's room for manoeuvre as regards combating recession and stagnation. In this context, the key factors will be the future balance of powers in the European Union and the

priorities of the United States' foreign policy. As the Brexit mechanism is underway and Eurosceptic and pro-Russian circles in Europe, lobbying to warmer relations with Moscow, gain strength, the EU crisis may result in a gradual disassembly of the sanctions regime. 2017, the year of elections in France and Germany, will be decisive in this context. Donald Trump's victory in the US presidential race in November 2016 may lead to attempts at making a 'new start' in relations with Russia, which potentially strengthens the Kremlin's position in contacts with Washington.

The fear of destabilisation in Russia is a factor that might guide Western leaders' decisions as regards policy towards Moscow; this should not be underestimated. Regardless of the fact that the Kremlin has been toughening its stance in foreign policy, it is very likely that the West will offer support should there be a serious crisis in Russia posing the risk of a collapse of the political system. From the perspective of the Western capitals, this would pose an existential threat to European security due to the problem of control over the Russian nuclear potential, a possible reactivation of terrorism in Russia or uncontrolled migration. It cannot thus be ruled out that Moscow will deliberately play on this threat to compel Western elites to participate in economic and financial co-operation, regardless of the Kremlin's unwillingness to make any concessions in international issues.

However, assuming that the international community will spare Russia serious turbulence and that the Russian government will avoid mistakes that might destabilise the country's socio-political situation, any serious threats to the government elite appear highly unlikely. **At present, the most realistic scenario for Russia is long-term stagnation** – without an economic collapse but also with no chance for real growth. **Russia will most likely continue to develop at a much slower rate than the rest of the world for many years⁹⁸, and its backwardness as compared to the developed countries will become more pronounced.**

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⁹⁸ While Russia is trying to overcome the recession, the IMF forecasted in October 2016 that the average economic growth worldwide will reach 3.4% in 2017; <http://www.cnbc.com/2016/07/19/imf-slashes-world-growth-forecasts-again-on-brexite-curveball.html>, 19 July 2016.