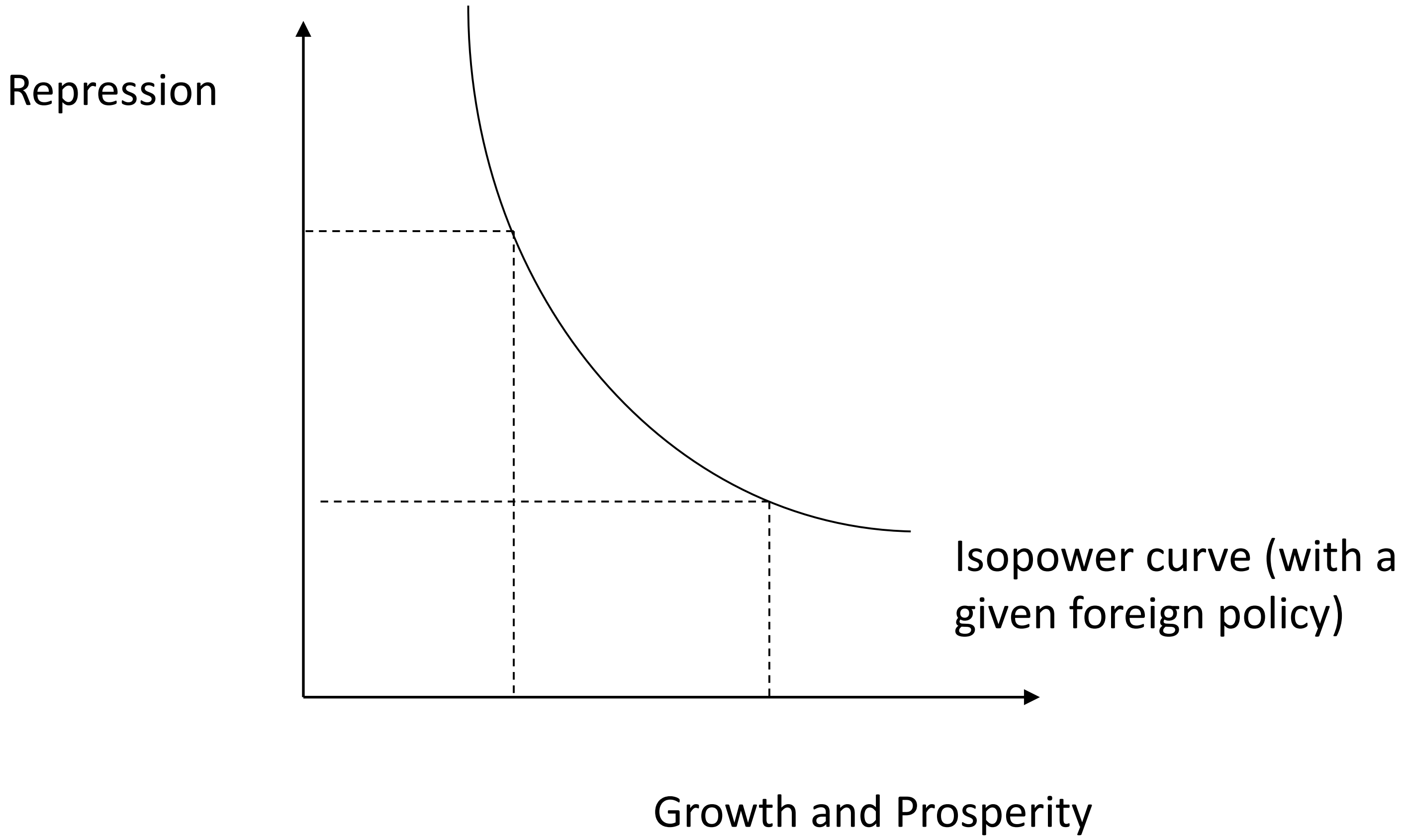
- Paul Gregory
- Hoover Institution
- May 16,2017

Prospects For Vladimir Putin and the Russian Economy

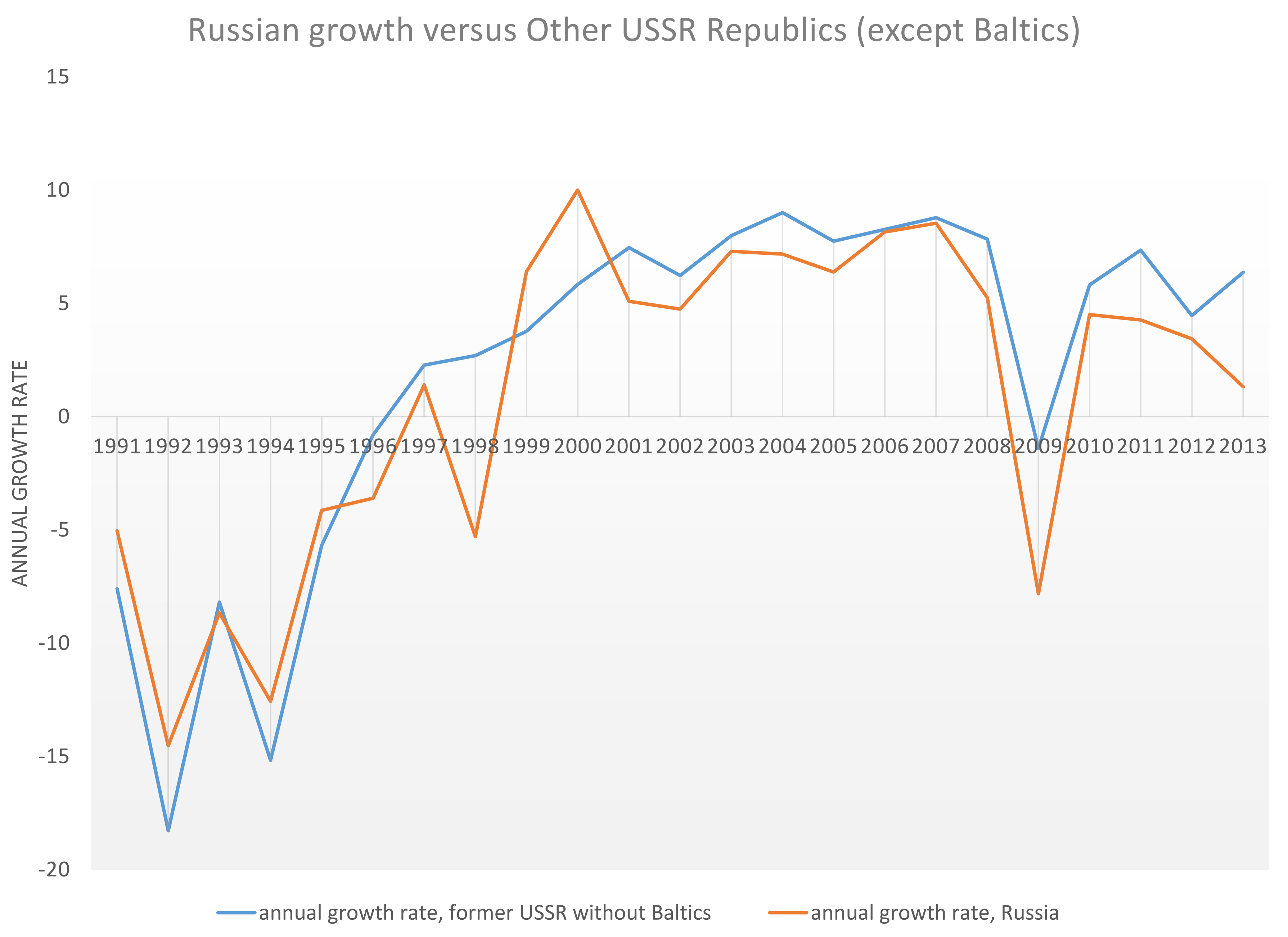
Balancing Loyalty, Foreign Adventures, and Repression to Stay in Power: The Political Economy of Vladimir Putin



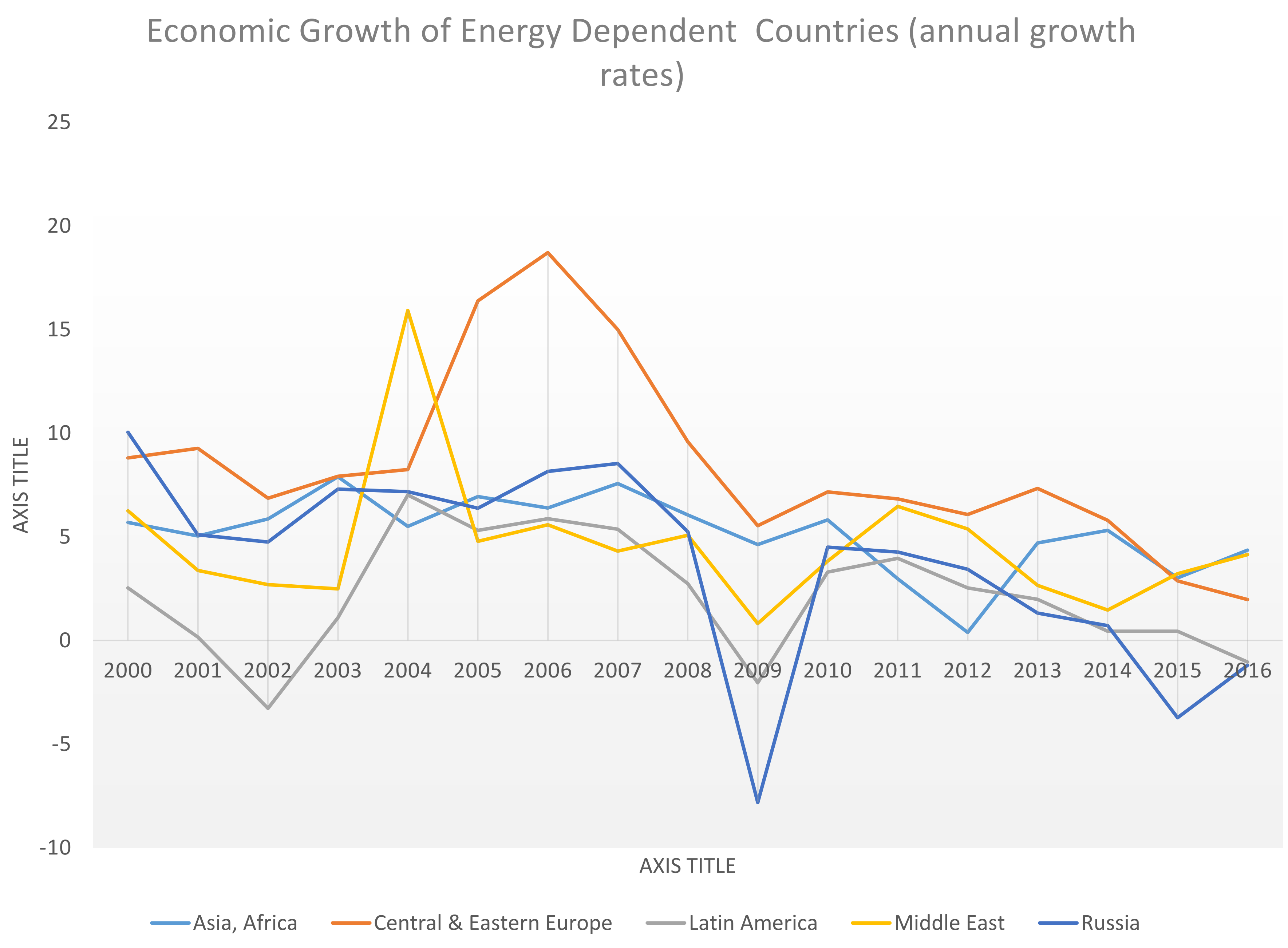

Russian Growth and Inflation, 1996 to 2020
GDP growth rate
inflation rate
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
-10.0
-20.0
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020

Putin’s carefully-cultivated image of economic management

- I create growth, prosperity, and stability
- Russia needs a strong hand to protect itself from foreign and domestic enemies
- We cannot afford to return to the days of “wild capitalism.”



Russian growth versus Other USSR Republics (except Baltics)
ANNUAL GROWTH RATE
15
10
5
0
-5
-10
-15
-20
1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013
annual growth rate, former USSR without Baltics
annual growth rate, Russia


Economic Growth of Energy Dependent Countries (annual growth rates)
25
20
15
10
5
0
-5
-10
AXIS TITLE
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
AXIS TITLE
Asia, Africa
Central & Eastern Europe
Latin America
Middle East
Russia

Putin’s Rise to Power in 2000

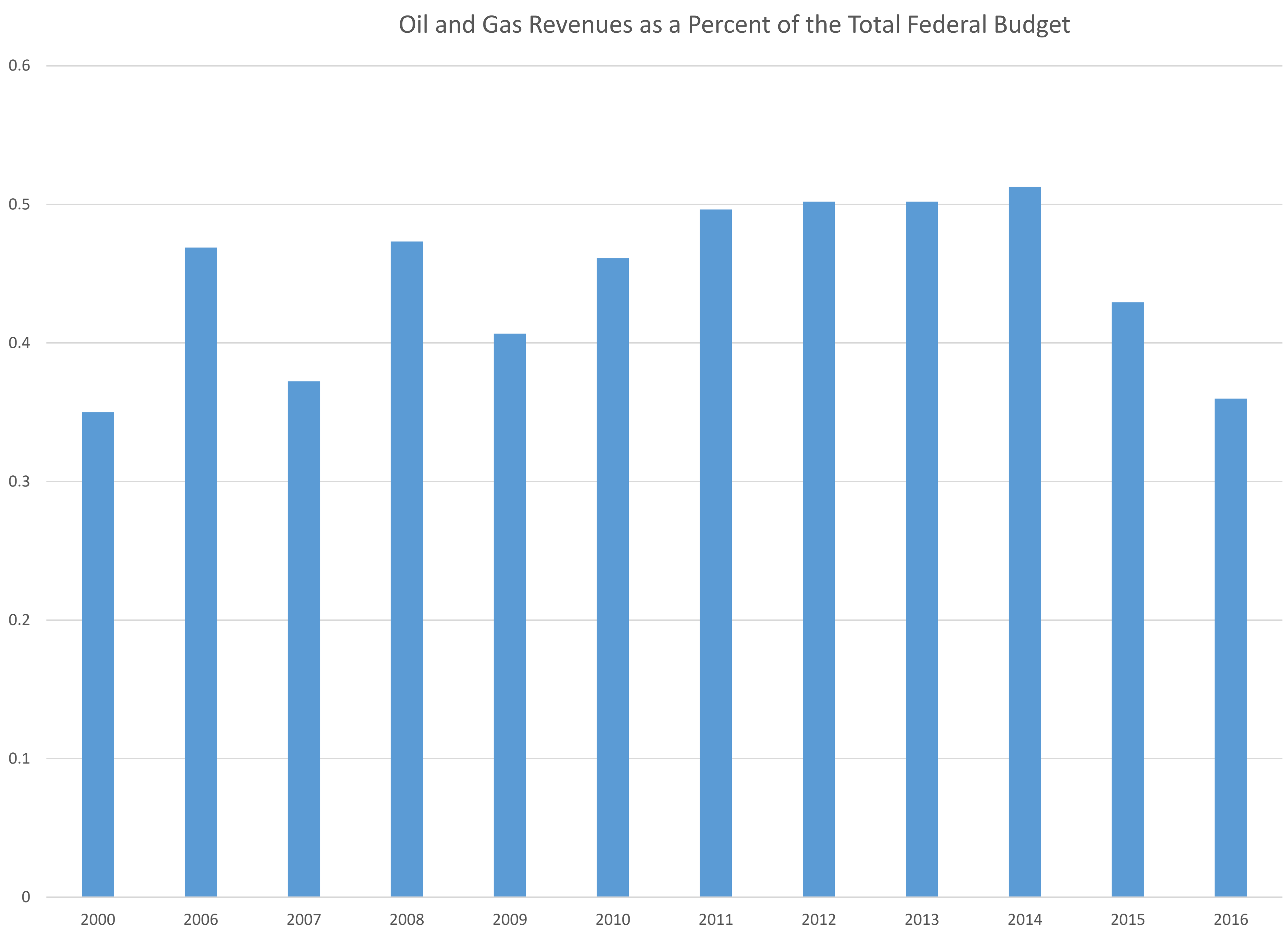
- Deal with the political elite
  - Protect the Yeltsin family and inner circle
  - Allow the Yeltsin oligarchs to maintain their property rights
- Social compact with the people
  - Replace disorder with order with a “strong hand.”
  - Promise growth and prosperity
  - Replace “wild capitalism and democracy” with “managed capitalism and democracy”
  - Restore Russia to its rightful place in the world order
  - Diversify the economy away from a Petrostate

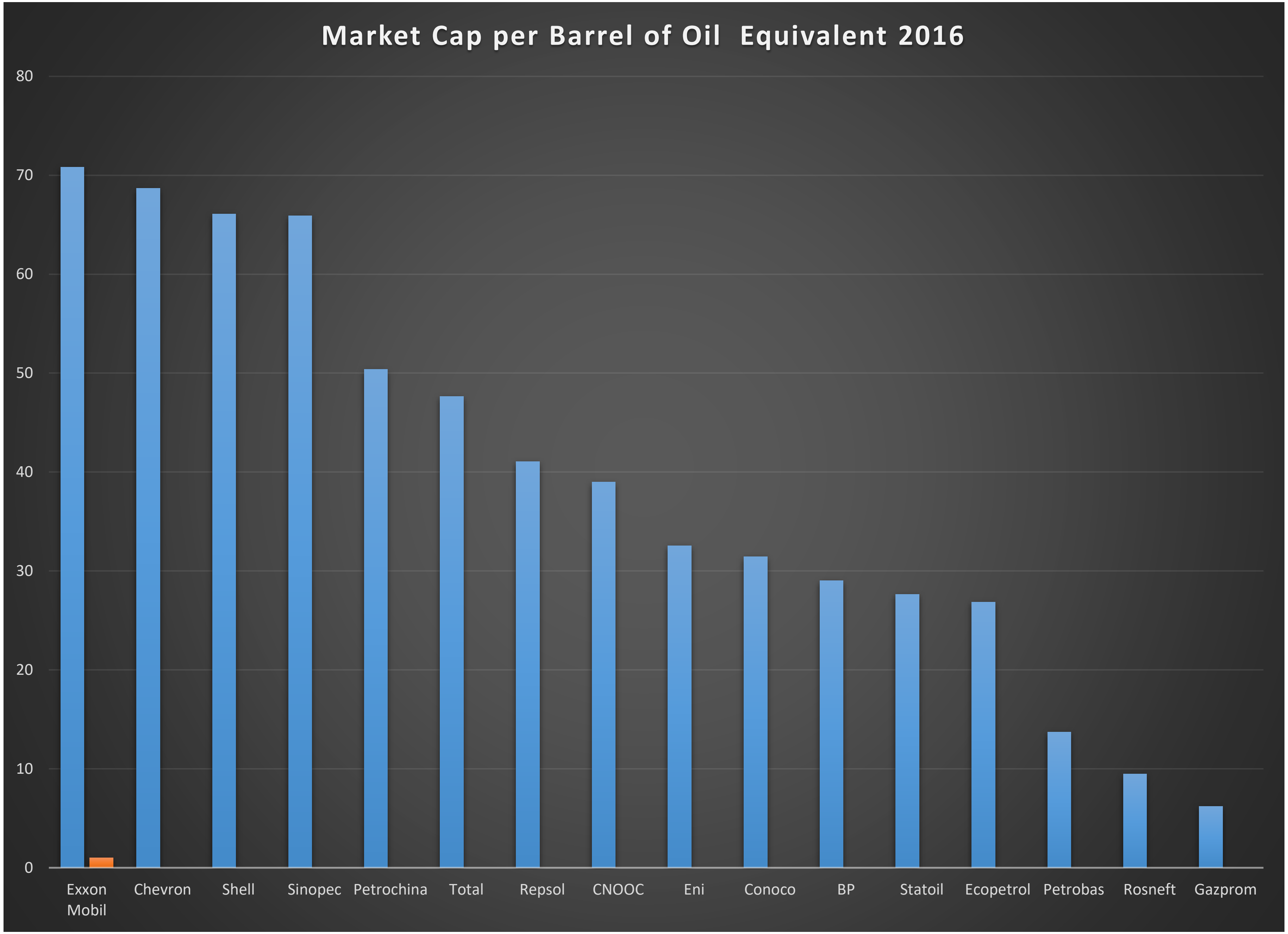
Putin’s formative experiences

- Political core: The Western world is the political, cultural, and economic enemy of Russia
  - West wishes to encircle Russia
  - West wishes to break up Russia and take Siberia
  - West wishes to keep Russia a minor geopolitical player
- Economic core
  - Hyperinflation destroys societies
  - People will not tolerate standing in line for basic goods
  - Defaults mean the end of the current regime (1991 and 1998)
- Political economy core
  - Repressive regimes can survive poor economic performance (USSR)
  - Military and political power can exceed economic power (Hybrid war)

The Status Quo After 17 years of Putin

- Extreme kleptocracy
- Re-nationalization or quasi nationalization (50 percent to 70 percent)
- Limited rule of law
- Property rights insecure, even of inner circle (2003 arrest of Khodarkovsky)
- Tax evasion as a threat to virtually everyone
- Flight of capital and people
- Russia is still a petrostate
- “National champions” managed as instruments of state policy
- Russia has returned as a major player in geopolitics (Crimea, Ukraine, Syria)


Oil and Gas Revenues as a Percent of the Total Federal Budget
0.6
0.5
0.4
0.3
0.2
0.1
0
2000
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016



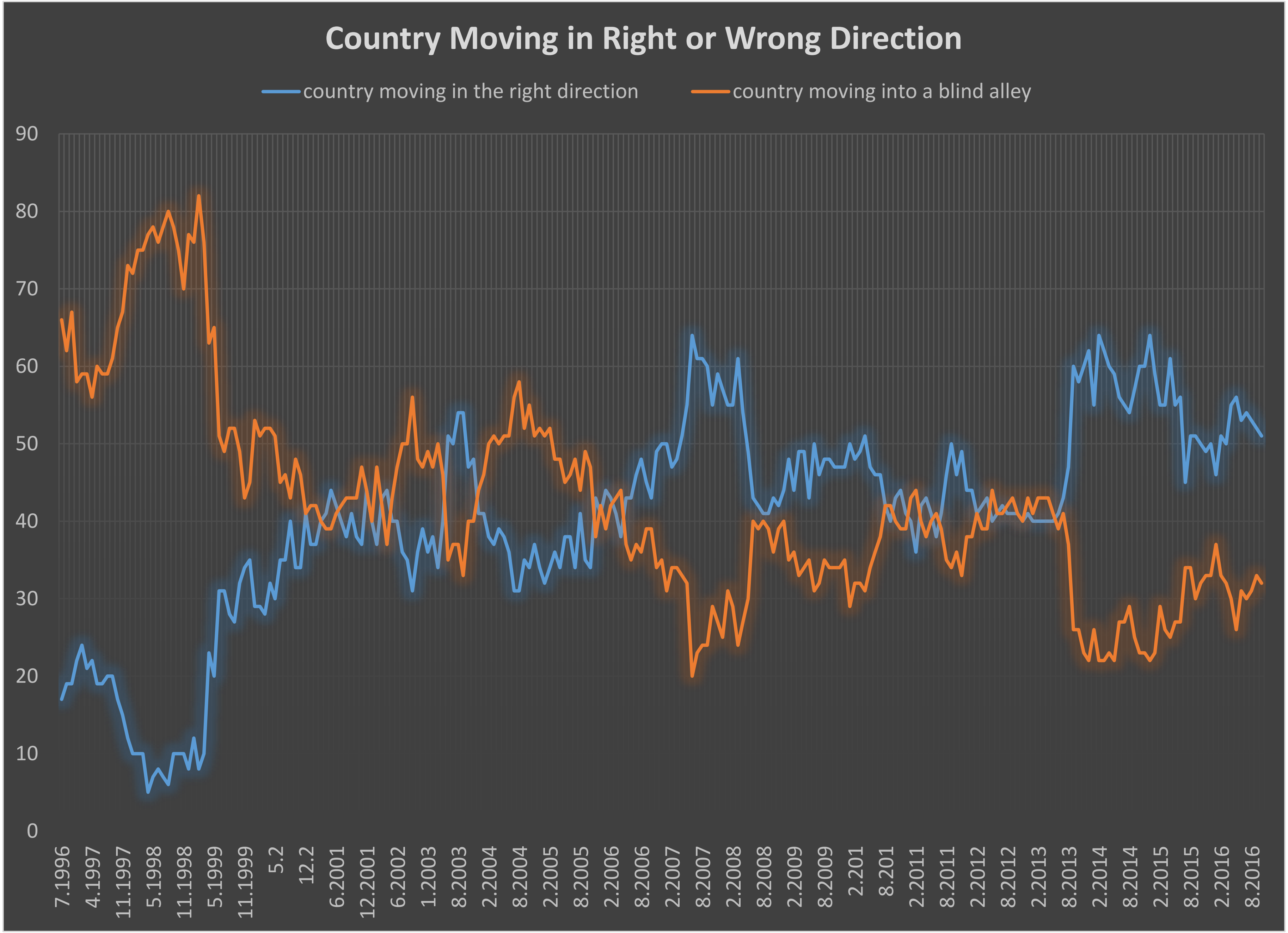
Market Cap per Barrel of Oil Equivalent 2016
80
70
60
50
40
30
20
10
0
Exxon Mobil
Chevron
Shell
Sinopec
Petrochina
Total
Repsol
CNOOC
Eni
Conoco
BP
Statoil
Ecopetrol
Petrobas
Rosneft
Gazprom

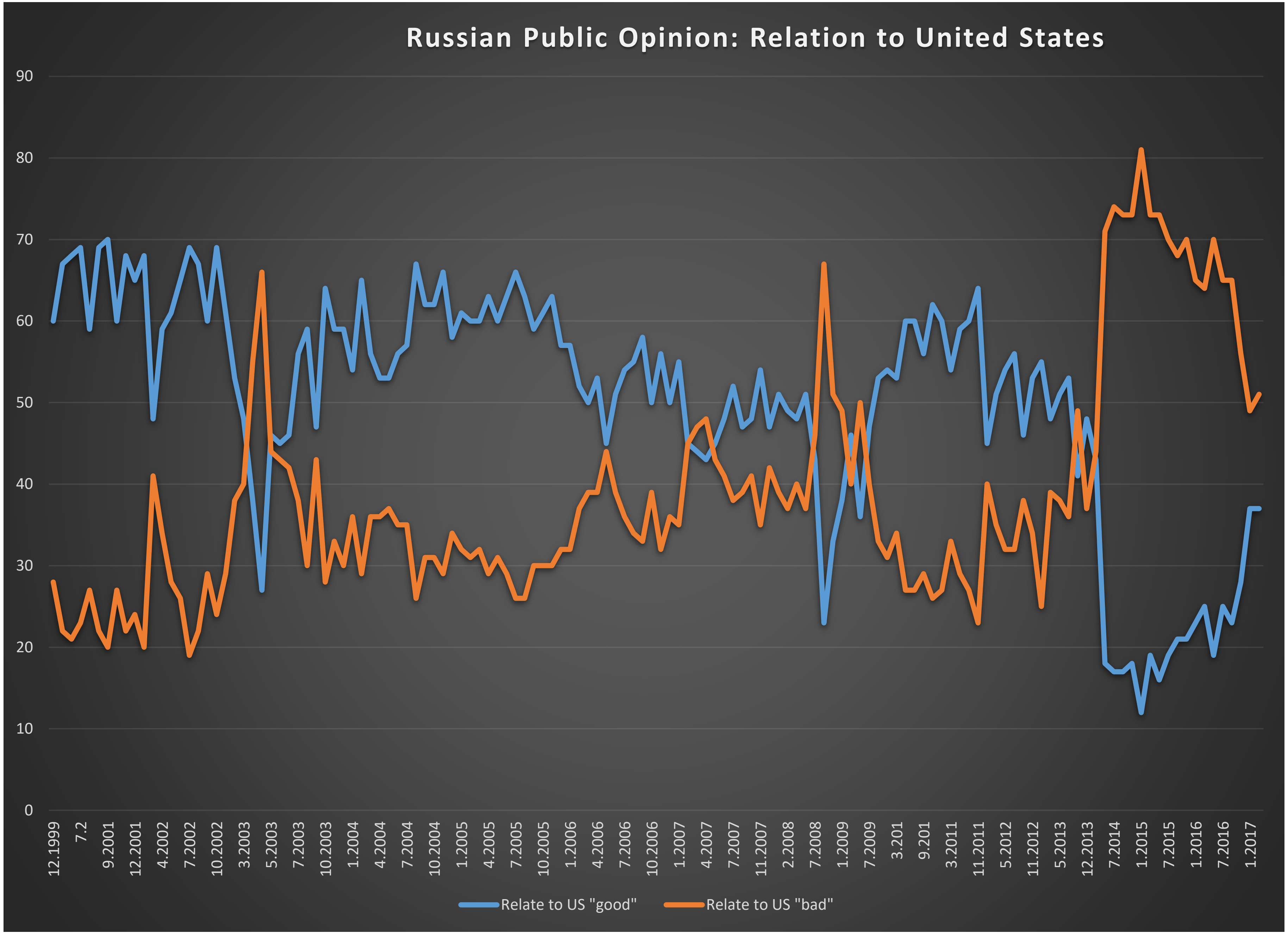
Primakov’s warning

- If Putin continues on his current path, Russia will become a third – world pariah Petrostate. To avoid this, Russia must become a rule of law state with a democratic order.
- Signs that Primakov’s warning is on the mark:
  - Russia is increasingly identified as a rogue state
  - Talented Russians are leaving Russia with their skills and capital
  - Russia’s “national champions” are operated as instruments of state policy, not as business enterprises. (The destruction of Gazprom).

Selling Russian Parallel Reality

- Propaganda is aimed primarily at the Russian people
- Propaganda convinces Russians that the country is moving in the right direction and that the West is the enemy.
- Domestic propaganda has been very effective.
- Foreign propaganda has been less effective.
- Propaganda delinks “narrative” from reality

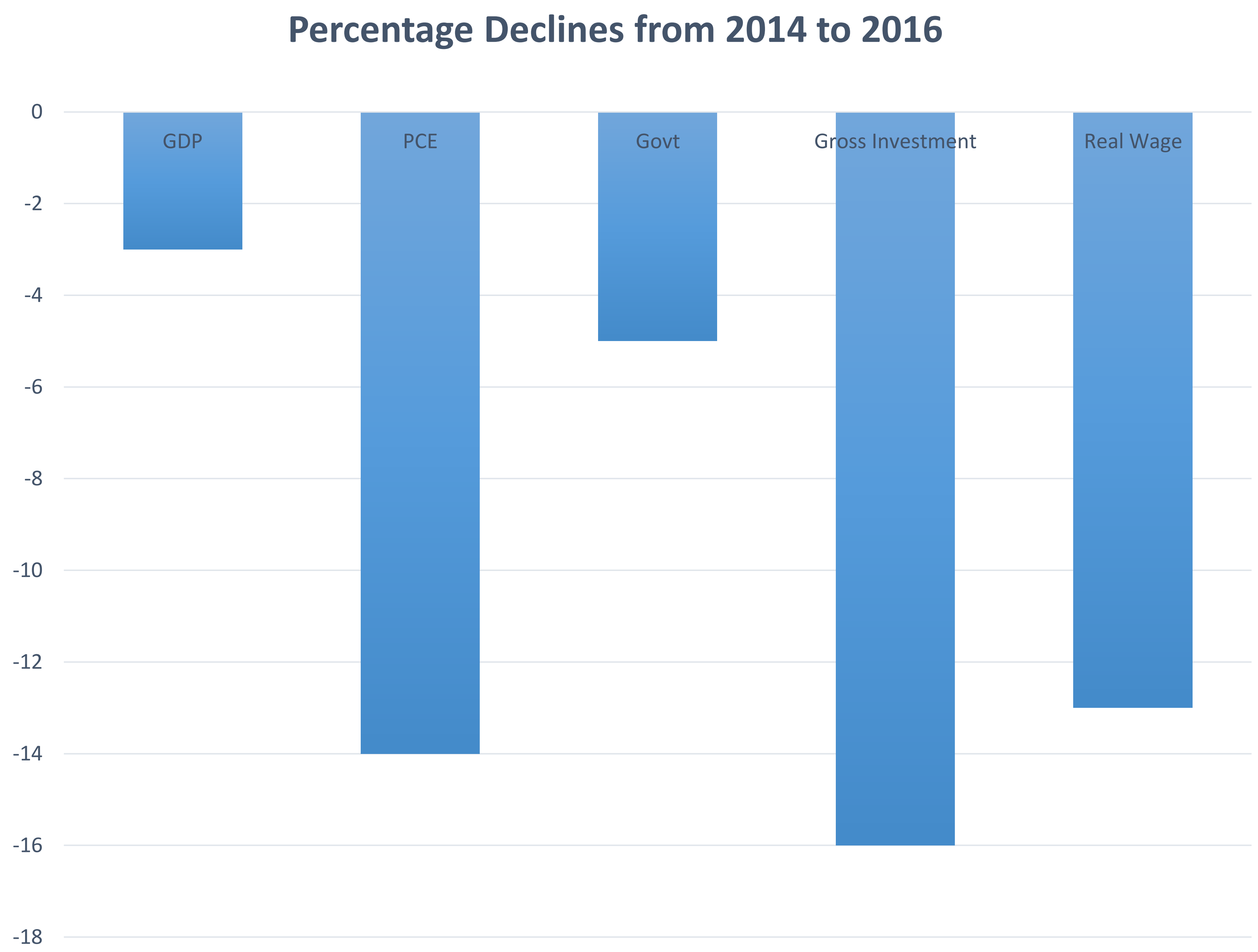

Country Moving in Right or Wrong Direction
country moving in the right direction
country moving into a blind alley
90
80
70
60
50
40
30
20
10
0
7.1996
4.1997
11.1997
5.1998
11.1998
5.1999
11.1999
5.2
12.2
6.2001
12.2001
6.2002
1.2003
8.2003
2.2004
8.2004
2.2005
8.2005
2.2006
8.2006
2.2007
8.2007
2.2008
8.2008
2.2009
8.2009
2.201
8.201
2.2011
8.2011
2.2012
8.2012
2.2013
8.2013
2.2014
8.2014
2.2015
8.2015
2.2016
8.2016


Russian Public Opinion: Relation to United States
90
80
70
60
50
40
30
20
10
0
12.1999
7.2
9.2001
12.2001
4.2002
7.2002
10.2002
3.2003
5.2003
7.2003
10.2003
1.2004
4.2004
7.2004
10.2004
1.2005
4.2005
7.2005
10.2005
1.2006
4.2006
7.2006
10.2006
1.2007
4.2007
7.2007
11.2007
2.2008
7.2008
1.2009
7.2009
3.201
9.201
3.2011
11.2011
5.2012
11.2012
5.2013
12.2013
7.2014
1.2015
7.2015
1.2016
7.2016
1.2017
Relate to US "good"
Relate to US "bad"

Putin has Presided Over Two Recessions

- 2009 associated with the world financial crises, which froze credit markets and drove down the price of oil. Duration: One year.
- 2015 to present: associated with decline in energy prices due to fracking revolution and financial sanctions
  - Sanctions for Crimean annexation, MH17, August invasion with regular troops.

Period	1st recession, Q1-Q4, 2009	Recovery 2009-2011	End of growth Q1 2014-Q4 2014	2nd recession, Q1 2015 to Q4 2016
1. GDP growth	-7.8%	4.9%	No growth	-4.1%
2. Oil price	$116 to $42	$42 to $112	$106 to $84	$54 to $46
3. Foreign borrowing (net change in foreign debt)	Falls $85 bn	Rises $63 bn	Falls $81 bn	Falls $76 bn
4. International Reserves	Falls $75 bn	Rises $80 bn	Falls $157 bn	Falls $37 bn
5. Sanctions introduced March, July, August 2014				

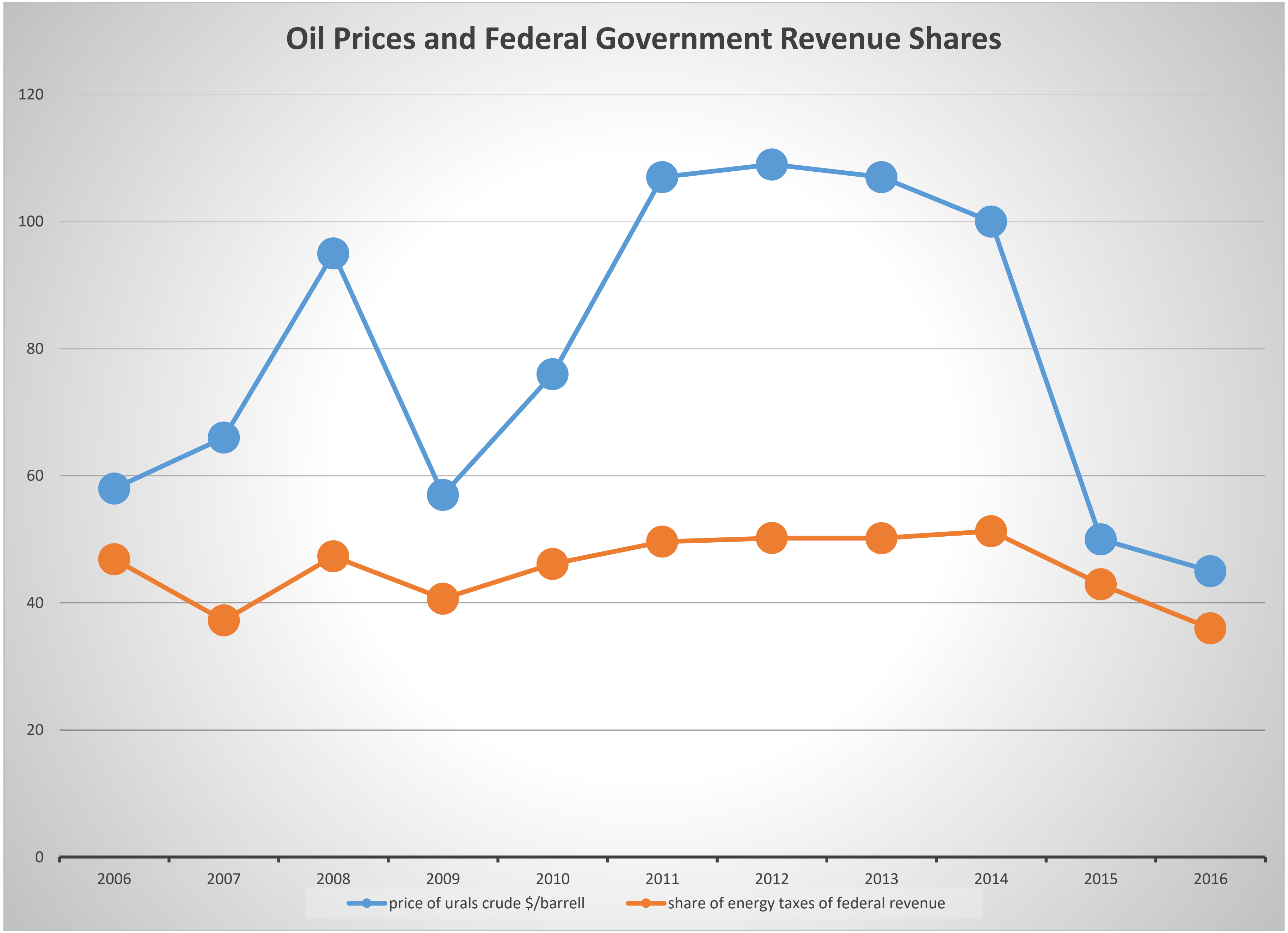

Percentage Declines from 2014 to 2016
0
-2
-4
-6
-8
-10
-12
-14
-16
-18
GDP
PCE
Govt
Gross Investment
Real Wage

Economic performance BC and AC (Before and After Crimea

- Oil prices began to decline late 2014
- Serious sanctions imposed July and August 2014
  - Sanctions on technology
  - Sanctions on specific companies and individuals
  - Sanctions not imposed on the Russian government

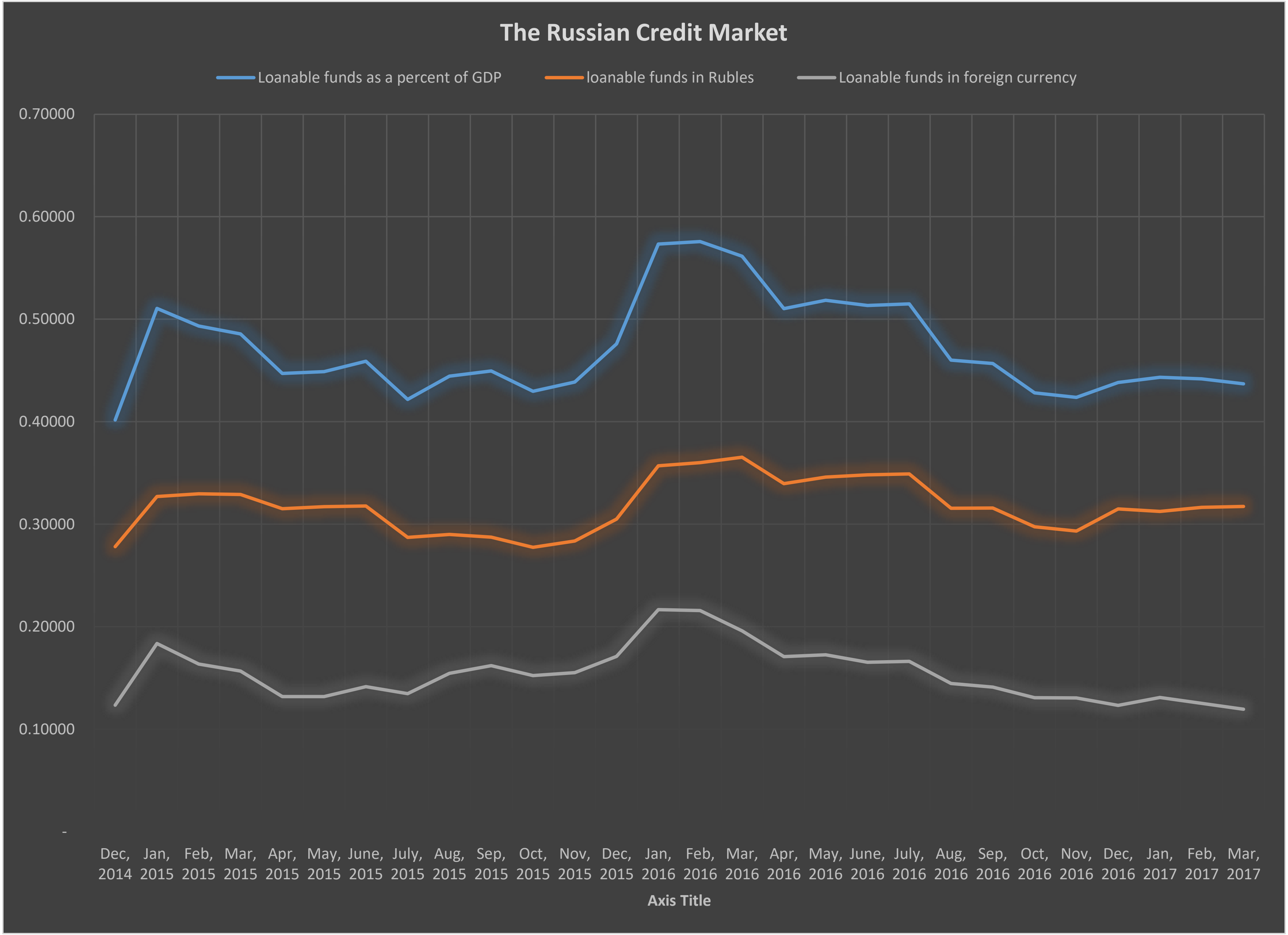
Before and After Crimea: Putin's Macroeconomics

- Can we pay for this venture?
- Federal government spending must be limited to revenues plus 3-4% deficit
- Emphasis on building reserves as a firewall


Oil Prices and Federal Government Revenue Shares
120
100
80
60
40
20
0
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
price of urals crude $/barrell
share of energy taxes of federal revenue

Russia’s Weak Credit Market and Danger of Sanctions

- Russia has financial depth roughly equivalent to a lower middle income country (Mexico)
- Russian households keep their assets in cash and metals
- Wealthier Russians try to park their assets abroad, largely in illiquid assets.
- Dependence on foreign credit markets
  - 2009: Russia marginal borrower
  - 2014 on: Russia suffered from financial sanctions



The Russian Credit Market
Loanable funds as a percent of GDP
loanable funds in Rubles
Loanable funds in foreign currency
0.70000
0.60000
0.50000
0.40000
0.30000
0.20000
0.10000
-
Dec, 2014
Jan, 2015
Feb, 2015
Mar, 2015
Apr, 2015
May, 2015
June, 2015
July, 2015
Aug, 2015
Sep, 2015
Oct, 2015
Nov, 2015
Dec, 2015
Jan, 2016
Feb, 2016
Mar, 2016
Apr, 2016
May, 2016
June, 2016
July, 2016
Aug, 2016
Sep, 2016
Oct, 2016
Nov, 2016
Dec, 2016
Jan, 2017
Feb, 2017
Mar, 2017
Axis Title

Putin's Primary Economic Concern: Avoiding Default and Bank Runs

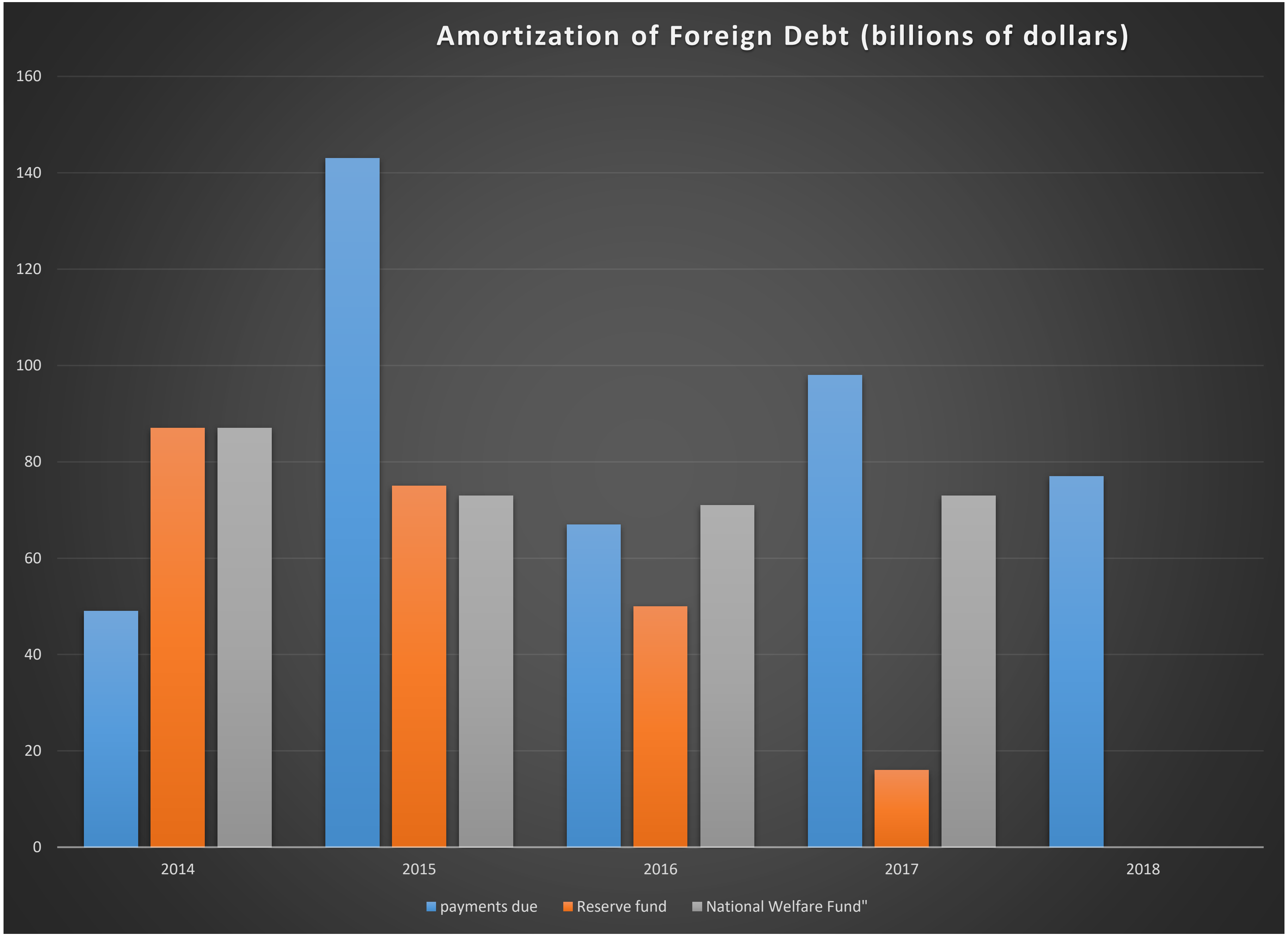
- Amortizing Russia's foreign debt
- Using Russia's two reserve funds (both managed by finance ministry)

    Reserve fund

    National Welfare Fund (perhaps already committed)

2009 needed to amortize only $14 billion

2015-present in next table



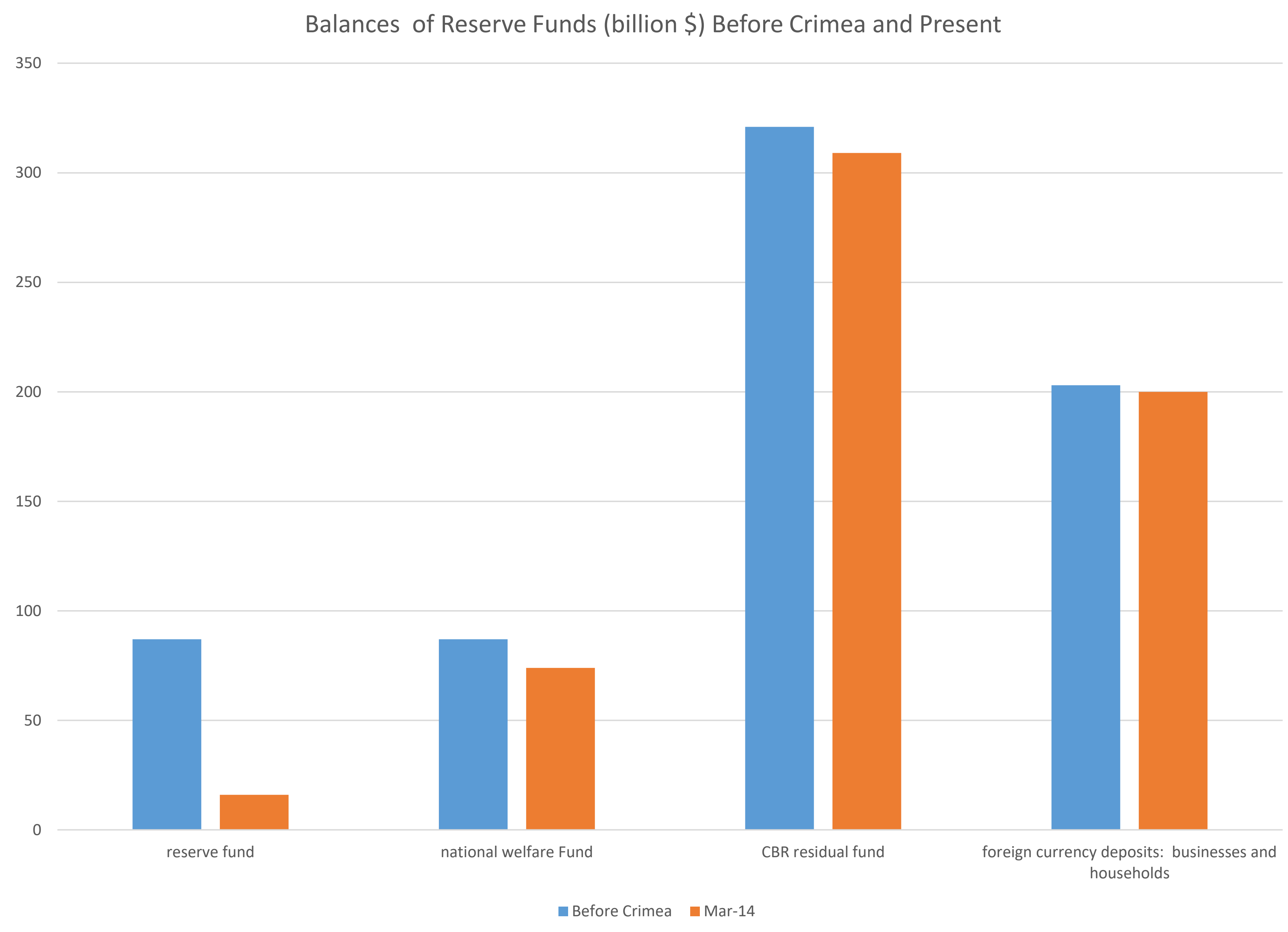
Amortization of Foreign Debt (billions of dollars)
160
140
120
100
80
60
40
20
0
2014
2015
2016
2017
2018
payments due
Reserve fund
National Welfare Fund"

Pressure of Low Energy Prices and Financial Sanctions in Midst of Military Build Up

- Russia’s weak domestic capital market
- Sanctions deprive Russia of foreign credit market
- Heavy repayment schedule (2015)
- Bank of Russia REPO operations
- Dwindling balances in reserve funds
- Involvement in Ukraine and Syria means must invest in military
- Russia regarded as unsafe and unprofitable target for investment
    - Domestic investors engage in capital flight
    - Virtually no FDI
    - Bad experiences of major investors

The Cost of sanctions and Anti Sanctions

- Russia narrative: We have sufficient foreign exchange reserves and rainy day funds to weather this easily. The sanctions are hurting Western business partners more than us. We can turn to China and Asia if we need to.
- Pro-Russian business and political lobby: The sanctions are not hurting Russia. They are hurting West. We need to go back to normal.
- Russian propaganda: The crisis is over. The exchange rate is rising. We are OK.

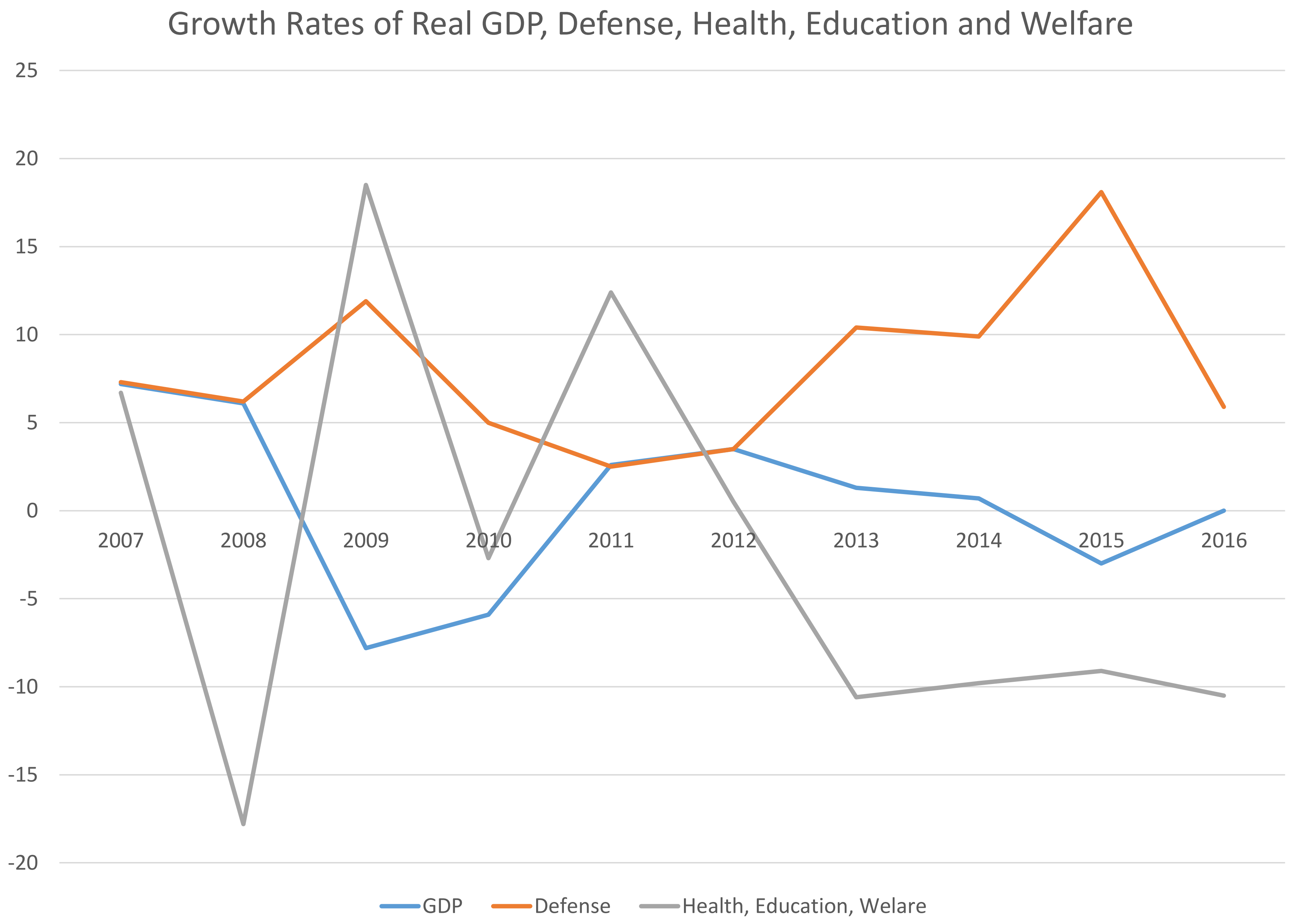

Balances of Reserve Funds (billion $) Before Crimea and Present
350
300
250
200
150
100
50
0
reserve fund
national welfare Fund
CBR residual fund
foreign currency deposits: businesses and households
Before Crimea
Mar-14

Putin’s Response: Austerity via Sequestration

- Russia is a country with modest national debt but troubling “national champion debt”
- Bank of Russia has little domestic debt but is a lender of last resort
- Modest programs of social security and pensions
- Large percent of labor force works for the state
- Putin’s goal of being an international player and world power requires a defense build up

Putin’s Austerity

- Introduce new taxes, Platon
- Delay indexation of pensions and wages
- Instead of indexation, one time payments
- Stop paying for Peoples’ Republics in Eastern Ukraine



Growth Rates of Real GDP, Defense, Health, Education and Welfare
25
20
15
10
5
0
-5
-10
-15
-20
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
GDP
Defense
Health, Education, Welare


Russian Statistics Office, GDP growth Rate (y/o/y)
0.15
0.1
0.05
0
-0.05
-0.1
-0.15
2004-1
3
2005-1
3
2006-1
3
2007-1
3
2008-1
3
2009-1
3
2010-1
3
2011-1
3
2012-1
3
2013-1
3
2014-1
3
2015-1
3
2016-1
3

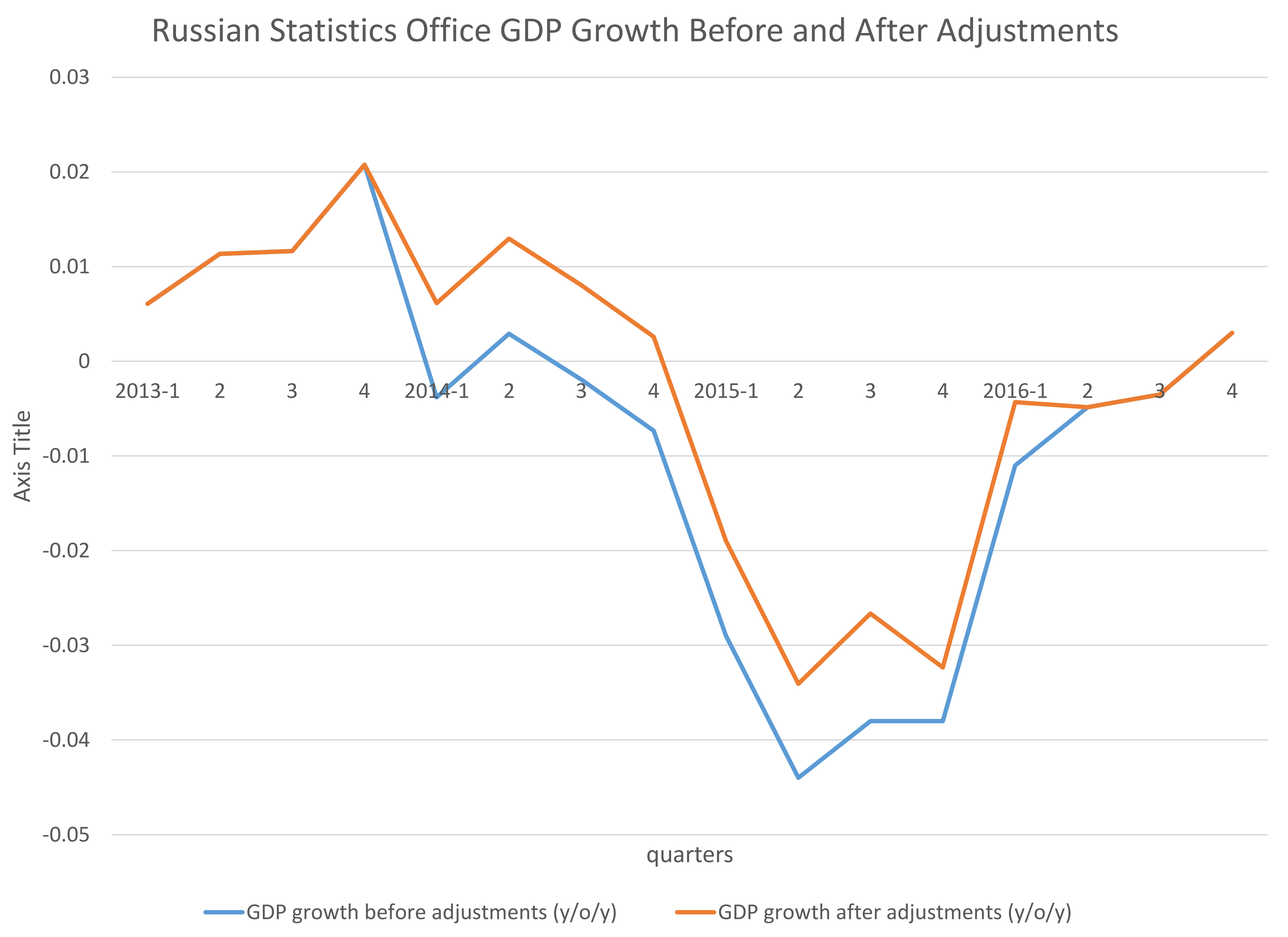
Looking for the Bottom

- Starting in 2015, Kremlin announced that “the bottom has been reached”
- Things are looking up
- Sanctions do not hurt
- Successful program of import substitution


Growth rates (y/o/y) major components of GDP, Russia 2004 to present
growth rate personal consumption y/o/y
growth rate government purchases y/o/y
growth rate gross investment y/o/y
ANNUALIZED GROWTH RATE
0.8
0.6
0.4
0.2
0
-0.2
-0.4
-0.6
-0.8
2004-1
2005-1
2006-1
2007-1
2008-1
2009-1
2010-1
2011-1
2012-1
2013-1
2014-1
2015-1
2016-1
3
YEAR

Start looking for Ways to Improve statistical results

- Handling of Crimea
- Reweighting
- Some 30 percent of defense budget now hidden



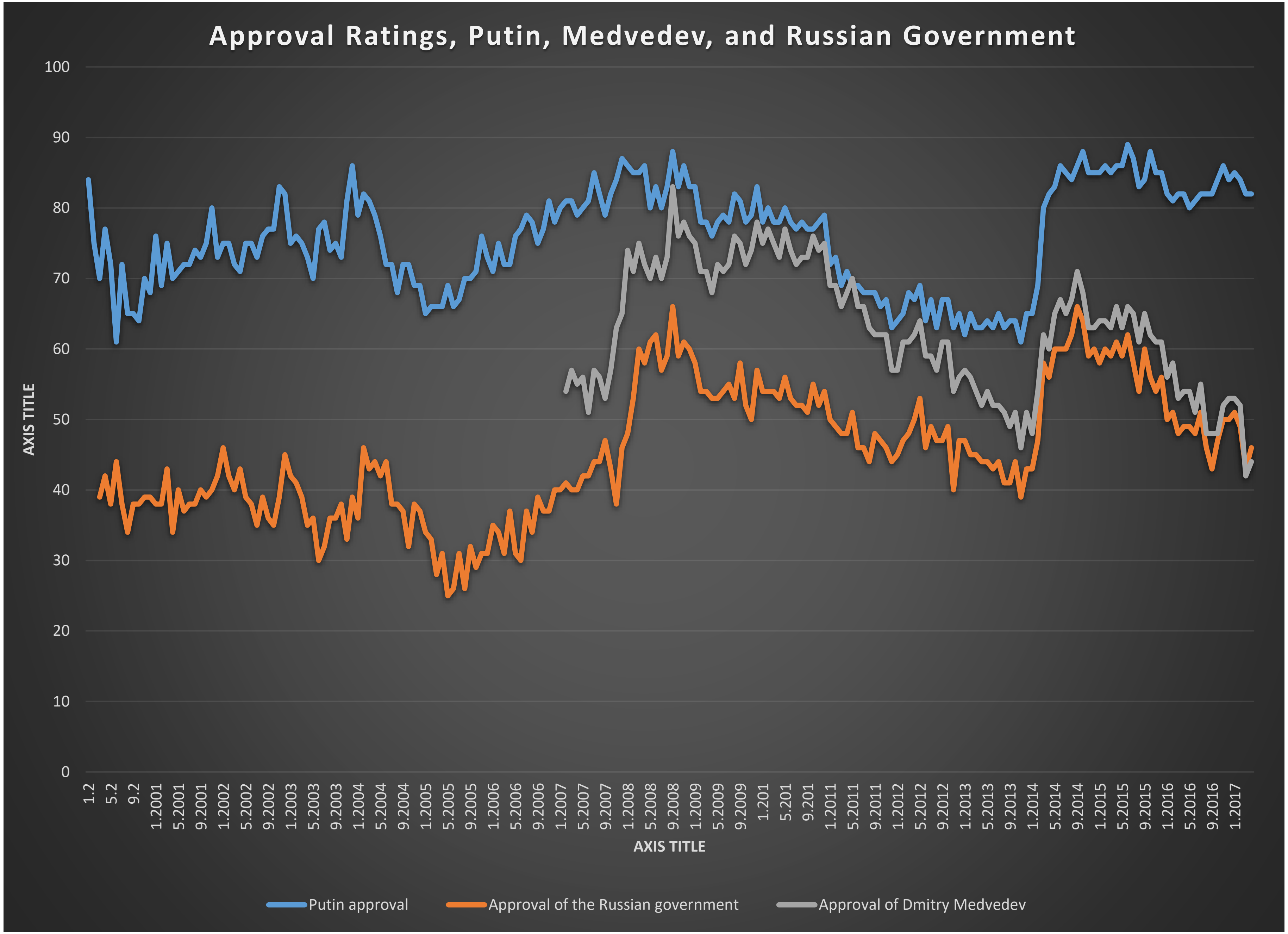
Russian Statistics Office GDP Growth Before and After Adjustments
0.03
0.02
0.01
0
-0.01
-0.02
-0.03
-0.04
-0.05
Axis Title
2013-1
2
3
4
2014-1
2
3
4
2015-1
2
3
4
2016-1
2
3
4
quarters
GDP growth before adjustments (y/o/y)
GDP growth after adjustments (y/o/y)

How to Maintain Approval Ratings

- The Western economy is to blame
- Import substitution is working
- Make sure there are no alternatives to Putin
- Conduct anti-corruption campaigns
- Western enemies responsible for most problems
- Political opponents as terrorists

Looking forwards to the March 2018 Presidential election

- Putin’s favorabilities still in the low 80s
- In 2011-12, they were in the low 60s
- Public opinion separates Putin from his government
- Presidential term now 6 years. Do Russian really want to elect Putin through 2024?



Approval Ratings, Putin, Medvedev, and Russian Government
100
90
80
70
60
50
40
30
20
10
0
AXIS TITLE
1.2
5.2
9.2
1.2001
5.2001
9.2001
1.2002
5.2002
9.2002
1.2003
5.2003
9.2003
1.2004
5.2004
9.2004
1.2005
5.2005
9.2005
1.2006
5.2006
9.2006
1.2007
5.2007
9.2007
1.2008
5.2008
9.2008
1.2009
5.2009
9.2009
1.201
5.201
9.201
1.2011
5.2011
9.2011
1.2012
5.2012
9.2012
1.2013
5.2013
9.2013
1.2014
5.2014
9.2014
1.2015
5.2015
9.2015
1.2016
5.2016
9.2016
1.2017
AXIS TITLE
Putin approval
Approval of the Russian government
Approval of Dmitry Medvedev

Prospects

- Defense share of GDP equals 6 percent plus
- Little optimism for oil prices
- Consensus forecasts call for one percent growth
- If immediate past holds, defense share will rise at 5 percent per year.