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Storm Clouds Ahead: Putin Lacks Strategy to Save Russia's Economy

Whether you view the glass as half full or half empty, the Russian economy is in for an unpredictable ride.

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Maxim Stulov / Vedomosti

Russian economic indicators were equivocal enough during the first half of the year to provide space for both optimists and pessimists. Arguably the glass was half full. Arguably it was half empty.

For the pessimists, GDP fell around 1 percent year-on-year, all components of the domestic demand continues to shrink, and the economy continues to be in recession, now six quarters in a row. For the optimists, the speed of decline is steadily reducing and, hopefully, in the second half of the year it might come to zero, after which the economy should start to recover — and a good harvest will help.

Inflation is going down. Five quarters ago, it was over 17 percent. Now it has fallen below zero, even to the point of deflation. OK, reply the pessimists, but deflation is a result of seasonal factors, while the Central Bank is keeping its key rate at a very high level (10.5 percent), and refrained from cutting it ten days ago, saying there are visible inflationary risks.

Investment continues to decline, both industrial and in residential construction. Private consumption declines as well, while Russian people say they are cutting their purchases of goods and services to survive. Then again, industrial production is stable, agriculture continues to grow, export is growing slightly in physical terms, despite the drop in commodities prices.

This economic dialogue will continue for a long time, but the main conclusion we can make is already visible. The Russian economy continues to shrink, while the rest of the world economy continues to grow. In other words, you cannot blame external factors for everything. Oil prices started to decline two years ago and since December 2015, i.e. more than year and a half, they have remained within the $35-$50 corridor. The Russian economy has adjusted to this fact — oil production is growing. After a 50 percent fall, import has stabilized and started to recover.

The budget, however, has not adjusted to the new level of oil prices. Buoyed by oil and gas revenues, the state budget inflated expenditures on wages, pensions and social transfers (now 56 percent of the federal budget.) It boosted military spending to 25 percent of overall federal budget spending.

In an attempt to keep the deficit within limits, the government froze wages and pensions, and is cutting investment and current expenditure. Unable to borrow sufficient funds in the financial markets, and unwilling to embrace privatization, the government is now heavily reliant on its “reserve fund,” which may be depleted as soon as the first half of next year.

Under current conditions, the main reserve fund will disappear in a couple of quarters. Russia has a second emergency fund, which will allow the deficit to be financed for another a 1-1.5 years, that is, providing budget expenditures are stable. No reform program currently implemented is likely to boost economic growth to 4-5 percent next year. That means the federal budget will be short of funds in the next 2.5-3 years at the very least.

The promotion of Alexei Kudrin to the Presidential Economic council a while ago boosted hopes for new reforms. But these hopes were soon undermined by the fact that Kudrin himself ruled out reform before 2018, and that Putin then asked for competing plans from other factions within government, including from the nationalist economist Sergei Glazyev. Such bureaucratic competition reduces the possibilities for a comprehensive plan.

Each group will now report directly to Putin with minimal interaction and cooperation between them. Putin himself is likely disinclined to make any decision on economic policy before his reelection in March 2018. No changes should be expected while many efforts will be dedicated to tighten the system before then.

Today, Russia faces two well-known impediments to economic development. The first one is its awful investment climate that prevents business from expanding. The second is Western sanctions that isolate the Russian economy from global cooperation and reduces its competitiveness. Both problems are not in themselves aspects of economic policy, but if they are not resolved no economic policy can ever provide needed results. Kudrin and the liberals know this rather well and try to place those ideas gently into their statements. All of them are afraid to do it openly since Putin is not yet ready to compromise and will not allow economic reform undermine positions at home and abroad.

We already know the pre-condition for sanctions to be removed, i.e. that the Minsk 2 eastern Ukraine peace agreement should be implemented, which means Russian soldiers and volunteers as well as Russian weapons should leave Ukrainian territory, and Ukraine should obtain full control over its borders. There may not be a plan for global war with Ukraine or Crimea/Abkhazia-type annexation of the Donbass, but Putin is not ready to give up the Donbass in this way. Instead Putin hopes to use the slow progress of Ukraine in reforms and Europe's fatigue of uncertainty to remove sanctions.

Such hopes are not entirely quixotic. Putin is extremely good at tactical moves, but fails in strategy. His favorite sport is judo. Here, all you need is a general vision in mind — victory — but you can hardly build any strategy, and instead you hope tactical decisions will lead you to your goal. Putin's lack of strategy has meant it is impossible to predict moves and actions. The continuing economic slide will force Putin to dedicate more time and efforts to the economy in the coming years. At the same time, we can expect his decisions to be chaotic and will hardly allow the economy to recover.

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