

# Economics and Politics of Modern Russia

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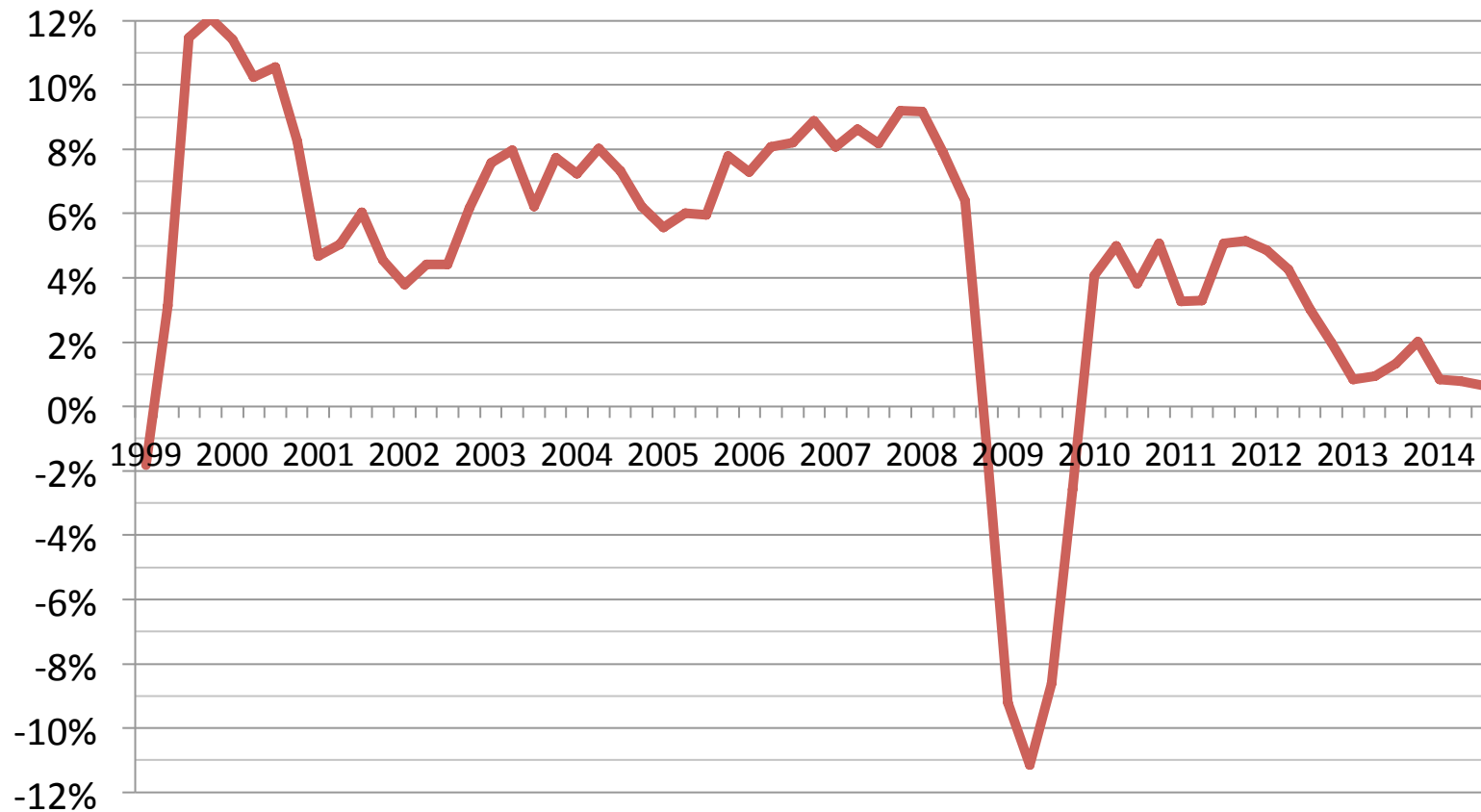
# Today's talk

- What is happening in Russian economy today
- Why it is happening
- Why could/should be done
- What will be done

# Russia's economy in the 21<sup>st</sup> century

- Dramatic economic performance
  - Spectacular growth in 1999-2008
  - Record decline in 2009
  - Recovery in 2010-12
  - Slowdown starting from 2H2012
  - Major recession in 2015
- How can we explain this?
- What to expect?
  - How long will it last?
  - How will it end?

# Russian GDP growth rates, constant prices, seasonally adjusted



# Interaction of economics and politics

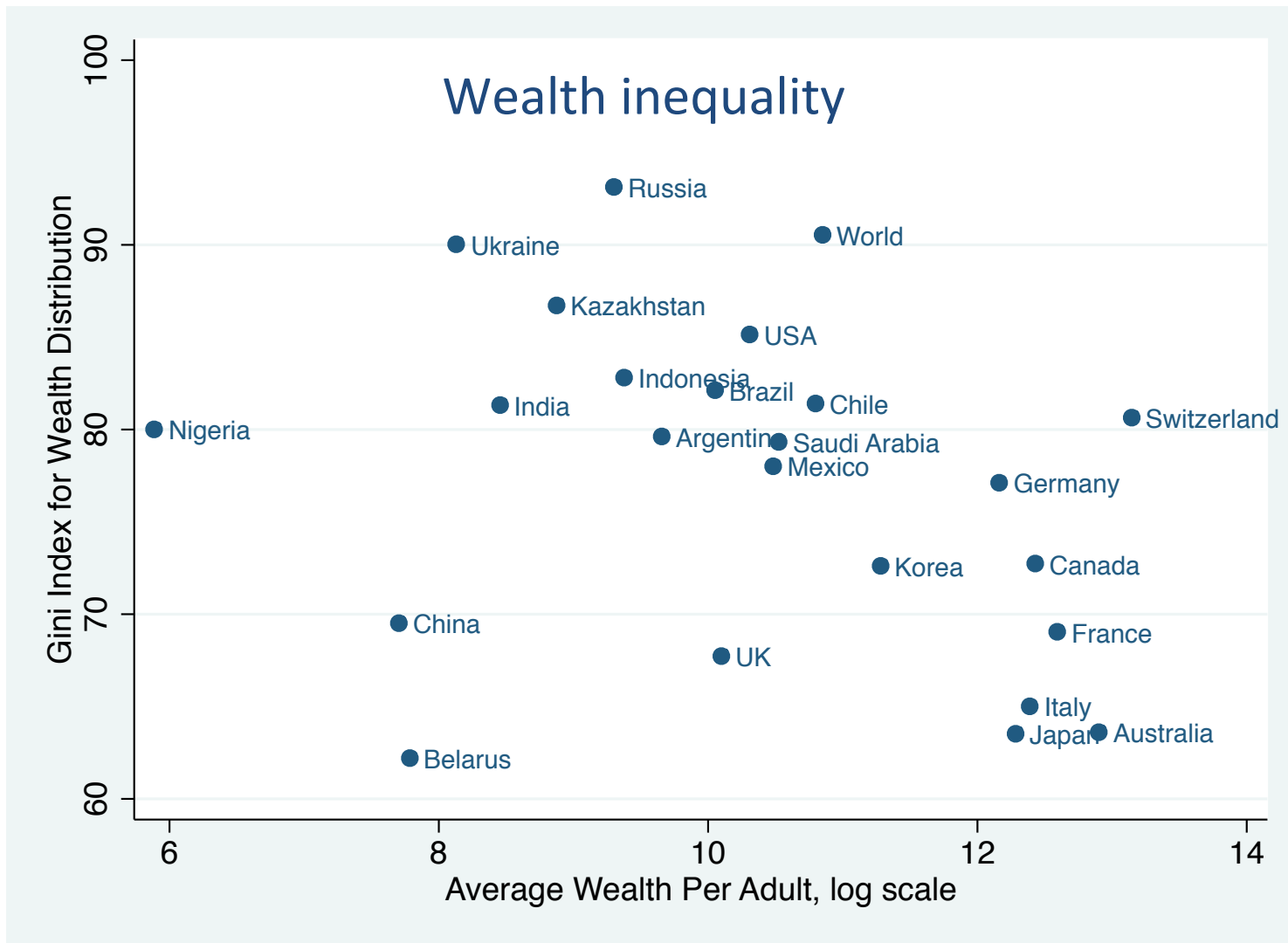
- Politics is crucial for understanding the economic slowdown
- And slowdown was important for foreign policy decisions in 2014
- The economic costs of 2014 foreign policy will eventually have political implications

# Impressive decade of growth

- 1999-2008: GDP per capita doubled
  - Average growth 7% per year – Russia has never had a decade like this (even in 1930s)
- Growth trickled down to all parts of Russian society
  - Oligarchs benefitted but not only
    - Inequality very high but has not increased
  - Unemployment and poverty halved
  - Real wages tripled
  - Russia became largest car market
  - Consumer lending (including mortgages) took off

# Forbes' Billionaires, 2014

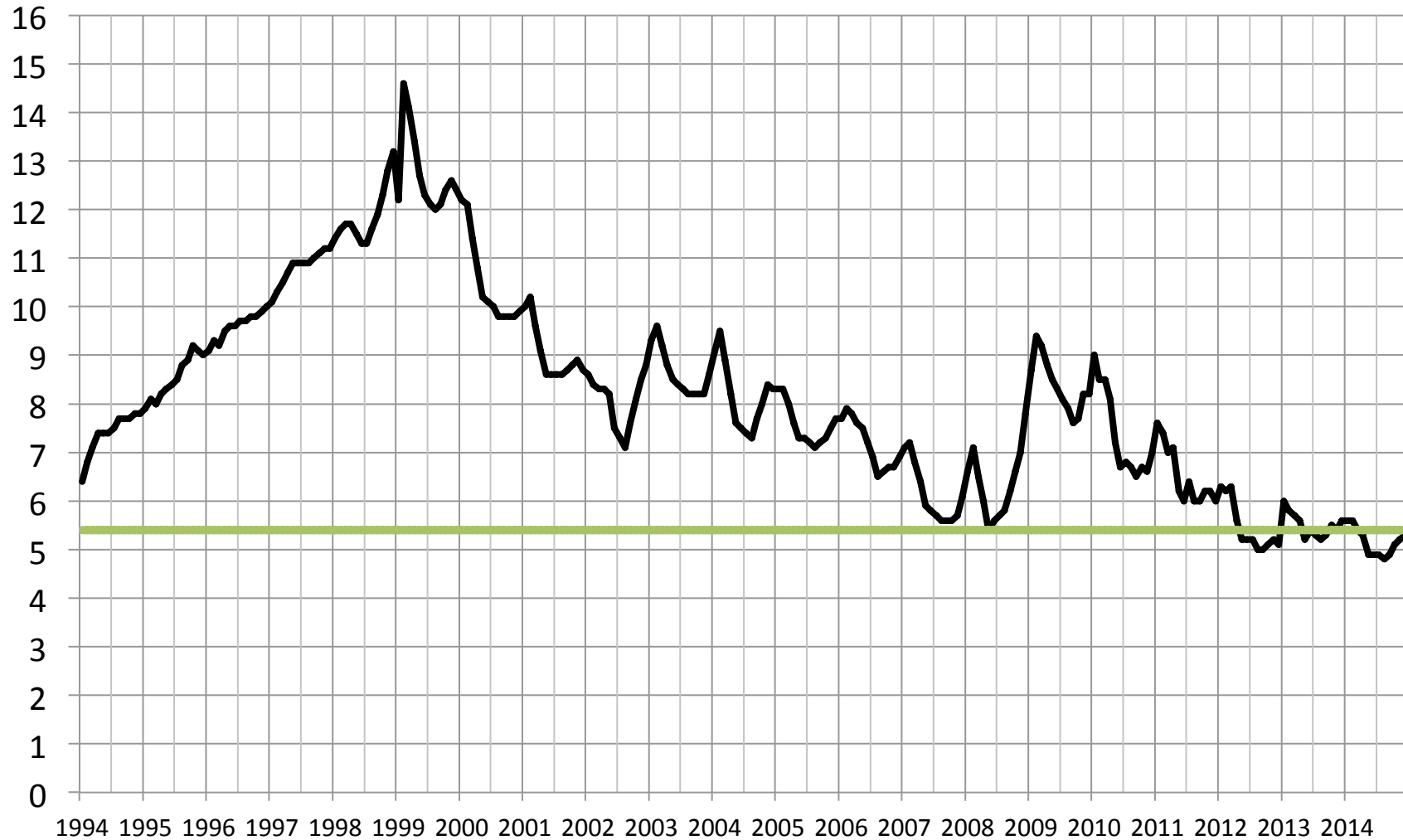
	<b>Number of billionaires</b>	<b>Total wealth, USD billion</b>	<b>Total wealth, % annual GDP</b>
USA	479	2321	14%
Russia	107	427	20%
China	127	322	3%

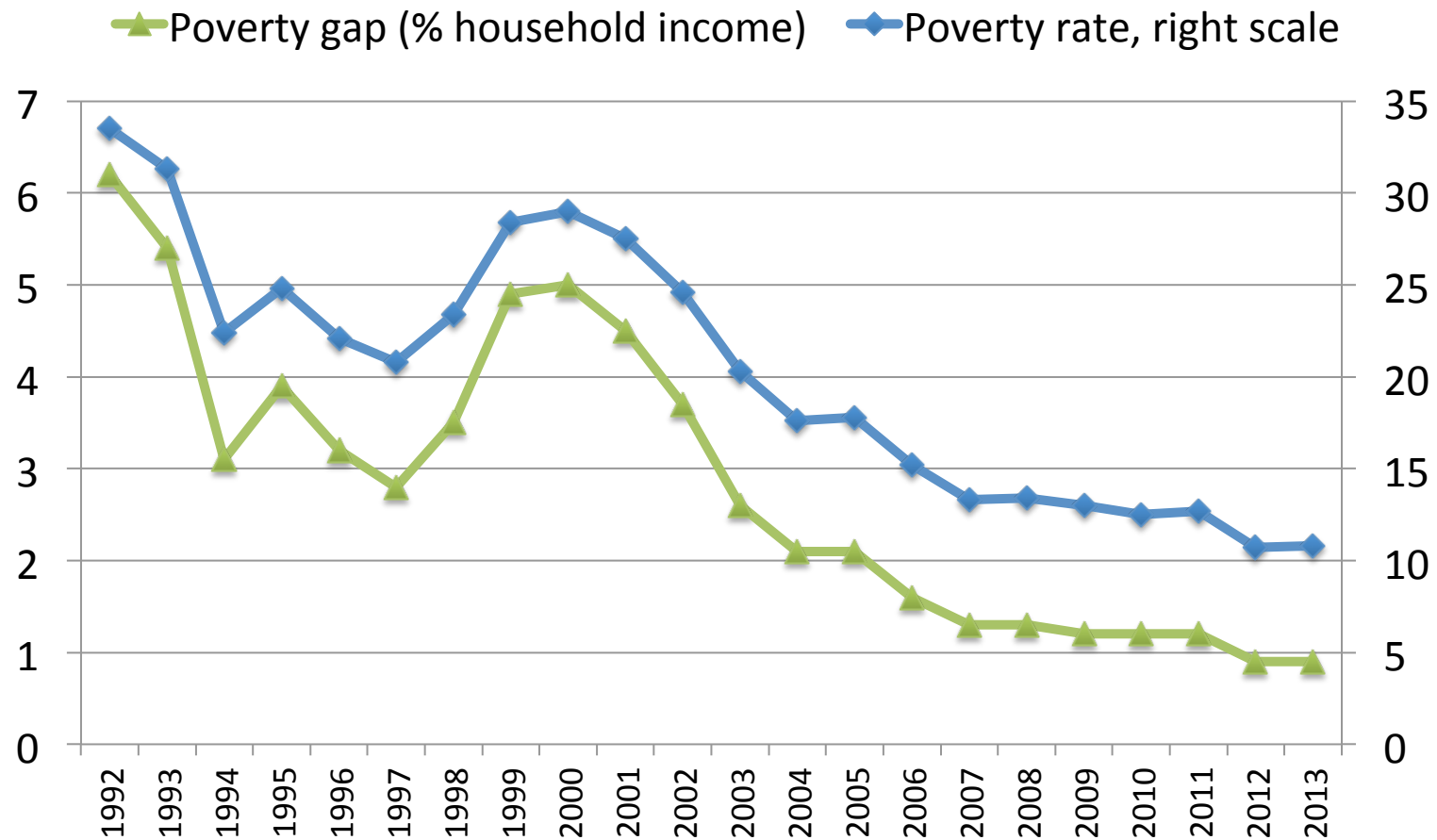


Source: Global Wealth Report, 2013



# Unemployment declined from 14% to 5%

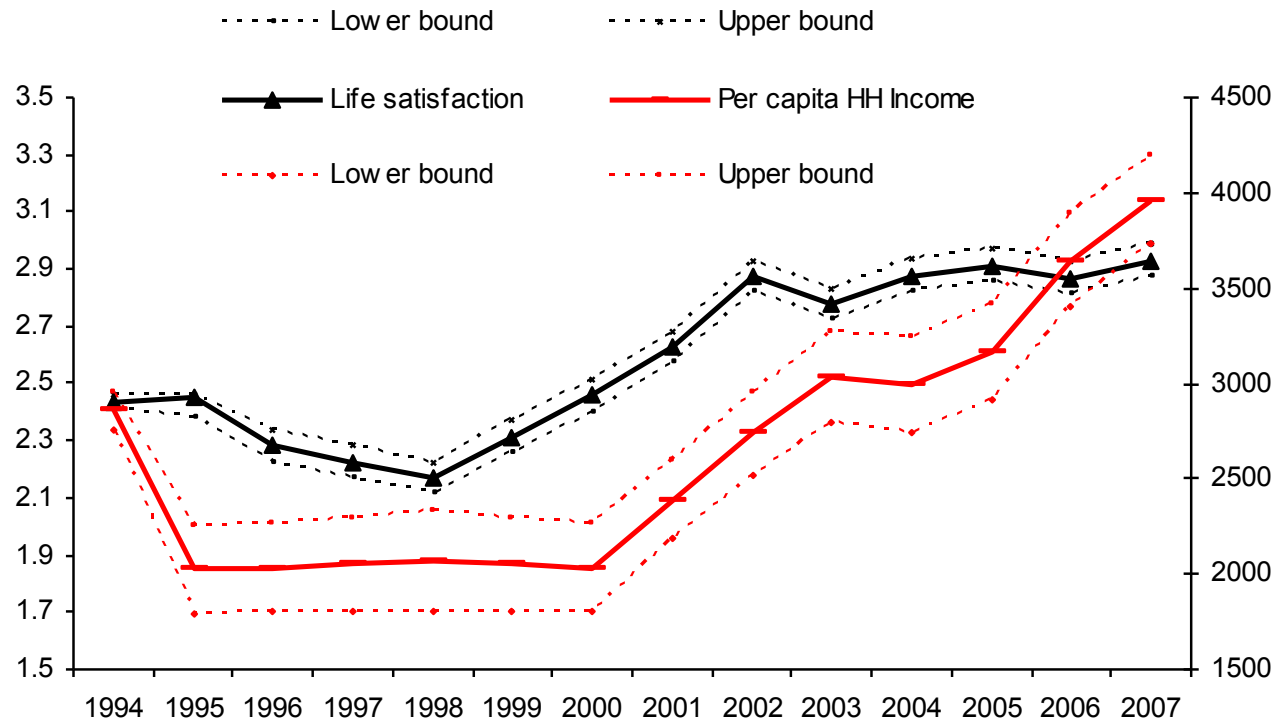




# Social contract in 2000s

- Putin centralizes government, reduces accountability and limits freedoms
- But public is satisfied with income growth
- Treisman (2011):
  - Putin's approval ranking was closely correlated with economic performance
- Guriev Zhuravskaya (2009):
  - in all transition countries – including Russia and especially in Russia – income growth raised subjective well-being

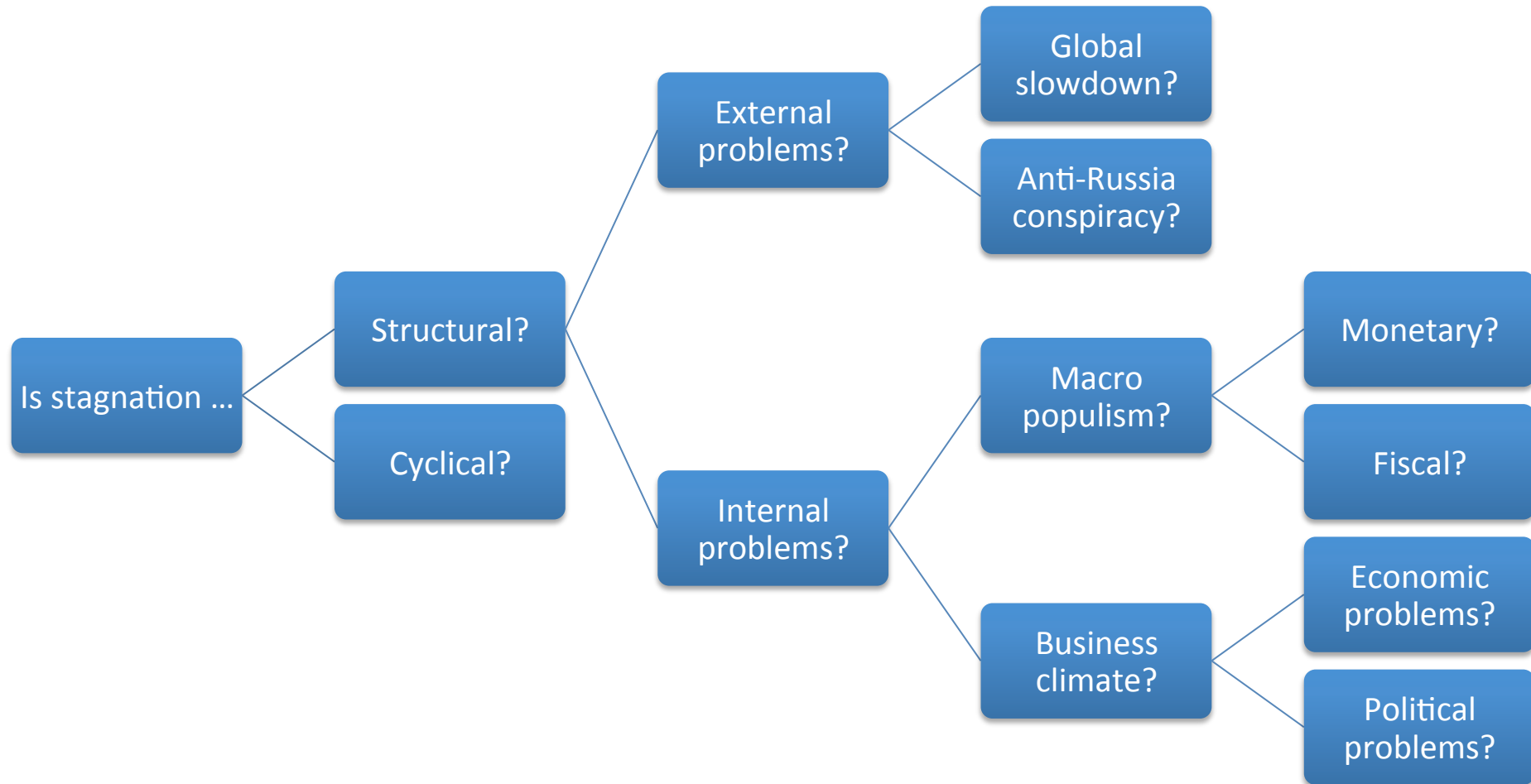
# Income and happiness in Russia, RLMS panel (Guriev and Zhuravskaya, 2009)



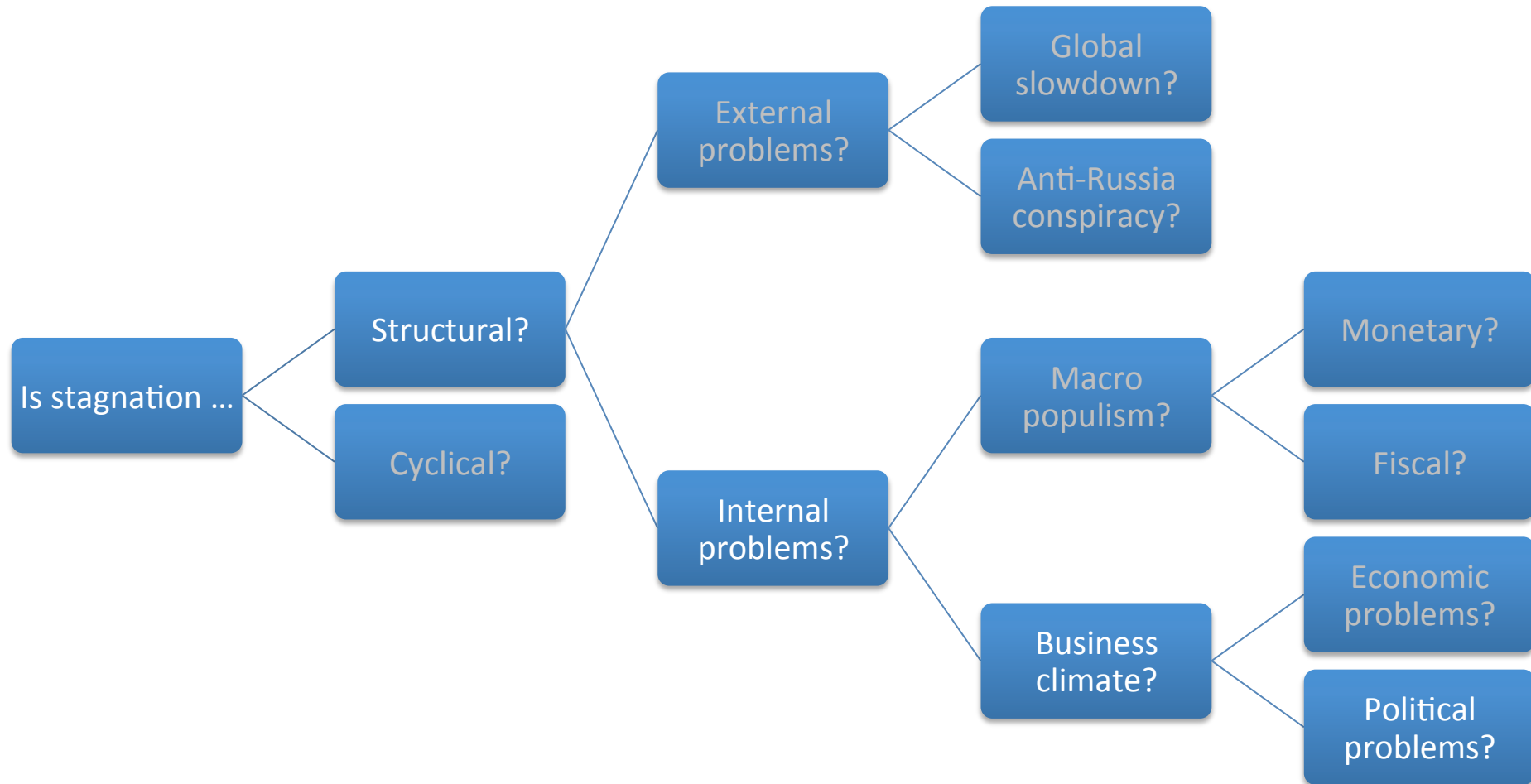
# Crisis, Recovery, and Slowdown

- 2008: oil prices and financial squeeze
  - Plus a few policy mistakes (in particular, delayed devaluation)
  - Largest GDP fall among G20 countries: -8%GDP in 2009
- Recovery in 2010-11: 4% per year
- Putin comes back as President in 2012
  - In 2H2012 growth starts to slow down

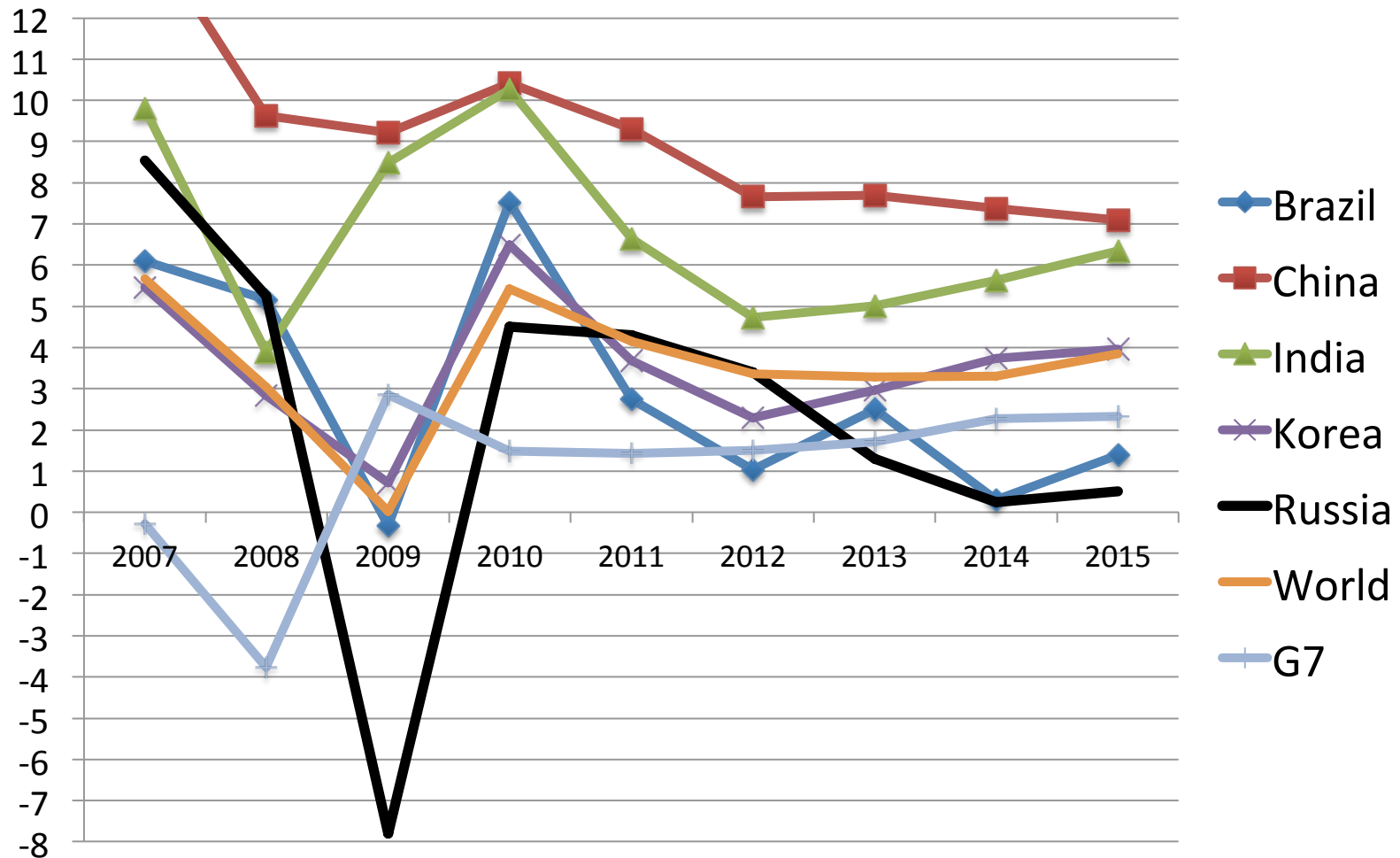
# Why slowdown?



Slowdown was due to poor investment climate which was/is an essential part of the political equilibrium



# Other emerging economies were growing – and so did G7 and the world economy

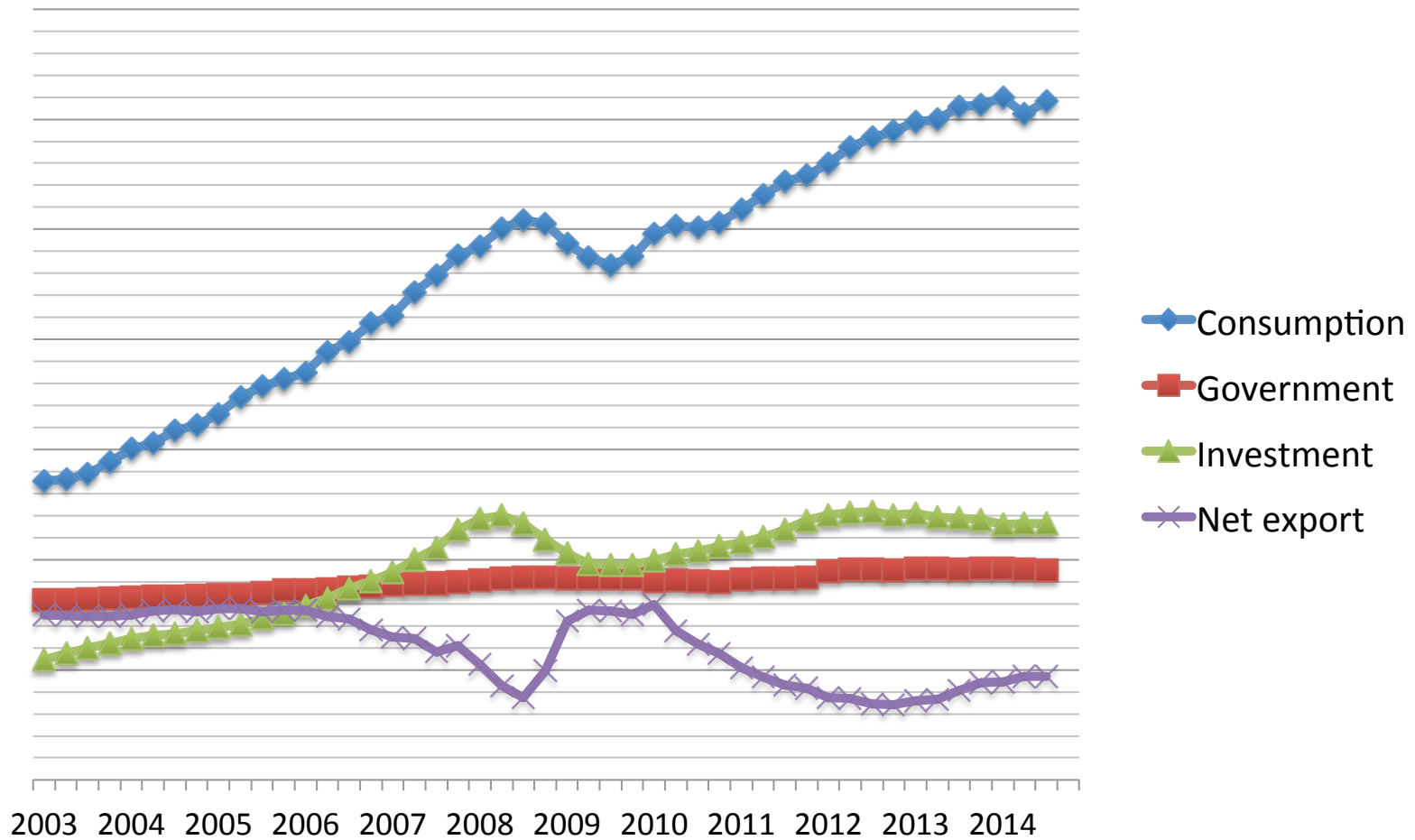




# Consumption was growing

- Consumption in 2012-13 was growing at 5-8% per year
- Driven by financial development:
  - Consumer lending went up by 40% in 2012 and by 25-30% in 2013
  - Now, the stock of consumer lending 10.6 trln rubles
  - This is not too high but if we look at non-mortgage lending, it would be 8 trln
  - This is 14% GDP – like in Western Europe (and not much lower than the US's 20%GDP)
- No “cyclical” problem of “saving rather than spending”
  - Consumers preferred to spend rather than save and invest

# Slowdown was due to falling investment (quarterly data, constant prices, seasonally adjusted)



# Stock market was heavily undervalued even before Crimea

- Trading at 50% of pre-crisis peak



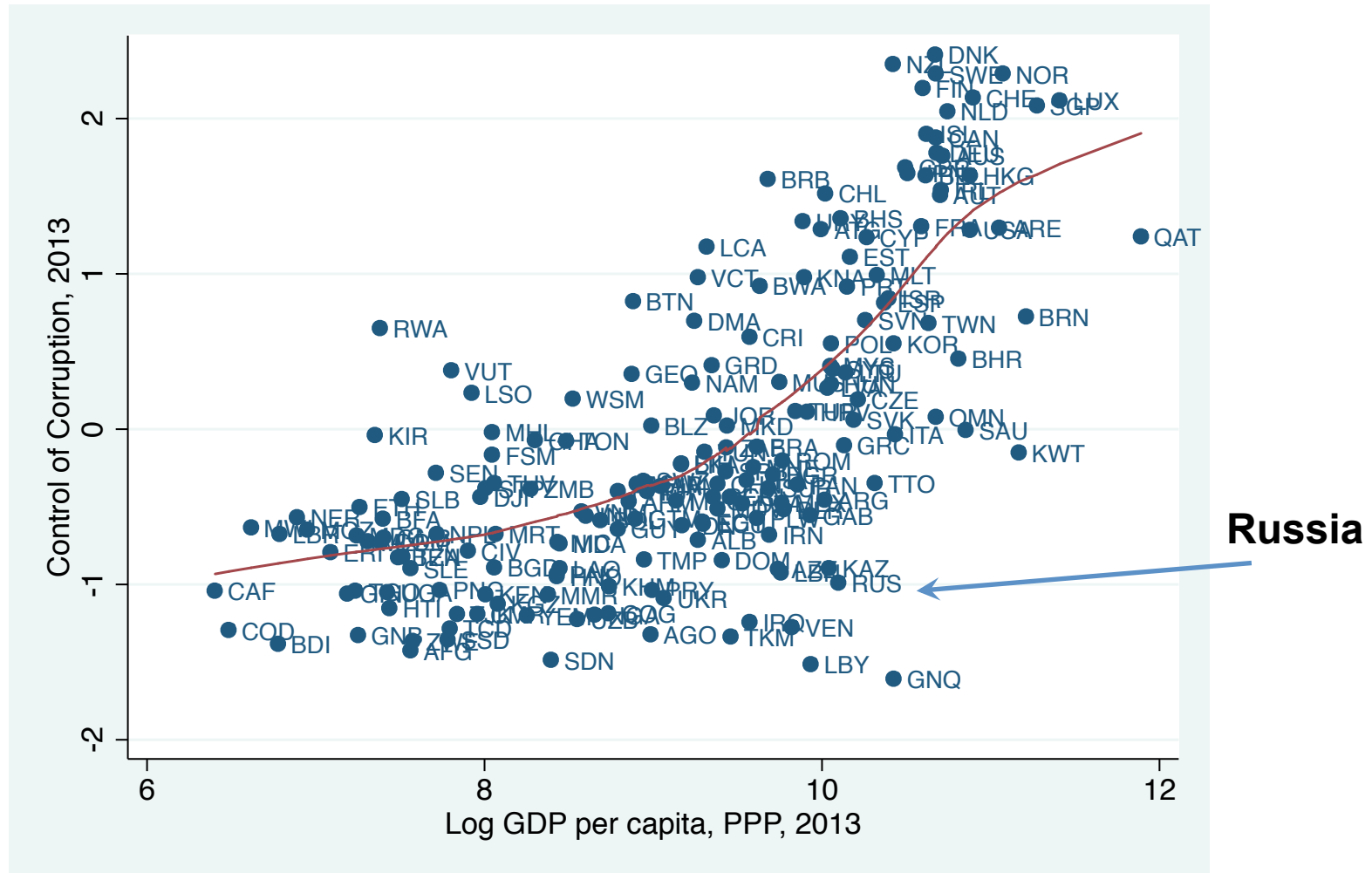
# Stock market multiples were VERY low already before Crimea

- Trades at P/E=5-6
- Compare to MSCI Emerging Markets Index of 12
- Investors vote with their feet?
  - Most of Russian stock market – government-owned companies, most in energy sector
  - Low valuations despite high oil prices before Crimea
  - Gazprom was trading at P/E=2.0-2.5

# Capital outflow

- 2007: Capital inflow (oil price was lower than than in 2012-13)
- Capital outflow started in Sep 2010
- In 2011: \$80.5B=4.5%GDP
  - Compare to 21%GDP investment
- Continued in 2012-13 at 3%GDP (despite “political stability”)
- Why?
  - High corruption and bad investment climate

# Corruption in Russia is much higher than in other comparable countries today



# Did government know what to do?

- Reforms plans have been drafted by the very same government several times
  - “Gref Program” 2000
  - “Concept for Long-Term Development” 2008
  - “Strategy 2020” 2011
  - “Open Government’s Report” 2012
- And President Putin’s programmatic article “We need a new economy” in January 2012 and Decree 596 in May 2012

# Political incentives?

- All governments need growth?
  - Ceteris paribus, better have a piece of a bigger pie
  - But pro-growth policies may undermine changes to hold on to power
  - Better have a bigger piece in a small pie than no piece in a big pie
  - Resource rents reinforce the attractiveness of the “smaller pie” scenario
- Government’s power base:
  - Bureaucrats → over-regulation
  - State companies → anti-privatization
  - Poor → redistribution
- Pro-business policies have much lower political returns
  - Rule-of-law
  - Competition
  - Openness



# 2014: the need for new social contract

- Social contract of 2000s:
  - Government is corrupt and is not accountable
  - Public enjoys the benefits of the economic growth
- Old sources of growth are exhausted
  - 1999-2008 growth was based on growing oil prices, cheap labor, underutilized capacity, reforms of Putin's first presidential term
  - And 2010-12 recovery was driven by credit-backed consumption boom
- Slowdown destroys the social contract:
  - Either improve investment climate (politically risky)
  - Or come up with a new social contract
- New social contract:
  - No reforms, no economic growth
  - But imperial rhetoric and territorial expansion

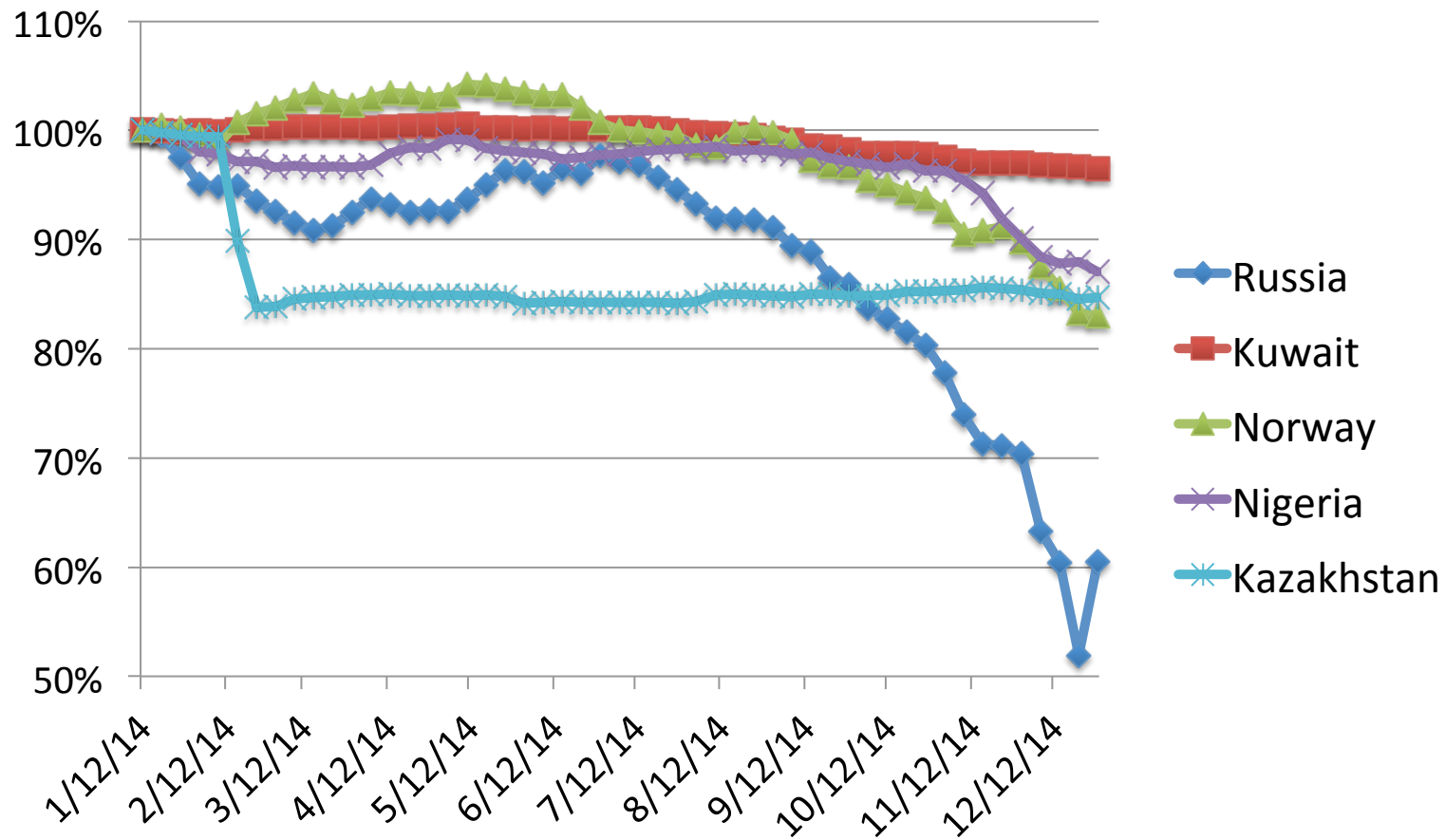
# 2015: Perfect storm

1. Corruption and bad investment climate
  - Slowed down already before Crimea
2. Low oil price
  - Even with floating ruble, additional fiscal problem of 3%GDP
3. Sanctions
  - Cannot borrow its way out of crisis

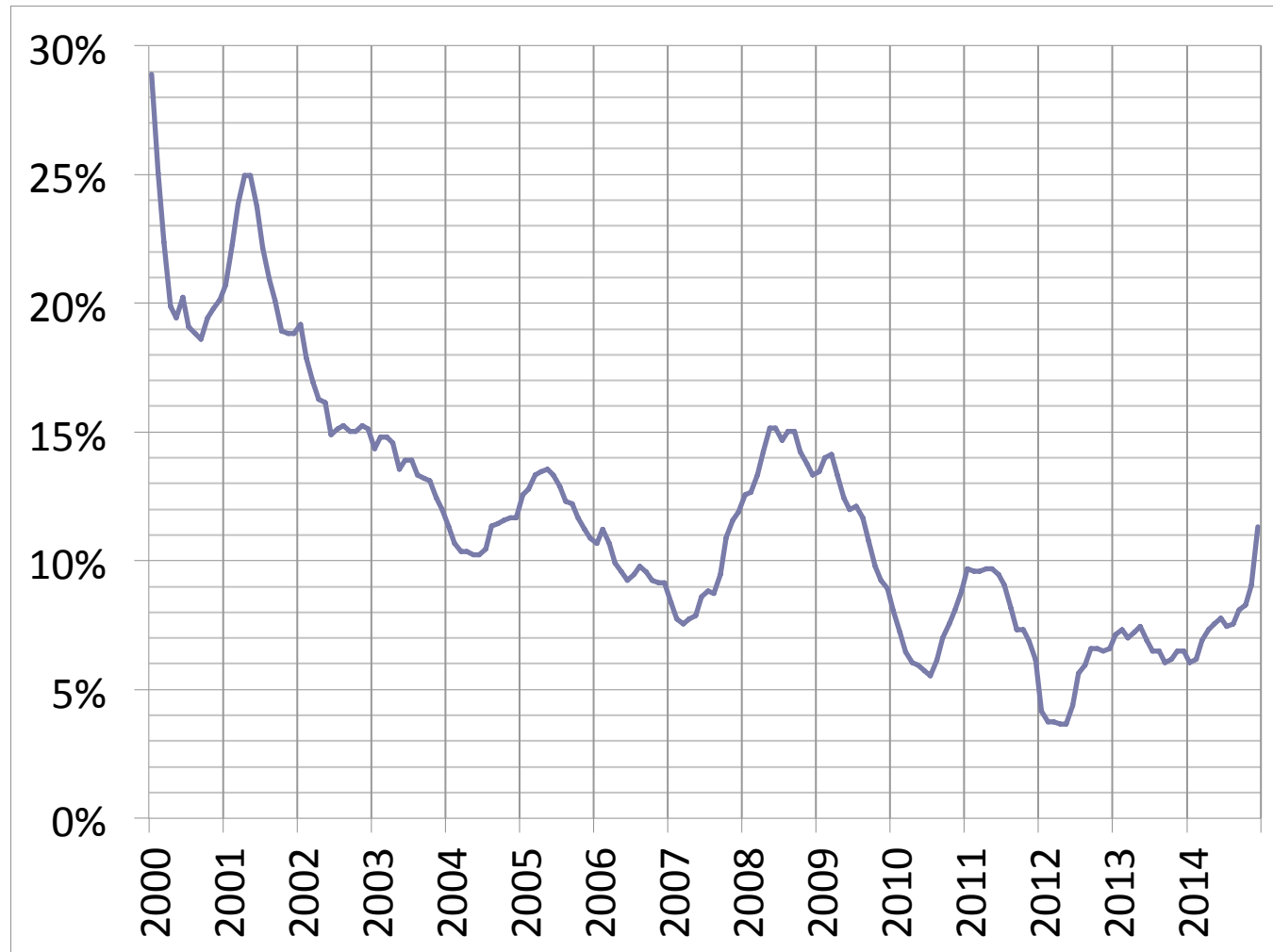
Consensus forecast for 2015:

- 4-5% GDP fall (at \$50-60/barrel)
- And up to 10% fall in real incomes (unlike 2009)

# Russian ruble in 2014 vs. other oil currencies



# Inflation is back to double digits



# Capital flight is even higher

- Compare to 3-4% GDP in 2011-13:
  - 150 billion dollars in 2014 (12% GDP)
- Official forecast for 2015:
  - 110 billion dollars in 2015 (10% GDP)

# Fiscal position

- Current budget is based on \$100/barrel and 2% growth
- Deficit in January 2015: 5.7% of (monthly) GDP
- Reserve Fund: 5.7% of (annual) GDP
  - National Welfare Fund (7.6% GDP) is already committed to infrastructure projects
- In order to stay afloat in 2016, government is planning to start spending cuts in 2015

# 2015 Budget

- Currently in the parliament
- Based on \$50/barrel and -3% change in GDP
- Spending is cut by 2% in nominal terms
  - Hence 8% in real terms
- Budget deficit 3.7%GDP
- Majority of Reserve Fund is spent in 2015
- Unless oil price recovers, Russia runs out of cash before the end of 2016

# External debt

- Sovereign debt is low (13% GDP)
- But together with corporate debt it is \$600B (now 50%GDP)
  - About 25% of it is denominated in rubles
- Only \$120B matures in 2015
  - Allegedly, only \$75B to the Western creditors
  - The rest to Russian-owned offshore entities
- Central Bank's reserves \$375B
- Thus, not a critical problem in 2015 or even 2016



# How does regime function now?

- There is no ideology
- There is no mass repression
- The main tool is propaganda and censorship

# Guriev and Treisman (2015) “How dictators survive: Cooptation, Censorship, Propaganda, and Repressions”

- Dictatorship based on information rather than ideology or repression
- Public prefers competent to incompetent dictators
  - Observe their own consumption
  - And signals from official media (propaganda) and independent media (elites/opposition)
- Dictator wants to convince the public that he’s competent
  - Uses propaganda
  - But also needs to silence informed citizens
    - Through cooptation
    - Or through censorship

# Russian regime is not unique

**Table 1: Changing characteristics of non-democracies, 1980-2012**

	Percent with ongoing mass killings	Percent with <i>no</i> elected legislature	Percent of those with legislatures where government parties have more than 95 percent of seats
1980	22	33	70
2012	6	15	35

**Sources:** Database of Political Institutions 2010 (see Beck et al. 2001); Polity IV database; Mass Killings Database (see Ulfelder and Valentino 2008, and updated data at <https://dartthrowingchimp.wordpress.com/2013/07/25/trends-over-time-in-state-sponsored-mass-killing/>).

# Multiple equilibria

- For the same parameters, there exist
  - Equilibrium with cooptation
  - And equilibrium with censorship
- Coordination problem among the informed citizens
  - If one is not coopted, dictator shifts resources previously spent on cooptation towards propaganda
  - Hence higher returns to joining opposition for other informed citizens  
... and more censorship
- In 2014, Russia may have switched to censorship equilibrium
- Reaction to economic shocks:
  - In the equilibrium in censorship, dictator responds to negative reallocation of resources towards propaganda and censorship

# What next?

- If sanctions are in place and oil price is at \$50-60/barrel, will run out of money in 2016-17
- If gives up on Eastern Ukraine and Crimea, will look incompetent
- How will the transition happen?
  - All non-democratic regimes change in very unpredictable way
  - This transition will be historically unprecedented: the richest and most educated country in history moving from dictatorship to democracy