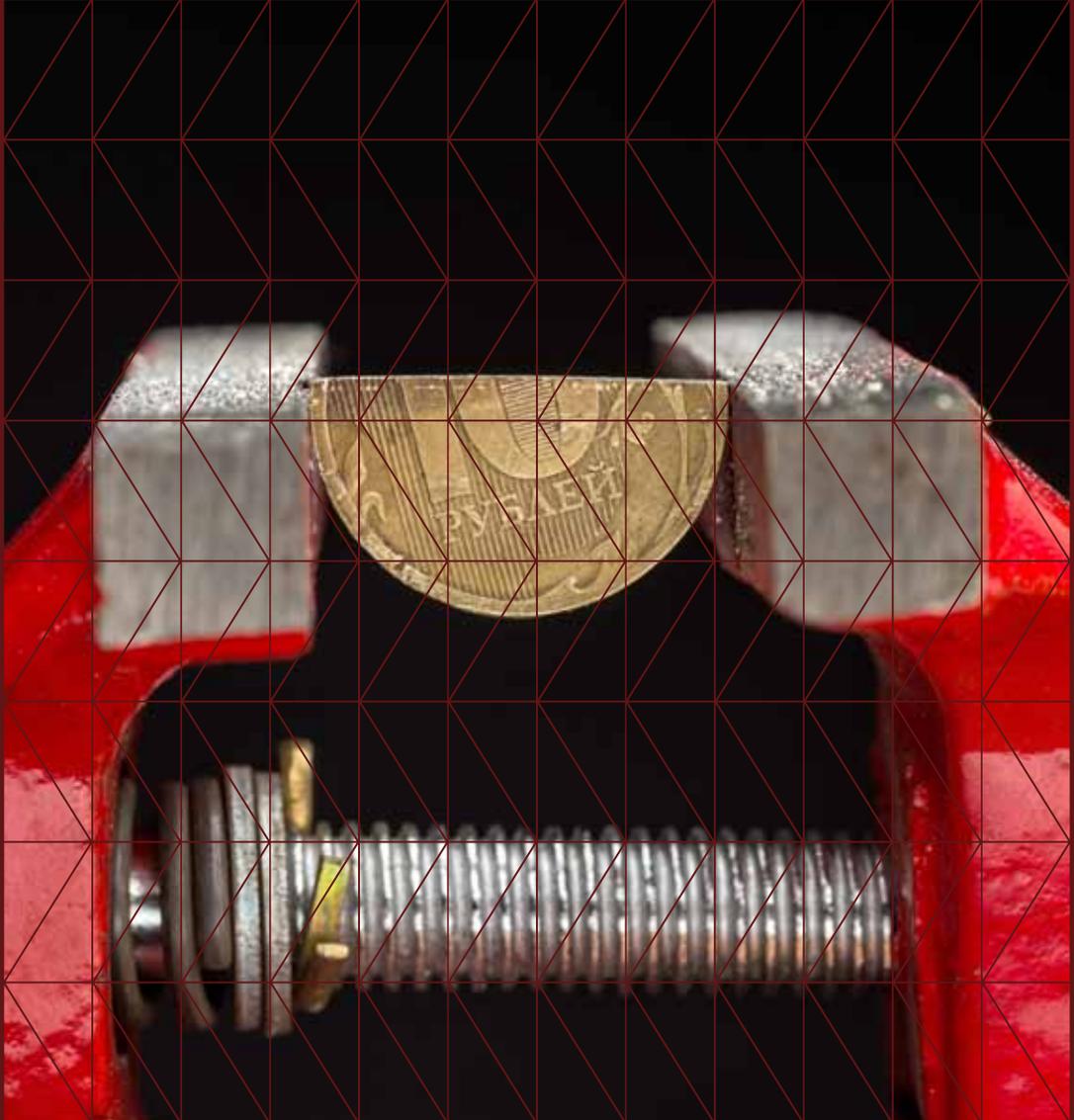


OSW REPORT

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THE ECONOMIC AND FINANCIAL CRISIS IN RUSSIA

BACKGROUND, SYMPTOMS AND PROSPECTS
FOR THE FUTURE

WARSAW
FEBRUARY 2015

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FOR THE FUTURE



OSW |

CENTRE FOR EASTERN STUDIES

OŚRODEK STUDIÓW WSCHODNICH im. **Marka Karpia**

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INTRODUCTION

The crisis in Russia's financial market, which started in mid-December 2014, has exposed the real scale of the economic problems that have been growing in Russia for several years. Over the course of the last year, Russia's basic macro-economic indicators deteriorated considerably, the confidence of its citizens in the state and in institutions in charge of economic stability declined, the government and business elites became increasingly dissatisfied with the policy direction adopted by the Kremlin, and fighting started over the shrinking resources.

According to forecasts obtained from both governmental and expert communities, Russia will fall into recession in 2015. The present situation is the result of the simultaneous occurrence of three unfavourable trends: the fact that the Russian economy's resource-based development model has reached the limits of its potential due to structural weaknesses, the dramatic decline in oil prices in the second half of 2014, and the impact of Western economic sanctions.

Given the inefficiency of existing systemic mechanisms, in the coming years the Russian leadership will likely resort to *ad hoc* solutions such as switching to a more interventionist "manual override" mode in governing the state. In the short term, this will allow them to neutralise the most urgent problems, although an effective development policy will be impossible without a fundamental change of the political and economic system in Russia.

I. HOW THE CRISIS BROKE OUT LAST DECEMBER

The “Black Tuesday” of 16 December 2014 on the Moscow stock exchange exposed the fragility of the Russian financial system. The dollar and euro exchange rates unexpectedly soared to record levels of 80 and 100 roubles per unit of currency, respectively. The collapse of the rouble was a culmination of its gradual depreciation in the preceding months,¹ caused in large part by declining oil prices and the tensions between Russia and the West over Moscow’s aggressive policy towards Ukraine. However, the Russian currency was also hit by a series of developments which destabilised the country’s financial market. The most important ones concerned a peak in demand for currency as the deadline approached for the repayment of a large instalment of the corporate sector’s foreign-held debt, and a crisis in market players’ confidence in the policy of the Central Bank of Russia (CBR). The latter occurred because of the Bank’s inefficacy in fighting inflation and defending the rouble exchange rate (the base rate was raised twice in December, increasing from 9.5% to 17%,² and even though the Bank spent more than US\$ 8 billion on currency interventions in the first half of the month, that failed to prevent the rouble from depreciating further) and this was also a reaction to the rumours of Rosneft’s currency speculations, which had been made possible by a loan of RUB 625 billion granted to the company by state-owned banks.

The pessimistic forecast predicting a serious recession in 2015, published by the CBR on 15 December, did not help ease the situation either. It is notable that the rouble crashed while oil prices were declining softly even if steadily (US\$60 per barrel at that time). Sergey Shvetsov, the first deputy governor of the CBR, described the situation as unforeseen and “critical”. Some symptoms of a bank run were observed as customers started withdrawing rouble-denominated deposits (albeit not on a massive scale) and some bank branches, fearing a loss of liquidity, imposed withdrawal limits.

In the days that followed, the situation in the financial market calmed down and the currency exchange rates became stable at the pre-crash levels, despite

¹ At the beginning of the year one dollar cost around 33 roubles while one euro – around 45 roubles. On 1 December the currencies cost around 49 roubles and 61 roubles respectively, and on 15 December – around 63 and 78 roubles, respectively.

² The base rate was 5.5% at the beginning of the year. The most recent increase of 15 December, when the base rate was increased by 6.5 percentage points to 17%, not only failed to calm down the financial market but on the contrary, worsened the crisis by provoking a loss of confidence in the Russian currency.

experiencing normal fluctuations.³ This was due mainly to the announcement of the government's anti-crisis action plan. The appreciation of the rouble could also have been related to the fact that the corporate sector faced a tax payment deadline (more than RUB 200 billion was due on 25 December), which increased the demand for the domestic currency. Moreover, customers gained greater trust in rouble deposits after the interest rates had been increased considerably (even above 20%).⁴

³ That is, at a level comparable to the exchange rate of 11–12 December when one dollar cost around 57 roubles and one euro – around 70 roubles. On 17 December the dollar and euro exchange rates started falling systematically to reach 52–54 roubles and 64–66 roubles, respectively, on 23–25 December, and in the last days of December and first days of January, the two currencies appreciated again 60 roubles for one dollar and more than 70 roubles for one euro. In late January the value of the currencies decreased again.

⁴ Efforts to prevent a bank run through high interest rates on deposits (much above the base rate) generate other problems with ensuring the financial liquidity of banks and necessitate recourse to financial assistance from the state.

II. THE GOVERNMENT'S ANTI-CRISIS TACTIC

The breakdown of the Russian financial market forced the government to immediately come up with a programme of anti-crisis action aimed mainly at safeguarding the stability of the banking system, whose sound condition is a prerequisite of the stability and reliability of Russia's entire economic system.

On 17 December the CBR announced a seven-point plan which provided for increasing the volume of currency credit available to banks in order to improve their foreign currency liquidity, easing the restrictions on banks with regard to the setting of interest rates on loans and deposits, and easing the requirements concerning mandatory reserves.⁵ The state Duma then endorsed the government's proposals for legislative amendments that would authorise the provision of RUB 1 billion in extra capital to the banks alongside a doubling of the volume of guarantees for deposits of citizens (from RUB 700 billion to RUB 1.4 trillion). The Russian finance minister also announced that the limit up to which the Reserve Fund may be drawn upon could be increased several-fold, even to as much as 70% of the Fund's value (the current limit is RUB 500 billion; the Fund was worth RUB 4.95 trillion as of 1 January 2015).

Informal measures have also been undertaken: the government started pressuring big business to start selling some of the foreign currency it was earning. Such unconventional measures included, for instance, Vladimir Putin's personal "persuasive" phone calls to certain oligarchs (of which he informed the public during a press conference on 18 December), as well as the fact that the subject was raised during the president's meeting with representatives of big business on 19 December. The government was successful in encouraging large companies to keep selling currency in accordance with a government-defined schedule at least until the end of the year, and decided to monitor the currency operations of the largest exporters.⁶ At the same time the government decided that – at least for the time being – it would not impose capital restrictions that could ultimately ruin Russia's reputation in the eyes of the investors.

⁵ *О мерах Банка России по поддержанию устойчивости российского финансового сектора*, http://www.cbr.ru/press/pr.aspx?file=17122014_171432dkp2014-12-17T17_02_49.htm, 17.12.2014.

⁶ On 23 December 2014 the Russian government also adopted special directives that imposed ceilings on the amount of foreign currency assets that certain large state-owned companies are allowed to keep, <http://government.ru/news/16277/>, 23.12.2014.

As the Russian minister for economic development Alexei Ulyukayev admitted, the anti-crisis measures were largely reactive⁷ and served to neutralise the biggest threats to the economic system as they emerged, but they did not add up to a coherent strategy to overcome the crisis.⁸ That is because the causes of the crisis run much deeper than a temporary breakdown of the financial market and are in part beyond the Russian government's control.

⁷ *Инфляция достигнет высших показателей в I квартале 2015 года — Улюкаев*, <http://www.vedomosti.ru/politics/news/37880501/inflyaciya-dostignet-vysshih-pokazatelej-v-i-kvartale-2015>, 26.12.2014.

⁸ Notable in this context was the statement by Vladimir Putin who ordered the government on 18 December to go for “manual override” in “crisis management” while carefully controlling the situation in individual sector of the economy and undertaking *ad hoc* “rescue” measures.

III. CAUSES OF THE CRISIS

The current economic crisis in Russia has three main causes:

- (1) the worsening structural problems of the Russian economy,
- (2) serious tensions in the relations between Russia and the West, which have led to the “sanctions war”,
- (3) the dramatic slump in oil prices in the second half of 2014.

None of those phenomena would have caused such a rapid decline of the country’s economic situation on their own, but their simultaneous occurrence has left the Russian government facing very serious challenges.

The dysfunction of the Russian economic system stems from the fact that **the current resource-based economic model has reached the limits of its potential**. The Russian economy depends on the extraction and export of energy resources (which account for around 70% of export revenues, 50% of budget revenues and 20% of GDP) and is therefore highly susceptible to fluctuations in the global commodity markets. The easy money from the oil rents has for years undermined any motivation the government could have to support more innovative, high-technology branches of industry, which are lagging behind in Russia as a result. Thus, it will not be possible for Russia to quickly develop other industry sectors that could generate stable export and budget revenue.

The internal sources of economic growth in Russia have also become exhausted in recent years as the production capacity of the current, unreformed system of “state capitalism” reached its limits (the state, along with state-controlled corporations, accounts for around 70% of the Russian economy). A quantum leap will not be possible without extensive reforms, which the Russian leadership is not prepared to undertake.

Some of the key problems concern insufficient investment and slow progress in the modernisation of production through new technologies and new management techniques. The main factors that have been impeding investment and modernisation include, first and foremost, the inefficient and corrupt state administration system, as well as Russia’s institutional and legal environment, which is unfriendly to investors and makes the costs of doing business disproportionately high.⁹

⁹ According to the minister for economic development Alexei Ulyukayev, transaction costs currently account for 35% of the total cost of doing business, and according to the minister

As the political elites have coalesced with big business in Russia, embezzlement of public money is rampant. The essence of Russia's economic problems can be seen in the debates, often fiery, among representatives of the government and the business circles about the course adopted by the Kremlin. In this context, the critiques of Russia's economic policy voiced by the economic development minister, Alexei Ulyukayev, and the CEO of the state-owned Sberbank, German Gref, were particularly symptomatic.¹⁰

The negative trends in the Russian economy began in 2012 when Russia reported slower GDP growth for the first time since the 2008–2009 crisis (3.4% compared to 4.3% in 2011). This trend deepened over the following year when Russia's economy grew by a mere 1.3%. Even though oil prices in international markets were still high during the period in question (over US\$ 100 per barrel¹¹), Russia reported one of the lowest growth rates among the emerging economies. This negative trend continued in 2014: between the 1st and 3rd quarter, GDP growth declined down slowly but systematically, decreasing from 0.9% to 0.7%. Adjusted for seasonal factors, this figure means that Russia's economic growth was close to zero.

Declining investment is another worrying trend, because investments account for 20% of Russia's GDP. Between January and September 2014, fixed capital investment decreased by 2.5% compared to the same period in 2013, and the decline continued in the months that followed (in November, fixed capital investment decreased by 4.8% year-on-year). Meanwhile, a downward trend in private investment persisted in Russia, which was not offset by increased public investment.¹² Even though industrial production was growing slowly for most

for open government, Mikhail Abyzov, ineffective administration reduces the GDP by 2-5%. *Этот шторм мы сами и готовили* – interview with Alexei Ulyukayev in *Vedomosti*, 18.12.2014; *Начавшийся кризис может стать затяжным*, <http://www.vedomosti.ru/politics/news/37879891/cugcvang-ekonomiki>, 26.12.2014.

¹⁰ Ulyukayev voiced his opinions most vocally in an interview for *Vedomosti* on 18 December 2014. Gref harshly criticised the government policies (comparing Russia's present situation to the final period of the USSR) at the "Russia calling!" investment forum in October 2014. His main points concerned overregulation of the legal sphere, weakness of state institutions, excessive red tape and the state's practices that suppress entrepreneurship (a more moderate critique was voiced during the Gaidar Forum in January 2015).

¹¹ The average price in 2013 was nearly US\$ 108 and in 2012 – more than US\$ 110 per barrel.

¹² *Инвестиции в основной капитал России сократились на 2,5%*, <http://vz.ru/news/2014/10/17/711087.html>, 17.10.2014; *Статистика ноября предсказывает России глубокую рецессию в 2015 году*, <http://ru.reuters.com/article/businessNews/idRUKBNoJV21O20141217?pageNumber=2&virtualBrandChannel=0&sp=true>, 17.12.2014.

of the year, this was mainly the result of public procurement, including in the defence sector, as well as the depreciation of the rouble and attempts at import substitution. Those impulses, however, reached their limits in the 4th quarter of 2014.

The Russian people have also become less inclined to consume (leaving aside the temporary spending spree in December when people tried to get rid of the depreciating rouble), which has further slowed down the economy (household spending accounted for around 50% of the GDP in Russia in 2013 and thus represents a significant factor).

After the rouble lost nearly half of its value, the Central Bank of Russia decided that this posed a threat to the financial stability of the country. The depreciation was the main factor behind the significant increase of inflation from 6.5% in 2013 to 11.4%¹³ currently (the dynamics of price increases visibly accelerated after the December “depreciation shock”). Inflation in Russia reached two-digit levels for the first time in six years.

As a result of the CBR’s repeated currency interventions in the market in order to combat inflation, Russia’s currency reserves shrank by more than US\$ 120 billion. The interventions failed to significantly improve the stability of the Russian currency but at the same time diminished the system’s financial security “cushion” (the reserves dropped below US\$ 400 billion for the first time since 2009: between 3 January and 26 December 2014 they decreased from US\$ 510.5 billion to US\$ 388.5 billion¹⁴).

According to the CBR, more than US\$ 150 billion of capital flew out of Russia in 2014. The only positive outcome of the depreciation was the budget surplus that Russia reported in 2014 as a result of growing export revenues, equivalent to 0.7% of GDP according to the Finance Ministry. However, at the same time, in view of Russia’s deteriorating economic situation, the main rating agencies cut its credit rating to levels only slightly above speculative grade or junk, with negative outlooks. On 26 January Standard & Poor’s cut Russia’s rating to junk. Moody’s downgraded Russia to Baa3-, i.e. the lowest investment-grade level, as did Fitch, with a rating of BBB. Bloomberg estimated that the likelihood of

¹³ According to preliminary Rosstat figures as of end of December; <http://www.interfax.ru/business/416458>, 31.12.2014.

¹⁴ Moreover, in just two weeks between 12 and 26 December the reserves decreased by US\$ 27 billion.

an economic breakdown in Russia was higher than in many countries with speculative-grade ratings. Meanwhile, the yields on Russian treasury bonds were among the highest among the emerging economies (around 7% for bonds denominated in dollars with maturity dates in 2023).¹⁵

While the deficiencies of the Russian economic and political system did threaten to cause economic stagnation in the foreseeable future, most probably they would not have led to major upheaval, if not for the **deep crisis in Russia's relations with the West in the aftermath of Russia's annexation of Crimea and its military actions in eastern Ukraine**. The crisis affected Russia's economy by significantly undermining the country's international image and engendering the "sanctions war".

The reaction of capital markets to Moscow's aggressive moves against Ukraine exemplified the rapid and politically motivated loss of trust in Russia on the part of the international community: it meant higher capital outflows from Russia (more than US\$ 50 billion in the first quarter of 2014, four times as much as had been expected), and considerable losses in the Moscow stock exchange on the "Black Monday" of 3 March 2014.¹⁶

Russia's investment and credit worthiness was further undermined by the Western economic sanctions imposed as of the end of July in response to Moscow's destabilisation of eastern Ukraine. Of the measures imposed, the financial sanctions have turned out to be the most significant in the short term. Many key Russian banks and companies faced restrictions on access to Western sources of financing, in a situation in which they heavily depended on foreign capital (in 2013, European banks provided around 75% of external financing for the Russian banking sector and European investments accounted for 80% of total investments in Russia¹⁷). In this context, one should be sceptical

¹⁵ *Трейдеры высоко оценили вероятность дефолта по гособлигациям России*, <http://top.rbc.ru/economics/09/01/2015/54af79129a79474c3096e015>, 9.01.2015.

¹⁶ The brief slump in the stock exchange was a reaction to the decision adopted by the Federation Council on 1 March 2014 to authorise the president to use Russian troops in the territory of Ukraine. In just one day, the RTS dollar index lost 12%, and the MMVB rouble index nearly 11%.

¹⁷ Figures for the banking sector in the 4th quarter of 2013 quoted after: R.M. Nelson, U.S.-Russia Economic Relations, CRS Insights, 1.08.2014, http://fas.org/sgp/crs/row/IN10119.pdf#_Ref390161120; figures of the Ministry of Economic Development on investment: <http://economy.gov.ru/minec/activity/sections/foreignEconomicActivity/cooperation/economicEurope/>.

about Russia's ability to raise capital in Asian markets because access to those markets is more difficult and the cost of capital for external players is higher.

The consequences of sanctions became painful for Russia in December 2014: the fact that the country had to repay or refinance a large tranche of its debt (around US\$ 35 billion), in a situation in which it was cut off from Western capital and the rouble had lost much of its value, was one of the reasons behind the slump in Russian financial markets in mid-December and also affected the corporate sector's financial stability. The indirect effect of sanctions is more difficult to estimate, but the tendency of European and US actors to withdraw *en masse* from financial and investment co-operation with Russian companies, often "just in case", may have some long-term consequences.

Russia's economic situation worsened further as a result of the retaliatory measures it applied in August, i.e. the embargo on the imports of many agricultural and food products from countries that had imposed the original sanctions. The resulting market shortages, combined with under-developed domestic production and the high cost of importing food from alternative sources, almost immediately drove up the prices of many categories of goods, in some cases by several dozen per cent. Average inflation in the food sector reached 15.4%, i.e. nearly twice as high as in 2013, and much higher than the price increases reported for industrial goods and services,¹⁸ despite the efforts made by the government to control prices, i.e. through the restrictions on the export of cereals imposed in December.

The mounting structural problems that have been troubling the Russian economy for years and the economic consequences of tensions in relations with the West were exacerbated by a number of factors that were beyond the Russian government's control, primarily, **the price of oil in international markets.**

The slump in oil prices in the second half of 2014 by more than 50%, the deepest since the 2008-2009 crisis (from US\$ 115 in June to US\$ 56 in late December), turned out to be particularly painful for the Russian economy. The causes of the slump included the slowing down of the global economy (largely as a result of the weakening dynamics of China's growth), as well as higher supply of oil due to growing production, especially in Libya, the US and Iraq, and the decision of OPEC to maintain production levels despite the falling prices.

¹⁸ Rosstat figures.

The dynamics of oil prices directly influences the budget stability of Russia because revenues from the sale of oil, gas and petroleum products account for half of its budget. The budget balance depends on the net effect of the dynamics of currency revenues and the rouble-to-dollar exchange rate. If oil prices decrease by 1 dollar, Russia's budget revenue decreases by around US\$ 2 billion, but at the same time if the dollar appreciates by 1 rouble, Russia gains RUB 210 billion in additional budget revenue. Even though this dynamic produced a positive outcome in 2014, and Russia closed the year with a budget surplus, the government, facing the continuing decline in oil prices, announced spending cuts of 10% and a budget deficit in 2015.¹⁹ The cuts will affect the defence, space and aircraft industries, i.e. Russia's high technology export sectors, as well as education.

¹⁹ In mid-January, the Ministry of Finance announced a deficit of 2-3% of GDP and around RUB 3 billion less in budget revenue. The finance minister Anton Siluanov said in late December that the depreciation of the rouble offset the drop in oil prices by only 50% in 2014.

IV. IMPACT OF THE CRISIS ON RUSSIAN BUSINESS

Russia's worsening economic performance and its political isolation from the West are having an impact on the condition of individual sectors of the economy and individual large companies. The depreciation of the rouble is the main factor behind the negative developments in this sphere. While it benefits those sectors that depend on imports of goods and technologies to a small extent, and which reap currency gains from exports, such as the energy, chemical or metallurgic industries, it generates losses in the import-dependent branches of the economy, which sell mainly in the domestic market (such as the machine building industry). The high-technology sectors are the most affected, which may solidify Russia's dysfunctional resource-based economic model.

Meanwhile, as servicing foreign debt has become more expensive in view of the cheapness of the rouble and Western financial sanctions, those companies that have little debt or debt denominated in foreign currencies have found themselves in a privileged position. One of the most visible consequences of the weakness of the rouble has been that the dollar-denominated capitalisation of many companies and banks has decreased dramatically (see the examples below). The US\$-denominated stock exchange index RTS, which is based on the listings of Russia's largest companies from key sectors of the economy, fell by 45% in the course of the year, performing worse than any other stock exchange index in the world.

The real economy, which in Russia has been struggling against a hostile legal and institutional environment even while the economic situation remained benign, is now experiencing serious problems caused by insufficient supply of foreign currency and more difficult access to credit in the domestic market (due to the significantly higher CBR base rate) and abroad (because of Russia's deteriorating credit ratings and Western financial sanctions). Rising inflation has been driving up most elements of the cost of doing business, and the declining domestic demand for goods and services has been suppressing revenues.

The situation of the energy sector, the pillar of the Russian economy, deserves particular attention. Even though revenues from the export of energy resources have increased considerably thanks to exchange rate differences, at the same time the industry suffered the accumulated negative impact of other factors such as the dramatic slump in oil prices, lower volume of gas exports in 2014 and Western financial sanctions.²⁰

²⁰ In the short term, the technological sanctions imposed by the West, i.e. the ban on supply-

In 2014 Gazprom reported the lowest production volume in its history (443–445 billion m³), as exports decreased in the aftermath of the Ukrainian crisis and due to lower demand in Europe and Russia as a result of warm weather (its 2014 exports were around 10% lower than in 2013). Gazprom’s financial outlook has also been negatively affected by the falling oil prices – because the prices in gas contracts are calculated in relation to the price of oil. Over the year, the company’s capitalisation decreased by more than 50% (to less than US\$ 60 billion), largely as a result of the depreciation of the rouble. The fact that in late December the company suspended the publication of its financial results may be an indication of the scale of its problems.

Other energy giants have also reported significant drops in capitalisation as a result of the depreciation of the rouble – the capitalisation of Resent decreased by 38% to US\$ 50 billion, and LUKoil and Surgutneftegaz were also affected.²¹ In connection with the sanctions, Rosneft and Novatek have announced that they would postpone the implementation of some of their extraction licences. In late December the Russian deputy prime minister Arkady Dvorkovich said that Russia could cut its oil production by 5–10% due to low prices and revise its investment plans.

Apart from the immediate difficulties in obtaining the necessary financing to service debt, another important problem that the Russian energy companies are facing concerns the higher “risk profile” of individual businesses and the entire Russian oil and gas sector, which may have an adverse impact on those companies’ attractiveness to investors for years to come. On top of this, Russia’s financial credibility is deteriorating, which affects the way international partners view the Russian companies with links to the state.²²

ing Russia with equipment, technologies and services for deep-water and arctic drilling and shale exploration are of marginal importance. Rather, those sanctions may affect the long-term development strategy of the Russian energy sector.

²¹ The ultimate balance of the gains and losses of energy companies is determined by the net effect of the decrease in capitalisation and the volume of debt in foreign currency: in the case of Novatek, Gazpromneft, Gazprom and Rosneft, i.e. the companies on which the Western sanctions have been imposed, the share of debt in dollars to total debt ranges from 70% to 90%.

²² As an illustration of this mechanism, in December Moody’s cut Gazprom’s foreign currency rating from Baa1 to Baa2, and then in January – to Baa3 due to increased risk of a protracted recession in Russia and the poor condition of the Russian financial market, as well as the risk related to state control of the companies (in January, the ratings of Rosneft, Transneft and LUKoil were also cut).

Other sectors of the Russian economy are also experiencing problems. This concerns the aviation industry (over the year, the capitalisation of Aeroflot decreased by nearly 80% and several other airlines have applied for state aid), the automotive industry (which closed the year with a loss of around 10%) and the tourism sector (tour operators are increasingly facing solvency problems, mainly as a result of the fall in real wages). Moreover, as the rouble crashed, the listings of those Western companies that had major investments in Russia declined, which further undermined Russia's attractiveness to investors.

As the real economy stalls, the conditions in which the banks are operating have also deteriorated: this was visible not only in the December bank run triggered by the crash of the rouble, but also in the financial results of banks for 2014: between January and November the Russian banks together earned 11.7% less than in the same period in 2013, mainly because they had to increase their risk reserves while the activity in the real economy was weakening and the demand for credit among individual customers dwindled.

The capitalisation of banks has decreased (Russia's largest state-owned bank, Sberbank, reported a decline of nearly 70%), as a result of the depreciation of the rouble, the falling listings of Russian assets in stock exchanges, and the fact that the system has been cut off from foreign capital. In mid-January Fitch lowered the long-term ratings of 30 large Russian banks by one notch, cutting the ratings of Rosselkhozbank and Gazprombank to speculative grade (BB+).

Oligarchs with links to the Kremlin have also felt the painful consequences of the crisis. According to estimates by Bloomberg and Forbes,²³ between February and December 2014 the top-twenty richest Russians lost a total of between US\$ 62 and 73.4 billion. The biggest losers included the Novatek CEO Leonid Michelson, Gennady Timchenko and Arkady Rotenberg (members of Putin's inner circle on whom sanctions have been imposed), the owner of the steelworks holding NLMK, Vladimir Lisin, and Alisher Usmanov, lost up to 50–70% of their wealth. The main reasons for the losses concerned lower capitalisation of their assets as a result of the depreciation of the rouble and, to a lesser extent, the tensions in relations with the West, which suppressed their business activity through sanctions.²⁴ At the same time, the sanctions offered the

²³ See: *Forbes подсчитал потери богатейших россиян в 2014 году*, <http://top.rbc.ru/economics/22/12/2014/5497e6da9a79471285128d65>, 22.12. 2014.

²⁴ During the two slumps in the stock exchange alone (on 3 March, after the Federation Council authorised the president to use armed forces in Ukraine and on 16 December, during the financial crisis) those twenty allegedly lost US\$ 10 billion on each occasion.

business people with links to Vladimir Putin a convenient pretext to demand financial aid from the state – Rosneft and Novatek have requested the largest amounts of RUB 1.5 trillion and RUB 150 billion, respectively. Since March 2014, when the first sanctions against Russia were imposed, companies associated with Gennady Timchenko and Arkady Rotenberg, both of whom are on the list of sanctioned individuals, have allegedly earned RUB 309 billion from public procurement, which is 12% more than their revenue from this source was in 2013. Similarly, the Rossia bank owned by Yury Kovalchuk, on which sanctions have been imposed, allegedly reported profits between January and September that exceeded its entire profit in 2013 (Vladimir Putin had personally encouraged people to deposit money with the bank).

V. IMPACT OF THE CRISIS ON THE PEOPLE IN RUSSIA

In the last months of 2014, ordinary people in Russia started to feel the deteriorating economic situation, especially in the form of rising inflation (in the agricultural and food sector in particular) and a decrease in real wages.

As Russia's financial reserves were shrinking and prices had increased much more than the 5.5% that had been expected, the government was not in a position to deliver on its pledge to adjust wages.

Real incomes in November turned out to be 4.7% lower than in November 2013.²⁵

While unemployment remains low for the time being (slightly above 5%), people in Russia are starting to fear for their jobs.

According to public opinion surveys, around 80% of Russians have already felt the impact of the crisis and believe that the situation is worse now than it was in the crisis year 2008. More than 20% of the people have had to give up buying things which they used to be able to afford.²⁶

The deteriorating economic situation has not generated any noticeable increase in people's readiness to protest, which can be explained firstly by the fact that the financial situation of people in Russia on average had improved considerably over the last decade, secondly – the government's assurances that the level of welfare spending would not be reduced despite the spending cuts, and finally, the widespread conviction that what determines the country's economic situation are primarily external factors.

²⁵ In this, the current crisis differs from the 2009 crisis when people's real incomes increased despite a significant drop in GDP (that crisis was said to have been "drowned" in money, thanks to Russia's huge currency reserves among other factors).

²⁶ On the basis of surveys by the Levada Centre: «Население наконец осознает, что произошло», <http://www.kommersant.ru/doc/2643585>, 30.12.2014.

VI. RUSSIA IN ANTICIPATION OF A RECESSION. OUTLOOK FOR THE FUTURE

The factors that will be of key importance for Russia's macroeconomic stability include the dynamics of oil prices (which are difficult to predict at this stage), Russia's ability to maintain sufficient currency reserves to service its foreign debt, and an effective budget policy under the conditions of shrinking resources. One of the most important objectives will be to keep the banking sector in good condition, since the risk of a bank run is currently one of the most important systemic threats. If Russia's credit ratings are cut further as a result of some serious upheaval in the Russian market (to junk level), that could trigger a mass sale of Russian assets and a large scale outflow of capital.²⁷

The forecasts for the coming years, formulated in late 2014, suggest that at least one year of recession is inevitable, with the GDP in 2015 decreasing by anywhere between 3% (according to the Ministry of Economic Development) and over 5% (according to the Ministry of Finance), provided that the price of oil does not drop below US\$ 60 per barrel. However, as the downward trend in oil prices continues, the Russian government is preparing for a "black" scenario in which the average price of oil will drop to as low as US\$ 40 per barrel: the Central Bank of Russia and the Ministry of Finance have been working on the respective stress tests. According to some experts, under such a scenario Russia's GDP could decrease by as much as 9%.²⁸

Importantly, the recession will coincide with inflation, and the latter will deepen the former (the Ministry of Finance expects two-digit inflation), and further depreciation of the rouble also cannot be ruled out. Russia could only remain relatively stable if the forecasts that predict an increase of the oil price to US\$ 70-80 per barrel in 2015 turn out to be accurate.

One should expect the standards of living to deteriorate for a prolonged period, largely due to the fact that the state's financial reserves have shrunk considerably, which means that the cycle of pay rises in the state-owned sector

²⁷ The minister for economic development Alexei Ulyukayev announced in late December that the government was preparing for such a scenario, e.g. it was discussing a mechanism for buying corporate bonds with funds from the state treasury. However, the shrinking financial reserves of the state may pose a problem.

²⁸ *В России готовят стресс-сценарий для нефти в 40 долларов за баррель на 2015 год*, <http://www.profi-forex.org/novosti-rossii/entry1008239665.html>, 25.12.2014.

will come to an end, wages in the public sector will be adjusted at a slower rate or not at all, and unemployment may increase by around 2 percentage points. While this is not much at the level of the entire country (the rise in unemployment may be offset by an expansion of the grey economy), serious problems at the local level are likely to occur, especially in the depressed regions and the “monocities” that depend on a single sector or a single large industrial plant.

According to the predictions of the former finance minister, Alexei Kudrin, with the oil price at US\$ 40 per barrel, real incomes of people may decrease by around 10% in the years 2015–2017. Combined with the erosion of revenues in the real economy, this will lead to a shrinking of the tax base and budget revenue.

The consequences of the Russian counter-sanctions in the food sector, which will become even more severe in 2015, will be the hardest factor for ordinary people in Russia. Food prices may increase by up to 20% (and Russians already spend around 40% of their incomes on food). It is also likely that a shortage of other consumer goods will deepen due to the steep price of imports and limited options for import substitution.

The calendar term of foreign debt repayments and Russia’s ability to raise capital for this purpose will be important for the country’s financial stability over the next two years. In 2015, even if the sanctions remain in place, Russia should be able to manage to service its foreign debt with its currency reserves at the present level.²⁹ However, individual companies may face serious difficulties in this regard.³⁰ While the debt of the public administration bodies is small (slightly over US\$ 57 billion, including only US\$ 3.2 billion with maturity dates within one year), the banking sector’s debt is nearly US\$ 209 billion, of which around US\$ 51 billion will have to be repaid within a year, and the total debt of the remaining sectors is US\$ 449 billion, including US\$ 105 billion with due dates in one year or less. Large debt repayments are already scheduled in February–March 2015.³¹ The situation varies among different companies in the

²⁹ The Central Bank of Russia, the Reserve Fund and the National Welfare Fund together hold around US\$ 450 billion, compared to total foreign debt of less than US\$ 680 billion as of the beginning of December 2014.

³⁰ According to Moody’s, only 7% of the companies it monitors may experience problems with servicing their debt by the end of 2015 and need refinancing. Debt repayment problems may worsen only in the longer term and then state aid will be necessary. *Moody’s проанализировал долги российских компаний*, <http://top.rbc.ru/finances/22/10/2014/5447c31acbb2of7d2ab7684e>, 22.10.2014.

³¹ See the Central Bank of Russia figures at www.cbr.ru.

real and financial sectors. The sanctioned state-owned banks (Vneshtorgbank, Sberbank, Gazprombank) will have to repay large amounts on their Eurobonds in 2015, and in the real economy, Rosneft will have to repay as much as US\$ 19.5 billion, more than any other company.³²

Beyond 2015, unless the sanctions are lifted, Russian analysts believe that most companies will face financing deficits that will push them to seek assistance from the state, but it is unclear to what extent the state will be able to offer such assistance under the conditions of a deepening recession.

The big companies that enjoy the patronage of the Kremlin will emerge victorious from the struggle over increasingly scarce resources, while the cost will be shouldered by those oligarchs with looser links to the decision-making centre (this trend is already evident in the decision, taken in December, to renationalise Bashneft, most likely in the interest of Rosneft), and even more importantly, the small and medium-sized enterprises, the cornerstone of Russia's long-term development, which will have to pay for saving the large state-owned and private companies while at the same time facing difficulties in securing access to credit (the Russian banks will likely prefer to save the giants with links to the state first, including the exporting companies who report revenues in foreign currency).

The likely lowering of Russia's credit rating, combined with the need to borrow more or reduce the "financial cushion" by eroding the state's reserves, will drive up the cost of stabilising Russia's economic system. The Russian economy should forget about development for the next couple of years – a survival strategy will be a priority.

OSW TEAM

The text was completed by the end of January 2015

³² In February and March, Vneshtorgbank will have to repay EUR 1 billion and more than US\$ 1 billion, Sberbank will have to repay US\$ 1.5 billion and more than CHF 400 billion in the second half of the year (Gazprombank will also have to raise similar amounts). Gazprom will have to pay a total of EUR 1.85 billion and US\$ 1.7 billion in the course of the year. *Правительство не исключило выкупа корпоративных облигаций при снижении рейтинга России до «мусорного»*, http://www.vedomosti.ru/politics/news/37917841/pravitelstvo-ne-isklyuchilo-vykupa-korporativnyh-obligacij?utm_source=vedomosti&utm_medium=widget&utm_campaign=vedomosti&utm_content=link, 26.12.2014; *Прогноз: «Роснефти» предстут самый трудный год*, <http://www.vedomosti.ru/companies/news/37879871/trudnyj-god-rosnefti>, 26.12.2014.