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Russia's Downfall:

The Worst Economic Crisis Since the Collapse of the USSR

Executive summary

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This working paper looks at the recent trends in the Russian economy and argues against the official view of the Russian authorities that the worst phase of the Russian economic crisis is over. The paper highlights the main driving factor behind the current crisis, the sharp decline of domestic consumption, unprecedented in the past twenty years, and argues that Western sanctions have had a great role to play in these developments

Keywords

Russia – Economy – Crisis – Domestic demand – Inflation – Real wages
– Sanctions



Introduction

Russian authorities have been constantly claiming during the past several months that the economic crisis in Russia has ‘bottomed out’ (or ‘passed its peak’,¹ as recently claimed by President Vladimir Putin—whichever term one prefers). However, a brief analysis of the raw data from the Russian economy and the most realistic patterns of development of the situation suggests that the crisis is not only far from over—it is actually only in the beginning phase, meaning that the economy has every chance of being further dragged into a strong downward spiral. This paper will consider several important reasons why this is so, including the impact of Western sanctions and the consequent depreciation of the rouble; the decline in investment in and the inefficiencies of Russia’s state-led economic system; and especially the significant, lasting and progressive collapse of consumer purchasing power, which is the main characteristic of the current crisis and is occurring at levels unprecedented since the early 1990s.

This final factor differs significantly from previous post-Soviet economic crises in Russia. During the period of the 1998 default, the collapse in real incomes was serious but short-lived and very much V-shaped.² In addition, few individuals kept their savings in roubles (most held them in hard currency due to the permanent instability of the rouble), which is why consumer power was only damaged to a limited extent. Later, during the crisis of 2008–9, despite a sharp plunge in GDP and output, real income growth was still positive, although it had decreased significantly compared to the average 12% growth per year in the period 2000–7.

¹ *Vedomosti*, Путин считает, что пик кризиса в России пройден [Putin Considers that the Peak of the Crisis in Russia is Behind], 22 October 2015, accessed at <http://www.vedomosti.ru/economics/news/2015/10/22/613983-putin-krizis-proiden> on 3 December 2015.

² Real household incomes dropped by 15.9% in 1998, and by a further 12.4% in 1999, but as early as 2000 12% growth had been recorded. Russian Federation, Federal State Statistics Service, *Уровень жизни*, [Standard of Living], accessed at http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/population/level/# on 3 December 2015.



Western sanctions have hit hard

It is clear that the current collapse of the population's purchasing power is associated with the sharp depreciation of the rouble, which has been caused by falling oil prices and Western sanctions against Russia. Sanctions, contrary to widespread opinion, have contributed greatly to the collapse: by mid-2014, Russian companies and banks were making heavy use of foreign debt, a large part of which was short term. Due to Western sanctions, Russia essentially found itself the subject of an international credit blockade: it became extremely difficult to borrow money on the international financial markets, even for those Russian companies and banks which were not directly subject to the sanctions. International creditors have severely reconsidered the level of political risk that Russia represents, which has hurt the credit chances of a much wider range of Russian borrowers than just those included in the sanctions lists, given that sanctions can always be expanded should Russia increase the intensity of its aggressive international behaviour. Russian corporate borrowers have been forced to repay huge amounts of foreign currency-denominated debt in a relatively short period, without the ability to roll over short-term debts. Since its peak in July 2014 (\$660 billion), the corporate and banking sector foreign debt portfolio has shrunk by as much as \$180 billion in just 15 months (dropping to a total debt of just \$479 billion by October 2015).³

It is important to note that in 2008, when the oil price collapse was much sharper than in 2014–15 (from \$144/barrel Brent in July 2008 to just \$34 in December), and a comparable amount of the Russian Central Bank's currency reserves was spent on supporting the rouble, no such severe collapse of the rouble was recorded, which adds credibility to the theory that the foreign credit blockade caused by the sanctions has played a considerable role in creating the current situation.

³ Bank of Russia, 'Статистика внешнего сектора' [External Sector Statistics], Moscow, accessed at <http://www.cbr.ru/statistics/?Prtd=svs> on 30 November 2015.



Real incomes have fallen sharply due to rouble depreciation

The collapse of the rouble has been the main factor behind the sharp plunge in real incomes—Russia’s domestic market is still overwhelmingly dependent on imports, and this situation has remained largely unchanged, even with the recent shrinking of the total volume of imports.⁴ Russian consumer-oriented industry remains mostly uncompetitive, which has reduced the opportunity for large-scale import substitution, despite the hopes of the authorities. As a result, prices have significantly increased—officially recorded year-on-year food inflation was over 20% between January and September, with prices for some basic items growing even faster. There are serious doubts about whether official inflation measurements accurately reflect the actual growth of food and other prices, due to overwhelming evidence that the actual prices in food stores have grown much more rapidly than Rosstat reports.⁵

Statistics show the rather devastating effect inflation has had on the purchasing power of the population: for most of the recent past months, retail sales and real wages have been down around 10% year-on-year, and real household incomes have shrunk by around 5%. There are many signs that in 2015 Russians significantly reduced their purchases of long-term goods, and that for a large proportion of the population basic food was the main component of their shopping basket.⁶

⁴ A. Sharovalov, ‘Россияне тратят на импортную еду столько же, сколько и раньше’ [Russians Spend Same Amounts on Imported Food as Before], *Kommersant*, 23 October 2015, accessed at <http://www.kommersant.ru/doc/2838062> on 30 November 2015.

⁵ Rosstat is the Russian official statistics agency.

⁶ O. Soloveva, ‘Россияне переходят на дешевые продукты’ [Russians Turn to Cheaper Products], *Nezavisimaya Gazeta*, 3 April 2015, accessed at http://www.ng.ru/economics/2015-04-03/4_food.html on 30 November 2015; N. Petrova, ‘Сказка о царевне-кубышке’ [The Tale of the Princess Money], *Kommersant Dengi*, 9 November 2015, accessed at <http://kommersant.ru/doc/2841745> on 30 November 2015.



Table 1 Key indicators of consumer purchasing power in Russia in 2015

(% year-on-year)	Jan 2015	Feb 2015	Mar 2015	Apr 2015	May 2015	Jun 2015	Jul 2015	Aug 2015	Sep 2015	Oct 2015
Retail sales	-4.4%	-7.7%	-8.7%	-9.8%	-9.2%	-9.4%	-9.2%	-9.1%	-10.4%	-11.7%
Real wages	-8.0%	-9.9%	-9.3%	-13.2%	-7.3%	-7.2%	-9.2%	-9.8%	-9.7%	-10.9%
Real household incomes	-0.8%	-0.6%	-1.8%	-4.0%	-6.4%	-3.5%	-2.0%	-4.9%	-4.3%	-5.6%

Source: Russian Federation, Federal State Statistics Service, 'Информация о социально-экономическом положении России - 2015 г' [Information About the Socio-Economic Situation of Russia in 2015], Moscow, accessed at http://www.gks.ru/bgd/free/B15_00/Main.htm on 3 December 2015.

As can be seen in Table 1, despite some indicators fluctuating back and forth, the general picture remains consistently negative over recent months, with overall retail sales in September 2015 falling more sharply than in any previous month (by over 10%), and in October even more sharply than ever before (by 12%), despite the new round of assurances made by the authorities during October about 'passing the bottom of the crisis'.⁷ Therefore, in reality there is no evidence to support the theory that Russia has already passed the peak (or bottom) of the crisis.

Theoretically, consumption could be supported by expanding the credit available to households, but even in 2014 there were clear signs that Russian demand for credit was showing signs of saturation, and banks have reported that the population basically does not want to take on more credit.⁸

⁷ J. Kuandikova, 'Улюкаев увидел «дно» экономического кризиса в России' [Uliukaev Saw the 'Bottom' of the Economic Crisis in Russia], *RBK.ru*, 27 July 2015, accessed at <http://www.rbc.ru/economics/27/07/2015/55b637df9a7947ce90ec47ff> on 3 December 2015.

⁸ A. Krasnova and A. Verenikin, 'Население отказывается брать кредиты на покупку жилья' [Population Refuses to Take Housing Credits], *RBC Daily*, 6 April 2015, accessed at



Additional factors weakening domestic demand

Two more factors are potentially contributing to domestic demand sliding further:

- The possibility of more shocks to the rouble,⁹ and
- The government's decision not to index wages and pensions in the budget system in 2016 in line with inflation,¹⁰ which will most definitely put a brake on domestic demand further into next year.

The problem is that the decline in the domestic market-oriented manufacturing and services industries has not yet matched the sharp decline in domestic demand. These sectors have kept producing, hoping for a relatively swift recovery driven by experiences of past crises and the constant reassurances from the authorities that they have 'passed the bottom of the crisis' and that 'things will get better soon'. For instance, while car sales in Russia have been down 30%–40% year-on-year for most months since March, many car makers initially only reduced their production plans for 2015 by 10%–15%. Only now have they begun to understand the lasting nature of the crisis, and to further reduce output plans and lay off workers accordingly.¹¹ September and October have also

<http://www.rbcdaily.ru/finance/562949994651349> on 30 November 2015; *Rosbalt Business*, 'Банки жалуются, что россияне не хотят брать кредиты' [Banks Complain About Russians Unwilling to Take More Loans], 3 December 2014, accessed at <http://www.rosbalt.ru/business/2014/12/03/1344318.html> on 30 November 2015.

⁹ G. Neyaskin, 'Сергей Алексашенко: «Конец года может стать тяжелым испытанием для рубля»' [Sergei Aleksashenko: 'The End of the Year May Become a Severe Test for the Rouble'], *Slon*, 12 October 2015, accessed at <https://slon.ru/posts/57863> on 30 November 2015.

¹⁰ R. Markelov, 'Сложение и вычитание' [Addition and Subtraction], *Rg.ru*, 25 October 2015, accessed at <http://www.rg.ru/2015/10/26/budjet.html> on 30 November 2015.

¹¹ Recent news suggests that AvtoVAZ, Russia's biggest car maker, is considering significant new output reductions and massive layoffs (*Auto Vesti*, 'RENAULT заставил автоваз сократить производственный план по LADA XRAY' [Renault Forces AvtoVAZ to Cut the Production Plan for Lada X-Ray], 19 October 2015, accessed at http://auto.vesti.ru/news/show/news_id/655861/ on 30 November 2015; *RBC TV*, 'Автоваз может сократить до 6 тысяч сотрудников из-за падения продаж' [AvtoVAZ Could Cut up to 6,000 Employees Due to Falling Sales], 12 October 2015, accessed at http://rbctv.rbc.ru/archive/main_news/562949997625690.shtml on 30 November 2015; P. Gritsenko, 'PwC ухудшила прогноз по рынку легковых автомобилей на этот год. В IV квартале из-за высокой базы 2014 года падение рынка ускорится' [PwC Now Forecasts Russian Car Demand to Drop for This Year. In the Fourth Quarter of 2014 the Market Drop will Accelerate Because of High Tax Base], *Vedomosti*, 9 November 2015, accessed at <https://www.vedomosti.ru/auto/articles/2015/11/09/615972-pwc-uhudshila-prognoz-rinku-legkovih-avtomobilei-etot-god> on 30 November 2015).



demonstrated record highs in the vacating of trading and office spaces.¹² What this means is that the relatively modest figures of decline in the manufacturing and services industries (manufacturing output has been lagging far behind retail sales growth, as shown in Table 2) are yet to catch up with falling demand, dragging demand for output down further rather than ensuring the fast recovery hoped for by optimists.

Table 2 Russian manufacturing sector versus retail sales in 2015

(% year-on-year)	Jan 2015	Feb 2015	Mar 2015	Apr 2015	May 2015	Jun 2015	Jul 2015	Aug 2015	Sep 2015	Oct 2015
Retail sales	-4.4%	-7.7%	-8.7%	-9.8%	-9.2%	-9.4%	-9.2%	-9.1%	-10.4%	-11.7%
Manufacturing industries output	-0.1%	-2.8%	-1.9%	-7.2%	-8.3%	-6.6%	-7.1%	-6.8%	-5.4%	-5.9%
Total industrial output	0.9%	-1.6%	-0.6%	-4.5%	-5.5%	-4.8%	-4.7%	-4.3%	-3.7%	-3.6%

Source: Russian Federation, Federal State Statistics Service, 'Информация о социально-экономическом положении России - 2015 г' [Information About the Socio-Economic Situation of Russia in 2015], Moscow, accessed at http://www.gks.ru/bgd/free/B15_00/Main.htm on 3 December 2015.

This is another factor which will drive domestic demand down even further, as domestic-oriented sectors are the biggest employers in the country, and workers will challenge layoffs, wage reductions, wage arrears and so on. Thus, the whole economy, contrary to popular expectations of

¹² *Irn.ru*, 'Knight Frank: сегодня в Москве пустует в 1,5 раза больше офисов, чем в кризис 2008-го' [Knight Frank: 1.5 Times More Empty Office Space in Moscow Now Than During the 2008 Crisis], 13 October 2015, accessed at <http://www.irn.ru/news/103167.html> on 30 November 2015; *Lenta.ru Dom*, 'Доля вакантных площадей в торговых центрах Москвы достигла 10 процентов' [Vacant Space in Moscow Shopping Centres Reaches 10%], 6 October 2015, accessed at <http://dom.lenta.ru/news/2015/10/06/emptyshoppingmalls/> on 30 November 2015.



recovery, could be dragged into a lasting downward spiral, which would make it the worst crisis since the collapse of the Soviet Union. Based on the criterion of a lasting plunge in consumer purchasing power, it is already possible to define it as such.

A decline in investment and an increase in taxes

There are further factors, beyond the collapse in domestic demand, that are contributing to the negative scenarios regarding the future of the Russian economy:

- Fixed investments are down (by 5.7% year-on-year during the first nine months of 2015 and by 5.2% year-on-year in September),¹³ and there is little prospect that they will begin to grow given the depressed domestic demand, terrible investment climate, sanctions, overly expensive credit and the fundamental problem of lack of access to international borrowing (see above). It currently makes no sense to invest—among other factors, there are no sources of finance—thus it is hard to imagine resumed growth in the economy when the capital investment situation is so bad.
- On far this year, the extractive industries have been showing modest growth.¹⁴ But this might end with the recent government decision to significantly raise taxes upstream in the mineral resource sector.¹⁵ The Russian oil industry is already struggling with poor planning—the bulk of production is delivered by mature depleted Western Siberian field stock, already in strong decline, and recent growth has only been secured by the on-stream introduction of a small number of new mid-sized fields and smaller companies, such as Bashneft, which have

¹³ Russian Federation, Federal State Statistics Service, 'Информация о социально-экономическом положении России - 2015 г' [Information About the Socio-Economic Situation of Russia in 2015].

¹⁴ Growth of 0.3% after the first nine months of 2015, with a notable contribution from growing oil output (1.4%).

¹⁵ By as much as 300 billion roubles in 2016, as recently agreed, but with a debate looming about the further increase of taxation to remove the budget deficit: A. Topalov, 'Нефтяникам и «Газпрому» придется заплатить' [Oilers and 'Gazprom' Will Have to Pay], *Gazeta*, 26 October 2015, accessed at <http://www.gazeta.ru/business/2015/10/26/7845359.shtml> on 30 November 2015.



caught the industry up with oil recovery enhancement standards. Given this situation, a significant tax increase may result in declining oil output very soon.¹⁶ Contrary to the Russian Finance Ministry's calls for the oil industry to 'increase investment efficiency instead of begging for tax relief',¹⁷ past experiences show that there is no way the oil producing companies can withstand the severe pressure on their profits without cutting capital expenditures—and with largely depleted field stock, this will have a rapid impact on output rates, as investment is constantly needed to maintain oil production levels.

The inefficiencies of a state-led economic model

It is also worth mentioning the overall low efficiency of the Russian economy, which became evident as early as 2013.¹⁸ The decade-long implementation of the strategic idea of expanding the government sector of the economy and making state investments a key driver of economic growth simply has not worked. Total general government fixed investment reached 1.9 trillion and 1.8 trillion roubles in 2013 and 2014 respectively, and combined fixed investment by the top 10 state-owned companies each year equalled 2.4–2.8 trillion roubles, totalling nearly 5 trillion roubles. However, growth had largely already perished by 2013—these massive state investments yielded no growth. The explanation is simple: although there is corruption, the problem is mostly due to a lack of motivation from the state-affiliated sector to invest efficiently, which has led to the huge

¹⁶ See the author's analysis at Forbes.ru on the situation in the oil producing industry and the potentially devastating impact of new tax increases: V. Milov, 'Новый курс: заплатят ли нефтяники за девальвацию' [New Course: Whether Oil Companies Will Pay for Devaluation], *Forbes.ru*, 23 September 2015, accessed at <http://www.forbes.ru/mneniya-column/gosplan/300635-novyi-kurs-zaplatyat-li-neftyani-ki-za-devalvatsiyu> on 30 November 2015.

¹⁷ Such an argument is used, for instance, in Finance Minister Siluanov's recent article in *Vedomosti* in which he tries to justify the planned increase of taxation in the oil industry: A. Siluanov, 'Брать или не брать' [To Take or Not to Take], *Vedomosti*, 6 October 2015, accessed at <http://www.vedomosti.ru/opinion/articles/2015/10/07/611748-brat-ili-ne-brat> on 30 November 2015.

¹⁸ By 2013, all the signs of stagnation were already present in the Russian economy—GDP grew by only 1.1%, industrial output by only 0.4%, and fixed investment was down 0.2% (and all this was against the backdrop of an average Brent price of \$108/bbl). Many experts were predicting stagnation even then, before the beginning of the Ukrainian crisis, sanctions and falling oil prices.



misallocation of capital and sunken costs. Examples of this are the massive 'bridges to nowhere' (specifically referring to the \$1 billion bridge from Vladivostok to the adjacent Russky Island, where there's no noticeable economic activity and not even many people, so the bridge stays empty), the \$50 billion investment in the Olympic city of Sochi (where the massive infrastructure and buildings are almost totally out of use now), the large hydropower dams and gas pipelines that use just a fraction of their capacity, and so on. On paper, these are all capital investments, but they do not generate further economic activity and value, and will be written off sooner or later as sunk costs. Therefore it is clear that the state investment model has not worked in Russia, while at the same time, private investment is being restricted by a bad investment climate, a lack of property rights and deliberate efforts by the state to limit private investment in strategic sectors of the economy.¹⁹

Given all of the above, it is really quite hard to imagine that the Russian economy is beginning to grow again. Proponents of the idea would do well to provide serious explanations of how the above challenges will be addressed—until a convincing explanation is provided, it does not make sense to discuss any of the optimistic forecasts. Optimists are simply hoping for the beginning of the 'low base effect',²⁰ but as explained above, there are serious factors at work which will most probably drag the economy further down in a spiral effect—the destroyed domestic demand will force manufacturers to lay off people and reduce wages, causing further shocks to domestic demand; investors will be increasingly cautious due to the continued weakening of demand; and so on.

¹⁹ Given these bad investment conditions, it is not surprising that the government's initiatives to favour 'import substitution' and make the Russian economy less dependent on foreign goods are not working.

²⁰ The 'low base effect' is 'the tendency of a small absolute change from a low initial amount to be translated into a large percentage change': Wikipedia, 'Low Base Effect', accessed at https://en.wikipedia.org/wiki/Low_base_effect on 30 November 2015.



The temptation of an inflationary stimulus by the Central Bank

Against this backdrop, the Russian authorities are playing around with the idea of beginning to print money to stimulate the economy (issuing Central Bank credit to the government and the real economy). While the Central Bank is already doing this on a limited scale,²¹ dirigiste economists are vocally demanding that the government step into this pattern more decisively.²² Proponents of this idea, however, do not realise that, without significant revival of entrepreneurial activity that can effectively absorb this influx of extra money, this new money will most probably end up on the currency markets and stimulate inflation, as happened in the early 1990s (when exactly the same arguments were used to support the idea of massive monetary emission, and the above-mentioned effects followed). So, if the government embraces this idea, there may be disastrous consequences. However, it is not clear just yet whether the move will be made and the authorities are being visibly cautious about the prospects of aggressive emission.

Remarkably, despite the severity of the situation, the Russian government not only continues to brag about 'passing the bottom' of the crisis, but has also refrained from adopting a specific plan to address the crisis and its challenges. Recently, the Ministry of Economic Development openly stated that 'there's no need for a special anti-crisis plan'.²³ This gives some idea of how seriously the Russian authorities have misinterpreted the whole landscape, and also does not offer any optimism regarding the

²¹ See Aleksashenko on the spending of 450 billion roubles on troubled bank bailouts this year: S. Aleksashenko, 'ЦБ и АСВ не перестают удивлять своими упорством и креативностью' [CBR and DIA Never Cease to Amaze with Their Tenacity and Creativity], *Kommersant*, 9 November 2015, accessed at <http://www.kommersant.ru/doc/2849916> on 30 November 2015.

²² The recent widely discussed public report *Экономика роста* [Economy of Growth], presented in October 2015 by Sergey Glaziev, Boris Titov and Andrey Klepach, suggests just that: S. Glaziev, B. Titov and A. Klepach, *Экономика роста* [Economy of Growth], Stolypin Club, Moscow, October 2015.

²³ ITAR-TASS, 'Минэкономразвития отказалось от антикризисного плана на 2016 год' [Economic Development Ministry Refused to Write an Anti-Crisis Plan for 2016], 20 October 2015, accessed at <http://www.vedomosti.ru/economics/news/2015/10/20/613611-minekonomrazvitiya-plana-2016> on 30 November 2015.



future prospects for what seems to be the worst economic crisis since the collapse of the USSR.

Implications for the West

There are two main implications for the West from this situation. First, contrary to widespread opinion, the economic sanctions against Russia are not only working, but are taking an unprecedented toll on the Russian economy. The Russian authorities have fundamentally underestimated the country's dependence on cheap foreign private credit and Russia is currently experiencing a major credit crunch, which has brought the rouble to historic lows, destroying domestic demand and dragging down the economy. Recovery is unlikely to occur any time soon, as sources of financing are unclear—access to Western private credit is still blocked, China is not lending Russia any significant amounts, and monetary emission risks rocketing inflation given the lack of sufficient entrepreneurial activity and a positive investment climate.

Second, the political implications from the ongoing crisis are more of a medium-term story, as the government still has some reserves left to try to withstand the current situation. However, it is quite clear that Russian public opinion has already shifted to domestic economic issues as a key area of concern,²⁴ which suggests the following:

- Economic woes will most probably act as a strong containing factor in Vladimir Putin's aggressive international gamble.
- It is reasonable to expect a significant downturn for the Russian authorities on the domestic political scene as a result of the growing economic difficulties. The recent regional elections of September 2015 show just that—the authorities were only able to win decisively in areas with extremely low voter turnout: in a quarter of the areas where regional gubernatorial elections were held, the incumbent ruling party candidates lost the regional capital cities (Arkhangelsk, Blagoveschensk, Omsk and Yoshkar-Ola), and for the first time in more than a decade, the ruling United Russia party lost a gubernatorial election by a landslide in Irkutsk.

²⁴ Although the government's policy towards the Syrian crisis is commonly thought to enjoy widespread support, polls consistently show low interest in the Syrian campaign.



- The key event to watch is the upcoming federal parliamentary election in September 2016, when Putin's supposed uncontested dominance over Russian politics will undergo a serious stress test clearly connected with the poor performance of the authorities regarding the ongoing economic crisis.
- Should Putin face a severe domestic backlash driven by the current economic difficulties, it is reasonable to expect two scenarios: (1) intensified foreign policy–related mobilisation to hide the implications of the crisis (this is a separate topic for analysis, such mobilisation is not likely), and (2) a refocus on domestic issues to secure Putin's position in power and, as a result, significant withdrawal from aggressive international behaviour.

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