



State of the Russian Economy

SUMMARY

- The economic problems of Russia are currently tied to the combination of the low oil price and the Covid-19 lockdown. Even though these two developments started independently, they are now very interconnected
- The reserve funds are well filled (the foreign currency reserve is 563 billion USD and the national wealth fund has 165 billion USD), but they will only serve as a temporary solution. If the oil price remains low for a long time, necessary investments have to be cut
- Due to the poor economic outlook, Russia has to cancel several of its planned investments in the national projects as well as planned military build-up
- Most importantly for the political stability, president Putin's promises in January of increased social benefits and other expenses designed to increase his popularity will also be cut. The approval ratings of president Putin have already dropped to very low levels
- The risk of economic as well as political instability will most probably trigger the Kremlin to act to increase the oil price and increase president Putin's popularity. This may include methods that can be very harmful to other countries, in line with the annexation of Crimea in 2014 in a situation similar concerning weak popular support for the political establishment.



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The two obstacles

The Russian economy is currently hampered by two developments that started independently, but now are very intertwined: the low oil price and the Covid-19 lockdown.

The oil price war started due to different interests between Russia and Saudi Arabia. Russia tired of reducing supply together with OPEC only to let the US increase their supply and gain market shares and profits. Saudi crown prince Mohammad bin Salman on the other hand got tired of Russia letting OPEC single-handedly turn down the supply of oil. When bin Salman demanded Russia to contribute to the reduction of supply and Putin refused, the deal between OPEC and Russia from 2017 finally collapsed on March 5th.

To force Russia back to the deal, Saudi increased their production dramatically and even gave special discounts to customers in Russia's traditional sales territories. The oil price had dropped from around 50 USD/barrel (Brent) in early March to half of that just two weeks later.

Figure 1: Price of Brent oil in 2020, USD/bbl



Simultaneously, the Covid-19 pandemic began to lead to lockdowns outside of China. The demand for oil decreased in a few weeks by around 30%. At first tourism and transports declined, but later also industrial production decreased considerably. For a short period, the oil price war and Covid-19 interacted to make the oil price drop to almost 20 USD/barrel (Brent).

Since all oil producers were hurt, even president Trump intervened to try to make OPEC and Russia get a deal on supply reduction. The earlier failed attempts to reduce oil supply by 3 million barrels per day were replaced by reductions of almost 10 million barrels per day. However, due to the Covid-19 crisis, even this was not enough. From a brief increase to 35 USD/barrel, the price dropped even lower than before. Brent was down to 19 USD/barrel and WTI even reached negative prices for a brief time on April 20th.

Considering the pace of recovery from the Covid-19 pandemic, it will probably take most of the remainder of the year before the demand of oil will return to its pre-Covid-19-levels. Even when the transport and tourism industries have recovered completely, the price of oil may still not be back at the New Year levels of 70 USD/barrel since the major oil producers have not agreed on permanent supply reductions. That is, the problems that



existed before the Covid-19-effect still remain.

Consequences for Russia

The federal budget will have to be considerably reduced during 2020. Since the federal income will be a lot smaller than planned (the 2020 federal budget planning price of oil was 42.5 USD/bbl), the expenses will have to be reduced as well, since president Putin has been clear about not increasing the state deficit. The Central Bank of Russia recently stated that they do not calculate with the price of Urals oil to rise above 40 USD/bbl until 2022. Minister of Finance Anton Siluanov calculates with an oil price of 30 USD/bbl this year.

In mid-January, president Putin announced major increases in federal spending when he presented the new government. The spending covered everything from social issues and the ordinary military and security expenditure increases but were in particular directed towards infrastructure in line with the so-called national projects.

In addition to these necessary cuts in the federal budget, the major Russian energy companies will also have to tighten the belt. They will have to cancel much needed maintenance of their facilities and new investments must be postponed. Different oil companies have different production costs. The production costs even differ widely depending on the specific oil field and their equipment. In many cases the short-term production costs are quite low

in Russia, around 20-30 USD/bbl. But maintenance and new investments that are needed in the long run give an actual production cost of 50-70 USD/bbl.

Filled up reserves

Most independent economic analysts currently believe that the Russian economy will contract by 5-10% of its GDP in 2020, depending on what happens to the oil price.

At the same time the Russian reserves are all filled up. Currently, the international reserves of the Central Bank of Russia stand at 563 billion USD, which is close to all time high. The National Wealth Fund (controlled by the Ministry of Finance and used to support the pension system) stand at 165 billion USD. These funds will be paramount in keeping stability of the Russian economy. However, the international reserves of the Central Bank are only supposed to protect the ruble and keep inflation at a desired level. It is not intended to support the federal budget or financial investments. The Wealth Fund is meant to support the pension system, not to be used for direct investments in infrastructure or to support the federal budget.

Economic credibility

The major potential problem for the Russian economic system is not that the government will run out of money soon. The issue is rather that the system may lose credibility if the oil price remains at a very low level for a longer period of time. There are several different groups of



actors that affect the Russian economic system.

The state-owned enterprises constitute one important category, which the Kremlin can rely completely upon. Also, the major private enterprise owners in Russia have become increasingly aligned with the Kremlin during Putin's time as leader. Nowadays, they are normally loyal to the Kremlin and will act to support the system even if they lose some money. But, if enough of the truly independent actors, domestic as well as international, lose faith in the Russian economy due to a long-lasting low oil price, the aligned private enterprise owners will eventually have to let go of their loyalty to the Kremlin in order to not lose too much of their fortunes. If this happens, the entire economic system may begin to shake in its foundations.

The Kremlin will do anything in its power to prevent this. When Putin's friends among the richest people lose much of their fortunes at the same time as the Kremlin is demanding that they should be loyal and contribute with even more investments to the benefit of the Kremlin, their commitment may begin to wither.

The two systems

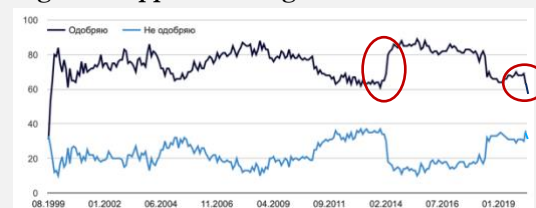
If the economic system starts to shake, there is a risk that the political system will become unstable as well. The two systems are intimately interconnected in today's Russia. With the current development, both systems run the risk of losing credibility.

In order to keep the political system stable, which is of high priority to the Kremlin, the leadership will do what they can to stabilize both systems. In order to stabilize the economic system, much effort will be made to prop up the oil price. To do this a range of resources will be used, but primarily the media, diplomatic, and military tools. In order to stabilize the political system, the resources used are partly overlapping; the media, security services, and the military.

Political credibility

If popular support starts to dwindle, Putin might want to repeat the success of the Crimean annexation.

Figure 2: Approval rating of Putin



In March, the approval ratings of Putin reached the second lowest level (63%) of any year since he became acting president on New Year's Day in 2000, according to the Levada center. Only in 2013 have the approval ratings been lower, and by only 2%-points. In April 2020, the poll was conducted by telephone instead of in person due to Covid-19. This has unfortunately made the results (59%) difficult to compare to earlier polls. However, all in all, they seem to suggest that Putin's approval rating in March is verified and there is no indication that his approval rating has changed significantly



in April. It is therefore too early to say whether this is a temporary downturn, or if it is the start of a serious challenge for the Kremlin. If the oil price remains very low for months to come, the risk is obvious that it may turn into the greatest challenge to the political stability in Russia since 2000.

Expenditure cuts and credibility

In conclusion, there are two serious consequences for the Kremlin; they must cut expenses substantially in a range of areas that Putin promised to deliver to the people as late as in January this year, and there is a possibly rising credibility problem for president Putin. If the oil price remains low throughout the year, both these problems will become serious.

Possible consequences to other countries

For other countries, the risk is that Putin will lose his popular support and credibility and therefore acts to keep the support from the power elites and the people in an attempt to repeat the Crimean annexation success. This may be done in two ways to handle the political respective the economic problems:

1. (Political) To regain popular and elite support, a foreign actor needs to be blamed so that Russia can act forcefully against this opponent, as was done in 2014 with the annexation of Crimea, the war in Donbass and blaming the West for supporting extremists in Ukraine.

2. (Economic) To prop up the oil price, the most efficient tool would be a war or at least instability in the Persian Gulf that limits or stops the supply of oil from the Persian Gulf.

The most effective action from a Kremlin perspective would be a combination of these two options, but one of them is also possible. To use diplomatic, military and media resources to blame a country in the Middle East and to provoke a war or at least a conflict that will make insurance companies refuse to insure oil tankers in the Persian Gulf would satisfy both to blame a foreign power for the problems in Russia and the need to rise the oil price.

A war in the Middle East might not lead to the same increase in nationalist feelings and support for Putin as the annexation of Crimea did, but it would – at least temporarily – take care of the economic problems by instantly make the oil price jump to high levels.

However, alternative one can be fulfilled in a more general way by using the already fiery Russian rhetoric towards Western liberalism, as started already in 2014. To blame western countries for not handling the Covid-19-crisis in a responsible manner, but letting the excessive tolerance, openness and liberalism of the West spread coronavirus in their own countries and to Russia. In this way, they will use their already vast media apparatus (including state-owned and private news media as well as bots and trolls) of anti-



liberal rhetoric to form a new argument against the most liberal countries and portray them and their liberalism as the main opponent.

Sweden has for quite some time been portrayed as one of the most extreme countries concerning liberal values, excessive tolerance, letting in far too many

refugees, being run by gays, pedophiles and feminists and have failed as a country with Islamist-run no-go-zones and no effective government. To engage in some kind of conflict with Sweden or the Baltic states, would be one of several possible ways to form a new opponent that can be used in a similar manner to the Crimean success.