

# **WHEN THE BILLS COME DUE**

## **Can Russia Afford Mr. Putin?**

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### **Can Russia Afford Mr. Putin?**

The March 2012 presidential election was a novel experience for Russia, in two critically important ways. One was that a good part of the battle for the voters' favor was fought in the country's newly emerging social media. Sites such as Twitter, Facebook, Live Journal and YouTube facilitated an unprecedented form of vibrant civic activity, prompting tens of thousands of people into taking to the streets in mass manifestations. This not only calls for a reassessment of previous beliefs that civil society in Russia was all but dead. It also indicates that the regime was bound to respond in some way.

The other novelty was that Vladimir Putin in the end saw no other choice but to actually campaign for his return to the presidency. Although there was little doubt, based on polling data, that he would win in the end, he was obviously fearful of the humiliation of having to stand in a runoff election, likely against communist party leader Gennady Zyuganov. His campaigning in consequence was accompanied by an unprecedented commitment to increases in federal budget spending. This in turn calls for a reassessment of previous beliefs about the inherent strength of the regime. Above all, it indicates that fiscal policy during Putin's third – nonconsecutive – term as president will be a crucial component in maintaining regime stability.

In the following, we shall argue that the two novelties in question are closely intertwined. They are the visible manifestations of underlying trends that combined to produce the drama of the “snow revolution.” The hallmark white ribbons worn by members of the liberal opposition were clearly designed to raise the specter of a Russian version of the prior “orange” revolution in Ukraine. And there can be little doubt that the

message was received. The way in which pro-Putin demonstrators lashed out at the “orange pest” indicates that a raw nerve had been touched.<sup>1</sup>

There is little to indicate that Russia will be transformed any time soon in the manner of Ukraine. There is simply no valid parallel to the conflict between the Ukrainian leaders Viktor Yanukovich and Viktor Yushchenko that marked the standoff in Kiev. It was the rigged presidential election in 2004, which awarded a fraudulent victory to Yanukovich, that triggered the crisis. And it was the focus and determination of the “orange” opposition, amply supported from abroad, to bring about a new election that caused the revolution to succeed. The Russian case bears no similarity to any of this. Its hallmark, on the contrary, is that of fragmentation. For all the calls that have been made for Putin to leave, all are aware that if he really were to leave utter chaos would follow.

This said, it remains important that mass rallies could indeed be held in downtown Moscow, very close to the Kremlin, calling both for honest elections and for Putin to leave. The first of two underlying trends that, we shall argue, prepared the ground for these events represents a classic case of loneliness at the peak of power. As President Putin began developing authoritarian tendencies, and as his spin doctors began cultivating his tough guy image, he quite simply became a hostage to his own success.

Putin could surf happily on an economic rebound that brought rising standards of living and orderly payment of both wages and pensions. He could bask in the glow of approval ratings that were the envy of any political leader. And he could get away with addressing both domestic opponents and foreign political leaders in manners normally considered unbecoming of a president. It was little wonder that he began to lose touch with reality. Although signs were accumulating, to suggest that he was no longer viewed as a force for the future, but rather as a remnant of the past, that message was not received. Both Putin himself and, apparently, his advisors were caught in their own myths of infallibility and untouchability.

Such cases of political disconnect are always treacherous. For Putin, the breaking point was reached on September 24, 2011. Addressing a meeting of United Russia,

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<sup>1</sup> The epithet of an “orange pest” was used already in 2007, by the Kremlin-organized pro-Putin “Eurasian Youth Union,” seeking to convince their leader to stand for a constitutionally unacceptable consecutive third term as president (<http://www.themoscowtimes.com/news/article/600-youth-vow-to-fight-orange-pest/197875.html>). In the counter-mobilization against the liberal opposition that began towards the end of 2011, it became a standard slogan of the pro-Putin activists.

previously known and feared as Putin's "party of power," that was held in Moscow's giant Luzhniki sports complex, President Dmitry Medvedev announced that he would not be seeking a second term in office.<sup>2</sup> He would instead offer his support for Putin's candidacy. And Putin in return proposed that Medvedev assume the post as premier. This put an abrupt end to years of speculation about the nature of the "tandem" that had ruled Russia since 2008, when Putin opted to leave the Kremlin and to tap Medvedev to keep his seat for him.

The announcement as such needed not have caused such a stir. Many if not most had expected that Putin would indeed return. If the fact of the matter had been presented as the result of careful deliberation, seeking to address the challenges of the day, even the staunchest of Medvedev's supporters might have taken it in the stride.

This is where the second of our two underlying trends comes into play. During the years when Medvedev served as caretaker president, the country's ruling elite was divided into two teams. Those who flocked around Medvedev and the presidency began forming expectations that the modernizing rhetoric was seriously meant, that campaigns against corruption would be conducted in earnest, and that the need to improve the country's abysmal investment climate would guide economic policy. In addition to this formation of expectations for the future course of the country, members of the two teams must surely also have formed expectations for what their respective patrons might deliver in terms of personal goods.

Up until the very end, Medvedev supporters such as Igor Yurgens remained committed to the hope and vision of a second term for Medvedev, and a belief that serious change was possible. But that was not to be. As it turned out, Medvedev had been slated from the very outset to ensure that Putin could have his cake and eat it too. He would sit for four years, and then depart quietly. The only problem was that he had forgotten to inform his supporters about this fact.

Accepting the party's nomination, at the carefully choreographed show in the Luzhniki stadium, Putin added insult to injury by saying that this was a decision the two had reached already in 2007, but kept a secret: "I want to say directly: (Medvedev and I) reached an agreement between ourselves long ago, several years ago, on what to do in the

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<sup>2</sup> <http://en.rian.ru/russia/20110924/167090260.html>.

future, on who should do what.”<sup>3</sup> The implication was that all of those who had believed in Medvedev’s modernizing rhetoric, and hoped for him to remain in office, had been simply deluded. It was the sheer arrogance of it all that caused so many to suddenly feel that they had had enough. And the role of the country’s social media was to ensure that all could be made quickly aware that they were far from alone in feeling that they had been deceived. Anger went viral, and people streamed into the streets. This was a transformation that may have substantial ramifications for the future course of Russia.

Turning to the other way in which the March 2012 election was novel for Russia, we may note that fiscal policy in the preceding years had been burdened by increasingly heavy social spending. One may certainly interpret this as compassion from the rulers, but a more likely story is that the regime was quite simply fearful of manifestations of mass discontent from below.

A variety of reasons for such fear had been provided. An early influence was the above-mentioned “color revolutions” that transformed Georgia in 2003 and Ukraine in 2004. Another was the “monetization of benefits” that brought masses of irate pensioners into the streets in 2005. A third was the emergence of a semi-organized opposition, led by Boris Nemtsov and Garry Kasparov, which began calling rallies in 2010, demanding that Putin must go. And then there was the “Arab Spring,” which brought home just how potent social media can be in organizing social protest.

The response from the regime to perceived threats of a mass mobilization of discontent, not to say an outright rebellion from below, has proceeded along two parallel tracks. First and foremost, during his initial two terms as president, Putin sought to prevent an open political challenge by deliberately constraining the arenas for expression and aggregation of interests. His notorious re-introduction of the Soviet-era “vertical of power,” the *vertikal vlasti*, was aimed at streamlining the system of command and control, so that power would flow from the Kremlin downwards. It entailed ensuring that no true opposition parties would operate within the duma, that governors in regions of the federation were appointed directly by the Kremlin, and that the media were cobbled into submission.

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<sup>3</sup> <http://www.reuters.com/article/2011/09/24/us-russia-idUSTRE78N0RH20110924>.

During the recent cycle of elections, what had come to be known as “managed democracy” proved its worth, at least in formal terms. Despite the mass demonstrations, United Russia did win the election to the State Duma in December and Putin did win the Presidency in March. What will come next remains to be seen. Having secured formal electoral victory at the cost of mass allegations of fraud may still turn out to have been something of a pyrrhic victory. The previously unthinkable has emerged out into the open, namely, a future without Putin.

On the second and more recently developed track, during his subsequent time as prime minister Putin sought to purchase acquiescence from below by engaging in lavish federal budget spending. The spending spree began with increased pensions, then broadened to a wager on health care reform and a massive military re-armament program, and culminated during the actual campaigning for the presidency, when Putin quite literally made promises of everything to everyone.

In the following we shall take a closer look at possible implications. We shall begin with the “snow revolution,” which will have a major impact on how the newly (re)elected President Putin approaches the question of political and other reforms. We shall then proceed to the evolution of fiscal policy, detailing how a fear of expressions of mass discontent from below caused a major rise in federal budget spending. We shall argue that lavish election promises have put an effective end to fiscal conservatism, and we shall take stock of the dangers that rest in basing fiscal policy on assumptions that the price of oil will remain high, or even very high.

Looking towards the future, Russia will be seen yet again to stand at an important crossroads. In one direction lies continued big spending, which will then have to be accompanied by a renewed borrowing spree on international capital markets. Assuming that Putin abhors the humiliation of dependence on foreign creditors that was the effective hallmark of the Yeltsin era, this does not appear likely. In the other direction lies a policy reversal, entailing spending cuts and a retraction of many of the election promises so recently made. Restoring fiscal conservatism would make room for a wager on modernization, but it would also be fraught with dangers of massive protests from those who would then feel cheated.

For as long as the price of oil remains high or even keeps climbing, there will be some leeway for simply continuing as if nothing had happened. But it would entail playing with fire. The longer action is delayed, the greater will be the risk that a sudden drop in the price of oil will create true havoc. And the longer action is delayed, the more remote will be the chance that modernization will succeed in achieving a true integration of the Russian economy into the global economy. Given that the latter must be the main imperative for the Kremlin, its dependence on hydrocarbon revenues, and the complacency generated when revenues are high, does come across as highly problematic. Let us proceed now to the “snow revolution.”

## **The Snow Revolution**

The internet arrived late in Russia. The real breakthrough came only with the global financial crisis, which erupted in the fall of 2008. Fearful of possible consequences for their own financial security, and distrustful of information provided in official sources, Russian families turned in large numbers to sources on the internet. Over the following years, internet use expanded rapidly and by the time of the election over 50 percent of all Russians had access.<sup>4</sup>

The political importance of this development rested in providing a platform for the spread of social media, which in turn was important in mobilizing the country’s emerging middle class. Access to sites such as *Zhivoi Zhurnal*, a Russian version of Live Journal, and *VKontakte*, a Russian version of Facebook, helped establish contacts between people and thus to dissipate feelings of being alone in discontent. Twitter was important in disseminating quick information and in calling flash mobs, and YouTube proved indispensable in heaping ridicule on the regime. All of this was highly conducive

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<sup>4</sup> According to the ITU, the UN agency for information and communication technologies, the number of Russian internet users increased from 3.1 million in 2000 to 59.7 million in 2010, or from 2.1 to 42.8 percent of the population (<http://www.internetworldstats.com/euro/ru.htm>). According to the Russian Minister of Telecommunications and Mass Communications, Igor Shchegolev, in 2011 the number of users reached 70 million, or close to 50 percent of the population (<http://www.cdi.org/russia/johnson/russia-seventy-million-internet-users-182.cfm>). The use of social media in particular has been rising very rapidly, prodded by the explosion in civic activity.

towards mobilizing protests – against alleged falsification of elections and against the way in which Vladimir Putin was engineering his return to the Kremlin.

Up until the fall of 2011 it had been generally held that civil society in Russia was all but dead. The country's emerging middle class had been allowed to engage in self-enrichment, in conspicuous consumption, and in foreign travel, but not to involve itself in civic or political activity, outside the approved channels. Some fragments of oppositional media outlets, such as the *Ekho Moskvy* radio station and the *Novaya Gazeta* newspaper, had been allowed to remain in operation, as safety valves for the country's intellectual elite. But the regime had remained confident that none of this made much of a difference.

The bedrock of Putin's popularity had consisted of his combined achievements in returning the country to economic growth and to political stability. Viewed against the background of the turmoil of the 1990s, when plundering oligarchs had roamed free, when the country had been threatened with fragmentation, and when the president had been an object of international ridicule, these were naturally viewed as great achievements.

What Putin and his advisers failed to realize was that as the years went by stability was increasingly viewed as stagnation, and the rise in living standards began to give rise to appetite also for civic and political rights and freedoms. As President Medvedev's campaign against corruption opened the sluice gates for revelations of the most egregious forms of self-seeking behavior by those at the top, previous distrust in the government began to morph into outright disgust. When the lawyer and subsequently famous anti-corruption blogger Aleksei Navalnyi branded United Russia as a "party of crooks and thieves," a *partiya zhulikov i vorov*, he quite evidently struck home.<sup>5</sup> The epithet quickly went viral and arguably did irreparable harm to what had been so painstakingly built into a "party of power."

An early warning of the trouble that lay ahead was given on November 21, when Putin attended a martial arts contest between between the Russian heavyweight champion Fedor Emelianenko and American challenger Jeff Monson. Considering the prime

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<sup>5</sup> The epithet was first introduced in a February 2011 talk show on the Russian radio station finam.fm, where Navalnyi engaged in debate with United Russia Duma member Evgeny Federov. The debate may be viewed on <http://www.youtube.com/watch?v=ccE-zCR1ej4>. (In early March 2012, it had received close to a million views.)

minister's black belt in judo, and his general tough guy image, this should have been home turf. Yet, when he entered the ring to congratulate the Russian fighter on his win, the crowd erupted in loud booing and heckling. Although pro-Putin spokesmen tried to spin it as boos against the American fighter, or as a pre-recorded provocation, the damage was done. Footage of the event was uploaded on YouTube and could be freely viewed.<sup>6</sup>

The message was that much of the previous sense of fear had dissipated. People were no longer wary of open manifestations against their leader. This had already been going on for some time in social media. Perhaps the most important single event was when the Russian rock group Rabfak uploaded a music video titled *Nash durdom golosuet za Putina*, loosely translated as "Our nuthouse votes for Putin," to YouTube.<sup>7</sup> It too went viral, and arguably inflicted severe damage on the regime. As the December 4 election to the Duma was approaching, the country was stirring.

As both Putin and his now discredited party of power began dropping in the polls, members of the opposition began voicing concern about pending electoral fraud. And they would be proven right. When the official results were announced, it turned out that United Russia had emerged victorious. In the 2008 election, Putin's party had won a constitutional majority of seats. This time, it won only a simple majority. But it did win, and that was the important point.<sup>8</sup>

Fuelled by reports of massive electoral fraud, which was said to have occurred in Moscow in particular, activists took to the streets. During an unsanctioned protest on Triumphalnaya Ploshchad, held on the day after the election, it came to violent clashes with the police. Scores of demonstrators were detained, according to some sources as many as 250. Navalnyi was amongst those arrested.<sup>9</sup>

Faced with an uproar against the violence, the regime found itself at a crucial watershed. Cracking down hard would have destroyed any future possibility of claiming that the anticipated return of Vladimir Putin to the Kremlin was the result of a free and fair election. In order to avoid open confrontation, the authorities gave permission for a

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<sup>6</sup> <http://www.youtube.com/watch?v=QzOhEFU2yFw>.

<sup>7</sup> <http://www.youtube.com/watch?v=fE91UduvNwo>.

<sup>8</sup> The official election results, giving United Russia 49.3 percent of the votes and 52.9 percent of the seats in the Duma, are available on [http://www.russiavotes.org/duma/duma\\_today.php](http://www.russiavotes.org/duma/duma_today.php).

<sup>9</sup> <http://www.dailymail.co.uk/news/article-2070615/Russian-election-protests-Mikhail-Gorbachev-calls-vote-annulled.html>.

big rally on December 10. It was held on Moscow's Bolotnaya Ploshchad, just across the river from the Kremlin.

Tens of thousands showed up, in the largest protest manifestation since the days of the collapse of the USSR. According to the organizers, more than 50,000 turned out, calling for honest elections and for a Russia without Putin. According to the police, the number was only 25,000. For the first time, numerous uploads to YouTube and other internet sources allowed independent observers to make their own counts, which tended towards the higher end.

But it was not only the sheer number of protesters that shook the regime. Many of those who took part in the rally were drawn from the capital's cultural and entrepreneurial elite. The crowd included quite a few celebrities. Many were dressed in designer clothes, and all conducted themselves in a peaceful and orderly manner. Allowing the riot police to beat them into pulp would have looked bad indeed. Both sides were clearly bent on ensuring that all should remain peaceful and orderly. And so it was. The impact on the regime was substantial.

Putin's personal reaction was likely colored by the fact that it was precisely those who had gained the most from his years in power that had now turned against him. This was clearly revealed on December 15, during his annual televised national call-in show. Responding to 4.5 hours of carefully vetted questions, he heaped scorn and ridicule on the activists. Citing Rudyard Kipling's *Jungle Book*, he castigated them as frightened Bandar Logs, the chattering monkey people that is scorned by the rest of the jungle. And he claimed to have believed that they had staged an AIDS rally – the hallmark white ribbons of the liberal opposition had reminded him of condoms.<sup>10</sup>

It was as if something had suddenly snapped. The tough guy image had cracked. The opposition quickly proved that it had a superior weapon, namely, that of ridicule. Putin's derogatory remark likening the white ribbons to condoms was met with images of inflated condoms bearing the face of Putin – to be used as contraceptive against authoritarianism. And so it continued. The country's by now very lively social media overflowed with pictures and video clips that excelled in sarcasm. In the words of a *New York Times* columnist, "Some of the strongest acts on Russia's YouTube are bands and

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<sup>10</sup> <http://russiaprofile.org/politics/51517.html>.

performers who have taken rock, rap, parody and satire to a new level in Russia's political culture, delivering their anti-government messages with irony and biting humor.”<sup>11</sup>

No one captured the change better than Navalnyi, who, as mentioned above, was arrested at a rally on December 5, the day after the Duma election. When subsequently released from a Moscow police station, he told a waiting crowd of supporters that “We were arrested for 15 days in one country and released in another one.”<sup>12</sup> Emerging as one of the most important leaders of the opposition, he used his own set of web sites as platforms for intensified mobilization. Perhaps the most important single event was to announce a prize of 100,000 rubles for the best song against the “party of crooks and thieves” posted on YouTube. The winner was Rabfak and “Nash Durdom.”<sup>13</sup>

On December 24, the regime had to abandon its early hopes that as time wore on the protests would simply fizzle. A sanctioned manifestation on Prospekt Sakharova attracted an even greater crowd of demonstrators, chanting the same slogans and brandishing the same placards heaping scorn and ridicule on Putin. Again there was a massive presence by the police, and again all went peacefully. Then followed the lengthy Russian holiday season, during which no protests were staged. Again the regime may have cherished hopes that the protests would die out, and again it saw its hopes come to shame. In early February, the activists were back in the streets, and during the presidential election weekend of March 3-4 parts of central Moscow resembled a city on military lockdown.

In a democratic setting, all of this would have been simply devastating. In the setting of Russian “managed democracy,” it could not produce any immediate results at the polls. United Russia did win the Duma election and Putin did win the presidential election. But this does not mean that the “snow revolution” will be without consequence. As Putin was getting ready to move back into the Kremlin, he was badly damaged. The remaining question is what this will mean for the coming six years, and beyond.

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<sup>11</sup> <http://www.nytimes.com/2012/02/16/opinion/putins-critics-hit-big-with-youtube.html>.

<sup>12</sup> <http://navalny-en.livejournal.com/3401.html>.

<sup>13</sup> <http://navalny.livejournal.com/tag/конкурс%20видео%20против%20ПЖиВ>.

As a first step towards an answer, we shall proceed to look at how the country's previously so successful fiscal policy was subordinated to the political needs of securing victory at the polls for Vladimir Putin.

## **The End of Fiscal Conservatism**

During the first two terms of the Putin presidency, Russian economic development was impressive indeed. Following the hyperdepression of the Yeltsin era, which saw GDP fall by around 40 percent, in the years from 2000 until 2008 Russian GDP grew by on average 7-8 percent per annum. The main driver of this rebound was the substantial devaluation of the ruble that followed in the wake of the financial meltdown in August 1998. Those who credit Putin with having pulled the Russian economy out of depression should consider that in the third and fourth quarters of 1999, with Yeltsin still president, GDP was already growing at double digits.<sup>14</sup>

A second element of sheer luck was related to the oil sector. The price of Urals crude, which is Russia's prime export blend, bottomed at \$8.73 to the barrel in December 1998. When Putin was appointed acting president, at the end of 1999, it was still at no more than \$24.71.<sup>15</sup> When Medvedev in turn assumed office, in May 2008, the price was only two months shy of reaching its peak at \$142.94 per barrel.<sup>16</sup> To this veritable bonanza of windfall gain on the price we may add that over the same time improved performance by several of the private oil companies resulted in a substantial rise in production.

Total Soviet oil production peaked in 1987. The share of the Russian Federation was then 11.48 million bpd. During the turbulence of the Yeltsin era, output dropped by close to half, to hover at about 6 million bpd. Over the two terms of the first Putin presidency, it rose by more than half, from 6.54 million bpd in 2000 to 9.88 million bpd

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<sup>14</sup> Compared to the same period in the previous year, the third and fourth quarters of 1999 came in at, respectively, 11.4 and 12.0 percent. By the fourth quarter of 2000, the rate of growth had dropped to 8.2 percent, and in the first quarter of 2001 it was down to 4.7 percent. (See further <http://www.cbr.ru/eng/archive/>.)

<sup>15</sup> <http://large.stanford.edu/publications/coal/references/oilprice/urals/>.

<sup>16</sup> <http://www.bloomberg.com/quote/EUCRURNW:IND/chart>.

in 2008. In 2009, output rose further, to 10.04 million bpd. In that year, Russia actually overtook Saudi Arabia, which had cut back its production from 10.84 to 9.89 million bpd. In 2010 and 2011, Russian production has leveled off at about 10.3 million bpd.<sup>17</sup>

The unusual confluence of prices and volumes rising in tandem resulted in a huge inflow of petrodollars. Over the decade from 1999 to 2008, Russia in consequence registered an accumulated total surplus on the current account of \$587.4 billion.<sup>18</sup>

The sudden windfall would have been a sore temptation for the government in any country, to embark on a massive spending program. In the Russian case, the minister of finance, Aleksei Kudrin, succeeded in winning the ear of his president for a policy of fiscal conservatism. It entailed paying down the country's foreign debt and building precautionary reserves, to act as a buffer in the case of a sudden drop in the price of oil. When the global financial crisis erupted, triggered by the collapse of the venerable investment bank Lehman Brothers in September 2008, Russia was in good shape.

Having reached a peak of \$138.9 billion by the end of 1998, representing 68 percent of GDP, by the end of 2008 sovereign foreign debt had been reduced to a mere \$29.4 billion, or less than two percent of GDP.<sup>19</sup> International reserves held by the Central Bank peaked at \$596.6 billion in August 2008.<sup>20</sup> This was roughly equal to the just mentioned current account surplus accumulated over the years 1999-2008. And in September 2008, the precautionary Reserve Fund peaked at \$142.6 billion.<sup>21</sup>

The global recession dealt the Russian economy a severe blow. In 2008, GDP was still growing at 5.2 percent, and the federal budget still turned in a surplus, corresponding to 4.1 percent of GDP. In 2009, Russian GDP contracted by 7.9 percent and the federal budget recorded a deficit corresponding to 5.9 percent of GDP.<sup>22</sup> Drawing on the reserves so wisely accumulated during the good years, the government was able to implement an

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<sup>17</sup> [http://www.bp.com/liveassets/bp\\_internet/globalbp/globalbp\\_uk\\_english/reports\\_and\\_publications/statistical\\_energy\\_review\\_2011/STAGING/local\\_assets/pdf/oil\\_section\\_2011.pdf](http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/reports_and_publications/statistical_energy_review_2011/STAGING/local_assets/pdf/oil_section_2011.pdf).

<sup>18</sup> See further [http://www.cbr.ru/eng/statistics/credit\\_statistics/](http://www.cbr.ru/eng/statistics/credit_statistics/).

<sup>19</sup> For details on Russian foreign debt, see [http://www.cbr.ru/eng/statistics/credit\\_statistics/](http://www.cbr.ru/eng/statistics/credit_statistics/).

<sup>20</sup> [http://www.cbr.ru/eng/hd\\_base/mrrf/?C\\_mes=01&C\\_year=2008&To\\_mes=04&To\\_year=2010&x=32&y=6&mode=](http://www.cbr.ru/eng/hd_base/mrrf/?C_mes=01&C_year=2008&To_mes=04&To_year=2010&x=32&y=6&mode=).

<sup>21</sup> <http://www1.minfin.ru/en/reservefund/statistics/amount/index.php?id4=5817>.

<sup>22</sup> [http://www.suomenpankki.fi/bofit\\_en/seuranta/venajatilastot/Pages/default.aspx](http://www.suomenpankki.fi/bofit_en/seuranta/venajatilastot/Pages/default.aspx).

anti-crisis program that in the words of Pekka Sutela, “rightly earned accolades” from several international organizations.<sup>23</sup>

As Russia emerged out of the crisis, supported by a rapid rise in the price of oil, it was as if nothing had been learned from the previous years of fiscal prudence. In preparations for the federal budget for 2010, then Prime Minister Putin vowed that 70 percent of spending would have a pronounced social profile.<sup>24</sup> Despite subsequent ambitions from Finance Minister Kudrin to warn against further deficit-enhancing spending programs, Putin would show great resolve in living up to this commitment.

First in line was to go ahead with promised increases in pensions. Following an increase by a fourth on average in 2009, such payments increased by almost half again in 2010.<sup>25</sup> A further burden was added in April 2010, with the announcement of a major increase in health care spending by \$16 billion over the coming two years. That increase was to be financed via an increase in the payroll tax, a move generally regarded by economists as a threat to economic recovery. Kudrin responded by claiming to be “disappointed,” hoping that the hike might be reconsidered.<sup>26</sup>

On a parallel track, Putin was equally determined to increase budget allocations for the country’s armed forces and security services. Increases in wages were important but overshadowed by the announcement, in 2010, of a program for military re-armament that would cost 19.4 trillion rubles (about \$650 billion) over the period until 2020. When Kudrin finally announced, on September 26, 2011, that he was leaving a post he had held since 2000 it was a pointed response to the news that Medvedev would replace Putin as head of government. But the more specific reason given was disagreement over the anticipated heavy defense spending.<sup>27</sup> Yet, there was more to come, much more.

During the election campaign, Putin made it clear that he would not take part in any form of public debate, or make any form of public appearance that was not carefully stage managed. This was in good keeping with the two previous occasions on which he had run for the country’s highest office. But this time round it was all very different.

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<sup>23</sup> Sutela, Pekka (2010), “Forecasting the Russian Economy for 2010-2012,” *Russian Analytical Digest*, no. 88, p. 4, at <http://www.isn.ethz.ch/isn/Digital-Library/Publications/Detail/?ots591=0c54e3b3-1e9c-be1e-2c24-a6a8c7060233&lng=en&id=124640>.

<sup>24</sup> *Moscow Times*, July 31, 2009.

<sup>25</sup> Sutela, op. cit., p. 3.

<sup>26</sup> <http://www.sptimes.ru/story/31273>.

<sup>27</sup> <http://en.rian.ru/russia/20110926/167150605.html>.

In the wake of the big rallies on Bolotnaya Ploshchad and on Prospekt Sakharova, Putin was clearly shaken. He had become an object of public ridicule, and his refusal to debate was no longer taken as a sign of strength but rather of weakness. Taking part in debates would have involved pointed questions that might have proven difficult to answer. And appearing in public in front of crowds that might be hostile was simply out of the question. The above-mentioned incident of the martial arts contest where he was booed was not to be repeated.

This said, it was equally clear that he could not simply ignore the opposition. He would need to respond, both by demonstrating that he could call out mass rallies of his own, and by presenting a political program that would appeal to the voters.

The former need was met with a mass pro-Putin rally in the giant Luzhniki stadium on February 23. The venue was, symbolically perhaps, the same as when he and Medvedev had jointly announced that they would be swapping jobs. And it was as carefully choreographed. According to generous police sources, some 130,000 people attended, in a stadium with a maximum seating of 78,360. Independent reports claimed participants had arrived in hundreds of buses, some from far away, and even in a special 17-car train from the Urals. Wary of the risk of booing, organizers ensured that attendance was by invitation only: “On arrival, people were asked to which group they belonged and directed to their assigned block of seats. Inside, names were checked off against attendance lists.”<sup>28</sup> This being the case, Putin’s eight-minute speech nevertheless offered all the right sound bites, to play back in the still government-controlled parts of the media.

Aiming to meet the second need, that of presenting a political program, Putin published a set of seven articles, in different Russian newspapers, covering different aspects of what could be viewed as an election platform. Actual authorship remains unclear, and may well have been mixed, but the topics addressed were important, and the message provided was well in tune with what many wanted to hear.

The issues of social spending that are in focus here were dealt with in an article in *Komsomolskaya Pravda*, titled “Building Justice: A Social Policy for Russia,” which was

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<sup>28</sup> *The Moscow News*, 2-5 March, 2012, p. 4.

published on February 13, 2012.<sup>29</sup> The text opened by stating that Russia is a welfare state, something that had clearly not been true during the 1990s. It then proceeded to note that over the past four years social spending had grown by 50 percent in absolute terms, or from 21 to 27 percent if measured as share of GDP. Wages, pensions and benefits had continued rising even during the crisis of 2008-2009.<sup>30</sup>

Proceeding from self-congratulation to visions for the future, the text addressed a number of priority areas. High on the list were teachers and doctors, dubbed as the “pillars of public morality.” The country’s one million teachers should be given salaries on par with the average in their respective regions. Doctors and university faculty could look forward to salaries twice the regional average. Families with a third child should be awarded a special allowance. Pensions would be raised, as would student allowances. Health care was to improve, and housing made more affordable.<sup>31</sup> In short, there was something for everyone.

The annual cost of these various social commitments was estimated at about 1.5 percent of GDP, or about \$161 billion for the six year term as a whole.<sup>32</sup> And it was not enough. The package of election sweeteners also included a postponement of hikes in utility tariffs, a deal with energy companies to freeze gasoline prices until after the election, an offer to buy back 16 billion rubles of shares in the state-controlled VTB bank, which had dropped substantially since the initial public offering in 2007, and a rather fanciful suggestion that football fans deserved to be given free flights to games in Ukraine and Poland during the Euro 2012 football tournament. The latter would be offered by Aeroflot and Transaero, which would recoup the costs via gains in goodwill.<sup>33</sup>

Driving the message home, many of these commitments were acted on already at the outset of the year. Military wages doubled in January, and those of police officers more than doubled. Pensions increased by 7 percent in January and by a further 2.4 percent in April. Compensation to energy companies for the gas price freeze came to about \$1 billion, etc. All told, federal budget spending for January-February was up 37

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<sup>29</sup> The Russian text is available on <http://kp.ru/print/3759/2807793/>.

<sup>30</sup> <http://rt.com/politics/official-word/putin-building-justice-russia-133/>.

<sup>31</sup> Ibid.

<sup>32</sup> <http://en.rian.ru/business/20120307/171834569-print.html>.

<sup>33</sup> <http://www.themoscowtimes.com/print/article/putins-election-promises-could-cost-161bln/453759.html>.

percent over the same period in 2011.<sup>34</sup> Needless to say, financial market analysts were hard at work trying to gauge what was going on.

Turning now to the likely implications of these lavish election promises for the future course of fiscal policy, and for general economic development, we shall take a closer look at the relation between the price of oil and the size of federal budget spending.

## **Taking Stock**

Oil and gas account for about two-thirds of Russia's total merchandise exports, and incomes from taxes on oil and gas make up about half of the revenue side in the federal budget. Based on these simple realities, we may conclude that Russia is extremely vulnerable to fluctuations in the price of oil. The price of gas also plays a role, but since it has long been linked to the price of oil, with a six- to nine-month lag, it is volatility in the market for oil that constitutes the main and most immediate problem. A rapid rise causes a large windfall, and a rapid decline wreaks substantial havoc.

The essence of the policy of fiscal conservatism that marked the first two terms of the Putin presidency was that projected federal budget spending must be based on a conservative estimate of the future price of oil. Any actual revenues in addition to those projected could then be sequestered into the special precautionary funds that have been mentioned above. Up until the global financial crisis, the Russian Ministry of Finance drew up federal budgets that ensured a steady accumulation. When the onset of the crisis caused the price of oil to literally collapse, dropping from \$142.6 in early July to \$35.7 in late December 2008, it became obvious just how wise the previous policy had been.<sup>35</sup>

As the country emerged out of the crisis, and as the price of oil again began to rise, all of this appeared to have been conveniently forgotten. As noted above, in preparing for the budget for 2010, then Prime Minister Putin promised that 70 percent of spending would have a social profile. The heavy emphasis that would henceforth be

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<sup>34</sup> <http://russianeconomicfreedom.org/>.

<sup>35</sup> <http://www.bloomberg.com/quote/EUCRURNW:IND/chart>.

placed on meeting various forms of social demands implied that federal budget spending would have to continue rising. In order to avoid having this cause a sharp rise in the projected budget deficit, which would have looked bad, in preparations for the 2011 federal budget Putin ordered an increase in the budget price of oil, from \$58 to \$75 per barrel.<sup>36</sup>

This was a drastic measure. It is generally assumed, as a rule of thumb, that every \$1 change in the price per barrel translates into about \$2 billion in federal budget revenue, added or lost. Accepting this estimate, the increase in the budget price of oil was tantamount to allowing for an extra \$34 billion in spending, without affecting the projected deficit.

The dangers that are inherent in this new approach concern what is known as the breakeven price of oil, i.e. the actual price of oil at which federal revenue suffices to cover federal expenditure. As expenditure keeps increasing, so does the breakeven price of oil. Fiscal conservatism entailed ensuring that surpluses in years of high energy prices could be used to compensate for deficit in years when the market is down. The abandonment of this policy was tantamount to massive risk taking.

To be sure, spending had been rising even during the years of fiscal restraint. Measured as share of GDP, federal budget expenditure increased from 14.1 percent in 2000, to 16.0 percent in 2006, and to 18.2 percent in 2008.<sup>37</sup> If we take into account that this steady rise in the share of spending in GDP took place during a time when GDP was also on rise, it follows that the rise in the actual level of spending was even steeper. The implication was that federal budget revenues would have to follow suit, which in turn means that the breakeven price of oil was also rising steeply. Over the period 2000-06, it was kept in the range from \$20 to \$40 per barrel. In 2008, it stood at \$62.<sup>38</sup>

During the crisis year 2009, expenditure in absolute terms rose to 9.6 trillion rubles, from 7.6 trillion rubles in 2008, or by no less than 27 percent. With a parallel contraction in output by 7.9 percent, the share of expenditure in GDP was pushed to a record high of 24.7 percent.<sup>39</sup> The breakeven price of oil was pushed to \$99.<sup>40</sup> Although

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<sup>36</sup> <http://uk.reuters.com/article/idUKLDE6511RI20100602>.

<sup>37</sup> <http://www.eeg.ru/pages/345>.

<sup>38</sup> <http://www.worldfinancereview.com/may2010/russianeconomyin2010.html>.

<sup>39</sup> <http://www.eeg.ru/pages/345>.

the price of Urals crude more than doubled during the year, rising from \$36.2 to \$76.8 per barrel, it was not sufficient to keep the budget in balance.<sup>41</sup> The federal budget deficit ended up at 5.9 percent of GDP.<sup>42</sup>

In 2010, the Russian economy began to stabilize. Growth returned, even if only at 4.3 percent.<sup>43</sup> Driven by Putin's promises of increased social spending, federal budget expenditure meanwhile continued its rise, reaching 10.1 trillion rubles, or 22.7 percent of GDP.<sup>44</sup> Although the price of Urals crude also continued its rise over the year, to reach \$90.4 per barrel, it again was not sufficient.<sup>45</sup> Federal budget revenue did rise, but only to 8.3 trillion rubles, or 18.7 percent of GDP. The breakeven price had been pushed to \$105.<sup>46</sup> The federal budget deficit ended up at 4.1 percent of GDP.<sup>47</sup>

It was against this background that the Russian government proceeded to grapple with the federal budget for 2011. Spending was fixed at 10.7 trillion rubles, and revenues at 8.8 trillion rubles, corresponding to 21.2 and 17.6 percent of GDP, respectively. The projected deficit came to 1.8 trillion rubles, or 3.6 percent of GDP. The simultaneously adopted outlook for 2012 envisioned spending rising to 11.2 trillion rubles and revenues to 9.5 trillion rubles. With continued growth in GDP of 3.9 percent, that would have implied a reduction in spending to 20.1 percent of GDP and of revenues to 17 percent of GDP.<sup>48</sup>

As it turned out, spending during 2011 was kept at 10.9 trillion and revenues rose by a striking 36 percent, to reach 11.3 trillion rubles. The federal budget in consequence ended with a surplus of 0.8 percent of GDP.<sup>49</sup> The main driver of this improvement was that the price of oil continued its climb, reaching \$105.7 per barrel at the end of the

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<sup>40</sup> <http://www.worldfinancereview.com/may2010/russianeconomyin2010.html>.

<sup>41</sup> <http://www.bloomberg.com/quote/EUCRURNW:IND/chart>.

<sup>42</sup> <http://www.eeg.ru/pages/345>.

<sup>43</sup> [http://www.suomenpankki.fi/bofit\\_en/seuranta/venajatilastot/Pages/default.aspx](http://www.suomenpankki.fi/bofit_en/seuranta/venajatilastot/Pages/default.aspx).

<sup>44</sup> <http://www.eeg.ru/pages/373>.

<sup>45</sup> <http://www.bloomberg.com/quote/EUCRURNW:IND/chart>.

<sup>46</sup> <http://www.worldfinancereview.com/may2010/russianeconomyin2010.html>.

<sup>47</sup> <http://www.eeg.ru/pages/373>.

<sup>48</sup> <http://en.rian.ru/infographics/20101126/161511100.html>.

<sup>49</sup> <http://www.eeg.ru/pages/148>.

year.<sup>50</sup> Measured as an average over the year, the price of Urals crude actually rose by 40 percent, to reach \$109.3 per barrel, well above the breakeven price.<sup>51</sup>

The dynamic importance of the price of oil may be seen in the fact that Russia's current account surplus increased from \$48.6 billion in 2009, to \$70.3 billion for 2010 and \$101.1 billion for 2011.<sup>52</sup> With high oil prices causing revenues to swell, the government clearly felt that it had plenty of leeway to embark on further spending hikes.

In preparations for the budget for the 2012 presidential election year, it in consequence continued its course of ransoming the future to the very hilt. By mid-year, expectations were that the federal budget might break even for the year as a whole. By the end of October, it actually showed a surplus corresponding to 3.3 percent of GDP.<sup>53</sup> Driven by ambitions to undertake a further expansion of spending, it was decided to raise the budget price of oil even further, to \$93 per barrel.<sup>54</sup>

The previous budget forecast had envisioned an increase in the price from \$75 in 2011 to \$78 in 2012. Retaining our previous assumption on the relation between the oil price and federal budget revenue, the latest hike would effectively make room for an additional \$30 billion in spending, without affecting the projected deficit.

In the final version of the federal budget for 2012, signed into law by President Medvedev in December 2011, the estimate for the average price of oil had been raised even further, to \$100. Based on this assumption, revenues were projected at 11.8 trillion rubles and expenditures at 12.6 trillion. The projected deficit was kept to 0.8 trillion rubles, or 1.4 percent of GDP. With a projected GDP of 58.6 trillion rubles for 2012, the share of revenues in GDP would rise to 20.1 percent of GDP and that of spending to 21.5 percent of GDP.<sup>55</sup> Deficits were assumed to remain over the whole planning period, i.e. through 2014.

Summing up, it should be noted that for as long as the actual price of oil does remain high, there is no immediate danger here. The problem is indirect. By hiking expenditure to levels well above the \$100 oil mark it not only becomes impossible to

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<sup>50</sup> <http://www.bloomberg.com/quote/EUCRURNW:IND/chart>.

<sup>51</sup> <http://www.bloomberg.com/news/2012-01-02/russian-crude-oil-production-rose-to-post-soviet-high-in-2011.html>.

<sup>52</sup> <http://www.cbr.ru/eng/statistics/?Prtid=svs>.

<sup>53</sup> <http://www.eeg.ru/pages/172>.

<sup>54</sup> *Moscow Times*, July 7, 2011.

<sup>55</sup> <http://www.itar-tass.com/en/c154/281911.html>.

return to the previous policy of prudent accumulation of reserves, which was the essence of Kudrin's fiscal conservatism. Even worse, when and if the price of oil drops back down, as it surely will, at some point, the need to undertake spending cuts will be severe indeed. It is this that makes the question of Putin's extravagant election promises so critical to any assessment of the future course of Russia. Let us turn now to conclude, by looking at what may lie ahead.

### **What Lies Ahead?**

At his first post-election Cabinet meeting, held on Wednesday, March 7, Putin addressed the question of ballooning social spending. Noting that issues of macroeconomic stability will have to remain the top priority, he instructed the Finance and Economic Development ministries to submit proposals for cutting some other expenditures in the current and the following years.<sup>56</sup>

There are two important elements of complication here. One concerns the stated expectation that reduction in waste and measures against corruption will take care of a good part of the needed cuts. While this may work, it is surely not to be considered as money in the bank. The second complication rests in the fact that a good part of the added expenditure for salaries to doctors and teachers will fall on regional budgets. While this will alleviate the pressure on the federal budget, it is far from certain that regional budgets will be able to cope with the sudden bout in spending.

It is the sheer size of the commitments that has caused so many to begin questioning what will come next. Putin's own estimate of the added social spending alone came to 1.5 percent of GDP, of which two-thirds would fall on regional budgets. Others have produced higher numbers. The program for military rearmament will add another 3 percent of GDP, to which may also be added the cost for increasing salaries and pensions for the military.

By far the most worrisome, however, is the Russian pension system. The pension fund deficit for 2012 is expected to reach 1.75 trillion rubles, or about 3 percent of GDP.

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<sup>56</sup> <http://www.themoscowtimes.com/print/article/putins-election-promises-could-cost-161bln/453759.html>.

In 2011, it was less than one trillion. The rapid increase in the level of pensions adds to the problem of adverse demographics. The share of retirees in the total population will increase from 22 percent at present, to above 25 percent in 2020 and close to 30 percent by 2030.<sup>57</sup> Experts in the field are becoming increasingly insistent that the system is simply not viable, that a different way of financing must be found, and that the pension age must be raised. In the meantime, the pension fund will continue to act as a serious and growing drain on the federal budget.

All told, Citibank experts have suggested that the breakeven price of oil could rise to \$150 per barrel over the next few years.<sup>58</sup> Estimates for 2012 range between \$115 and \$120 per barrel. And this still does not take into account extravagant promises made for showcase events such as the 2012 Asia-Pacific Economic Cooperation (APEC) summit in Vladivostok and the 2014 Winter Olympics in Sochi.

One rather obvious solution to the fiscal problems would be to embark on another borrowing spree on international capital markets. Russian debt to GDP is insignificant, its credit rating is good, and markets would surely be happy to lend substantial amounts. The problem here, as mentioned above, is that Putin may be expected to take a dim view of the associated political dependence that would come with rising indebtedness. The humiliation involved in dealing with creditors during the Yeltsin era is still fresh in mind.

A more likely way out might be to simply retract some of the promises made, but this in turn brings to the fore the key question of whom Putin would dare to antagonize. He has been badly shaken by the “snow revolution” and if the fiscal situation deteriorates he will need all the support he can get. It is of course possible that the price of oil will continue rising, but this will only postpone the inevitable. A price of oil in the \$150 range would trigger a global recession, with substantial backlash effects for Russia. At some point, the level of expenditure will simply have to be brought down.

Retracting promises about military modernization would go down well both with markets and with the liberal opposition. But it would also be dangerous. It is likely that many within the power elites have already made plans on how a good part of the huge expenditure that is planned for military procurement may be channeled into private bank

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<sup>57</sup> <http://www.itar-tass.com/en/c39/370605.html>.

<sup>58</sup> <http://www.themoscowtimes.com/print/article/putins-election-promises-could-cost-161bln/453759.html>.

accounts. According to a statement by Sergei Fridinsky, Russia's top military prosecutor, to the *Rossiyskaya Gazeta*, at least 20 percent of the defense budget is being siphoned off every year via various forms of fraud.<sup>59</sup> If one-fifth of the anticipated addition in military spending were to go the same way, we can imagine that expectations are presently being formed of a true bonanza to come. Betraying such expectations could provoke serious counter reactions from powerful interests within the power ministries.

Going back on promises to pensioners, or to doctors and teachers in the provinces, would also be fraught with danger. It was amongst these groups that Putin drew much of the support that got him elected in March 2012. And he may need their support again, before long.

What remains is to cut deep into expenditure that ought to go to upgrading the country's sadly neglected and dilapidated infrastructure, and to create the preconditions for successful modernization. These are the types of measures that were promised by President Medvedev, and that created a good deal of enthusiasm amongst his supporters. To openly and brutally make it clear that they will not be honored, that it was all just for show, would be an open provocation against all of those who did believe in Medvedev's rhetoric and who took to the streets to protests against Putin's return.

Retaining our assumption that modernization of the Russian economy is a *sine qua non* for the Kremlin, if it wishes to avoid being reduced to a raw materials colony, then it is simply imperative that some form of agreement can be reached with the liberal opposition. The country's image in the eyes of outside investors is largely shaped by the liberal intelligentsia in Moscow, and it showed its preferences on Bolotnaya and Sakharov. Similarly, a large part of the country's entrepreneurial elite may also be found amongst those who vented their frustration.

Towards the end of campaigning for the presidency, opposition leader Vladimir Ryzhkov warned that an election victory for Putin could trigger a mass exodus.<sup>60</sup> Although there was an obvious political ambition behind this statement, this does not mean that it can be simply dismissed. According to numbers released by the Federal Audit Chamber in February 2011, over the past three years about 1.25 million Russians

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<sup>59</sup> <http://rt.com/news/prime-time/russia-defense-budget-corruption/>.

<sup>60</sup> <http://www.themoscowtimes.com/news/article/opposition-leader-predicts-mass-emigration-after-presidential-vote/453943.html>.

had emigrated.<sup>61</sup> Many of these were likely young entrepreneurs, and many more already have the equivalent of “green card” status in Western countries, implying that they can leave on short notice.

In conclusion, there can be little doubt that Russia is faced with a set of decisions that will have a major impact on the way in which both the economy and society at large will develop over the coming decade or so. The most immediate fiscal pressures may be relieved via a combination of cautious borrowing, careful spending cuts, and increased taxes. The latter calls to mind Putin’s repeated if veiled references to a pending “tax maneuver.”<sup>62</sup> If not carefully balanced, an operation to raise taxes would depress the prospects for growth. It thus represents yet another tradeoff that will have to be approached with caution.

The real challenge, however, lies beyond pressing fiscal needs. The future will be determined by whether the Kremlin is able to reach a new form of understanding with its subjects. The old “social contract” that entailed allowing the emerging middle class to get rich, but not to get involved in civic or political activity, is clearly dead. It perished on Bolotnaya and Sakharova. Attempting to achieve modernization without having the cultural and entrepreneurial intelligentsia on board simply will not work. Bureaucrats, blue collar workers and siloviki may remain beholden to Putin and the Kremlin, but these groups cannot be counted on as a modernizing force.

While Putin considers how to proceed, he clearly has a window of opportunity. According to a VTSIOM poll from March 2012, the percentage of Russians who say they wish to emigrate had dropped by half since June 2011, from 22 to 11 percent, and is now lower than it was in the final days of the Soviet Union.<sup>63</sup> In a comment to *Kommersant*, Svetlana Gannushkina, of Memorial’s migrant rights division, saw these numbers as proof that members of the opposition now have begun to view themselves as empowered stakeholders in the country’s future, giving them a reason to stay: “People began to feel

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<sup>61</sup> [http://www.rferl.org/content/emigration\\_blues\\_russias\\_sixth\\_brain\\_drain/2294463.html](http://www.rferl.org/content/emigration_blues_russias_sixth_brain_drain/2294463.html).

<sup>62</sup> <http://en.rian.ru/business/20120209/171232785.html>.

<sup>63</sup> <http://wciom.ru/index.php?id=459&uid=112633>.

that they're not alone, that something can and must be done. ... Regardless of Putin's return to the presidency, this is our country, and we can be responsible for it."<sup>64</sup>

The sole remaining questions concern how the opportunity is being perceived by those in power, and for how long the window will remain open. When and if it closes again, the doors to the outside world will still remain open.

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<http://www.themoscowtimes.com/print/article/poll-fewer-russians-want-to-emigrate-than-in-1991/455523.html>.