

# Russia Considers a New Economic Model

by Ekaterina Zolotova - December 2, 2020

The flaws in Russia's economy might be too deep to gloss over. At an annual civil forum in Moscow on Saturday, Alexei Kudrin, the chairman of Russia's Accounts Chamber and finance minister from 2000 to 2011, spoke rather pessimistically about the Russian economy. He predicted a drop in economic output this year of 4.5 percent, a significant fall in living standards and that 1 million more people will slide into poverty. It's no secret that the Russian economy is under serious stress – made worse by the coronavirus pandemic – but Kudrin's remarks were unusual for a government that has been promoting the rehabilitation of Russia's economy by 2022. Given the unavoidable economic difficulties ahead, the Kremlin appears to be changing tone and priming the public for more hardship – and potentially a massive economic transformation.

## From Bad to Worse

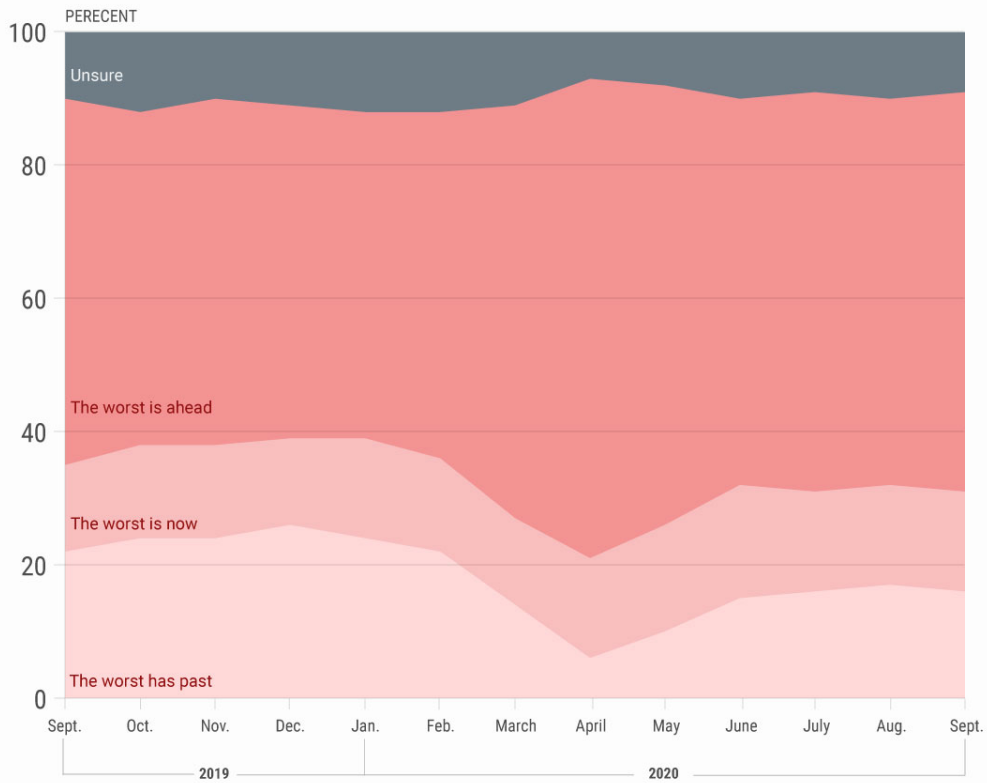
At the forum, Kudrin said Russia needed a new economic model, and it's hard to argue with that. Oil remains the backbone of the Russian economy. Approximately half its exports are of mineral resources (mostly natural gas and oil), and oil and gas revenues make up about 30 percent of its federal budget (and that's excluding tax revenues from oil and gas giants like Rosneft and Gazprom). The pandemic, however, has cratered economic activity, and thus demand for energy, and OPEC+ members including Russia agreed to cap production for the time being. In these circumstances, it is difficult for an economy that depends on energy exports to remain afloat. And even after demand recovers, Kudrin said he believes oil consumption will start to decline from its peak in the next 5-10 years, forcing Russia in the 2030s to shift away from oil exports.

One significant challenge is finding an effective economic model that can ensure Moscow's continued control of its vast territory and far-flung regions. Today, the Kremlin maintains control using not only the security apparatus and political institutions but also the redistribution of budget revenues between regions. These revenues, however, depend on the oil and gas industry. Beyond its own borders, Moscow has offered neighbors discounted energy in exchange for greater regional influence and security, defending itself and its sphere from encroachment by China in the east, Turkey in the south and Europe in the west. But as the role of oil and gas in the Russian economy declines, the Kremlin will need its new economic model to serve a similar purpose with respect to building and maintaining allied relations with its neighbors.

During his speech at the civil forum, Kudrin suggested that what Russia's economy needs is "revolutionary deregulation." He recommended a model he called NEP 2.0 to encourage entrepreneurship, a reference to Lenin's New Economic Policy of the 1920s following Russia's Civil War. Under the original NEP, the Soviet Union temporarily turned toward state capitalism and away from extreme centralization – with noticeable success. By 1928, the national income had surpassed prewar levels and the material situation of citizens of all stripes had grown more stable. But when Stalin took power that same year he abandoned the NEP, whose legacy remains controversial in Russia to this day.

## Russian Pessimism Survey

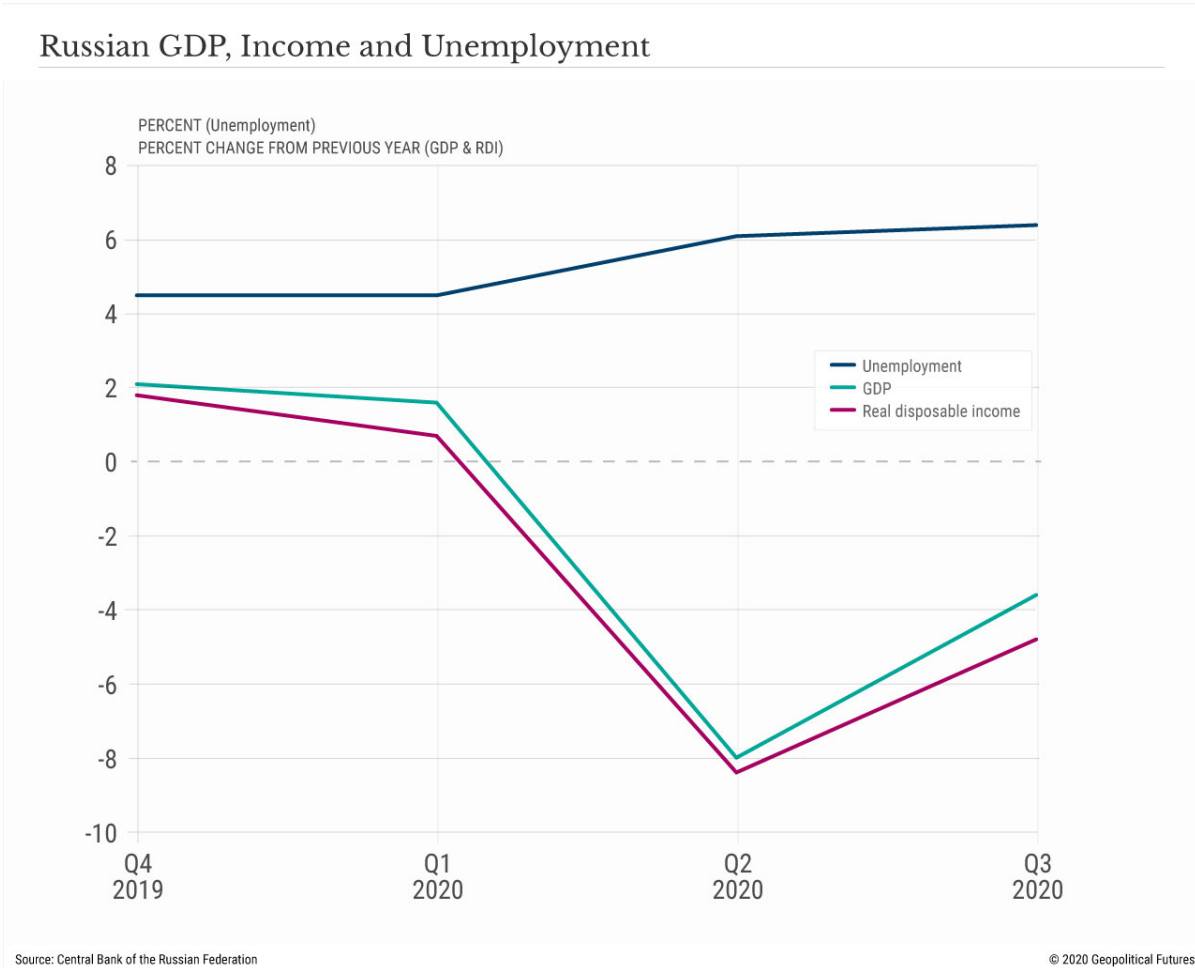
Do you think we are going through the most difficult times now, or are they behind us, or still ahead of us?



Source: Vciom News

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The situation in Russia in 2020 isn't even close to as bad as it was in 1921, but it's going to get worse. Kudrin, after touting Russia's victory over extreme poverty, said COVID-19 would by the end of the year force another 1 million Russians into destitution. In the second quarter of 2020, Russians' real disposable income fell by more than 8 percent, and it dropped by another 4.8 percent in the third quarter. Leaders in Moscow apparently see the COVID-19 recession as an opportunity to implement transformational change.

### A New Model

The Kremlin could, for example, claim that raising living standards and rescuing private small and medium-sized enterprises at this time will be too difficult, given the current extraordinary challenges, and save what's left of its public funds for future use. Indeed, though Moscow has said it's prepared to help stimulate the economy, it has been hesitant to pile more stimulus on top of its initial efforts to

aid Russian businesses. In this way, it's leaving the economic recovery in the hands of the Russian people. It believes that the economy will continue to chug along, while the state continues to manage key sectors including much of heavy industry and transport. (During the lockdown, the public sector appeared more stable than the private sector, so state-owned enterprises could also use this as an opportunity to dominate the market even more than they had before.)

Though Russia still has substantial reserves in its national wealth fund – roughly 13 trillion rubles (\$170 billion) – it's not in any hurry to spend them to prop up large Russian corporations. It sees relying on SMEs as a better method of stimulating economic recovery, in part because they don't require the same level of financial support that large firms do, and in part because individual SME owners can't challenge the Kremlin the same way powerful oligarchs who control massive Russian corporations can. So by allowing SMEs to take on the bulk of the responsibility for economic recovery, the Kremlin ensures that its own influence in the regions outside of the capital isn't overrun by other wealthy interests.

Moscow is also using this time – while many countries' economies are stalled by the pandemic, and while the United States is preoccupied with the presidential transition – as an opportunity to improve relations with the western buffer states and increase its influence among its neighbors. After negotiating a peace deal between Azerbaijan and Armenia over the Nagorno-Karabakh conflict, Russia secured a long-term presence in the South Caucasus by including in the deal a Russian peacekeeping force that will monitor the cease-fire. To its west, Russia saw President Alexander Lukashenko elected to another term in Belarus in August, and since the disputed election, he has been looking to Moscow for even more support and cooperation. Meanwhile, the conflict in eastern Ukraine remains frozen, which suits the Kremlin just fine.

One of Moscow's key tools of projecting influence in the post-Soviet states is the Eurasian Economic Union. The head of the group's executive body, the Eurasian Commission, said this week that the bloc was moving into a new phase of integration and ready to build projects worth \$200 billion. A long-awaited draft agreement on gas prices and tariffs on gas transport – which will essentially create a common market for natural gas – is expected next year. (Members are still divided on this issue, however, meaning an agreement may be hard to come by. Belarus and Russia will therefore continue to negotiate between themselves while they await a broader deal.) In addition, Russia is spending millions to support external economies, even while its own economy struggles. It provides Kyrgyzstan, for example, millions of dollars' worth of financial assistance. It is also considering financing the second stage of a project to increase production of hydrocarbons in Uzbekistan and has provided the country with loans worth \$650 million. And it has also issued Belarus \$1.5 billion in

loans.

In the short term, the Russian economy will survive. In the long term, it will need substantial changes. It continues to depend too much on profits from oil and gas exports, which were previously used as an instrument of influence and control for the state. It now needs to look for new tools with which to maintain state power at the lowest possible cost. While the pandemic has presented many countries with enormous challenges, it may also present Russia with an opportunity to conduct an experiment in economic reform. And if the experiment succeeds, it could help the Kremlin fulfill both of its key imperatives: to preserve the unity and power of the state, and strengthen its power within the broader region.

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