The Telegraph

Russia retreats to autarky as poverty looms

Vladimir Putin is falling back on Soviet-era self-reliance as oil wealth evaporates and sanctions cut off vitally-needed technology

A 1948 propaganda poster showing Stalin surrounded by admirers and reading 'Long live the Komsomol generation!' Photo: Alamy

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Russia is running out of money. President Vladimir Putin is taking a strategic gamble, depleting the Kremlin's last reserve funds to cover the budget and to pay for an escalating war in Syria at the same time.

“Our policies are not frozen. They adapt to circumstances”
President Vladimir Putin

The three big rating agencies have all issued alerts over recent days, warning that the country's public finances are deteriorating fast and furiously. There is no prospect of an oil revival as long as Saudi Arabia continues to flood the market. Russia cannot borrow abroad at a viable cost.

Standard & Poor's says the budget deficit will balloon to 4.4pc of GDP this year, including short-falls in local government spending and social security. The government has committed a further $40bn to bailing out the banking system.

Deficits on this scale are manageable for rich economies with deep capital markets. It is another story for Russia in the midst of a commodity slump and a geopolitical showdown with the West. Oil and gas revenues cover half the budget.

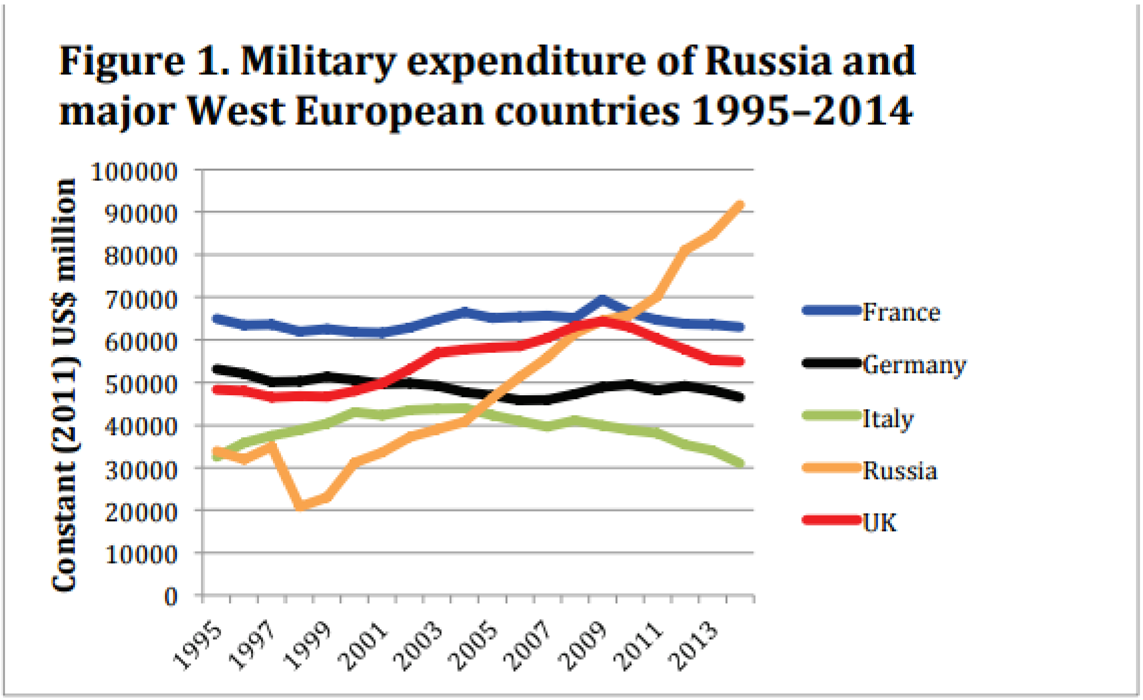
"They can't afford to run deficits at all. By the end of next year there won’t be any money left in the oil reserve fund," said Lubomir Mitov from Unicredit. The finance ministry admits that the funds will be exhausted within sixteen months on current policies.

Alexei Kudrin, the former finance minister, said the Kremlin has no means of raising large loans to ride out the oil bust. The pool of internal savings is pitifully small.

Any attempt to raise funds from the banking system would aggravate the credit crunch. He described the latest efforts to squeeze more money out of Russia's energy companies as the "end of the road".

Mr Kudrin resigned in 2011 in protest over Russia's military build-up, fearing that it would test public finances to breaking point. Events are unfolding much as he suggested.

Russia is pressing ahead with massive rearmament, pushing defence spending towards 5pc of GDP and risking the sort of military overstretch that bankrupted the Soviet Union.



The Stockholm International Peace Research Institute said the **military budget** for 2014 rose 8.1pc in real terms to $84bn as the Kremlin took delivery of new Su-34 long-range combat aircraft and S-400 surface-to-air missile systems.

It is to rise by another 15pc this year, led by a 60pc surge in arms procurement. This is an astonishing ambition at a time when the economy is in deep crisis, contracting by 4.6pc over the last twelve months.

Mr Putin pared back the plans earlier this year but has since restored the original target, telling a VTB Capital forum this week that the economy has hit bottom and "things are looking up."

Diplomats say the reality is that wars in Syria and Ukraine are eating into the budget. Cruise missiles are not cheap.

Mr Putin knows he cannot count on oil and gas any longer, belatedly recognizing that shale technology in the US threatens to cap crude prices for a decade or more, and has effectively destroyed Russia's petro-power business model.

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The Kremlin has gone back to the drawing board, working from the Spartan assumption that oil will remain stuck at $50 a barrel for the next three years.

It could be even worse. Russia's central bank warned in a report that it may take $30 oil to stop the US shale juggernaut.

The central bank's "risk scenario" talks of a new era of sub-$40 crude that would entrench the current depression. "Under these conditions, GDP could fall by more than 5pc in 2016," it said.

Mr Putin claims to have an ace up his sleeve: Russia will fall back on industrial self-reliance and import substitution. "Our policies are not frozen. They adapt to circumstances," he said.

The Kremlin is launching a radical plan to slash imports across twenty key sectors within five years, ranging from heavy machinery to electrical engineering, photonics, cars, tractors, chemicals, pharmaceuticals, and food.

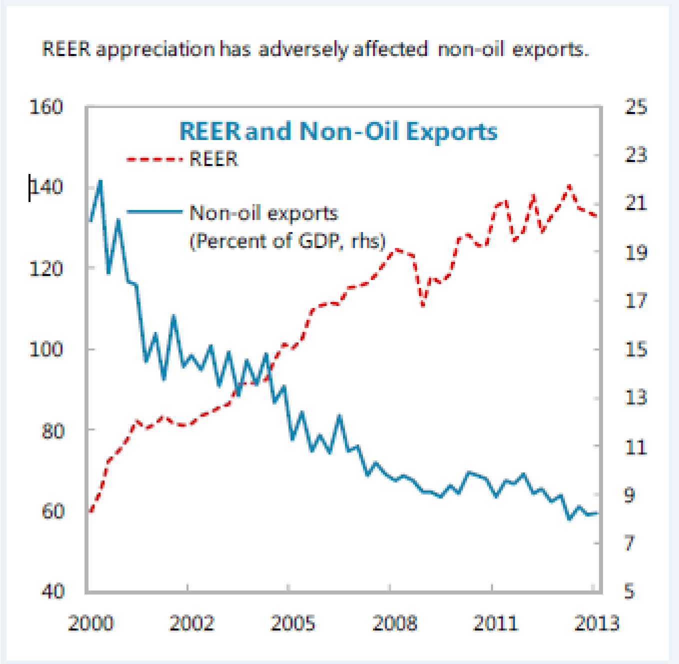
The targets are drastic. Reliance on foreign farm and forestry machinery is to be cut by 56pc, food processing by 53pc, and engineering equipment by 34pc. State procurement contracts will be steered to companies that produce in the country, whether or not they compete on quality.

But the switch-over costs money that the government does not have. Viktor Semenov from the Belaya Dacha Group said his agro-conglomerate is raking in big subsidies to grow lettuces in the Siberian heartland of Novosibirsk, relying on heated greenhouses to fight temperatures of minus 20 degrees.

"We're building 250 hectares of hothouses a year on my farms," he said. Whether it makes sense is anybody's guess. The same vegetables could be imported more cheaply from Turkey.

Trade experts are already shaking their heads. Such a reflex usually means a country is going badly off the rails, though Germany pulled it off with macabre success in the 1930s. "In most of the cases I have known import substitution policies have failed. They degrade the economy," said Pascal Lamy, former head of the World Trade Organisation.

Russia has pockets of excellence - currently on display in the Syrian theatre - but the engineering and industrial base of the Soviet era has largely been hollowed out by an overvalued rouble during the commodity boom.

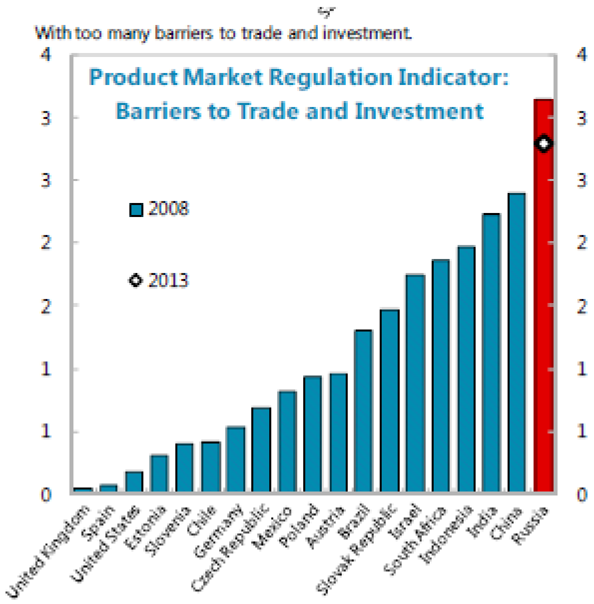


It has been a textbook case of the Dutch Disease. Many of the best engineers and technicians have emigrated in a chronic brain-drain. Russian economists say it is far from clear whether the country can suddenly pirouette and manufacture the machines itself.

Vladislav Inozemtsev, from the Center for Post-Industrial Studies in Moscow, said the **likely outcome** is a retreat into autarky and pauperised decline, ending in withdrawal from the global trading system. “This way leads us towards a quasi-Soviet economy detached from the world and, at the same time, proud of its autarky; towards a deteriorating economy which compensates for the drop in living standards with pervasive propaganda,” he wrote.

Mr Putin is counting on a 50pc devaluation since early 2014 to restore lost competitiveness and ignite a manufacturing renaissance. Having presided over a destructively-strong rouble for a decade, he has now embraced the virtues of a weak currency with the zeal of the converted.

Oleg Deripaska, chief of the aluminium group Rusal, said it is wishful thinking to suppose that a cheap rouble can kick-start an economy caught in a tangle of red-tape, crying out for root-and-branch reform and the rule of law.



"We should stop looking at the exchange rate and give some thought to the economic policy we really need. Nobody is going to borrow at 12pc in hard currency to invest," he said.

The chief effect has been to shrink the Russian economy in global terms. "GDP was $2.3 trillion at the peak. It is now $1.2 trillion, and I fear we are going back to the level of 1998 when it was $700bn," he said.

This would be smaller than Holland ($850bn) or half the size of Texas ($1.4 trillion), a remarkable state of affairs for a country vying for superpower military status in Europe and the Middle East.

Igor Sechin, the head of oil giant Rosneft, said devaluation is a false strategy, adding sarcastically that if it was so good to halve the rouble from 30 to 60 against the dollar, why not just keep going and push it all the way to 100. "That would be a dream wouldn't it?" he said.

In a sense, Mr Putin has little choice. He cannot afford burn through foreign reserves to defend the rouble. They have already fallen from $520bn to $371bn. Standard & Poor's said two-fifths of this money is ear-marked for other functions and cannot be deemed "usable".

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Ivan Starikov, the former deputy economy minister

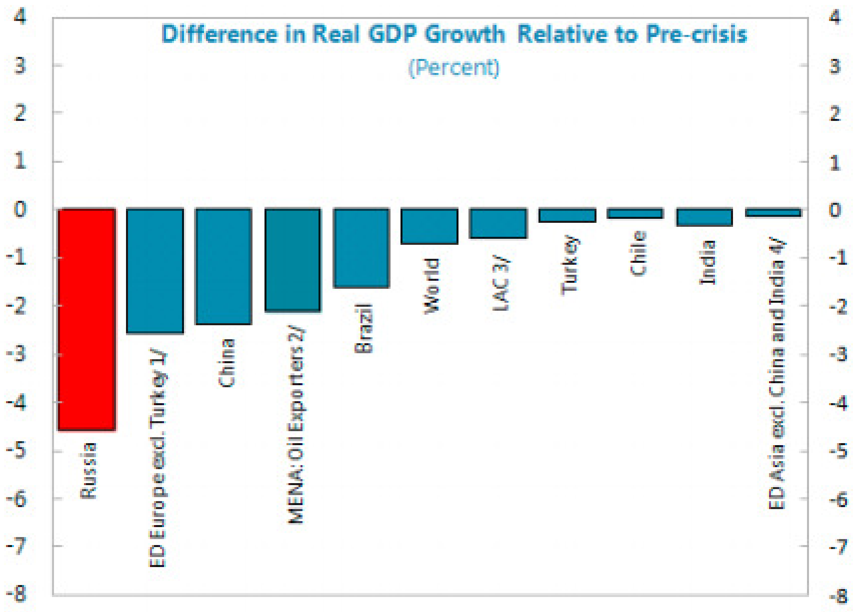
These reserves look large on paper but are near the minimum safe levels needed to uphold confidence and to cover foreign debt redemptions of Russian companies, running at $12bn to $15bn a quarter.

What is clear is that Russia's attempt to reinvent itself as an industrial tiger will take years to bear fruit, if it is possible at all. The early evidence is dismal, though Ford has announced that it will start building engines for the Fiesta later this year at its Russian joint venture in Elabuga.

Non-energy exports plunged by 25pc in the third quarter. “This is a vivid illustration of the economy’s deep recession and lack of competitiveness,” said Eldar Vakhitov from BNP Paribas.

“Theoretically, rouble weakness should have supported competitiveness of non-oil exports; in reality, it did not help at all,” he said. Russia's capital stock is so badly eroded that the devaluation may leak into price rises and 'stagflation' without boosting output.

Elvira Nabiullina, the central bank governor, said the floating rouble had acted as “shock absorber” when the crisis hit. It is a pre-condition for recovery, but is not enough in itself without deep reform. “We have to swallow the bitter pill,” she said.



Source: *World Economic Outlook.*

What is disturbing is that companies have seen a rise in windfall profits of almost 40pc this year from devaluation but investment has dropped by 6.7pc. They are paying off debt and battening down the hatches instead. “Why are they not investing? This is the main question for economic policy in Russia,” she said at the VTB Capital forum.

Polls suggest that Mr Putin remains popular but the full force of the crisis has only started to hit home, and he can no longer keep putting off the choice between guns and butter. Real incomes have dropped by 9.8pc over the last year. Food prices have jumped 17pc.

Ivan Starikov, the former deputy economy minister, said the true inflation rate is near 30pc. “We are rapidly approaching the fateful mark where of 50pc of the average Russian family's income will be spent on food. We have again become a country of poor people,” he said.