

The Cost of Putin's Economic U-Turn

By Simon Kennedy and Henry Meyer September 29, 2014

When U.K. Prime Minister Tony Blair became the first leader of a major economy to meet Russia's new president in March 2000, Vladimir Putin couldn't have been more gracious.

Accompanied by their wives, Putin showed Blair around the Hermitage museum in his hometown of St. Petersburg. At the Mariinsky Theater, they watched an operatic version of "War and Peace." Blair praised Putin for seeking to modernize his economy and make it more open to foreign investment. Putin the week before had mentioned the idea of Russia joining the North Atlantic Treaty Organization.

The Russian leader initially lived up to expectations as he reduced taxes and pushed entry into the World Trade Organization. Markets rallied and foreign investors poured in, driving the Micex Index (INDEXCF) of stocks up 12-fold in Putin's first two terms, before the financial crisis hit in 2008. The ruble rose 12 percent in the same period.

Those days are now consigned to what might have been. Putin began turning away from his new friends as early as 2003, and accelerated the retreat as his third term in the Kremlin got under way in 2012. He cracked down on dissidents, curbed economic freedoms and, this year, fomented the rebellion in eastern Ukraine.

The result: Russia, now bordering on recession, suffers mounting international sanctions and, increasingly, is a pariah in capital markets. While the MSCI World Index of equities is up 9.7 percent from a year ago, the Micex is down 2.6 percent. The ruble, hovering

near a record low, has fallen 29 percent since Putin first became president.

‘Wasted Moment’

“There will be long-term damage to Russia,” Michael McFaul, until February U.S. ambassador to the country and now a professor at Stanford University in California, said in a telephone interview. “That’s a great wasted moment because Russia was on such a different trajectory. It’s just a tragedy for all that Putin went off in a different direction.”

For what could have been, look no further than the \$2 trillion economy, which expanded an oil-powered average of about 7 percent from 2000 to 2008.

As Putin resumed the presidency in 2012, the International Monetary Fund was predicting growth of 3.9 percent in 2013. Instead it was 1.3 percent, an undershoot equivalent to about \$50 billion. A similar shortfall is forecast for this year, according to Anders Aslund, a senior fellow at the Peterson Institute for International Economics in Washington, who advised Russia on privatization in the 1990s.

Even worse, Alexei Kudrin, who as finance minister from 2000 to 2011 helped return Russia’s budget to surplus, said Sept. 16 that his country will post zero or negative growth for the next two to three years.

Weaker Path

“The engagement with Ukraine has put the economy on a far weaker growth path,” said Charles Collyns, chief economist at the Institute of International Finance in Washington and a former U.S. Treasury official.

Global investors withdrew about \$850 million from Russian bond and stock funds in the year through Sept. 24, according to data compiled by EPFR Global in Cambridge, Massachusetts. Economy Minister Alexei Ulyukayev said on Sept. 18 that this month's arrest of billionaire Vladimir Evtushenkov could lead to increased capital flight.

Business people are signaling flight as well. Where once they rubbed elbows with Putin at the St. Petersburg Economic Forum, the chief executive officers of Goldman Sachs Group Inc. and Citigroup Inc. were among those to skip the gathering in May of this year.

New York-based Blackstone Group LP stopped seeking investments in the country after the private-equity firm failed to strike a deal in three years of trying, said a person with knowledge of the plan.

Business Ease

Putin's dream of making Russia one of the world's five biggest economies by 2020 is now in ruins, according to Sergei Guriev, a former economic adviser to Prime Minister Dmitry Medvedev who fled to Paris last year. He says it could have been achieved had Putin focused on delivering economic growth of 5 percent to 6 percent as promised.

"Russia had such a massive potential because of its inefficiencies that it was perfectly feasible to achieve this rate of economic growth," said Guriev. "What changed is that the government decided not to fulfill its promises."

The sentiment was different in 2000, when Putin replaced Boris Yeltsin. One of his early acts was to close Russia's radar base in Cuba, the only intelligence-gathering center it had in the Western Hemisphere. He also shut a naval base in Vietnam, its biggest

outside Warsaw Pact countries. After the Sept. 11 attacks, Putin pledged unconditional support for the U.S.

Tax Cuts

Domestically, he cut income taxes to a flat rate of 13 percent from a maximum of 30 percent and reduced corporate taxes to 24 percent from 35 percent. Budget revenue surged.

“That was a completely different life and Putin behaved completely differently,” said Mikhail Kasyanov, who was prime minister during Putin’s first term and is now an opposition leader.

Putin’s embrace of capitalism was never a full one. In 2000 he wrested control of NTV, a leading independent TV station owned by an oligarch, Vladimir Gusinsky, and in 2003 Mikhail Khodorkovsky, head of Yukos Oil Co., was arrested on charges of money-laundering and tax evasion. After 10 years in prison, he was freed last year by presidential pardon.

Ties with the U.S. began deteriorating further during President George W. Bush’s 2003 invasion of Iraq and Russia’s opposition to U.S. missile defense plans in eastern Europe.

Reset Button

When President Barack Obama arrived at the White House, he sought a “reset” in relations. Secretary of State Hillary Clinton offered Foreign Minister Sergei Lavrov a toy box with a large red button when she visited Moscow in 2009. The U.S. even supported Russia’s entry to the WTO.

The make-up didn’t last. Putin offered asylum to fugitive American government intelligence contractor Edward Snowden in August 2013 and Russia defied the U.S. in shoring up the regime of Syrian President Bashar al-Assad.

Then came Ukraine and the Cold War-style standoff. The overthrow of Russian-backed President Viktor Yanukovich in February marked the culmination of years of Kremlin frustration at NATO's steady encroachment on former Soviet territory.

Vladimir Lukin, Russia's ambassador to the U.S. in the early 1990s, says Putin isn't solely to blame for the state of affairs. The U.S. and the European Union must bear some responsibility for the "persistent and unilateral expansion" of NATO, and then the EU, towards Russia's borders, he said.

"Putin was picked partly to stand up to the West, so the guy we got is partly a product of those decisions," said Tony Brenton, U.K. Ambassador to Russia from 2004 to 2008.

Sanctions Impact

U.S. and EU sanctions might be biting more deeply after the U.S. expanded them to encompass OAO Sberbank (SBER), the country's largest bank, and energy companies as well as five state-owned defense and technology companies.

"These sanctions are limiting his ability to implement those projects he needs to imitate normal economic growth in Russia," said Kasyanov, the onetime prime minister. "Sanctions should speed up the collapse of the whole economic system, which would lead to a deep, systemic crisis."

While the ruble and Russian stocks gained in recent days on the hope sanctions may be eased and the ceasefire maintained, Benoit Anne of Societe Generale SA expects further selloffs.

"I don't know many international investors that are currently bullish on ruble assets," he wrote in a Sept. 24 report. "These are either bearish, for the large part, or have decided to stay away altogether."

Gurieiev, the former prime ministerial adviser, says plans for a balanced budget also are predicated on economic growth of 2 percent to 3 percent. With that now in jeopardy he predicts Putin will soon have to shrink spending on military and pensions as a falling oil price provides another fiscal challenge.

“This is an entirely new thing and we don’t know what will happen,” said Gurieiev. “It’s unprecedented for Putin.”

To contact the reporters on this story: Henry Meyer in Moscow at hmeyer4@bloomberg.net; Simon Kennedy in London at skennedy4@bloomberg.net

To contact the editors responsible for this story: Balazs Penz at bpenz@bloomberg.net Anne Swardson, Brad Cook