POLITICAL AND ECONOMIC RESULTS OF AUGUST 2014

S.Zhavoronkov

In August 2014, Russia's authorities announced that the funded component of labor pensions would remain frozen in 2015 – something that they had previously adamantly denied. This decision is fraught with numerous negative long-term consequences, including the erosion of the impetus to be paid over-the-counter wages and salaries. August saw an increase in the already acute competition for the resources of the National Welfare Fund (NWF), the main contesters being those Russian state-owned companies and banks that had begun to face difficulties with refinancing their debts as a result of the sanctions imposed on them by the USA and the EU. In August, a lot of money was invested in the privileged shares in VTB and Russian Agricultural Bank (Rosselkhozbank), while Igor Sechin, chairman of Rosneft, asked the government to dole out Rb 1.5 trillion to help the state-owned giant oil company refinance its debts. As no diplomatic solution to the military conflict in eastern Ukraine has been found so far, the ongoing armed confrontation is fraught with risks of further escalation – which, in its turn, will inexorably result in the OECD imposing new sanctions against Russia.

In August 2014, the RF Government discussed a number of very important economic issues, including the introduction of alterations in Russia's pension system and the adoption of tit-for-tat trading sanctions against the countries that had previously introduced trade restrictions on Russia. The final week of August saw a sharp deterioration of the situation in eastern Ukraine, whose territory was actually entered by Russian troops. As a result, the international situation immediately worsened.

On 5 August, the State Council (an advisory body mainly composed of governors) held its plenary meeting, during which it addressed the issue of introducing alterations in Russia's pension system. Most probably, it was at this meeting in Voronezh (unattended by most of the ministers) that the decisions to keep the funded component of labor pension frozen for yet another year (2015) and to impose retaliatory sanctions on a number of OECD countries (publicly declared on 6 August) were taken. The decision that the funded component of labor pension should remain frozen throughout 2015 blatantly contradicted the previous promises of the RF Government[1]. It had an unexpected fallout – Sergei Beliakov, First Deputy Minister of Economic Development, proved his mettle by publicly and harshly criticizing this move, and being immediately sacked in response. The previous government decision that the funded component of labor pension should be frozen throughout 2014 had been 'explained' by the necessity to insure the contributions already paid to non-governmental pension funds and to convert these funds into joint-stock companies in order to prevent their bankruptcies and possible capital losses. Serious misgivings had been voiced, namely that the main intention of the government was to transfer these savings to the budget for the purpose of spending them, and to prevent a continuation of the mass exodus of contributors from State Corporation 'Bank for Development and Foreign Economic Affairs (*Vneshekonombank*)' acting as the asset manager for *molchuny* (the silent ones)[2]. Thus, the authorities have considerably complicated the procedure for submitting applications (according to the new regulation, such applications must be submitted personally, by the citizens themselves, while in the past this could be done through a relevant non-governmental pension fund). Moreover, there was a sharp rise in the number of applications rejected for minor errors, etc. To make a long story short, the State annually expropriates from non-governmental pension funds approximately Rb 250bn. On the one hand, this is a huge amount of money. On the other hand, this sum is far too small to make any difference for the state budget, or even for the pension system itself. But in one respect the alarmists were definitely right – the RF Government is clearly planning to continue the use of this method of income mobilization at least for the time being. Furthermore, Deputy Prime Minister Olga Golodets

1 Thus, as early as December 2013 Dmitry Medvedev affirmed that the RF Government had no plans to abolish the funded component of labor pensions, while in July 2014 the heads of the RF Ministry of Finance and the RF Ministry of Economic Development unequivocally promised that the funded component would be restored in 2015.

2 According to the National Association of Non-governmental Pension Funds, nearly 27 million persons have so far chosen one or other non-governmental fund as their asset manager. In recent years the numbers of such persons have been growing rapidly – more than one half of the afore-said 27 million persons made their choice in 2012 and 2013.

and Minister of Labor and Social Protection Maxim Topilin have both spoken in favor of completely abolishing the funded component of labor pension. However, neither of them has – so far – advocated a direct confiscation of the Rb 1 trillion already accumulated in the funded system (although it would have been a logical step along the chosen path). Without going into too much detail about the pluses and minuses of one or other pension system[1] (this issue is a subject tirelessly discussed at worldwide conferences and congresses, and it should also be added that in some countries, including Russia, the growth rate of savings lags behind the growth rate of inflation), it is important to emphasize two points. The first one is political in nature: the authorities have been disregarding the clearly stated public opinion shared by the majority of people, who may of course make mistakes but nevertheless will never forget this experience when shaping their own attitude towards the government. And the second point is that the administrative leapfrog involving the pension system (this is a second large-scale reform literally in one year's time) deprives people of any true incentives to seek sources of legal earnings – which previously had been considered one of the government's major achievements, because in 2013 the revenue generated by personal income tax and social contributions became the biggest budget revenue item, pushing aside revenues from mineral resources (generated by the mineral resource extraction tax and export duties), which used to top the budget. It is expected that the people's response would be to move into the shadow economy, and not to invest their personal savings in the non-governmental pension system. The final decision will probably be made by the RF Government at the time of preparing the next draft budget in September 2014.

By way of responding to sanctions against Russia, this country for her part imposed a ban on imports of a broad range of foodstuffs from the USA, the EU, Canada, and for some reason also Norway (a country that prior to the introduction of Russian sanctions had taken no part in the EU economic sanctions). The choice of food as a target for retaliatory tit-for-tat sanctions is quite logical due to an oversupply of food in the developed world. Besides, agricultural producers are a modestly sized but a very active political lobby – especially in Europe. Another point on the plus side is that, in a situation when the Russian Federation's obligations to the WTO are, in fact, being devalued, Russia can now replace some types of imported goods by their domestically produced counterparts, which previously had practically no chances of winning in a competition with well-subsidized European imports – first of all, vegetables and poultry meat. However, some other circumstances should also be remembered: thus, for example, after pork imports from the EU had been discontinued in March in the framework of the so-called 'sanitary sanctions'[2], while Russia does not supply sufficient quantities of pork on the domestic market, growth of pork prices over six months amounted to nearly 20% – roughly the share taken up by European pork in the Russian market. It is evident that, even if we tomorrow launch an energetic and carefully planned campaign, we could not be able to save the situation in sectors like beef or ve-getable production, where the production cycle can last several years, and so it would have been much more logical not to impose sanctions on Russia's domestic consumers and to be more selective when choosing a target for sanctions. Besides, from the point of view of economics, the impact of sanctions will be different for each country of the EU. Some will suffer seriously as a result (in terms of percentage, the bite of Russia's counter-sanctions will be strongest in Lithuania, whose exports to Russia amounted to 20% of total exports, and in this 20%-share 40% was taken up by agricultural products); in other countries, the effect will be noticeable (Finland, Poland, Latvia); and there will also be countries where this effect will be almost zero – for example, Germany's exports to Russia amount to 3.8%, of which agricultural products take up only 0.4%. Besides, these countries vary in the degree of toughness displayed in their attitude towards Russia (two opposite examples being Finland and Poland). It would have been more logical to impose sanctions on each individual country instead of the entire EU. And finally, Russia must be aware and estimate the effect of potential anti-Russian sanctions in the agricultural sector, where the losses could be most substantial due to the Russian Federation's strong dependence on imported seeds and biotechnologies. In other words, if the EU, for example, imposes a ban on exports of potato seeds

1 For example, as demonstrated by the data published in *Investitsionnye riski institutsional'noi sredy sistemy obiazatel'nogo pensionnogo strakhovaniia RF. Sravnitel'nyi analiz po stranam OESR* [Investment Risks in the Institutional Environment of the RF Compulsory Pension Insurance System. A Comparative Analysis of OECD |Countries], a review prepared by the Ural Federal University (UrFU), the Laboratory of Competition and Antimonopoly Policy of the Institute for Industrial and Market Studies of the Higher School of Economics (SU-HSE), and the Russian State Vocational Pedagogical University (RSVPU), in Russia minimum yield on pension saving is counterbalanced by minimum risks, which represents a rather logical combination.

2 An indisputably positive fact is the open recognition of the political factors that motivated the Russian government with regard to this issue, which put an end to the clownish and ridiculous practice of declaring certain products like Borzhomi mineral water (produced in Georgia) harmful for human health and then, once again, to be wholesome, and so on.

to Russia, the result will be a total collapse of this seemingly 'native Russian' product. It should be admitted that the erroneousness of such decisions has already been recognized by Russian authorities who discovered that, having banned all imports of Norwegian salmon into Russia, they inadvertently included in this commodity group also smolt (juvenile salmon), which was also imported from Norway. This means that without Norway, Russia will not be able to substitute imports from Norway – and so, only two weeks later, the ban on smolt imports was lifted. It is sad that, in their attempt to somehow 'level down' the situation on the consumer market, which did not change significantly over the past month thanks to availability of old product supplies, Russian authorities are speaking of setting some sort of control over market prices instead of searching for a solution to the old-standing problem of shortage of storage capacities for storing vegetable products or the issue of retail area deficit in big cities[1] which, once solved, could have made possible large-scale supplies by big producers capable to deal with networks sales and overcome the problems posed by deficit and high price of retain area lease.

At the present moment it is difficult to predict exactly what the response of the EU countries to Russian sanctions is going to be. The leaders of some countries (for example, Hungary and Slovakia) have publicly spoken against escalating the 'war of sanctions', others (for example, the British government) believe it to be a correct strategy which, while bringing no immediate benefits, will nevertheless provide an efficient tool for depriving Russia of resources so as prevent her from pulling geopolitical tricks in the long run. It is evident that if the situation in Ukraine is not properly settled, more sanctions against Russia are inevitable, because the few countries opposed to the policy of sanctions themselves depend on EU subsidies (as shown, for example, by Bulgaria's experiences with regard to the South Stream natural-gas pipeline). The main focus of pressure on Russia may become further restrictions on financial borrowing by Russian state companies and the Russian government, as well as bringing down the volume of international purchases of Russian energy carriers to a level as low as would be physically possible. It can be expected that the Russian authorities will rethink their policy of import restrictions, as this will be a potentially even more dangerous course of 'self-sanctions' in view of the low localization level of Russian production, and so there cannot be an easy switchover to products from, say, Turkey and Argentina.

1 In Moscow, retail area availability is about 800 m² per thousand persons, which twice as low as in European big cities and three times as low as in US big cities.

Although the Russian budget in itself has not been faced with any serious problems so far, the need to replace the lost European and US sources of borrowed funds has triggered a competition of lobbyists for public financial resources. August, for example, saw some public discussions as to the necessity to redirect the investment of the National Welfare Fund's resources from the already approved projects of the expansion of the Baikal–Amur Mainline and the Trans-Siberian Railway (the feasibility of the first one is arguable, but that of the second one is indisputable due to the current evident shortage of the railway's actual carrying capacity) to other investment projects in the Far East, an initiative put forth by the RF Ministry for Development of Russian Far East. Prime Minister Dmitry Medvedev signed a decree ordering a purchase, at the expense of the National Welfare Fund, of preference shares in JSC VTB Bank and JSC *Rosselkhozbank* to the total value of Rb 239.04bn – evidently by way of responding to the financial sanctions imposed on these two major banks. And Chairman of *Rosneft* Igor Sechin asked for Rb 1.5 trillion – actually half of all the money held by the National Welfare Fund in its coffers, which caused a (mild) surprise among the members of the RF Government in view of the fact that *Rosneft* already holds Rb 684bn in its accounts. Later on, Igor Sechin explained that this money was necessary for the company's development, but that in principle it would not be a tragedy if the government should allocate somewhat less than the sum he had originally asked for. However, the demonstrated readiness to attract borrowings from Chinese companies for investment in the Vankor Field (which this year will reach its rated capacity, and so no significant investment in its fixed assets is actually needed any more) is a sign that one month after the introduction of sanctions, state companies began to experience difficulties in refinancing their debt. The most important goal for Russian authorities in the present situation is to avoid the mistakes made by countries like Venezuela, where all the money was spent on 'promising projects', after which the government attempted to regulate prices in conditions of inflation and ended up with a collapse of the economic system.

The Ukrainian Army, after its successful offensive against the self-proclaimed Donetsk People's Republic (DPR) and Lugansk People's Republic (LPR), during which it had managed to take hold of the larger part of relevant territory and directly approach the cities of Donetsk and Lugansk, was then faced with some serious setbacks in August: in addition to the evident deficit of weapons, it had to deal with the results of the tactical error of attacking the enemy along a thin strip of territory hugging Ukraine's eastern border with the RF in order to regain control over it, which resulted in several units of the Ukrainian Army being surrounded by enemy troops and suffering heavy losses in manpower and military equipment. Nevertheless, the strategic position of the two 'republics' remained grave and precarious – in fact, their only connection (in fact, their life line) with the Russian border comprised a handful of roads across a narrow stretch of land. So, in late August, the 'republics' launched a 'counteroffensive' in the direction of the Azov Sea, displaying an astonishing abundance of 'boots on the ground' and an impressive array of military hardware. Russia had already been repeatedly accused of providing support to the 'republics' [1], but in late August ten men from the 98th Guards Airborne Division, officially stationed at the city of Kostroma, were captured**,** the Committees of Soldiers' Mothers of Russia discovered the disappearance of soldiers allegedly participating in military exercises in Rostov Oblast, and fresh graves of military servicemen were found in the city of Pskov. The captured soldiers were declared to have lost their way, and then exchanged for Ukrainian 'prisoners of war'. These events actually coincided with the meeting of Vladimir Putin and Petro Poroshenko in Minsk, which had been planned with a strong hope for a political breakthrough, but which in fact yielded no results, as only issues of secondary importance like exchange of captured men and supplies of humanitarian aid to the combat zone were discussed. The gas issue had not been settled, either, in spite of the call for a compromise voiced by EU authorities, who have a vital interest in gas supplies. The diplomatic standpoints of the two parties remain mutually exclusive: Russia demands a political agreement (without actually specifying what needs to be agreed upon) – not with Russia, but with the two 'republics' as yet unrecognized by Ukraine; Ukraine, for her part, believes that an amnesty for those Ukrainian citizens who have not committed grave crimes will be sufficient, and insists that Russia is a party to the conflict. Here we witness an evident 'legitimacy gap', as not only the subject of potential negotiations, but also the status of their participants remains undefined. The consultations, nevertheless, go on. Against this background, a noteworthy development is the decision of the EU summit that took place on 30 August 2014, where the participant countries' leaders attempted to assume the role of a go-between in the conflict. In fact, the only solution theoretically acceptable for both sides in the conflict is the introduction of a 'viable ceasefire regime' – that is, freezing it in its current phase. The document also envisages the consideration, within a week's time (although the timelines may be moved depending on the actual situation), of the possibility of slapping additional sanctions against the Russian Federation, including entering everybody involved in one way or another in the functioning of the self-proclaimed 'people's republics' onto the list persons banned from entering EU countries.

The prospects of the conflict, where no agreement can be shaped so far, suggest that its further escalation is very probable, with a progress towards direct military actions between Russia and Ukraine, when Ukraine will be able to get not only economic, but also military aid from some NATO countries (the NATO's charter requiring a unanimous decision of all its participants will probably prevent any moves on the part of the entire bloc). In any event, some hints in this line were voiced in August by NATO Secretary General Anders Fogh Rasmussen in his articles and public speeches. This may result in protracted military actions with the same consequences for Russia's national economy as are being now faced by the weaker national economy of Ukraine: economic slump, the bulk of government's funds being spent on military needs, shortage of funding for social security issues or government investment, and forced capital flight. From this point of view, it would be much more preferable to freeze the conflict in its present phase – should no compromise between Russia and Ukraine be achieved.

1 Russia has always protested against such accusations, noting that Russian citizens may only take part in the hostilities as individuals on a private basis, and that their weapons have been seized from the Ukrainian military.