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Putin Devotes Oil Windfall to Guns, Not Butter

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The recent rise in oil prices -- almost 80 percent from their mid-January low -- is a sudden gift to the Russian economy and government. Yet officials act as if the country is as squeezed financially as it was earlier this year: There's no sign of expanded social spending, despite approaching parliamentary elections and worrying poll results. The Kremlin has other plans for any extra money.

In early April, the Economy Ministry issued a forecast for the year based on an average oil price of $40 per barrel. That seemed optimistic at the time, when the year-to-date average price hovered around $35. At the beginning of June, the average has almost reached $40, and it could rise because the current price is $50 and the rally shows no signs of letting up. Russia added $20 billion to its international reserves between January and April. Inflation has been stable at 7.3 percent (on a year-on-year basis) for three consecutive months -- the slowest price growth since 2014, creating conditions for an interest rate cut, perhaps even this week.

Things are clearly looking up on the macro-economy front. The government's recent $1.75 billion bond sale proved that it can borrow overseas if needed, though investors with Russian roots apparently bought most of the issue.

At the same time, Russia will hold parliamentary elections in September, and polls show that only 42 percent of voters approve of the current legislators' work -- since last November, the parliament has not had majority approval. The government's approval is at its lowest since before the annexation of Crimea. Even President Vladimir Putin's support is at a mere 80 percent, the lowest since March 2014.

Yet late last month, when retirees in Crimea complained to Prime Minister Dmitry Medvedev that their pensions were too low and asked when they might be indexed to inflation -- as the government is supposed to do every year -- he gave a reply that has since turned into a meme on the social networks and forced Putin to half-apologize:

> "We just don't have the money. If we find money, we'll do an indexation. You hang on in there. All the best, don't be sad, stay healthy."

This sounded openly mocking -- especially in Crimea, where the desire to qualify for relatively high Russian pensions was one of the main drivers of the high pro-Russia vote in the March 2014 referendum that formalized the peninsula's secession from Ukraine. Putin sensed it:

He said a few days later that Medvedev's phrase must have been taken out of context -- it wasn't -- and that the government wouldn't renege on its social obligations.

Some economists, including Sergei Guriev, a Russian emigre who is taking over as chief economist of the European Bank for Reconstruction and Development in the fall, agree that the government doesn't have much money. Guriev says that the country's Reserve Fund, which is specifically intended for covering the budget deficit, has shrunk by $31 billion this year. The remaining $45 billion would be slightly more than enough to cover this year's estimated shortfall. That, according to Guriev, makes a countercyclical policy all but impossible. "The Russian government cannot sharply increase spending," he wrote in a blog post. "Increasing the deficit by 2 percent of GDP would lead to the Reserve Fund's being exhausted before the end of 2016."

Formally, Guriev is right: The budget deficit is meant to be covered from the Reserve Fund if other sources are not available. Yet Andrei Illarionov, a former Putin economic adviser and now a Cato Institute fellow who has criticized the Russian president, points out that the entirety of Russia's financial reserves could be used to offset the deficit, and that these reserves have been growing.

Illarionov has a better explanation of why the Russian government has lacked the money to continue buying the support of poor and government-dependent Russians by increasing social benefits when it was politically helpful, as it did throughout the Putin years. The funds have been spent on security and defense at unprecedented levels. From January through April, Russia's defense expenditure was 15 percent higher than for 2015. In constant prices, it increased 75 percent compared with 2010, while Russia's economic output only grew 5.4 percent in the same period. Russia is spending 4.6 percent of its GDP on defense this year -- the highest in Putin's entire tenure:

"The promised 8-percent pension indexing costs half a trillion rubles," Illarionov wrote, "about as much as this year's actual growth in military spending."

Putin recently showed an interest in plans to get Russia out of recession. Two teams -- one led by former Finance Minister Alexei Kudrin, the other from the Stolypin Club, backed by Russia's medium-sized business lobby -- recently presented proposals. Kudrin's centered on fiscal tightening and improving the business climate. The Stolypin Club's called for quantitative easing. Yet neither called for cuts to military and security spending: These are Putin's sacred cows, and the drafters of plans to revive growth know that.

Putin is even willing to risk the ratings of his closest political allies (his own can stand losing a few points) to keep funding military adventures like the one in Syria. He appears to believe that the post-Crimea explosion of patriotism and anti-Western hysteria is still strong enough that he doesn't need not to change these priorities. That probably isn't too risky in the short run, polls show, but the growing militarization is sucking resources out of private business, whose ability to borrow is impacted by Western attempts to isolate Russia's regime. Russian companies' debt levels are already the lowest since 2010, and they are constantly squeezed for more taxes.

The government could easily restart growth by reducing military spending to the levels that prevailed five years ago and easing the tax burden. That, however, is not likely in the near future: Fortress Russia puts weapons first and economic development second.