How Can the Consequences of the Global Financial Crisis for Russia Be Minimized

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The world economy has plunged deep into a financial crisis which is provoking recession in the real sector of most national economies. An artificial market overcapitalization of leading global corporations was (obviously) predicted. Now most experts are talking with one voice of "financial bubbles" that have exploded. But quite a few of them kept mum until not so long ago.

Yet, it was clear that the United States was spearheading a systemic demolition of the pricing mechanism in the global market system in the last 6 or 7 years: the repudiation of free competition and antimonopoly policy principles primarily in the oil and gas sector.

In 2001, the world price of the Dubai crude was 22.80 USD/barrel and Brent, 24.77 USD/barrel. In the meantime, production costs ranged from 3.5-5.0 USD/barrel to18-20 USD/barrel in the highest-cost producing regions. In the first half of 2008, the market oil price approached 130 USD/barrel and some noted experts were predicting it to grow to 150 USD/barrel before long. Production costs, however, had increased only marginally pushing the profitability rates in the oil industry to 300%-400%.

Crude is a low-elasticity good and extremely difficult to be substituted. Such substitution would require huge investment. Market traders, however, were able within one day to increase the crude price by 10%-15% by referring to a hurricane in the Gulf of Mexico, hostilities by Nigerian militants or personal standoff between Bush and Chavez, i.e. reasons of negligible importance for the global economy. It should be noted that annual oil deficits (the difference between production and consumption) stood at almost 600 million tons in the United States, 480 million tons in Europe (excluding Russia), 120 million tons in China, and 85 million tons in India. The modern monopoly oil market is therefore provoking colossal multibillion flows of financial resources across the world's regions. All these monies end up in the international banking system. Only a minor share is invested in energy (4%-5%).

Some money settles down in the accounts of banks, and mortgage and insurance companies. What compounds the situation is that countries receiving bonanza profits from high crude prices prefer to keep their earnings in United States securities rather than at their national banks. This creates the illusion of "easy money" that needs to be used some way or other. "Easy money" leads to a slackening of borrower requirements. As a result, borrowers' creditworthiness drops. Loans began to be issued without collateral for dubious investment projects or for purchasing private real estate to businesses and individuals with medium or irregular incomes without their credit histories analyzed.

"Easy money" is financial resources received under board from natural or artificial monopolies.

Russia found itself embroiled in the global financial gamble. Globalization ideas prevailed over national security principles.

Much of the revenues from the export of oil, gas and other raw materials accumulated in the stabilization fund (or its modifications). The fund was growing at an unusual speed. It had about 1.7 trillion rubles in Q3 2006 and as much as 3.8 trillions by the time the crisis broke out. Two-thirds of the money was invested in Fannie Mae, Freddie Mac and the Federal System of Mortgage Banks. The US-controlled rating agencies had given these papers the highest ratings - AAA. In the meantime, Fannie Mae suffered net losses of USD 2 billion because of falling realty prices as early as 2007 and its capitalization shrank from USD 44 billion to 11.5 billion. It is a big question if Russia will be able to get its money back.

External debt is another important problem for Russia as it struggles to emerge from the financial crisis. Russia had quite an unpleasant structure of external debt by the time the financial crisis hit (see the table below).

Russia's external debt

	1.01.2008 -	1.07.2008 -	% of total debt
Government	USD 47 billion	USD 40 billion	7%
Companies	USD 253 billion	USD 295 billion	56%
Banks	USD 163 billion	USD 192 billion	37%

These numbers show that the government, on the one hand, and the banks and companies, on the other hand, had approached the crisis on convergent courses. The government was consistently paying off its debts, whereas the banks and companies had increasingly bogged down in external debt. They increased their combined foreign borrowings by USD 71 billion in the first half of 2008 alone. How solvent are they to return the principal and interest? The way the top managements of banks and companies assess their risks in the light of their current borrowings makes one doubtful of their professionalism. Russia is threatened either with massive bankruptcies or with government bailouts to the private sector. But the total external debt of the government, banks and companies is roughly equal to Russia's gold and foreign currency reserves.

Important levers to cushion the effects of the financial crisis in Russia include:

1. The government should strictly limit its support for so-called "system-forming" banks. Banks are commercial entities and their key objective in the market is to maximize their "margins" and profits from currency and other transactions. Providing financial support to the banks for earmarked loans is an effective lever with which the

government can influence their business operations. This would dramatically improve their transparency. What needs to be saved is the real economy, not the banks. The role of the Long-term Development Bank needs to be revived and dramatically increased, if the course toward modernization is to be sustained.

2. Antimonopoly agencies need to overhaul their operations. What they are largely doing now is looking for price conspiracies between individual businesses and companies. The history of artificial, as well as natural, monopolies shows that monopoly prices can be inflated other than through agreements between the sellers. Competitors can be crowded out from regions and industries through "friendly takeovers" and other hard or soft raider tactics. The key indicator of a monopoly is bonanza profits. The concept of a standard margin must be fixed by law and it should include not so much bonuses paid to top managers as spending on innovation, improved quality and reduced cost of goods and services. All remaining super profits must be shared with the product users by forced reduction of prices on pain of destructive penalties imposed by the government. This is what the fight against monopoly and support for fair market pricing boil down to.

3. Russia has lived with unprecedented budget surpluses in the last few years. This is different from the experience of the leading economies. A budget surplus measured with hundreds of billions of rubles indicates that the government collects more taxes than it is able to spend (or is unwilling to spend). As a result, all kinds of stabilization funds are set up to channel taxpayer money out of the country. Economically, a budget is a balance-sheet. The income and expenditure sides of the budget must be roughly the same, although a little surplus or deficit may occur. (The European Union recommends that its members limit their budget deficits to 3% of GDP). Taxes that are much larger than expenditures run contrary to the market because they limit the private sector's growth potential and force it to keep high prices.

At a time of financial crisis, the government should announce a far-reaching tax holiday. It needs to dramatically cut the VAT rate and abolish all other enterprise taxes. It needs to assist all entrepreneurs and the real sector of the economy, not just the banks which have already been privileged with eased provisioning rates. An anti-crisis softening of tax policies needs to be implemented in 2009-10. A national tax reform should be prepared in the meantime.

The above package of actions can help to stave off an economic recession in Russia.

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