Will Russia be the Worst Victim of the Global Crisis?

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The first crisis in the era of globalization is developing under the classic scenario. It all started with the housing prices collapsing in the U.S. in the fall of 2006, followed by the domino effect in the housing mortgage market with a whole range of problems caused by the secondary and tertiary financial instruments (derivatives) providing mortgage coverage and investment of the U.S. and European banks in those instruments worth many hundreds of billions of U.S. dollars. The liquidity crisis brought down stock exchange indicators and led to the credit crunch, making it much more difficult to get home or car loans. Many investment projects were frozen. By the fall of 2008, the global crisis entered the acute phase. The world was on the verge of a large-scale recession. Pessimistic forecasts were snowballing. In early October 2008, the IMF and major rating agencies predicted a 3-percent world GDP drop in 2009, and in early November, that estimate was reduced to 1.3 percent. The growth rates in the largest developing countries (China, India, and Brazil) will be declining, yet these countries will continue to display positive growth. Meanwhile, GDP indicators are most likely to decline in all developed economies.

The threat of economic recession in Russia has become an objective reality. Many industrial forecasts for 2009 are not too optimistic. Production will drop 20-30% in the steel industry, almost 20% in non-ferrous metallurgy, 10-20% in the oil sector, 5-10% in the automotive industry, and 20-30% in construction. The services sector will also be strongly affected (the retail trade, banking and advertising sectors). There will be a growing rate of local unemployment.

The government has already allocated around 6 trillion rubles for anti-crisis steps, which include loans worth 5 trillion loans. An additional one trillion rubles will be used to set off the cuts in expert duties and make up for the suspended requirement to commercial banks to maintain their Central Bank reserves. The total amount of government steps will account for 15% of Russia’s GDP. Five percent of the U.S. GDP and ten percent of the total European GDP will be spent for the same purpose.

Russia’s package of anti-crisis steps looks similar to the package used in other countries. What causes our doubts is the need to support the stock market through Vneshekonombank interventions. The scheme is used to support the shares of several large businesses and banks. These activities, however, violate the fundamental stock market principles. The market must provide information on investment opportunities and most prospective industries to all players. The budgetary interventions may distort the overall picture, and, on top of that, may create the favorable conditions for speculation and insider deals.

At present, the bankers, retailers, oil businessmen and developers are queuing up to receive government and Central Bank finance. The steelmakers, who, until recently were relatively OK, are now joining the line. Officially, defense and agricultural business are the first to be served, but in reality the banks have been receiving the largest share of finance, which was probably a good idea, since no one wants to see the banking system collapse. However, the government admits that the mechanism for making cash available to the real sector using the banks is far from perfect. Effectiveness of government support is more important than the volume of support. The U.S. and European nations have spent a lot of effort to ensure effectiveness of government steps. The European Commission has introduced a number of strict rules of assistance to the banking sector: equal access to public finance, regulated time and scale of support, bank involvement in anti-crisis activities, inadmissibility of bank shareholders drawing benefits from government-provided funds, etc.

Russia's high vulnerability in the current global crisis is determined by the following aspects:

- Underdeveloped domestic financial system. Many banks, for example, Rosselkhozbank, which is lending to the risky agribusiness sector, are using the assets borrowed in other countries, and that model represents the bank's only source of finance;
- Significant external debt of national companies and banks exceeding Russia's foreign reserves (over USD 160 bln must be repaid before the end of 2009);
- Too much dependency on the oil market prices: current actual oil prices have dropped to the level of 2002;
- Lack of cash supply due to restrictive policies that have proved to be ineffective against inflation;
- Excessive budget spending, half of which is covered from Russia's export revenue which is currently declining;
- Excessively high share of export in several major sectors; the country exports 60% of oil, 80-85% of fertilizers, 60% of timber, almost 50% of steel and 90-95% (!) of nickel. Due to the dropping world market demand, the companies have been forced to cut their output.

Government monetarists have committed a number of currency policy errors. Company and bank debt kept growing without any third-party control. The banks would borrow and spend the funds on consumer loans, and were actually financing car and equipment imports. The steel companies would borrow to purchase assets abroad. In 2008 alone, Russian steel companies (Severstal, Novolipetsk, and Magnitogorsk steel companies) purchased USD 10 bln worth of assets in the U.S. And there was no clear explanation of the way those assets were to be used. After all restrictions on the free flow of capital were lifted two years ago, it was expected that the government would still continue to control that process. Yet, even Western regulators are saying that Russia had no control over the process.

Another error committed during implementation of the monetary policy was that under the 15-30 percent inflation, the nominal ruble exchange rate was maintained on the USD/EUR exchange rate level. As a result, over the past seven years the ruble exchange rate grew 145 percent. Naturally, it became very attractive to borrow cheap currency loans abroad, because the interest was paid after the "strong" rubles were converted to the “weaker” currencies, and it is small wonder that Russian corporations were heavily investing in external markets. The currency liability has grown to become a huge potential risk. The market thought the ruble was overvalued, and foreign investors decided that it was the right time for withdrawing their assets. That process started a little earlier, in Q1 2008, long before the Russia-Georgian conflict, and before the crisis entered the acute phase. In the second half of 2008, the ruble exchange rate started to go down and the citizens rushed to convert their ruble savings to dollars, and the government was forced to use foreign reserves. But no "safety cushion” can help when demand for foreign currency is skyrocketing. Of course, I believe that it would be a much better idea to use a certain share of government reserves for carrying out economic modernization and expanding national export. Unfortunately, there were no proposals on efficient ways to invest Stabilization Fund assets in real economy.

I’m afraid that compared to 1998, this time it will take a longer time to withdraw from the crisis.

In 1998, Russia emerged from the crisis fairly quickly after the ruble was devaluated four-fold, which provided strong import replacement opportunities to domestic businesses. In addition, by that time, the companies had almost completely repaid their ruble debts. It became possible to resolve the crisis situation mainly at the expense of the population. Another favorable factor was the fact that the country was going though the process of restoring growth.

At present, Russia is in a completely different situation. Before the outbreak of the current crisis, the national economy was overheated. The previously accumulated "safety cushion” reserves have so far allowed to refrain from taking radical anti-crisis steps. Another helpful aspect is the fact that the ruble is not as overvalued as it was in 1998. I believe that the current 0.7 ruble exchange rate/purchasing power ratio is not quite accurate. If we take into account the low economic and productivity levels, the ratio of 0.5 would be a more adequate estimate, which would correspond to the 1USD/34RUR exchange rate.

There are several arguments in support of and against ruble devaluation (see the Table).

Pros and Cons of ruble devaluation during the crisis period

Pros	Cons
✓ Domestic demand partially reoriented from import to domestic production ✓ Stronger policy to stimulate domestic demand ✓ Higher export returns; improved trade balance ✓ Easier to balance the budget 40 percent of which are currency earnings and primarily ruble spending. ✓ Outflow of capital may slow down (if investors find that the ruble is undervalued); preservation of foreign reserves	✓ Large-scale bankruptcies of private banks and businesses with significant external debt ✓ Higher rate of inflation; declining purchasing power of the population ✓ Growing social tension ✓ Higher prices of imported technology required for modernization ✓ Loss of the economic policy image built up over the past several years

The Government and the Central Bank have chosen the soft option of ruble devaluation. The government seems to be willing to take the country out of the current crisis using its industrial potential. The "soft" option of ruble devaluation will provide no added opportunities for Russia's domestic industry, which could be there in the case of quick ruble devaluation. Instead, we'll observe the growing production costs and re-dollarization of Russia's national economy.

Understandably, the decision to devaluate the ruble will be more of a political than economical nature.
If the soft option is pursued, urgent measures are required to restrict the import volume and tariffs. Otherwise, due to the higher ruble cost expectations, Russia's importers may build up their operations.

The current crisis has exposed a number of structural faults in the Russian economy, and has shown that the country is in need of a fundamental reform of its national financial system that must cover Russia's stock market and banking institutions. The latter group is the most critical component. We must not allow the post-1998 situation repeating itself, when the national fiscal system was put on the way of speculative development.

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