The Crisis and Prospects for the Russian Economy[1]

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From January to July 2008 the global financial crisis raging in the West seemed to harbinger no particularly bad news for the Russian economy. Russia's GDP had increased by 7.5% over the same period of 2007, fixed capital investments by 15.4% and consumption by 15.3%. Q1 statistics on the flows of goods, services and capital in and out of Russia also gave hope: the current account balance of payments was USD 37.7 billion in the black and an influx of foreign direct investment had amounted to USD 20.2 billion compared with an outflow of USD 16.2 billion.

The "first bell" rang in July when capital began to flee the Russian stock market. Some experts said this was due to an overheated market. I think the reason was different: foreign investors who had played a key role in the Russian security market urgently needed funds to cover huge losses from their investments in derivatives that had their roots in the American mortgage market. Not surprisingly, the outflow of speculative capital was occurring in virtually all countries classified as "emerging economies."

At first, authorities were not particularly concerned about stock market developments. But it became clear in August that these developments were far from harmless. The capital outflow caused the stock market indices to drop and put a lot of downward pressure on the ruble. As a result, the private sector's external debt reached a critical value of USD 436 billion at the end of Q1 2008 (including USD 171 billion in the banking sector). Ruble depreciation dramatically increased debt service costs while falling stock prices required that borrowers raise significant funds to back up the collateral for the loans they had received.

The government reacted to the challenge by supporting the ruble and stating a preparedness to assist Russian banks and corporations to refinance their external debts. But measures to support the ruble (USD 36 billion worth of international reserves had been spent by as early as September 19) resulted

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[1] The article cites official statistics published in the websites of Russia's Central Bank and Rosstat.

in a contraction of money supply, a growing liquidity shortage in the banking sector, and a noticeable deterioration of lending terms for the real sector. In a certain sense, they subsidized further capital outflows from the country.

The government and Central Bank took steps to increase money supply by offering additional ruble liquidity for the banking sector. But these policies were successful only in August and at the end of the month M2 reached the year's high (9.5% higher than on January 1, 2008). The Russian economy launched an automatic mechanism to sterilize ruble emission because of the ingrained expectations of ongoing external depreciation of the national currency: as soon as rubles were delivered to the economy, they were immediately exchanged for foreign currency. As a result, M2 had visibly shrunk by January 1, 2009 and was now only 1.7% higher than a year before. This despite the fact that the authorities had done their best to control the "dollarization" process by increasing interest rates.

The Russian economy suffered another mighty blow in October and November 2008 when world crude prices plummeted. Foreign exchange receipts dropped and the downward pressure on the ruble increased dramatically. Furthermore, the economy faced a crushing shock on the demand side because as they adapted to a fundamentally new environment, the oil companies began curbing their pipelines of investment projects. Industrial production fell by 8.7% in November and by 10.3% in December over the same months of 2007. Arrears were on the rise: overdue payables totaled 1.048 trillion rubles in November, 7.2% up on October.

The government (broadly defined, monetary authorities included) continued to use foreign currency reserves to support a "soft depreciation" of the ruble. As a result, the international reserves had shrunk to 387 billion rubles by February 1, 2009 - down USD 200 billion from the maximum level of USD 597 billion on August 1, 2008. The policy of high interest rates remained: on December 1, 2008 the Central Bank raised the refinancing rate to 13%. Pinpointed measures began to be developed and implemented to support the real sector and decisions were made to support vulnerable groups.

The chief positive outcome of the government's crisis response economic policies achieved by the end of January 2009 was that massive bankruptcies of major Russian corporations, especially banks, had been averted, the economy had remained "afloat," and relative social stability had been maintained.

In the meantime, the government failed to stop the capital outflow from the country: Russia's international investment position – capital inflow less capital outflow - equaled USD (-36.2) billion at the end of 2008 compared with (-127) billion rubles at the end of 2007. This was USD 90 billion less in absolute terms, with the decline occurring almost exclusively in the fall and winter. Production had continued to drop and serious problems had persisted in the social sphere (people's incomes in real terms continue to fall off and unemployment is rising).

But what appears particularly impressive is the price the government has paid for maintaining relative monetary and financial stability. In just six months it used one-third of its international reserves (USD 200 billion), an equivalent of 800 million tons of crude at a price of 40 USD/barrel (or 250 USD/ton); this is the amount Russia produces in more than 18 months.

The government began moving to a new crisis response policy in late January. It announced that it had completed "adjusting the exchange rate of the ruble" and fixed the boundaries of a two-currency corridor within which the Central Bank was to keep the national currency. It launched a sequester of the federal budget in what demonstrated its intention to toughen financial and fiscal policies. In the meantime, it is planning new injections of public funds into the banking system, apparently, as subordinated loans. In these new conditions interest rates are expected to start moving down, which combined with more liquidity will broaden access to credit for the real sector.

This combination of economic policies appears quite strange given the situation in which the Russian economy is at the moment. Setting a currency corridor is fraught with continual speculative attacks on the ruble and with the spending of dozens of billions of dollars out of the international reserves. With the economy facing a shock from the demand side, the cocktail of relatively tough fiscal policies and relatively soft monetary policies doesn't look attractive. There are big doubts that the automatic sterilization mechanism for ruble emission will stop operating or that interest rates will go down of their own accord. In the meantime, there is a risk that an excessive limitation of budgetary spending would provoke more non-payments and eventually cause the budget deficit to deepen (as we experienced in 1997-98).

Before outlining key elements of an alternative crisis response policy, the government should recognize that a visible reduction of export earnings and it being virtually impossible to refinance the external debts of the private sector will objectively constrain our economy in the foreseeable future. We will simply have less resources than before. But these resources (as estimated by the RAS Institute of Economic Forecasting) appear at best adequate to avoid a protracted production downturn or maybe even to quickly get back to growth.

It is very important to create conditions to re-orient part of the export commodity flows to domestic production and consumption in order to make the best possible use of the diminished potential. In other words, what needs to be done is set the stage to substitute internal demand for the decreased external demand.

But there is a trap. Everyone is complaining that enterprises lack working capital and are unable to get loans to form it. Naturally enough, the government is trying to provide financial support to concrete enterprises especially system-forming ones. But in most cases the lack of working capital (just as the reluctance of banks to provide loans to form it) is the result of weak demand for products and no one-off injection of funds can solve the problem in this situation.

The government has a key role to play in encouraging internal demand for local products. It should act primarily as a source of end-user demand by developing and funding major projects to build up infrastructure and upgrade production technology. In some cases, foreign currency funds can be raised from the government in addition to rubles. Another effective approach can be to increase purchases to build up government reserves.

The government can also help restore investment demand from the fuel and raw materials sector. To this end, it should at least bring royalties into line with the changed market conditions. It should keep in mind that royalties are factor revenues, not tax revenues, for the government. So if it fails to reduce taxes used to exact royalties, the government, for no apparent reason, increases the tax burden on the sector. The RAS Institute of Economic Forecasting estimates that this policy is counterproductive given the fact that the GDP multiplier relating to investment in the oil industry is one of the highest and equals 1.5.

Finally, protectionist measures can promote demand for local products in economically sound situations. I believe that at a time of crisis a priority should be to limit the movement of capital and return to 100% surrender of foreign currency earnings. This would eliminate the need for the Central Bank to make large interventions in the forex market and save foreign currency reserves for more important needs. It would deal a blow at mechanisms leading to the dollarization of the economy and wipe out the need to maintain high interest rates. Reduced interest rates would promote investment activity and help normalize the credit process. Finally, in this context, the Central Bank will need to implement an effective mechanism to refinance commercial banks.

Policies aimed at encouraging demand for local products will be fully effective if they are implemented in favorable financial conditions. Banks and corporations should be assisted to repay their external debts by directly providing them with foreign currency loans or by the government contributing additional foreign currency funds to their capital stocks. This would dampen the downward pressure on the ruble. Needless to say, support decisions should be taken on a case-by-case basis.

The government will have to experimentally find the best possible level of the budget deficit which, on the one hand, would promote economic recovery and, on the other hand, would not lead to financial destabilization. It should be clear that a desire to reduce the inflation rate at any price may have grave consequences. The budget deficit can be funded from the reserve fund, government borrowings, or direct Central Bank loans to the government.

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