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POLICY OUTLOOK

Russia's Response to the Global Financial Crisis

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Summary

While the timing and extent of the global financial crisis surprised many countries, Russia was generally prepared. Its macroeconomic management of the recession rightly earned accolades from several international organizations.

But Moscow's industrial and social policy responses were not as praiseworthy, representing yet another victory of political tactics over economic strategy. Although Russia's leaders saw the crisis as vindicating their past policies—including the reform strategies they devised from 2006–2008—most of the structural issues in Russia's economy remain, with solutions likely delayed for several years. Russia's fiscal decline—from an average of 7 percent annual growth before the crisis to a loss of 7.9 percent GDP in 2009—is the highest figure among G20 countries.

Russia's economy in the near term will largely depend on oil prices and how Moscow handles the country's demographic challenges. But the economy's medium-to-long-term outlook will be influenced by the lessons that leaders take from the crisis, which will affect Russia's economic structure and policies for many years to come.

An Evolving Economy

Observers generally agree that Russia's leaders were for the most part prepared for the global financial crisis. Like their counterparts in several other countries, they assured the population that their country would be safe from the turbulence of the worldwide economic downturn.

As long as the crisis remained within the financial sector, the leaders had solid ground for this argument. Russia's financial system had recovered from the 1998 ruble crisis and evolved. From 2001 to 2007, M2—the broadest measure of money supply—grew rapidly. The growth rate varied between 32.4 percent in 2002 and 50.5 percent in 2003. In addition, barter and various money substitutes—a defining feature of the Russian economy in the 1990s—gave way to rubles.

There was also a sharp drop in the share of foreign currency deposits in all savings accounts, from 32.5 to 13.2 percent, showing that the domestic economy was growing stronger. At the same time, total assets in the banking sector grew from 34.3 to 54.4 percent of GDP. The Russian equity markets were among the world's best performing.

Still, Russia's financial system in many ways was not as evolved as that of countries with similar income levels. Some 60 percent of households do not have a bank account—most Russians continue to live in a cash-based economy, with wages and salaries distributed in envelopes—and even large consumer items like cars are routinely bought with cash.

Just one in ten housing transactions is conducted using bank credits, a number that rises to one in five in the metropolitan areas of Moscow and St. Petersburg. The ratio of household bank debt to GDP was slightly above 10 percent, a fraction of that seen in more established market economies with similar income levels. And with less than one million in the more than 50 million Russian households having any real wealth, few households would feel an effect if stock indices tumbled.

Of course, the major role of the banking industry in Russia is serving companies rather than households. While banks contribute little to enterprise investment, public offerings, and bonds, bank credit to companies grew from 12.4 percent of GDP in 2001 to 26.5 percent in 2007.

These developments—in addition to Russia's emerging dependence on foreign markets as the number of ruble-based markets grew and its creditworthiness increased—made Moscow an inviting target for global markets awash with cash.

Few other countries could boast of Russia's economic situation. Official currency reserves covered the few percentage points of publicly owned foreign debt several times over, in addition to all of Russia's foreign debt—public and private—which grew fast but always remained under 40 percent of GDP.

The state could not only guarantee the repayment of its own debt, but the markets had reason to assume that similar coverage extended to state-controlled or quasi-state companies and banks. Russia would, in fact, answer for private debt as needed as a way to preserve its creditworthiness and boost the Russian economy and its reputation.

As a result, Moscow was increasingly seen as a safe bet. In 2000, the net capital outflow from Russia was $24.8 billion. In 2007, the inflow was $81.2 billion. The net foreign asset position of Russian banks was +2.3 percent of GDP in 2001 but -5.5 percent in 2007. Russia's exchange rate policy also underpinned this change. With significant amounts of money flowing into the country, real appreciation of the ruble was inevitable. That made all exchange rate bets one-way.

Russia's Dual Financial System

In the aggregate, Russia had few debts and strong cash reserves. But most of its debt had a short maturity and grew quickly, concentrating in a small number of banks and companies. In a way, Russia had a dual financial system.

While the overall economy had a low monetization of assets, it was divided into two parts—a smaller domestic part serving households and a larger part serving the corporate sector and the increasingly important foreign markets.

Foreign markets played a key role in providing short-time finance essential for the everyday functioning of the banking sector. They were also a source for long-term finance, as the number of Russian Initial Public Offerings (IPOs), syndicated loans, and bonds grew from zero to a position of prominence, especially in London, where they were favored due to their issuer-friendly requirements.

The Russian state bridged the two parts of the financial system. It received half of its tax revenue from energy and other commodity exports, accumulated significant reserves, provided investment finance directly from the budget and indirectly through the banks it controlled, and was seen as the guarantor of last resort for most Russian foreign funding. Accumulation of public reserves facilitated that funding.

But authorities, the markets, and the public failed to appreciate the potential intricacies of this situation. The Russians appeared relatively calm even as the U.S. subprime market deteriorated in summer 2007. While the amount of Russian investment in the market at the time is unknown, estimates are in the high tens of billions of dollars.

Russia's exchange rate policy further supported this system as the central bank sought to maintain stability. But real appreciation of the currency was inevitable, as the ruble was heavily undervalued after the 1998 crisis and large amounts of money flowed into the economy. Together with the ample global supply of finance and Russia's improving creditworthiness, Russian entities were able to borrow for what amounted to a negative price.

But considering Russia an economic safe haven does not suggest it was completely unprepared for the economic crisis. Few, if any, countries could boast of being able to foresee the recession's timing and extent. Like many other resource-dependent countries, Russia had accumulated reserve funds for such an eventuality—funds that amounted to $225.1 billion at the end of 2008 and were held in conservative and liquid forms. Fortunately for Russia, the funds that had accumulated since 2004 were kept as part of the official currency reserves.

Reserve funds had other roles, such as containing domestic inflation, but they also created a high level of preparedness for an economic crisis given Russian leaders' general lack of trust in the capitalist world. Taking global imbalances seriously, the Russians disapproved of what they saw as Western nations' overly broad influence in global economic governance—even though they had no practical proposals to bring to the table.

There is strong anecdotal evidence from the mid-2000s that then-President Vladimir Putin, in particular, expected a world economic crisis of some kind within the next few years. Other leading experts, like Vladimir Mau, Rector of the Academy of the National Economy, also warned in early 2008 of the major threat posed by Russia's growing dependence on high export prices and large financial inflows. Some contingency thinking on policy measures must have been underway inside the administration by fall 2008.

The International Monetary Fund (IMF) originally thought Russia's anti-crisis package was exceptionally large. Of course, it makes little sense to produce detailed statistics on the size of anti-crisis policy packages, since they consist of measures that have little to do with those that are actually implemented, and are often incomplete, unclear, and inconsistent. This is true of Russia's packages in 2008 and 2009.

But one has to agree with the IMF and the World Bank's assessment now that Russia's anti-crisis policy was a major success overall: timely, consistent, and effective. As federal budget revenue fell from 23.6 percent of GDP in 2007 to 18.8 percent in 2009, and expenditures rose from 18.1 to 24.7 percent, respectively, the budget balance shifted by a huge 11.3 percent of GDP—a major fiscal stimulus. Roughly half of Russia's policy measures aimed to strengthen the fiscal system, the other half to support the economy. In short, they worked.

The Fiscal Crisis Hits Russia

When the economic crisis hit Russia, it arrived via three channels: a drop in export prices, a decline in some export volumes, and a withdrawal of capital.

The price of oil—which closely tracked the prices of gas and Russia's third export, minerals—dropped as export volumes of metals fell significantly when construction and other activity in Europe suddenly slowed. Europe's decision to temporarily suspend deliveries from Russia—after Moscow's January 2009 dispute with Ukraine—also drove prices down.

As with other emerging economies that depend on global financial markets, Russia saw the amount of capital flowing in diminish as creditors sought to improve their own balances. Net capital flow to the private sector had grown from negative figures in the early 2000s to $81 billion in 2007. In 2008, however, the figure fell to $-148 billion. Most of the outflow happened in the last quarter of the year, in expectation of the ruble's devaluation.

Russia's steep economic contraction was not simply a consequence of its resource dependence. In fact, on average, resource-dependent countries fared slightly better in the crisis than others. They had learned from previous crises, accumulated reserves, and used them to maintain domestic demand.

But Russia's response to the economic crisis differed from other countries in several important ways. Its reserve fund was never intended as a long-term, Norwegian-type entity for maintaining popular welfare in the post-hydrocarbon era. At 13 percent of GDP, the fund's main role was to soften fluctuations in fiscal revenue (although a smaller part of the fund was separated into a welfare fund in 2008, presumably to prop up the pension system during the next several years).

While Russia has weak institutions, many countries with even weaker institutions, such as India and Indonesia, were unaffected by the crisis. But these countries are not open economies. Foreign trade is a small portion of their national product, capital flows are controlled in various ways, and the banking sector is protected.

Elsewhere, where banks are totally or to a large degree foreign owned, it mattered whether those banks are funded domestically, like in Latin America, or by other countries, as was the case in Central and Eastern Europe. Those dependent on foreign funding suffered most.

It also mattered whether foreign investors hailed from countries that were badly hit by the crisis. Importing institutions and aiming at participation in international production networks had served many countries well during good times. In a worldwide crisis, such policies became a handicap.

In assessing the role of institutions during the crisis, one must also remember that some countries whose institutions are generally regarded as strong in any global comparison—like Germany, Japan, and Finland—saw their GDP decline by nearly as much as Russia did.

Russia's Unusual Anti-Crisis Policies

The major peculiarity of Russian anti-crisis policies was the decision by its leaders to gradually devalue its currency—known as stepwise devaluation—after months of expectation in November of 2008. Such devaluations are rarely recommended. They tend to create expectations of a continuous cycle of currency depreciation, and consequently, a vicious cycle easily arises leading to excessive depreciation of the currency.

Observers believe that the Prime Minister Putin adopted the stepwise devaluation policy over the objections of practically all others involved. He apparently based it on arguments that it would maintain the currency's stability, whereas a one-off devaluation—usually the preferred alternative—might have led to difficult-to-forecast reactions of the public.

At the same time, gradual devaluation gave economic agents ample time to adjust their assets through the privatization of currency reserves. This meant that the authorities did not have to fulfill their initial promises to provide foreign currency support to all companies and banks with foreign debt.

There is little doubt that devaluation was necessary as Russia's exports plummeted in the second half of 2008. In hydrocarbon exporting, a country's real oil price has a strong impact on the equilibrium exchange rate. Whether a one-off devaluation would have led Russia to a smaller depreciation remains an open question. Ruble depreciation did not imply a boost in competitiveness, given that export competitors such as Ukraine and Kazakhstan also devalued steeply.

Overall, like other resource-dependent countries, Russia's normal measures of real effective exchange rates have basically returned to their pre-crisis levels. And fluctuations around the equilibrium exchange rate—whatever that might be—are to be accepted in a hydrocarbon-dependent country with either a managed float or a pegged exchange rate.

With the economy overheating in 2007 and 2008 and strong financial inflows, the authorities preferred to let the real exchange rate appreciate through high domestic inflation. The real deposit rate was strongly negative—another factor behind the reliance on foreign funding—and despite high interest rate spreads, the average credit rate was also below zero.

Unlike other countries, there was little possibility of decreasing central bank rates as the risk rose of stagflation, the coincidence of high inflation and declining production. On the contrary, the wish to stop the outflow of finance gave Russia an incentive to increase domestic interest rates.

During this time, bank interest rate spreads, which had always been very large, widened further as banks took precautions against expected non-performing loans, which fortunately never grew as large as was generally feared. Although real credit rates finally reached positive levels, there was almost no demand for credit. Only in early 2010 could the central bank start decreasing its policy rate in a number of steps.

This policy had two consequences. On the one hand, the burden of stimulating the economy fell on fiscal policy. Without true support from monetary policy, the impact of fiscal adjustment in 2008 and 2009 could not be as strong as the simple budget balance figures imply.

On the other hand, inside the banking sector, the state-controlled banks, such as Sberbank, VTB, and Rosselkhozbank, adopted conflicting roles and acted as liquidity channels, akin to force-feeding finance into an economy reluctant to take it. They were expected not to use stepwise devaluation for trading in the foreign exchange market in an obvious effort to make money. But they were supposed to be profit-oriented entities, not branches of the government bureaucracy.

Finally, fiscal stimulus was geared toward achieving politically motivated goals. From 2005–2006 Russia drafted "national priority programs," overseen by the head of presidential administration at the time, Dmitri Medvedev. These programs—first planned for 2007 and 2008—aimed to improve agriculture, education, health, and housing. Although they continued afterward, the programs never increased the share of such social expenditures in the consolidated budget and later gave way to other spending to boost the national economy.

The structure of this expenditure had two prominent aspects: supporting banks and backing many of the estimated hundreds of company towns usually supported by plants in the resource sector or metal industries.

Unfortunately, many of these plants had been inherited from the Soviet Union and had low productivity, outdated facilities and machinery, large investment needs, and were far from competitive. Such plants are extremely energy intensive and create the backbone of an industrial structure that is—according to estimates used by the Russian government—responsible for Russia's notoriously low energy efficiency. This is no small detail.

It is clear that Russia will not be able to increase its primary energy production in the coming years. Closing many of the plants in company towns would help enhance domestic energy efficiency and ensure that Russia can continue to export energy volumes in the future.

More often than not, such plants belong to military industries or have important dual-use surge mobilization capacity. They originally owed their existence to the centuries-long Russian military threat assessment of a massive land-based war along the country's Western borders. But a recent military doctrine shows this threat no longer exists.

Russia's emphasis on boosting certain employment sectors during the crisis was highly problematic in more than one respect. It helped to maintain existing jobs, not to soften the dislocations caused by the inevitable exit of companies. Many of these companies lack a competitive streak and are a huge drain on Russia's energy supply, threatening the country's future export capacity.

Naturally, closing down whole towns, or even cities, is not a measure easily taken in any country. But in Russia tactics, rather than strategy, too often win the day, especially in a regime uncertain of how long it will continue to enjoy high approval ratings.

In addition to supporting company towns, fiscal stimulus programs have targeted pensions, the minimum wage—to which some social benefits are tied—and public-sector salaries. Since these payments have historically been low and about one-third of all voters receive pensions, such hikes in spending are to be expected.

During the crisis years, there is the additional justification that low-income people tend to use most of their money for domestically produced goods. The problem is that such hikes are permanent and, absent high future inflation, will continue to burden the budget for years to come.

Moscow's Challenges Going Forward

Russia's fiscal balance sheet is a major concern. At the moment, its reserve funds are being used for their original purpose: as a substitute for lower tax revenues and to support the pension system. Depending on oil prices and their implications for fiscal revenue, both funds may be exhausted in a few years.

Russia's fiscal conservatives, led by Finance Minister Alexei Kudrin and supported by Putin, understand that the decision made in 2003 and 2004 to garner such funds was justified by the recent economic crisis. They will start re-accumulating the money as soon as circumstances allow.

But taking the current price of oil into account, it is unclear when Russia will again be able to generate the fiscal surpluses it needs. In 2010, the budget break-even oil price is close to $100. The target is to balance the budget in 2015.

There is an additional structural problem, too. If oil prices remain at current levels, primary energy production grows modestly, and the economy grows at a rate currently estimated to be less than 4 percent, the share of GDP that can be extracted as tax revenue from the energy sector is bound to decline.

What can be done? Putin recently emphasized increasing the effectiveness of expenditures. This is something all governments would like to see but the results are usually mixed. Another possibility is a large-scale tax reform that is likely to shift more of the burden to progressive income taxation. All large-scale tax reforms, again, are difficult to implement and the existing flat tax on incomes has been a source of pride to Russian decision makers.

It is difficult to turn back. The only other option is to freeze or even to cut expenditures. Kudrin prefers this alternative but it is not politically popular.

Barring a turn for the worse in the world economy, current forecasts call for the Russian economy in 2010 to grow 5 or 6 percent, most of which would be due to the base effect of a very low GDP in 2009. Private consumption may grow even faster than expected, given that household incomes on average did not decline during the crisis and household debt is even lower than in the pre-crisis period. In the medium term, Russia's growth potential might well be 3 or even 4 percent annually.

Russia experienced a sharp drop going into the crisis, but it also seems to be making a fast recovery, faster than most if not all of the other European economies. Somewhat troubling is the fact that the recovery is driven by the same factors that led Russia into the crisis. The oil price is again higher than expected and financial inflows are worryingly high.

Perhaps this is another lost opportunity. Reforms needed for the medium-to-long term will again be postponed. True, many of the reforms are technically difficult and politically problematic, but a regime unsure of its long-term popular support seems all too ready to abandon them. Allowing tactics to trump strategy again would be a waste of a crisis indeed.

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