RUSSIA'S FINANCIAL CRISIS: ECONOMIC SETBACKS AND POLICY RESPONSES

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The financial turmoil originating from the U.S. subprime mortgage crisis hit Russia by early September 2008, prompting the Russian government and the Central Bank of Russia to undertake a set of speedy and concerted measures to soften the impact of the crisis. These initial measures supported the value of the ruble as ruble holders, domestic and foreign, switched to dollars. They also provided hard currency to major Russian banks and Russian big business (the so-called oligarchs) which had borrowed heavily from foreign banks for their expanding operations from 2000 to 2007.[1]

As the crisis unfolded, the Russian central bank's policy choices for unlocking the credit crunch and reviving the declining economy were constrained by a double-digit inflation rate in 2008. At the same time, the Ministry of Finance faced a high budget deficit as tax revenues from oil export earnings steeply declined from the end of 2008. In short, the Russian economy faced a negative growth rate and a significant budget deficit in 2009, a sharp reversal from their sustained positive record from 2000 to 2007.

Symptoms of the Crisis

The initial severity of the crisis was underlined by a series of indicators. By mid-October 2008, the Russian stock market (Fig. 1) had plummeted by 70 percent from its May peak. Its fall was accelerated by nervous foreigners discarding their ruble-denominated assets following the Russian-Georgian war of early August.[2] The Russian ruble had also declined by 14 percent against a combined dollar/euro basket since mid-July (Fig. 2). The foreign exchange reserves of the Russian central bank had dropped to $484 billion from approximately $600 billion (Fig. 2) although they still remained the third largest in the world after those of the central banks of China and Japan.[3]

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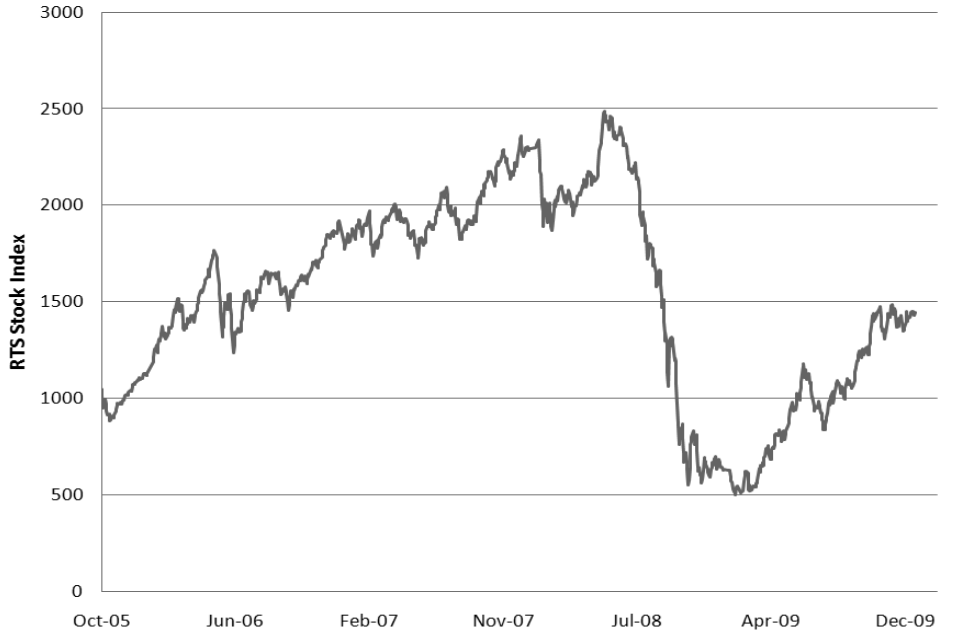
Figure 1: Russia's Benchmark RTS Stock Index, October 2005-December 2009 (Daily Figures)



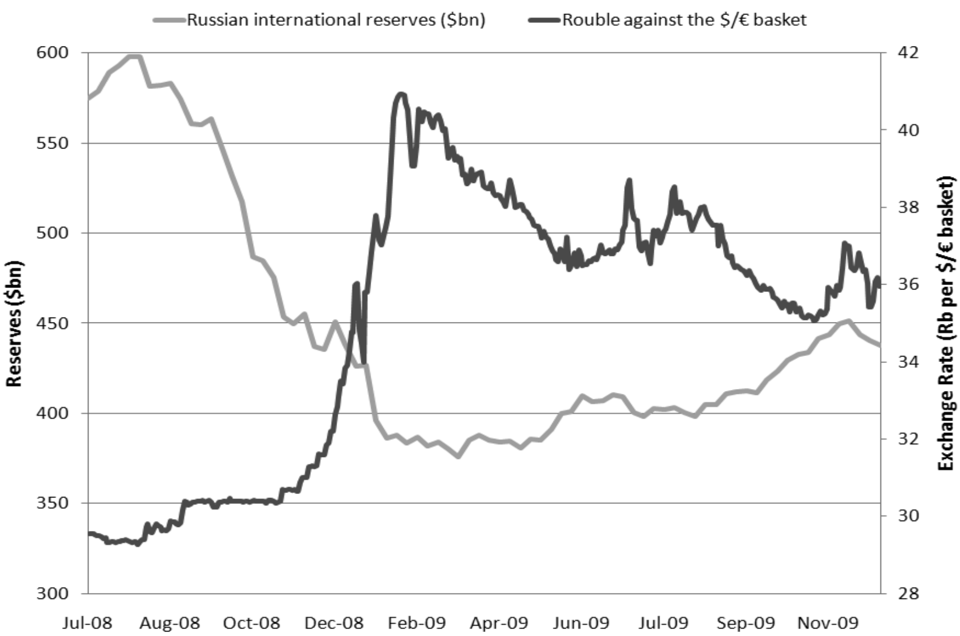
Source: Bloomberg, "Russia's Benchmark RTS Stock Index, October 2005-December 2009," Bloomberg Chart Builder.

The plunging stocks severely threatened the financial fortunes of Russian oligarchs who had borrowed heavily from western banks to expanding their businesses, offering their company stock as collateral.[4] The plummeting stock market, however, had not affected ordinary Russians because they did not hold stocks as American households do (although labor layoffs by the troubled companies had begun to have an effect). But the declining ruble had the Russian populace worried. Toward the end of the year, currency exchange booths in Moscow began facing demands from Russians wanting to convert their rubles into dollars and euros. Marketing surveys of the period also report that the Russian middle class, including those who could afford to buy household appliances and mobile phones, had shrunk for the first time in a decade, from 25 percent to 18 percent of the population.[5] According to a report by Russia's Interior Ministry, 5.5 million Russians had demonstrated in 30,000 protests during 2009.[6]

Initial Remedial Measures

By the middle of October 2008, the Russian central bank and government sources had earmarked up to $200 billion to stabilize the situation and contain the outflow of dollars from the economy. The stabilization measures included outright purchases of plunging stocks (in the amount of $20 billion), capitalization of selected banks, and financial support (of up to $50 billion) to companies owned by Russian oligarchs who had scrambled to raise cash in order to meet margin calls.[7] A significant amount of cash had been assigned (about $36 billion) to the two largest state-owned banks, Sberbank (the savings bank) and Vneshekonombank (the foreign economic bank).[8] The total proposed bailout, estimated at 13 percent of GDP, was the largest bail out among the G-8 member countries.[9] It was substantially higher in terms of national GDP than the U.S. stimulus package (amounting to $787 billion) adopted by Congress, which was 5.5 percent of U.S. GDP.

Figure 2: Russian International Reserves and the Ruble Against a $/€ Basket, July 2008-December 2009 (Daily Figures)



Source: Bloomberg Chart Builder.

The Central Bank of Russia continued offering dollars in exchange for the continuing flood of rubles in the foreign exchange market (as rubles earned from the sale of ruble-denominated assets were converted into dollars which were then whisked out of Russia). It had substantial foreign exchange reserves but this process could not continue indefinitely. Toward the end of 2008, it was losing dollars at the rate of $12 to $14 billion a week. Despite the hemorrhaging, the bank had refrained from imposing explicit exchange control measures to stem the outflow of dollars. Some foreign banks located in Moscow had reported that they were contacted by officials from the Russian central bank with suggestions that they should voluntarily discourage dollar outflows from their coffers.

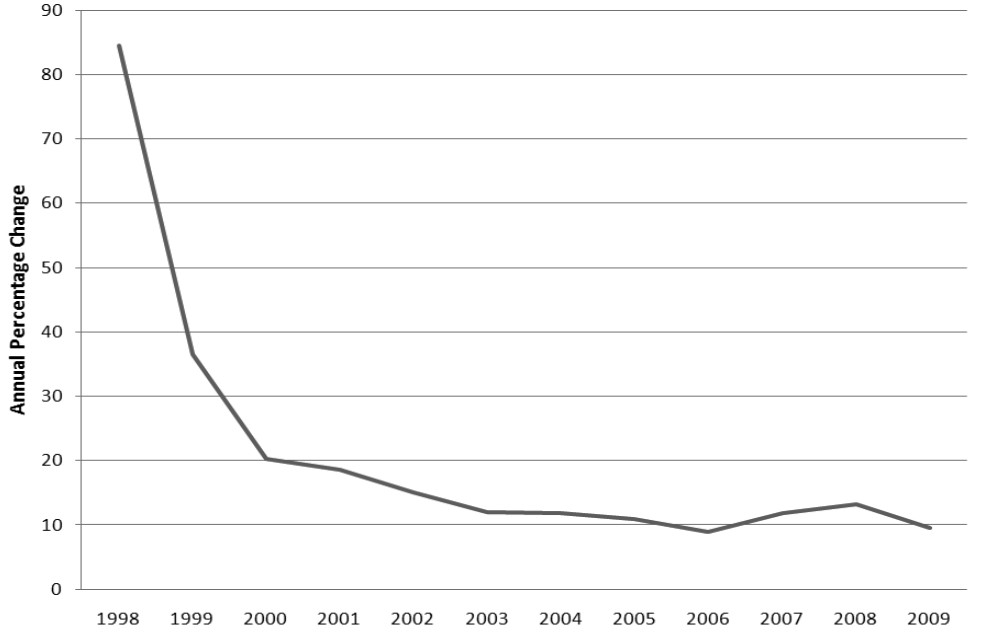
The initial Russian bailout was a top down, speedy process involving a few decision makers without being subjected to independent scrutiny or legislative oversight or systematic winnowing of the turmoil victims. One looked in vain for the likes of Congressman Barney Frank insisting on a vigilante role for lawmakers. Vneshekonombank, fully state-owned, handed out cash in the amount of $11 billion (out of the earmarked $50 billion) to the oligarchs who were threatened with the loss of their assets (in the nickel, aluminum and steel companies' and a telecommunication conglomerate) to European banks.[10] The choice of who would be rescued and in what amounts was influenced by the judgment of Prime Minister Vladimir Putin and his close advisors. More to the point, European banks were not allowed to capture stocks of "strategic" Russian companies. By a strange irony of circumstances, the Russian state (via the state-owned Vneshekonombank) was regaining stocks which it had given away to the oligarchs who had provided cash support to the Russian budget in 1996 and 1997. This move to larger state ownership reflects a danger facing the Russian economy, despite Prime Minister Putin's reassuring comment on 29 October 2008 that, "the expansion of the government's presence in the economy is a forced measure, and is of a temporary nature."[11]

On October 23, President Dmitry Medvedev posted this encouraging entry for Russian citizens on his video blog on the Kremlin website: "I will tell you honestly, Russia has not yet been caught in this whirlpool and has the opportunity to escape it."[12] Despite the concerted measures and presidential cheerleading, Russia's policy makers faced two immediate issues.

Immediate Policy Concerns in Early 2009

The slide of the ruble, continuing almost through the first quarter of 2009 from 34 rubles for a combined dollar/euro basket to 41 rubles by mid-March (Fig. 2), remained the chief preoccupation of the Russian central bank. Similar to the preoccupation of Washington policy makers, Russian authorities wanted Russian banks to start lending to alleviate the credit crunch. The declining ruble (in contrast to the reviving dollar which was a safe haven in late 2008 for risk-averse clients), however, had serious implications for Russia's finance minister and central bank chairman. A weakening ruble implied that it was worth less for Russian buyers of imported goods as well as of homemade items (in the absence of domestic productivity gains). Russian inflation, which had been steadily brought down to an annual 10 percent in 2006 (Fig. 3), was running at 13.7 percent in the first quarter of 2009, and the declining ruble aggravated the policymakers' inflation control maneuverability. Unlike the U.S. Federal Reserve, the Russian central bank could not lower the rediscount rate in order to facilitate commercial bank borrowing so that the credit crunch in the economy could be overcome via bank lending to businesses. Instead, it continued fighting the high annual inflation rate of 13 percent in March 2009 via an exorbitant rediscount rate of 13 percent.

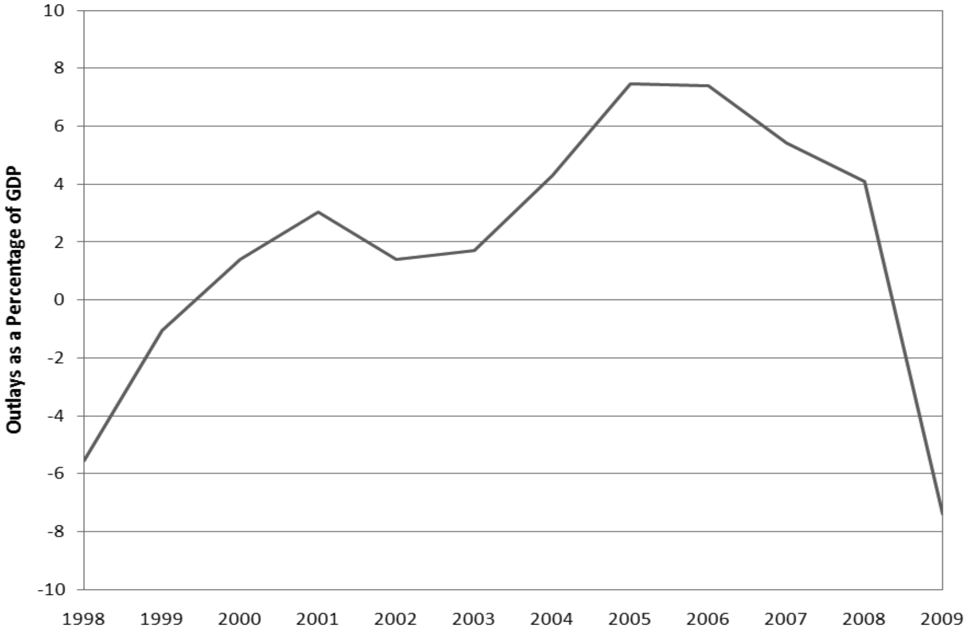
Figure 3: Annual Percentage Change in Consumer Price Index, 1998-2009



Source: Economist Intelligence Unit.

The second issue was related to declining oil prices in world markets which had tumbled from $147 a barrel in July 2008 to $30 per barrel by December 2008. At a price of $50 per barrel in late March 2009, the projected deficit of the government would be as high as 8 percent of GDP. On the other hand, at an oil price of $70, the 2009 budget of the government would break even. Unless oil prices rose above that level, the budget surpluses of the immediate past (Fig. 4), which provided resources for defense spending and infrastructure upgrades, would vanish. The Russian energy sector, which included oil and natural gas together, generated a significant portion of central government revenues. Previously, the high oil prices in world markets (combined with revived Russian oil production) supported an export-led annual growth rate of the Russian economy averaging 7 percent starting in 2000 (Fig. 5). That growth performance, which kept the unemployment rate (Fig. 6) at 6 to 6.7 percent of the economically active population in 2008, was in danger as 2009 unfolded. Not surprisingly, the Ministry of Finance was geared up for the challenge of supporting unemployed workers from a separate, off-budget Welfare Fund of $49 billion set up using the budget surpluses from the years 2000 to 2007.

Figure 4: Annual Central Government Receipts Minus Central Government Outlays as a Percentage of GDP, 1998-2009

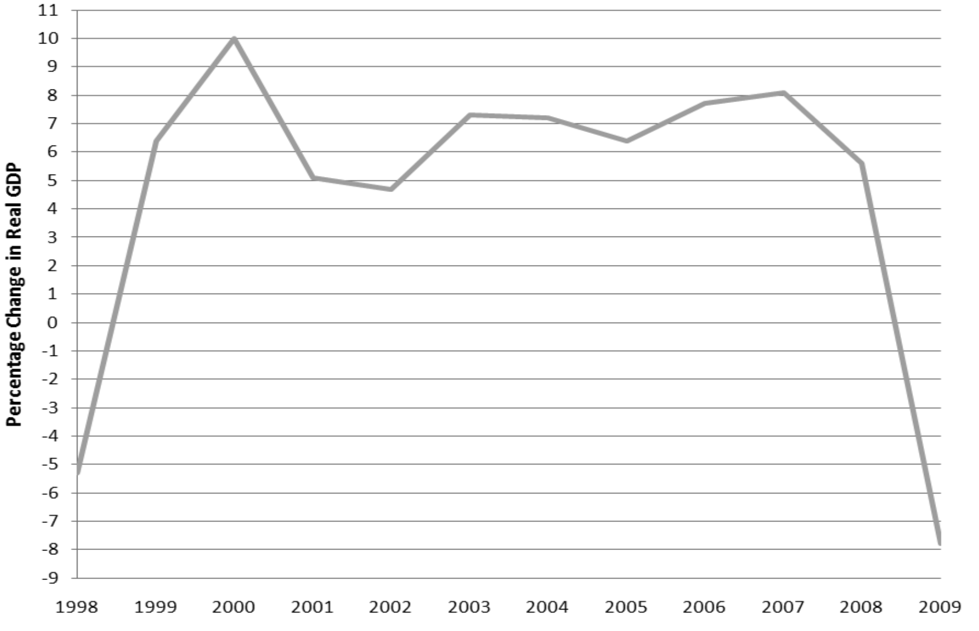


Source: Economist Intelligence Unit.

2009 Policy Issues

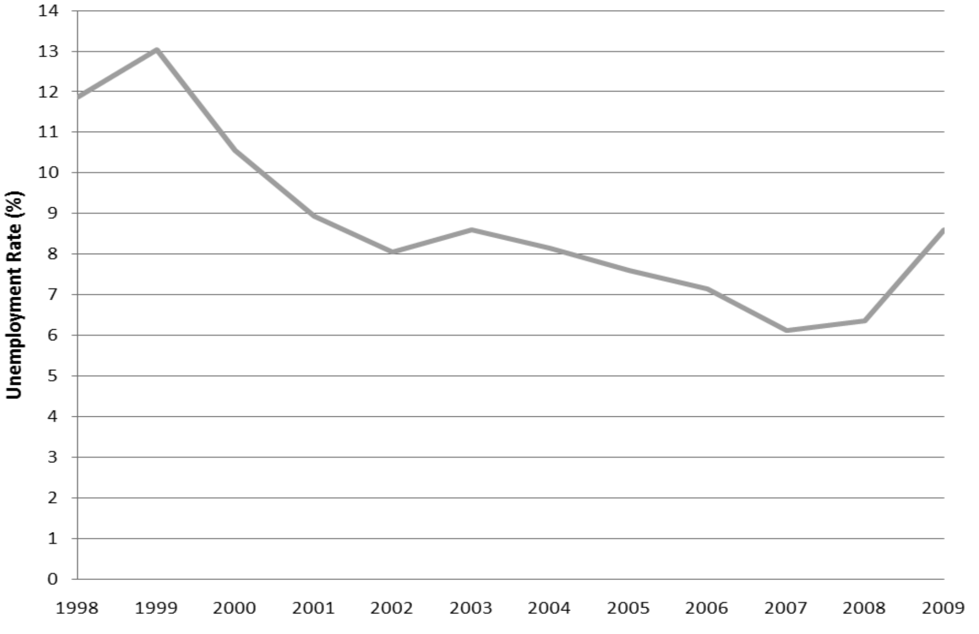
Throughout 2009, the Central Bank of Russia continued lowering the rediscount rate from a high of 13 percent in order to facilitate bank borrowing while warily watching the high inflation rate, which to its relief was declining as the economy moved into a recession with lower spending by businesses and households. At the same time, the Putin government managed to finance the stimulus, which was directed at supporting the unemployed from a separate off-budget fund accumulated during years of oil-revenue-financed budget surpluses. To its dismay, the projected budget deficit of 8 percent of GDP in 2009 required an overall cutback of expenditures and strenuous juggling of budget appropriations among several categories of defense, infrastructure buildup, and social services maintenance.

Figure 5: Annual Percentage Change in Real GDP, 1998-2009



Source: Economist Intelligence Unit.

Figure 6: Annual Recorded Official Unemployment as a Percentage of Total Labour Force, 1998-2009



Source: Economist Intelligence Unit.

But not all was lost as far as budgetary policy was concerned. As the global economy revived, oil prices began moving up from a low of $30 per barrel in December 2008 to around $75 per barrel a year later. This increased Russia's oil export earnings, its central bank foreign exchange reserves moved up, the ruble stabilized, and foreign capital started returning to Russia. On the eve of the G-20 London Summit of 2 April 2009, the Russian ruble traded at 41 rubles against the dollar/euro basket, and the official reserves of the Russian central bank were close to $385 billion. In late November, the exchange rate had appreciated to 29 rubles measured against the combined basket, and the central bank's foreign exchange reserves had risen to $444 billion. Even the stock market had gained 176 percent from its low rating in January 2009.

On the macroeconomic front, the projected GDP decline of 8 percent for 2009 could turn out to be lower, although the estimates varied. Rosstat, Russia's official statistics gathering agency, announced on 18 February 2010 that retail sales had increased by 0.3 percent (year-on-year) in January for the first time in a year.[13] More substantively, the projected budget deficit of 8 percent of GDP for 2009 promised to be smaller in the end as oil prices revived, oil export earnings picked up, and tax revenues trickled in. Indeed, the federal budget signaled improved performance and posted a surplus of 2.4 percent of GDP for the month of January 2010.[14] The most worrisome macroeconomic indicator proved to be the unemployment rate, which had climbed to 9.2 percent of the economically active population of 74.8 million, up from 8.2 percent in December 2009. It was expected to rise to 10 percent by the end of 2010, similar to that of the U.S. economy.[15] Problems in Russia's banking sector hobbled the economy's growth and employment prospects as it moved into 2010.

Russian Banks in Continuing Trouble in 2009 and Early 2010

The Central Bank of Russia was unable to promote liquidity in the economy by encouraging banks to borrow from it at a low rediscount rate. As I have noted, the central bank could not lower the rediscount rate significantly because the annual inflation rate (in terms of the Consumer Price Index) was still a high 9.1 percent in November 2009. By contrast, Ben Bernanke, the chairman of the U.S. Federal Reserve, repeatedly declared in meetings of the Federal Open Market Committee in 2009 that the short-term interest rate at which U.S. banks could borrow from the Fed would remain at close to zero "for an extended period of time," because inflation was not an imminent danger for the U.S. economy.[16] At the same time, the nonviable condition of Russian banks continued to pose a major hurdle with regard to the prospects for the Russian economy's revival. During the economy's expansion from 2000 to 2007, some banks had expanded their loan activity on the basis of foreign deposits which foreign claimants had begun withdrawing. The Association of Russian Banks (ARB) reported on 18 February 2010 that overdue commercial bank loans, relative to total loans, would rise from about 12-13 percent at the end of 2009 to as much as 20 percent in the first half.[17] On the other hand, Russian central bank chairman Sergei Ignatiev suggested that bank lending would rise by 20 percent in 2010 because Russian banks had excess liquidity.[18] But precise details relating to the balance sheets of Russian banks are difficult to track down. By contrast, the U.S. Federal Reserve carried out a stress test in May 2009 for assessing the financial health of the "too big to fail" (TBTF) U.S. banks, and the U.S. Treasury provided them with taxpayer dollars to bolster their capital requirement.

Russian banks have received bailout funding from the government, too, but they remain closed to Russian lawmakers' watchdog surveying and public scrutiny. A major complicating feature with regard to the speedy and decisive cleanup of these banks arises from their ownership by Russian oligarchs.[19] Despite this dilemma, the reorganization of banks with a view to restoring their essential function as business lenders constitutes the most urgent policy task confronting Russian authorities today. According to Standard and Poor's, nearly fifty banks are likely to be merged in the coming months. The performance of the banking sector, however, calls for tougher oversight by the Russian central bank and improved banking practices.[20] Beyond 2010, the leadership also faces the formidable challenge of diversifying the Russian economy away from an excessive reliance on volatile exports of energy and commodities.

Long-Run Policy Challenges

With a reviving global economy, the demand for oil and natural gas in particular is forecast to bounce back. In the assessment of the International Energy Agency, the demand for energy will remain high for the foreseeable future.[21] The current expansion plans in the Russian energy sector are predicated on the near-term potential of the energy market. But beyond excessive dependence on energy exports, the Russian economy's diversification dilemmas arise from the interlocking of massive industrial companies in the commodities sector with large service, technology, and trading enterprises. For example, Gazprom, the world's largest natural gas monopoly, not only supplies gas to customers inside and outside the country but also effectively controls the entire natural gas transport network. Both, in turn, with majority ownership by the Russian state, are effectively controlled in their production and pricing decisions by state-appointed executives. The interlocked structure not only prevents the emergence of robust corporate governance and market–based competitive decision making but also fosters an attitude of "legal nihilism."[22] In a striking display of forthrightness, President Medvedev remarked on 10 September 2009: "Can a primitive economy based on raw materials and economic corruption lead us into the future?"[23]

Clearly, the adoption of market-based budgetary, monetary, and exchange rate policies by technocrats in the Ministry of Finance and the Central Bank of Russia has helped them steer the economy through the financial crisis. But these policy instruments may not be enough to alter the nature of Russia's entrenched, state-controlled big business. The flow of foreign investment into Russia's big businesses, even in a minor role, can help initiate the process but it is a risky venture. Russia's entry in the World Trade Organization (WTO) can also promote rule-based procedures in pricing and trading activities, but foreign investors and WTO rules can only play a marginal role. Ultimately, the Russian economy's overhaul from the top down will depend on "destructive creation" initiatives from the leadership in Moscow, to replace an opaque state-controlled economy with a open, transparent, and market-driven system.

NOTES

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4 Yuriy Humber and Torrey Clark, "Oligarchs Seek $78 Billion as Credit Woes Help Putin," *Bloomberg*, 22 December 2008.

5 Mikhail Delyagin, *Novaya gazeta*, 22 September 2008, 2.

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[13] *Bloomberg*, 18 February 2010, cited in U.S.-Russia Business Council Daily Update, 18 February 2010, 1.

[14] *Nezavisimaya gazeta*, 9 February 9 2010, cited in U.S.-Russia Business Council Daily Update, 9 February 2010, 1.

[15] *Vedomosti*, 18 February 2010 cited in U.S.-Russia Business Council Daily Update, 18 February 2010, 1.

[16] Statements can be accessed at Board of Governors of the Federal Reserve System, "Meeting calendars, statements, and minutes (2004-2010)," http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm, accessed 7 February 2010.

[17] *Bloomberg*, 15 February 2010, cited in U.S.-Russia Business Council Daily Update, 17 February 2010, 1.

[18] Alfa Bank, Morning Brief, 5 February 2010, cited in U.S.-Russia Business Council Daily Update 5 February 2010, 1.

[19] A 2005 study by Standard & Poor's shows that 77 percent of aggregate ownership capital of the top thirty banks represented by controlling or blocking stakes. See Julia Kochetygova et al., "Transparency and Disclosure by Russian Banks: Disclosure Practices of Russian Banks Currently Dismal," Standard & Poor's, 26 October 2005.

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[21] International Energy Agency, "Energy to 2050. Scenarios for a Sustainable Future," 2003, 63; International Energy Agency, "Oil Market Report," 15 January 2010, 4.

[22] On becoming president on May 7, 2008, Medvedev remarked: " We have to achieve a true respect for law and overcome legal nihilism." Details can be found at http://www.rian.ru/politics/20080507/106773965.html.

[23] See President Medvedev's remarks at: http://eng.kremlin.ru/speeches/2009/09/10/153_-type104017_221527.shtml.