

Russia's Financial Crisis: Economic Setbacks and Policy Responses

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The financial turmoil, originating from the U.S. sub-prime mortgage crisis, had hit Russia by early September 2008, and had prompted the Russian government and the Central Bank of Russia to undertake a set of speedy and concerted measures to soften the crisis impact.

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.

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 began a steep decline from the end of 2008. In short, the Russian economy faced a negative growth rate and a significant budget deficit in 2009, both marking a sharp reversal from their sustained positive record from 2000 to 2007.

The Crisis Symptoms

The initial severity of the crisis was underlined by a series of indicators. By mid-October 2008, the Russian stock market (in Fig. 1) had plummeted by 70 percent since May. Its fall was accelerated by nervous foreigners discarding their ruble-denominated assets following the Russian-Georgian war of early August. The Russian ruble had also

declined by 14 percent against a combined dollar/euro basket since July 14 (in Fig. 2). The foreign exchange reserves of the Russian central bank had dropped to \$484 billion from approximately \$600 billion (in Fig. 2) although they still remained the third largest after those of the central banks of China and Japan.

The plunging stocks severely threatened the financial fortunes of Russian oligarchs who had borrowed heavily from Western banks for expanding their businesses by offering their company stock as collateral. 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 creeping up). But the declining ruble had Ivan Ivanov 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 reported 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.¹ According to an upfront report by Russia's Interior Ministry, 5.5 million Russians had demonstrated in 30,000 protests during 2009.²

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.³ A significant amount of cash

had been assigned (at about \$36 billion) to the two largest state-owned banks, Sberbank (the savings bank) and Vneshekonombank (the foreign economic bank). The total proposed bailout, estimated at 13 percent of GDP, was the largest among the G-8 member countries. It was substantially higher, relative to GDP, than the stimulus package (amounting to \$787 billion) at 5.5 percent of U.S. GDP adopted by Congress in early 2009.

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 the 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 of 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 it being subjected to independent scrutiny or legislative oversight or systematic winnowing of the turmoil victims. One looked in vain for the likes of Representative Barney Frank insisting on a vigilante role for the U.S. 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. 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 would not be 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. A more critical issue related to the danger of the Russian economy reverting to larger state ownership despite a reassuring comment on October 29, 2008 from Prime Minister Putin: “The expansion of the government’s presence in the economy is a forced measure, and is of a temporary nature.”⁴

On October 23, President Dmitry Medvedev had this encouraging entry for Russian citizens on his video blog on the Kremlin web site: “I will tell you honestly, Russia has not yet been caught in this whirlpool and has the opportunity to escape it.”⁵ Despite the concerted measures and presidential cheerleading, however, 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 exchanging for a combined dollar/euro basket to 41 rubles by the middle of March (in Fig. 2) remained the chief preoccupation of the Russian central bank. The authorities also wanted Russian banks to start lending and alleviate the credit crunch (similar to the preoccupation of the Washington policy makers). However, the declining ruble (in contrast to the reviving dollar as a safe haven in late 2008 for risk-averse clients) had serious implications for Russia’s finance minister and central bank chairman. A

continuously cheapening ruble implied that it was worth less for Russian buyers of imported goods as well as of home-made items (in the absence of domestic productivity gains). Russian inflation, which had been steadily brought down to an annual 10 percent in 2006 (in Fig. 3), was running at 15 percent in the first quarter of 2009, and the declining ruble aggravated the policymakers' inflation control maneuverability. Unlike the 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. It continued fighting the high inflation rate of annual 13 percent of March 2009 via an exorbitant rediscount rate of 13 percent.

The second issue related to declining oil prices in world markets which had tumbled from \$147 a barrel in July 2008 to \$30 a barrel in December. At a price of \$50 a 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 revived above that level, the budget surpluses of the immediate past (in Fig. 4), which provided resources for defense spending and infrastructure upgrade, would vanish. (The energy sector, oil and natural gas together, generated 60 percent of central government revenues). More to the point, 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 (in Fig. 5). That growth performance, which kept unemployment rate (in 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 to the challenge of

supporting unemployed workers from a separate, off-budget Welfare Fund of \$49 billion set up from the budget surpluses of the years from 2000 to 2007.

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 expenditure and strenuous juggling of budget appropriations among several categories of defense, infrastructure buildup and social services maintenance.

But not all was lost as far as budgetary policy was concerned. As the global economy began reviving, oil prices began moving up from a low of \$30 a barrel in December 2008 to around \$75 a barrel a year later, oil export earnings and Russian 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 April 2, 2009, the Russian ruble traded at 41 rubles against the dollar/euro basket, and the foreign exchange 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 as well, the projected GDP decline of 8 percent for 2009 could turn out to be lower although the estimates varied. Rosstat, the official statistical agency, announced on February 18, 2010 that retail sales had increased by 0.3 percent (year-on-year) in January for the first time in a year.⁶ 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 2010.⁷

The most worrisome macroeconomic indicator was 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 2010,⁸ the same as for the U.S. economy.

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 8.4 percent in November 2009. By contrast, Ben Bernanke, the chairman of the Federal Reserve, declared repeatedly in meetings of the U.S. 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. At the same time, the unviable condition of Russian banks posed a continuing 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 February 18, 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.⁹ 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.¹⁰ But precise details relating to the balance sheets of Russian banks are difficult to track down. By contrast, the 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 tax-payer-funded cash for bolstering their capital requirement.

Russian banks too have received bailout funding from the government but they remain closed to Russian lawmakers' watchdog surveying and public scrutiny. A major complicating feature with regard to their speedy and decisive cleanup arises from the significant bank ownership by Russian oligarchs. Despite the dilemma, their reorganization with a view to restoring their essential function as business lenders constitutes the most urgent policy task confronting Russian authorities in 2010. In the judgment of Standard and Poor's, nearly 50 banks are likely to be merged in the coming months¹¹ but the banking sector performance calls for tougher oversight by the Russian central bank and improved banking practices.

Beyond 2010, the leadership also faces the formidable challenge of diversifying the Russian economy from 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 in the foreseeable future.¹² The current expansion plans in the Russian energy sector are predicated on the near-term potential of the energy market. But beyond excessive energy export dependence, the Russian economy's diversification dilemmas arise also from the interlocking of the 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 of 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."¹³ In a striking display of forthrightness, President Medvedev remarked on September 10, 2009: "Can a primitive economy based on raw materials and economic corruption lead us into the future?"¹⁴

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 the tail of these policy

instruments cannot wag the sprawling dog of the entrenched, state-controlled big business in Russia. The flow of foreign investment, even in a minority role, can help initiate the process but venturing in Russian big business is an unmitigated risk. Russia's entry in the World Trade Organization 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.

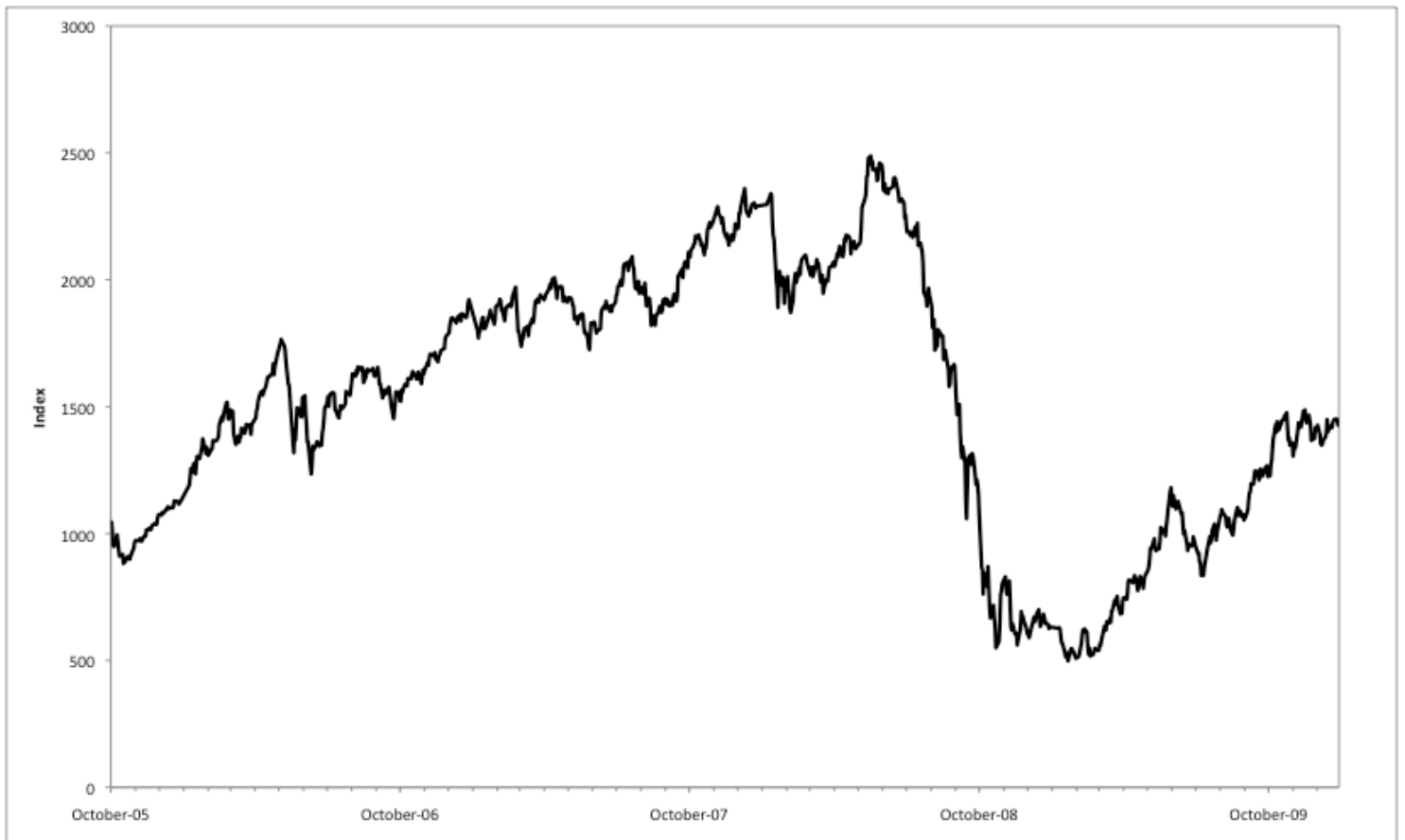


FIGURE 1. RUSSIA'S BENCHMARK RTS STOCK INDEX, OCTOBER 2005-DECEMBER 2009 (DAILY FIGURES)

Source: Bloomberg.

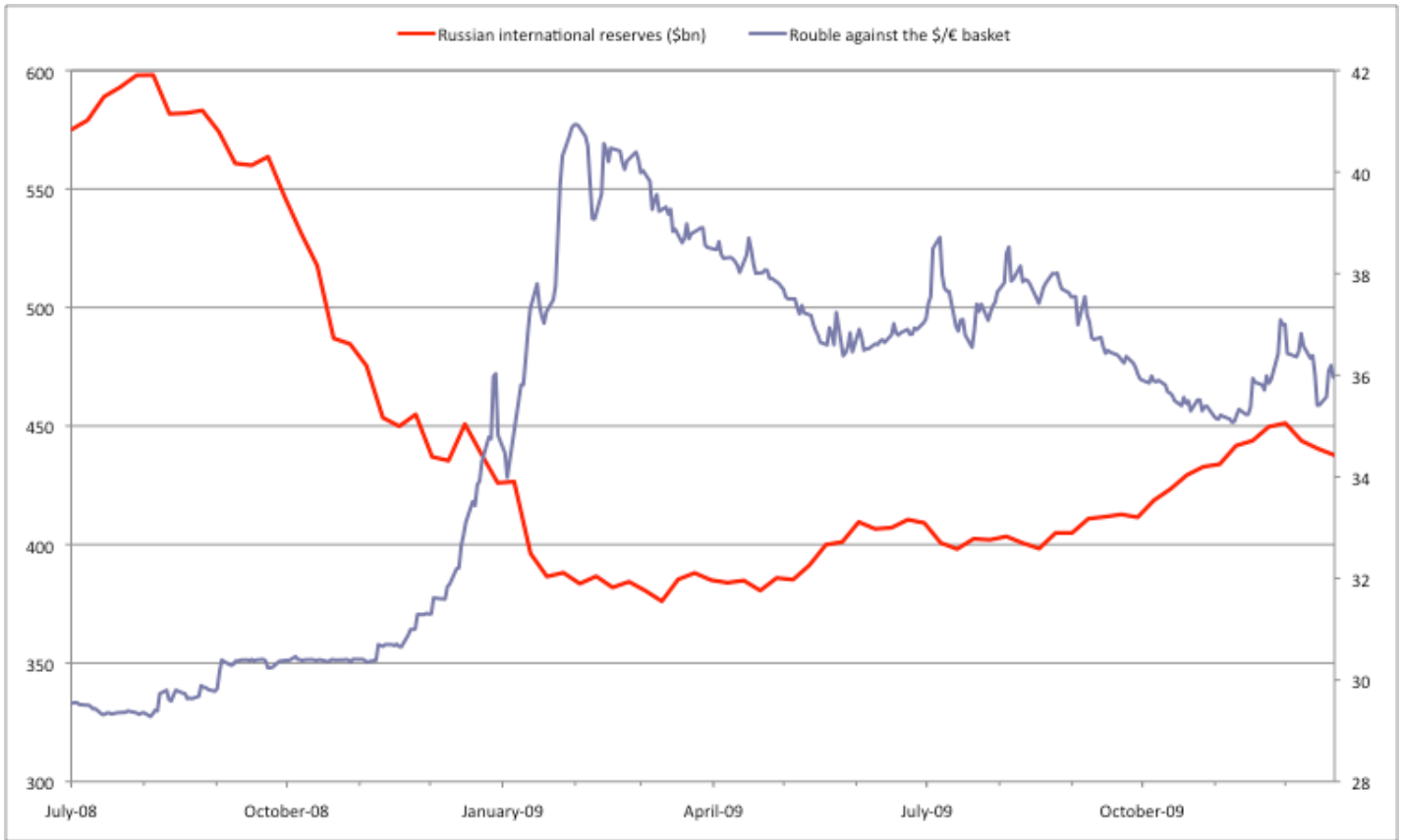


FIGURE 2. RUSSIAN INTERNATIONAL RESERVES VERSUS THE ROUBLE AGAINST THE \$/€BASKET, JULY 2008-DECEMBER 2009 (DAILY FIGURES)

Source: Bloomberg.

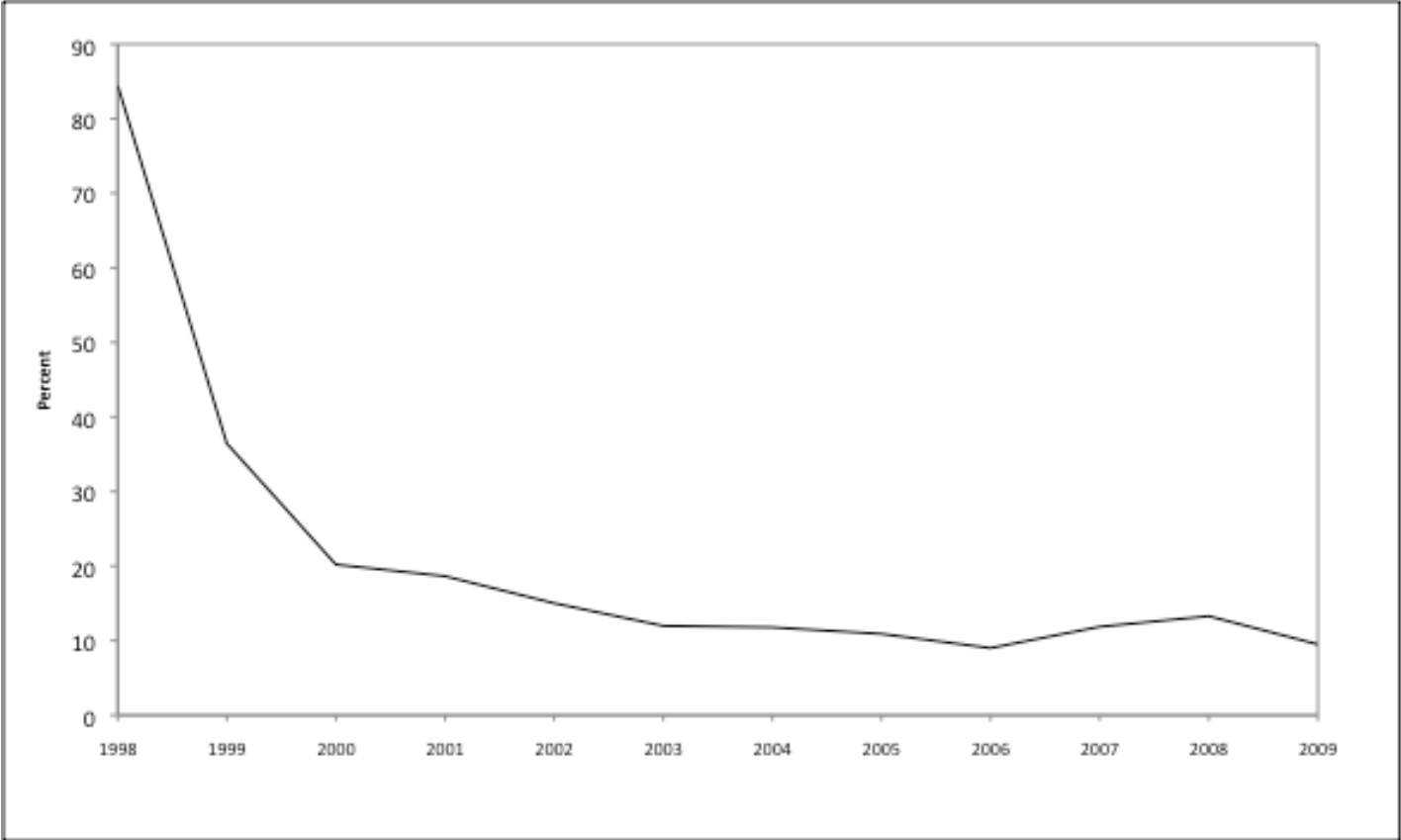


FIGURE 3. ANNUAL PERCENTAGE CHANGE IN CONSUMER PRICE INDEX, 1998-2009

Source: Economist Intelligence Unit.

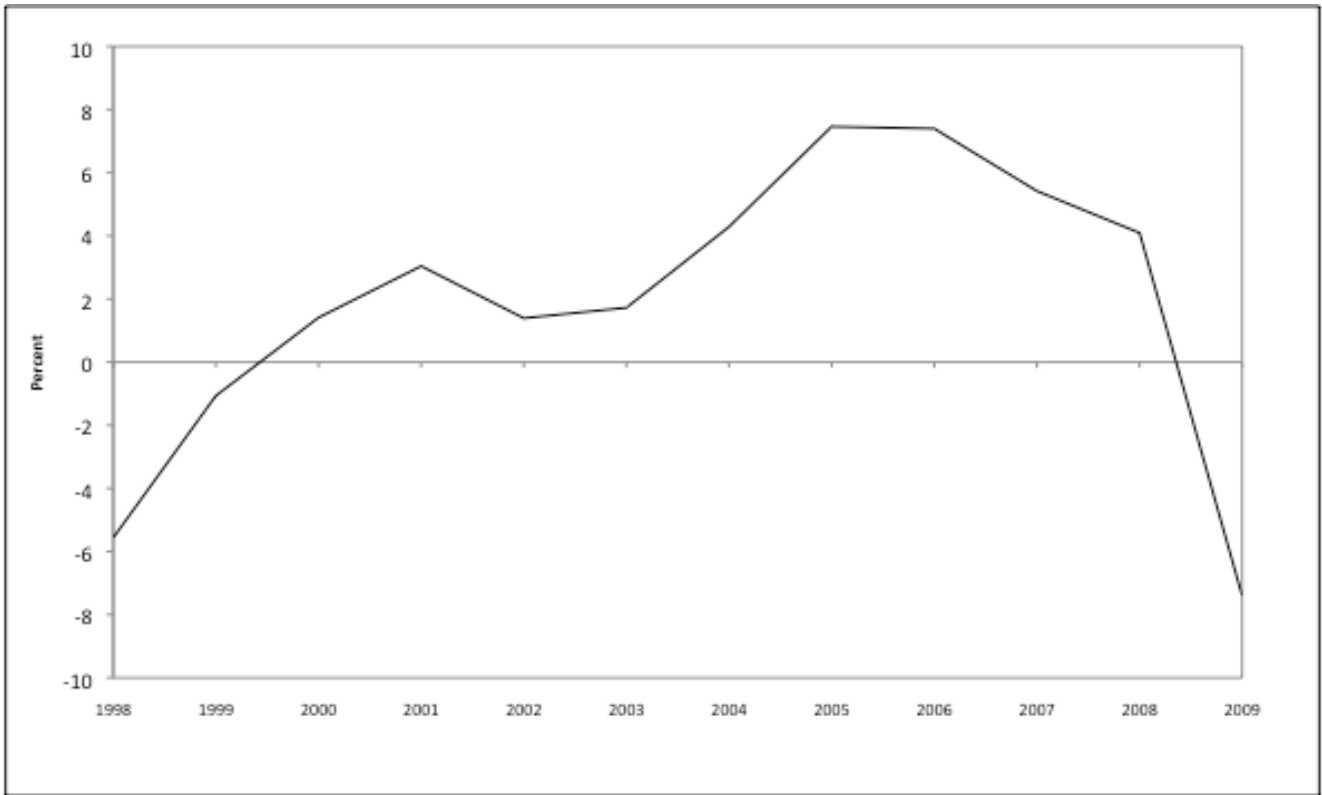


FIGURE 4. ANNUAL CENTRAL GOVERNMENT RECEIPTS MINUS CENTRAL GOVERNMENT OUTLAYS AS A PERCENTAGE OF GDP, 1998-2009

Source: Economist Intelligence Unit.

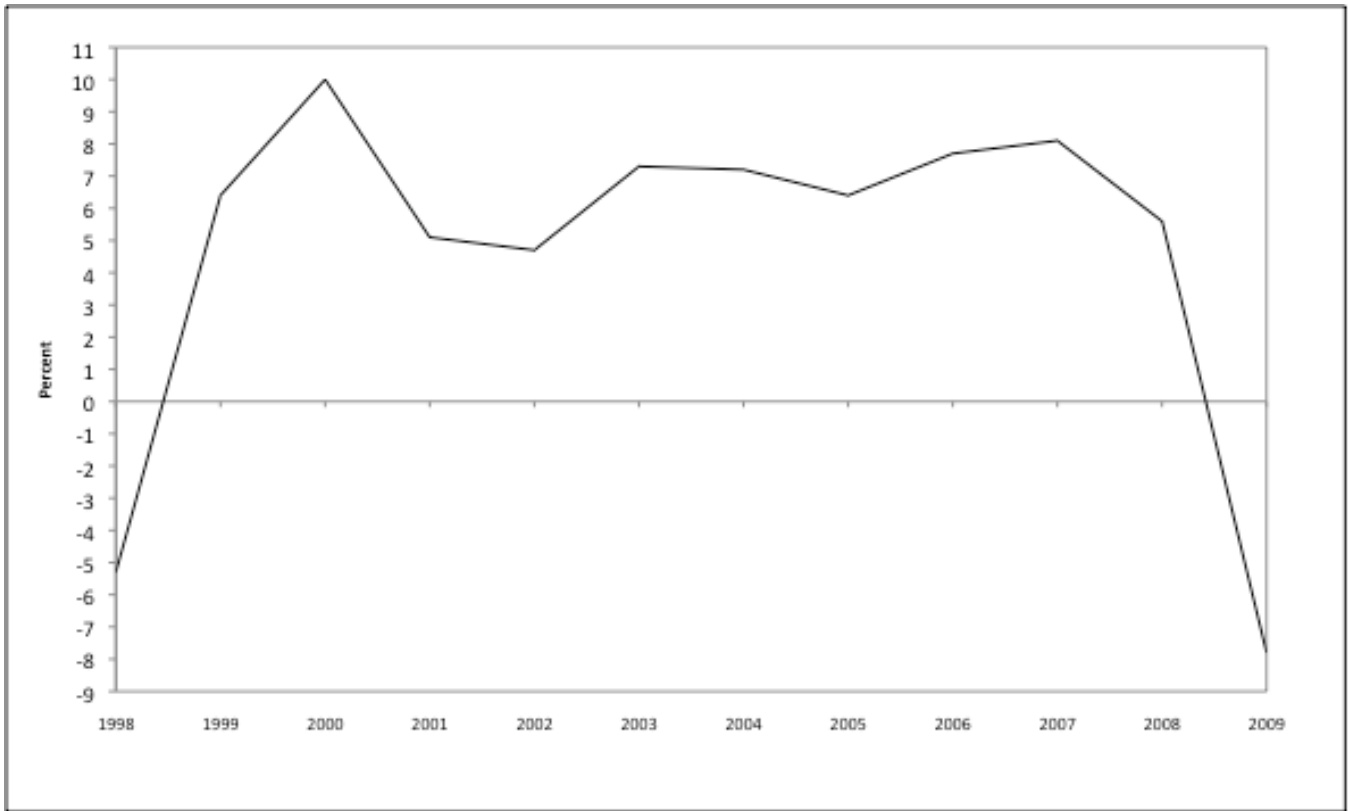


FIGURE 5. ANNUAL PERCENTAGE CHANGE IN REAL GDP, 1998-2009

Source: Economist Intelligence Unit.

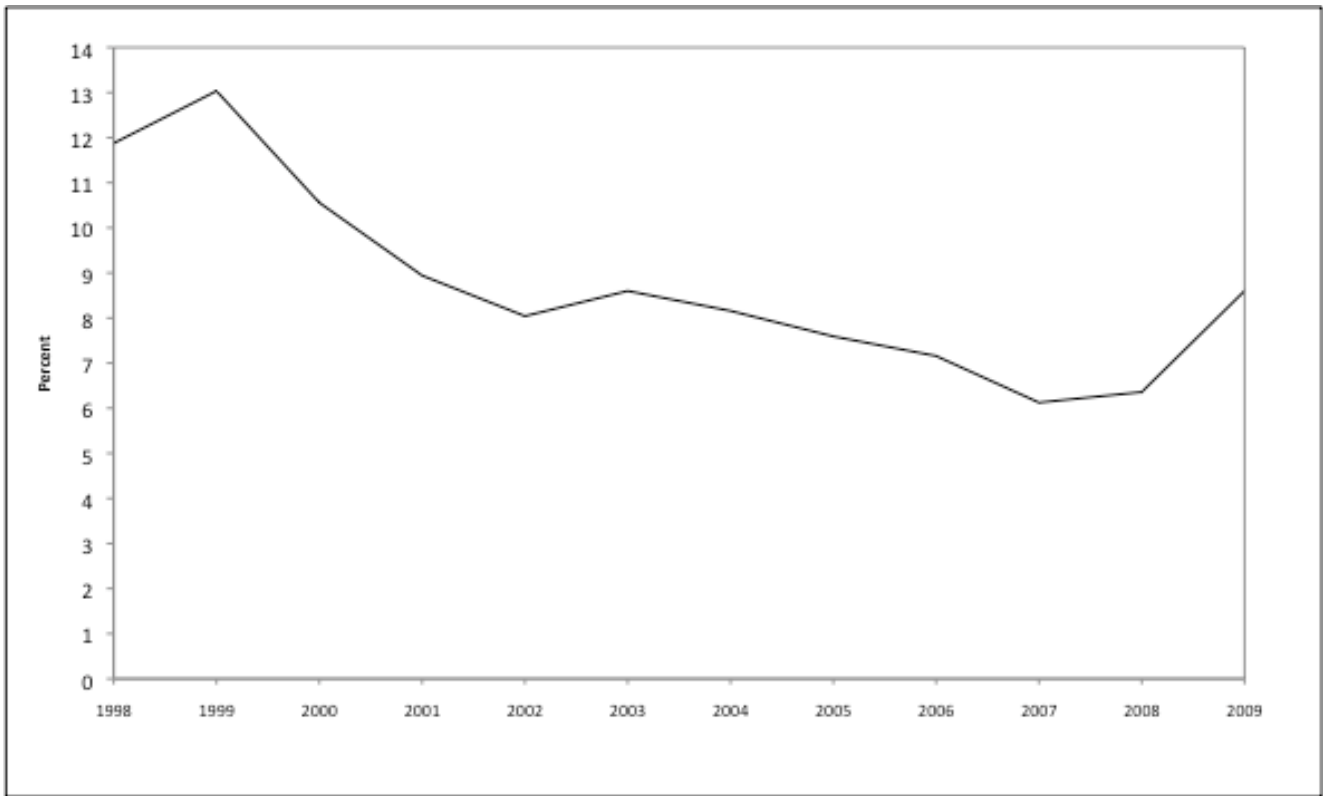


FIGURE 6. ANNUAL RECORDED OFFICIAL UNEMPLOYMENT AS A PERCENTAGE OF TOTAL LABOUR FORCE, 1998-2009

Source: Economist Intelligence Unit.

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¹ Mikhail Delyagin, *Novaya gazeta*, September 22, 2008, p. 2.

² Itar-TASS, February 17, 2010 cited in U.S.-Russia Business Council Daily Update, February 23, 2010, p. 1.

³ Details are in http://www.kommersant.com/p-1356/world_financial_crisis_intervention.

⁴ <http://www.vesti.ru/doc.html?id=219561>.

⁵ <http://blog.kremlin.ru/post/2>.

⁶ Bloomberg, February 18, 2010 cited in U.S.-Russia Business Council Daily Update, February 18, 2010, p. 1.

⁷ *Nezavisimaya gazeta*, February 9, 2010 cited in U.S. Russia Business Council Daily Update, February 9, 2010, p. 1.

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- ⁸ *Vedomosti*, February 18, 2010 cited in U.S.-Russia Business Council Daily Update, February 18, 2010, p. 1.
- ⁹ Bloomberg, February 15, 2010 cited in U.S.-Russia Business Council Daily Update, February 17, 2010, p.1.
- ¹⁰ Alfa Bank, Morning Brief, February 5, 2010, cited in U.S.-Russia Business Council Daily Update, February 5, 2010, p. 1.
- ¹¹ *Forbes*, December 9, 2009 cited in U.S.-Russia Business Council Daily Update, December 9, 2009, p.1.
- ¹² International Energy Agency, “Energy to 2050. Scenarios for a Sustainable Future,” 2003, p. 63.
- ¹³ On becoming president on May 7, 2008, Medvedev remarked: “ We have to achieve a true respect for law and overcome legal nihilism.” Details are in <http://www.rian.ru/politics/20080507/106773965.html>.
- ¹⁴ http://eng.kremlin.ru/speeches/2009/09/10/153_-type104017_221527.shtml.