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The Crisis and Its Lessons for Russia
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Dear Forum participants,

Our meeting takes place at the point when the perspective of surmounting the global financial and economic crisis by the world economy has only started to take shape. Actually, this first global economic crisis made the world community, individual regional associations, and states face a series of major, we may say, core issues. I am convinced these issues, in one form or another, will be central in the discussion at our Forum.

In my report I would like to present to your consideration some ideas related to the development mechanism of the financial and economic crisis in Russia, dwell on the measures adopted by the government (in broad terms) to counter the crisis and their efficiency, and, finally, desirable (to me, naturally) changes in the economic policy.

I shall begin with the issue of **the mechanism of crisis development in Russia**. It is important to realize it in order to adequately evaluate challenges linked with the crisis and map out an effective economic policy.

The world crisis is known to have started on the market of US mortgage-backed derivative financial instruments. Everything seemed to have no relevance to Russia, whose financial institutions were not detected in active operations with these instruments. Everybody remembers the optimistic declaration of the Finance Minister of our country about Russia's economy as a "quiet haven".

The development of Russian economy in the first half of 2008, when the world financial crisis was already raging in the West, seemingly confirmed the forecast. Between January to July the gross domestic product grew by 7.5% against the same period of 2007, investment into fixed capital by 15.4%, consumption of the population by 15.3%. The first quarter statistical data for the flow of goods, services, and capital inflow into and outflow from Russia was encouraging: the current account surplus in the balance of payments made $37.7 bln, the inflow of foreign direct investments $20.2 bln, their outflow $16.2 bln.

The "first bell" rang in July with the start of capital flight from the Russian stock market. The trend was linked with its overheating, according to some experts. To my mind, the reason is different: foreign investors who played the key role on the Russian securities market felt an urgent need for assets to cover huge losses in investments into the collapsed derivatives market. Not coincidentally, the outflow of speculative capital occurred in this period from, practically, all countries referred to as "emerging market economies".

The belief that capital outflow from the stock market is not a particular threat for Russian economy was not long lasting. In August-September it became clear that the phenomenon triggered a whole range of processes, which catastrophically exacerbated the foreign debt problem of the private sector and jeopardized the country's banking system.

Let me remind you that by the end of the first quarter of 2008 foreign obligations of the private sector amounted to $436 bln (including $171 bln of the banking sector). Up to recently they were serviced, to a considerable degree, on the account of new borrowings. With a deficit of financial resources that emerged in the world the opportunity to refinance the debt practically disappeared. The situation was aggravated by the fact that capital outflow produced falling stock indexes and a strong downward pressure on the ruble exchange rate. The falling ruble exchange rate drastically increased the value of debt service, and depreciation of stocks required that borrowers mobilize considerable funds to replenish their collateral for raised loans.

Massive capital outflow from the country also aggravated the liquidity problem of the banking sector. As a result, the volume of credits for real economy began to diminish rapidly and their conditions to tighten, accordingly. Faced with the problem of obtaining the necessary working capital, enterprises experienced serious difficulties in maintaining their production. In other words, liquidity deficit in the banking sector produced a heavy supply-side shock.

In autumn an additional trouble, not less big, emerged. Partly as a result of "removing the speculative component", partly because of the recession that gripped the world economy, the price of oil, our main export product, plummeted on the world market, thus leading to a marked contraction of foreign currency inflow into the country and increased downward pressure on the ruble exchange rate. But more important: Russian economy suffered a vigorous demand-side shock. The export revenues of our economy decreased in the 4th quarter of 2008 by almost \$40 bln compared to the 3rd, rather successful quarter. Oil companies began to quickly cut down investment programs, which could not but provoke a broad negative multiplication effect along the entire reproduction chain.

Faced with this set of factors, in autumn 2008 Russian economy found itself in principally new and very complicated reproduction conditions. The strong inflow of capital gave place to its equally strong outflow. The economy experienced the impact of negative processes both on the supply and demand sides. Production downturn aggravated social problems, among these the employment problem advanced to the forefront. In the twinkle of an eye the big federal budget surplus converted into its even bigger deficit.

Of course, it was impossible to foresee all the details of the events that occurred in Russian economy in autumn 2008. However, another thing is clear as well. The chance of a radical change in the trajectory of short-time transnational capital flows under conditions of financial crisis already spreading in the West was obviously underestimated. Meanwhile, at least since December 2007, the government was receiving danger warnings about the eventual course of events for Russia.

How did the government act when the impact of the crisis on Russian economy became evident?

It concentrated a considerable part of its efforts trying to prevent a systemic banking crisis. A complex of measures was taken with this goal in view. A considerable volume of ruble liquidity was extended to banks, also in form of subordinated credits. Restructuring of the banking system aimed at its recovery started. And, finally, in order to mitigate the burden of servicing external obligations of the private sector of economy (including and in the first place, of the banking sector) the so called "soft ruble devaluation" was effected.

In real economy numerous measures of pinpoint support for enterprises recognized as strategic were adopted.

Efforts to cope with the negative processes in the social sphere were central. Resources were allocated to render material support to the jobless, and involve them into the retraining process. Administrative levers to limit unemployment growth were used (and are actively used now). A decision on implementing also all social obligations previously assumed by the state, including those concerning pensions, was taken.

Against the background of considerably reduced budget revenues the government did not correspondingly cut down budget expenditures and thus recognized that under new conditions a big federal budget deficit is admissible.

Since the start of the crisis up to the present, the monetary policy may be characterized as rather tough: as of 1 September 2008 money supply (M2 indicator) made 14,530 trillion rubles, as of 1 August 2009 13,121 trillion rubles, that is almost 10% less.

To decelerate capital outflow the Central Bank pursued a high interest rate policy: since 1 December 2008 the refinancing rate amounted to 13%. Only in late April it began to slowly descend although even today it is rather high (10.75%).

After concluding the "soft devaluation" of the ruble in January 2009 the Central Bank introduced a currency corridor to create a more stable situation for economic decision-making.

Along with current measures of economic regulation an attempt was made to devise the perspective for post-crisis Russian economy. In particular, economic modernization during the process of overcoming the crisis was formulated as a goal, five main strategic avenues were traced whose support should help achieve it.

On the whole, one can say the center of gravity in current economic policy was shifted towards supporting banking and, in part, stimulating production by way of subsidizing the interest rate for a certain number of enterprises. At the same time many of the implemented decisions showed serious negative side effects.

For example, the “soft devaluation of the ruble” was linked with expenditures of considerable foreign currency reserves. By 1 February 2009 Russia’s international reserves dropped to $387 bln, that is more than by $200 bln against the maximum level of $597 bln achieved by 1 August of the past year. Besides, the devaluation being protracted in time actually subsidized capital flight from the country.

The “currency corridor” system creates, in its turn, a threat of big speculative attacks at the ruble and compels the Central Bank to be ready to massive foreign currency interventions. It should be said, to be just, that the volume of international reserves of the country increased since the moment the “currency corridor” was introduced. But simultaneously fluctuations of this parameter rose steeply: from little less than $384 bln as of 1 April 2009 to more than $412 bln as of 1 July of the current year and, finally, to circa $402 bln as of 1 August of this year.

The tough monetary policy backed the trend of supporting high interest rates. All this, however, obviously blocked access of the majority of real sector enterprises to bank credits.

The emphasis on pinpoint support of strategic enterprises and insufficient attention paid to the problem of stimulating aggregate demand caused a threat that the support granted would result inefficient because the objects chosen for this support stood often in the middle of the reproduction chain.

The administrative pressure on enterprises to preserve jobs blocked in many cases a restructuring dictated by the crisis and modernization of relative economic links. On the other hand, when banks became objects of administrative pressure the danger of subsequent non-payment of credits and, as a consequence, of a deepening crisis in the banking sector emerged.

What are **the results of our country’s development under conditions of the crisis?**

Preventing mass bankruptcies of significant Russian corporations and, particularly, banks, keeping the economy “afloat”, maintaining relative social stability are to be considered the principal positive outcomes of the governmental anti-crisis economic policy.

Inflationary processes have not intensified, a positive, though unstable dynamics of stock market indexes has been outlined.

Now a substantially increased level of oil prices on the world market has a favorable impact on the economic development.

It seems also the economy “has touched the bottom”, next year we may expect a small GDP increase (of 1% according to governmental assessments).

At the same time, Russia found itself among countries with the deepest production downturn caused by the crisis. Numbers like -10% GDP, -15% of industrial production, -18% of investment into fixed capital make us recall the early 1990s.

The country has lost approximately one third of her international reserves, mainly in the course of “soft devaluation of the ruble”. More than $200 bln spent up to 1 February 2009 to attain the goal equaled the value of 800 mln t of oil at the then oil price of $40 per barrel. This amount of oil is extracted in the country during more than 18 months.

There are no visible signs of economic modernization. On the contrary, several high-tech productions (particularly machine-tool construction) are again on the verge of total collapse. Governmental plans of restricting the funding of research and high-tech projects in the coming years also make us pessimistically minded.

On the whole, the prospects of Russia’s economic growth remain highly dependent on the dynamics of external demand for our fuel and raw goods.

Of course, the question remains whether we still have **the possibilities to ensure a more successful economic operation** under present conditions. It seems to me these possibilities do exist.

The debt problems of the private sector which played such a negative role in the crisis became feasible only due to a liberalized regime of trans-border capital movement in Russia.

Therefore, introducing restrictions of asset movement in capital items of the balance of payments (primarily, short-term speculative capital trans-border movement) should be regarded now as expedient with all seriousness, without any ideological prejudices. In case a positive decision is taken we would have to return to the mandatory sale of export proceeds on the foreign currency market.

The positive aspect here consists in the fact that in this way we would manage to radically foster stability of the ruble exchange rate, eliminate the need for large-scale Central Bank interventions on the currency market and thus free up a substantial part of currency assets in state property to allocate them for production purposes. Simultaneously the need to combat capital outflow by raising the refinancing rate would pass, which would allow to lower the interest rates for real economy enterprises and bring them down to a reasonable minimum.

Thanks to higher oil prices external demand has somewhat improved. But aggregate demand-induced limitations for economic growth remain rather tough. Investment activity is still extremely slack, consumer demand for national goods narrow. That is why the state, though belatedly, should intervene as a powerful source of final demand by devising and financing big projects aimed at infrastructure development and technological renovation of production. These steps would solve current problems of stimulating economic activities and long-term problems of modernizing Russian economy.

This approach requires, of course, that serious changes are introduced into the financial and budgetary policy of the state.

I shall touch upon the mechanisms of financing the federal budget deficit. In this field we should primarily stop intimidating each other by quoting numbers, which characterize the dynamics of the country's Reserve Fund. This Fund like the Future Generations Fund is incorporated into Russia's international reserves and managed by the Central Bank together with foreign exchange assets in its possession. Financing the deficit from the Reserve Fund represents, technically speaking, a transfer by the Finance Ministry of a part of foreign exchange in its possession to the Central Bank against rubles emitted by the Bank. The operation is 100% monetary financing. Therefore, if the Reserve Fund is exhausted (that is, if relative foreign exchange passes from the Finance Ministry to the Central Bank) the latter can continue issuing rubles and transfer them to the Finance Ministry with the same macroeconomic consequences. In other words, the question is not whether there are financial means available in the Reserve Fund, but how many rubles can be issued without undermining financial stability of the economy.

Certainly, a reasonable scale for monetary financing of the budgetary deficit exists. That is why the state should be ready to start financing the budget deficit by borrowing, that is, to mobilize necessary resources on the financial market. Meanwhile, the monetary policy of the Central Bank should be shaped in a way so as not to allow extreme rise of the interest rate.

If necessary, along with ruble resources foreign exchange resources in state possession can also be attracted to efficiently carry out projects. It may be both direct state import and private import based on long-term foreign currency loans extended by the state. Of course, in this case aggregate demand for Russian products does not change, but the problem of modernizing the production apparatus is resolved.

I would like to finish my report with the following statement. It seems to me today we are witnessing a very important moment which in many aspects predetermines the future of our country for many years to come. The question is posed as follows: Shall we overcome this crisis with an economy oriented at dynamic innovative development? Or shall we reinforce our status of raw material appendage of developed countries (which, by the way, make enormous efforts today to accomplish a new round of modernization)?

One thing is clear: the crisis can urge us to set and carry out ambitious tasks, but the crisis cannot accomplish them instead of us.

Thank you for your attention.