

# DEVELOPMENT STRATEGY

UDC 338.124.4

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## Russia and the global crisis

*The following issue is a scientific report “Russia and the global crisis: first results”, which was represented by the author at the permanent Russian and French seminar on monetary and financial problems of the Russian economy, held in Vologda in April 2010. The text is published with abridgement.*



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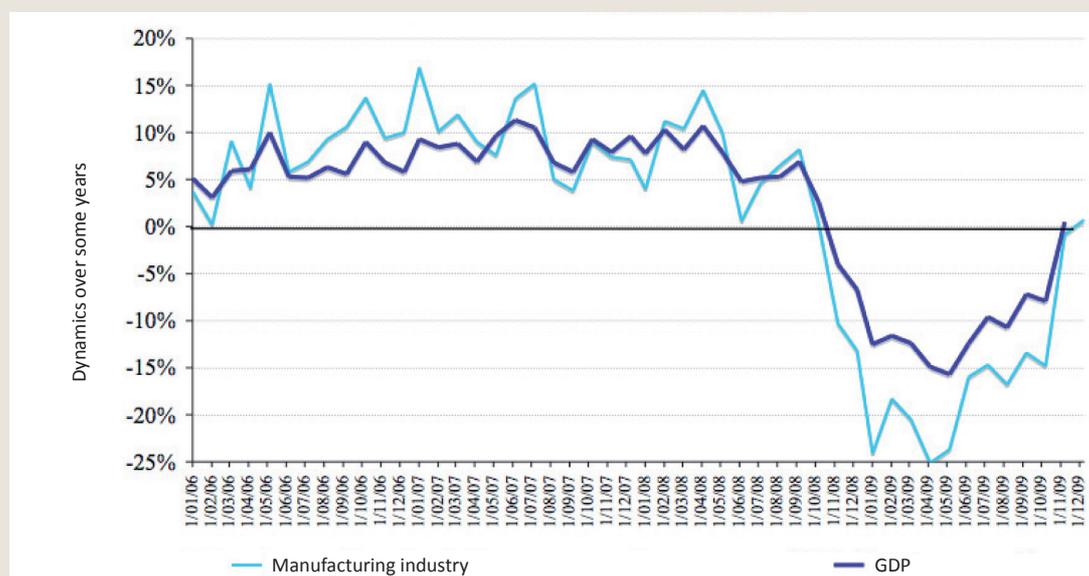
In Russia, there was a severe recession during the global crisis that began in 2007. It reached its peak in the first half of 2009 and now there is a trend to its weakening. The scale and severity of the recession caused a lot of questions.

Obviously, Russia has been protected from the international banking crisis. Indebtedness of the population was extremely low compared to many developed countries, and most Russian banks have not been very active in the derivatives markets, which were particularly affected by the crisis. Nevertheless, indebtedness of some companies and banks may cause some problems. This gives the reason to speak of a “psychosis of default” in Russia and abroad, while the overall situation in the country is stable. This psychological aspect, of course, had an aggravating effect, at least at the beginning of the crisis.

The liquidity crisis in the international markets acted as a detonator of the crisis in Russia. The crisis was caused mainly by the shock provoked by the massive withdrawal of short-term capital by brokers, who desperately pursuing liquidity, which appeared in Russia because of the difference in exchange rates. Indebtedness of Russian companies contributed to aggravation of this phenomenon. Originally crisis was viewed through the prism of the debt of some major Russian companies, which are massively applied for state aid.

In fact, if to consider the crisis mechanism at the international and domestic markets, the impact of the global liquidity crisis in October 2008 and instantly fall in material prices were caused primarily by internal mechanisms, which largely explain the scale and high degree of severity of the crisis.

Figure 1. The dynamics of growth (reduction) of the gross domestic product and the volume of manufacturing industry in Russia



Source: data from the Central Bank of Russia.

This aspect of the crisis was largely caused, firstly, by the policy of the Central Bank, and secondly, the Ministry of Finance. Such a policy mainly explains the scope and high degree of severity of the crisis and the slump in the domestic market, and that such policies were implemented before the economic growth in Russia. This situation gives rise to many questions about the economic recovery that we see today, and its term.

### 1. The crisis is severe but time-limited

The severe impact of the crisis in Russia occurred in the period from October to November 2008. It was the result of the liquidity crisis that has paralyzed the entire global economy.

Source: data from the Central Bank of Russia and the Federal State Statistics Service.

The economic recession was so severe that it affected all exporters<sup>1</sup>. In the manufacturing industry in Russia (*fig. 1*) rapid reduction in activity was particularly impressive in the first months of 2009. The automotive industry during the first quarter almost stopped as the production of cars and trucks. Production vol-

ume for the domestic market (building materials, construction equipment, trucks and cars) decreased from -40% to -65%. The extractive industry also showed much more moderate level of decay (*fig. 2*). It depends on various factors, such as falling exports, affected the prices in the oil sector (although production increased slightly). In the gas sector there have also been significant reductions in export volumes, but the fluctuations in prices are much lower.

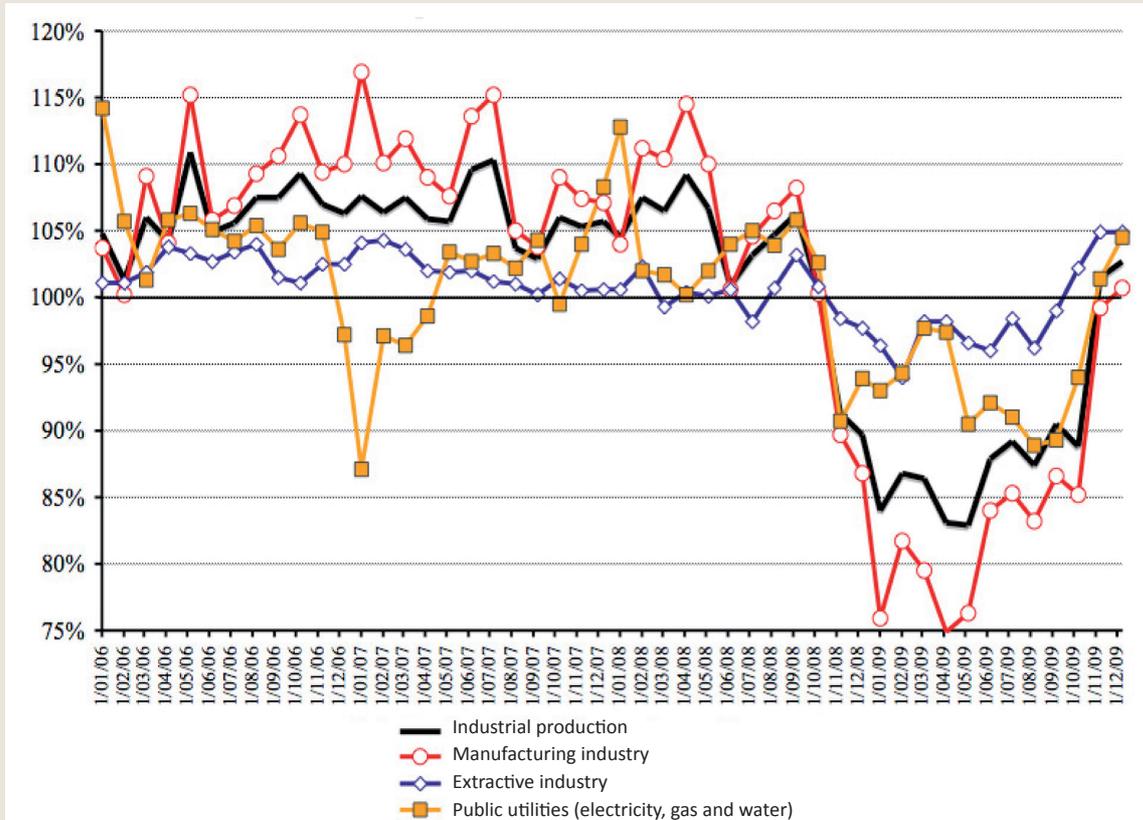
The oblasts closely related to international economies, have suffered most of all. As the graph (*fig. 3*) shows, the crisis has caused a strong reduction of production in oblasts where ferrous metallurgy played the important role, the lowest level was in the second half of 2008

Source: data from the Federal State Statistics Service.

Production in the oblasts which specialize in the processing industry begins to experience decline in 2008 (*fig. 4*). In these oblasts, however, the level of production in the last decade was much more varied and uneven. If the level of activity in oblasts such as Moscow, Leningrad and Saratov, was much higher than the average

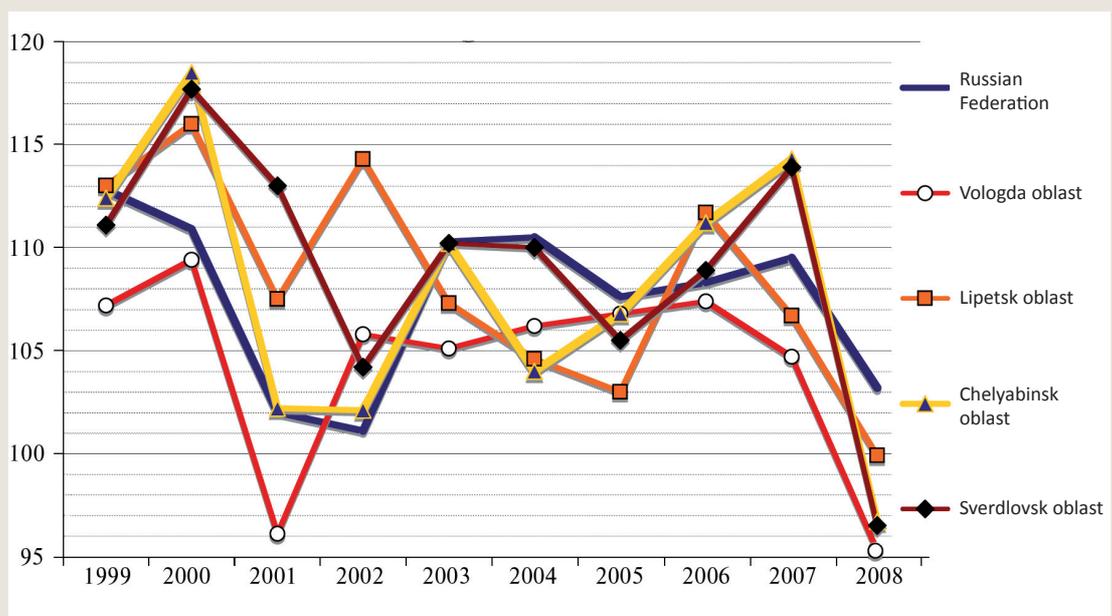
<sup>1</sup> Clenfield J. (2009).

Figure 2. Dynamics of production industries, in %

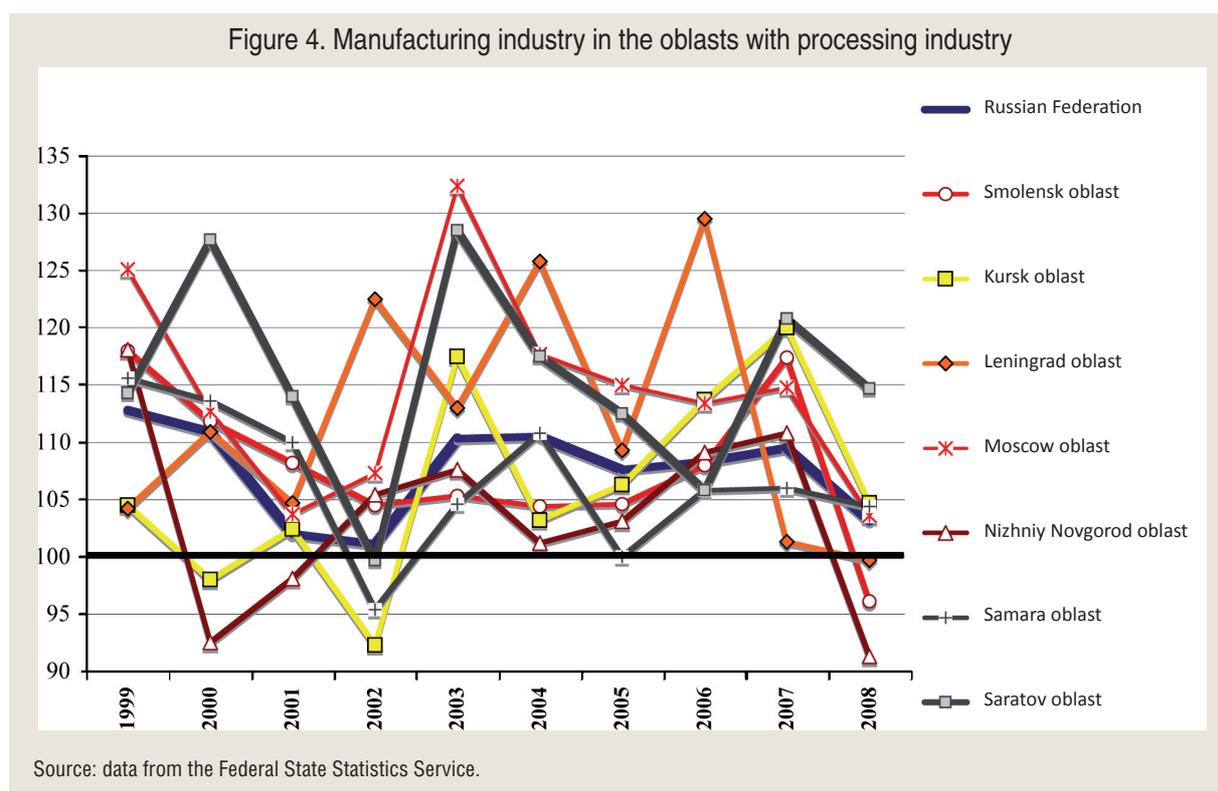


Source: data from the Central Bank of Russia.

Figure 3. Volume dynamics of manufacturing industry in oblasts with ferrous metallurgy, in %



Source: data from the Federal State Statistics Service.



for Russia, and decline, respectively, started earlier and was stronger.

The Russian government has submitted a plan that includes measures to provide financial assistance to banks and businesses since late October 2008. Later regular changes were made in the plan. It should be noted that in 2009 an important part of this plan was the financial assistance. The amount of this assistance (banks and non-financial firms access to bank loans) amounted to 3.46% of GDP.

In addition, the government has greatly increased unemployment benefits and supported the leading companies experiencing difficulties (for example, AvtoVAZ).

These measures have mitigated the effects of the crisis, but nevertheless, they are insufficient.

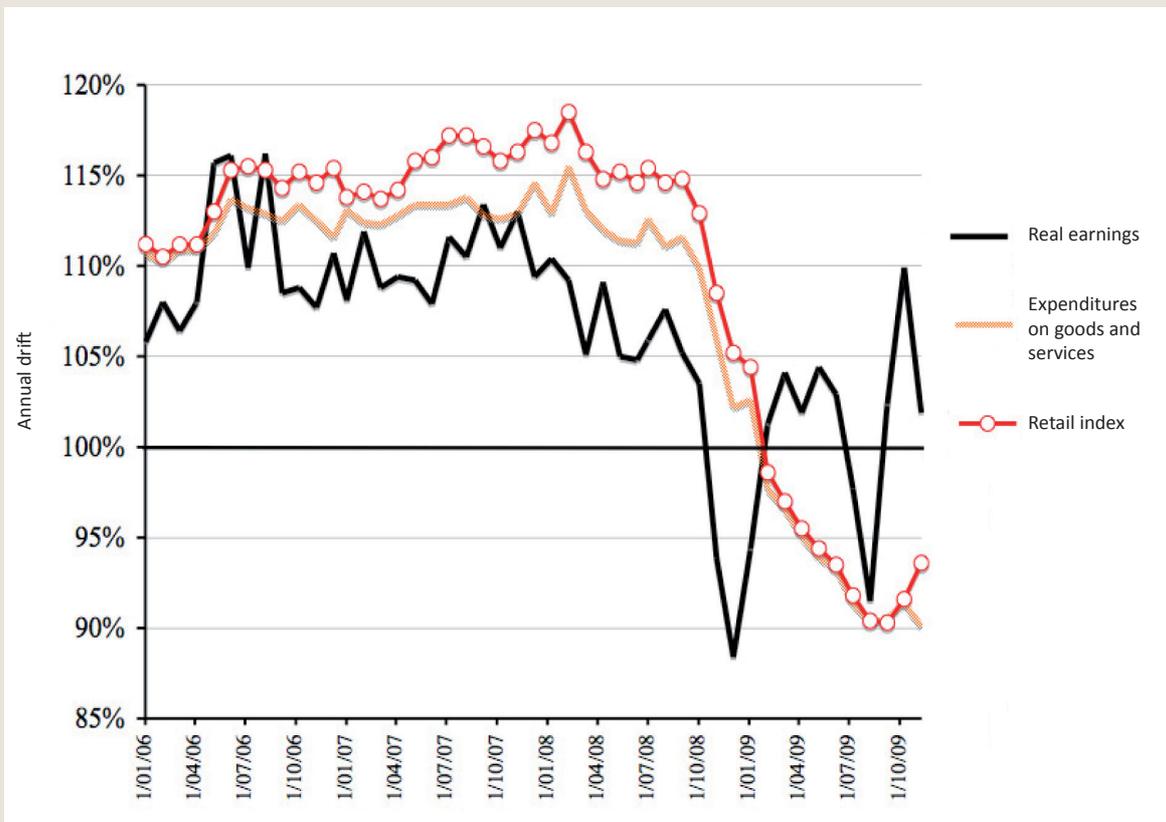
As shown in *figure 5*, real earnings, which fell rapidly in early 2009, began to recover and does not decrease compared with 2008.

However, despite the fact that incomes are generally preserved, there is a decline of about 10% of spending on goods and services, which is correlated with the index of retail trade.

In addition to the “crisis management” measures of the plan it should be noted that the requirement of government to industry to prevent arrears of wages, which are usually grown in the first weeks of the crisis. Such a government requirement played an important role in stabilizing the resources of the population. After a sharp increase, up to March 1, of the number of redundant workers, it then stabilized. On June 4 Putin visited Pikalevo, where he protested against Oleg Deripaska. Company “Rusal” owned by Oleg Deripaska has received a loan of 4.5 billion dollars, which were provided by state-owned Vnesheconombank<sup>2</sup>. Arrears of wages fell, when Deripaska’s company “Basic Element” paid 41 million rubles in the afternoon of June 4, and 88 million rubles on June 8. Other companies have followed this trend, and we can say that wage arrears ceased to be a serious problem in the summer of 2009

<sup>2</sup> Humber Y., and Kolesnikova M. (2009).

Figure 5. The dynamics of household consumption



Source: data from the Federal State Statistics Service and the Central Bank of Russia.

## 2. Complex interactions

Russia, of course, has suffered from falling oil revenues. But this is not the whole crisis. The fall was huge, since the price per barrel went up to 147 doll. in pure speculation.

Russia has also suffered from falling exports to the metal, chemical and non-ferrous industries, which accounts for a very large amount.

Finally, Russia has become a victim of international liquidity crisis<sup>3</sup>, like a contagion effect, described in the literature<sup>4</sup>. But the external causes of the crisis should not distract us from internal causes.

*The role of raw materials.* The fall in material prices had been one of the most serious consequences of a liquidity crisis that led to the virtual disappearance of international interbank

transactions at the end of September 2008. It also became apparent that a partial increase in prices for several months before the crisis was caused by speculation of banks in the commodity markets.

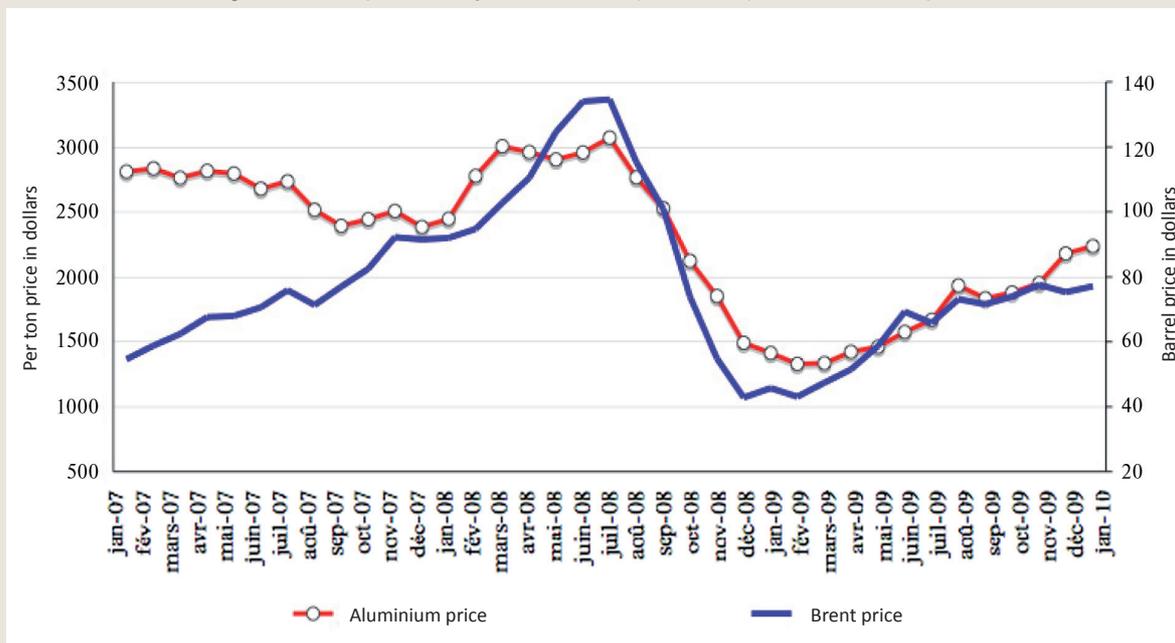
The fall in prices was quite dramatic as a result of speculation of banks, but time-limited. Since June 2009, oil prices reached the average price of 2007. As for the price of aluminum, it was greatly influenced by the fall in automobile production, which is one of the main markets for this product (*fig. 6*).

A similar situation is in the metallurgy due to the decrease in housing construction in Western Europe, which strongly affects the demand for steel. The impact on Russian economy of the reduction of foreign demand was so strong that we must distinguish two exposures: the first – industrial and the second – financial.

<sup>3</sup> Sapir J. (2008d).

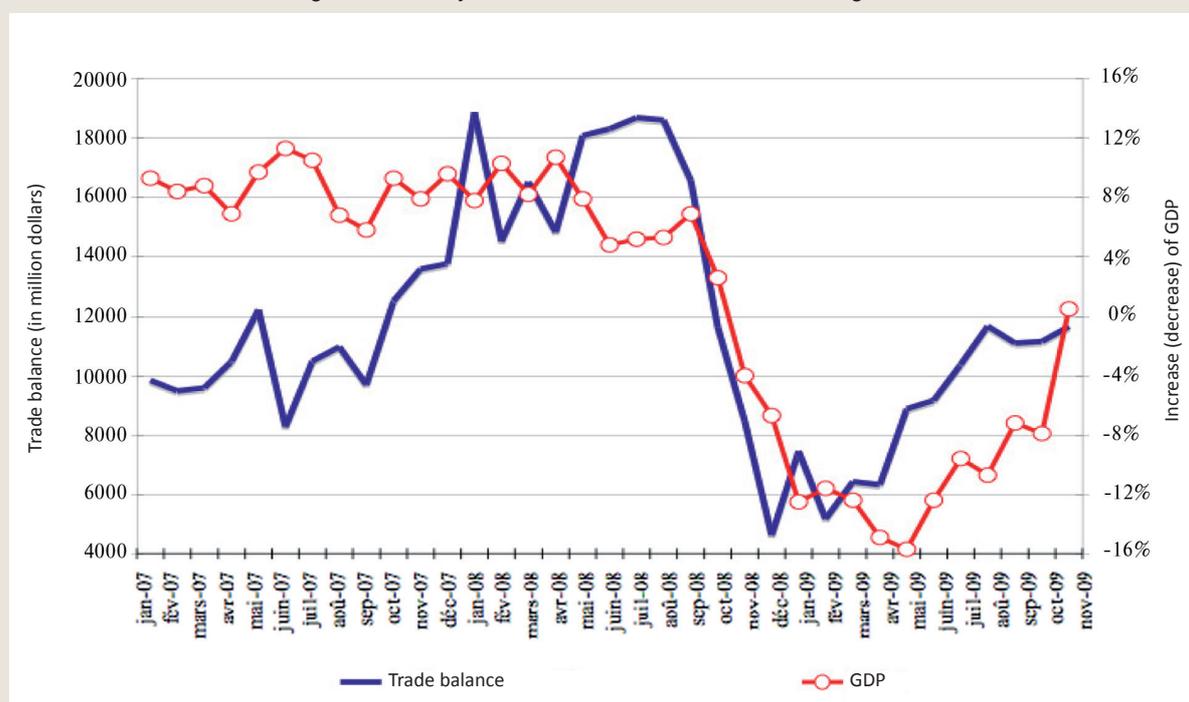
<sup>4</sup> Cifuentes R., Ferruci G., Song Shin H. (2005).

Figure 6. Comparative dynamics of oil (Brent ICE) and aluminum prices



Sources: Brent Price: Energy information agency [Electronic resource]. – Access mode: <http://tonto.eia.doe.gov/dnav/pet/hist/rbrtem.htm>; The price for aluminum. – Access mode: <http://www.ereport.ru/stat.php?selnum=2>

Figure 7. The dynamics of trade balance and GDP growth



Source: Database of foreign trade statistics of the Central Bank of Russia.

From the perspective of industry, oil and gas have little effect on employment, because they are capital-intensive activities. Crude oil

production actually increased in 2009 (+1.2%), while natural gas fell (-12.1%). The production of metals, by contrast, has a greater impact.

Table 1. Russia's debt to non-residents, billion dollars

	31/12/2006	31/12/2007	31/03/2008	30/06/2008	30/09/2008	31/12/2008	30/06/2009
Government	44.7	37.4	36.9	34.7	32.3	29.5	30.0
Monetary authorities	3.9	9.0	4.1	4.2	10.2	3.3	11.0
Banks (excluding fixed assets)	101.2	163.7	171.7	192.8	198.2	166.3	141.7
Others (excluding fixed assets)	160.7	253.5	265.0	293.1	299.6	281.4	292.8
Total	310.6	463.5	477.4	524.8	540.5	479.9	468.4
Including currency	252.5	370.2	379.4	407.2	427.9	396.1	383.0
Including rubles	58.4	93.3	98.0	117.6	112.6	83.8	85.4
Ruble share	18.8%	20.1%	20.5%	22.4%	20.8%	17.5%	18.2%
Reserves	303.7	477.89	512.58	568.97	556.81	427.08	412.59

Source: Central Bank of Russia, Bulletin of Banking Statistics. Moscow.

Table 2. Investment state in Russia, in billion dollars

	31/12/2005	31/12/2006	30/12/2007	31/12/2008
<b>Assets</b>	<b>499.100</b>	<b>705.983</b>	<b>1099.335</b>	<b>1009.95</b>
Direct investment	146.676	209.559	370.161	202.84
Portfolio investment	17.772	12.268	27.007	24.67
Other investment	152.358	180.202	222.981	350.055
Reserves	182.240	303.732	478.762	427.080
<b>Liabilities</b>	<b>547.715</b>	<b>769.199</b>	<b>1244.651</b>	<b>755.885</b>
Direct investment	180.313	271.590	491.232	213.734
Portfolio investment	166.116	259.776	363.018	111.425
Other investment	201.234	237.656	389.526	420.330
<b>State of the accounts</b>	<b>-48.614</b>	<b>-63.216</b>	<b>-127.048</b>	<b>254.065</b>

Source: Central Bank of Russia, Bulletin of Banking Statistics. Moscow.

Closure of factories (blast furnaces) had consequences. Steel production fell by -13.6%, rolled metal by -10.3%. Production of aluminum products (profile) dropped to a critical level – -23.4%<sup>5</sup>. If the effect of an industrial factor varies significantly depending on the production, the financial impact is more homogeneous. Whether this occurs due to prices or exports decrease, it causes reduction in the trade balance.

As seen in *Figure 7*, the trade balance is correlated with GDP in the period between October 2008 and in the previous period it is not observed. The sharp rise in the trade balance from summer of 2007 to summer of 2008 might have no effect on GDP. However, the financial impact on these processes should not be underestimated.

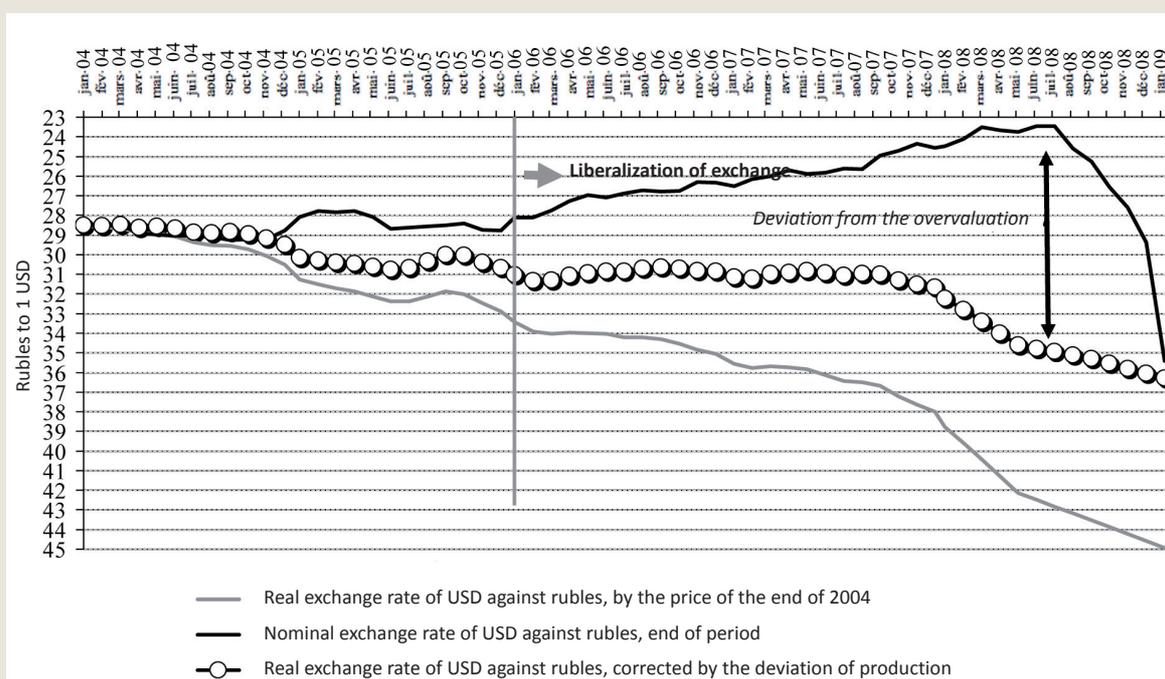
<sup>5</sup> Figures are available on the Federal State Statistics Service site in the section "On industrial production in 2009", January 2010.

*Financial aspects.* International liquidity crisis may have caused a greater shock than external trade. Russian companies and banks strongly increased their presence abroad (*tab. 1*).

The investment situation in Russia should be also considered (*tab. 2*). At the end of 2007, the situation has largely been payable thanks to the growth of foreign portfolio investment, which increased by almost 40% this year and 118% since the end of 2005. The elimination of foreign positions on the Russian financial market in 2008 has significantly reduced this figure, which led to the return of capital of 254 billion dollars.

Debt of banks to foreign institutions increased by 96% in the period from late 2006 to September 2008, and to the large industrial enterprises by 86%. However, it should be noted that until the end of June 2008, the proportion of debt in foreign currencies decreased slightly,

Figure 8. Comparison of nominal and real exchange rate of dollars for rubles



Sources: data from the Central Bank of Russia, Federal State Statistics Service and CEMI-EHESS.

and a significant portion of these debts (about 2/3) is in the medium and long term.

Large companies and major Russian banks were indebted on the international market. This situation is partly explained by the credit policy, which took place in Russia. Priority measures to combat inflation, of course, led to complications of domestic lending, which did not allow to the interbank market to exist in a proper manner.

The overall situation of the Russian economy in terms of international shocks was significantly worsened by the policy pursued by the Ministry of Finance and Central Bank of Russia. Through a policy of “strong ruble” and the full liberalization of the exchange rate mechanism in early 2006, these two institutions have caused massive capital inflows<sup>6</sup>, which increased from fall 2007 until spring 2008, despite the warnings<sup>7</sup>. Such a policy has provoked a sharp increase in the real exchange rate (*fig. 8*), including the adjustment of the relative increase

in labor productivity<sup>8</sup>. Sensitivity of the Russian economy to financial difficulties increased.

Existence of a large surplus of foreign exchange reserves led to the visibility of long-term and stability, despite significant social costs of such a strategy<sup>9</sup>. Once the crisis erupted, it became apparent that the government should be a lender last of all. In addition, procyclical effects of liberalization of the exchange rate should be taken into account<sup>10</sup>.

In these circumstances it was inevitable that a liquidity crisis, that began in the international market with the bankruptcy of “Lehmann Brothers” in mid-September 2008 and the freezing of foreign exchange market, had particularly serious consequences for the Russian economy.

These shocks that occurred after the crisis of “Fannie Mae” and “Freddie Mac” (*fig. 9*) in July 2008, almost immediately were followed by others since the beginning of October 2008 to January 2009.

<sup>6</sup> Calvo G., Leiderman L., Reinhart C.M. (1994).

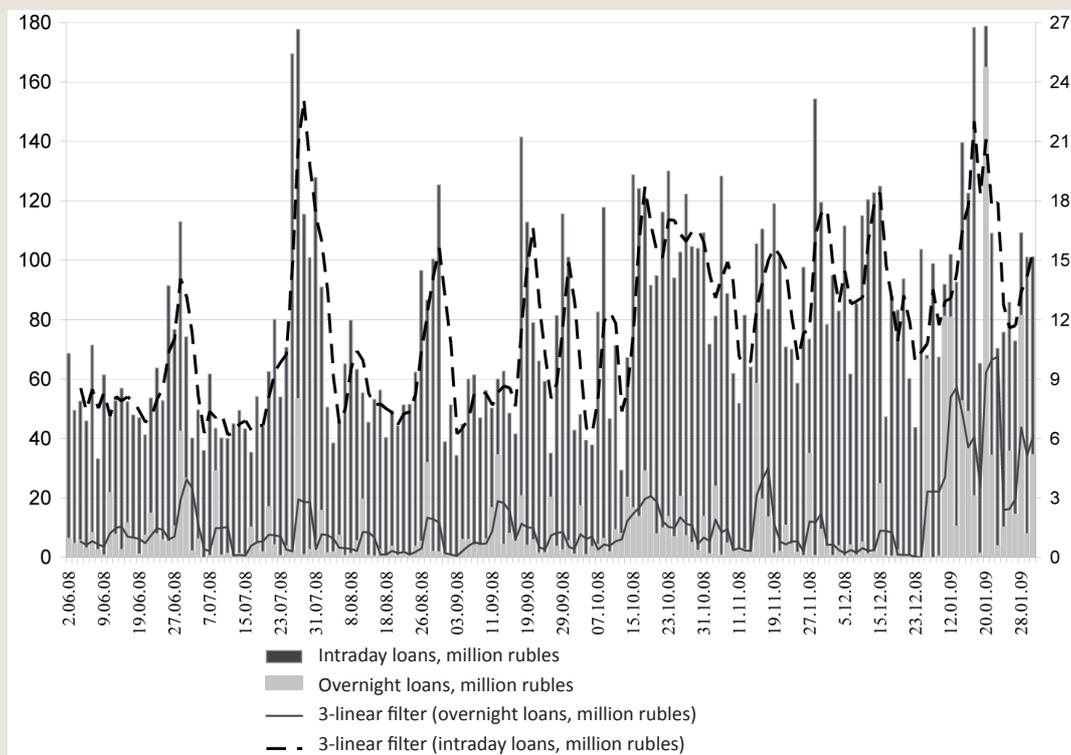
<sup>7</sup> Sapir J. (2008).

<sup>8</sup> Rodrik D. (2008).

<sup>9</sup> Rodrik D. (2006); Baker D. and Walentin K. (2001).

<sup>10</sup> Kaminsky G.L., Reinhart C.M., Végh C.A. (2004).

Figure 9. Intraday and overnight loans of the Central Bank of the Russian Federation



Source: data from the Central Bank of the Russian Federation.

Thus the situation presented a series of distress calls. However, these signals were largely ignored by the Central Bank.

*The reaction of the Central Bank.* The Central Bank of the Russian Federation responded correctly to shocks in liquidity and supported several banks in Russia. It should be noted that the government has allocated 2.7 trillion rubles (about 81 billion dollars), of which 60% must be spent in July 2009.

These amounts, of course, are fewer of those that have been spent by major developed countries, but they are extremely important. They are much higher than the amounts allocated to the recovery plan. In connection with the omission of the interbank market, almost all of these amounts represent liquid funds, as well as the source of refinancing (*tab. 3*).

In addition, saving banks, the Central Bank at the same time sharply increased interest rates (*fig. 10*) to try to cope with the sharp fall in the

exchange rate, prompting the repatriation of speculative capital (*fig. 11*).

Reduction in reserves in the second half of 2008 was really impressive, but less than the speculative outflow of capital (171.5 billion dollars compared to 254 billion dollars). In an attempt to counter it the Central Bank increased the rate from 11 to 13% and kept it until April 2009.

This sharp increase has had dramatic consequences not only for consumption of durable goods in Russia, but also in the sphere of investment.

We can compare these data with data on the reduction of spending on goods and services. A large proportion of these expenditures were financed through loans. However, Russian banks have made rationing of credit very strict.

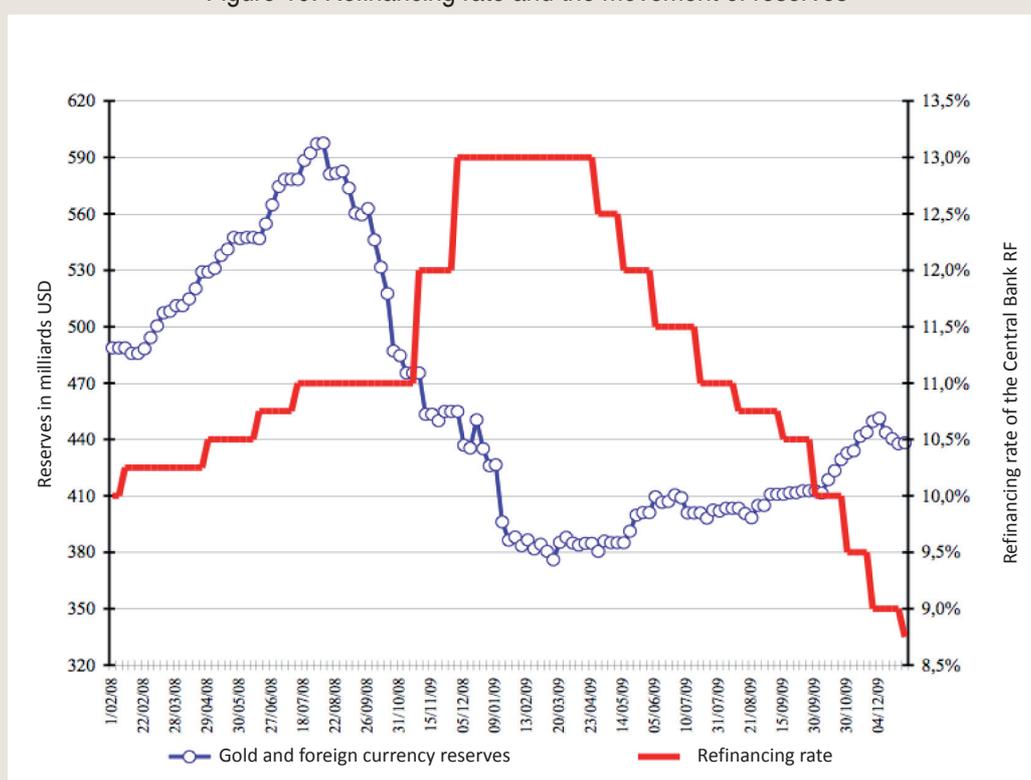
*The crisis of domestic lending.* The amount declined from 3,566 billion on September 30, 2008 to 3,190 billion rubles on October 31,

Table 3. The inflow of liquidity from the Central Bank and the state to banks, in billions of rubles

	3 quarter of 2008	4 quarter of 2008	1 quarter of 2009	Total
Amount involved by CBR and the authorities				
– in billions of rubles	1416.5	3536.7	3533.0	8486.2
– in billions of USD	56.1	120.4	101.6	278.1
Of which the inflow is:				
– from the CBR, billions of rubles	197.0	3249.0	3209.0	6655.0
– from the Russian Government, billions of rubles	1219.5	287.7	324.0	1831.2
In favor of state-owned banks, billions of rubles.	1059.0	2251.0	2390.0	5700.0
In favor of private banks in Russia, billions of rubles	325.0	1037.0	966.0	2328.0
In favor of foreign banks, billions of rubles	32.0	249.0	177.0	458.0
Percentage:				
– to state-owned banks	75.0	64.0	68.0	67.2
– to private banks of Russia	23.0	29.0	27.0	27.4
– to foreign banks	2.0	7.0	5.0	5.4

Source: data from the Central Bank of the Russian Federation.

Figure 10. Refinancing rate and the movement of reserves

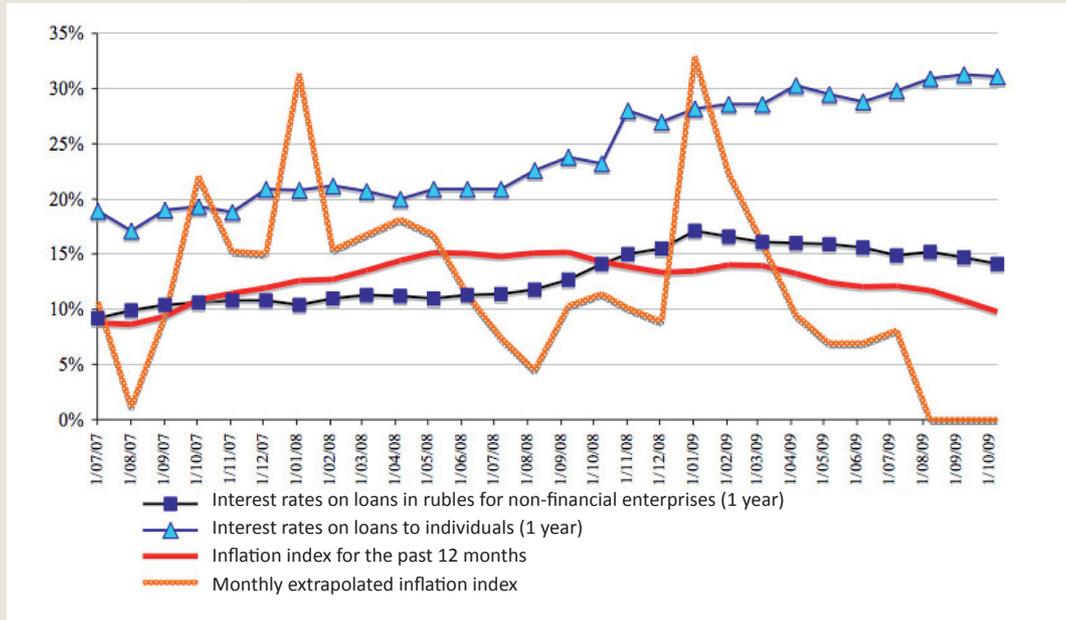


Source: data from the Central Bank of the Russian Federation.

2009, representing 10.5% of outstanding loans to the public. Given the pace of renovation of loans, which means a very low credit activity of banks, in particular as for the financing of consumer loans, called “long term” loans.

For a mortgage loan, which is currently a priority form of housing loans (*tab. 4*), the amount decreased during the same period from 555.5 billion rubles to 116.7 billion rubles. This drop was accompanied by an increase, although

Figure 11. Development of inflation index and interest rates



Source: data from the Central Bank of the Russian Federation.

relatively weak, of nominal interest rates. In periods of falling inflation, it usually leads to a significant increase in real interest rates. Interest rates (for loans in rubles) have increased from an average of 12.7% in the third quarter of 2008 to 14.6% in the third quarter of 2009.

Real interest rate of 1.5% increased to 5%, if we take the inflation criterion at 12 months.

Fall in mortgage lending is very significant. In the first quarter of 2009 it was issued only 16.3% of the mortgage loans of the first quarter of 2008. Such a reduction has had a very

Table 4. Quarterly issuance of mortgage loans

	The volume of mortgage loans in rubles, mln rub.	The same in currency, mln rub.	Total, mln rub.	Growth rates, quarterly
Q1-2006	13,254	9,741	22,995	
Q2	33,263	22,279	55,542	141.5%
Q3	51,236	25,878	77,114	38.8%
Q4	81,859	26,051	107,910	39.9%
Q1-2007	61,940	20,376	82,316	-23.7%
Q2	91,323	29,497	120,820	46.8%
Q3	127,612	33,007	160,619	32.9%
Q4	157,270	35,464	192,734	20.0%
Q1-2008	129,206	21,553	150,759	-21.8%
Q2	164,745	23,679	188,424	25.0%
Q3	167,990	30,290	198,280	5.2%
Q4	77,582	18,767	96,349	-51.4%
Q1-2009	23,060	1,533	24,593	-74.5%
Q2	28,813	2,026	30,839	25.4%
Q3	34,099	2,011	36,110	17.1%

Source: The Central Bank of the Russian Federation, Bulletin of Banking Statistics. Moscow.

negative impact on construction and, consequently, production of construction materials and equipment.

This situation leads to a fall in the productive and consumer goods sectors (*tab. 5*).

Table 5. The decline in production in 2009

Types of products	Decline in production in 2009 in % to 2008
Industrial production	-15.6
Cement	-17.3
Gypsum	-19.9
Concrete	-29.8
Cranes	-42.8
Refrigeration equipment	-26.3
Automobiles	-59.4
Trucks	-64.3
Televisions	-32.7

Source: data from the Federal State Statistics Service.

### 3. The puzzle of the monetary policy in Russia

Thus, the monetary policy in Russia has had a significant impact on the crisis, exacerbating it.

This influence was, on the one hand, direct, if we talk about the decrease in lending, which was conducted by the Central Bank. And on the other hand, it was indirect, the indirect effect associated with the opening of Russia for short-term investment and speculative capital movements. It was the indirect mechanism that made Russia suffer in the first place.

It is necessary to go back in time and examine the evolution of the monetary policy in Russia, to understand how and why the country brought on itself such a crisis.

*Choosing a policy of "inflation targeting"*. It was assumed that the monetary policy of the Central Bank will be built in 2009 as it is practiced in developed countries, i.e. as a policy of "inflation targeting"<sup>11</sup>. But it was a belated choice as the major central banks took this decision in the early 1990's. But I must say that this choice has not always been successful.

This type of policy is a part of the so-called "New Financial consensus", which replaced

<sup>11</sup> The Central Bank of the Russian Federation (2009).

the indestructible monetarism of the 1980s<sup>12</sup>. Such a policy is sometimes called "Neo-Keynesian", but it would be more accurate to call it "Néo-Wicksellien"<sup>13</sup>, since it is based on the difference between the equilibrium interest rate and the rate of the Central Bank.

In a paper published in 2008, the Central Bank of Russia announced that it: "... *intends in this period to complete the transition from policy of controlling inflation to a policy aimed primarily at reducing inflation*". And a few lines later: "*The main objective of the monetary policy over the next three years will be a gradual decline in inflation by 5% – 6.8% in 2011*"<sup>14</sup>.

It was quite a dramatic change in the monetary policy over the previous law, which declared control over the development of exchange rates, as well as indicators of a growing money supply<sup>15</sup>.

It is known that the ineffectiveness of quantitative indicators of the monetary policy has led to the abandonment of the monetary policy.

Nevertheless, the policy, known as the "inflation control" means the freedom of the exchange rate<sup>16</sup> at which the Bank of Russia saves the desire to have a residual form of control<sup>17</sup>.

In fact, the policy of controlling money supply, which is still used, was disappointing. Inflation in Russia always seems to have had a fairly large structural aspect<sup>18</sup>. (The author makes a conclusion on the basis of special tests to detect the influence of foreign variables on the rate of inflation<sup>19</sup>. — *Editor's note*).

The Central Bank of Russia has refused to monetary orthodoxy, but that does not mean that it made the right choice by joining the "New Financial consensus" (NFC). The latter is the subject to be seriously criticized.

<sup>12</sup> Goodfriend M., King R.G. (1997); Clarida R., Gali J., Gertler M. (1999).

<sup>13</sup> Canzoneri M., Cumby R.E., Diba B., Lopez-Salido D. (2008).

<sup>14</sup> The Central Bank of the Russian Federation (2009).

<sup>15</sup> The Central Bank of the Russian Federation (2009).

<sup>16</sup> Kam E., Smithin J. (2004).

<sup>17</sup> The Central Bank of the Russian Federation (2009), Pp. 5, 25.

<sup>18</sup> Sapir J. (2006).

<sup>19</sup> Sapir J. Évaluation de l'impact de la hausse de la liquidité dans l'économie russe sur l'inflation. Document du séminaire franco-russe. — Paris, Juillet 2008, miméo.

The criticism touches upon the crisis and its consequences<sup>20</sup>, which the consensus could not foresee and then helped in solving problems. Its alleged effectiveness in reducing inflation in developed countries was discussed<sup>21</sup>, but imports of goods produced in countries where production costs are pegged at low levels, may also explain the decline in inflation as the monetary policy<sup>22</sup>.

But the main criticism is focused on the purely theoretical aspects<sup>23</sup>. The lack of any bank in the models of the NFC was sharply criticized<sup>24</sup>. If the interest rate set by the Central Bank, should be related to the equilibrium interest rate<sup>25</sup>, then how to install the latest<sup>26</sup>. The concept of “equilibrium interest rate” was heavily criticized. The inconsistencies of the neo-wicksellien theory were disclosed<sup>27</sup>. Finally, during the period of decline, we see that inflation is in fact ineffective, as showed the experience of Japan’s “lost” decade in the 1990’s<sup>28</sup>.

Appeared need for stability and financial security led to a relative decrease in the role of NFC in the fight against inflation. The risk of deflation caused by the accumulation of debt, more than 20 years ago was marked by Hyman P. Minsky<sup>29</sup>. More recently, the chairman of the U.S. Federal Reserve said that deflation is a bigger threat than inflation<sup>30</sup>.

These criticisms have even more concern in transition economies. The role of the Central Bank here can not be reduced only to the fight against inflation. It may have the structural aspects<sup>31</sup>. Thus, focusing on the fight against

inflation, the Central Bank refused to the goal, such as the structuring of the banking sector which is not less important.

Finally, what is of particular importance for Russia is the refusing to control the exchange rate.

In fact, this aspect of monetary policy remained important since the crisis began until the end of September 2008, that is why it has attracted the attention of the Central Bank of Russia. It tried to take control of the exchange rate rather than inflation. But in this case, it certainly used poor weapons – the interest rate.

If the purpose of the Central Bank is to hold the parity of the ruble, the restoration of the exchange control would probably be much more effective.

We know that such a measure has drawn sharp criticism at the theoretical level<sup>32</sup>, and what it means to the Central Bank<sup>33</sup>. But this criticism does not seem very compelling<sup>34</sup>. Exchange control, moreover, was offered to the countries, recently joined the European Union, by an economist known for his orthodox views<sup>35</sup>. The absence of such measures also suggests a very high cost to the economy, which is estimated about 10% of GDP<sup>36</sup>.

The only alternative that remains under the full liberalization of the ERM<sup>37</sup>, is the accumulation of foreign reserves, that made the Central Bank of Russia, when its reserves were nearly \$ 600 billion just before the liquidity crisis. But there are other expenses, this time in the socio-economic development, because such a strategy involves the accumulation of money that could be invested<sup>38</sup>.

*The contradictions of the Central Bank of Russia.* Russia’s central bank has faced controversy before its policy in two directions.

<sup>20</sup> Goodhart C.A.E. (2008); Goodhart C.A.E., Tsomocos D.P. (2007).

<sup>21</sup> Papadimitriou D., Wray L.R. (2007).

<sup>22</sup> Bivens J. (2007); Artus P. (2006, 2004).

<sup>23</sup> Arestis P., Sawyer M. (2008).

<sup>24</sup> Blanchard O. (2008), Goodhart C.A.E. (2005).

<sup>25</sup> Fullwiler S.T., Allen G. (2007); Le Heron E., Carré E. (2006).

<sup>26</sup> Weber A., Lemke W. и Worms A. (2008).

<sup>27</sup> Tymoigne E. (2007), Fongenie C.A. (2005).

<sup>28</sup> Nishiyama S.I. (2003).

<sup>29</sup> Minsky H.P. (1982, 1981).

<sup>30</sup> Bernanke B.S. (2002).

<sup>31</sup> Sapir J. (2006).

<sup>32</sup> Dornbusch R. (1998).

<sup>33</sup> Sweeney R.J. (1997).

<sup>34</sup> Rodrik (1998).

<sup>35</sup> Buiter W. (2009).

<sup>36</sup> Hutchison M.N., Noy I. (2002).

<sup>37</sup> Greenspan A. (1999); Feldstein M. (1999).

<sup>38</sup> Rodrik D. (2006); Baker D., Walentin K. (2001).

Table 6. Quarterly amounts of GDP and budgetary components

	Quarterly amounts of GDP, in billions of rubles	Revenues of consolidated budget, in billions of rubles	Income in % of GDP	Expenses of consolidated budget, in billions of rubles	Expenses in % of GDP	Production balance in % of GDP
Q1 2006	5661.8	1989.5	35.1	1274.2	22.5	12.6%
Q 2	6325.8	3395.0	53.7	2707.6	42.8	10.9%
Q 3	7248.1	2227.7	30.7	1499.4	20.7	10.0%
Q 4	7545.4	3013.6	39.9	2894.0	38.4	1.6%
Q 1 2007	6747.9	2530.2	37.5	1754.7	26.0	11.5%
Q 2	7749.1	3164.0	40.8	2475.1	31.9	8.9%
Q 3	8826.6	3209.2	36.4	2491.0	28.2	8.1%
Q 4	9663.7	4464.9	46.2	4657.8	48.2	-2.0%
Q 1 2008	8891.0	3334.2	37.5	2335.9	26.3	11.2%
Q 2	10193.3	4209.5	41.3	3179.6	31.2	10.1%
Q 3	11639.5	4635.2	39.8	3226.0	27.7	12.1%
Q 4	10944.2	3825.0	35.0	5250.3	48.0	-13.0%
Q 1 2009	8482.8	3033.5	35.8	2807.1	33.1	2.7%
Q 2	9326.4	3009.2	32.3	3812.6	40.9	-8.6%
Q 3	10489.5	3512.3	33.5	3884.2	37.0	-3.5%

Source: The Central Bank of the Russian Federation, Bulletin of Banking Statistics.

First, in fact it was not able to make decisions to maintain its currency. It was forced to depart from the strategy of controlling inflation, spending massive operations in the foreign exchange market and allowing to see its real preferences.

Then, faced with exchange rate, it refused the opportunity to control the movement of capital and decided it could raise its rates for banks to face serious difficulties.

We could watch the spectacle: while the Government has allocated substantial funds to support the economy, the Central Bank led a restrictive policy. The cumulative amount of purchases and sales shows that the Central Bank sold from August 2008 to January 2009 177.5 billion dollars and 22.9 billion euros.

Nevertheless, the creditworthiness of Russia has never been questioned. The reserves, estimated in months of imports amounted to 18 months in December 2008, while in December 2007 it was 19 months. Then it reached a very high level (see figure 11).

But this seemingly positive trend also reflects a drop in imports into Russia. The fall of the latter, in principle, is a positive phenomenon, but it should be mitigated by the differ-

ence between imports of investment and consumption. The reduction of imported products consumption is obvious, but the phenomenon of import substitution by products of domestic production was much lower than during the 1998 crisis. This applies, above all, food. In particular, we see that in the field of consumer durables output decline was quite significant.

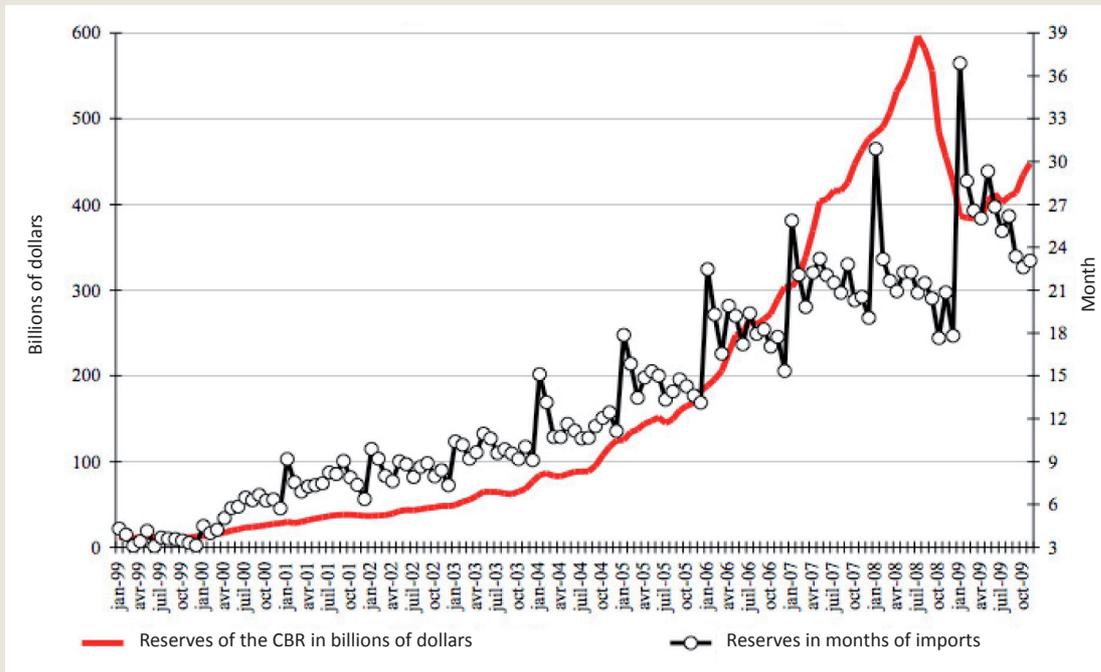
Decline has also affected capital goods, because their reduction was by 20%.

In addition to the recovery plan, which led to a significant increase in costs (from 4.8% to 9.3% of GDP), revenues also declined, as the government reduced taxes in various industries.

Thus, the budget surplus, amounting to about 11% on average for the first three quarters of 2008, was followed by a deficit of 3.2% for the first three quarters of 2009 (*tab. 6*). This indicates a clear distinction between budgetary practices in the early 2000's and especially after 2004 when Russia sought through the budget surplus to sterilize part of the revenues from exports.

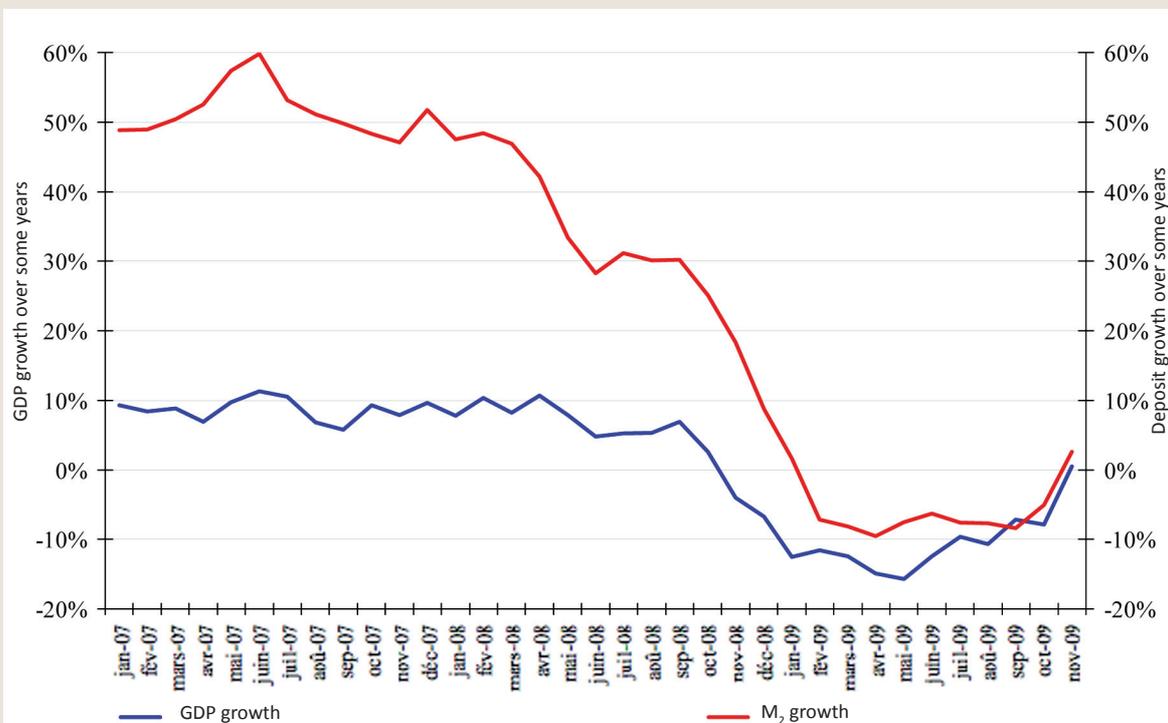
It is worth noting that Russia could and can afford a few quarters of strong fiscal deficit. Amounts that were earned and invested by the budget surplus and then allowed to establish

Figure 12. Gold and foreign currency reserves and the fill rate of imports



Source: data from the Central Bank of the Russian Federation.

Figure 13. Comparison of GDP and the liquidity



Source: data from the Central Bank of the Russian Federation.

the “Stabilization Fund” (then it was divided into “Investment Fund” and “Reserve Fund for Future Generations”) are extremely important.

But at the same time, when large financial contributions were made through the budget deficit, the Central bank and commercial banks started to reduce the funding that was as intense as the high growth for a few months before. The degree of decline, with growth over the same period last year, of 30% to the fall of -10% (*fig. 12*) shows the spontaneous process, and the volume of the measures taken by the Central Bank as well.

The measures taken by large commercial banks added to the measures of the Central Bank. The sharp decline in M2 (*fig. 13*) was the result of an absolute reduction in credit in the economy of Russia.

In the domestic market, banks have created the credit crisis, which took the form of regulation on prices and, as we have seen, quantity.

We can only guess the real meaning of such a strategy in which monetary policy is directly opposed to fiscal policy. This monetary policy has undoubtedly had an aggravating effect on the crisis, that is obvious and after the analysis of monetary policy in Western countries<sup>39</sup>, especially in the euro zone<sup>40</sup>.

But this situation reveals a deeper problem: uncertainty in the implementation of Russia's economic strategy.

#### ***4. The crisis and the development model of Russia***

In recent years, Russia is a country with huge reserves of oil and gas. It simplifies the existing situation. A variety of export products and the structure of Russian industry give the right to say that the country is not comparable with countries that live exclusively by revenues from oil and gas exports.

Nevertheless, undeniably, Russia, using the significant revenues from raw materials exports, was the victim of a particularly serious “Dutch disease”<sup>41</sup>. The situation was aggravated by the policy of the Central Bank, which in this period

liberalized the exchange rate (the transition to convertibility at the expense of capital account), while interest rates were high enough. The pressure on the structure of industry in Russia has been particularly strong.

#### ***Dutch disease and the presence of the state.***

The main reason, but not the only one, is the use of external debt by companies. Moreover, the company could expect to win on two fronts, firstly, the use of lower interest rates of foreign exchange than in rubles, and also through the effect of reducing the debt, which produced a revaluation of ruble, not only in real terms (since 2004), but also in nominal terms (since 2006)

It is this policy which was a powerful incentive to use international financial markets was aggravated by the lack of banks in Russia<sup>42</sup> and the domestic financial markets. This situation also forced Russian companies to choose models of external growth through their acquisitions outside Russia<sup>43</sup>. In this sense, Russia's vulnerability to the international financial crisis is the result of the Central bank policy.

The effects were partially compensated by the actions of the state. The latter in a rather pragmatic and empirical manner implemented industrial policy to counteract the effects of the “Dutch disease”<sup>44</sup>. Support provided by the state to manufacturing, in particular the aerospace, automotive and shipbuilding industries, certainly played a role in the revival of the purely Russian industrial economy and slowed, but did not stop the “Dutch disease”. It can be seen in the structure of capital investments (*tab. 7*). It seems that the state's share declined (from 26.8 to 21.7%). But investing is partly due to the growth of bank loans, as well as through financing companies by other companies. The total weight of public financing of enterprises changed from 33.5% in 2000 to 31.9% in 2007, the decline in this case is much less significant. Self-financing of state enterprises is only a little over 40% of the annual accumulation of fixed assets.

<sup>39</sup> Fontana G. (2009).

<sup>40</sup> Bibow J. (2009).

<sup>41</sup> Vercueil J. (2007).

<sup>42</sup> Speranskaia T. (2008, 2005).

<sup>43</sup> Durand C. (2007).

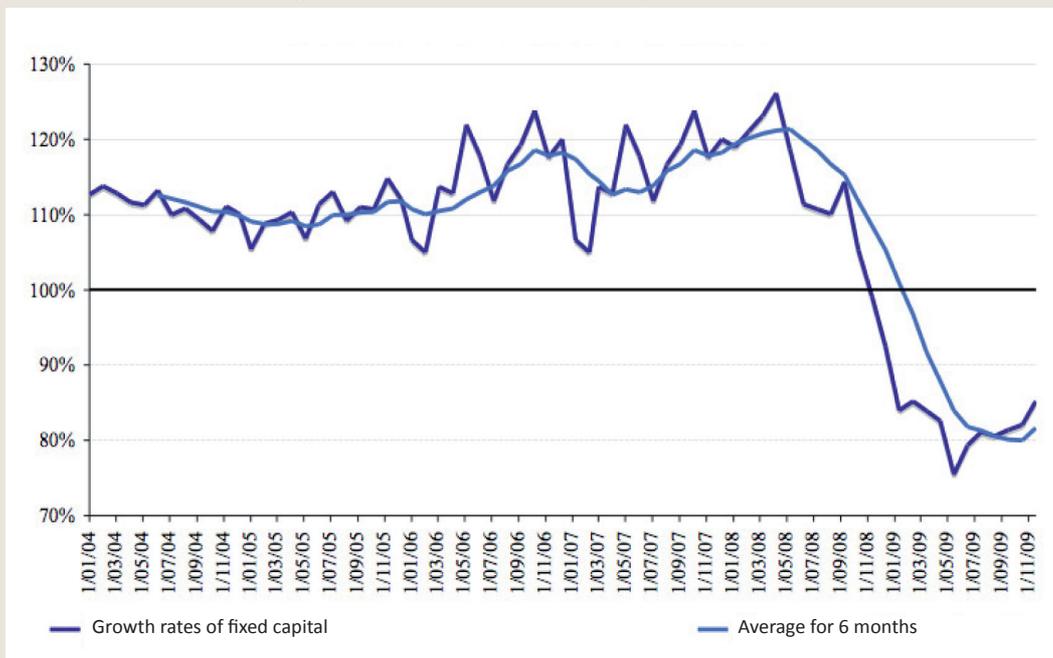
<sup>44</sup> Sapir J. (2008д).

Table 7. The distribution of investments in fixed assets, %

Index	Year of 2000	Year of 2001	Year of 2002	Year of 2003	Year of 2004	Year of 2005	Year of 2006	Year of 2007
Total investments in fixed assets	100	100	100	100	100	100	100	100
Own funds	47.5	49.4	45	45.2	45.4	44.5	42.1	41.5
Call for funds	52.5	50.6	55	54.8	54.6	55.5	57.9	58.5
Including: Bank loans	2.9	4.4	5.9	6.4	7.9	8.1	9.5	9.4
Among them: foreign banks	0.6	0.9	0.9	1.2	1.1	1	1.6	1.1
Loans of non-financial enterprises	7.2	4.9	6.5	6.8	7.3	5.9	6	6.1
Budgetary funds	22	20.4	19.9	19.6	17.9	20.4	20.2	21.2
Other state funds	4.8	2.6	2.4	0.9	0.7	0.5	0.5	0.5
Others	15.6	18.3	20.3	21.1	20.8	20.6	21.7	21.3

Source: data from the Federal State Statistics Service.

Figure 14. Investments in fixed capital in Russia



Source: data from the Federal State Statistics Service.

Such a strong state intervention in the investment process, of course, increased the share capital (fig. 14).

In the structure of fixed investment there were significant changes (tab. 8). The share of machinery and equipment has increased significantly since 2004. If it fell in 2008, it is associated with a sharp increase in residential investment (compared with 2 to 3% of GDP,

an increase of 50%), and, also with the development of federal programs on health and education (building of hospitals, schools and universities) – with an increase from 7.2 to 9.3%, or an increase of almost 30%.

Increasing the share of investment in equipment is particularly important, its share rose from 6% of GDP in 2000 to 7.5% in 2008. Even if all these investments are not relevant to the

Table 8. Investments in fixed capital

	Year of 2000	Year of 2001	Year of 2002	Year of 2003	Year of 2004	Year of 2005	Year of 2006	Year of 2007	Year of 2008
<i>In billions of rubles</i>									
Investments in fixed capital	1165.2	1504.7	1762.4	2186.4	2865.0	3611.1	4730.0	6716.2	8764.9
Including:									
Dwelling	132.0	171.5	214.5	275.8	340.8	434.3	557.2	876.3	1235.7
Other buildings	502.2	628.4	722.7	951.0	1200.9	1460.2	1935.3	2798.4	3881.9
Machinery, equipment, vehicles	426.6	527.0	663.9	811.5	1158.2	1484.0	1917.5	2612.3	3105.3
Others	104.4	177.8	161.3	148.1	165.1	232.7	319.9	429.2	541.9
<i>In percentage</i>									
Investments in fixed capital	100	100	100	100	100	100	100	100	100
Including:									
Dwelling	11.3	11.4	12.2	12.6	11.9	12.0	11.8	13.0	14.1
Other buildings	43.1	41.8	41.0	43.5	41.9	40.4	40.9	41.7	44.3
Machinery, equipment, vehicles	36.6	35.0	37.7	37.1	40.4	41.1	40.5	38.9	35.4
Others	9.0	11.8	9.1	6.8	5.8	6.5	6.8	6.4	6.2
<i>In percentage of GDP</i>									
Investments in fixed capital	16.5	16.6	16.2	16.5	16.9	16.7	17.7	20.4	21.0
Including:									
Dwelling	1.9	1.9	2.0	2.1	2.0	2.0	2.1	2.7	3.0
Other buildings	7.1	7.0	6.7	7.2	7.1	6.8	7.2	8.5	9.3
Machinery, equipment, vehicles	6.0	5.8	6.1	6.1	6.8	6.9	7.2	7.9	7.5
Others	1.5	2.0	1.5	1.1	1.0	1.1	1.2	1.3	1.3
Source: data from the Federal State Statistics Service.									

Table 9. Labour productivity growth in Russia, in %

Industry	Percentage to the previous year						Total for the period from 2003 to 2008
	Year of 2003	Year of 2004	Year of 2005	Year of 2006	Year of 2007	Year of 2008	
Labour productivity in general	107.0	106.5	105.5	107.0	107.0	105.2	144.8
Agriculture	106.0	103.6	102.5	105.0	105.5	110.9	138.3
Extractive industry	109.2	107.3	106.3	102.5	102.3	100.7	131.5
Manufacturing industry	108.8	106.3	107.1	108.1	106.5	103.7	147.9
Construction	105.3	106.9	105.9	115.6	112.8	109.1	169.6
Source: data from the Federal State Statistics Service.							

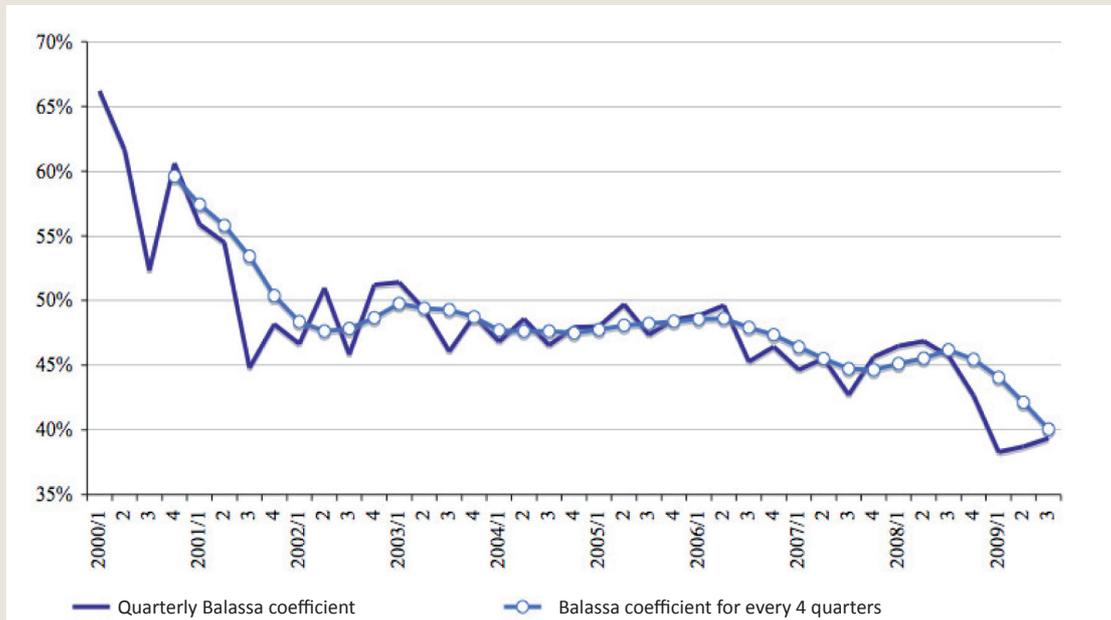
industry, it is still obvious that in 2002 – 2004 there was an urgent catch-up of mistakes of the so-called “lost decade” of the 1990-ies.

These investments have contributed to the growth of labor productivity, especially in the manufacturing industry (excluding mining), as well as in the construction sector (*tab. 9*). From this we can conclude that Russian industry has no longer relied on the capital of the Soviet period. Almost 68% of assets were created during the period from 1999 to 2008, i.e. for 9 years, and 50% in just six years – since 2003.

Investment efforts and investment structure reflect the renewal of fixed capital, which took place between 2002 and 2008, although it still remains inadequate in terms of the Russian leadership.

This policy was quite successful, judging by the relative stability and reducing of the Balassa coefficient (*fig. 15*), which is calculated on the database of foreign trade flow (imports plus exports) as a percentage of GDP. The fact that the increase in raw materials prices is accompanied by a stabilization of this indicator suggests

Figure 15. The Balassa coefficient of the Russian economy



Source: data from the Central Bank of the Russian Federation.

that the national economy grows as fast (if not more) as the volume of trade flows<sup>45</sup>.

Such a policy is largely attributed to the conditions put forward by Russia to join the World Trade Organization, in particular, the wish to see recognized customs union, which it signed with Belarus and Kazakhstan<sup>46</sup>.

*Make Russia an international financial center?*

The policies that we have just described have another aspect. It stems from the fact that the Russian government since 2008 is trying to make the country a financial leader at regional and global levels.

For the first time this topic was raised by Alexei Kudrin at a public meeting in Moscow in early 2008. Moreover, such projects have already been discussed by experts in the summer of 2007. It is clear that Russia is concerned about the value of their assets, which are partly in dollars and partly in euros. Due to the fact that these currencies have been the subject to sharp fluctuations, Russia wants to use a more stable standard of value.

<sup>45</sup> Fig. 14 shows reduction of this factor, but it is more typical for the revaluation of the nominal exchange rate.

<sup>46</sup> RIA-News (2009)

In the spring of 2009, Russia formally proposed to amend the special eligibility for currency in dollars and to reform the IMF. On these proposals, Russia received support from China<sup>47</sup>. China's position was noticed by financial operators<sup>48</sup>. Two countries that have amassed large amounts of foreign exchange reserves (about 440 billion dollars in Russia and more than 1.9 trillion in China) are not willing the international reserve currency to belong to one country.

The idea of creation a regional reserve currency from ruble seems very attractive.

The superiority of Russia over its closest neighbors, as well as on the "new entrants" of the European Union was noticed by operators in the financial market<sup>49</sup>. This is undoubtedly a source of satisfaction in Moscow, and strengthens the belief of some Russian politicians that the country is a financial center, if not global, then at least at the regional level.

To this we must add the importance of remittances from Russia, including those from migrant workers in neighboring countries.

<sup>47</sup> RIA-News (2009).

<sup>48</sup> Yamping L. (2009); Stanton E. (2009).

<sup>49</sup> Cochrane L. (2009).

Table 10. Remittances made by citizens from Russia in 2008

Country	Amount in billions of USD	In %
Uzbekistan	2.978	22
Tajikistan	2.516	18
Ukraine	1.690	12
Armenia	1.249	9
Kyrgyzstan	1.157	8
Moldova	1.114	8
Azerbaijan	0.887	6
Georgia	0.683	5
China	0.473	3
Kazakhstan	0.187	1
Others	0.772	6
Total	13.707	

Source: data from the Central Bank of the Russian Federation.

The data in *table 10* show the figures recorded by various mechanisms of transferring money. They include data on the cash amounts and the cost of consumer goods bought in Russia for sale to local markets<sup>50</sup>.

The impact on the economies of neighboring countries is considerable, and this supports the idea that Russia's influence over its neighbors is much greater than simple trade relations<sup>51</sup>, and that ruble could become a regional reserve currency, at least in some CIS countries. The current uncertainty, which affects both the dollar and the euro, can only strengthen the faith of the Russian authorities in this.

It can be concluded that the relative stabilization of the exchange rate, which was observed before the crisis, had a positive impact on the economy of Russia. These results, however, at least with respect to the stabilization of the ruble could be achieved in different ways, not necessarily in conflict with long-term capital movements.

In fact, regardless of the impact of current monetary policy to financial markets, it is possible to prejudice its effectiveness in the long run, though uncertainty exists about its effect on growth rate and the interior life.

<sup>50</sup> Experts of the CBR estimate the non-counted flows from 60 to 100% of the counted flows.

<sup>51</sup> Alturki F., Espinosa-Bowen J., Ilahi N. (2009).

From this perspective, the contradiction between the policy of focusing on internal operations, and Russia's desire to build an international financial power, it seems, has paralyzed the government during the crisis in 2008 – 2009 period.

In this sense, Russia alone has involved itself in crisis. And one of the main reasons was the significant reduction in lending from late 2008 until the fall of 2009. Although the Central Bank played its role, providing daily liquidity to some banks, this was done in the context of rising interest rates. In addition, the lack of structure of the interbank market has led to a significant reduction in the positive impact of these measures. Taking into account the fact that the Central Bank supervises other banks, we can conclude that its passive actions in the organization of the interbank market and ineffective response as well to the reduction in lending by banks only increased its responsibility of the process of reducing lending. The presence of conflicting objectives in the economic strategy as well as the government's failure to prioritize has led to these consequences.

Russia has experienced a year of economic recession, largely related to external causes, but which is partly the result of internal causes. The country will get out of the crisis as easy and fast as it manages to combine their financial ambitions with the logic of internal development.

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