

Challenges of Post-Crisis Economic Policy in Russia

By Sergey Drobyshvsky

The 2008-2009 global financial crisis hit Russia's economy harder than many other emerging markets. Russia turned out to be an "outlier" within the BRIC countries for several reasons. First, Russia's substantial raw materials sector depended heavily on shifting price dynamics within world commodity markets. Second, the Russian economy had experienced cyclical overheating in the form of growing economic imbalances and asset bubbles. Third, Russia's investment and business climate suffered from a lack of institutional reform. Fourth, while Russia's state sector was growing in size and influence, the quality of public sector management as well as public confidence (in both the rouble and the state's economic policies) was deteriorating. Finally, like many other former Soviet economies, including the Baltic States and Kazakhstan, both Russian companies and state banks borrowed heavily abroad. All of these factors assumed the depth, scale and dramatic effects during autumn 2008 and early 2009. However, as early as the first half of 2009, the situation in both Russia's real and financial sector stabilized. This leaves several questions to be analyzed in further detail. One, what are Russia's current economic policy challenges? And two, what are the problems and constraints of post-crisis development?

"Unexpected" Revival

At the start of 2009, prospects for the Russian economy were pessimistic. Economists and analysts predicted a further devaluation of the rouble against the bi-currency (US dollar and euro) basket, substantial (up to 10%) fall in real GDP, a large-scale banking crisis generated by an increase in non-performing loans (NPL), crash in the real estate market and loss of control over the federal budget deficit.

Despite the negative forecasts, the situation stabilized rather quickly. First, the Central Bank of Russia (CBR) managed to stabilize the foreign exchange market. A moderate tightening of monetary policy, which included abandonment of new unsecured loans to commercial banks, turned out to be sufficient enough to stop attacks against the rouble. In addition, an increase in world oil and metals prices resulted in the nominal appreciation of the rouble in February 2009, supplying the domestic market

with additional foreign currency.

The real sector declined during the entire first half of 2009 (the average quarter rate of real GDP growth was about negative 10%), but in the summer of 2009 the trend reversed. Initially the situation in the raw materials sector became stable (though below pre-crisis levels), after companies producing for the domestic market found they had lower stocks of goods and increased their production in order to compensate. Higher prices for hydrocarbons on the world market just added to the growth of real output. In fact, many industries showed up to 10% growth (in annual terms) to match higher aggregate demand.

The situation in the banking sector calmed down as well, especially as predictions of a "second banking crisis wave" did not come to fruition. The most probable reason for why it was avoided was the improved financial position of many companies and the growing savings rate among Russia's population. Both provided banks with new resources and opportunities to restructure NPLs without the risk of losing liquidity. It is also important to note that Russia's banking sector was the only one (in 2009) to pay its foreign debts. According to CBR data, the banking sector's external debt fell from \$166 billion to \$125 billion, while the external debt of firms within the real sector grew from \$281 billion to \$300 billion.

The state of the federal budget also turned out to be better than expected. The 2009 federal budget deficit did not exceed 7% of GDP due to higher than expected oil export revenues and lower government expenditures within its anti-crisis package (e.g., the Government "saved" about 1% of GDP allocated for supporting the banking system).

Therefore, thanks to an increase in oil prices and no evident economic policy missteps on the part of the government or monetary authorities, the Russian economy began its exit from crisis, as early as May/June 2009. This was a surprise for both experts and authorities in the Russian Federation.

Exit strategy "Russian style"

The factors and features of Russia's economic recovery influenced its exit strategy. It could be characterized by the following:

1. No public presentation and discussion of the exit strategy
2. No explicit coordination of exit policies between the Government and the CBR
3. Conservative fiscal and monetary policies
4. Generous social welfare policies
5. Primary focus of recovery rested on the market, without active participation of the state.

Therefore, one could say that the actual exit strategy chosen by the Russian authorities lacked any specific strategy or task-oriented exit policy. The government tried to avoid mistakes and missteps which could negatively affect economic recovery. Instead they looked for recovery in the world oil markets, renewed confidence among foreign investors and the “invisible hand”. The only major step taken to stimulate domestic demand was a sharp (up to 40%) increase in pensions and indexation of salaries in the public sector. This kept the population’s real income stable, with the majority of additional income saved, not spent.

Unresolved problems

While the Russian government reviews the self-supporting recovery of the Russian economy, the fundamental problems affecting economic development are still in place (most of them – existing prior to the crisis), with progress yet to be seen. The main problems include:

1. Lack of labour market adjustment mechanisms. During the crisis, Russian companies preferred not to fire workers (partly – because of government pressure). However, they did cut wages, declined to pay salaries, or sent workers on unpaid leave. The economic rationale for these policies was a growing deficit of qualified labor. Specifically, firms were afraid that after firing people they would fail to hire new staff with similar qualification, due to shortages in the market. At the same time labor hoarding impedes productivity and efficiency of Russian companies.
2. Unsolved problem of mono-cities (one company or one plant towns) and failure to restructure old Soviet era industrial centres. One example is Avto VAZ. It is high time the biggest Russian car producer either modernized or found a foreign owner. However, due to social sensitivities surrounding potential employment cuts, this solution has been postponed.
3. Anti-crisis policies crowded out institutional reforms and measures aimed at improving Russia’s investment and business climate such as reforming law enforcement and the judicial system, fighting corruption, protecting investor rights, increasing the quality of public management and the efficiency of public finances, reforming the military, etc. The national political cycle (which left less than two years until both State Duma and Presidential elections) also decreased chances that reforms would go forward.
4. Lack of progress in forming strong national financial and banking systems. The financial market in Russia remains small relative to the economy, thus, it pushes the largest and most ambitious Russian companies to borrow money abroad. The fact that the Russian banking system escaped a systemic crisis cannot provide a financial basis for a new stage of economic growth due to its internal structure (low capitalization, plenty of tiny banks).
5. Growing problems within the pension system. The Russian pension system is not able to secure retired people decent pensions because of its financial structure (mostly because it is a re-distributive system with a small funded component) and low retirement age. The Russian government saw that the only solution was to increase transfers from the federal budget to the Pension Fund, which increased the budget deficit.
6. Continuing imbalances in the real estate market. During the crisis the real estate market in Russia demonstrated an amazing lack of price flexibility. For instance, the Russian stock market fell, the rouble devaluated by 30% in nominal terms and new construction was cut by 40%. However, housing prices in big cities decreased by 20% at most while rental rates in the commercial sector were reduced by 30-40%. Hence, housing in Russia is unattainable for a majority of the population. The “bubble” is still in place because developers and building companies form a fictitious shortage of housing, keeping prices and profitability high with implicit approval by city authorities

Nowadays Russia finds itself in a rather difficult situation. It faces the risk of losing previous gains brought on by the period of rapid economic growth. It also suffers from a lack of political will to conduct difficult institutional reforms. The Russian government’s inability to implement solutions to its most critical problems and postponement of badly needed reforms, will continue to preserve the dominant role of its raw materials sector, despite popular slogans about the need for modernization, economic diversification and shift towards more innovative development paths.

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