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RUSSIA AND THE FINANCIAL CRISIS

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Analysis

The Impact of the Global Financial Crisis on Russia

Peter Rutland, Middletown, CT

Abstract

Russia's rosy economic development outlook has been thrown into question by the global financial crisis. The stock market has lost about 60 percent of its value. So far only two banks have fallen into bankruptcy, but industry has suffered from the twin problems of the slump in global commodity markets and the credit crunch. In the short term, the crisis may help Russia reintegrate into the international community following its invasion of Georgia, but in the long term, its fate depends heavily on the price of oil.

Commodities Connect Russia to Global Market

For the first few weeks, as the financial crisis unfolded in the United States and metastasized around the globe, the Russian reaction was rather calm. Only a small fraction of Russians, less than two percent of the population, personally hold shares or mortgages – in sharp contrast to the situation in the US, where a majority of the population could see the impact of the crisis on their pension fund, or on house prices in their neighborhood. As late as mid-September, a poll reported in *Ekspert* magazine found only 42 percent of Russian respondents felt that a crisis was coming.

The government, for its part, was also confident that the crisis was a "made in the USA" problem. All Russians remember the devastating impact of the 1998 financial meltdown, which led to a default on foreign debts, a 75 percent depreciation of the ruble, the collapse of most private banks and the loss of personal savings therein. But the situation in 2008 looked vastly different. Sitting on $560 billion of hard currency reserves, with low foreign debts and a huge current account surplus, the Russian Central Bank was confident that it could meet Russia's obligations and defend the ruble at its preferred rate of 24–25 to the dollar. Regulation of the banking system had been tightened since the 1998 crash, and the majority of personal deposits were secure in the state-owned Sberbank. More broadly, GDP had been growing at 7 percent a year for the past eight years, and living standards had been rising at an even faster rate. The future looked bright.

However, while Russia was insulated from the impact of the US financial crisis in some respects, it was dangerously vulnerable in others. It had less domestic exposure – but high international exposure, and limited institutional depth to cope. The Russian stock market (RTS) had been weakening over the summer well before the US crisis hit. In the two months after 18 May, the US stock market fell by 11.5 percent, and the Russian market by 13.1 percent. Then in the next two months, the RTS crumpled by 51.8 percent, while the US fell only 8.5 percent. Various factors combined to drag down the Russian stock market – the messy fight for control over TNK-BP; the outbreak of fighting in Georgia on August 8; and a tiff over the steel-producer Mechel. (On July 24 Putin casually accused the company of price-gouging, causing its stock to fall by one third.)

But the main factor was the plunging price of commodities – the backbone of Russia's export-led growth – due to the global economic slowdown. Oil fell from a peak of $147 in July to $86 by October 10. (These are prices for West Texas Intermediate.) Metals prices have also fallen considerably since the start of the year. The last time the world oil price fell by half was 1998, and prior to that 1986 – both of which triggered devastating political consequences in Moscow.

As US stocks plummeted, international investors cashed out their Russian holdings – which accounted for about half the Russian stock market – in a bid to generate cash and cover their obligations. Foreigners have now pulled $74 billion out of the market, and both the dollar-denominated RTS and ruble MICEX have fallen by more than 60 percent – while the US markets have fallen about 50 percent. Bloomberg rates RTS as the sixth worst performing out of the 88 stock indices it tracks. The Federal Financial Markets Service (FSFR) introduced a blanket ban on short-selling – one of the few countries to introduce a blanket ban (most limited the prohibition to financial companies). But this did nothing to stem the slide.

After Russian shares fell 20 percent on September 16, the exchanges were closed for two days, during which a $130 billion rescue package was assembled. The Central Bank and finance ministry would intervene to buy shares in Russian companies and strengthen bank balance sheets. The Central Bank and National Welfare Fund would loan the equivalent of $36.1 billion to Sberbank, VTB (formerly Vneshtorgbank) and VEB (Development Bank) at 7 percent interest for five years (later raised to ten). They in turn were to lend the

money to banks and companies. *Ekspert* has estimated the total value of the rescue package at 3 trillion rubles, or 10 percent of GDP.

The market recovered 25 percent when it reopened on Friday September 19, but fell again the next week as a number of bank failures in Europe deepened the global crisis. On October 6 oil fell below $90 a barrel, and the RTS and Micex fell 19 percent on Monday October 7, leading to another two-day market closure. (Like the Asian markets, the Russians failed to enjoy a bounce after the US House of Representatives approved its $700 billion bailout.) On October 3 the State Duma introduced a bill authorizing a rescue package, which passed its second and third reading on October 10. The bill also raises the state guarantee on personal bank deposits to cover the first 700,000 rubles ($26,800, up from 400,000). There is no sign of organized political opposition to the government's actions, as even the Communist Party has refrained from criticism.

The bailout deal included an immediate cut in oil export tariffs, worth 140 billion rubles for oil producers. Still, on September 24 four Russian oil companies sent a letter to Putin, complaining that they hold $80 billion in foreign loans and asking for low-interest loans from the state to enable them to continue investment projects. It's hard to feel sorry for the oil barons, though. On October 10 TNK-BP paid out all of its first half year's profits, some $2 billion, in dividends. Surgutneftgaz, flush with $20 billion cash, did not sign the letter. Russian oil stocks have fallen by more than 60 percent, in contrast BP stock fell 38 percent since the start of 2008, and Exxon Mobil by only 17 percent (as of October 6). The total value of all Russian oil companies on October 6 was $128 billion – while Brazil's Petrobras alone was valued at $135 billion.

The nominal exchange rate against the dollar fell 3.2 percent in August and 4.5 percent in September, standing at 26.2 to the dollar on October 10. But the Central Bank spent $16.7 billion defending the ruble in the week ending October 3, leaving the total hard currency reserves at $546 billion, down from a peak of $596 billion on July 31.

The government has been able to hold the ruble steady and to prevent a rash of bank collapses. But it has not been able to stabilize the stock market: it has been pouring money into a bucket without a bottom.

Sectoral impact

So far only two banks have fallen into bankruptcy. Svyaz-bank was taken over by the state-owned Vneshekonombank, and after several weeks of rumors on October 8 it was announced that the investment bank KIT-Finans was being taken over by Alrosa and the Russian Railways for a nominal 100 rubles. In both cases the government took over their liabilities – which amounted to $6 billion in the case of KIT-Finans, including $1 billion lent to it by Gazprombank in September. It seems that KIT-Finans was handed over to Russian Railways simply because the giant state corporation wanted its own bank. There is clearly a danger that most of the bailout package will be channeled to well-connected state corporations, keen to strengthen their holdings. Such fears were expressed in an open letter published by Aleksandr Shokhin, the president of the Russian Union of Industrialists and Entrepreneurs, on October 9 ("An Appeal to the Country's Leadership"). He warned that an ongoing bailout could drain the Stabilization Fund (which now stands at $143 billion) in two years, with no discernable impact on the country's economic development. On October 10 Standard & Poor's lowered the rating of 13 Russian private banks from stable to negative, including Alfa Bank and Troika Dialog. People have been pulling money out of private banks and putting it into state-owned banks like VTB-24, which saw deposits jump from the equivalent of approximately $494 million to more than $8 billion. Some private banks, such as Renaissance and Standart, introduced limits on cash advances.

The industrial sectors affected by the crisis can be divided into two groups. First, there are those suffering from the slump in global commodity markets. Second, there are those who were exposed to the credit crunch – notably, construction and retailing.

The metals sector's output is expected to contract by 20 percent during the fourth quarter, and some companies (such as Magnitka) have already put workers on short-time. Steel-makers in China and India are facing similar cut-backs. Export markets are no longer profitable and Russian customers cannot afford to pay. The market capitalization of the top six firms (Norilsk Nickel, Evraz, NLMK, Severstal, Mechel and Magnitka) has fallen by 75 percent this year, from a combined total of $170 billion to $40 billion.

Construction and retail firms have been leading Russia's domestic economic growth, and were borrowing heavily to expand. With interest rates jumping from 12 percent to 20–25 percent in a matter of weeks, they immediately began delaying or cancelling new projects. On October 10 Sberbank and VTB agreed to provide loans to nine retail chains at 15–18 percent interest. Priority will be given to firms with a debt/cashflow (EBITDA) ratio of three to one or less. Although a slump in con-

struction and retailing will affect GDP growth, labor economist Vladimir Gimpelson argues that adjustment will come through wage cuts and not layoffs, so it is unlikely that we will see an increase in the current reported unemployment rate of around 6 percent.

Among manufacturing industries, the hardest hit is likely to be auto sales – a big ticket item for consumers. Auto sales across Europe fell by one quarter in September. Inside Russia, sales of domestic brands such as Ladas have slumped 40 percent in the past two months, but half of the foreign brands did not experience a decline in sales, in part because they have been discounting heavily. Some auto producers have cut hours or temporarily closed production lines, including truck manufacturer Kamaz, hit by the construction freeze. Daimler may be having second thoughts about its plan to buy 42 percent of Kamaz.

Even firms with substantial cash flows were not immune if they had borrowed heavily to finance acquisitions. For example, Gazprom needs 400 million euros to buy Serbia's NIS; Lukoil $2.1 billion to buy the Italian ISAB refinery and $555 million for the Turkish distribution company Akret. The total value of foreign debt owed by banks and corporations is around $440 billion, with $48 billion falling due over the next four months (and another $115 billion next year). Such loans were often granted using company stock as collateral. Plunging share prices led lenders to issue margin calls – requiring the borrowers to increase their collateral. The primary case in point is leading oligarch Oleg Deripaska. In April Deripaska agreed to buy 25 percent of Norilsk Nickel from Mikhail Prokhorov for $13 billion, with the help of a $4.5 billion loan. By October the entire market capitalization of Norilsk had fallen below $12 billion (though the company did book first-half profits of $2.6 billion on revenue of $8.31 billion). Scrambling to meet his payment schedule, Deripaska sold a $1.4 billion stake in Canadian auto parts maker Magna and his 10 percent stake in the German construction firm Hochtief. The combined assets of the 25 top oligarchs on Forbes magazine's billionaires list are estimated to have shrunk by 62 percent, or $230 billion, between May and October.

Implications

The financial crisis may actually help Russia's re-entry into the international community after its ostracism following the Georgian war. One unexpected example was Iceland's appeal to Russia for a 4 billion Euro loan to avoid national bankruptcy. President Dmitry Medvedev has tried to make common cause with the Europeans in blaming the US for the crisis. In his speech to the World Policy Forum in Evian, France on October 8, he said that the crisis was caused "by the economic egoism of certain countries," and was "a consequence of the unipolar vision of the world and of the desire to be its megaregulator." He added that "Globalization must be accompanied by an increased role of states as guarantors of successful national development." At the same time, on October 10 Medvedev argued that "Europe understands that today no economic problems of a global order can be solved without Russia's participation, just as the global nature of the economy precludes Russia from resolving all the problems associated with the crisis in financial markets alone." Russia was excluded from the G7 finance ministers meeting in Washington on October 11 – that failed to come up with a plan – though it was included in the simultaneous consultations with G20 countries.

What of the long-term prospects? The main source of concern in the medium to long term is of course oil. Oil alone accounts for one third of Russian government revenues and 60 percent of export earnings. The budget is projected out three years ahead, based on a conservative price estimate of $70 a barrel. However, rising costs of production mean that some of the new fields may simply not be profitable at $70 a barrel. Some of those production costs – such as steel pipe – are now coming down thanks to the crisis. But the cost of capital has gone up. Compounding the problem is the fact that sluggish investment over the past decade has led to a slowdown in oil output. In the first half of 2008 Russia saw a decline in oil production of 0.8 percent and volume of oil exports by 5.2 percent. Finance Minister Aleksei Kudrin openly mused that Russian oil output may have reached its historic high (know as "Hubbert's peak"). These negative trends in oil output volume and price may erode the current account surplus, which was still a healthy $64 billion in the first half of 2008.

There are several reasons for believing that the Untied States is better placed than Russia to ride out the crisis – notwithstanding the fact that the crisis is of the US's own making. First there is the oil factor – lower prices for oil and other commodities ease the US trade deficit and bring immediate and visible relief to US consumers. Second, given the role of the dollar as the main global currency, and the credibility of the US government, there has paradoxically been a flight of frightened investors into US treasury bonds, and a strengthening of the dollar. In the long term, once the fear subsides, it may be replaced by greed – and a search for higher returns outside the US.

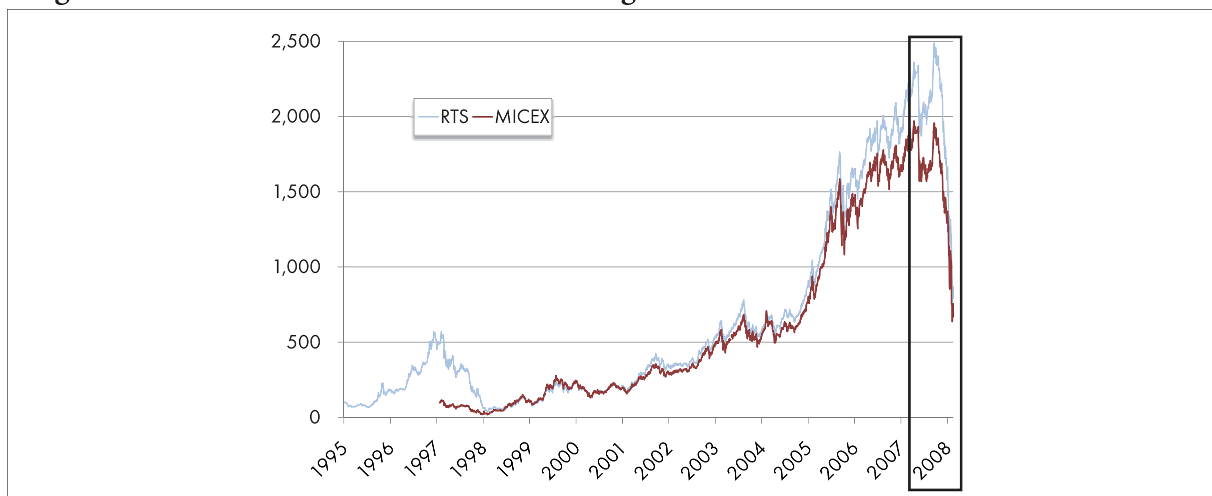
Third, there is the political dimension. The legitimacy of the US political system is not on the line, and the upcoming wave of elections will produce a new set of leaders. In Russia, however, the political system is ossified, and discontented citizens have few options other than taking to the streets. There have already been some unconfirmed reports of panic buying of consumer staples ("salt and matches"). The crisis will clearly increase an already excessively high level of state control of the Russian economy, which bodes ill for efficiency, growth and the battle with corruption. With wildly gyrating asset values, and vast flows of rescue cash, one can expect a fresh round of turf wars between newly-empowered banking corporations on one side and the old stalwarts like Gazprom, Rosneft and Russian Railways on the other.

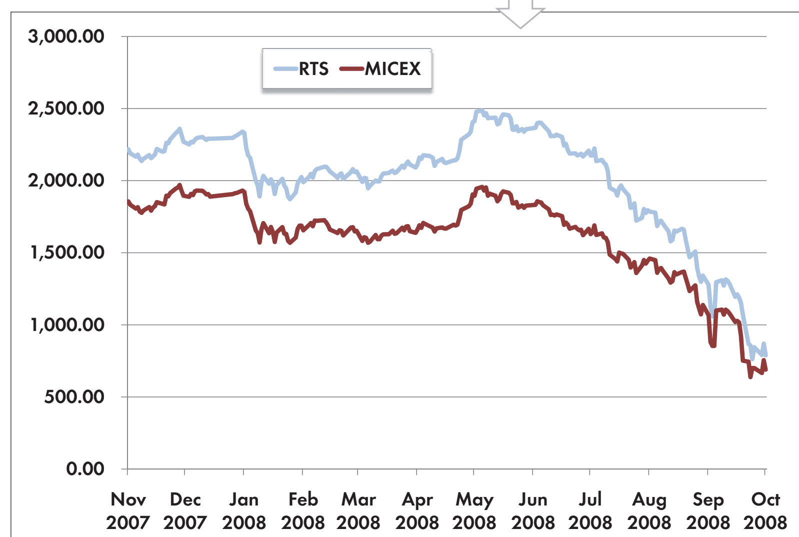
About the author:
Peter Rutland is Professor of Government at Wesleyan University.

Statistics

Financial Indicators

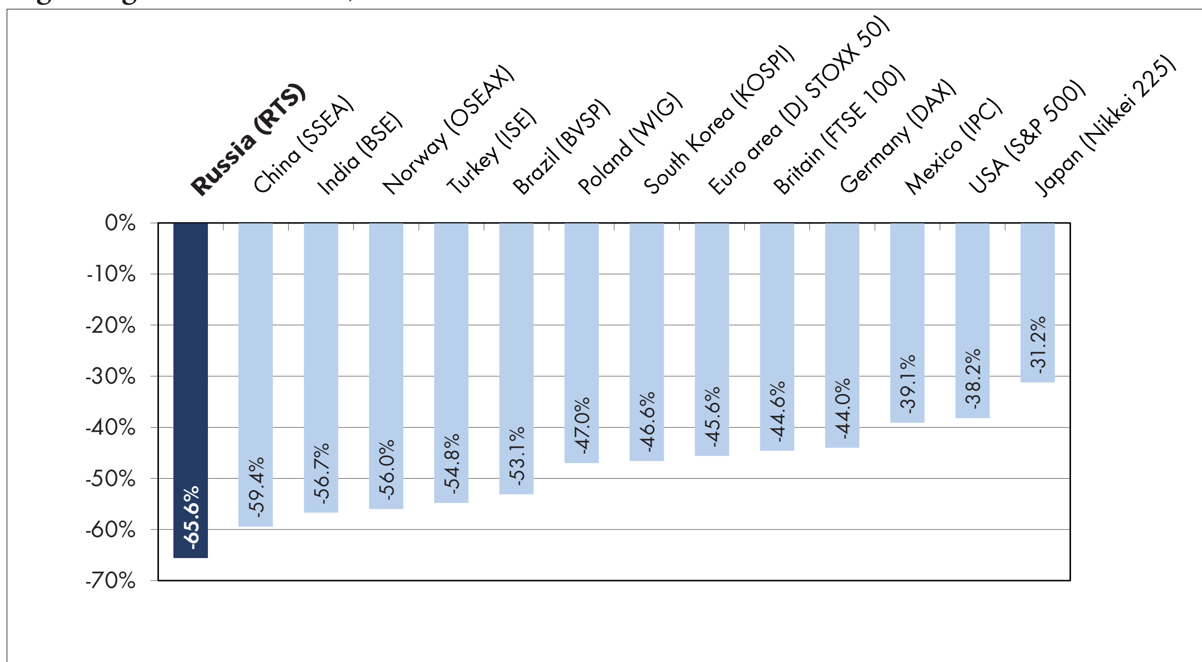
Diagram 1: Indices of the Russian Stock Exchanges 1995–2008





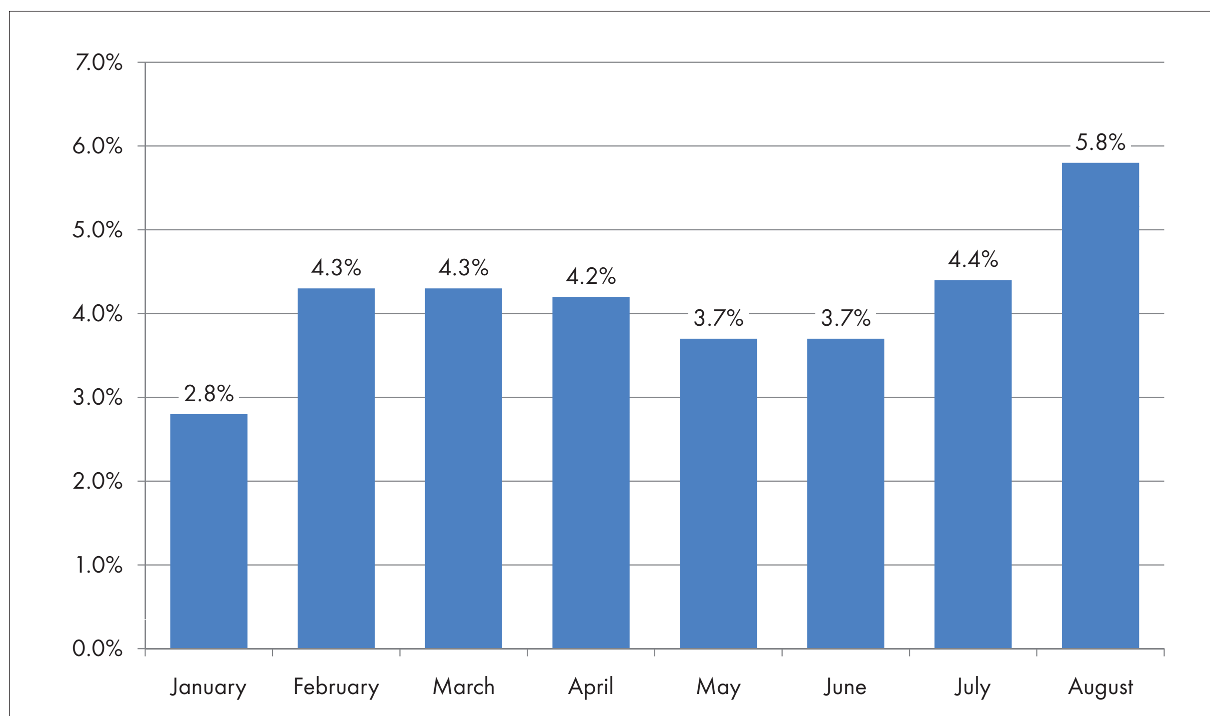
Sources: http://www.rts.ru/ru/index/stat/dailyhistory.html?code=RTSI *and* http://www.micex.ru/stockindices/data/

Diagram 2: The Russian Stock Exchange in a World-Wide Comparison (Change since Beginning of the Year in %)



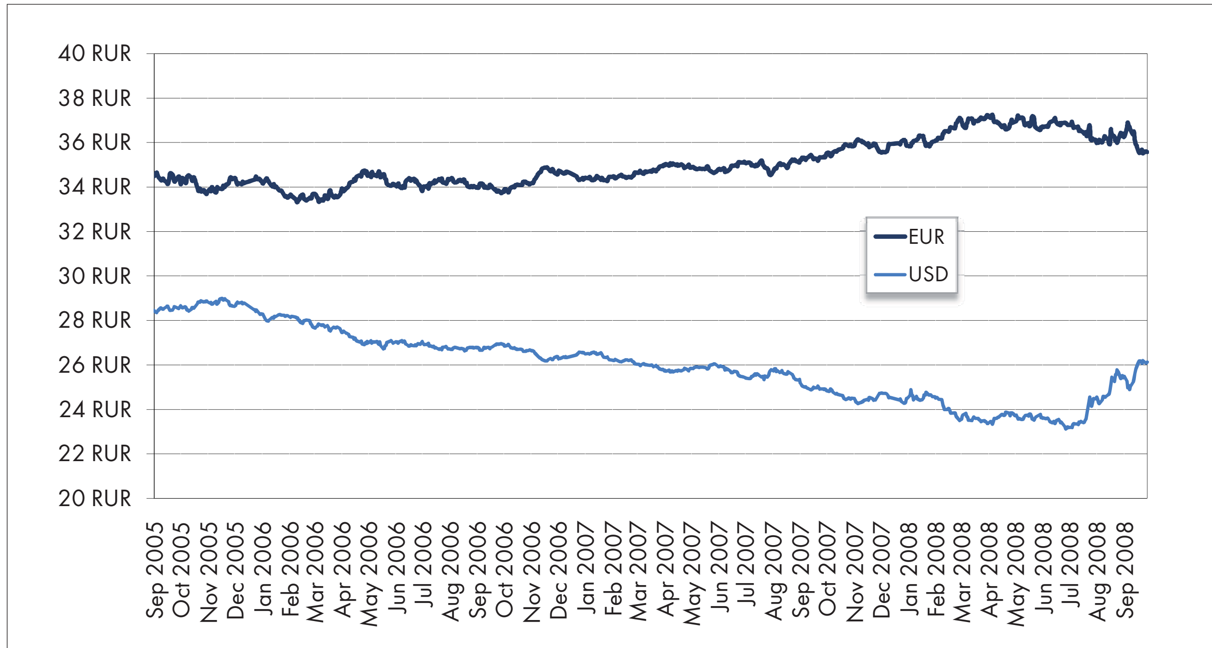
Source: The Economist, 16 October 2008

Diagram 3: Russian Interbank Call Money Rates 2008



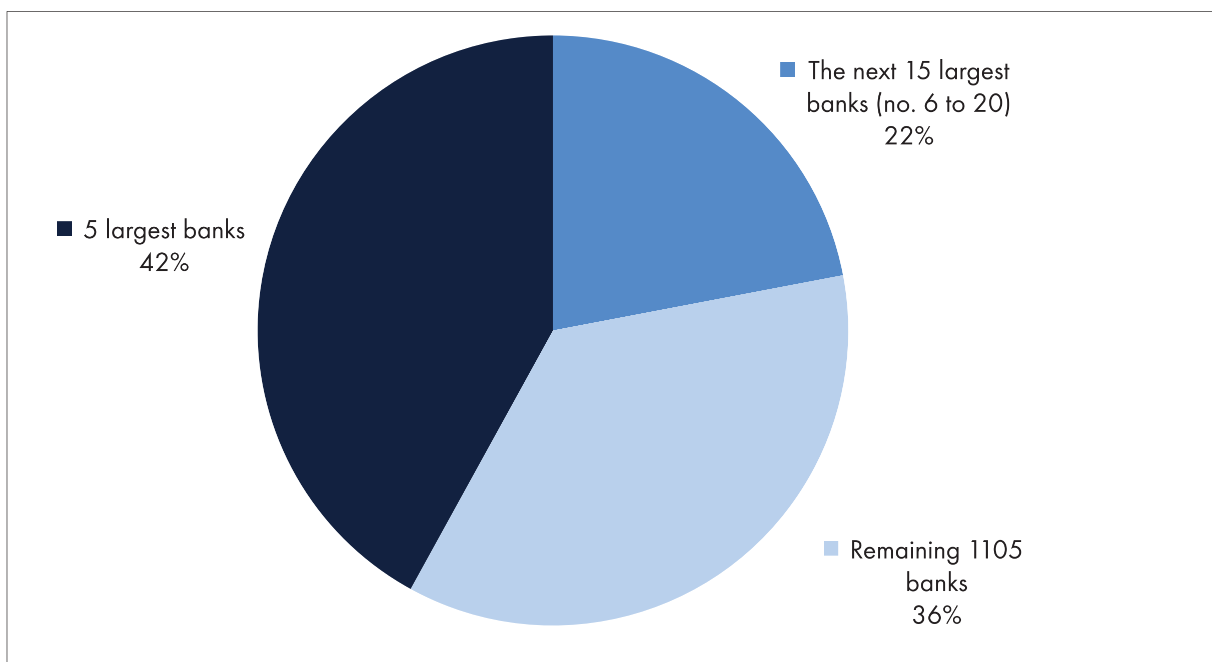
Source: Central Bank of the Russian Federation,
http://www.cbr.ru/statistics/print.aspx?file=credit_statistics/interest_rates_08.htm&pid=cdps&sid=svodProcStav

Diagram 4: The Exchange Rate of the Ruble to US-Dollar and Euro 2005–2008



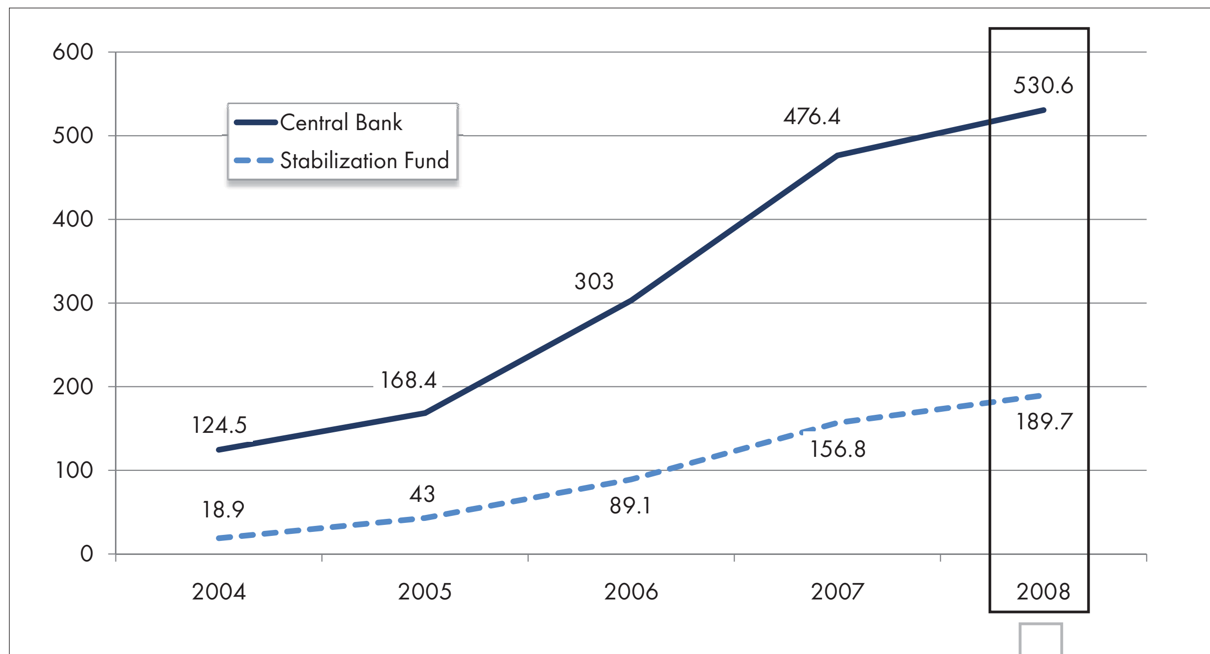
Source: Central Bank of the Russian Federation, http://www.cbr.ru/currency_base/dynamics.asp

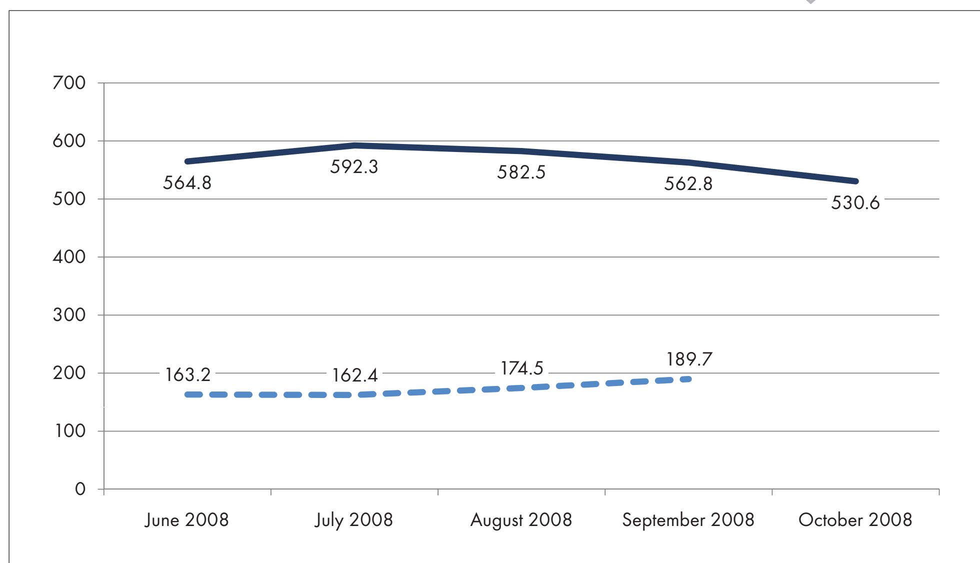
Diagram 5: Distribution of Assets of the Banking Sector (1 September 2008)



Source: Central Bank of the Russian Federation, http://www.cbr.ru/analytics/bank_system/obs_ex.pdf

Diagram 6: Foreign Currency Reserves of the Russian Central Bank and Assets of the State Stabilization Fund (in bln. US dollars)



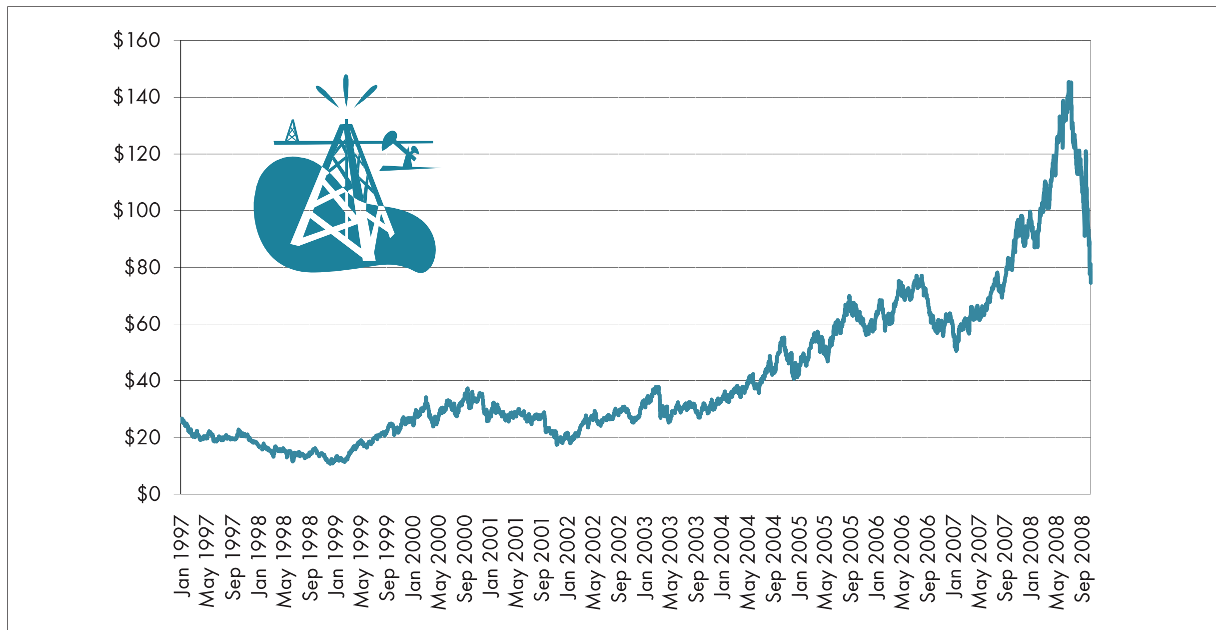


Note: Stabilization Fund: since 2008 Reserve Fund and National Wealth Fund.
Sources: Central Bank of Russia, http://www.cbr.ru/Eng/statistics/credit_statistics/print.asp?file=inter_res_08_e.htm#week*;*
Russian Ministry of Finance, http://www.minfin.ru/en/

Statistics

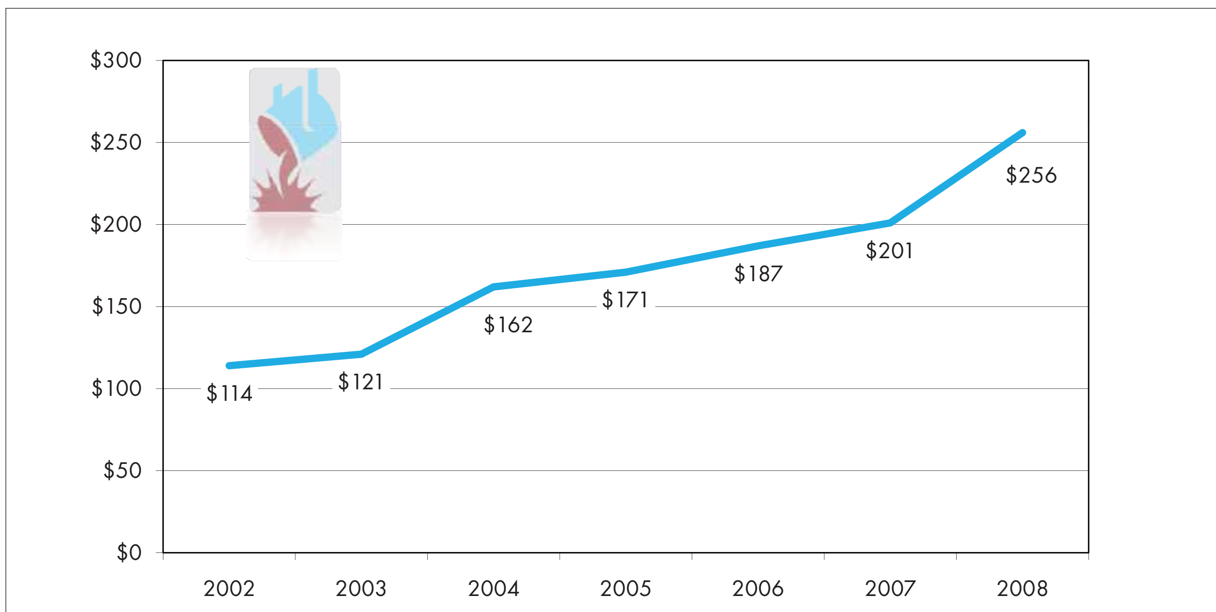
World Commodity Prices

Diagram 1: Crude Oil Price 1997–2008 (US dollars, NYMEX Light Sweet Crude, Contract 1)



Source: http://www.eia.doe.gov/emeu/international/prices.html#Crude*, 16 October 2008; Source: Reuters News Service as reported in EIA, Weekly Petroleum Status Report, Table 16*

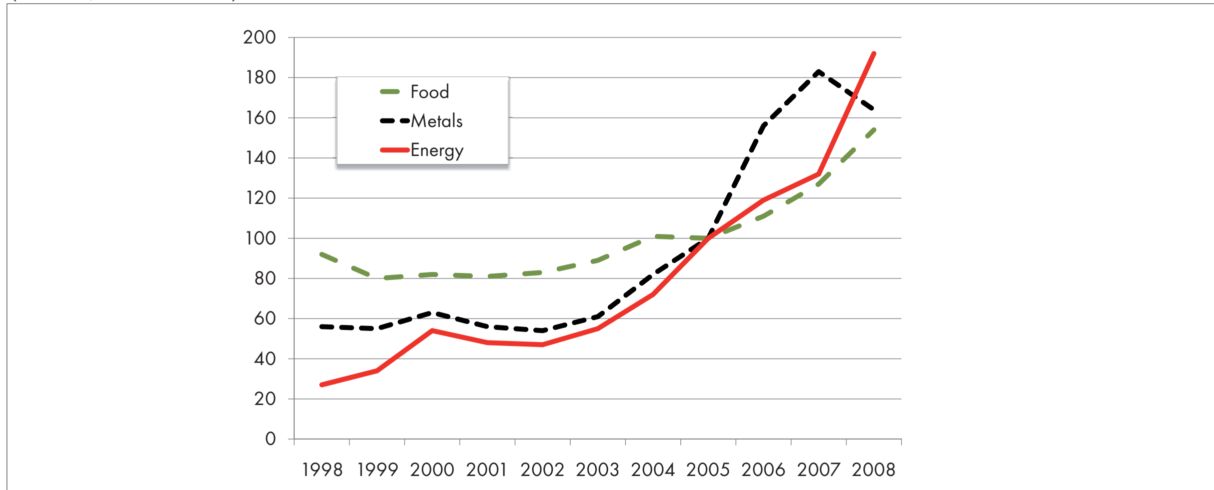
Diagram 2: World Market Price of Steel 2002–2007 (in US-Dollar/t)



Note: value for 2008 is for the period January to August.

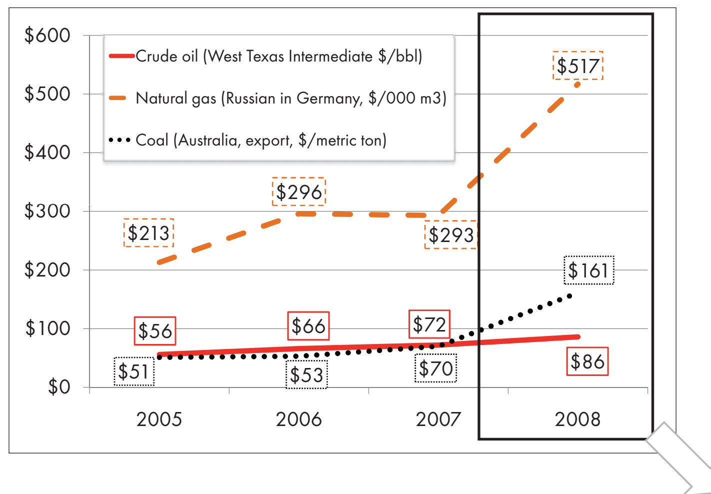
Source: Price Indicator WPU101 (Iron and Steel), US Bureau of Labor Statistics, http://www.bls.gov/ro3/ppi_metals.pdf

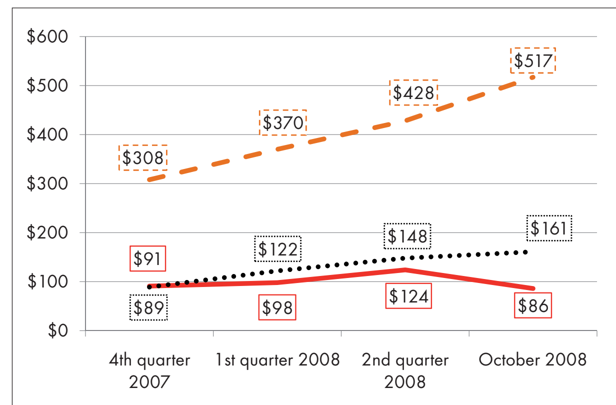
Diagram 3: World Market Prices for Important Commodity Groups 1998 – 2008 (Index, 2005=100)



Note: value for 2008 is for September
Source: IMF, http://www.imf.org/external/np/res/commod/table1a.pdf

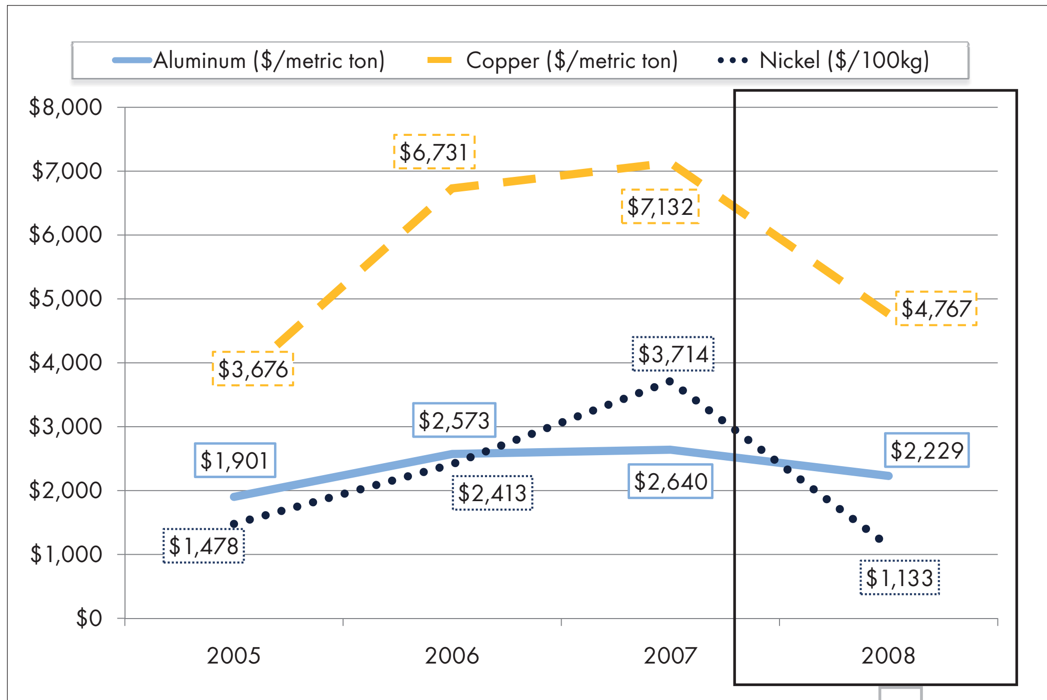
Diagram 4: World Market Prices for Fossil Fuels 2005–2008

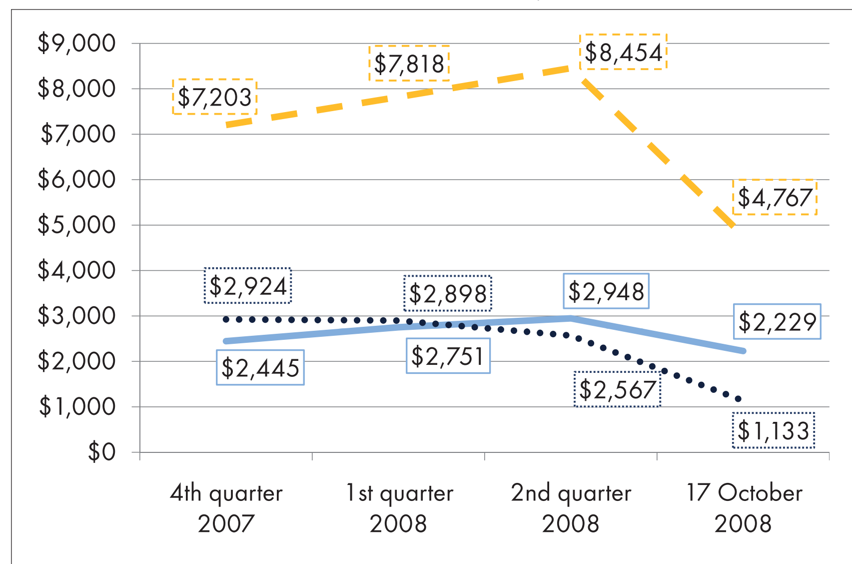




Source: IMF, http://www.imf.org/external/np/res/commod/table3.pdf

Diagram 5: World Market Prices for Metals 2005–08



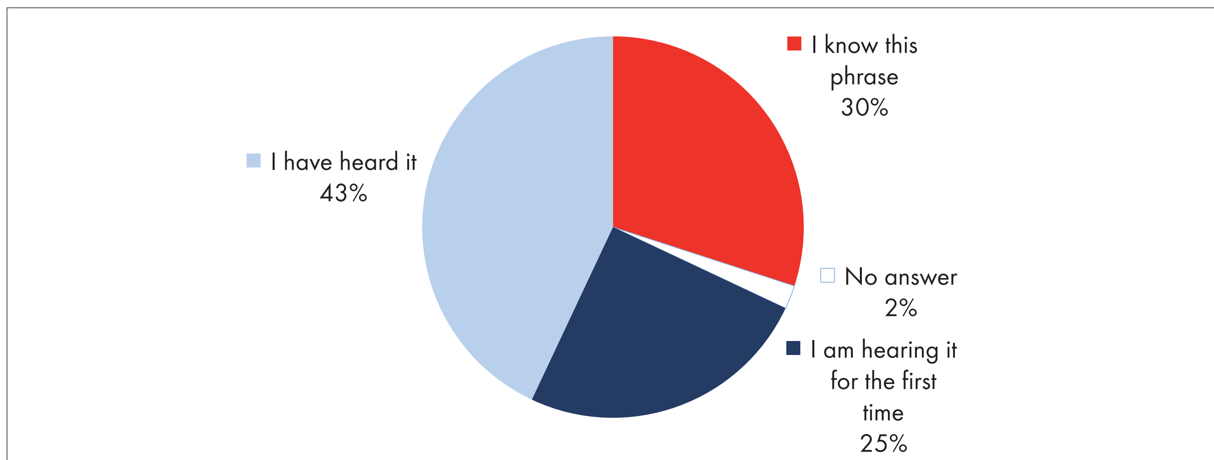


Sources: IMF, http://www.imf.org/external/np/res/commod/table3.pdf; *for October 2008:* http://rohstoffe.wallstreet-online.de/

Opinion Poll

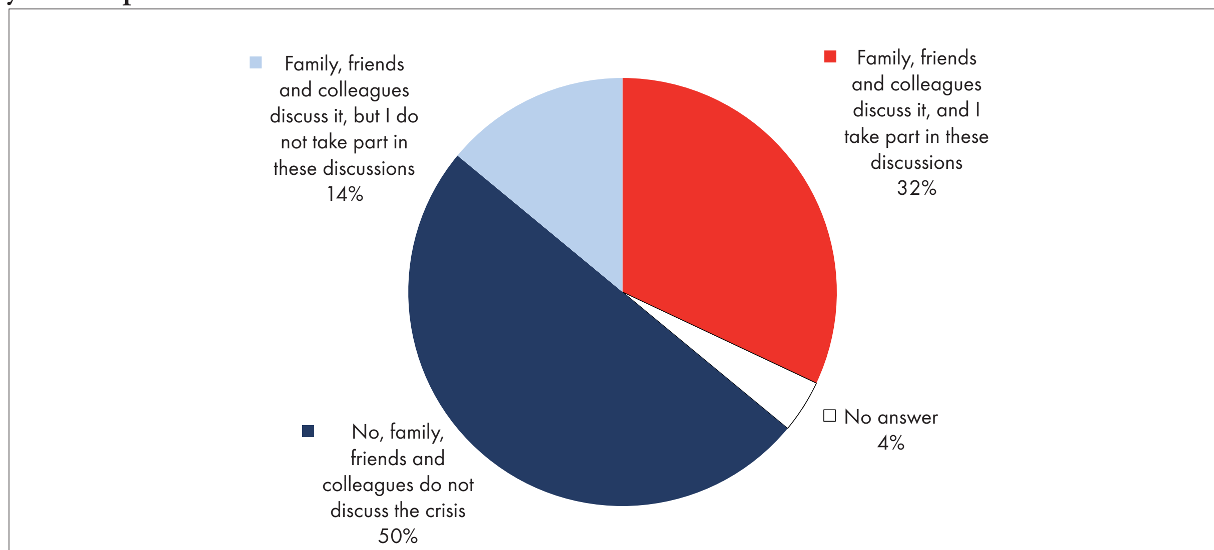
The Financial Crisis as Perceived by the Russian Population (Late September 2008)

Diagram 1: Do you know, have you heard or are you hearing the following phrase for the first time: "World Financial Crisis"?



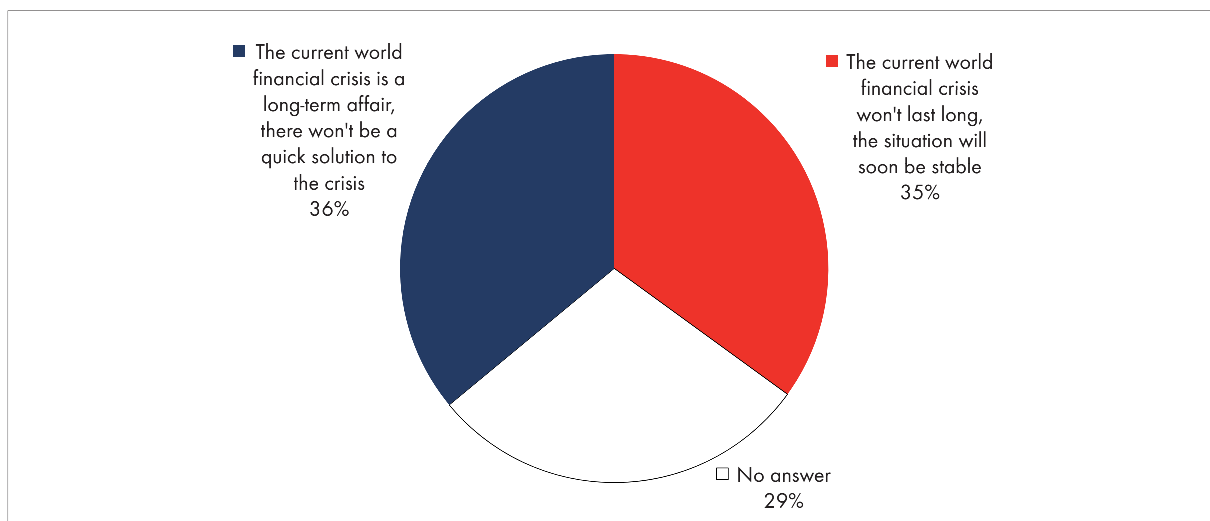
Source: FOM, http://bd.fom.ru/report/map/projects/dominant/dom0839/d083921

Diagram 2: Do your family, friends or colleagues discuss the world financial crisis? If yes, do you take part in these discussions?



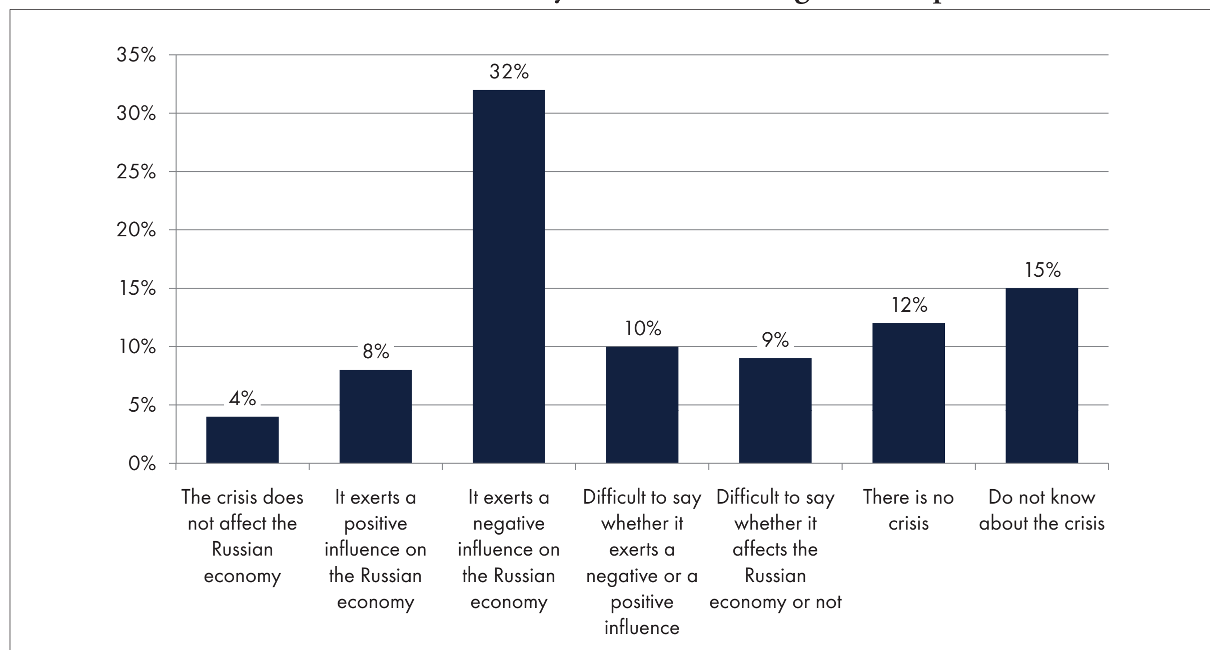
Source: VTsIOM, http://wciom.ru/novosti/press-vypuski/press-vypusk/single/10787.html

Diagram 3: Which of the following opinions corresponds most to your own opinion?



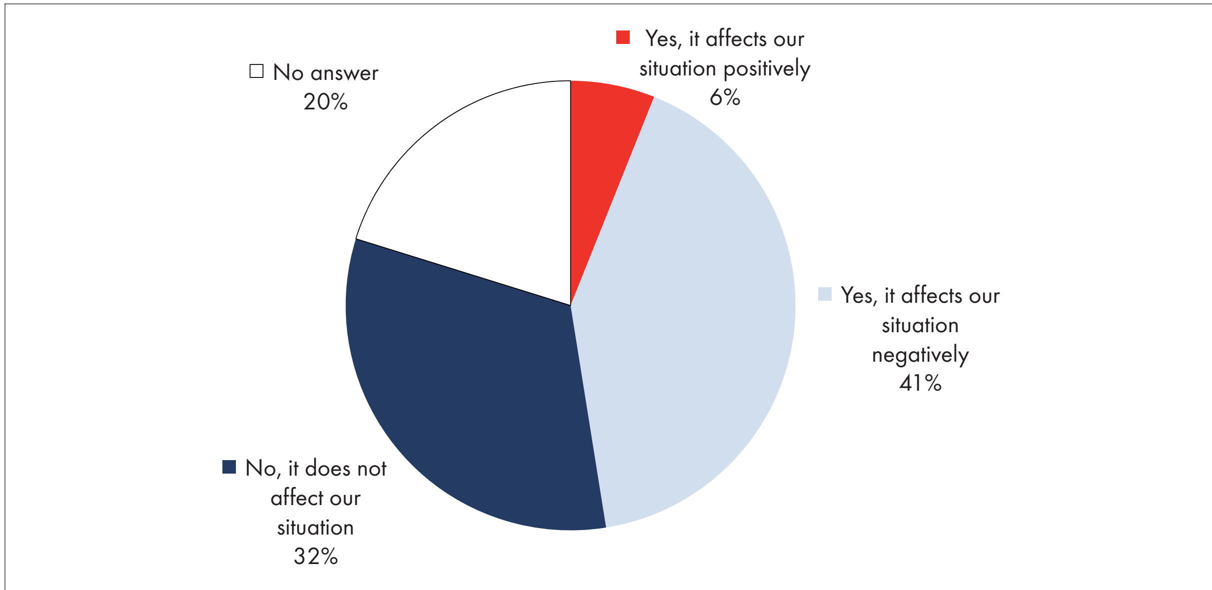
Source: VTsIOM, http://wciom.ru/novosti/press-vypuski/press-vypusk/single/10787.html

Diagram 4: In your opinion, does the current world financial crisis affect the Russian economy, or not? If it does affect the Russian economy, does it exert a negative or a positive influence?



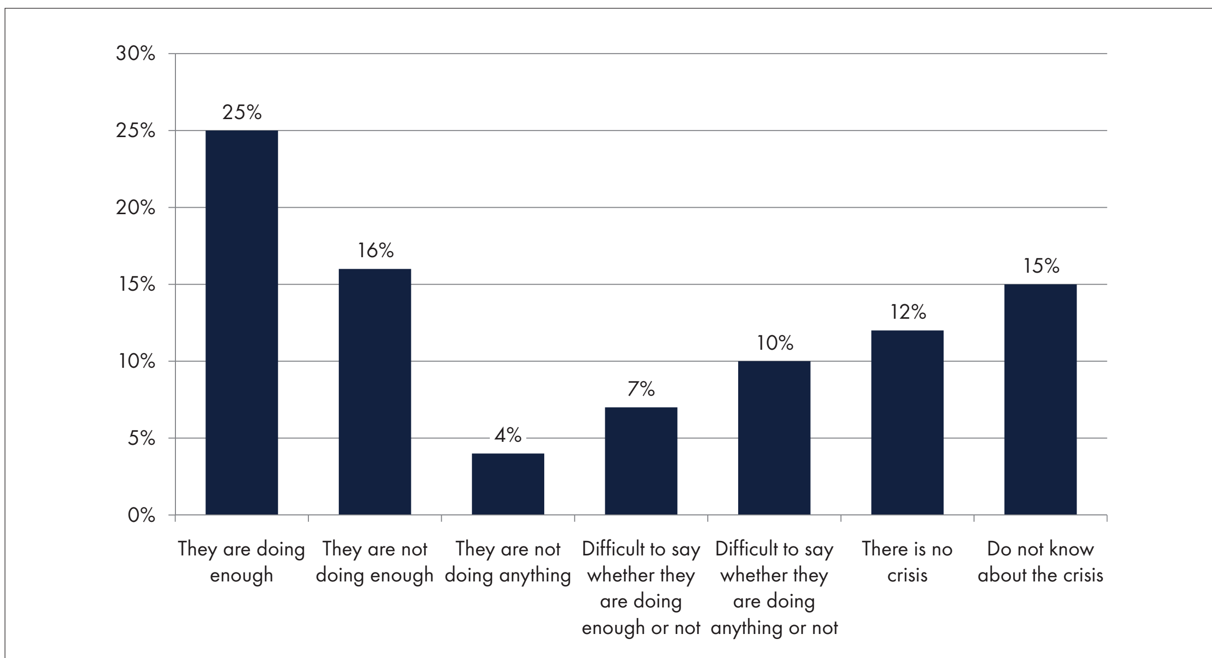
Source: FOM, http://bd.fom.ru/report/map/projects/dominant/dom0839/d083921

Diagram 5: Does the world financial crisis affect your and your family's financial situation? If it does affect your financial situation, does it affect your situation negatively or positively?



Source: VTsIOM, http://wciom.ru/novosti/press-vypuski/press-vypusk/single/10787.html

Diagram 6: Are the Russian authorities doing something or not doing anything to protect the Russian economy from the effects of the world financial crisis? If they are doing something, are they doing enough?



Source: FOM, http://bd.fom.ru/report/map/projects/dominant/dom0839/d083921

Analysis

After 10 Years of Growth, the Russian Economy May Be Losing Steam

Vladimir Popov, Moscow

Abstract

From May to October 2008, Russian stocks, as measured by the RTS index in dollar terms, lost two-thirds of their value. The decline was driven partly by the world financial crisis and partly by declining world oil prices, which fell from a maximum of nearly $150 in June to below $100 in October. Between August 1 and October 1, 2008, capital outflows drained foreign exchange reserves by approximately $40 billion. The seasonally adjusted index of industrial output has not grown since May 2008. If global recession pushes fuel prices further down, the Russian economic growth of the past 10 years may also come to an end. Is the Russian economy today better suited to survive the coming downturn than it was ten years ago?

The Achievement of the Past 10 Years

The Russian economy lost 45% of its output during the transformational recession of 1989–1998, income inequalities increased greatly, the crime rate doubled, and life expectancy dropped from 70 to 65 years. The short-lived stabilization of 1995–98 (when the ruble was pegged to the dollar and inflation subsided) ended in the spectacular currency crisis of August 1998 – the ruble then lost over 60% of its value in several months, inflation spiraled out of control, and crime, suicide and mortality rates increased once more.

However, after the 1998 currency crisis, the Russian economy started to grow. With an average annual growth rate of about 7% in 1999–2007, Russia's GDP is gradually approaching the pre-recession level of 1989. Real incomes and personal consumption increased even faster – they more than doubled in 1999–2007 – and have already surpassed the pre-recession level of the late 1980s. The major push came from the devaluation of the ruble in 1998 and higher world prices for oil and gas in the later years, but the government can at least take credit for not ruining this growth. Inflation fell from 84% in 1998, when prices jumped after the August 1998 currency crisis and dramatic devaluation of the ruble, to 10–12% in 2004–07 (see Figure 1).

Economic growth and high world fuel prices helped the government collect more tax revenue, so the government budget moved from deficit to surplus, and government spending as a proportion of GDP increased since 1999 (Figure 2), allowing a partial restoration of the state's institutional capacity that had been lost in the 1990s. Moreover, high oil and gas prices in the world markets allowed Russia to enjoy large foreign trade surpluses and to accumulate foreign exchange reserves – they increased from less than $15 billion right after the 1998 currency crisis to nearly $600 billion by August 2008.

True, in comparative perspective, Russian performance was not that impressive. By 2007, many other former Soviet republics – Armenia, Azerbaijan, Belarus, Estonia, Kazakhstan, Latvia, Lithuania, Turkmenistan, and Uzbekistan, to say nothing of the Central European countries, – had surpassed the pre-recession level of output, whereas Russian GDP was still only 99% of the 1989 level. Russian growth rates in 1999–2007 were high (7%), but still lower than other fuel exporters from the former Soviet Union, such as Azerbaijan, Kazakhstan and Turkmenistan (over 10% in 1999–2007). Even some fuel importers, like Armenia and Belarus, showed higher growth rates than Russia (Figure 3).

Russia's performance on the Human Development Index (HDI), which measures GDP per capita as well as life expectancy and education levels, is still below the USSR level and even below that of Cuba, where the average person lives 77 years, 11 years more than in Russia. China, with a life expectancy of 72 years, is rapidly approaching Russia's HDI level. Nevertheless, at least there is more stability in Russia today than in the rocky 1990s.

Economic growth and the gradual restoration of the government's ability to provide public goods led to improved conditions in the social sphere – since 2002–03 the murder, suicide and mortality rates started to fall, albeit very slowly, while the birth and marriage rates increased, helping to slow the decline of the Russian population (it fell from 148.6 million in 1993 to below 142 million by mid-2008). The number of murders reached a peak in 2002 and fell in 2003–08; the suicide rate decreased in 2001–08 (Figure 4); and the mortality rate stabilized and fell in 2004–08 as life expectancy increased slightly (Figure 5). After reaching a 50-year minimum in 1999, the birth rate started to grow. As the marriage rate increased, divorces fell. On the other hand, the over 50% increase in the crime rate in 2002–

06 most likely indicates that the police were doing a better job registering crimes reported to them rather than an actual jump in the number of crimes committed because the number of violent crimes (which are always registered more accurately than others) continued to decline.

Remaining Weaknesses

Unfortunately, the Russian achievements of recent years are based on weak foundations. Russia was unable to properly cope with the growing stream of petrodollars. In fact, the right question to ask about the recent performance of the Russian economy is why Russian growth rates lagged behind the growth rates of other countries and were not even higher in 2001–08 despite a nearly fivefold increase in average annual oil prices (Figure 6). The answer may be disappointing, but is hardly disputable – Russia did not manage to use its growing resource rents in the best possible way.

The Russian economy faces several weaknesses. First, the economy is too dependent on the oil and gas exports that account for one-half to two-thirds (depending on world fuel prices) of total Russian exports. The prosperity of recent years was mostly based on growing world fuel prices. A simple calculation shows the importance of the windfall oil revenues for Russia: Russian GDP at the official exchange rate was about $1 trillion in 2007, whereas the production of the oil and gas sector, which employs less than 1 million workers, is valued at about $500 billion at world oil prices of $80 per barrel. When oil was priced at $15 a barrel in 1999, Russian oil and gas output had a value of less than $100 billion. The difference, $400 billion, is the fuel windfall profit that literally fell on Russia from the skies.

Few specialists would call the USSR a resource economy, but Russia's industrial structure changed considerably after the transition to the market began. Basically, the 1990s were the period of rapid deindustrialization and "resourcialization" of the Russian economy and the growth of world fuel prices since 1999 seems to have reinforced this trend. The output share from major resource industries (fuel, energy, metals) in total industrial output increased from about 25% to over 50% by the mid-1990s and stayed at this high level thereafter. Partly this shift was the result of changing price ratios (higher price increases in resource industries), but also the real output growth rates were lower in the non-resource sector. The share of mineral products, metals and diamonds in Russian exports increased from 52% in 1990 (USSR) to 67% in 1995 and to 81% in 2007, whereas the share of machinery and equipment in exports fell from 18% in 1990 (USSR) to 10% in 1995 and to below 6% in 2007. The share of R&D spending in GDP amounted to 3.5% in the late 1980s in the USSR, but fell to 1.3% in Russia today (China – 1.3%, US, Korea, Japan – 2–3%, Finland – 4%, Israel – 5%). So today Russia resembles a "normal resource-abundant developing country".

Second, the government failed to channel the stream of petrodollars into repairing the "weakest link" of the national economy – provision of public goods and investment into non-resource industries. Investment and government consumption amounted to about 50% of GDP in the early 1990s, fell to below 30% of GDP in 1999 (right after the 1998 currency crisis), and recovered only partially afterwards – to about 40% of GDP in 2007 (Figure 7). Wages and incomes in recent years have been growing systematically faster than productivity.

Tax collection fell dramatically in 1992–98, from over 50% of GDP to about 30%, whereas GDP itself nearly halved. The efficiency of the government in the 1990s deteriorated greatly: low spending levels meant that the state simply could not provide enough public goods. The shadow economy, which according to the most generous estimates placed at 10–15% of GDP under Brezhnev, grew to 50% of GDP by the mid-1990s. In 1980–85, the Soviet Union ranked in the middle of a list of 54 countries rated according to their level of corruption, with a bureaucracy cleaner than that of Italy, Greece, Portugal, South Korea and practically all the developing countries. In 1996, after the establishment of a market economy and the victory of democracy, Russia came in 48th in the same 54-country list, between India and Venezuela.

Since 1999, state revenues and expenditures increased as a percent of GDP, but by far too little to restore the provision of public goods to the levels of the late USSR. As a result, provision of education, healthcare, public utilities and law and order continue to be dramatically underfinanced. Instead of using windfall petrodollars to repair the weakest link – state capacity to provide public goods – the government, on the one hand, decreased tax rates, allowing petrodollars to leak into personal incomes, and, on the other, maintained a budget surplus that expanded to nearly 10% of GDP and was used to finance the accumulation of foreign exchange reserves in the Central Bank and the Stabilization Fund.

The share of investment in GDP increased marginally after 1999, but again, far too little to compensate for the fall of the 1990s. This share remains at a level of

25% as compared to 36% in 1990–91 (Figure 7), whereas the real volume of investment in 2007 barely reached 40% of the 1990 level (Figure 8). These figures mean that Russia was literally "eating up" its capital stock at a time when the stream of petrodollars created better conditions for repairing this stock than ever before.

Third, in recent years Russia has suffered from the "Dutch disease" – a dramatic appreciation of the real exchange rate of the ruble (Figure 9) that undermined the growth of all industries except for those in the resource sector). The Russian Central Bank was doing the right thing by going against the grain and accumulating foreign exchange reserves to prevent the appreciation of the ruble, but it did not do it fast enough, which resulted in the growing ratio of Russian prices to foreign prices. As a result, Russian non-fuel industries could not compete with foreign producers, so imports in real terms grew faster than anything else in the national economy. As Figures 10 and 11 suggest, the growing trade surplus of recent years is mostly due to constantly increasing fuel prices, whereas the growth of the physical volume of imports (fivefold in real terms in 1999–2008) greatly outpaced the growth of exports in real terms.

True, Russia maintains low fuel prices in the domestic market via export taxes and direct administrative restrictions on exports, which create stimuli for the manufacturing industries. But such a policy has a high cost since the Russian economy is one of the most energy intensive in the world, consuming much more energy per unit of GDP created than other developed countries. It is theoretically possible to switch to a more promising industrial policy – undervaluing the ruble exchange rate and imposing high domestic prices for fuel. Such a policy would stimulate growth for the whole economy, and especially in the high tech industries, without the unfortunate energy waste. However, there are virtually no resource-rich countries with this combination of policies. Typically, these countries, like Russia, have exactly the opposite combination – low domestic fuel prices and an overvalued exchange rate, usually combined with poor quality institutions.

Finally, income inequalities have increased considerably. The Gini coefficient (which ranges from 0 to 100, with higher numbers representing higher inequalities) increased from 26 in 1986 to 40 in 2000 and 42 in 2007. The decile coefficient – the ratio of the incomes of the wealthiest 10% of the population to incomes of the poorest 10% – increased from 8 in 1992 to 14 in 2000 to 17 in 2007. But the inequalities at the very top increased much faster: in 1995 there was no person in Russia worth over $1 billion, in 2007, according to *Forbes*, Russia had 53 billionaires, which propelled the country to the second/third place in the world after the US (415) and Germany (55) – Russia had 2 billionaires fewer than Germany, but they were worth $282 billion ($37 billion more than Germany's richest). In 2008 the number of billionaires in Russia increased to 86 with a total worth of over $500 billion – one-third of the country's GDP.

These weaknesses – an overvalued exchange rate, poorly diversified economy and export structure, low spending for investment and public goods, and high income inequalities – were partially concealed by high oil and gas prices in 2003–08, but are being revealed now, as oil prices fall. Foreign exchange reserves of over $550 billion (as of early October 2008) provide some room for maneuver and a chance for a "soft landing." At the current rate of depletion ($20 billion a month), Russia still has more than two years to adjust to the terms-of-trade shock. But even if oil prices do not fall faster, at the end of the day, there is no way to avoid devaluation and real restructuring in order to tackle the root problems rather than their symptoms. The paradox, however, is that the need to deal with these weaknesses becomes more acute with the depletion of the required financial resources.

About the author:
Vladimir Popov is a professor at the New Economic School in Moscow.

Diagrams

Economic and Social Indicators

Figure 1: GDP Growth Rates and Inflation (Right Axis, Log Scale) in Russia, %, 1990–2008

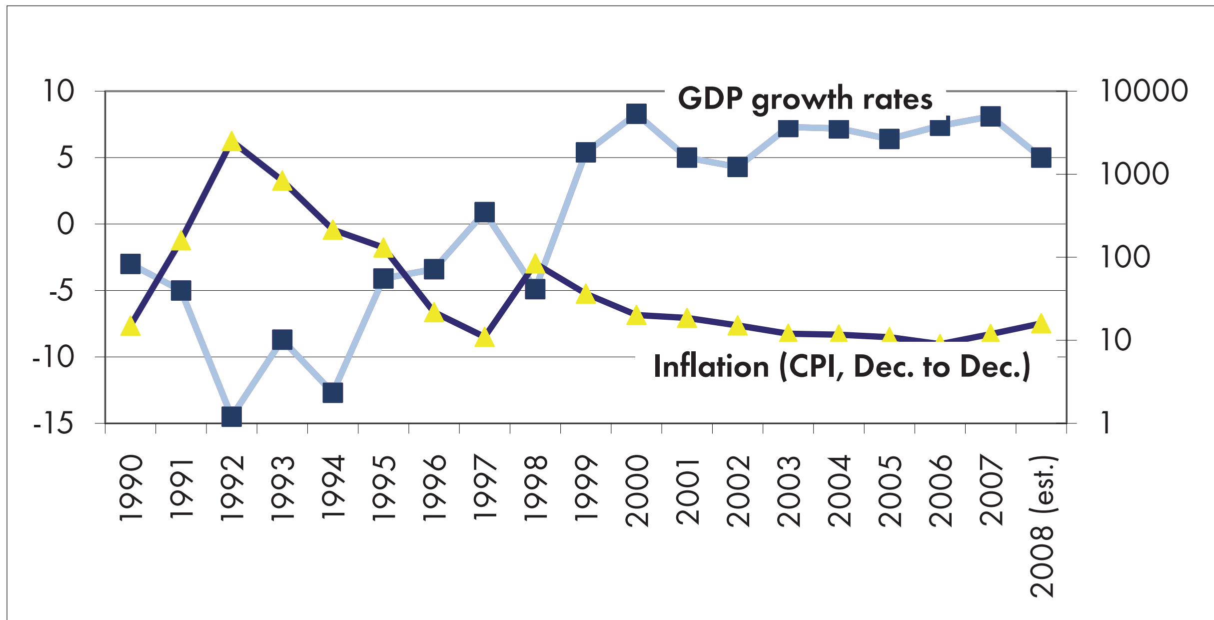


Figure 2: Government Budget Revenues and Expenditure, % of GDP, EBRD Data

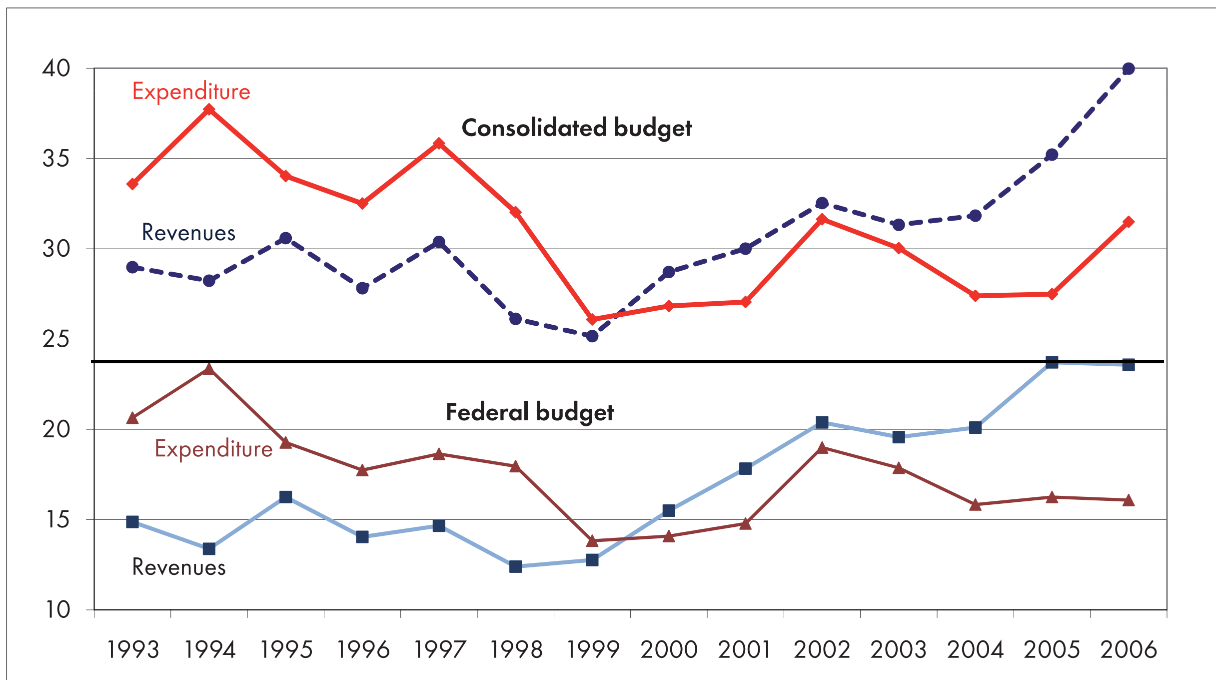


Figure 3: Average Annual GDP Growth Rates in CIS Countries in 2000-07, EBRD Estimates

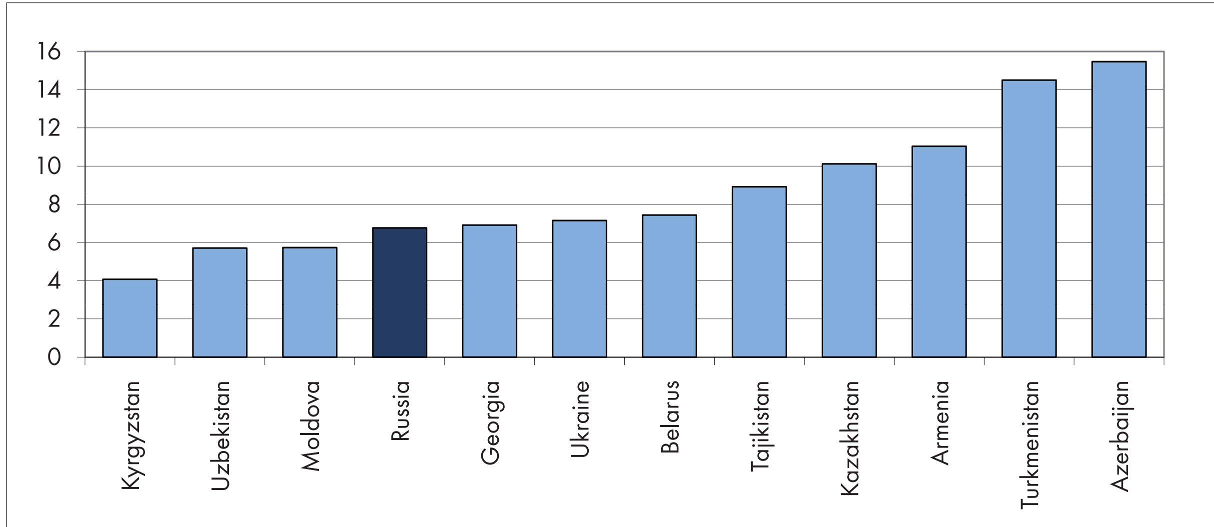


Figure 4: Crime Rate (Left Scale), Murder Rates And Suicide Rate (Right Scale) per 100,000 Inhabitants

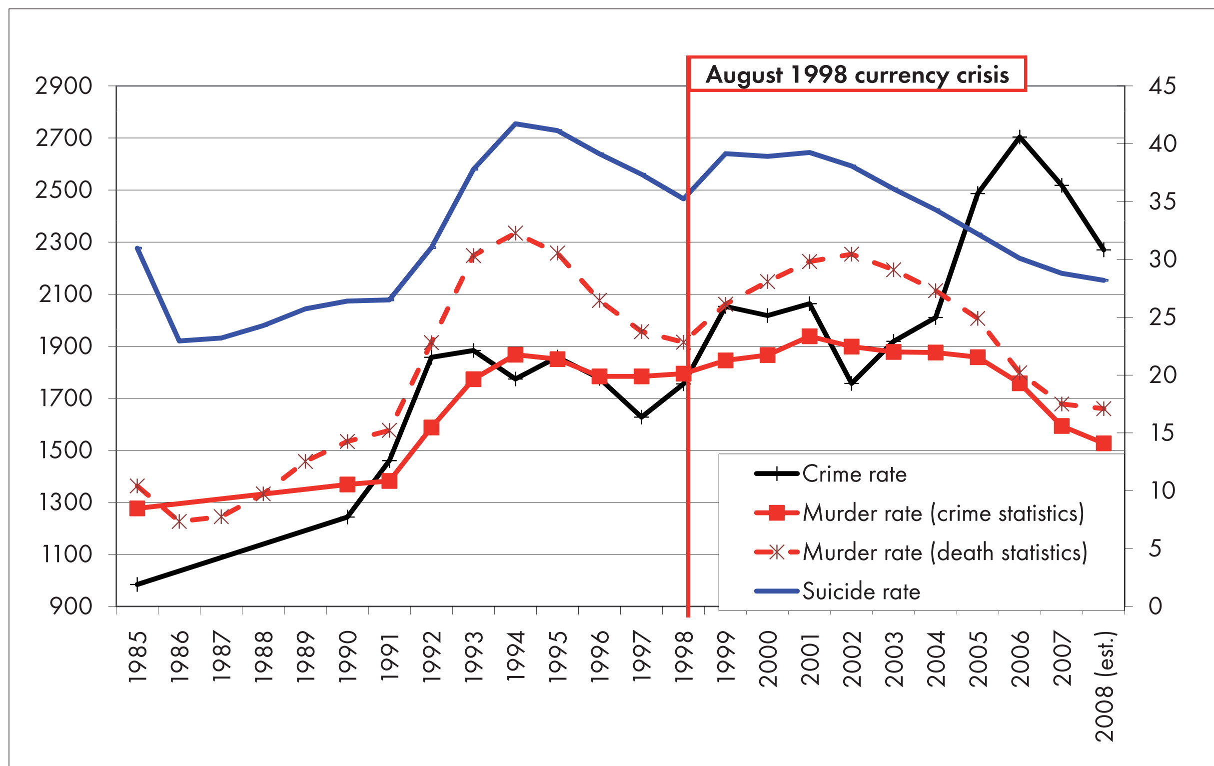


Figure 5: Mortality Rate (per 1000, Left Scale) and Average Life Expectancy (Years, Right Scale)

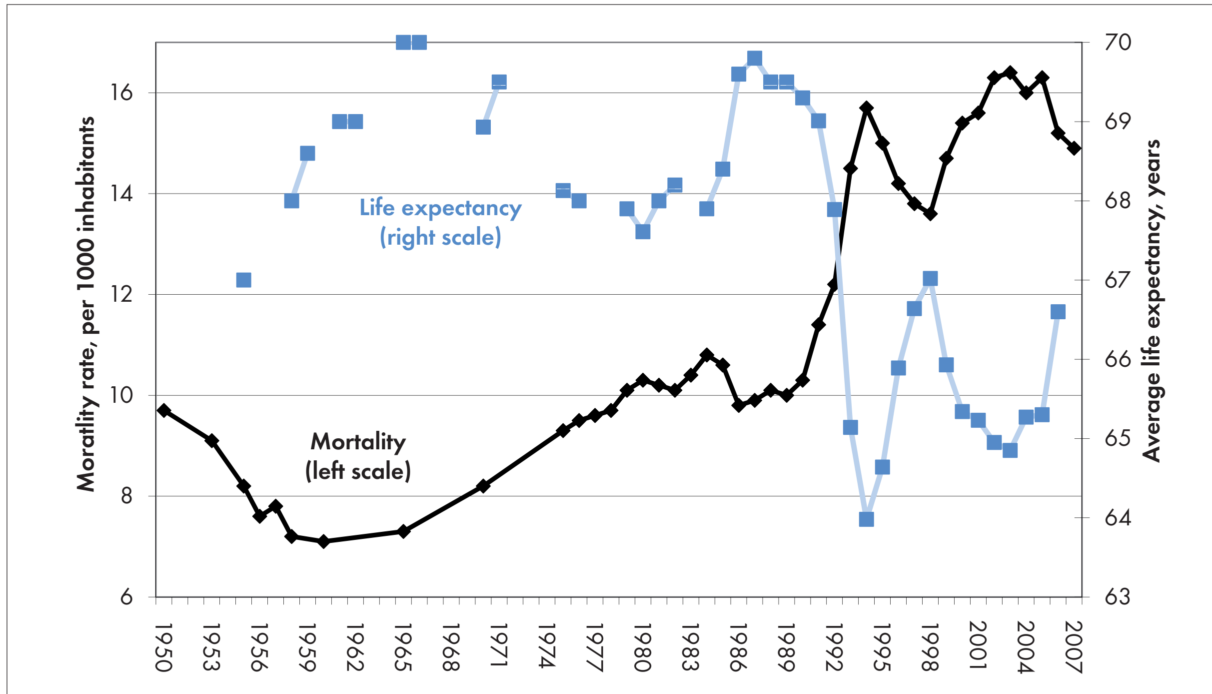


Figure 6: Oil Prices (Brent, $/bbl, Right Scale) and GDP Growth Rates in Russia (%, Left Scale), 1990–2008

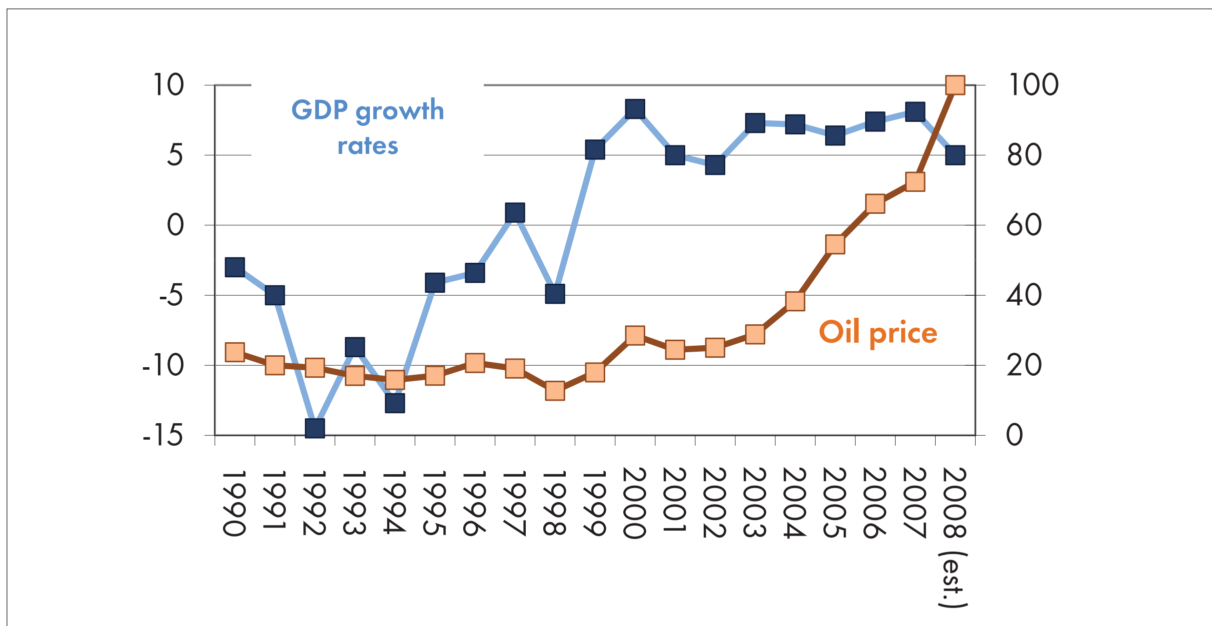


Figure 7: Structure of Russian GDP, %

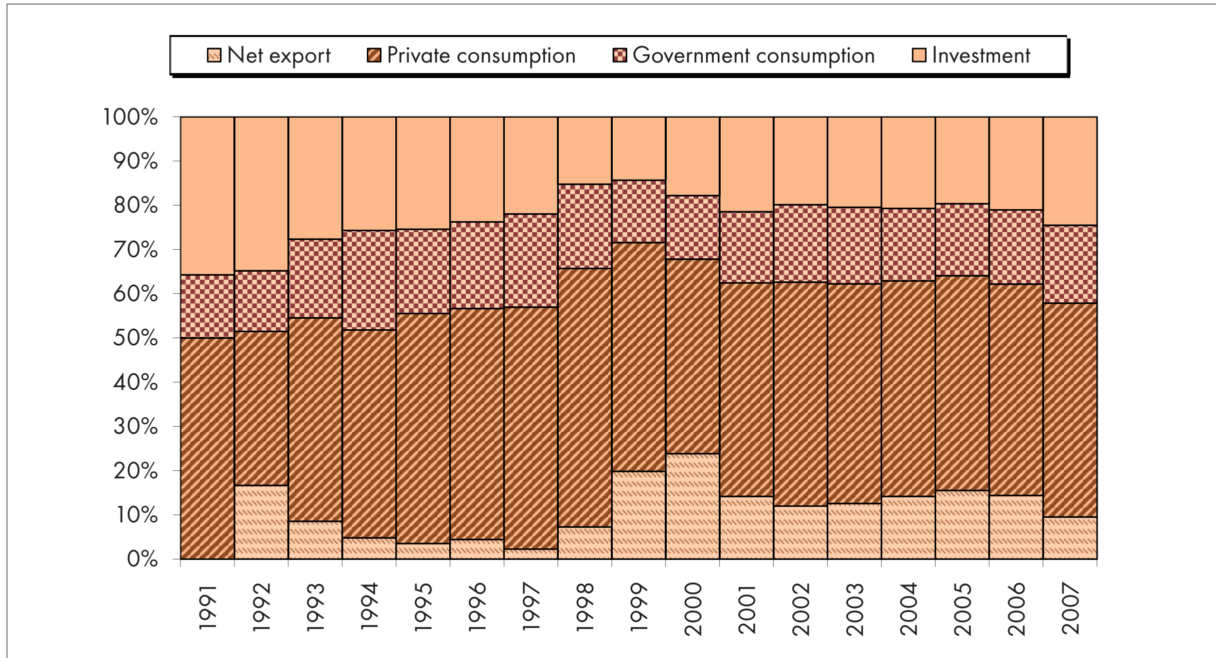


Figure 8: Growth of Real Investment and Total (Private and Government) Consumption, 1991=100%

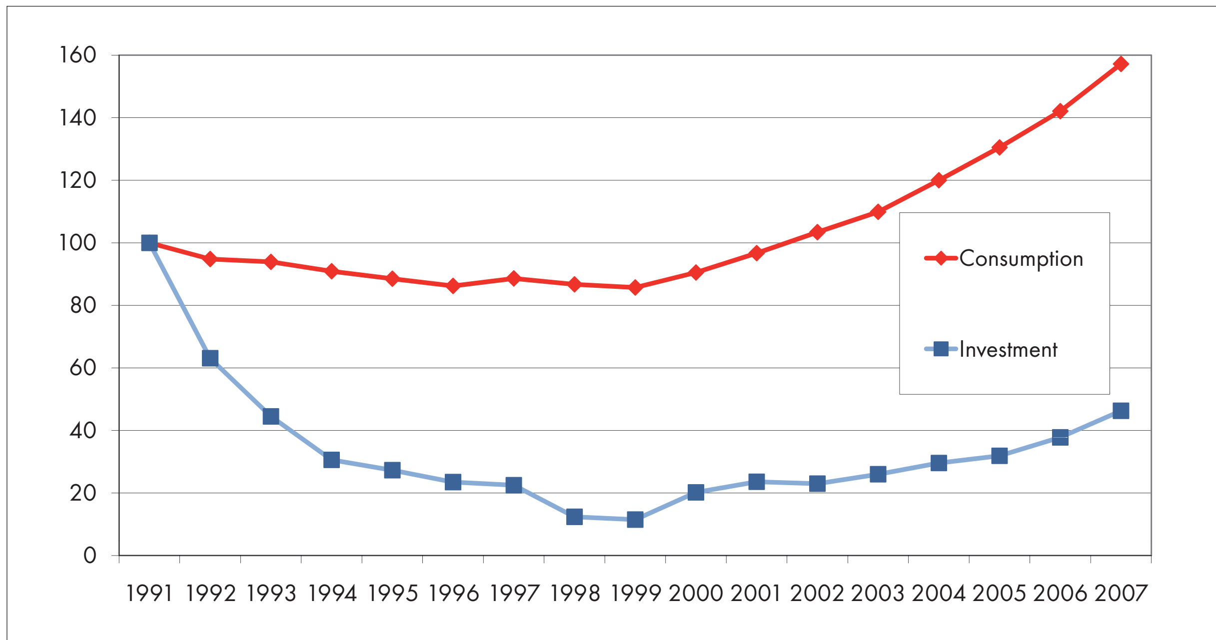


Figure 9: Real Effective Exchange Rate, Dec. 1995=100% (Left Scale), and Year End Gross Foreign Exchange Reserves, Including Gold, Billion $ (Right Log Scale)

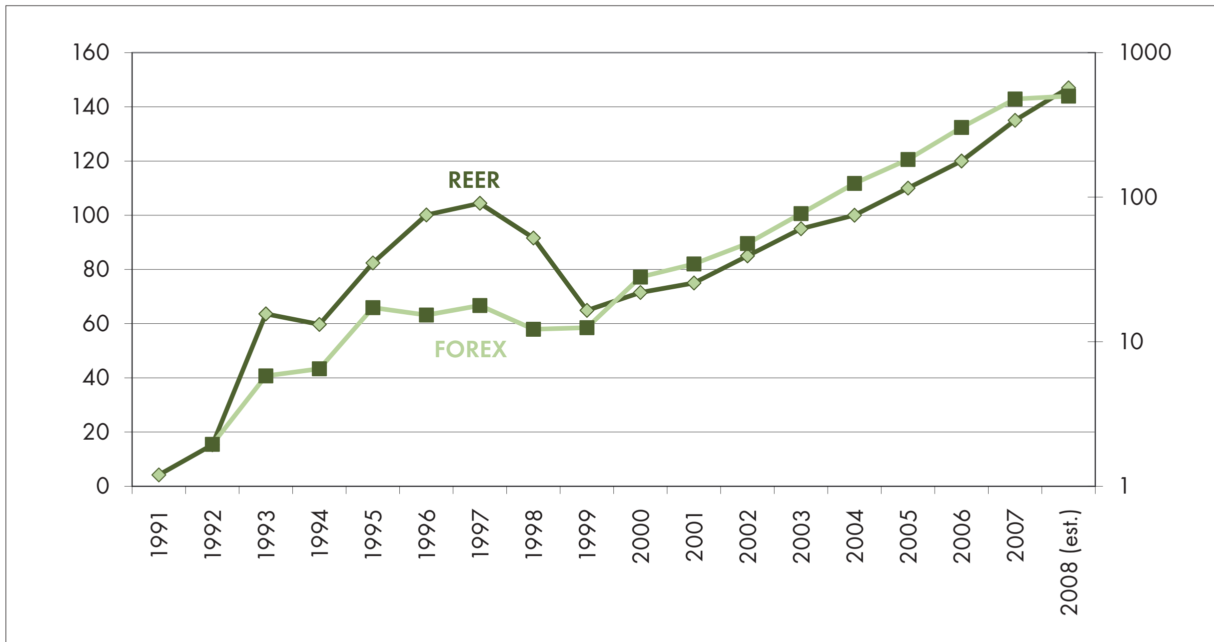


Figure 10: Goods Export from and Import to Russia, Billion $, Monthly Data

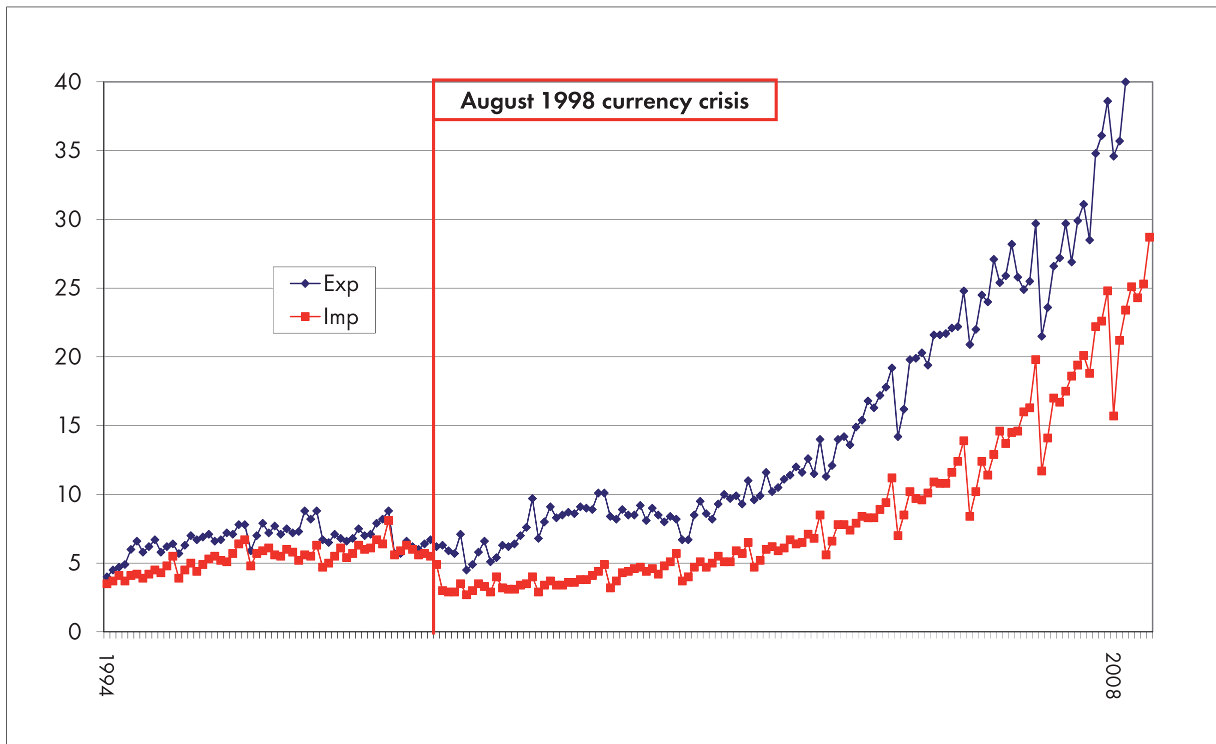
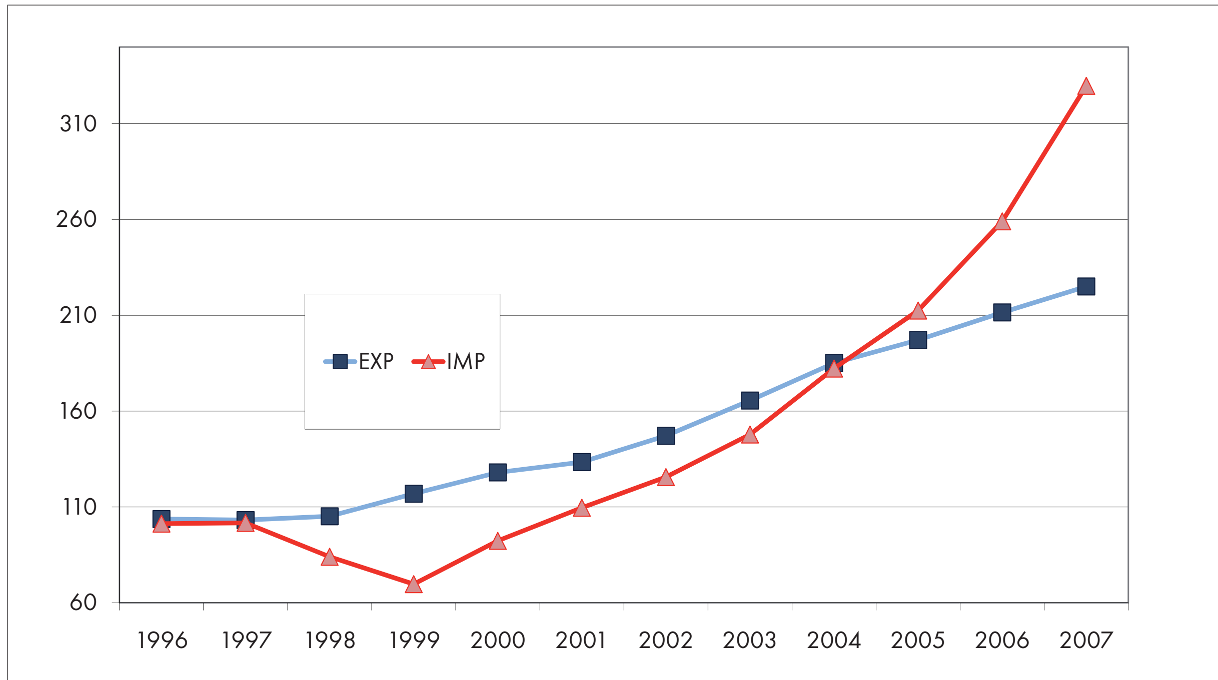


Figure 11: Real Exports and Imports of Goods and Services, National Accounts Statistics, 1995=100%



Diagrams on pp. 18–23 compiled by Vladimir Popov.

About the Russian Analytical Digest

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