The Russian Economy in the Crisis:

Trends and Perspectives

Sergey Zhavoronkov and
Tatiana Drobyshevskaya

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CREDITS

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Executive Summary

It took only several months for Russia and a number of other developing markets that had been experiencing miraculous economic growth to deteriorate to the point of near economic collapse.

According to the preliminary data for 2008, Russian GDP growth was equal to 5.6%, approaching the figures of 2001–2002, which have been the lowest during the ten-year recovery period. The rate of growth in investments in fixed assets has slowed to 9.1% in 2008, compared with 21.7% in 2007. This decline was not compensated for by a corresponding growth of consumption by the population, resulting in a gradual decrease in internal demand. In the current year a decrease in growth rates is being observed for nearly all kinds of economic activities.

The financial crisis has been a central issue in Russia's monetary and credit sphere since September 2008. To prop up the rouble exchange rate, which was under strong pressure generated by the capital outflow due to the deepening financial crisis, the Central Bank of Russia (CBR) was selling foreign reserves to buy roubles, thus reducing the money in circulation. A rapid decrease in exports and the private capital outflow noted in the 4th quarter 2008 have resulted in a contraction of the nation's foreign reserves for the first time since 1998.

Beginning late August and September 2008, negative trends in the Russian stock market and the domestic debt market were being felt more strongly against the background of the deepening financial crisis.

Huge oil and gas revenues collected in the previous year allowed for a substantial financial reserve in the form of a budget surplus, which has made it possible for the government not only to fulfil its expenditure obligations, but also to replenish the Reserve Fund and the National Welfare Fund. The increase in federal budget expenditures in 2008 versus 2007 took place against a background of plunging revenues, which resulted in a shrinking surplus in the federal budget.

In its anti-crisis policy, the Russian government gradually withdrew its provision of direct state aid to troubled banks and firms. Simultaneously there was a movement toward stronger indirect control through a small number of 'propped-up' banks, the formation of preference lists of 'significant' enterprises, the continued activity of state corporations and state holdings (few market subjects, providing an opportunity for new mergers), and the nationalisation of problem assets in 'hard' or 'soft' options.

Forecasts of the dynamics the dynamics of the basic macroeconomic indicators of the Russian Federation show that the most probable scenario is the most basic one, in which Russia has a chance to survive the year with minimal macroeconomic shocks, which might form a favourable starting position for exiting the crisis. However, the positive forecast is very unstable, and the range of fluctuations of exogenous parameters under which the situation is favourable appears extremely narrow.

1 Introduction

The main characteristic of last year, the one that will make it stand out in economic history in both Russia and the world, is the rapidity with which the current economic crisis unfolded. The crisis quickly spread across a country which was characterised by an especially favourable macroeconomic situation, a country which had a double surplus (of its budget and balance of payments) but is now facing severe economic turmoil as a result of the crisis.

Among the major sources of the crisis in Russia the following factors contributed to the national recession: the beginning of global deceleration of economic growth; the fall in the prices of oil and other Russian exports; the emergence of a deficit in the balance of payments that resulted in the country's growing dependence on the inflow of foreign investments; the rapidly increasing external debt of Russian companies and a high probability of their becoming incapable of repaying their debts in the absence of state aid; and the failure of many investment projects, created during times of economic growth, that are unlikely to survive the test of a crisis. Finally, in the course of its eight years of prosperity, Russia produced a generation of politicians accustomed to 'managing the growth of affluence' but quickly losing expertise in crisis management. Similar overconfidence were on the rise among the general public.

2 The Political-Economic Consequences of the Russian Crisis

The first cycle of regional elections taking place during the depths of the economic crisis (regional elections in Russia are held twice a year in October and March) revealed, according to official data, a fall in popular support for the ruling party. United Russia saw its support drop by 15 percentage points, from 64% in parliamentary elections in December 2007 to about 50% in March 2009.

In the regional elections—where opposition candidates were running; namely in Murmansk and Smolensk—the opposition won. In Petropavlovsk-Kamchatski and Tomsk the candidates in power won with a minimal margin and only in Chelyabinsk did the incumbent candidate win convincingly. However, it is worthwhile to note that political competition at the federal level in Russia is extremely limited: there are only seven registered political parties and none of them criticise Putin. During elections, the parties compete on giving advice to Putin, and choose only to criticise lower-level officials. In fact, the opposition candidates who criticised Putin in the 2008 presidential election have not been registered at all. Existing Russian legislation does not guarantee opposition candidates equal conditions during the election campaign, or honest polling practices, or even a right to participate in the elections.

The loss of support for United Russia, therefore, might cause some changes to the Russian political landscape: the elimination of even minimal competition, and also a more liberal regime and greater competition at elections below the level of presidential ones. Before the crisis, in conditions of stable growth in real income, repression of political competition was simplified by the lack of mass protests; the largest political protests took place in Moscow in 2007, and mobilised only five to six thousand people. The latest economic protests against the abolition of social benefits at the beginning of 2005 were redeemed by a compromise—increase in monetary compensations instead of benefits. The crisis situation in the Far East of Russia, in the Leningrad region and surrounding regions, has evoked the potential of economic protest—especially given the fact that, unlike in 2005, leaders in power do not have a significant reserve of financial strength.

The political stability of those in power has remained intact during the financial crisis. Of course, the state leadership has increased its influence over owners of large firms, given that their dependence on the state to provide aid in this time of crisis has increased. Even in a crisis situation, state power in this domain has not extended far beyond this, however, as state powers have not yet attempted to replace the ownership of large Russian firms, such as Norilsk Nickel and the assets of Oleg Deripaska. This almost appears to be paradoxical behaviour; however, it should be seen context: fully private property does not exist in Russia.

Feudal ‘conditional holding’ is the form of property allowed by the state in Russia, who can replace the asset’s manager at any time. In this way, to replace the formal owner of a private business is not much more problematic than appointing a new head of a state-owned company. It is more difficult to do so when the owners of a company are not Russian citizens, but some examples (e.g., Sakhalin-2), show that even their position is not fully protected against state interference. To counter difficulties that would arise for the state in this sense, a set of laws was passed in 2007–2008 limiting foreign investment in 'strategic enterprises' in order to prevent the establishment of new large firms by non-citizens in Russia.

Even in the crisis, Russian authorities and Russian businesses continue to strive to acquire economic assets in countries governed by the full rule of law (the example of Opel is instructive). Russian authorities have become concerned that the capitalisation of Russian assets has fallen to a greater extent than those assets in countries with legal order. However, this concern will not compel Russian authorities to take steps to improve the investment climate, because the institutions which are required for the investment climate (an independent court, government transparency, personal and property immunity) directly threaten Putin's autocracy.

Due to the necessity of external borrowing, however, certain steps to improve the image of Russian economy abroad can be expected. Russian authorities have taken steps over time to acquire symbolic assets underlining their equal (or almost equal) place in the range of leading powers. These assets include participation in the G-8, WTO, Council of Europe and others. On one hand, the Russian authorities are becoming increasingly irritated by the restrictions imposed by these institutions, especially the Council of Europe and the European Court of Human Rights. In the summer of 2009 Russia officially terminated payments for claims lost by Russia in European Court of Human Rights (official pretext—exhaustion of the funds budgeted by Russia in 2009).The Russian leadership is now discussing the question of Russian departure from the

Council of Europe. However, the implementation of this threat will deprive Russia of an important tool for diplomatic blackmail (a Russian proverb says ‘threat is stronger that its execution’). Additionally it may provoke EU sanctions and worsen the prospects for stability of European assets belonging to the Russian authorities and the Russian oligarchs. Discussion on this issue is continuing.

In the present time there is no doubt that the de jure Head of State, President Medvedev, will hand power back to Prime Minister Putin, who once again will formally take over the position of President for two terms (2012–2024) which, practically, is for an unlimited time. Putin openly hints at this, even during international visits (for example, in Japan in May 2009). A year and a half into President Medvedev’s term, he has neither created his own team nor has he successfully advocated his own deals as a means of attaining support within the Duma and FSB.

However, one must keep in mind that in case President Medvedev decides to take full power, he will face no legal limitations, only limitations connected with physical force. It must be stressed that the decrease in budgetary expenditure has caused a decrease in private gain for the highest bureaucrats and oligarchs. There is undoubtedly a struggle going on within the public service over which expenditure to cut, whether funds going to corrupt public servants, or funds going to civil society?

3 The Real Sector and Investments: How Steep was the Fall?

In 2008 there was a considerable slowdown in the growth of the Russian economy from that observed in the period 2003–2007, when the average annual growth rates were the following: GDP, about 7%; investments in fixed assets, 14%; final consumption of households, 11%. The growth rate of investments in fixed assets slowed to 9.1% in 2008 as compared with 21.7% in 2007, which was not compensated for by a corresponding growth of consumption of the population, and accounted for the gradual decrease in domestic demand. The slowdown in the growth rate of industrial production to 102.1% versus 106.3% in 2007 had a considerable impact on the internal market.

Table 1: Basic Macroeconomic Indicators, 1999-2008, as a Percentage of the Previous Year

	2001	2002	2003	2004	2005	2006	2007	2008	2008 by Quarters			
									1	2	3	4
Gross Domestic Product	105.1	104.7	107.3	107.2	106.4	107.4	108.1	105.6	108.5	107.5	106.2	101.1
Real final household consumption	108.2	107.7	106.7	110.2	110.5	109.8	111.0	111.5	114.1	112.2	112.4	109.7
Investments in fixed assets	110	102.8	112.5	111.7	110.9	116.7	121.1	109.1	119.1	113.0	109.8	101.9
Planned residential building	104.6	106.7	107.7	112.6	106.1	116.1	119.4	105.3	108.1	99.1	105.7	105.1

Table 1: Basic Macroeconomic Indicators, 1999-2008, as a Percentage of the Previous Year (continue)

	2001	2002	2003	2004	2005	2006	2007	2008	2008 by Quarters			
									1	2	3	4
Industrial production	102.9	103.1	108.9	108.0	105.1	106.3	106.3	102.1	106.2	105.5	104.7	93.9
Agriculture production	107.5	101.7	101.3	103	102.4	102.8	103.3	110.8	104.5	104.2	108.5	59.2
Freight turnover	103.2	105.8	108	106.5	102.7	102.5	102.2	100.6	105.1	102.9	101.5	93.0
Communication services	119.1	115.6	127.5	129	115.7	124.0	120.1					
Retail trade turnover	111	109.3	108.8	113.3	112.8	114.1	116.1	113.0	116.7	114.4	114.4	108.2
Paid services rendered to population	101.6	103.7	106.6	108.4	106.3	107.6	107.9	104.9	107.7	105.6	105.3	102.0
Foreign trade turnover	103.8	108.1	126	132.4	131.5	127	120.8	132.2	148.8	147.9	149.3	95.4
Real disposable income	108.7	111.1	115	110.4	112.4	113.5	112.1	102.7	107.8	106.0	106.6	94.2
Real wages	119.9	116.2	110.9	110.6	112.6	113.3	117.2	109.7	113.4	112.5	112.2	102.5
Real amount of accrued pensions	121.4	116.3	104.5	105.5	109.6	105.1	104.8	118.1	119.0	113.7	122.7	116.9
Average number of employed	100.7	100.9	100.6	100.6	100.6	100.6	101.3	100.6	100.8	101.2	100.8	99.7
Number of officially registered unemployed	89.1	97.9	92.3	101.6	90.2	96.0	84.9	104.3	96.5	94.2	105.6	123.0
Consumer prices indices	118.6	115.1	112.0	111.7	110.9	109.0	111.9	113.3	104.8	103.8	101.7	102.5
Industrial producers' prices indices	108.3	117.7	112.5	128.8	113.4	110.4	125.1	93.0	103.0	113.6	100.5	79.1

Source: Federal State Statistics Service.

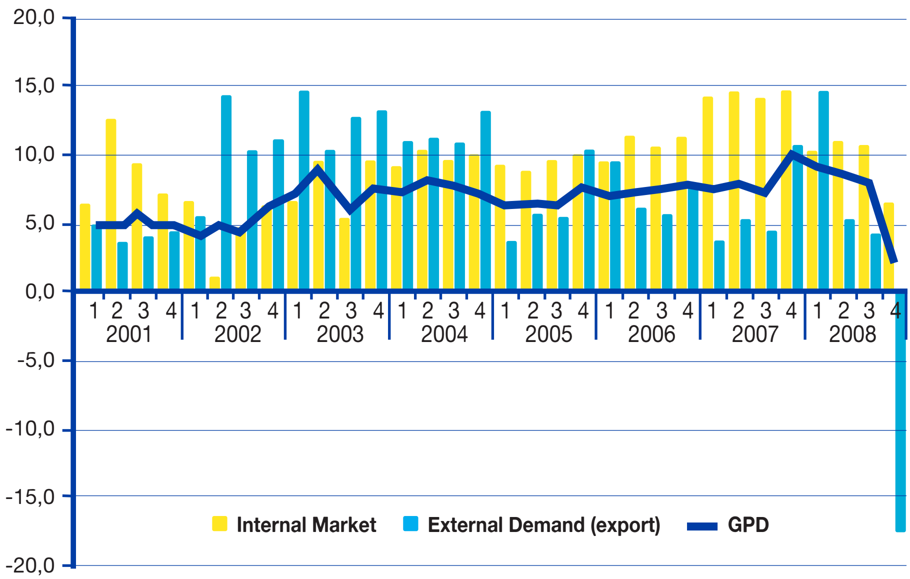
The GDP growth slowed from 8.5% in the 1st quarter to 1.1% in the 4th quarter. The initial growth in the first half of 2008, supported by a favourable situation in the world market for raw materials, was replaced by a slowdown in economic development in the second half, which was caused by the sudden worsening of the global economic situation and the crisis in financial and credit institutions. In October–December 2008 the situation was aggravated by the spread of the crisis throughout the economy. The most dramatic decreases in production were observed in construction, transport and industrial production. According to the data of the Federal State Statistics Service, in the 4th quarter of 2008 the volume of the industrial production was 93.9% and the commercial freight turnover was 93.3% compared with the level of the corresponding period of the previous year. The growth rate of investment in fixed assets continued to slow down for two quarters in a row, and the amount in December 2008 was 2.3% below that of December 2007. The increase in gross accumulation of fixed capital in 2008 was estimated to be 110.3% as compared with 121.1% in 2007.

The dynamic of the consumer demand in 2008 was still determined by household consumption. The increase was estimated to be 111.5% in 2008, as compared to 113.6% in 2007. In connection with the slowdown of growth in real wages in the 4th quarter of 2008, the growth rate of retail trade turnover and of paid services rendered to the population have dropped. Although the growth rate of retail trade turnover was down to 8.2% in the 4th quarter of 2008 versus 16.2% in the corresponding period of the previous year, the growth of investments in fixed assets—down to 1.9% versus 20.6% in the previous year—did mean an increase in GDP in October–December, though at a level which is the lowest since 2001.

The situation has been aggravated by a large-scale outflow of capital. Whereas in the first half of 2008 there was an inflow of foreign capital in the amount of $18 billion, in the second half of 2008 the outflow of capital reached $147.9 billion.

Throughout 2008 the decrease in economic growth was determined by a simultaneous reduction in external and internal demand (see Figure 1). Starting with the 3rd quarter of 2008, a sharp drop in world prices for raw materials and the contraction of demand in the world market was accompanied by the reduction of export volumes both in physical and value terms. In the 4th quarter, according to preliminary estimations, the export of goods dropped by nearly 17%. However, since the volume of exports had been high in the first half, on the whole in 2008 the export of goods and services increased by 0.2% versus 6.4% growth in 2007. It should be noted that the anticipated growth of imports as compared to exports in terms of both volume and value was a characteristic feature of 2006–2008, which in the end resulted in the absolute reduction of net export volume in the GDP.

Figure 1: Change in GDP broken down into Internal and External Demand in 2001-2008, as a Percentage of the Corresponding Quarter of the Previous Year



Source: Federal State Statistics Service.

In 2008, the slowdown in the growth of investment and consumer demand occurred against the background of the considerable decrease in the volume of goods and services imported. As a result in 2008 the growth in the physical volume of goods and services imported was 17.7% versus 26.6% the previous year; the growth in imports being twice as large as the growth in internal production.

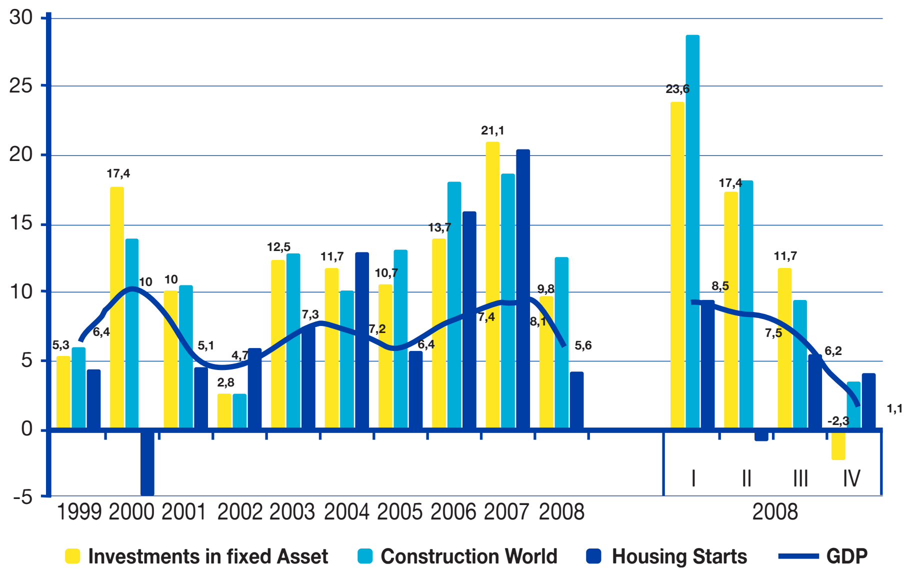
In January–April 2009 the economic situation was defined by a low level of domestic business activity and the contraction in solvent demand.

In 2009, the decrease in growth rates is observed for nearly all kinds of economic activity. Compared with the corresponding period of the previous year, in January–April 2009 the decline was 14.9% in industrial production, 6.4% in minerals extraction and 22.0% in the processing industries. The absolute decrease in the volume of output resulted in the contraction of demand for the services of natural monopolies. Freight turnover went down by 17.7%, including a decrease in railway transportation by 24.3%. Electricity, gas and water production and distribution were down by 4.6%.

It should be noted that in the 1st quarter of 2009 the investments made by medium and large enterprises decreased in real terms by 4.8%, while the investments of small enterprises were down by more than 55%. Because of the decrease in investment, work in construction was down by 18.4% over January–April 2009, and investments in fixed assets over the same period was only 84.2% of the corresponding figure from the previous year. In the current year foreign investment in the Russian economy fell at a greater rate than domestic investment in fixed assets.

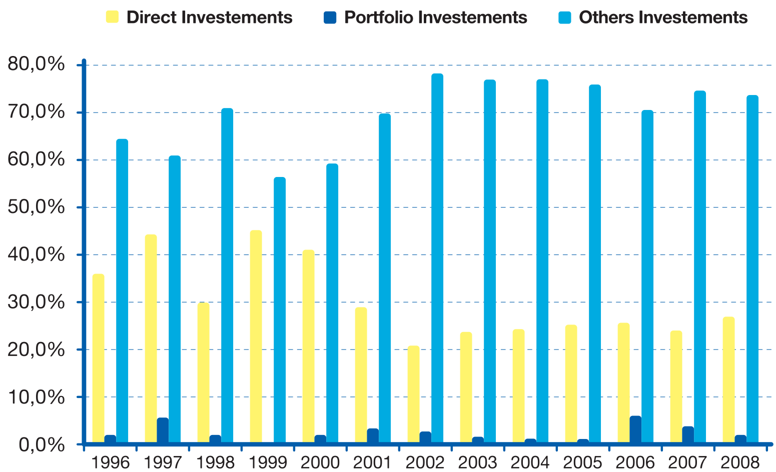
The tendency for investments in fixed assets to grow at higher rates than GDP has been observed in the Russian economy since 2002. In 2008 this ratio was sustained, although compared with 2007 the growth rates of both GDP and investments in fixed assets have slowed down considerably. In 2008 the growth in GDP was 5.6% versus 8.1% in 2007, while investment in fixed assets went up by 9.8% versus 21.1% in the previous year (see Figure 2).

Figure 2: GDP, Investment in Fixed Assets, Construction Work and Housing Starts in 1999–2008, Percentage Growth over the Previous Year



Source: Federal State Statistics Service.

Figure 3: Foreign Investments in the Russian Economy in 1996–2008, Percentage Change over the Previous Year



	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Direct Investements	35,0	43,4	28,6	44,6	40,4	27,9	20,2	22,8	23,3	24,4	24,8	23,0	26,0
Portfolio Investements	1,8%	5,5%	1,6%	0,3%	1,3%	3,2%	2,4%	1,4%	0,8%	0,8%	5,8%	3,5%	1,4%
Others Investements	63,2	59,1	69,8	55,1	58,3	68,9	77,4	75,8	75,9	74,8	69,4	73,5	72,6

Source: Federal State Statistics Service.

In the total amount of foreign investment received by the Russian economy in 2008, it was in the portfolio investment sector that the most substantial decrease (66.3%) was observed, the majority of which was accounted for by investments in shares and stocks (95.5% of total portfolio investments in 2007, versus 79.6% in 2008).

In 2008 the amount of other investments was down by 15.3% compared with 2007. The proportion of trade credits in the total of foreign investment went up from 12.7% in 2007 to 21.5% in 2008. As for the attraction of new funds, the volume of credits for in the first 6 months decreased by 27.1%.

Thus, compared with the previous year, in 2008 the structure of foreign investments in the Russian economy was subject to some changes (see Figure 3).

As a whole, according to the preliminary data for 2008, GDP increased by 5.6%, approaching the figures of 2001–2002, which were the lowest of the ten-year recovery period. The growth rate of investment in fixed assets slowed to 9.1% in 2008 as compared with 21.7% in 2007 and was not compensated for by a corresponding growth in domestic consumption. This accounted for the gradual decrease of the internal demand. The situation was aggravated by a large-scale outflow of capital.

In the current year decrease in growth has been observed for nearly every kind of economic activity.

4 The Monetary Sphere: Inflation and Rouble Devaluation

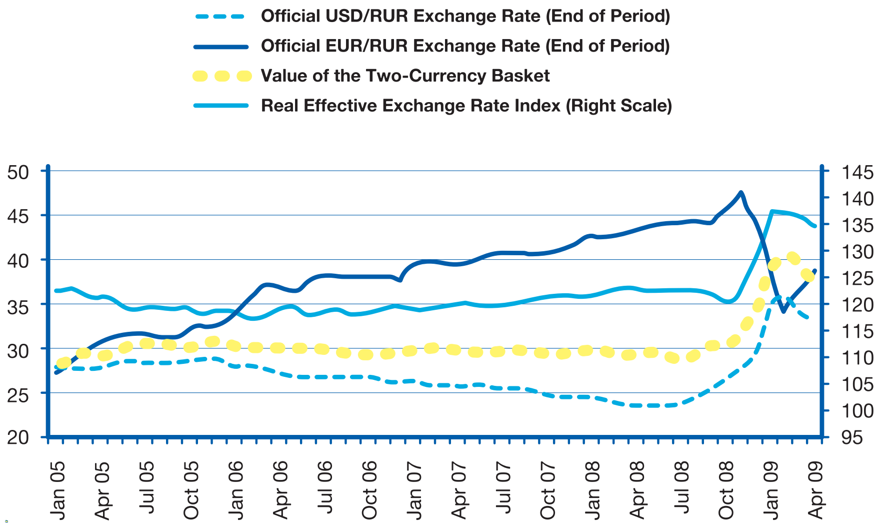
In early 2008, inflationary pressure was still high compared with the same period of the prior year (see Figure 4). The measures the Russian government undertook in January to extend the October 2007 agreement with the largest producers and retailers on freezing the prices of some socially significant goods proved to be fairly ineffective. Meanwhile, a rapid rise in the money supply in late 2007 led to upward pressure for price increases. But in the second half of the year, because of the contraction in its foreign reserves which the CBR was selling to maintain the rouble exchange rate, the money supply began to diminish, while the rate of price increases started to decelerate. In the end, the change in the CPI for the year was 13.3% versus the 11.9% reported in 2007.

Until the end of 2008, the growth in foreign currency markets was fuelled by the influx of imports from overseas and its sales by the non-financial sector within the country. This resulted in a rise in the real exchange rate of the rouble—it appreciated by 5.1% that year (see Figure 4). This was primarily because the inflation rates in Russia were higher than those in Russia's major trading partners. To maintain the rouble exchange rate, the CBR began selling its foreign reserves, but in September the rouble began to gradually depreciate against the bi-currency basket[1]—which was tolerated in order not to waste all of the CBR's foreign reserves. The pace of the rouble's depreciation coincided with the decline in prices for major Russian exports and with the acceleration of capital outflow. Data from 2008 shows that the rouble plunged against the US dollar from 24.55 to 29.38 and against the Euro from 35.93 to 41.44, while the bi-currency basket rose from 29.67 to 34.81.

Along with the amount of foreign exchange reserves, the inflow of foreign capital into the country was drastically reduced. Thus it was possible only for a short time to maintain the overvalued rouble exchange rate by means of spending foreign reserves. Meanwhile, as the CBR was pursuing a gradual depreciation of the national currency, buying foreign currencies has become for economic actors a relatively low-risk and highly lucrative investment instrument, which has led to an increasing demand for foreign currencies and the need for the CBR to spend more and more of its foreign reserves.

[1] The bi-currency basket is a working indicator used by the Bank of Russia in its currency policy. It consists of the rouble/Euro exchange rate (45% weighting) and the rouble/US dollar exchange rate (55% weighting).

Figure 4: The Rouble Exchange Rate between January 2005 and April 2009



Source: the CBR, the authors' calculations.

Let us note that monetary policy experienced considerable changes in 2008. Underpinning these changes was the impact the crisis had on the national financial markets. First, despite problems with liquidity, in 2008 cash balances on the credit organisations' correspondent accounts with the CBR grew by nearly one-third. The trend is explained by the fact that, with the crisis unfolding, the CBR provided banks with a sizeable volume of financing, particularly on an uncollateralised basis. But, facing mounting risks, banks opted to scale back their volume of lending and placed the funds with the CBR. Second, according to year-end results the volume of credit organisations' compulsory reserves shrank dramatically, as the CBR had lowered the required rates of their contributions to the compulsory reserve fund in order to give credit institutions additional liquidity.

The financial crisis has been central to Russia's monetary and credit sphere since September 2008. In the midst of crisis conditions, it was the CBR's moves to refinance credit organisations which gradually became a major source of shaping the money supply—the practice long inherent in most developed economies. In such a situation, interest rates on the CBR's credits play a far greater role, given that the CBR can exercise substantial influence on the situation in the monetary and credit sphere.

5 The Balance of Payments: A Puzzle

In 2008 the sustainability of Russia's balance of payments was maintained without taking extra measures, thanks to exports—and primarily, the outputs of the fuel and energy sector. Despite a sharp fall in prices for energy sources in autumn of 2008, thanks to a rapid rise in prices over the first half of the year the balance of trade ultimately posted growth of 34.9%, while that of balance of payments was up by 29.7%. Against the backdrop of high prices for energy, Russian exports surged by more than 32%, while imports grew by 30.9%. However, the world financial crisis has so far resulted in a fall in prices for major Russian exports and a massive flight of capital out of the country. As a result, even though the balance of payments will seem fairly sustainable by the end of the year, a rapid decline in exports and the private capital outflow noted in the 4th quarter have resulted in a contraction of the nation's foreign reserves for the first time since 1998.

Table 2: Main Items of the Balance of Payments and the Dynamic of External Debt in 2006-2008 (in Billion US Dollars)

Balance Sheet	2006					2007					2008				
	I Q.	II Q.	III Q.	IV Q.	*Year*	I Q.	II Q.	III Q.	IV Q.	*Year*	I Q.	II Q.	III Q.	IV Q.	*Year**
Current account	30.4	24.3	23.9	15.7	94.3	22.4	14.4	15.5	24	76.2	37.4	25.8	27.6	8.1	98.9
Capital and financial instruments account**	-7	15.7	-14.8	9.5	3.4	14.5	48.5	-3.6	26.5	85.9	-24.7	35.4	-9.4	-129.7	-128.4
Change in Forex reserves ('+' 'decline of reserves', '–', growth in reserves)	-21.4	-40.9	-13.8	-31.3	-107.5	-32.9	-65.5	-7.9	-42.6	-148.9	-6.4	-64.2	-15	131	45.3
Net mistakes and omissions	-1	0.9	4.8	6	9.7	-4	2.7	-3.9	-8	-13.2	-6.3	3.1	-3.2	-9.4	-15.8
Change in external debt of RF ('+ equals growth in debt, – equals decrease of debt)	16.0	15.6	-19.5	41.3	53.4	37.4	43.9	39.1	32.5	152.9	13.9	47.4	15.7	–	–
Change in the external public debt of the RF	4.0	-7.6	-24.5	-5.1	-33.2	3.6	-3.2	3.5	-6.1	-2.2	-5.4	-2.1	3.8	–	–
Change in the external debt of the private sector in the RF	12.1	22.7	5.1	46.9	86.8	34.0	47.1	35.5	38.7	155.3	19.2	49.5	11.9	–	–

** Preliminary estimates. ** Less currency reserves.*
Source: The CBR.

It is worth noting that against the background of a drastic shrinkage of current accounts in Russia's balance of payments, the problem of the sustainability of the latter is further complicated by the huge foreign debt accumulated by Russian corporations, including quasi-public ones (banks and non-financial companies in which the public administration bodies and monetary and credit regulators hold, directly or indirectly, more than 50% of participation in capital or otherwise exercise control over them). According to the CBR, as of 1 October 2008, the quasi-public companies' aggregate debt amounted to $146.1 billion, including $14.4 billion in short-term (up to one year) debt. The aggregate external debt accumulated by the private sector as of the same date was $351.6 billion, which included $87.5 billion in short-term liabilities. In 2009 national corporations will have to repay their $136 billion worth of external debt (including the repayment of the body of the debt and interest payments).

In 2008, the balance of capital accounts slid substantially and hit $128.4 billion. That was a result of the financial turmoil in the world and national markets stirred by the fall in prices for energy sources. The 2008 balance of capital transfers accounted for $6 billion. So, without regard to capital transfers, the 2008 deficit in financial accounts amounted to $129 billion.

As in the previous year, federal administrative bodies likewise became net payers in relation to non-residents. Their external liabilities slid to $7.4 billion because of the repayment of Russia's external public debt. The balance of external liabilities across the Russian Federation remained unchanged. The liabilities held by the monetary and credit authorities amounted to $4.7 billion. The intensifying global financial crisis sharply diminished the ability of Russian economic agents to attract new sources of funding. Consequently, the growth in the banking sector's liabilities (+ $9 billion) plunged by 87.4% compared with the same period in 2007.

The net foreign assets of residents (the liabilities of foreign economic agents minus the foreign liabilities of Russians) grew over 2008 by $216.5 billion (in 2007 they grew by 112.8 billion), with the bulk of the increase being secured by the private sector's operations.

Foreign assets held by the federal administrative bodies rose by $2.4 billion, while those of the monetary and credit authorities remained practically unchanged.

Because of the turmoil in the national financial market coupled with the fall in prices for major Russian exports and, consequently, expectations of a significant depreciation of the national currency, Russian banks in 2008 began aggressively accumulating foreign assets. More specifically, by the end of the year the foreign assets held by the banks increased by $66.4 billion, whereas in the previous year, 2007, the increase did not exceed $25.2 billion.

Thus, as in the prior years, the main factor that determined the value of the balance of current accounts was the balance of trade, which was in turn, to a significant degree, dependent on fluctuations in international markets for the price of energy and other major Russian exports; there was a fall in prices for major Russian exports, resulting in a massive capital flight out of the country. A huge amount of private sector debt had accumulated to the end of the year (see Table 2), and caused the negative balance of investment earnings to grow, despite the sizeable investment revenues the monetary and credit regulatory agencies collected from investing the nation's international reserve assets.

6 Financial Markets: Going Down

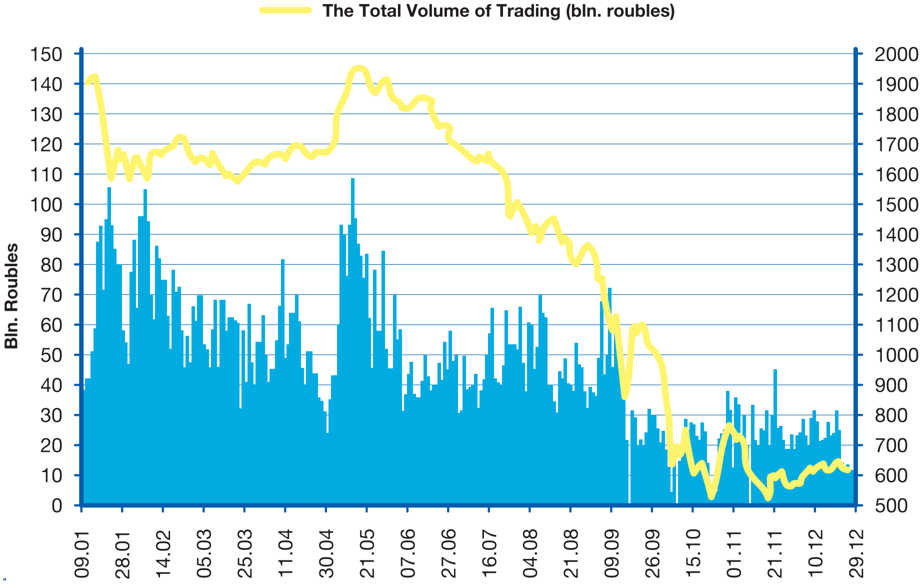
The Stock market. During 2008 the Russian stock market, in contrast to the situation a year earlier, experienced dramatic fluctuations (see Figure 5). Among the main factors that caused this trend on the Russian stock market, the following events were especially noteworthy: the negative situation in the US mortgage market; the world credit crisis; highly volatile prices on the international oil market; the bankruptcy of two biggest US investment banks and the takeover of the third one; partial nationalisation of several of the biggest banks, insurance companies and mortgage agencies; the weakening of dollar exchange rate in the first half of the year, followed by its strengthening in the second half of the year; and a revival of investor activity in the absence of negative external news. Besides, in 2008 there was a dramatic decline of liquidity in the banking sphere, and so the CBR had to implement certain measures that had a transient positive effect on the behaviour of the Russian market. Additional support for international markets was provided by the decision of the US Federal Reserve, followed by the central banks of some other countries, to lower the key rates and to undertake certain anti-crisis measures designed to sustain their national economies.

Domestic news was also very important. Thus, the collapse in the shares of Mechel in July, the abrupt slowdown in industrial production in the second half of the year, the growing rate of inflation, the events in South Ossetia and Abkhazia in August, the frequent suspension of trading on the Russian exchanges (the MICEX and the RTS Exchange) by the Federal Financial Markets Service

(FFMS) of the Russian Federation (from mid-September onwards), the recall of licenses of some credit institutions because of their inability to fulfil their obligations in a timely manner, and the dramatic weakening of the rouble against the dollar and the Euro in the last quarter of 2008—all of these contributed to the decreasing attractiveness of the Russian stock market in the eyes of investors. Another factor which had a noticeable effect on the market was the lowered rating of some of the companies actively trading in shares.

At the same time, beginning from late August and September 2008, the negative trends on the Russian stock market began to be felt more strongly, against the background of the deepening financial crisis.

Figure 5: The MICEX Index and Trading Volume in Billion Roubles, in 2008



Source: The Moscow Interbank Currency Exchange (MICEX).

In 2008 the Russian stock index (MICEX) suffered a record drop of 1,287.33 points (from 1,906.86 to 619.53 points, down by two-thirds) from its value as of the close of trading on 9 January 2008 (in 2007 it had grown by 20.16%). The low point of the MICEX index in 2008, 513.62 points, was recorded on 24 October (compared with 1,516.09 points a year earlier). On 19 May it had reached its 2008 high of 1,956.14 points (compared with its high of 1,969.91 points in 2007). As for investor activity, in 2008 it also declined by comparison with the previous year. In particular, the volume of trade in the shares constituting the base of the MICEX index in 2008 amounted to approximately 1.14 trillion roubles, with an average daily volume of trading of 45.74 billion roubles. In 2007, the aggregate volume of trading had been approximately 13.6 trillion roubles, with an average daily volume trading of 55.33 billion roubles. Thus the trading volume in 2008 dropped by comparison with 2007 by 16%.

The Corporate Bond Market. Among the main factors influencing the situation on the domestic debt market, two have been pointed out: the monetary policy of the CBR (in particular, the increased rate of refinancing) and the weakening of the national currency. As a result, the second half of 2008 was a period of ‘large-scale placements by big issuers’, whereas the securities of small and medium-sized businesses were gradually disappearing from the market as a result of the execution of their offering and redemption.

The volume of the domestic corporate bond market (that is, the aggregate face value of securities in circulation) had been increasing over the year, and then in December—at the peak of the financial crisis—it reached its historic high of the period under consideration (1,666.5 billion roubles). However, this trend—at first glance a positive one—arose as a consequence of the activity on the debt market in the first half of 2008, when a sufficiently large quantity of bond issues were registered and placed. The average duration of a corporate bond portfolio in the 4th quarter had shrunk dramatically, until in late December it was 587 days; in fact, it dropped to the 2004 level, while as late as the previous September this index had been approximately 1.5 times higher.

In the 4th quarter of last year the index of the Russian corporate bonds market—IFX-C bonds—dropped to its lowest point since mid-2006, while the value of the reduction, in relative terms, was a record figure for the whole period since records were first kept.

At the tender for determining the rate of coupon yield in January–February 2008, it was established at the level of 9–11% per annum, while in November–December it was already at least 13–14%. Over the last year, the average weighted effective rate of coupon yield on the secondary market increased by more than 2.5 times, and so by late 2008 it had reached more than 20%. Whilst in the first half of the year bonds of closed-end joint stock companies were being traded on the FB MICEX at a level of ± 1–2% over their face value, in the 4th quarter the bonds of big issuers on this index had dropped to approximately 80–90% of their face value, while the securities issued by small companies had declined to 20–40% of their face value or even less.

7 Budget Policy: Revenues Down, Expenditures Up

The dynamics of the main components of the budgetary system of the Russian Federation in 2008 was substantially different from trends prevailing over the prior year. While in 2007 revenues and expenditures of budgets of all levels were on the rise vis-à-vis their respective figures of 2006, in 2008, changes were headed in the opposite direction (see Table 3). Against the backdrop of the economic crisis the revenues of the enlarged government fell fairly significantly to 38.5% of GDP (down by 1.7 percentage points of GDP vs. 2007) and so did the revenues of the federal budget (down to 22.3% of GDP, or by 1.3 percentage points of GDP). At the same time, revenues of the consolidated budgets of the federal subjects of the Federation were up by 0.2 percentage points, to 14.9% of GDP.

Huge oil and gas revenues collected in the prior year allowed a substantial financial reserve in the form of a budget surplus, which made it possible for the government not only to fulfil its expenditure obligations, but also to replenish the Reserve Fund and the National Welfare Fund.

Table 3: Revenues and Expenditures Across Budgets of all the Levels of Government in 2000–2008 (as % of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
The Federal Budget									
Revenues	15.5	17.8	20.3	19.5	20.1	23.7	23.3	23.6	22.3
Expenditures	14.2	14.8	18.9	17.8	15.8	16.3	15.9	18.1	18.2
Deficit (–) /Surplus (+)	1.4	3.0	1.4	1.7	4.3	7.4	7.4	5.5	4.1
Consolidated Budgets of Federation Subjects									
Revenues	14.1	14.5	15.1	14.6	14.1	13.9	14.1	14.7	14.9
Expenditures	13.4	14.5	15.5	14.9	13.9	13.6	13.6	14.6	15.1
Deficit (–) /Surplus (+)	0.7	0.0	–0.4	–0.3	0.2	0.3	0.5	0.1	-0.1
The Budget of the enlarged Government									
Revenues	38.3	38.4	37.8	37.1	37.5	39.7	39.6	40.2	38.5
Expenditures	34.3	35.2	36.3	36.0	32.9	31.6	31.2	34.1	33.7
Deficit (–) /Surplus (+)	4.0	3.2	1.5	1.1	4.6	8.1	8.4	6.1	4.8

Source: The Russian Ministry of Finance, the IET calculations.

In the second half of 2008, the progressive deterioration of financial health inevitably caused a drop in budget revenues and put into question the financial stability of the national budgetary system as a whole. The fall in the enlarged government's revenues against the figures for 2007 was determined primarily by the contraction of tax revenues[2] (by 0.5% of GDP). It was at the federal level where tax revenues slid most notably (by 0.1 percentage points, down to 21.2% of GDP), while the fall of non-tax revenues (by 0.4 percentage points to 1.1% of GDP) and uncompensated

[2] For the purposes of the present analysis tax revenues comprise insurance premiums to the compulsory medical insurance fund and revenues from foreign trade (in compliance with effective provisions of the applicable section of the Budget Code of the RF, these categories of revenues are counted as nontax).

receipts from other budgets of the budgetary system (by 0.7 percentage points, to 0.03% of GDP[3]) were major factors behind the overall fall in federal budget revenues in 2008. The growth in revenues to regional budgets is related solely to a 0.8 percentage point rise in transfers from the federal budget, to 2.7% of GDP (meanwhile, both tax and non-tax revenues were on the decline).

The rates of change in the volume of expenditure were also different across budgets of different levels. While federal and regional budgetary expenditures rose by 0.1 and 0.5 percentage points (to 18.2% and 15.1% of GDP, respectively) vis-à-vis the 2007 figures, the enlarged government's budgetary expenditures, on the contrary, tumbled by 0.4 percentage points to 33.7% of GDP. The rise in federal and regional budgetary expenditures in 2008 versus the 2007 figures was fuelled mostly by inter-budgetary transfers and, accordingly, this rise could not but affect the enlarged government's volume of budgetary expenditures.

The rise in federal budget expenditures versus the 2007 figures took place against the background of plunging revenues, which resulted in a shrinking surplus of the federal budget (down by 1.4 percentage points to 4.1% of GDP). Because of the substantial growth in expenditures in the budgets of the federal subjects, the latter ran a minor deficit in 2008 equal to 0.1% of GDP. While the government's enlarged budgetary expenditures plunged in terms of GDP equivalent, they did so to a far lesser degree than the revenues. This resulted in a substantial fall in the surplus, by 1.3 percentage points, down to 4.8% of GDP.

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[3] This contraction is related to the fact that in 2007, this revenue item reflected the collection to the federal budget of additional revenues from YUKOS, while in 2008 there were no such transfers to the budget.

In addition to a substantial fall of revenues from the mineral tax and customs duties to the federal budget, according to some moderate projections, in 2009 the shortfall in budgetary revenues from other taxes may reach 2.9–3.3% of GDP. Hence, the bulk of the burden of execution of the expenditure obligations undertaken will be laid upon the Reserve Fund. Its resources undoubtedly appear sufficient to execute all the obligations stipulated in the 2009 Federal Budget Act. However, given the unforeseen expenditures (the anti-crisis package of measures introduced by the Russian Ministry of Finance on 19 March 2009 in the form of amendments to the 2009 federal budget—measures for the stabilisation of the financial market—for the support of individual sectors of the economy, and for the social protection of the population,), the long-standing nature of the crisis and the unpredictability of exchange rate fluctuations, the stability of the budgetary system in the medium term depends on changes to the general direction of budgetary policy towards restricting public expenditures and increasing requirements for their efficiency.

8 Putin’s Anti-Crisis Plan: Who wins?

General overview. Fearing the collapse of the banking system and a deflationary shock, economically developed countries resorted to a number of aggressive measures designed to support the banking system and to stimulate production activity. The most important measures included the allocation of liquidity, the expansion of the deposit guarantee system for physical persons, the buy-out of some of the banks by the state, the aggressive reduction of refinancing rates, and the adoption of ‘stimulus plans’ (envisaging budget injections into the real sector of the economy designed to stimulate demand therein). At the same time, the governments of many countries resorted to lowering the exchange rates of their national currencies against the US dollar. This measure was designed to preserve those countries’ foreign currency reserves and to become an additional factor in stimulating internal production. An analysis of the logic and the efficiency of these measures is beyond the scope of the present article. However, the key problem consists in the fact that these measures could yet bring about a serious macroeconomic destabilisation.

The Russian authorities also offered a number of sufficiently radical measures to soften the crisis. To a certain extent, those measures were similar to those taken by the governments of the most developed countries, but in some important aspects they differed considerably.

A collapse of the credit system was prevented. Considerable financial resources were allocated to banks in an attempt to overcome the liquidity crisis. On the one hand, these measures were designed to sustain productive activity. It is the availability of credit resources and not the stock market that constitutes the vehicle of growth of the real sector of Russia’s economy. On the other hand, the stability of the banking system was also directly linked with the challenge of safeguarding socio-political stability in the country. Losses incurred by citizens because of bank failures would be incomparably more painful and politically dangerous than any losses resulting from a fall of stock indexes.

Naturally, there were some unavoidable dubious schemes. The banks which received liquidity from the state preferred to convert it into foreign currency as much as they could, in order to insure themselves against currency risks or to repay part of their debts to foreign creditors. From the point of view of economics, this behavior was quite reasonable, although it did not correspond to the intentions of the monetary authorities who had allocated the funds. Also, there emerged some situations in which the reallocation of state-allocated funds involved bribe-taking, which is not surprising when a resource in short supply is being allocated at an underestimated price. (It was expected that the monies received by primary recipients would be allocated to second-level borrowers, not at the market rate but at a much reduced one, which would only slightly exceed the interest rate at which the initial allocation of funds had been effected.)

The state made a half-hearted attempt to prop up plunging stock indexes but quickly abandoned this initiative. Although the fluctuations in the stock indexes were breathtaking and dramatic, this is not the sphere where the state's resources should be concentrated today. Any attempt at supporting the stock exchange in the present situation would mean only one thing: helping the fleeing investors to sell their shares at a higher price and to depart with the money. Of course, it is very unpleasant for shareholders to see the value of their shares falling. It is also true that the collapse in share prices has produced a sharp rise in margin calls, but the solution to this problem lies in quite another sphere.

Decision-makers have started a discussion on ways of preventing a production crisis. The rapid economic growth achieved in recent years was caused to a major extent by the world market being awash in cheap money which was eagerly borrowed by Russian companies. However, the cheapness of money is not conducive to its being invested effectively, especially in the case of companies linked to the state and especially favoured by creditors who understand that come hell or high water, the state will never let these companies fail.

Now the situation has changed. There are no available credits, and the securities placed as collateral for credits are rapidly falling in price. Of these debts, about $43 billion must be repaid by the end of the year. The state has expressed its readiness to allocate, via the Russian Bank for Development, a sum of $50 billion for eliminating the bottlenecks.

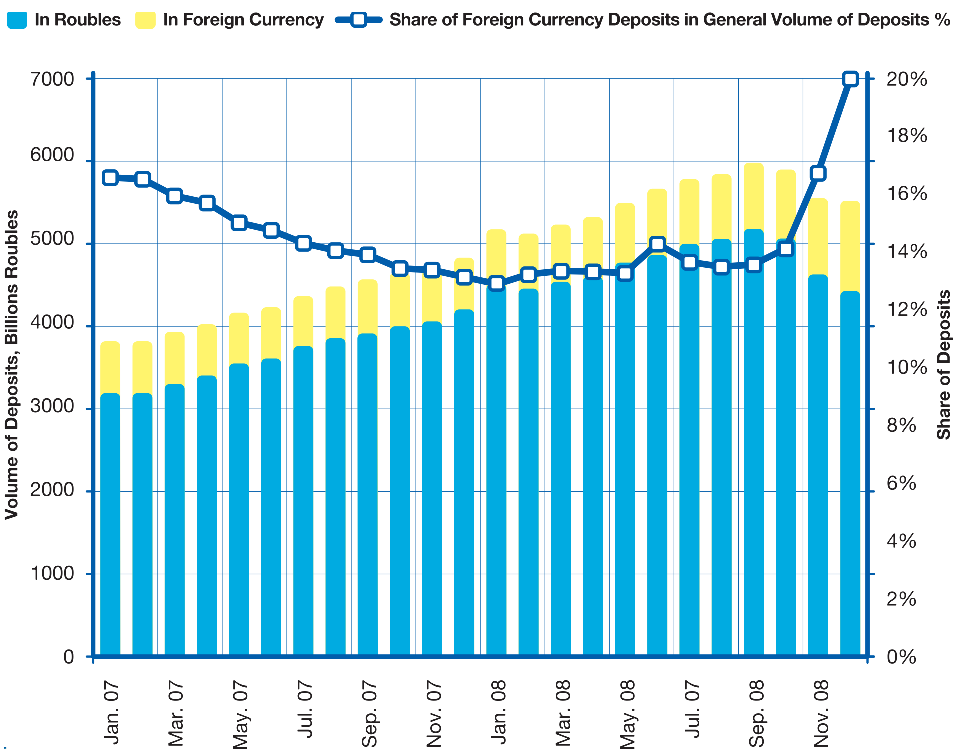
The currency policy was rather ambiguous as well. For political reasons, the authorities did not dare to completely abandon control over the rouble's exchange rate and therefore resorted to a gradual devaluation of the national currency. The causes of their caution in this matter are clear: with rouble savings being devalued for the third time in twenty years, confidence in the national currency could hardly be expected to rise. The population was given a chance to insure itself against a depreciation of the rouble. Practically everybody who wanted to exchange the roubles into dollars or Euros could do so (see Figures 6 and 7).

However, the smooth devaluation of the rouble has increased panic on the market and caused a considerable depletion of the gold and foreign exchange reserve, which may result in the emergence of a new equilibrium level of the rouble's exchange rate, which might not have been the case with an abrupt devaluation. Also, the uncertainty about the rouble's exchange rate has nearly completely frozen the activity of credit institutions. Expecting the exchange rate to drop, banks were not inclined to grant rouble credits, while potential borrowers, for the same reason, did not want to use foreign currency credits.

Moreover, a sharp devaluation of the rouble would have become an additional factor in support of domestic production and protecting the Russian market from imports. It would have supported Russian exporters and created additional stimuli for the future inflow of foreign capital in the form of direct investments.

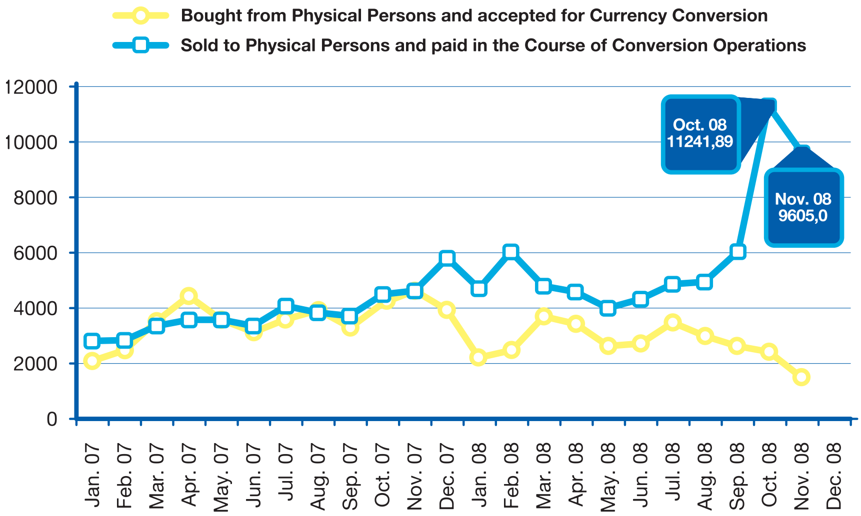
Finally, the government put forth a broad package of incentives, primarily in the sphere of taxation, which were designed to encourage the development of actual production: tax cuts, a number of measures aimed at supporting small businesses and the compilation of a list of the system-forming enterprises enjoying special attention on the part of the state. Some of these measures are rather ambiguous.

Figure 6: The Volume of Deposits of Physical Persons received by Credit Institutions



Source: CBR, the author's estimates.

Figure 7: The Volume of Currency Transactions Between authorised Banks and Physical Persons (all Kinds of Currency, in Millions of US Dollars)



Source: CBR, the Author's estimates.

Support for small businesses is undoubtedly crucially important for both economic and social reasons, because this sector can play a significant role in reducing unemployment by absorbing the most active groups of the population. However, it should be borne in mind that in Russia, the problems of small businesses lie not in the economic sphere or the domain of law, but in the areas of law enforcement and politics. Traditionally viewed with scepticism, small businesses in Russia have always been the most defenceless when confronted with bureaucratic lawlessness and extortion. Small businesses will be capable of developing only on condition that the value orientation of Russian society and especially its elite undergoes some far-reaching serious changes.

There exist serious doubts as to the effectiveness of direct assistance to big enterprises. The main problem of production development is not so much the lack of money as the malfunctioning of economic mechanisms and, in the final account, the inefficiency of many production sectors. Lavish financial injections will not solve the issue of increasing the effectiveness and the structural renovation of the economy, without which an exit from the crisis will be delayed. Nevertheless, such measures could certainly alleviate current social problems.

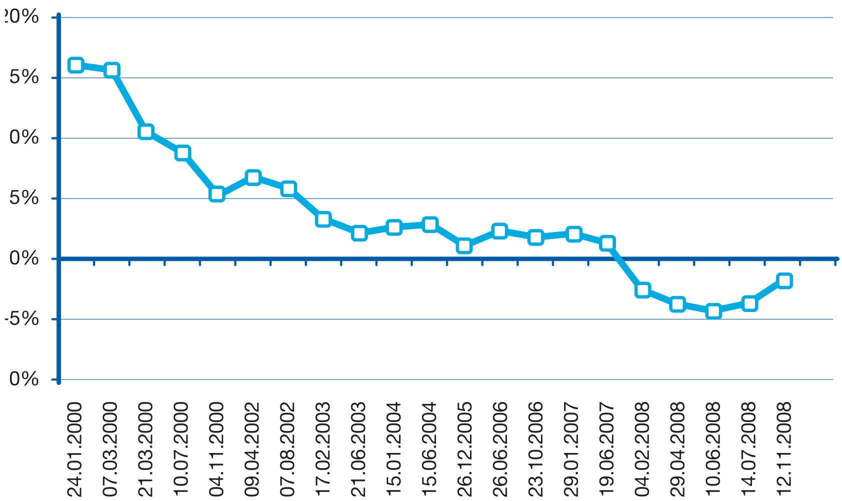
The CBR's Policy. In 2008, the CBR also aggressively employed an important monetary and credit policy measure: modification of the compulsory reservation rates. They were raised four times through September and ultimately reached 8.5% (annualised) of the Russian banks' debts to foreign credit organisations, 5.5% of their rouble-denominated liabilities to private individuals and 6% of other liabilities. It is worth noting that it was the compulsory reservation rate of the banks' debts to non-residents that was growing at the greatest pace. Apparently this was because of the CBR's desire to decelerate the growth rate of the bank's external debts to bolster their financial sustainability in the event problems on the world financial markets were aggravated.

With domestic financial turmoil on the rise, the CBR acted to drastically decrease rates of bank's mandatory reserves effective as of 15 October. In the aftermath of a two-stage decrease across all kinds of reserved obligations, the rates were set at the level of 0.5%, but only for a certain period of time—they should have risen to 1.5% in 1 February 2009 and up to 2.5% in 1 March 2009. But in January 2009, the Board of Directors of the CBR decided to change the timelines for a stage-by-stage increase in the rates of contributions to the CRF. According to this decision, the new dates were set for 1 May 2009 and 1 June 2009. In all likelihood, the CBR made this decision because of a complex situation in the national financial sector caused by the world financial downturn. Russian credit organisations should shortly face a rapid growth in defaults of loans they issued earlier, which will undermine their financial health. Withdrawal of liquidity in the form of deductions to the CRF in such conditions would fuel the rise of financial instability.

In 2008, the Bank of Russia raised its refinancing rate six times, which has grown from 10% to 13% annualised. It should be noted that this was done in parallel with the raising of rates on the credit organisations' deposits with the CBR and the acceleration of inflation in the country. But because of rapidly mounting inflation pressure, the refinancing rate in real terms has remained negative practically the whole year.

In autumn 2008, when conditions on the financial market were becoming aggravated, the commercial banks' demand for the CBR's credits grew sharply, which resulted in an increase in the CBR's interest rate policy, as its resources had become a major source of growth of the money supply (see above). The CBR maintained low interest rates in real terms to vigorously refinance commercial banks. Meanwhile, despite the effects of the recession the CBR increased the recession's momentum by raising the refinancing rate to counter the capital outflow, which started because of the development of the world financial crisis and the subsequent fall in prices for major Russian exports (see Figure 8).

Figure 8: The CBR's refinancing Rate in 2000–2008, in Real Terms



Source: The CBR, the Statistics Service of the RF.

However, in the first half of 2009, the CBR took steps to soften its credit and monetary policy. On 24 April the CBR reduced the refinancing rate by 0.5 percentage points. The basic incentive for the CBR to lower interest rates was to reduce the cost of credit provided by the CBR to credit organisations, under the assumption that this would eventually lead to the reduction of the cost of credit to the real sector. However, credit risks still remain high; the decrease of the basic interest rate could therefore result in a corresponding decrease of interest rates on credit to non-financial sectors.

The reason for the repeated reduction of interest rates was the decline in inflation and lowered expectations of rouble devaluation. For the second consecutive month, there was a declining trend with regard to inflation. The growth of oil prices in the global market has contributed to rouble strengthening and decreased devaluation expectations. The CBR does not exclude the possibility that in case of further rouble strengthening and a decrease in inflation the CBR will continue to lower interest rates.

At the height of the financial crisis in late 2008, the national financial intermediaries in Russia faced liquidity shortages, which compelled the CBR to embark on a series of emergency measures (apart from lowering interest rates on its credits and reducing the CRF deduction rates). These measures sought to prevent instability in the national banking sector from spreading to other parts of the economy. More specifically, on 10 October, the Duma passed an act that allowed the CBR to disburse unsecured loans to Russian credit organisations. Such loans became available to credit organisations whose credit rating was not below a set value, and could be disbursed for up to six months. This measure was aimed at supporting the national banking sector that had found itself in a difficult situation. Because of a large-scale outflow of private capital from the country, sizeable external indebtedness had accumulated over the previous years and aggravated the crisis in the real sector. Prior to the promulgation of the act, the CBR had been able to disburse credits to the national commercial banks against securities, hard currency and receivables under credit agreements, or against a credit organisation's pledge. But because of the banks' huge need for credit resources, they lacked assets that might serve as collateral for loans from the CBR. In such a situation, granting the CBR the possibility to disburse unsecured loans enabled it to support Russian banks, even though it increased potential risks associated with the borrowers' inequitable conduct.

To support the banking sector amidst the deepening financial crisis, the CBR began entering into agreements with large Russian banks on compensation for a fraction of their possible losses in inter-banking lending operations. As well, the CBR has undertaken such measures as provision of repo financing on security of an extended list of assets, extension of the repo financing term, disbursement of subordinated credits to the so-called 'backbone' banks and adoption of the legislation on loan guarantees for corporations. Moreover, the capitalisation of the Deposit Insurance Agency was boosted for the sake of the financial rehabilitation of the banking system.

Finally, on 30 December 2008, the CBR modified the procedures of formation of reserves by credit organisations in order to help them withstand possible credit losses. According to the effective procedures, credit organisations are bound to form reserves to back possible credit losses, depending on credit risks assessments. The procedures also imply that this diminishes the volume of funds available for commercial banks to carry out their current operations.

In compliance with the above decisions, the credit institutions were granted the right not to increase their credit reserves until 31 December 2009, in the event that

- the duration of overdue indebtedness on the loan principal or interest on the loan extends for a term of not more than 30 calendar days relative to the effective timeline;

- the loan has been restructured (for instance, the currency in which the loan was denominated was changed), or the loan period (with regard to the loan principal and/or interest on the loan, or a change in the interest rate) has been modified in the period since 1 October 2008;

- the loan received since 1 October 2008 has been used to repay the earlier extended loan.

This measure has de facto stimulated banks to give credit to more risky borrowers. But it should be understood that an overly liberal approach to credit risk assessment procedures may derail financial stability. In other words, this measure should be conceived of as a purely temporary measure to aid the national financial system. Furthermore, in late 2008, information surfaced that the government authorities had instructed the largest Russian banks to bolster their credit portfolios at a certain rate. With financial instability on the rise, such an approach may simply entail the accumulation of 'bad' debts on the banks' balance sheets and trigger further challenges facing the credit organisations.

Russian banks are going to face yet another major challenge in the near future: a rise in the volume of overdue debts on earlier extended credits. At this juncture, the main tasks in the area of support of the banking system will focus on the development of approaches to diminish the banks' 'bad' assets, easing the M&A processes in the banking sector, refinancing the banks' external debts at arm's-length terms and improving the regulation and oversight procedures in the sector. International experience shows that an increasingly popular measure that complements the provision to banks of additional capital has been the redemption of their bad assets by a special agency. Such a structure might be established in Russia, too; however, to minimise risks associated with the banks' inequitable conduct, the agency should redeem only the debts on loans extended in the pre-crisis period.

Measures taken by the Russian Government to mitigate the Impact of the Crisis on the Regions. Trends observed in sub-national finances in the last two months of the past year confirm that the crisis has expanded to regional economies and has, consequently, increased the tension in the area of regional finance. In view of these circumstances, the Ministry of Finance and the Russian government in late 2008 and early 2009 took a series of measures aimed at mitigating the impact of the crisis on sub-national budgets.

On 20 December 2008, a letter[4] was sent by the Ministry of Finance of the Russian Federation to all the federation subjects with an explanation of the priority measures to be taken by the subjects in 2009, aimed at preventing crises in the financing of expenditure liabilities of regional authorities. In general, the recommendations of the Ministry of Finance addressed primarily the most conservative expenditure estimates for 2009 with regard to the reduction in estimates of the tax base (primarily, corporate profits and payroll deductions). It was emphasised that sequestering expenditures when the budget is under execution is undesirable.

The letter also provided a number of specific recommendations to federation subjects. First, they should assign the surplus revenues received in 2008 to a reserve fund for 2009, rather than finance expenditures of the current year (as used to be done in all preceding years). Second, it was emphasised that the decision to raise the

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[4] Letter of the Ministry of Finance of Russia nº 06-03-07, dated 20 October 2008: ‘On recommendations on the formation of budgets of the Subjects of the Russian Federation in 2009 and for the planned period up to 2010 and 2011’.

salaries of public sector employees should be implemented with due regard to the capacity of regional budgets. In this respect, the upgrading of salaries for workers at federal agencies should not be taken as a benchmark for similar solutions at the regional level. Third, the letter noted that the budget deficits of federation subjects should be planned with regard to available credit resources and opportunities for the placement of the debt securities.

Let us review the actual situation with respect to the prospects for the formation of the financial reserves of the regional budgets. According to the Russian Ministry of Regional Development, the unallocated balances carried over to 2009 but not allocated to cover the budget deficit in 2009 amounted to about 273 billion roubles. The largest balances are available in seven federation subjects; their share exceeds 10% of the revenues estimated for 2009. These regions are the following: Lipetsk, Tver, Tyumen, Chelyabinsk, Sakhalin Region, Yamalo-Nenets and Chukotka Autonomous Region. Those regions have great potential to compensate for decreased revenues in 2009. However, the majority of the regions do not have any significant balances to be carried over to 2009 and will be forced to significantly reduce their expenditures in the first quarter of 2009.

There are three main reasons for the fact that at the end of 2008, despite the recommendations of the Russian Ministry of Finance, the majority of federation subjects were unable to accumulate significant financial reserves:

1. Objective slowdown in revenue growth of the consolidated budget of the federation subjects at the end of 2008. In November–December 2008, the total income of the federation subjects grew only by 5.7% over the

same period in 2007. It is obvious that at the beginning of the fiscal year many federation subjects had hoped for greater revenue growth in 2008. Consequently, the majority of the federation subjects have not obtained considerable surplus revenue as compared to the estimates of late 2008.

2. Inertia in the budget process. Federation subjects failed to dismiss many expenditure liabilities on time.

3. Intentional reluctance of regional authorities to reduce expenses and accumulate financial reserves. In a situation where the federal centre has provided neither a clear macroeconomic forecast for 2009 nor criteria for the provision of financial assistance to regions, some regions intentionally refused to cut back expenses in late 2008 and, accordingly, failed to form necessary financial reserves. In some regions this was done partially because there was doubt that the federal centre would provide emergency financial assistance only to those federation subjects who had a cash gap (i.e., no financial reserves).

On 31 December 2008, the Russian government issued Resolution N 1089, 'On subsidies from the federal budget to the budgets of the Russian Federation Subjects for implementation of additional measures, aimed at reducing tension in the labour markets of the RF Subjects'. It put forth a strategy to allocate 43.7 billion roubles from the federal budget for such subsidies in 2009.

A review of regional programmes was undertaken by the Ministry of Health and Social Development of the Russian Federation with the participation of interested federal executive authorities. The Ministry of Health and Social

Development of Russia, within 10 days from the date of receipt of the regional programme, would prepare an expert opinion and submit it to the Russian government. Selection of regional programmes for a subsidy allocation would be implemented by an interdepartmental working group whose task was to monitor the situation in the labour market.

The criteria for selection of subsidy allocations to federation subjects were the following:

1 growth in the level of unemployment in the federation subject;

2 an increasing number of employees of the federation subject under threat of mass dismissal (or the establishment of part-time, temporary suspension of work, the provision of leave without pay or arrangements for the release of employees);

3 the presence of core businesses in the federation subject.

Subsidies were to be provided in accordance with the decision of the interdepartmental working group on the basis of agreements concluded by the Federal Service for Labour and Employment and the government authorities of the federation subjects. The scope of co-financing of regional programmes aimed at reducing tension in the labour market, was set at 95% to be allocated from the federal budget.

9 Anti-Crisis Measures in the Context of an Increasing Public Sector

There are several trends that should be highlighted in the package of anti-crisis measures taken by the Russian government authorities in September–October 2008, with respect to the problems of expanding the public sector.

1 *Public credits for servicing the foreign loans* of the Russian companies and banks (initially $50 billion in 2008).

According to available data,[5] in the 4th quarter of 2008, the amount paid by Russian companies on external debts was estimated at $47.5 billion, and at $115.7 billion in 2009. Deposits (in the amount of $50 billion), allocated by the CBR through Vnesheconombank Development Bank (VEB), were enough to finance companies' payments in 2008.

In exchange, it is justifiable that credit terms be extremely strict (including such terms as 'temporary nationalisation'): securities pledges; pledges of export earnings; undisputable and acceptance-free write-off of funds from any account of the borrower to recover credit; the inclusion of representatives of the CBR on the board of the borrowing company; an agreement with the CBR to attract other loans and transactions amounting to more than 10% of the company value; credit securities similar to foreign credits; etc. However,

[5] For more information, including detailed diagrams and charts of government anticrisis 'injections', it is enough to refer to the official web sites of the major news agencies and periodicals for October 2008 (in particular, www.vedomosti.ru, www.kommersant.ru, www.expert.ru etc.).

the VEB retains an unprecedented right of decision-making with regard to any increase in the pledge, as well as the opportunity to choose between debt redemption and the 'off set' by the pledge.

By mid-October 2008, applications were submitted for the refinancing of Rosneft, VTB, Gaspromneft, TNK-BP, Lukoil, UC Rusal, the AFC System, Severstal, Michel and other companies. The minimum standard amount of refinancing at the level of $100 million (according to the memorandum of the CBR's financial policy), relates only to the largest companies and banks. OAO Gazprom, having initially declared that it had no problem with payments, can apparently become an applicant for public funds, although, due to its exclusive status in the view of the Russian authorities, its refinancing terms and schedule can be different from those of other companies.

2 *Direct (anti-crisis) public intervention* in the stock market (175 billion roubles in 2008 and 2009).

In mid-October 2008, it was also decided to allocate assets from the National Welfare Fund for the purchase of shares in Russian companies (in the amount of 350 billion roubles in 2008–2009). Currently there is no official information on the interventions, the exact amount of investments and purchased shares or the beneficiaries thereof. It would be at least reasonable to ask a question about the *expediency of the monopolisation of virtually all transactions* by VEB and about the procedures for the selection of comptrollers (professional agents) for the transactions which have been executed or will be executed in the future, including the commissions paid.

One of the very reasonable questions that arise in relation to this kind of activity by the VEB is about the source of the funds allocated for the intervention. One of the key objectives of the establishment of the National Welfare Fund was pension reform financing. It would be quite reasonable, given the crisis situation, to place the blocks of shares acquired by the Fund in the open market, namely in the Pension Fund (or its equivalent) to ensure pension payments in the future (at the stage of market capitalisation growth). It is still unknown where and to whom, in the existing non-transparent situation, the blocks of shares purchased by VEB in 2008 and possibly in 2009–2010 will be transferred.

The issue of *transparency criteria for the expediency of these transactions and their public control* is no less important. According to the decree of the Russian government dated 15 October 2008, the Ministry of Finance has the right to invest in stocks and bonds up to 80% of the National Welfare Fund assets, including up to 50%[6] in securities listed on the MICEX and RTS, or included in the MSCI World Index and FTSE All-World Index, and in the funds that carry out relevant investments.

Judging only by indirect information, such injections began only from 17 October 2008 in the shares of Gazprom, Rosneft and Sberbank, and, according to the available data, in the shares of Lukoil. Leaving aside general theoretical considerations of the near-zero efficiency of budgetary fund investments in the stabilisation of stock markets during a crisis,[7] available expertise estimates that no overall strategy of intervention, no proven anti-crisis measures with regard to divergent market trends, can be implemented even in relation to a narrow range of the leading companies or issuers.

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[6] In the range of $45–50 billion as of October 2008.

[7] It is estimated that during the week of 17–24 October 2008 at least $1 billion was spent, but the fall in securities equities of the supported issuers continued (from 15 to 33%). This means at least direct losses by government funds, although in the short term the decline in share prices would be more significant in the absence of government interventions.

Apparently there have been three possible trends: random counteraction against *margin calls*, the acquisition of certain problematic assets and the attempt to provoke market adjustments in favour of individual issuers selected by the government. The problem of insider trading and, in the broad sense, the need for a general policy against any kind of financial abuse (theft of funds) becomes particularly acute in this context.

According to the VEB, by the end of November 2008 the Bank received 115 billion roubles from the National Welfare Fund. Of this, 85 billion roubles were spent to 'support the financial market'. The funds were intended for 'the acquisition of shares and corporate bonds of the top Russian issuers', and the actions under those operations 'were approved by the Ministry of Finance'.[8] Although there is no more recent data on this type of intervention, in February 2009 the issue of VTB participation in this scheme was also under consideration.

3 In October 2008, as one of the more extreme measures of support, an option was considered— the *acquisition of preferred shares and convertible bonds* (new issues) of the companies supported by the government. This tool is common and has been used in a number of countries (UK, Switzerland) to support banking groups in difficulty. Moreover, the use of this tool makes it unnecessary for the country to interfere in the operational management or direct participation in stock equity.

By the end of February 2009 no information was available on the allocation of financial resources and the target of the government's allocation in this respect. Nevertheless, such

[8] Commersant, 12 December 2008.

proposals were submitted, for example, in late January 2009 with regard to OC Rusal (the conversion of preferred shares of the company debt to public banks in the amount of $6 billion—a pledge that included 25% of GMK Norilsk Nickel shares owned by Rusal).

Apparently, in early 2009 *the policy of support experienced significant changes* amidst the background of an overall shift of tone from the statements, made in autumn 2008, that 'there is enough money for everybody' to the more conservative strategy of reserve preservation until 2010–2011 and selective support of the largest banks rather than global support directly to the companies.

First, through the above-mentioned programme of foreign loan refinancing in the corporate sector, about 100 applications were submitted to VEB, totalling $75 billion. The programme was halted, however, when its expenditures reached $11 billion. Among the recipients were Rosneft ($800 million), UC Rusal ($4.5 billion), VimpelCom, Euras and some others. On the one hand, the programme has been recognised as inexpedient, as the majority of the participants have accumulated sufficient foreign currency reserves and have been able to solve their problems with creditors independently (about $85 billion by February 2009, which is, according to government estimates, enough to settle credit payments in 2009).[9] On the other hand, the terms of such credits apparently seem too strict to the applicants (which points to the undisclosed internal resources of companies to solve their financial problems without tighter government control).

Nevertheless, it should be noted that, even with respect to the allocated credits, transparent public information on the selection criteria of the participants for the public

[9] *Money*, nº 6, 16 February 2009.

support programme is almost completely unavailable. It is also not clear how VEB intends to dispose of the blocks of shares obtained as a pledge, after the established one-year term (the maximum period of credit maturity).

Secondly, in October 2008, it was envisaged to allocate 450 billion roubles from the National Welfare Fund to the VEB, followed by a 225 billion rouble allocation to the banking system for the co-financing of the capital increase (by February 2009, private banks had accepted 17 billion roubles). Nevertheless, the policy of extensive infusion of funds into the banking system (by mid-February 2009 it amounted to nearly 3.4 trillion roubles, including 1.9 trillion roubles of the debt of the banks to the CBR under unsecured credits[10]) did not result in the renewal of mass bank investments in the industrial sector. On the contrary, it is estimated that the total credit requested by the Russian enterprises from the government was about 3.5 trillion roubles, while in December 2008, the relevant estimates of the Russian budget for 2009 allocated only 325 billion roubles for the crisis measures, and 300 billion roubles (including 100 billion roubles for defence enterprises) for the government guarantees.[11]

This has served, in particular, as a motivation for the government to search for new ways to support enterprises in the real sector.

The programme for a recapitalisation of the banking system in order to renew lending to the enterprises of the real sector (in fact, this means an increase in state participation in capital), it was claimed in 2009, could cost about $40 billion (which is, in fact, equivalent to the ‘balance’ of the

[10] *Power*, nº 6, 16 February 2009 .
[11] *Mergers and Acquisitions*, 2009. nº 1–2, p. 4.

suspended 2008 programme of credit refinancing). The number of banks which can participate in this program is not yet defined, but there are notably different official estimates, depending on the scope and models of public support and on participation (according to Vladimir Putin there would be 81 banks; according to I. Shuvalov, up to 50 in the case of subordinated credit co-financing, or from four to a maximum of 30 banks in the case of additional issues redemption). By early February 2009 the model of support with direct state participation in capital was foreseen to involve only three banks (VTB, VEB, Gasprombank). Sberbank, VEB, VTB and Gasprombank were instructed to expand their credit portfolios by at least 2% per month.[12] It was envisaged to provide subordinated credits to private banks in the (total) amount of 100 billion roubles. In particular, this meant government unwillingness to take on the risks of operational management as a shareholder.

Back in 2008, financial experts began to explore alternative (financial) approaches to the support of Russian enterprises, operating in 'important sectors of economy'. By the end of December 2008 the absolute number of potential recipients of state aid in the short term decreased five-fold (1,500 as per the initiative of Vladimir Putin, 500 proposed by I. Shuvalov and 295 by E. Nabiullina). Among the formal requirements for companies to enrol in the anti-crisis program were terms such as these: that the company has at least 5,000 employees, its revenue is at least15 billion roubles, or the company is the principal local employer and mainstay. VEB would become the government agent in this model of state support. Companies would be able to invest up to 50% of government guarantees (enterprises engaged in the military-industrial complex, up to 70%) as credit

[12] *Vedomosty*. 3 February 2009.

security. In this way, the maximum amount of public guarantee to each applicant was limited 10 billion roubles.

For 293 enterprises from 25 industries eventually included in the list drawn up by the Russian Ministry of Economic Development and Trade, credit support instruments were provided, but the range of possible solutions was much wider: government guarantees (which are widely used as anti-crisis measures in developed countries, in the amount of nearly $10 trillion and require only a conditional reservation of funds), interest rate support funding, and restructuring of tax arrears, public contracts, customs and tariff policy. Some measures on mitigating the 'negative social and economic impact of the business's closure' are foreseen, apparently, in the event of bankruptcy.[13]

By mid-February 2009, information was disclosed on the applications of the largest Russian manufacturers for government guarantees under credits (from AvtoVAZ, GAZ, Kamaz and Sollers, totalling 29.5 billion roubles). Among other methods of public support to the Russian automobile industry, the redemption of bonds up to 60 billion roubles and public procurement contracts in the amount of 12.5 billion roubles were envisaged. In the military-industrial complex decisions were made on the provision of state guarantees to three enterprises, on subsidies for 19 enterprises and on the balance of capitalisation for RSK MiG, amounting to 15 billion roubles. The state corporation Rostechnologies (which has taken ownership of 20 of the local economic mainstays and of 278 strategic enterprises) has requested state guarantees in the amount of 110.8 billion roubles (in addition to 151.32 billion roubles in the form of material contributions).[14]

[13] 'Public feeder for three hundred hamsters.' www.gazeta.ru, 26 December 2008.

In its anti-crisis policy the Russian government seems to be withdrawing gradually from direct methods of support involving direct public participation in the capital of problematic private companies and banks in favour of stronger indirect control through a small number of banks supported by the government, the formation of preference lists of 'significant' enterprises, continued activity of state corporations and state holdings (the few market subjects able to consider new mergers), and the inevitable (though not as extensive as expected) nationalisation of problem assets in its 'hard' or 'soft' options.

In any case, it is too early to give any more detailed assessments of current developments, not least because of the lack of a critical mass of transactions actually executed, as well as insufficient information, at least regarding the scope and criteria for state interventions.

In view of the above, in terms of qualitative assessments, the precise strategy, objectives (incentives) and long-term results (costs) of the process are the most acute issues.

10 Scenario Forecasts

Below we present a few possible scenarios for the development of Russia's economy in 2009. The forecasts are built on the basis of a structural econometric model designed

[14] It is remarkable that 34 billion roubles have been allocated to finance the purchase of shares in OAO VSMPO-Avisma by a public corporation. See *Vedomosti*, 9–10 February 2009; *Kommersant*, 8 February 2009.

by the Institute for the Economy in Transition. In the current economic conditions, which are characterised by a drastic rise of uncertainty and the collapse of entrenched trends, the accuracy of forecasts, including the one that rests on results of the econometric evaluation of dynamic correlations in the economy, decreases dramatically. That is why, in contrast to the previous years, we did not contemplate providing medium-term forecasts (at least for the upcoming three years), but instead presented results just for the quarter-by-quarter forecasts through the end of 2009.

We will be considering four possible scenarios.

Scenario 1 (basic) was prepared in conformity with major prerequisites the Russian Ministry of Economic Development and the Russian Ministry of Finance employed to develop the 2009 forecast for Russia's socio-economic development, and with the specified 2009 draft of the federal budget. Thus, the average annual price for oil (Urals) was assumed to be $41 per barrel, while the capital outflow from the country (taking into account the section 'Omissions and mistakes' in the balance of payments) was set at $80 billion. Federal budget expenditures were assumed to amount to 9.69 trillion roubles, with the federal budget deficit financed primarily from the Reserve Fund of the RF. The Euro/US dollar exchange rate was assumed to remain stable at the level of $1.35/Euro.

In addition, in the framework of the scenario it is presumed that the problem of 'bad' debts in the national banking sector would further deteriorate in the 3rd quarter of 2009. More specifically, we assume that the level of such debts could account for 10% of the overall volume of credits disbursed to the non-financial sector of the economy. Accordingly, we take into account the need for an additional supply to the banking system of liquidity from the CBR (in the amount of as much as 700 billion roubles), a further decline of the lending activity in the economy and a decline of the money multiplier from 2.5 to 2.2 between the 3rd and the 4th quarters of 2009. Whereas the federal budget deficit would be funded from the Reserve Fund (effectively by means of monetisation of the deficit), in an effort to shield it the CBR would not refinance the uncollateralised loans to Russian banks disbursed earlier and due to be repaid this year.

Scenario 2 (the scenario of low prices) implies consideration of a situation in which the average annual price of oil has plunged to $32 per barrel. Taking into account a preliminary estimation of oil prices in the 1st quarter ($44 per barrel), this conforms with a price decline between the 2nd and the 4th quarters of 2009 to $28 per barrel. Apart from this, all the other prerequisites are those of the basic variant.

The 3rd and 4th scenarios deal with various modifications of the basic scenario. **Scenario 3 (the scenario of a crisis of the external debt)** suggests an aggravation of the situation through repayment of the external debt of national corporations and banks. In the framework of this particular scenario we assessed the consequences for the economy generated by a rise in capital outflow from the country in 2009 which matches the initial debt repayment timetable set for 2009 (according to the CBR data), that is, in the amount of some $120 billion (including $117.1 billion in repayment of the principal).

Scenario 4 (budgetary expansion) adds an additional increase (against the draft federal budget as of 19 March 2009) of budgetary expenditures of 2.5% of GDP, that is, 1.0 trillion roubles, to the basic scenario.

The results of the forecast for the dynamics of the basic indicators of Russia’s socio-economic development are presented in Table 4.

Table 4: The Results of Forecast on the Dynamics of the Basic Indicators of Socio-Economic Development of the RF

	1st Q*	2nd Q	3rd Q.	4th Q	2009
Oil Prices, Urals, as US Dollars/Barrel					
Scenario 1, 3, 4	44	40	40	40	41
Scenario 2	44	28	28	28	32
Real GDP, as % of the respective Period of the Prior Year					
Scenario 1	–4.8	–4.1	–2.8	–0.5	–3.1
Scenario 2	–4.8	–4.9	–3.2	–1.0	–3.5
Scenario 3	–4.8	–4.1	–2.9	–0.7	–3.2
Scenario 4	–4.8	–4.1	–2.9	–0.6	–3.2
The Federal Budget Deficit (as % of GDP)					
Scenario 1	0.8	10.1	9.1	8.2	7.0
Scenario 2	0.8	10.8	9.6	9.1	7.7
Scenario 3	0.8	9.3	8.1	7.3	6.5
Scenario 4	0.8	10.1	13.7	12.6	9.4
The CBR's International Reserves (Billion US Dollars)					
Scenario 1	396.5	396.5	395.6	395.0	395.0
Scenario 2	396.5	395.3	393.4	391.2	391.2
Scenario 3	396.5	388.1	382.9	380.9	380.9
Scenario 4	396.5	396.5	395.6	395.0	395.0
CPI, % Change					
Scenario 1	5.2	2.7	1.0	1.9	11.2
Scenario 2	5.2	5.5	3.9	3.2	18.4
Scenario 3	5.2	7.1	2.6	2.4	18.4
Scenario 4	5.2	2.7	2.2	3.4	15.4
Rouble/US Dollar Exchange Rate					
Scenario 1	35.26	35.3	35.3	35.4	35.32
Scenario 2	35.26	40.7	45.0	45.0	41.49
Scenario 3	35.26	46.2	46.5	46.5	43.62
Scenario 4	35.26	35.3	35.9	36.4	35.72

**Assessment of actual data over January or between January and February 2009*

According to the basic scenario, in 2009 Russia's real GDP should fall by 3.1%, with the nominal value of GDP amounting to 40.83 billion roubles. The decline of investment in fixed assets over the year would amount to 5.8% on the whole, while the decline in the population's real incomes would be 3.8%. At the same time, some stabilisation of the rate of decline in real income is expected in the 4th quarter of the year.

According to our calculations, the federal budget deficit should amount to 7% of GDP, with aggregate revenue coming to 6.82 trillion roubles (16.7% of GDP), which is slightly in excess of the Russian Ministry of Finance's forecast (6.71 trillion).

In the context of this particular scenario, the situation with the nation's balance of payments is presumed to be fairly sustainable. Providing that the move towards the restructuring of the debt of Russian private corporations and banks is in place and the volume of the foreign debt repayment does not exceed $70–80 billion, a positive balance of current accounts would enable the Russian monetary authorities to save their international reserves, without resorting to a further depreciation of the rouble. More specifically, according to our forecast, the 2009 volume of exports should reach some $248 billion (down by 47.5% against its 2008 level), while imports are forecast to be $136.0 billion (down 53.5% from the 2008 level). So the surplus in the balance of trade should amount to at least $112 billion.

Accordingly, the CBR would be capable of maintaining the declared band of fluctuation of the bi-currency basket, that is, at a level not higher than 41 roubles through the end of the year, with its international reserves maintained at the level of $395.0 billion. Thus the contraction in the reserves over the year (some $32 billion) would occur in the period between January and February.

The stabilisation of the rouble exchange rate and a fairly conservative monetary and credit policy (restricting the issuing of roubles between the autumn of 2008 and the winter of 2009, capping the budgetary deficit at 7% of GDP and the CBR providing limited support to the national banking system) would allow one to count on fairly low inflation rates (11.0–11.5% over the year). At the same time, nearly half of the increase in prices (5.0–5.5%) would occur in the 1st quarter of the year. Overall, by the end of the year the increase in the monetary base is envisaged to be within the 10% range, with money supply (M2) remaining roughly at the level reported in late 2008.

However, should oil prices further decline to an annual average of $32 per barrel (as suggested by Scenario 2), the decline in GDP might reach 3.5% of GDP, the decline in real volume of investment, 6.6% and the decline in the population's real incomes by 4.7%. Meanwhile, due to the contraction of volumes of export (down $29 billion according to the basic scenario), the CBR would be compelled once again to depreciate the rouble against the bi-currency basket, tentatively to 52 roubles, by the end of the year (at 26% relative to the current upper margin). If this happens, the rouble/US dollar exchange rate would reach 45 roubles/US dollar. Accordingly, inflation on the consumer market would accelerate by 18.4%.

A higher rate of inflation and a depreciating rouble would bolster the nominal volume of GDP (up to 41.98 trillion roubles) and engender a slight drop in the nominal revenues to the federal budget (6.5 trillion roubles). Thus the federal budget deficit would grow by 0.7 percentage points of GDP, that is, to 7.7%.

Equally dire for Russia's economy would be the consequences of a renewal of the capital outflow from the country. It may restart, for example, in the event that Russian corporations and banks are no longer be able to successfully negotiate their external debt restructuring, as they were able to do in February–March 2009. According to Scenario 3, the decline in the real GDP would accelerate (up to 3.2%) and so would the decline in real investment (6.7%). To secure stability of the nation's balance of payments, the CBR would be compelled to depreciate the rouble exchange rate against the bi-currency basket to 53.5–54.0 roubles, equivalent to a US dollar exchange rate of 46.5 roubles/US dollar. As in the case of the scenario of low oil prices, inflation would likewise accelerate to 18.4%. A 'positive' aspect of this particular scenario would be a 6.5% contraction of the federal budget deficit, due to growth in the nominal value of GDP and revenues to the federal budget.

In the context of Scenario 4 we estimated the consequences of the budgetary expansion between the 3rd and the 4th quarters of 2009. Powered by growing budget expenditures (up to 10.7 trillion roubles for the year), the deficit would surge to 9.4% of GDP. An additional money emission would fuel not only inflation (up to 15.4%), but a new round of rouble depreciation as well. The CBR would ultimately face a situation in which it would not be able to hold the declared upper marginal rate of the bi-currency basket without sacrificing its reserves. Should the policy of saving the reserves at the current level be pursued, the rouble exchange rate should plunge roughly 5% against the current level—in other words, down to 42–42.5 roubles/bi-currency basket, equivalent to 36.5 roubles/US dollar.

The above results of the scenario-based forecasting calculations of the dynamics of the basic macroeconomic indicators of the Russian Federation make it clear that it is the most probable scenario (the basic one) which would give Russia the best chance to survive through the year with minimal macroeconomic shocks, which might form a favourable starting position for exiting from the crisis.

But the positive forecast is very unstable, and the range of fluctuations of exogenous parameters under which the situation is favourable appears to be extremely narrow. A further decline in oil prices, an additional capital outflow and a new increase in budget expenditures would result in very dramatic dire consequences. More specifically, those would include a sharp acceleration of inflation and a drastic new depreciation of the national currency. In conjunction with this the CBR and the Russian government should pursue a maximally conservative policy, so as to preclude a new wave of negative expectations from arising.

Tatiana Drobyshevskaya

Tatiana Drobyshevskaya is Associate Professor at the Economic Faculty of Moscow State University. Previously she worked in the Institute for the Economy in Transition, the Academy of National Economy under the Government of Russian Federation and the Russian-European Centre for Economic Policy. She holds PhD in Economics from the Moscow State Lomonosov University. Drobyshevskaya is the author of over 20 publications; among others 'The Economics of Russian Transition' or 'Russian Economy After August 1998'.

Sergey Zhavoronkov

Sergey Zhavoronkov is a Senior Research Fellow at the Institute for Economy in Transition. From 1997 until 2006 he was a Leading Specialist at the Working Center for Economic Reforms of the Russian Federation Government. He holds an honours degree from the History Faculty of the Moscow State Lomonosov University. He is the author of numerous publications such as 'Political economy of financial crisis', 'Political and legal sources of investment risks in Russian regions', and others.