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Event Report

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Communication to members

Russia in the global economic storm

Policy Dialogue - 6 May 2009

Summary

Russia has been badly affected by the economic crisis, because in the boom years - when it was able to rely on oil and gas exports - it had not diversified its economic base or introduced any major structural economic reforms, speakers agreed at an EPC Policy Dialogue organised with the Calouste Gulbenkian Foundation and with World Bank support. They hoped the crisis would spur Moscow to introduce reforms, particularly to modernise the banking sector, public administration and governance structures.

Full Report

Klaus Roland, the World Bank's Country Director for Russia, said the picture was grim for Russia and for other developing economies like China or India, which the world had hoped would act as a buffer for the rest of the world to lean on**.**

While optimistic figures for global stock markets have prompted people to predict "light at the end of the tunnel", it is difficult to assess whether Russia will ever return to its 8% growth rates of the mid-2000s.

Ziljko Bogetic, the World Bank's Lead Economist and Country Sector Coordinator for Russia, Europe and Central Asia, said the world was passing through the worst global crisis since World War II, and the "synchronised global financial crisis" was affecting both industrialised and developing countries.

There is no single explanation for this deep crisis, he said, as it is the result of a confluence of factors: low interest rates and asset price bubbles in housing and sub-prime mortgages, coupled with failures in regulation and at the corporate and risk management levels.

The global economic outlook for 2009-10 is grim, he said, with global GDP growth falling by 1.7% and world trade by 6.1%. Capital flows to developing countries are drying up and, with oil prices remaining low, Russia will face difficulties.

Russia hit by a "triple whammy"

The country has been hit by a "triple whammy", said Mr Bogetic, moving from the 8% growth rate in 2007 into negative growth of -7.3%; oil prices are down from $140 to $40 per barrel; and capital inflows have fallen from $80 billion to minus $130 billion. The country's strong economy "melted away" by January 2009, with the collapse of the Russian rouble, a fall in currency reserves and growing unemployment.

This was partly caused by the collapse of Russia's demand side, led by the drop in investment and consumption, with falls of 19% in construction, 18% in transport, 2% in retail and 18% in manufacturing in early 2009.

This collapse is more pronounced than in other developing countries as Russia is dependent on oil, gas and metals, capital inflows and short-term external borrowing. The

SME sector is small, and the country's narrow economic structure has been affected by a deep drop in world demand. The related fall in wages, increase in unemployment and the growth of informal, unprotected labour has hit households hard.

The massive trade shock has considerably weakened the balance of payments; capital outflows fell from $98 billion for all of 2008 to $8 billion in the last quarter of 2008, and the capital account balance fell from $82 billion in 2007 to minus $130 billion in 2008. A 4.5% decline in GDP is forecast for 2009, with a fall in the current accounts balance from $31 billion in 2009 to $16 billion in 2010.

Russia's initial response was to provide fiscal support to the tune of 6.7% of GDP, mainly to support banks and enterprises. Support for the real economy has focused on reducing taxes, with little help for the most vulnerable sections of society.

Compared to other G20 countries, Russia has weaker social stabilisers to absorb the shock, so the social impact is spreading fast and the 12% unemployment rate has put an additional 4.7% of the population below the poverty line.

Looking at measures the government should take, Mr Bogetic said it should target households, reform the country's infrastructure and build up small- and medium-sized enterprises. It should draw up a social protection package in the form of child allowances, pensions and unemployment payments, which could move 4.1 million people out of poverty.

Russia should use this crisis to accelerate much-needed structural reform, making the economy more competitive and modernising the banking sector, public administration and governance structures.

EU-Russia relations

Hilde Hardeman, Head of the Unit for Russia and the Northern Dimension Policy, Directorate-General for External Relations, European Commission, said the global economic crisis highlighted that the EU and Russia are interdependent, and the January gas crisis was an acute reminder of the need for a partnership based on predictability and transparency.

She said that, initially, Russia had treated the global financial crisis as a form of "Mexican flu" – something which came from outside, while the country remained an "island of stability". However, this quickly changed last autumn, when the government realised that Russia was not immune.

The crisis has illustrated the need for the country to diversify and introduce structural economic reforms, so that it does not revert to its role as "a colony to provide raw materials for the rest of the world", said Ms Hardeman. During the boom years, Russia benefited from its oil and gas resources, but failed to diversify its industrial base, although President Medvedev intends to introduce measures to improve the rule of law, which is intended to help this process.

She said that while Russia is working to speed up its accession to the World Trade Organization, it is also introducing protectionism measures, such as increasing import duties on certain products.

The EU is now on the fifth round of negotiations on a new EU-Russia agreement, which will be based on transparency, predictability and the rule of law, and the protection of human rights. This is designed to develop a level regulatory playing field, to be in place when Russia becomes a WTO member.

She was not sure whether the crisis would facilitate the EU-Russia agreement, but hoped this crossroads would help Russia to become more open, move into a global rules-based economy, and introduce structural and social reforms.

Marat Terterov, Project Director, Gulf-Russian Relations, Gulf Research Centre, said that during the years when Vladimir Putin was President, Russia's image was of a prosperous country taking its place on the world stage, with growth based on energy and metal exports.

The West believed this economic miracle was benefiting Russian's entire population, but in fact it only benefited certain social groups and failed to create a middle class. Just a few kilometres out of Moscow and in certain regions, there are still people living in considerable poverty, and moves to build adequate housing and medical coverage and a social safety net have not been fully successful. Russia has retained its Soviet 'top down' model, and its structural and economic problems.

The government used the oil boom to accumulate $388 billion in currency reserves to weather the financial storm, but the lack of economic diversification means it is finding it difficult to cope with the crisis. In addition, during the 1999-2004 energy boom, the country's oil and gas companies produced for export from maturing fields without investing in new fields. The large volumes of foreign direct investment during this boom discouraged the government from promoting reforms or opening up the economy.

Unfortunately, during the period from 2002 to 2006 many of Russia's assets which were privatised after the fall of the Soviet Union have been redistributed and renationalised by the Russian authorities**.** There has been a transfer of wealth "officially into the hands of government officials", with "close cohorts of Prime Minister Putin now in control of leading state enterprises", said Mr Terterov.

This, coupled with moves to investigate the Russian oligarchs who became rich during President Yeltsin's era, has scared the markets – hence the Russian stock market collapse in mid-2008.

Mr Terterov wondered whether this would force the government to push through reforms, including empowering sectors of the Russian opposition - as one of the problems is the lack of criticism of government performance.

Mr Roland concluded by cautioning Europeans to take a more humble attitude to Russia's problems, rather than coming up with plans for them to make improvements. He noted that the EU also has its failings, as the World Bank's Russian staff has considerable problems trying to get Schengen visas. Easing regulations such as this would be a positive way to engage the Russian administration.

Discussion

Asked whether the implosion of the Russian economy meant the country was likely to return to the barter system of 1998, Mr Bogetic felt it was unlikely to be widespread (although it was occurring in some sectors) as the country now had a more sophisticated economy, with a more robust and supervised system.

Responding to a remark about the need for structural reforms, Ms Hardeman stressed that the rule of law and individual rights need to be a strengthened. Support for civil society and human rights is now an important element of the EU assistance programmes to Russia. Mr Bogetic said that while Russia had learned the macro-economic policy lessons of the 1998 crisis, it had failed to follow through with reforms.

Asked whether the 'Putin/Medvedev regime' was losing popularity as people are feeling the effects of the crisis, Mr Terterov said that when President Putin came to power he had created stability after the turmoil caused by events in Chechnya and had doubled economic growth. This crisis is the first real test of the Putin/Medvedev approach.