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# Russia and the Global Crisis

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**Abstract:** This paper assesses the impact of the global economic crisis of 2008 on the Russian economy. It includes a general outline of the dynamics of the basic macroeconomic indicators, and analyses the major factors that resulted in the sharp decline of output in Russia in autumn 2008 and in the first three quarters of 2009. Further, the paper discusses the main characteristics of the Russian Government's anti-crisis policy and its influence on economic development. This paper concludes that the roots of the present crisis lie in the shortcomings of Russia's model of economic growth, which is highly dependent on world commodities prices and external financing of banking and corporate sectors. Thus, the recovery of the economy will strongly depend on the ability of the economic agents, including the state, to establish a new type of growth model that is less vulnerable to external shocks.

**Keywords:** crisis, Russia, economic growth, economic policy

**JEL Classification Numbers:** D21, E20, L52, O52

## 1. Introduction

It is a well-known fact that Russia is one country that has been most severely hit by the global financial and economic crisis of 2008–2009. For many successive years, Russia enjoyed stable and rather high rates of economic growth. However, in the fourth quarter of 2008 and the first quarter of 2009, the Russian economy demonstrated a sharp and rather severe decline: during the period of November 2008 to February 2009, the GDP fell by about 10%, including the industrial output. In fact, similar, but less dramatic, negative changes occurred in employment, real wages etc.

While we will attempt to provide a general picture of the impact of the crisis on the Russian economy, the primary focus of this paper is not to address what happened, but to respond to the question of 'Why it happened?' We believe that this particular question is of considerably more interest to an economist, and it is of more importance with respect to understanding what should be expected in the near and mid-term future and what should and can be done to overcome the negative consequences.

In this paper, we will argue that while the crisis in Russia was 'triggered' by the events occurring in the global financial system, the basis for the crisis was in the internal weaknesses and structural imbalances of Russia's economy. Of course, to some extent, this can perhaps be stated with respect to any country. However, the Russian case should be considered somewhat special as a crisis has affected the entire model of economic development, which was formed in the beginning of the decade and provided almost eight years of stable growth (the longest period of growth in history of modern Russia). Further, in some sense, Russia's economic crisis had it's own internal logic and was inevitable, regardless of the existence of external shocks.

In addition, we propose that in order to understand the long-term consequences of the crisis, we need to consider not only the macro-level data (export/import, capital flows etc.) but to analyze processes at the micro-level (the level at which firms and corporations operate) as well. This is because the business strategies and low competitiveness of these firms and corporations to the great extent made the crisis possible. Furthermore, the situation at the micro-level will also dictate the path that needs to be taken in order to overcome the crisis and create a new model for economic growth.

Finally, since the state policy played a considerably important role both before the crisis and particularly during the crisis, we will also analyse the state anti-crisis policy of 2008–2009 in order to better understand the impact of this policy on the model of development and on the long-term perspective of the Russian economy. Thereafter, we will discuss the current trends with respect to the economy as well as the economic policy in order to understand how the Russian economy will revive itself. Moreover, we will also attempt to determine what kind of economy Russia will have, following the impact of the crisis.

## 2. Description of the crisis dynamics in the Russian economy

In comparison to other countries, the global crisis affected Russia much later in October 2008, albeit some negative changes were witnessed as early as in the first half of 2008. Nevertheless, the slowdown of the economy in the first three quarters of 2008 was not dramatic: in the first quarter, the GDP grew 8.5%; in the second quarter, it grew by 7.5%, and in the third quarter, by 6%. The slowdown was a result of the reduction in oil prices and the general slowdown of the world economy. Despite the slowdown of the growth rates, exports for nine months of 2008 (before October) totalled \$372 bln (this was 150% more than the figures of the same period in 2007); real income grew by 7.8% and investments continued to grow as well (by 13%)[1]. While stock indexes began to fall sharply as early as in June 2008, their dynamics were attributed to the fact that non-resident short-term investors has begun drawing out of the Russian market due to the liquidity problems in the world financial sector. Thus, it was mostly considered to be an indicator of a crisis in other countries, not in Russia. At the end of the third quarter 2008, both the Russian government and most of independent economists expected somewhat lower growth rates for 2009, albeit very few expected the dramatic fall that occurred in the following months.

Initially, the global crisis began to affect sectors that are mostly involved in borrowing money on the world financial markets, namely, the banking sector and large industrial groups that were heavily borrowing in the previous years. For some industrial groups, an additional impact came from the stock markets when the so-called ‘margin calls’ (demands for additional collaterals due to the sharp decrease of stock prices) started in foreign banks. Other sectors influenced by the crisis at an early stage were exporting industries such as ferrous metal and chemicals (mainly mineral fertilizers), where both the demand and world market prices fell significantly. Other sectors negatively affected by the crisis included car industry, cement production, as well as the manufacture of some investment goods. It should be noted that the crisis was not ‘frontal’; in other words, many industries, such as the food industry, retail trade, and industries related to personal consumption, were not seriously affected[2].

**Table 1 Macroeconomic impact of crisis**

| | 2008 | | 2009 | |
|---|---|---|---|---|
| | February | January-February | February | January-February |
| GDP | 109,3 | 108,5 | 92,7 | 92,0 |
| Industrial output index | 107,5 | 106,0 | 86,8 | 85,4 |
| Real incomes | 109,0 | 109,5 | 95,3 | 92,8 |
| Real wages | 114,1 | 113,7 | 100,1 | 101,0 |
| Exports of goods, $bln | 35,7 | 70,2 | 19,3 | 39 |
| Import of goods, $bln | 21,2 | 36,8 | 13,5 | 23,8 |

Source: Ministry of Finance of Russia.

Nevertheless, the macroeconomic indicators showed a considerable drop (see Table 1). The percentage of registered unemployed people (people receiving unemployment benefits) rose to 44% in the first quarter of 2009 (2.2 mln), and the total unemployment level (measured using the ILO methodology) reached 9.5%. At the same time, however, household consumption did not experience a serious decline, and as a result, retail trade and the food industry were supported. This may be partly due to the fact that the Russian population, in general, at the start of the crisis was not heavily indebted to banks, as compared to other countries. In fact, despite the high growth rates with respect to personal loans in the previous years, most of the population did not use bank loans (mostly due to the still underdeveloped system of mortgages in Russia).

In the first stage of the crisis in Russia, high inflation was witnessed. In fact, consumer prices grew by 5.4% only in the first quarter (January–March 2009). To great extent, the high inflation was a result of the significant devaluation of the rouble (by more than 40%); however, it was also partly due to the high monopolization of the economy and the state policy concerning the regulated tariffs of natural monopolies.

Nevertheless, the period of sharp decline and high inflation was relatively short. By March 2009, the negative dynamics of the main indicators slowed down significantly, and by May 2009, the second phase of the crisis began. This stage was characterized by (1) considerably unstable dynamics in industrial output (poor growth in some months and minimal decreases in others), (2) some decline in unemployment, (3) reduction of inflation and (4) significant revaluation of the national currency (albeit it was still about 30% lower than what it was before the crisis). At the same time, investments as well as export volumes continued to fall.

Preliminary values for the period of January to August 2009, published by the Ministry of Economic Development of Russia (MoED, 2009), indicates that for this period, the GDP remained more than 10% lower than what it was in the same period last year; the industrial output fell by 14% and manufacturing industries, construction and investments reduced by 20% (Table 2). Other economic indicators also demonstrated ambiguous dynamics: unemployment levels were lower than what they were in the first quarter of the year, but nevertheless high based on the Russian standards of the previous years (about 8%); stock indexes remained at low levels and import and export was 40% and 45%, respectively, lower than what it was in 2008.

The relative stabilization in the second and third quarters was driven first of all by the stabilization of the world economy and the consequent growth of the world market prices for oil and other products that Russia exports. Furthermore, the state policy, particularly the decision to keep state expenditures high despite the drop in state revenues, supported internal consumption. While revenues of the federal budget fell by more than 30% (as compared to January–August 2008), the budget expenditures rose by almost 40%. As a result, the current deficit of the budget reached 4.8% of GDP (in the same period in 2008, the budget had a surplus of 8.8% of GDP). While inflation is still high, it is much lower than it was expected to be at the beginning of the year.

One of the most immediate and spectacular consequence of the crisis with respect to Russian firms was the considerable worsening of the financial situation of enterprises. The so-called financial result (total profits of all firms minus total losses) in the first seven months of 2009, according to Rosstat data, was 50% less than the financial result in the same period in 2008; in other words, on average, the firms were generating only half of the profits that they were generating before the crisis. However, by May 2009, this indicator also stabilized. Although it may be considered an improvement after January 2009 when the total losses amounted to 184 bln

**Table 2 Main indicators January- August 2009**

| | 2008 | | 2009 | |
|---|---|---|---|---|
| | August | January-August | August | January-August |
| GDP | 105,6 | 107,4 | 89,5 | 89,8 |
| CPI | 100,4 | 109,7 | 100,0 | 108,1 |
| Industrial output index | 104,7 | 105,3 | 87,4 | 86,0 |
| Manufacturing | 106,5 | 107,6 | 83,2 | 80,2 |
| Agriculture | 116,8 | 109,0 | 87,4 | 96,3 |
| Inveestments into fixed assets | 110,1 | 116,9 | 80,6 | 81,1 |
| Costruction | 106,4 | 118,2 | 84,5 | 81,5 |
| Real income | 107,6 | 107,1 | 93,2 | 99,3 |
| Real wages | 112,1 | 112,8 | 94,4 | 96,7 |
| Retail trade | 114,6 | 115,7 | 90,2 | 95,3 |
| Exports of goods, $bln | 45,7 | 329,8 | 28,7 | 180,9 |
| Import of goods, $bln | 27,1 | 191,3 | 15,6 | 114,0 |
| Average oil price for Urals, $ per barrel | 111,5 | 109,4 | 72,3 | 55,3 |

Source: "Current situation in the Russian Economy in January-August 2009", Ministry of economic development of Russia, September 2009. www.economy.gov.ru

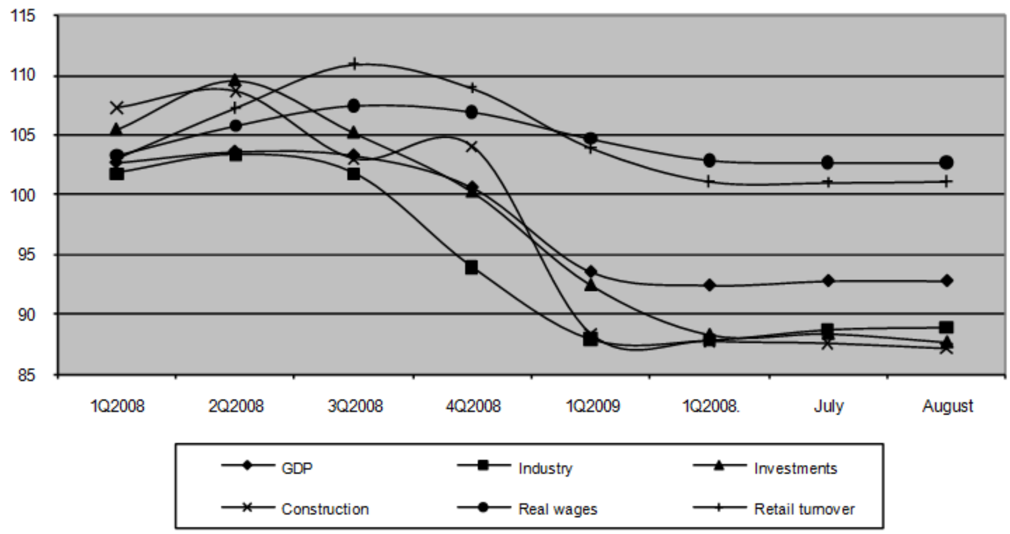
roubles (more than US $5 bln), it is still an indication of the fact that Russian firms are having difficulty in coping with the new levels of demand.

It is worth noting that the drop in nominal profits is unrelated to the lowered prices (the industry price index was 13% in January–August 2009); in fact, it can attributed to the inability to cut production expenses in accordance with the declining output. The most affected with respect to reduced profits is the manufacturing industry, wherein the joint profits for all the firms was 4.6 times less than what it was in 2008. If we take into consideration that this figure is valued in nominal, devaluated roubles, it becomes obvious that most of the firms are incapable of financing any serious investment from their own resources. Moreover, the existing high levels of debt and the unwillingness of banks to provide loans in such a situation of uncertainty, makes investment activity near to impossible.

Based on an analysis of macro-level data, it may be stated that since May 2009, the Russian economy has been in rather unstable equilibrium, achieving almost zero growth. These rather contradictory dynamics provided for the wide spectrum of forecasts made by analysts: from very optimistic ones who predict the beginning of growth of the economy in the fourth quarter of 2009 to rather pessimistic ones who proclaim an imminent 'second wave' of the crisis. Most of the 'optimists' may be found among experts of international organizations (World Bank, OECD etc.) and governmental analytics[3]. On the other hand, majority of the 'pessimists' belong to private sector analytics or independent research structures. While both sides have proposed valid arguments to support their positions, the truth was that nobody could predict future dynamics, as there were insufficient data regarding the situation at the firms' level.

If we consider the crisis data (see Fig.1), we can observe that indicators have actually stabilized. However, they have stabilized at different levels. For instance, indicators related to consumption (turnover of retail trade and real wages) did not fall as drastically and are still above the pre-crisis 2007 level. At the same time, indicators related to industry, construction output and investments fell considerably and stabilized at 90% below the pre-crisis level.

**Figure 1 Quarterly dynamics of main indicators for 2008-2009 (4 quarter 2007==100%)**




Source: calculated from MoED data (MoED 2009)

While a decrease in investments as a reaction to a crisis is a well-known and widely witnessed phenomenon, for Russia (which lags behind in infrastructure development and at a technological level, as compared to most of the manufacturing industries in developed countries and developing countries (Desai, Goldberg eds., 2008), and where the investment to GDP ratio only began to grow recently, after decades of 'underinvestment'), a decline in investments, investment machinery output, construction etc. may indicate the forsaking of chances to achieve modernization and to change the resource-oriented economy to a more diversified, innovation-based one. From this point of view, while the sharp decline in Russian imports in 2009 (by 43.5%) help to keep trade surplus, they also probably indicate the slowdown of technological modernization (import of machinery goods fell by 54.6%).

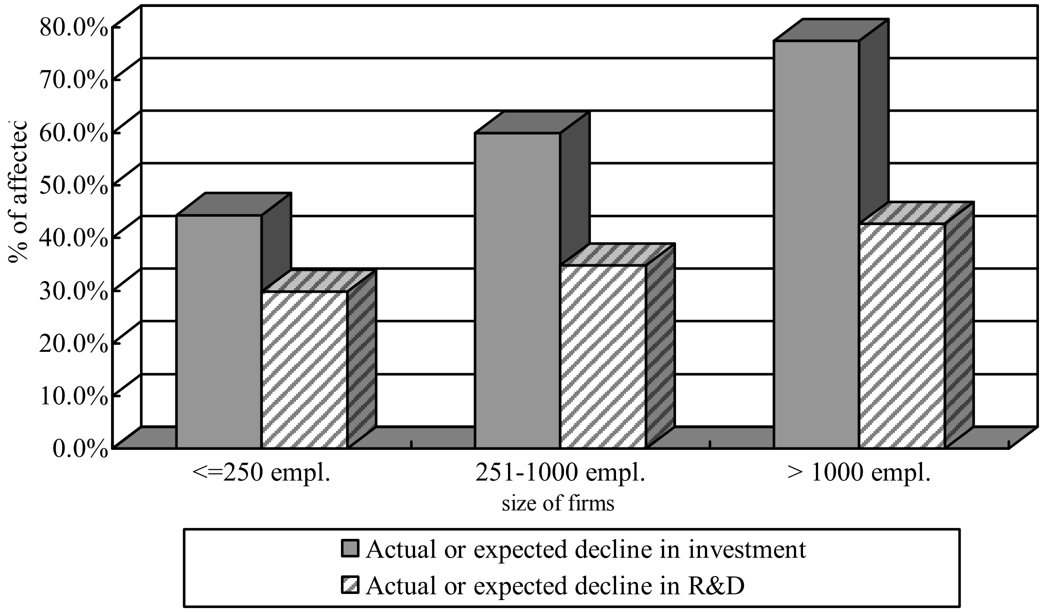
If the increasing gap between consumption-related and investment-related sectors is not bridged by 2010, it may actually suggest that the country (not for the first time in Russia's recent history) has sacrificed resources for future growth in order to maintain consumption at a stable level.

It should be noted that the crisis in Russia also has an important regional aspect due to the high levels of specialization in this region (concentration of certain industries) and the high diversity in regional development. In general, the more economically-developed regions of Russia were much more affected by the crisis than the less developed ones were. The first 'victims' of the crisis were export-oriented regions (mostly those related to the export of metallurgy, mineral fertilizers etc.). Further, regions in Volga macro-zone that have a high concentration of machinery firms were also considerably negatively affected. The less affected regions were those focussing on agriculture, not manufacture. In addition, depressive regions that are highly dependent on transfers from the federal budget have not yet experienced serious shocks[4].

The concentration of risks in the developed regions can be explained by several factors. First, the reduction in industrial production created serious problems for the labour market, leading to higher unemployment. Second, the sharp decline in construction also negatively affected these regions (developed regions, particularly large cities, had experienced a construction boom for several years prior to the crisis). Third, the relatively 'rich' cities were further affected by the constriction of financial markets, because of the concentration of banks and financial services in such areas. The most significant factor for the regional differentiations with respect to the consequences of the crisis was the structure of the regional budget revenues. In the developed regions, a high share of the budget revenues (more than 25%) is derived from the regional share of profit tax, and these revenues fell dramatically (41% in the first half of 2009), following the crisis (Zubarevich, 2009). On the other hand, in less developed regions, major sources for budget revenues are personal income taxes (a relatively stable source, witnessing only a 5% decline) and inter-budgetary transfers from the federal budget. Thus, the decline of budget revenues in the developed regions was much more significant, resulting in an additional negative impact on the regional economies.

The information provided by the macro data is supported by micro-level evidence as well. Investment and R&D were one of the first few aspects that the Russian firms sacrificed during the crisis. According to a recent large-scale survey of large and medium-sized Russian manufacturing firms, which was conducted in March–May 2009[5], more than half of the surveyed firms had already stopped new or continuing investments projects due to the crisis or were going to stop them in the near future. What is worse is that investments projects were stopped more often by large-sized firms as opposed to smaller firms; as a result, the average impact of the crisis on investments was considerably more significant. The same situation was observed with respect to R&D expenditures (Fig. 2).

**Figure 2 Share of manufacturing firms whose investment or R&D activity has been negatively affected by the crisis**




Note: Impact on R&D calculated only for R&D active firms

Source: HSE survey of manufacturing firms

Thus, based on the above, it can be assumed that the impact of the current crisis will not be exclusively focussed on output decline. In fact, it will have far-reaching and long-term effects on the Russian economy, particularly in terms of efficiency, productivity growth and general competitiveness.

In this section, we attempted to provide a general outline of what has happened in the Russian economy, following the global crisis. On the surface, it may seem that the Russian case has no specific characteristics and can be easily explained based on problems related to liquidity in the financial system and declining external demand (and world prices) followed by the contraction of output, export, employment etc. If this were the case, we could have expected some adjustment at the firm level (some inefficient firms would leave the market), adjustment of incomes, and revision of state budget expenditures. In other words, we could have expected some type of 'creative destruction' process, focused on future recovery, after the external shocks wore off. To put it simply, when the world economy will begin to grow, the demand and prices will return to their pre-crisis levels and the liquidity of financial systems will be re-established. Or, as long as the oil prices stabilize at an acceptable level, all of Russia's problem will be resolved and the country will return to its previous trajectory.

However, as stated in the introduction to this paper, we believe that the causes for the current crisis in the Russian economy stem from internal fundamental problems, at least to some extent, regardless of external shocks. Thus, to attempt to explain the Russian crisis simply based on changes in oil prices and demand is at the very least 'over-simplification'. It would be wrong to consider the Russian economy as a market economy, which it is definitely not, and as an economy integrated into the world economy, which it is, but in a rather specific way. While the sharp drop in production and GDP can be associated with the crisis, other consequences that can be witnessed globally are not evident in the Russian case, both on the side of the state and on the side of the business community. For instance, in Russia, following the decline of output, there has been no price adjustment, moderate labour adjustment, minimal bankruptcies and no adjustment of the state budget. Therefore, to better understand both the mechanisms by which the global crisis impacted Russia and to explain a possible way out, it is necessary to revisit the previous crisis of 1998 and analyse the model of economic development that evolved in Russia after it.

## 3. Russia's growth model

The pre-crisis model of growth in Russia evolved during the period of stable growth after the financial crisis of 1998. It is worthwhile here to briefly consider the main drivers of the growth during this period. The growth began after a four-time devaluation of the national currency that led to the reduction of import, providing opportunities for import substitution to Russian firms. At the later stage (since 2001), the growth was supported by an increase in oil prices. Further, additional export revenues redistributed through the economy led to the growth of real wages and revenues, which, in turn, stimulated the growth of consumption and internal demand for consumer and intermediate goods and services. Since 2003, the growth of consumption was the main source of economic growth till the crisis of 2008. However, for several years, the growth of production was not accompanied by growth in investments. In fact, it was only recently (in

2006–2007) that investment growth became a significant factor: in 2002–2005, the annual growth of investments was about 10%; in 2006, it was 16.7%, and in 2007, it was 21.1%.

It can be stated that the high rates of growth, the conservative budgetary policy, and the macroeconomic and political stability attracted foreign investments. Thus, together with high export revenues that were coming into the country, it led to a current and capital accounts surplus, further leading to the revaluation of the national currency. Once the initial effects of the devaluation wore off, Russian manufacturing industries began to lose competition to foreign firms, both inside and outside the country (Gonchar, Kuznetsov eds., 2008). As a result, production growth was concentrated in sectors producing mostly non-tradable goods and services. Moreover, the import of goods grew much faster than internal production: in 2006, imports grew by 24%, and in 2007, they grew by 26%; industrial output grew by only 6.3% annually (CMESTF, 2009).

One of primary characteristics of Russia's economic growth has been high inflation, driven by both monetary and non-monetary factors. In order to keep the inflation under control and to prevent large revaluation, monetary authorities began to 'sterilize' excessive money supply by creating reserve funds in which 'natural rent' from rising oil prices was accumulated. By the end of 2008, the reserve funds of the federal authorities amounted to US $226 bln. At the same time, by mid-2008, the Russian Central Bank reserves had reached almost US $600 bln.

In general, on the surface, the economic growth appeared to be considerably sustainable. The positive macroeconomic dynamics of the Russian economy led to still higher expectations of future growth. These expectations were commonly shared by the people, government, business sector, and foreign investors. Further, such expectations resulted in a credit boom: households began to take bank loans (including mortgage credits) in order to finance consumption, and firms began to take loans for their investment programmes. Moreover, the credit boom additionally triggered demand, thus supporting further growth. While everything appeared to be in order on the surface, the model of economic development had several inbuilt deficiencies and contradictions, making Russia's economy extremely vulnerable to the external shocks.

First, the most often mentioned source of vulnerability is, of course, the high dependency of export revenues on world market prices for oil, natural gas, metals and other primary commodities. Although it is most definitely true that the Russian economy, particularly Russian export, is not diversified and is highly dependent on commodity prices, this factor was not directly responsible for the sharp drop in the economy in 2008–2009. In fact, oil prices recovered considerably quickly after the crisis, reaching about US $70 per barrel, which can be regarded as safe for both oil companies and the budget. Moreover, two years before, this price level was considered to be not only sufficient but even high. However, the oil price shock did have an indirect impact in that it resulted in the reassessment of the Russian economy and its attractiveness for investments.

Second, a more serious source of vulnerability stemmed from the relative weakness of the Russian banking and financial systems in general. Most of the Russian banks are poorly capitalized and do not have long-term passives. In fact, there were almost no institutional investors such as pension funds to provide 'long money'. Further, the strict monetary policy and the accumulation of export revenues in the state reserve funds also did not help to raise the liquidity of the financial system. As a result, the country with 'triple surplus' (trade balance, current account and capital account) could not fully satisfy the demand for long-term loans to both the people (mortgage) and large corporations (investments into fixed capital and M&A financing).

Given that the world interest rates at the time were at a minimum (or were at least very low), it seems obvious that the Russian banks and corporations would have applied to external creditors. By the end of 2008, the accumulated external debts of Russian companies amounted to about US $250 bln (CMESTF, 2009). Moreover, many of these were short-term loans that needed to be refinanced. However, during the pre-crisis period, no one thought this to be a problem. Simply put, the Russian bank sector fell into the classical trap of borrowing short and lending long. In this sense, we agree with researchers of the Center for Macroeconomic and Short-term Forecasting that 'the key feature of Russian economic development in recent years was adjustment to significant in-flow of resource export revenues and excessive (thus, cheap) liquidity on the world financial markets' (CMESTF, 2009). As pointed out in the same report, this adjustment was revealed in the behaviour of all the economic agents. For instance, companies increased wages and investments, simultaneously borrowing extensively abroad; financial institutes increased the share of loans into high-risk projects (namely, building of houses); households enhanced borrowing for current consumption and the federal budget accumulated reserves and simultaneously increased social-oriented expenditures and obligations of the state.

The third source of vulnerability is of a more fundamental nature; it lies in the low competitiveness of many Russian industries, primarily manufacturing. Despite the appearance of productivity growth during the last ten years, in general, the Russian economy is still lagging behind most of the OECD countries. In April 2009, McKinsey presented a report on the competitiveness in most of Russia's basic sectors (McKinsey, 2009). Although one may question the methodology of the measurement of productivity used in the paper, the basic findings are valid and are supported by other evidences as well. In addition, the McKinsey report of 2009 is of increased interest because it follows the same methodology used in the McKinsey report of 1998 (McKinsey, 1999), thus allowing for comparison.

In the last ten years, the growth in labour productivity (6% annual growth) accounted for two-thirds of the economic growth. Still, by 2008 the labour productivity in five sectors included in the survey varied from 33% of the US level in steel production to 15% of the US level in electrical energy production, amounting to 26% on the average for all five sectors. It should be noted that for the 2009 survey, researchers from the McKinsey Global Institute included mostly sectors with stable and high growth rates: house-building, retail trade, retail banking and financial services, steel and energy. In the manufacturing sector, in general, the situation is probably much less optimistic.

The reasons for the low productivity of the Russian manufacturing industry are numerous. Some of them have been researched in Desai, Goldberg, 2008; Kuznetsov, 2009 and Gonchar, Kuznetsov eds., 2008. To summarize: the main factors for the low competitiveness lie partly in the low quality of the inherited Soviet-time inefficient equipment, but mostly was due to the low level of competition, the very low innovation activity, the low quality of human capital, inefficient management and the unfavourable business climate.

During the period of rapid growth, these negative factors could be compensated for by the expanding internal market, wherein even inefficient firms could find some narrow 'niche' market segment to sell their products. Further, the worsening of conditions (rapid growth of labour costs, increase in prices for energy and raw materials, significant real revaluation of national currency etc.) could also be compensated for, for a while, by (1) the growth in productivity through higher capacity utilization (from less than 50% in 1998 to 70%–80% in 2008), (2) the optimization of the number of employees (manufacturing industries lost about 20% of jobs only in 2004–2008) and (3) the extensive use of relatively more available bank loans. Nevertheless, the profit margins (profits to sales) were low, particularly in comparison to some of the non-manufacturing sectors (energy resources, financial services, house-building and retail trade) and taking into the account high inflation rates. Thus, factors such as narrow specialized markets with weak competition and low profitability determined to a great extent the fact that many manufacturing firms preferred to cut down production but not prices to keep profit margins positive in response to the crisis. The HSE 2009 survey mentioned earlier indicates that 33% of the firms raised or were going to raise the prices for their products as a way to compensate for the impact of the crisis (38% lowered or were going to lower prices).

Some economists analysed the problems of the Russian economy before the crisis and pointed out other factors as well, such as the price 'bubble' in the real estate market and high income differentiation. However, from our point of view, these factors, while important, are not as significant as those that we have pointed out above.

Nevertheless, there is one more 'non-economic' factor that also affected the Russian economy: the general inefficiency of state administration. Moreover, we believe that it will play a major role in choosing the way out. As M. Porter and co-authors have pointed out in their report on the competitiveness of the Russian economy: 'Administrative efficiency remains perhaps the major weakness and fundamental challenge for Russian competitiveness' (Porter et al., 2008). It can be stated that the economic growth in 2000–2008 has been achieved not because of the government's economic policy, but despite it. All the major weaknesses of the Russian economy (concentration of extraction of resources and low diversity of export, low competitiveness of the national manufacturing sector, weakness of the national financial system and high dependence of Russian banks and corporations on external borrowing) were well-known before the crisis and had been identified as possible dangers. However, very little was done to address these weaknesses. As stated by researchers from the Institute of Contemporary Development in a recent report: ‘The realization of the imperative need for modernization got no support from the pragmatic combination of development institutes and private business… Time for creation of development institutes and instruments, strengthening the national banks and corporate obligations market has been wasted’ (ICD, 2008). In fact, economic growth was accompanied by the (1) growth of administrative barriers related to business, (2) growth of corruption and (3) curtailment of institutional reforms. Furthermore, the decision-making system became increasingly more cumbersome and inefficient. While it did not create insurmountable obstacles with the growing oil prices feeding internal demand, it did become a major problem during the crisis.

The crisis immediately revealed all of the weaknesses of the Russian economic and political system. The crash of oil and metal prices in 2008 resulted in a severe blow to Russian exporters and state revenues. However, it was primarily a major blow to the expectations of Russian economic agents both inside the country and abroad; these expectations had been the basis of consumer and investment decisions. The first impact of the crisis was the massive withdrawal of non-residents from the Russian financial markets. Thereafter, from July to October 2008, the Russian stock indexes fell more than three times, and the capital outflow in September–October amounted to more than US $80 bln). Further, the crisis in the world financial markets affected the financial system, making it evident that it could no longer provide the necessary liquidity without the constant inflow from external sources. At the same time, the declining demand and prices for export goods led to problems in the large Russian export-oriented corporations. Subsequently, the fall of investments led to a widespread decline in investment-oriented sectors, including the house-building industry. In addition, the combination of the effects of the credit squeeze (due to the inefficiency of the banking system and higher risks of loaning) together with the low competitiveness of the industry, which had no internal resources to compensate for the lack of debt financing, led to a major decline of output in some industries. Being unevenly distributed among regions, this decline created social problems and provided some considerably serious challenges for the Russian Government, which up till the autumn of 2008 believed that the accumulated state reserves would be sufficient to solve any problems and to make Russia a ‘safe harbor’ in the world financial storm.

## 4. State anti-crisis policy[6]

When it became evident that the world crisis had severely affected Russia, the Russian Government reacted quickly, even if did not react efficiently. Many anti-crisis measures were announced in a considerably short span of time (specifically, since November 2008). These measures required not only the drawing up and adoption of a great number of legal acts but also the shaping of mechanisms for the manual control of certain instruments. The first Program for Rehabilitation of the Financial Sector and Selected Industries, enacted on 6 November 2008, included 55 items (separate measures), 34 of which were to be implemented in November 2008 and another 10, in December 2008.

The first immediate task of the government was to prevent the crash of the financial system, which was damaged by the withdrawal of non-residents from Russian markets. The monetary authorities attempted to help liquidity by providing additional money from the Central Bank and other resources. Nevertheless, these injections did not prevent the credit squeeze, and instead added to the pressure on the national currency; in a situation of uncertainty and expected devaluation, banks prefer to buy hard currency and not to provide loans to the real sector of the economy. As a result, the exchange rate constantly grew, which resulted in further expectations of devaluation, triggering the purchase of currency by banks, firms and people. In an attempt to curb the devaluation, the monetary authorities began to increase the interest rates of the Central Bank which (combined with higher risks of loans to the real sector) led to a further decline in the credit activity of the banks.

Another challenge to the state came from the drop of stock markets and the capitalization of the largest corporation. As we have already mentioned, some corporations were heavily indebted abroad, with stocks used as collateral. The drop of stock values, i.e. the drop of collateral value, provoked the so-called 'margin calls' from creditors with a demand to increase the collateral. The government decided that the risk of stocks being sold to foreign investors was against national interest. Thus, in order to prevent the change of ownership, the state provided money to the state-owned development bank (Vnesheconombank) so that it could buy out the collateral and transfer the corporate debt from foreign banks to the Russian state bank. This step is difficult to justify from an economic point of view since it can be considered as a measure to support Western creditors more than a measure to help Russian companies. In fact, only a few companies used this instrument: from the US $50 bln limit that was allowed for these buy-outs, only US $11.5 bln was actually used.

The anti-crisis activity of state was aimed at resolving the following major problems:

- ✓ Facilitate access to financial resources (direct lending by government-affiliated banks and financial institutions for development; injecting of public funds into these institutions; subsidizing interest rates and giving government guarantees; providing recommendations to banks about lending to 'priority groups' of enterprises).
- ✓ Reduction of the financial burden on firms (lower tax burden; lower rates of customs

duties; measures to lower administrative burden).

- ✓ Easing of negative social consequences of the crisis and development of the labour market (higher unemployment benefits; co-financing regional employment programmes; introduction of more strict quotas for using foreign labour force).
- ✓ Expansion of domestic demand (through government procurements, advances and preferences for domestic producers; procurements and investment programmes of natural monopolists; subsidizing consumer loans).
- ✓ Support of small and middle-sized enterprises (co-financing regional programmes for development of SME; implementing programmes to facilitate lending from Vnesheconombank; enhancing competition).

Judging by the quantity of measures, the industry-wise priorities of the anti-crisis activity can be identified with considerable ease: car industry, agricultural machinery, the defence-industrial complex and housing construction. Taking into account not only the number of measures but also the scale of resources involved, the oil and gas sector was certainly a priority, because the relevant enterprises would gain an estimated 200–250 bln roubles from the lowered burden. Further, direct and indirect support of automobiles and agricultural machinery weighed in at 190–200 bln roubles, and the defence-industrial complex were to gain about 180 bln roubles[7] (HSE, 2009).

In general, the main beneficiaries of the anti-crisis measures are the traditional industrial sectors, primarily the most vulnerable ones. Further, the measures are chiefly aimed at compensating for the losses of larger companies. A major share of measures with substantial anti-crisis effects are compensatory in nature (i.e. they alleviate the after-effects of the crisis). However, there are minimal measures to encourage enterprises to undertake active tasks of their own (technological modernization, product diversification, opening of new markets etc.). While the importance of assistance to the most vulnerable sectors is understandable, it appears that there is a shortage of measures that could provide conditions for new dynamic sectors and support the growth of middle-sized companies.

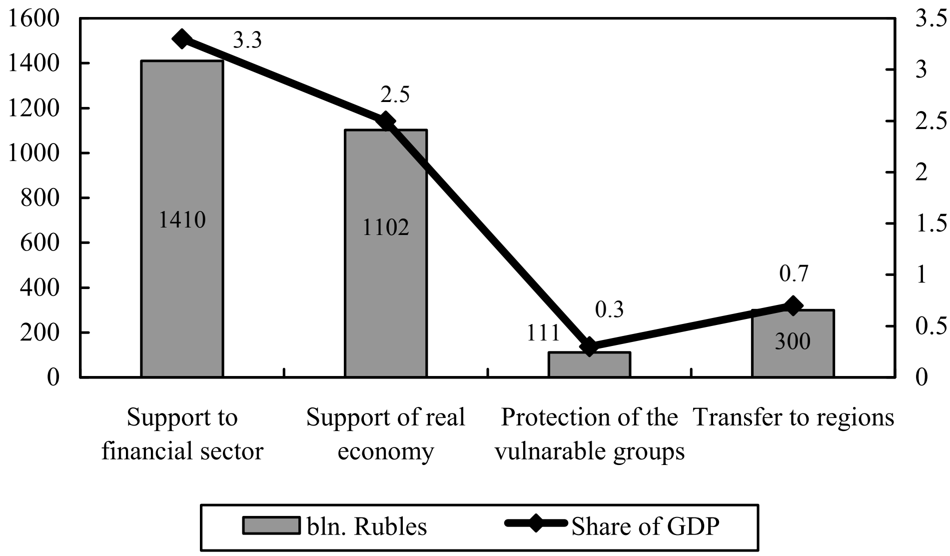
In total, a considerable share of the GDP (6.7%; probably one of the largest shares among G20 countries) was used to support the economy. Still, the overall results were not impressive. The reason for this was not insufficient funding but rather inefficient state administration.

While supporting the financial sector and providing liquidity was relatively easy to administrate, the measures for the real sector became a real challenge. As a response to the crisis, every state agency and ministry began to propose numerous measures. Although not all of them were finally approved by the government, the list of approved items consisted of about 150 different measures that needed legislation changes and/or administrative mechanisms to be implemented. As a result, the public administration faced a considerably increased workload, and in some instances, the practical implementation of these measures was not properly coordinated. For

**Box 1 Distribution of anti-crisis measures by major goals**

According to (HSE 2009) most of the measures – by number if not by amount – were related to help to the real sector and to social issues In general, the total volume of additional resources for anti-crisis activity for 2008-2009 is assessed at about 2.5-2.9 trillion rubles (about $80 bln.) pending on the methodology used (The HSE report (HSE 2009) assess the costs of Russia's anti-crisis program to real sector of the economy in 2.1. –2.5 thrillions rubles. The World Bank report (World Bank 2009) in 2.9. The HSE report the difference is explained by different methodology used to evaluate "lost revenues" to the budget due to various tax and tax related measures.). The most significant sum went to banking system for stimulating loans to real economy (1.1-1.2 trillion rubles). The losses of budget revenues due to decrease of profit tax rate (by two percent points) and other tax-related measures was evaluated as about 500-700 billion rubles (actual losses were lower as the profits fell down significantly in 2009). The measures for social protection and the support of start-up entrepreneurs costed about 250-300 billion rubles and 180-230 billion rubles were allocated to expand demand, 60-90 billions rubles went for the support of existing SME.

The World Bank classification and assessments (World Bank 2009a) are slightly different (Fig. 2) but the priorities are still clear – financial sector support and real sector support.




Source: World Bank 2009a

Figure 2. Distribution of state support by main beneficiaries

example, changes in the state procurement procedures, which were aimed at speeding up the signing of contracts with producers in the defence industry, had a considerably opposite effect. While the old rules were no longer valid, the new ones were not introduced in time, leading to delays in the signing of contracts, which, in turn, forced the government to help in directly financing the largest, systemically important companies and enterprises in the defence-industrial sector.

Thus, while many anti-crisis measures were announced, they were not implemented, and this created the impression that none of the measures were effective, triggering a wave of new anti-crisis proposals from the ministries. By March 2009, the total set of anti-crisis measures appeared mixed and inconsistent.

Furthermore, in many cases, hastily-declared measures were not, and could not, be supported by carefully-designed legislation in order to ensure that these measures could be implemented. For this reason, the actual execution lagged far behind the declared time limits. As a result, the pre-emptive anti-crisis potential of a number of measures remained unused. We have to recognize that on many occasions, the government overestimated its real administrative ability to enact the declared measures.

At the same time, it may be stated that in many aspects, the anti-crisis programme helped in accelerating a number of strategic policies that had been planned earlier, particularly with regard to corporate law, the support of small and middle-sized enterprises and the improvement of tax administration.

In sum, the crisis revealed the basic, fundamental contradiction between the government's inclination toward certain instruments (selective support of certain industries and selected enterprises) and the capability of the administrative system to efficiently implement those instruments. Selective measures presumed a solid system of 'picking the beneficiaries' and to do it rather quickly. The Russian decision-making system proved to be inadequate for this task. As a result, while 'system-oriented measures', such as tax reduction and corporate legislation changes, were implemented, most of the measures for selective policies were delayed or were implemented without any real impact on the economy.

## 5. Conclusion: Lessons learnt from the crisis and post-crisis perspectives

The global crisis revealed many weaknesses in the Russian economy and provoked significant structural changes. In fact, it proved what many economists and even the government had known all along: Russia cannot achieve sustainable growth based on raw, natural resources specialization. Without modernization and diversification, Russia's economy is already lagging behind in technology, and with a weak financial sphere, virtually no innovations, and underdeveloped market institutes, it is doomed to fall into one crisis after another. The present crisis demonstrated that while growth oriented on the growing internal demand is possible, this kind growth in demand should be supported by growth in productivity and not just by oil revenues. The growth model based on accumulating foreign reserves and indulging in extensive borrowing aboard proved to be considerably vulnerable. Thus, a more balanced system of transfer of internal savings into internal investments is required, suggesting the need for major changes in the financial sector.

The current crisis made it evident that Russia lacks several important institutes of coordination that are needed to change the resource-oriented development to a more sustainable one. In particular, Russia lacks powerful interest groups that are oriented towards modernization. Moreover, there are no effective means of communication between authorities and businesses, with the exception of several large corporations (most of them state-owned). The failure of the authorities to create a 'coalition for modernization' in the years of economic growth and to set up powerful groups of interests around the goals of renewal is perhaps the most fundamental problem in the design and implementation of the economic policy in Russia. Communication between authorities and the business community was often limited to a narrow circle of large and super-large corporations; thus, a general distrust between the authorities and business community continued, and a mechanism for private-public partnership, which had been declared a priority, remained uncalled for. However, it would be unfair to blame only the state for the failure to build such a coalition. The poor channel of communication was largely the result of weak and inefficient business associations and underdeveloped institutions and organizations of the civil society. Nevertheless, the very fact that the government did not fully recognize its own need for such a dialogue is the primary reason why many initiatives for modernization were slowed down and stalled, and offers to develop new instruments for the economic policy were redundant. Russia's experience with the development and implementation of the anti-crisis policy has clearly indicated the limited potential of the administrative system. Multiple and mostly selective measures adopted without proper discussion with the wide spectrum of economic agents makes the economic policy open to risks of lobbying and opportunistic decisions.

Furthermore, the crisis demonstrated that despite the significant growth of the state's role in the economy in the recent years, the range of tools for governmental influence is limited. When the crisis broke out, the government had a limited range of tools which it could use to influence the economy (federal target programmes, public procurement orders, taxes, tariffs etc.). Many of these tools are not sufficiently flexible and possess no devices for regular optimization, improvement and transfer of the best practices. This is because when financial resources were abundant, the state had few stimuli to make these tools more effective and transparent and to create a system for high-quality monitoring of the state-of-affairs by industry and sector (particularly outside the area of the government's influence). However, these (actually well-known) defects were to some extent moderated because before the crisis, there was sufficient time for the gradual tuning of certain tools to improve administering, to learn how to use them more skilfully and to pay close attention to the reactions of the business community. At the time, the public administration could concentrate its efforts on the enactment of regulations rather than on monitoring their practical effects. However, during the crisis, it became impossible, and even dangerous, to tune these tools by adopting the approach of 'first act, then watch, and then react', particularly because the systemic mechanisms of interaction between the state and the business community had become much weaker.

Therefore, given the above, the question that arises is what kind of changes can be expected in the near future in terms of both economic growth and different models for this growth. One thing can be stated for sure: there will be no quick revival of the economy and no return to the previous model of growth. In fact, even if there is no 'second wave' of the world economy crisis and the oil prices remain at a comfortable level US $60 to US $80 per barrel, the internal demand growth based on expectations and credit expansion akin to the pre-crisis period is rather improbable. The recovery will be slow and will be combined with structural and institutional changes. The direction of these changes will depend mostly on political choice: further growth of state influence and paternalistic policies vis-à-vis modernization of market institutions. At the moment, taking into account the social expectations as well as the inclination of the authorities, the former appears to be more probable.

If the global crisis, or rather the stagnation, is prolonged, focusing on instruments for selective assistance will create areas of 'chronic distress', such as the car industry, which will call for more and more state support. Moreover, industry-wise priorities of the anti-crisis policy, which are presently determined based on which is the most vulnerable sector, will become predominant in the direct or indirect allocation of resources through state-controlled banks. This may subsequently lead to an excessive concentration of public and private funds on solving the problems of large companies; as a result, the more promising firms will be faced with additional resource constraints. Thus, this approach can be acceptable only if one is certain that the crisis will end after 2009.

A prolonged crisis can convert temporary protectionist measures into constant ones, encouraging interest groups that are seeking wider and stronger protection from foreign competition to exert powerful pressure on the Russian Government. If this practice becomes widespread, it will increase the risk of inflation and suppress final demand.

In addition, an extension of assistance to private businesses in exchange for a higher share of the state in capital can unfold another round of 'creeping nationalization' (quite voluntary on the side of business) without any improvement in productivity and competitiveness. This will impose a higher responsibility on the state for everything that happens in the economy.

The budget shortage and lack of funds for supportive measures may push the government to withdraw money from institutions for development (which were established in order to achieve the ambitious goals of technological modernization). The government will consequently exert fiscal and administrative pressure on ‘affluent’ enterprises that have managed to adapt themselves to the new conditions and have survived without any public assistance. Moreover, a decrease in resources for the anti-crisis policy will expand the range of non-monetary (regulatory) measures.

The growth of state influence at the federal level may be accompanied with worsening state-business relationships in many regions. If the federal authorities are unable to support regional economies in distress, the regions will most likely begin unauthorized ‘anti-crisis activities’ of their own, relying on an abuse of their administrative power.

It should be stressed that regardless, it does not indicate the ‘crash’ of Russia’s economy. Russia still has the necessary resources to prevent the collapse of its economy. Currently, most of the forecasts related to the Russian economy predict slow (at the level of 2%) growth for 2010 and the years to come. Nevertheless, it will take several years to return to the pre-crisis level of production. However, that is not the problem. The problem is that those years may become another ‘period of lost opportunities’, inhibiting modernization and diversification of the economy.

**Notes**

[1] Current quarter to the quarter of the previous year. Source: Data by Rosstat and Ministry of Economic Development.

[2] The influence of the first phase of the crisis on the different industries and sub-industries has been analysed in detail in Bessonov (2009).

[3] While the World Bank changed its forecast for Russia several times during the year (and always to the worse), the last evaluation of 7.9% decline in GDP in 2009 and 2.5% growth in 2010 (World Bank 2009b) still looks overoptimistic. OECD’s forecast for Russia is even more optimistic: 6.8% decline in 2009 and a 3.7% growth in 2010 (OECD, 2009).

[4] A detailed analysis of the crisis’ impact on the regions can be found in Zubarevich (2009).

[5] The survey was conducted by Levada Center for Higher School of Economics in March–May 2009, and it included 1,000 large and medium-sized firms in the primary manufacturing industries.

[6] This section is mostly based on the results of the joint project of HSE and Interdepartmental Analytical Center, namely, ‘Assessment of Policy Measures to Support Russia’s Real Economy’, which was conducted in the spring of 2009 (HSE, 2009).

[7] In the case of automobile enterprises, their share of state guarantees (70 bln roubles) as well as the assistance to the floatation of their bonds (60 bln roubles) has been taken into account. In the case of the defence-industrial complex, granting of state guarantees to defence enterprises has been taken into account (100 bln roubles).

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