

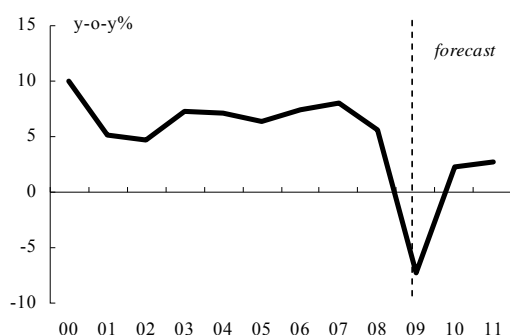
## 35. RUSSIAN FEDERATION

### Unexpectedly deep recession, tentative recovery

Russia in 2008 saw its 10<sup>th</sup> straight year of strong growth, with GDP growing at 5.6% in that year and bringing the 1999-2008 average to 6.9%. However, amidst the global crisis, in 2009 the country was hit by an unexpectedly deep recession. After a double-digit GDP fall in the first half of 2009 (the economy contracted by 9.8% in the first quarter, and by a surprising 10.9% in the second quarter) growth in 2009 is expected to be -7.2%, while a relatively mild recovery is foreseen for 2010 (2.3%), gaining some speed in 2011 (2.7%). The main reason behind this expected recovery is positive net exports, linked to a recovery in commodity prices.

This contraction was the result of the twin shocks that hit the Russian economy and the interaction between these: firstly the financial shock caused by the sudden stop in access to international capital flows (affecting a domestic banking system that was financing double-digit credit growth with external resources); and secondly the real shock linked to the sudden and sharp fall in commodity prices that form the bulk of Russia's exports. On the demand side, the profile in 2009 is driven by steep falls in the main domestic demand components: investment fell by around 19% until July, and retail sales (a proxy for consumption) by over 8% in the same period (on the other hand, the contribution of net exports to GDP became positive for the first time since 2006).

Graph II.35.1: Russia - GDP



This GDP fall should be accompanied by a reduction of the current account and trade surpluses and by a swing from large fiscal surpluses to significant fiscal deficits. The budget is expected to swing sharply from a hefty surplus

to large deficits, of around 6% of GDP in 2009, falling to around 2% in 2010 and 2011, due to the reduction in commodity prices and in economic activity, plus the fiscal stimulus package. In the case of Russia, it is important to keep in mind that, at least for 2009 and 2010, these fiscal deficits will be financed by the Oil Stabilisation Fund. Russia is also forecast to see a large fall in its trade and current account surpluses in 2009, with slight increases in 2010 and 2011. Respectively, the trade surplus shall be 3.6%, 5.3% and 6.4%, while the current account surplus is expected to reach 1.7% in 2009, growing to around 3% and 4% of GDP. Unemployment is also foreseen to reach around 8%, falling slowly towards 7%, while inflation is expected to slow from 10.5% in 2009 to below 8% by 2011.

#### Financial and real sector developments

Signs of recovery in financial variables appeared in March 2009 (when oil prices started to increase again), while indications of improvement in real variables only occurred by the summer of 2009.

Russia's main stock markets indexes (the MICEX and the RTS) fell by 33% and 47% respectively since mid-2008, but had stabilised in levels already by November 2008 (after foreign investors withdrew speculative short-run liquidity from the Russian markets). These indexes increased by around 52% and 78% respectively between the end of the first quarter and early October 2009.

A similar pattern is to be found in exchange rate developments. The Central Bank of Russia (CBR) aim is to stabilise a nominal euro-dollar currency basket (set at 45 cents of the EUR and 55 cents of the USD). Faced with the 2008 terms of trade shock, the CBR chose for greater flexibility, announcing in January 2009 a 26-41 rouble "band" to the basket in which the currency has been allowed to float mostly freely. While the rouble lost around 22% against the basket since mid-2008, the exchange rate has not only stabilised since the introduction of the band, but appreciated by over 8% up to early October 2009 (with the CBR even having to recently intervene to counteract what it perceived as excessive appreciation).

Russian hard currency reserves fell from a peak of almost USD 600 billion at the summer of 2008 to

around USD 413 billion by late September 2009 (still the third largest reserves worldwide). This is a fall of around 31%, but this hides the fact that reserves have stabilised roughly at the current level since late January 2009. Additionally, at least part of the loss in reserves was potentially justified as a tool to enable a staged and orderly de-leveraging of foreign currency debt by Russian companies and banks, faced with the “sudden stop” of capital flows in late 2008. The Russian banking system was financing double-digit growth rates of credit (over and above the double-digit growth rates of domestic deposits) via external financing. Since the significant and abrupt worsening of international capital markets in the fall of 2008, the net external liabilities of the Russian banking system fell from USD 130 billion in mid-2008 to USD 26 billion by June 2009. This huge adjustment was only possible without widespread bank failures due to the massive transfer of hard currency reserves from the CBR to the banking system. Also, data up to July 2009 indicates a limited nominal increase in deposits.

Finally, another sign of stabilisation lies in interest rates. After massive liquidity provisions by the CBR, the overnight “Mosprime” rate declined from 25% to 6.2% by early October 2009. Parallel to that and to the fall in inflation, the CBR reduced its own overnight rates (which had been hiked in late 2008, as part of its initial strategy to defend the peg) six times up to late September 2009.

Indications of stabilisation in real variables are both more recent and more tentative. The “Basic Sectors” monthly index, a composite indicator that proxies for GDP, started showing month-on-month positive growth only in June (following the pattern of industrial production). This brief positive trend was interrupted in August 2009, which might merely reflect a base effect (as August 2008 was the peak of the previous positive manufacturing cycle). On the other hand, the Russian PMI finally went above the 50-mark for the first time in fourteen months in September 2009 (signalling a return to expansion). Russia is the third most important trading partner of the EU (and its second export market after the US). Its nominal USD exports fell by an estimated 45% y-o-y up to September 2009 (although the speed of the fall seems to be slowing, reflecting the relative recovery in oil prices, from -48% in January 2009 to around -40% by September). Imports, on the other hand, fell by somewhat less, by -40%, during the same period, but the speed of decline

seems to have increased as 2009 progressed (from -33% in January 2009 to over -40%). This may reflect some limited lagged expenditure-switching effects arising from the earlier rouble devaluation. As a result, the trade surplus until September 2009 was down by -52% compared to September 2008, but improving from the -60% in January to around -40% by September.

### Policy reactions

Similarly to other countries, Russia enacted an extensive set of policy measures, from the provision of liquidity to direct support to the banking sector, discretionary fiscal stimulus and a more flexible exchange rate. Some of these were discontinued as the economic situation stabilised (notably, the auctioning of fiscal funds by the Ministry of Finance to banks and the provision of uncollateralised short term funds by the CBR).<sup>(90)</sup> The additional fiscal impulse for 2009-10 is estimated at around 6% of the 2008 GDP.

### Policy issues and overall prospects till 2011

Russia has been significantly affected by the global downturn, although some initial, early signs of stabilisation may be appearing. Arguably for Russia the main channel of transmission was the real one, while the financial channel also had large effects. The real channel originates in the fall of commodity prices, which, beyond trade, has direct investment, consumption and budgetary consequences. The unexpected depth and duration of the downturn, given Russia’s strong initial position, is due to the specific way in which those shocks interacted in the country. Briefly, the forecast is of a subdued recovery from the depths of a profound 2009 recession. Inflation should fall below double-digit levels only slowly. The budget is expected to post significant deficit throughout the forecast horizon. Trade and current account surpluses are expected to decline. Unemployment will only progressively be reduced.

Russian policies used to counteract the downturn are very similar to the ones pursued in more mature economies: measures to support and re-capitalise financial markets and institutions,

<sup>(90)</sup> Also similarly to other regions, there is a significant difference between the announced amounts of the stimulus and the totals actually committed. For instance, in terms of capital injections in the banking sector, the values committed are around 40% of the ones announced, while for the purchase of assets and lending by the Ministry of Finance, this is even lower, at around 31%.

enabling credit markets to continue to work, plus fiscal support packages for the wider economy. Additionally, Russia, a country with a pegged exchange rate, allowed more flexibility in the rouble as part of its policy tools. As the economic situation stabilizes, some tools are already being withdrawn or scaled back.

Certain longer-term policy issues could also be drawn from the current downturn. A first one is that a greater integration into the World economy, via trade and capital flows (the large capital outflow from Russia, for instance, was only possible because of its liberalised capital account, while its most exposed banks were those that were privately-owned, either domestically or foreign) might also imply some costs. However, such recognition of some possible costs associated with “Globalisation” does not imply a support for protectionism. The relevant policy question to be potentially explored would be to design mechanisms that could dampen the transmission mechanisms of negative shocks arising from the changes brought about by greater global economic integration.

A second point is that, as the financial component of the shock arguably led (or at least preceded) the real one, supervisory and regulatory financial frameworks reforms are central in this respect.

Given the observed spillovers and the integration of the global financial system (which, again, ought to ultimately be preserved), such reforms should have a global and coordinated character. The G-20 process, in which both the EU and Russia are already intensely involved, is the best example of those global coordinated policy responses.

A third element is that albeit macroeconomic stabilisation factors (sound fiscal positions, robust fiscal rules, large hard currency reserves, a more flexible exchange rate) did not insulate Russia from the crisis, they enabled it to implement policies that cushioned the shock. This could be interpreted as reinforcing the importance of the (largely pre-existing) robust and consistent macroeconomic policy frameworks.

A fourth aspect is that the growth models that relied more on primary sectors have seemingly showed themselves to be more affected by the downturn. Efforts for a diversification of growth sources towards a less commodities-biased economic structure could be intensified in the future. This, incidentally, is something that is explicitly indicated in Russia’s own long-term development strategy, the so-called “Russia 2020”.

Table II.35.1:

**Main features of country forecast - RUSSIA**

	2008			Annual percentage change						
	bn RUB	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	41173.4	100.0	-	-	7.7	8.1	5.6	-7.2	2.3	2.7
Private consumption	19634.4	47.7	-	-	11.2	13.6	11.2	-6.0	2.5	3.0
Public consumption	6975.7	16.9	-	-	2.4	3.4	2.5	0.9	1.5	1.0
Gross fixed capital formation	9408.7	22.9	-	-	18.0	21.1	10.0	-21.0	1.8	3.9
of which : equipment	3388.5	8.2	-	-	-	-	-	-20.0	2.0	4.0
Exports (goods and services)	13067.5	31.7	-	-	7.3	6.3	0.5	-11.6	3.0	2.5
Imports (goods and services)	9156.0	22.2	-	-	21.3	26.5	15.0	-20.0	2.0	3.0
GNI (GDP deflator)	39952.2	97.0	-	-	7.2	8.8	5.0	-5.4	2.2	2.7
Contribution to GDP growth :										
Domestic demand			-	-	9.2	11.1	8.0	-7.5	2.0	2.6
Stockbuilding			-	-	-	-	-	-	-	-
Foreign balance			-	-	-2.0	-3.4	-3.1	0.8	0.3	0.1
Employment			-	-	0.6	0.8	-0.5	-1.3	0.6	0.0
Unemployment rate (a)			-	-	6.7	5.6	5.6	7.2	6.8	6.5
Compensation of employees/head			-	-	-	-	-	-	-	-
Unit labour costs whole economy			-	-	-	-	-	-	-	-
Real unit labour costs			-	-	-	-	-	-	-	-
Savings rate of households (b)			-	-	-	-	-	-	-	-
GDP deflator			-	-	15.5	13.9	19.2	1.0	9.7	9.3
General index of consumer prices			-	-	9.7	9.0	14.1	10.5	9.0	7.8
Terms of trade of goods			-	-	-	-	-	-	-	-
Trade balance (c)			-	-	14.1	10.1	10.7	5.0	6.4	7.3
Current account balance (c)			-	-	9.6	5.9	6.1	1.7	3.2	4.3
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-	-	9.6	5.2	6.1	-	-	-
General government balance (c)			-	-	-	-	-	-6.5	-2.6	-2.7
Cyclically-adjusted budget balance (c)			-	-	-	-	-	-	-	-
Structural budget balance (c)			-	-	-	-	-	-	-	-
General government gross debt (c)			-	-	-	-	-	7.7	10.4	10.9

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.