Russia and the Global Financial Crisis

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The present financial crisis is a further link in the chain of crises widely described in economics literature. As recently as in the 1990s the global economy was affected by a number of crises which had an impact on several whole groups of countries. In 1992-1993 several countries of the European Union (United Kingdom, Italy, Sweden, Norway and Finland) suffered currency crises. In 1994-1995 a severe crisis which had started in Mexico expanded to other countries in Latin America. In 1997-1998 a global financial crisis began in the countries of Southeast Asia (Korea, Malaysia, Thailand, Indonesia, Philippines), and then spread to Eastern Europe (Russia and several countries of the former USSR) and Latin America (Brazil).

Causes, occurrence and manifestation of the current global financial crisis

The current financial crisis is distinguished by both its depth and scale – it is perhaps the most serious one since the Great Depression gripped the whole world. Problems existing in the US mortgage market were the “trigger” of the crisis mechanism. However, there are more fundamental reasons underlying the crisis, including macroeconomic, microeconomic and institutional ones. The leading macroeconomic cause of the crisis was the excessive liquidity in the US economy which, in turn, had been driven by many factors, including:

— the general decline of confidence, after the 1997-1998 crisis, in countries with emerging markets;

— investment in American securities by countries accumulating reserves of foreign exchange (China) and oil funds (countries of the Persian Gulf);

— the policy of low interest rates conducted by the Federal Reserve System in 2001-2003, in an attempt to stop the cyclical recession of the US economy.

The excessive liquidity resulted in an intensification of the process of market bubble formation — a distorted overestimation of various types of assets. At various points such bubbles had formed in the real estate markets, in stocks and in commodities, and this process became an important part of the crisis mechanism. As shown by data from multi-country studies carried out over long periods of time, credit expansion is one of the typical conditions of a financial crisis. Thus, the risks of a crisis developing due to easing of the monetary policy which were realised in 2007-2008 were not an exception at all, but adhered to a general rule.

Against this background the crisis was also nurtured by microeconomic factors — the development of new financial instruments (primarily, structured derivative bonds). It was believed that they could reduce risks by distribution amongst investors while ensuring a correct assessment of such risks. In fact, the use of derivatives actually resulted in a masking of the risks associated with the low quality of subprime mortgages, and their non-transparent distribution amongst a wide circle of investors. Finally, amongst the institutional reasons, we should note an inadequate level of risk assessment by both the regulators and rating agencies.

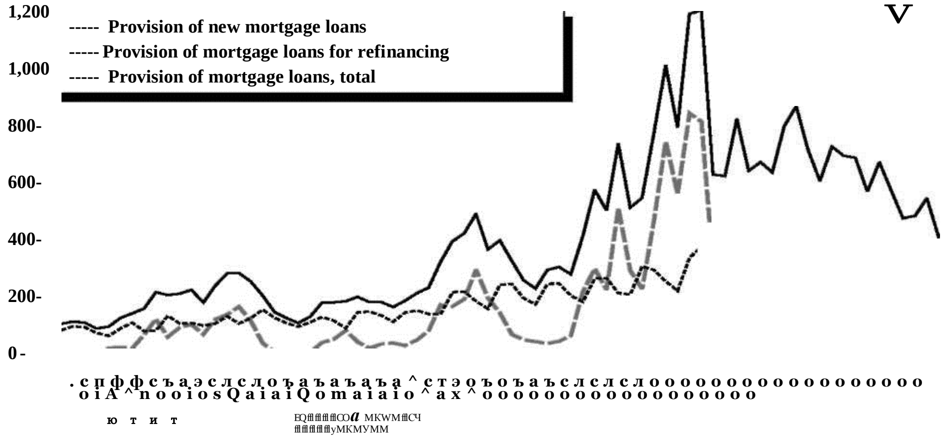
The soft monetary policy pursued by the US Federal Reserve System since the early 2000s had stimulated bank lending. The annual average growth of consumer lending by banks in 2003-2007 was at a level of 5% while the growth of consumer loans in the third quarter of 2007 was 7.2%. The volume of mortgage loans being provided had increased from USD 238 billion in the first quarter of 2000 to USD 1,199 billion in the third quarter of 2003.

As the US economy was entering recession, a tendency towards a gradual reduction of bank lending became established. In the third quarter of 2008 the volume of mortgage loans provided to the population was only USD 415 billion (see Figure 1). Consumer lending growth rates showed a considerable decrease — in November 2008 their volume had decreased by 3.7% compared to the October figures.

The key role in development of the current crisis was played by the asymmetry of information. The structure of derivatives became so complicated and non-transparent that it was virtually impossible to assess the real value of the portfolios of financial companies. Since the credit market was no longer able effectively to identify potentially insolvent debtors, it became paralysed. Further developments in the financial sector seriously affected the real sector economy. Soon after the worsening of the problems in the US financial system, the USA entered a recession. The US National Bureau of Economic Research (NBER), a council of economic researchers which is deemed the official arbitrator in determining the start and end dates for recessions in the country, declared, in December 2008, that the recession in the USA had started a year previously, back in December 2007.

The US financial crisis gradually spread all over the world. American corporations commenced urgent

Mortgage lending in the USA *(USD billion)*



Source: MBA Mortgage Origination Estimates, 2008, 15 Dec.

Figure 1

sales of assets and the withdrawal of monetary funds from other countries. According to estimates by the Bank of England, the total losses due to the crisis in the economies of the USA, UK and EU have already amounted to USD 2.8 trillion.

The US GDP in the third quarter of 2008 decreased by 0.5%, which was the most significant drop since 2001, due to the greatest reduction of consumer spending (by 3.8%) in 28 years. Concurrently, the reduction of this indicator was partially offset by increased government spending, export growth and a decline in imports. According to estimates by the US Congressional Budget Office, the growth in GDP in 2008 was 1.2%.

The volume of capacities employed in the US economy dropped to 75.4% compared to 76.3% in October, which is 5.6 p.p. lower than the average level of 1972-2007. The ISM manufacturing index[1] decreased to 32.4 points in December 2008 compared to 32.6 points in October. This was the lowest value of the index since July 1980, when it was at a level of 30.3 points. In 2007 its average value was 51.1 points.

According to data from the US Department of Labor, in December 2008 the American economy lost 524 thousand jobs (and 2.6 million for the year overall). This was the biggest decrease since 1945, when the country was transitioning to a peace-time economy. The level of unemployment in the USA reached 7.2%, its maximum value since 1992 (having been 4.4% before the beginning of financial crisis). Taking into account employment termination of part-time workers, it increased to 13.5% (against 8.7% at the end of 2007).

Construction of new houses in the USA decreased by 19% in November 2008 compared to the preceding month. This was the lowest indicator value since monitoring began. Compared to November 2007 the reduction was 47%. In annual terms, sales of new houses in November 2008 were 35.5% lower than in November 2007.

The events in the US economy had an adverse effect on equity markets in both developed and developing countries. Figure 2 illustrates the 2007-2008 dynamics of one of the main American

[1] ISM manufacturing index is the result of a survey of industrial purchasing managers. An index value below 40.0 points means a reduction of business activity both in the manufacturing sector and in the economy as a whole.

Stock Market Indices of the USA and emerging markets

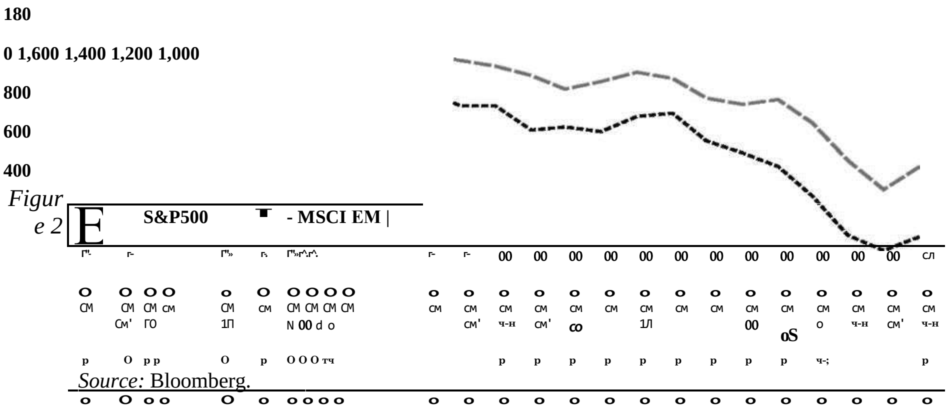


Figure 2

Source: Bloomberg.

stock market indices, the S&P 500, and stock market index for emerging markets, the MSCI EM, developed by Morgan Stanley bank (data in the Figure do not reflect the intra-month dynamics of the indices).

In 2007, the stock markets of developing countries were growing faster than those of the developed countries, this growth being facilitated by portfolio investments from the leading world economies. In 2008 the massive inflow of funds to emerging markets from abroad stopped, and the dynamics of the stock market index for developing countries virtually repeated the dynamics of the leading American stock market index. In 2008, the S&P 500 decreased by almost 40% and the MSCI EM decreased by more than 50%.

An analysis of the situation in the global economy, based on the results of 2008, allows us to predict the global growth slowdown in the current year. The November forecast of the IMF estimates it at a level of 2.2% and that of the World Bank — at a level of 0.9%. In the future these values can be expected to decrease. The most developed economies are expected to show a serious decline in the coming year.

For example, the European Commission forecasts a decline in GDP of the European zone by 1.8%. According to the US Congressional Budget Office (CBO) estimates provided in “The Budget and Economic Outlook: Fiscal Years 2009-2019”, the USA should expect a strong reduction of economic activity in 2009. The real GDP, without taking into account the economic stimulus programme will reduce by 2.2% with a decrease of more than 1% in real consumption. In 2010 a slow recovery, with real GDP growing by 1.5% is possible. The CBO forecasts a drop in the national average price of a home by an additional 14 percent between the third quarter of 2008 and the second quarter of 2010. The budget deficit in the USE, in 2009, is anticipated to be the largest recorded since World War II. The CBO projects that the budget deficit this year will total USD 1.2 trillion, or 8.3 percent of GDP. Enhancement of an economic stimulus package will add to this deficit but in 2010 it will fall to 4.9% of GDP.

Spending by state and local governments will only mildly ease the downturn in economic activity. In response to lower-than-expected revenues and requirements for balanced budgets they are cutting back their spending on goods and services and the CBO's forecast assumes essentially no real growth in that spending in 2009.

The CBO anticipates that the current recession in the USA will last until the second half of 2009, making it the longest recession since World War II (the longest such recessions otherwise, those in 1973–1974 and in 1981–1982, both lasted 16 months). If the current recession were to continue beyond midyear, it would have lasted at least 19 months. It could also be the deepest recession during the post-war period: by the CBO's estimates, economic output over the next two years will average 6.8 percent below its potential — that is, the level of output that would be produced if the economy's resources were fully employed. This recession, however, may not result in the highest unemployment rate. That rate, in the CBO's forecast, rises to 9.2 percent by early 2010 (up from a low of 4.4 percent at the end of 2006) but this is still below the 10.8 percent rate seen near the end of the 1981-1982 recession.

Based on the results of 2009, some analysts predict a deeper global recession than has ever been seen before, even at the times of the largest economic crises in the leading countries. The most serious slowdowns in the global economy were observed in 1975 when global growth was only 0.93% compared to the previous year and in 1980, when its value decreased to almost zero (0.3%).

It is expected that in the near future the "locomotives" of global economic growth will be China and India. The situations in these countries are different though.

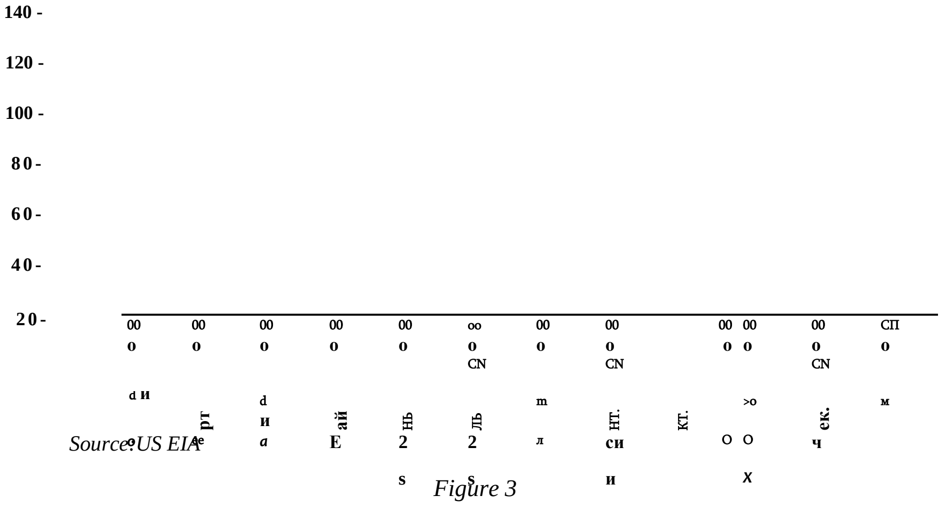
It will not be easy for the export-oriented economy of China to replenish the decrease in external demand with domestic demand. Even the implementation of a package of anti-recession measures, which is estimated to be worth USD 570 billion, and its possible further increase, will not prevent a strong decline in growth rates down to 6% and less. As forecast by the World Bank, with the reduction in the volume of direct foreign investments, India's GDP growth rate is expected to decrease to 5.8% in 2009 compared to 6.3% in 2008.

The GDP of another dynamically developing country — Brazil — in 2009 is expected to grow by 2.8% compared to 5.2% in 2008. Inflation has already started to flatten, influenced by an increase in interest rates initiated by the country's Central Bank, amidst falling commodity prices. Inflation of consumer prices should lower from 6.3% in 2008 to 4.8% in 2009. According to estimates by analysts at Barclays Capital[2], the current account deficit in Brazil in 2008 will be 1.9% of GDP. For the first time since 2002, the country faces a negative balance on this account. Barclays Capital analysts have forecast a further increase in the deficit to 2.4% of GDP in 2010.

The expected level of world oil prices is also steadily declining. According to the latest forecast provided by the US Energy Information Administration on 13 January 2009, the average WTI crude oil price for 2009 is estimated at 43 USD/barrel (corresponding to about 40 USD/barrel for Urals oil). This means that oil will become almost 2.5 times less expensive than in 2008. Figure 3 illustrates the dynamics of the monthly forecasts of the US Energy Information Administration for average oil prices in 2009. It should be noted that during the last four months (October 2008 to January 2009) these fell almost threefold. This can be explained by the expected decline in the global demand for oil.

Global Economics Weekly/Barclays Capital. 2009. 16 Jan.

Dynamics of the US Energy Information Administration's forecast for average oil prices in 2009 *(USD/barrel)*



Source: US EIA

Figure 3

The International Energy Agency revised down its forecast for 2009 global oil demand by 1 million barrels per day following a halving of the assumed GDP growth to 1.2%, given the worsening outlook[3]. Global oil demand is now projected at 85.3 million barrels per day in 2009 (-0.6% or -0.5 million barrels per day year-on-year). According to the OPEC forecast[4], world oil demand in 2009 will be 85.7 million barrels per day (compared to 85.8 million in 2008 and 85.9 million in 2007). The main driver of the considerable decline in demand for oil is the decrease in US demand by 1.1 million barrels per day.

We must remember that in order to develop the strategic principles of its budgetary policy the Russian Ministry of Finance accepted a long-term oil price of USD 50 at 2007 prices, which may be substantially lower in a period of economic decline and substantially higher in a period of economic upturn. In recent years, prices for oil have increased considerably. In 2008 the average price for Urals oil climbed to its all-time high of 94.4 USD/barrel (see Figure 4). This is the maximum recorded value since 1970. Taking into account the forecasted changes in world oil demand, this value is not expected to be exceeded.

This conclusion is confirmed by the latest long-term OPEC study[5]. Its experts note the increasing influence of investors and stock exchange dealers on the pricing process, as they assess oil, not by its consumer qualities, but as an attractive financial asset. Thus, in the New York Mercantile Exchange, whilst in 2003 for each barrel of oil actually sold, there had been six "paper" barrels, in 2008 this value was over 18.

According to the OPEC forecast to 2030, as provided in the 'World Oil Market Outlook for 2008', the population growth rates

Highlights of the latest OMR // WEA Oil Market Report. 2009. 16 Jan.
Monthly Oil Market Report / OPEC. 2009. 15 Jan.
World Oil Outlook 2008 / OPEC Secretariat. Vienna, 2008. July.

Источники: ОПЕК, расчеты автора.

Рис. 4

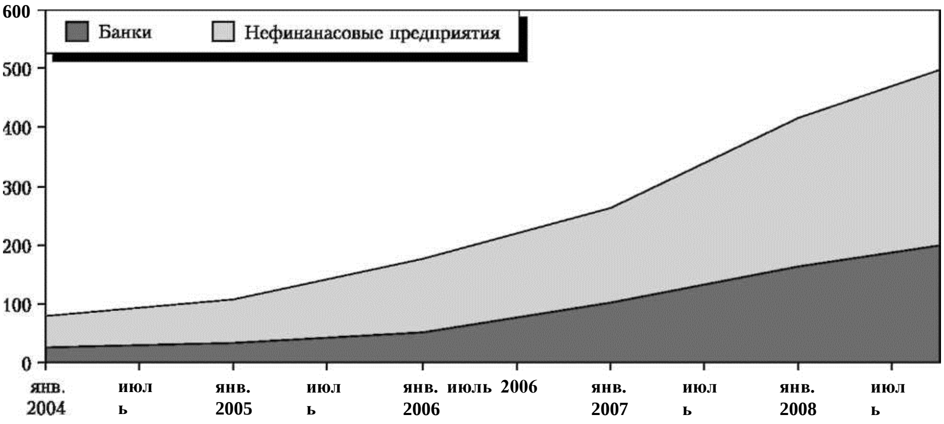
Динамика мировых цен на нефть марки Urals (долл./барр.)	Dynamics of world oil prices for Urals oil (USD/barrel)
В текущих ценах	In current prices
В ценах 2008 г.	In 2008 prices
Источники: ОПЕК, расчеты автора	Sources: OPEC, author’s calculations
Рис. 4	Figure 4

in 2006-2015 will be higher than in 2015-2030 (1.1% and 0.9% per annum, respectively). Moreover, in the second half of the period in question the working age population will start to decrease and this will have an impact on economic activity thereby reducing energy consumption.

Impact of the global financial crisis on the monetary policy and banking system of Russia

Just before the crisis the Russian economy was demonstrating very good macroeconomic indicators: a substantial budget and current account surplus, with a rapid growth of gold and foreign currency reserves and budgetary funds. However, in recent years there has been an easing of monetary and budgetary policy to a certain extent. For example, in 2007, federal budget expenditure increased in real terms by 24.9%, i.e. its growth exceeded GDP growth by a factor of three. Consistently low (virtually negative in real terms) interest rates emerged in the economy, which boosted lending. This naturally resulted in “overheating” of the economy. This contributed to an increased inflation pressure, on one hand, and to a rapid growth of external borrowing, on the other. In just three years (2005-2007) the private sector external debt increased almost fourfold. As of the beginning of 2005 it was USD 108 billion whilst at the end of 2007 it amounted to USD 417.2 billion (see Figure 5). The rapid growth of government spending and imports was masked by the increased prices for oil and other Russian exports. However, the above processes made the Russian economy vulnerable to the impact of the global crisis.

External debt of the private sector *(USD billion)*



Source: Bank of Russia

Fig. 5

Банки	Banks
Нефинансовые предприятия	Non-financial organisations
Янв.2004	January 2004
Июль 2004	July 2004
Янв.2005	January 2005
Июль 2005	July 2005
Янв.2006	January 2006
Июль 2006	July 2006
Янв.2007	January 2007
Июль 2007	July 2007
Янв.2008	January 2008
Июль 2008	July 2008

Raising funds on the world capital market enabled Russian banks to perform expansion of the credit market, which resulted in greater availability of monetary resources and reduced rates in the domestic loan market. The net international investment position of credit institutions was steadily worsening. By the end of 2005 it had been - USD 20.827 billion, but by the third quarter of 2008 it was -USD 99.651 billion.

The decline in oil prices from last May, and limited borrowing on the external market caused a substantial weakening of the balance of payments in the second half of 2008. The net inflow of private capital, amounting to USD 83 billion in 2007, turned into a net outflow of USD 130 billion in 2008. In the fourth quarter of the last year, compared to the first quarter of the same year, the current account decreased by a factor of 4.5 — from USD 37 billion to USD 8 billion so the total for the year amounted to USD 99 billion (see Table 1). In 2009 a zero balance is expected on the current account.

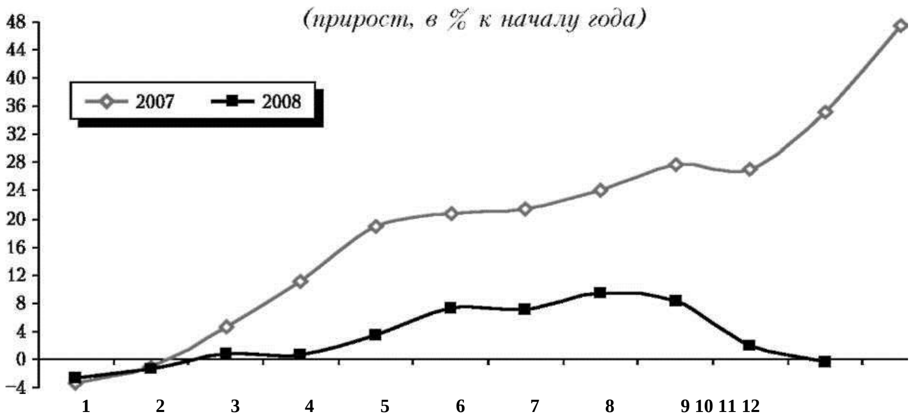
T a b l e 1

Payment balance of the Russian Federation for 2008 *(USD billion)*

	I	II	III	IV (estimate)	Year (estimate)
Current account	37.4	25.8	27.6	8.1	98.9
Account for transactions with capital and financial instruments	-24.7	35.4	-9.4	-129.7	-128.4
Financial account (excluding reserve assets)	-24.6	35.2	-9.6	-130.0	-129.0
Change in the reserve assets ("+" — decrease, "-" — increase)	-6.4	-64.2	-15.0	131.0	45.3
For reference only:					
Urals oil prices (global), USD/barrel	93.4	117.1	113.0	54.2	94.4
Net capital import/export by the private sector	-23.1	41.1	-17.4	-130.5	-129.9

Source: Bank of Russia

As a result, in the last year, foreign currency reserves decreased by USD 45 billion (while gold and currency reserves decreased by USD 51.7 billion) and actually stopped performing the function of being a source of money supply. Their reduction led to a serious slowdown of money supply. During the 11 months of 2008 the M2 money stock decreased by 0.3%, whilst in the corresponding period of 2007 it had increased by 35.2% (see Figure 6).



Source: Bank of Russia

Figure 6

(прирост, в % к началу года)	(growth, in % to the beginning of the year)

The main source of money supply was liquidity replenishment by the monetary authorities. These measures allowed saturation of the market with short-term liquidity, however they failed to compensate for the deficit of long-term resources. The supply of “long” money in the economy and the stabilisation of the money market in the long term must be ensured by the institutional investors and commercial banks themselves, through lending activities.

One of the sources of “long” liabilities is the deposits, with maturities of more than three years, by legal entities and individuals. During the last two years their share in total liabilities amounted to 5-6%.

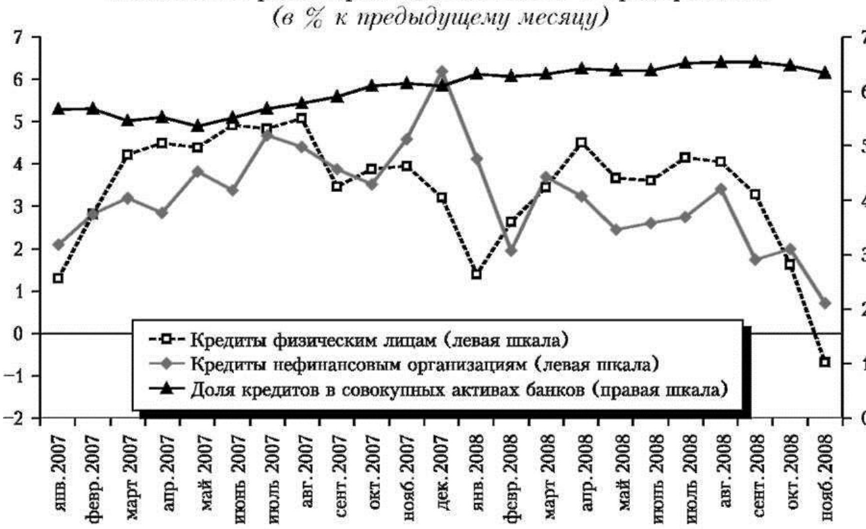
Under the conditions of a lack of “long money” banks must use “short” liabilities as a source for forming “long” assets. This situation is typical not only of the current period of financial instability but also of the last few years, when short-term liabilities covered at least 10-14% of long-term bank assets. Obviously, further growth of long-term loans involving short-term liabilities could have an adverse effect on the liquidity of the banking system.

Recently, a pronounced slowdown of loan portfolio growth rates has been observed. In November 2008, compared to October, the volume of loans provided to the population actually decreased by 0.7% and the increase in the volume of banking loans provided to companies was only 0.7% (see Figure 7). Based on the results of the eleven months of 2008 the indebtedness

Money Stock M2

Замедление роста кредитов населению и предприятиям

(в % к предыдущему месяцу)



Источник: Банк России.

Рис. 7

Замедление роста кредитов населению и предприятиям	Slowdown in growth of lending to the population and companies
(в % к предыдущему месяцу)	(as % of the previous month)
Кредиты физическим лицам (левая шкала)	Loans to individuals (left axis)
Кредиты нефинансовым организациям (левая шкала)	Loans to non-financial institutions (left axis)
Доля кредитов в совокупных активах банков (правая шкала)	Share of loans in banks' total assets (right axis)
Январь 2007	January 2007
Февраль 2007	February 2007
Март 2007	March 2007
Апрель 2007	April 2007
Май 2007	May 2007
Июнь 2007	June 2007
Июль 2007	July 2007
Август 2007	August 2007
Сентябрь 2007	September 2007
Октябрь 2007	October 2007
Ноябрь 2007	November 2007
Декабрь 2007	December 2007
Январь 2008	January 2008

Февраль 2008	February 2008
Март 2008	March 2008
Апрель 2008	April 2008
Май 2008	May 2008
Июнь 2008	June 2008
Июль 2008	July 2008
Август 2008	August 2008
Сентябрь 2008	September 2008
Октябрь 2008	October 2008
Ноябрь 2008	November 2008
Источник: Банк России	Source: Bank of Russia
Рисунок 7	Figure 7

of non-financial organisations to credit institutions grew by 32.6% compared to 46.9% in the same period in 2007.

The dynamics of bank loans in 2008 were also affected by the fact that many organisations started to close their investment programmes and to reduce their operating costs. Banks began to tighten their financial requirements for citizens due to the increased risks of non-repayment of loans (decrease in purchasing ability, increase in the number of unemployed people). In the very near future the banks will have to pay more attention to attracting resources from the domestic market.

A strengthening of competition in the domestic financial market in 2008 resulted in increased interest rates on bank deposits. For example, the average weighted rate on ruble deposits by individuals in credit institutions for a period of up to one year increased from 5.4% per annum in January 2008 to 6.2% per annum in October, and an average weighted rate on ruble deposits belonging to companies for a period of up to one year increased from 3% to 6.7%.

It should be noted that until now the growth of interest rates offered by the banks on deposits by individuals has been very modest and has failed to compensate for the acceleration of inflation. At the same time, the growth in bank deposits has decreased (see Figure 8).

In addition to deposits by individuals and legal entities, in 2008 the main sources of resource generation for commercial banks were loans, deposits and other funds obtained from other credit institutions, as well as the funds from legal entities in settlement and other accounts and bonds. These items, including deposits, as of the beginning of December 2008, accounted for 71.3% of total liabilities (see Table 2). The share of loans from the Bank of Russia obtained by banks has increased by 8 p.p. to 8.2% of the total liabilities. Obviously, the Bank of Russia loans are of a short-term and regulatory nature.

Источник: Банк России.

Рис. 8

Замедление роста депозитов	Slowdown of deposit growth
(в % к предыдущему месяцу)	(as % of the previous month)
Депозиты физических лиц (левая шкала)	Deposits by individuals (left axis)
Депозиты нефинансовых организаций (левая шкала)	Deposits by non-financial institutions (left axis)
Доля депозитов в совокупных пассивах банков (правая шкала)	Share of deposits in banks' total liabilities (right axis)

T a b l e 2

Structure of liabilities of credit institutions

	January 1, 2008		December 1, 2008	
	RUB billion	% of liabilities	RUB billion	% of liabilities
Deposits by individuals	5,159.2	25.6	5,523.8	21.3
Deposits and other borrowed funds of legal entities (other than credit institutions)	3,520.0	17.5	4,849.7	18.7
Funds of legal entities on settlement and other accounts	3,232.9	16.1	3,063.5	11.8
Loans, deposits and other funds obtained from other credit institutions, total	2,807.4	13.9	3,879.0	15.0
Loans, deposits and other funds obtained by credit institutions from the Bank of Russia	34.0	0.2	2,123.4	8.2
Bonds, notes and bank accepts	1,112.4	5.5	1,162.7	4.5
Funds of credit institutions	2,182.2	10.8	1,821.1	7.0
Other liabilities	2,077.0	10.4	3,500.7	13.5
Total	20,125.1	100.0	25,923.9	100.0

Source: Bank of Russia.

Январь 2007	January 2007
Февраль 2007	February 2007
Март 2007	March 2007
Апрель 2007	April 2007
Май 2007	May 2007
Июнь 2007	June 2007
Июль 2007	July 2007
Август 2007	August 2007
Сентябрь 2007	September 2007

Октябрь 2007	October 2007
Ноябрь 2007	November 2007
Декабрь 2007	December 2007
Январь 2008	January 2008
Февраль 2008	February 2008
Март 2008	March 2008
Апрель 2008	April 2008
Май 2008	May 2008
Июнь 2008	June 2008
Июль 2008	July 2008
Август 2008	August 2008
Сентябрь 2008	September 2008
Октябрь 2008	October 2008
Ноябрь 2008	November 2008
Источник: Банк России	Source: Bank of Russia
Рисунок 8	Figure 8

The cost of resources for commercial banks is affected by a change in the value of substantive items in the bank liabilities, i.e. primarily, by a change in interest rates on deposits by individuals and legal entities. To maintain their activities commercial banks cannot provide loans at a lower interest rate than their interest rates on deposits. At the same time, under the conditions existing in Russia, the latter must be at least zero in real terms in order to stimulate saving. Rates in the economy are determined, primarily, by the level of inflation, the creation of incentives to save, and by the level of risk.

In 2008 inflation increased again due to the soft monetary policy of previous years. The Government and the Bank of Russia failed to restrain the excess money supply resulting from the high prices for oil and the inflow of capital. This caused a substantial increase in total demand in the economy and led to a credit boom. The growth in loans provided for construction was 85.8% as of 1 October 2007 and 54% as of 1 October 2008, while loans provided to the transport and communications industry were 81.5% and 38.2%, respectively (see Table 3). Maintaining such volumes of lending in the long run is impossible because it eventually results in a credit bubble. In the medium term the credit boom may result in a decrease in the creditworthiness of borrowers and, in a crisis, will eventually cause a "hard landing" of overheated industries, in addition to loan defaults, as well as a worsening of the banks' loan portfolios.

Table 3

Indebtedness under bank loans provided to legal entities

(increase, as % of the corresponding period of the previous year)

	1 October 2007	1 October 2008
Mineral extraction	90.9	9.5
Processing industries	38.8	42.8
Production and distribution of energy, gas and water	25.0	43.8
Agriculture, hunting and forestry	56.3	56.5
Construction	85.8	54.0
Transport and communications	81.5	38.2
Wholesale and retail trade; repair of motor vehicles, motorcycles, housing appliances and personal products	37.0	39.8

Source: Bank of Russia.

With an inertial increase of loan volumes, a significant reduction in the stability of the liability base causes an acute shortage of liquidity. The situation in the real sector is also complicated by a rise in interest rates. In addition to the inflation factor, the high cost of resources for companies is determined by the fact that the market is signaling a considerable level of uncertainty: newly produced goods and services may be not in demand. As a result, loans can be used only by manufacturing companies with high-incomes and quick-returns.

Russian banks had worked with loan interest rates of over 15% until 2003. Until then our country had been moving towards economic growth. But these rates were acceptable only for a limited number of industries with quick returns. The conditions needed for the development of basic industries arise only when inflation and loan interest rates are decreased. Upon reaching equilibrium, additional pumping of monetary funds into the economy may result in excess liquidity and additional growth in inflation, so the task of creating "long" money will again be postponed for several years. This means that one of the most important conditions for ensuring long-term growth is control over inflation. This is why, in leading countries, low inflation acts as the main indicator of the economic policy. Thus, the policy of the Bank of Russia, aimed at increasing interest rates in the economy, is justified. Other countries have reduced their interest rates because of a very high risk of severe deflation.

It is expected that in 2009 and in the period of 2010-2011 the external environment for the development of the Russian economy will worsen compared to the previous three-year period. The expected slowdown in growth of demand, in the current year, in the group of countries which are leading importers of Russian goods, and the slowdown of the growth of consumer prices in the group of countries which are leading suppliers of goods to Russia, as well as low commodity prices, will influence the Russian economy in the direction of limiting the rate of economic growth rates, and curbing inflation.

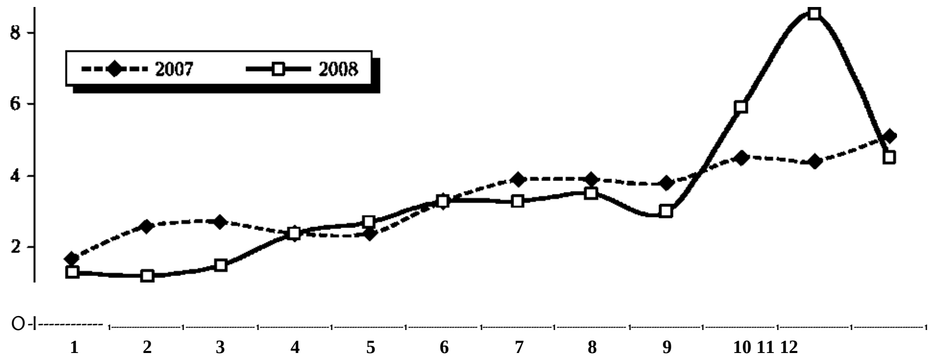
As a result of its scenario options for economic development, the Bank of Russia assumes an increase in M2 by 19-28%. In 2010 and 2011 the growth of money supply will slow down and could be 16-25% in 2010 and 14-22% in 2011.

A transition to the generation of money supply mainly through an increase in gross loans to banks, with a decreasing role for the growth of net international reserves, will allow a more effective use of interest-bearing instruments of monetary and credit regulation, as well as rendering effective the interest channel of the transmission mechanism of the monetary policy. At the same time, a reduced presence of the Bank of Russia in transactions on the domestic currency market will allow increased flexibility of the exchange rate policy and enable a gradual transition to a free-floating exchange rate to be brought about.

The choice of an exchange rate policy is also quite challenging. As the crisis in the global economy began to develop, the Bank of Russia maintained a fixed rate for the national currency against the dual currency basket. This was accompanied by a decrease in international reserves and a reduction of the money stock. From early November 2008 it started soft attenuation of the national currency by a gradual expansion of the limits of the permissible fluctuations of the cost of the dual currency basket. In 2008 the real effective exchange rate of the ruble against foreign currencies strengthened by 4.5%, although in December, compared with November, it weakened by 3.6% (see Figure 9).

Containment of the weakening of the ruble required that the Bank of Russia performed considerable interventions on the foreign currency market. Experts agree that a gradual weakening of the national currency is more demanding in terms of the expenditure of international reserves. In anticipation of a devaluation of the ruble the demand for foreign currency increases many times. However, the gradual weakening of the exchange rate enabled the banks to create the necessary foreign exchange reserves, and to ensure stability of the liabilities side of the banking system.

Real effective exchange rate of ruble against foreign currencies
(increase, in % to December of the preceding year)



Source: Bank of Russia.

Figure 9

Main directions of the budgetary policy in the crisis period

The instability of financial systems, the worsening of social problems and the slowdown of economic growth have forced the governments of many countries to take various measures for stabilisation of the situation and the stimulation of their economies, and this includes fiscal policy measures. Historical experience indicates that, for stimulating economic policy during a period of crisis, in most cases the key role has been played by monetary policy measures, due to their greater immediacy and relatively higher efficiency. However, a discretionary fiscal policy can only be used subject to certain limitations, especially in countries with emerging economies.

It should be noted that the in-built automatic stabilisers of fiscal policy are deemed to be relatively effective and, importantly, work adequately both in the conditions of recession and of “overheating” of an economy. In Russia they are quite sensitive to changes in economic conditions, including those occurring outside the country — for example, in a period of slowdown of economic growth, the tax burden on the oil sector decreases substantially because of the decrease in the prices for energy resources - to which the main levies in the oil sector are tied.

In emerging economies a stimulating fiscal policy leads to an increase in the deficit and, hence, to a growth in state debt. However, usually in periods of “overheating”, the restraining fiscal policy is less actively implemented, i.e. it turns out to be asymmetric and shifted toward stimulation, which, in turn, results in a continuous increase in debt. The growth of state debt in countries with emerging markets acts as an unfavorable factor and increases risks for the country in the future. In particular, it may result in excessive interest rates on external borrowings, which further worsen the situation. Another serious problem is ensuring the "temporary nature" of the stimulating fiscal policy. If, during the crisis period taxes were decreased, with the state taking on new expenditure obligations, then, even at the stage of transition to recovery, such changes would be politically hard to undo. This is why, when making decisions regarding the stimulus measures of fiscal policy, the government must thoroughly assess the opportunities for curtailing them in the future. One of the most important factors influencing the effectiveness of anti-recession policy is the targeting of the measures being taken, whether they are measures affecting social support or those for stimulation of real sector companies.

Our country faces the following tasks relating to fiscal policy, which require quite rapid solutions.

Use of measures of monetary and fiscal policy for stabilising the situation in the country's financial market. As already noted above, the solution to this problem is mainly provided by measures of monetary policy, however, fiscal measures can also be used, especially when there are considerable reserves (including money in oil and gas funds). Nevertheless, the key question here is one of how to determine optimal measures and the volume of budgetary funds which would have a positive effect on the financial sector, yet would not result in unfavorable medium and long-term consequences — inflation, sharp growth of the budgetary deficit, etc.

Use of the fiscal policy measures for resolving acute social problems. During a global financial crisis, economic instability and the slowdown of economic growth despite quite a high level of inflation can mean that Russia, as with other countries, may face various social problems. On one hand there is a decline in the standard of living and rising unemployment and, on the other hand, a slowing of development of the social field. The choice of stimulus measures is important here because assistance should be provided to those who are in real need while budgetary expenditure must not lead to further growth in inflation.

Support of the real economy sector under the conditions of a possible recession. To avoid a sharp downturn in the real economy (due to unfavorable external conditions and internal instability), and the related economic and social consequences, requires incentives from the government.

Table 4 presents a set of measures using tax and budgetary policy aimed at overcoming the consequences of the global financial crisis in our country. The total cost of the tax policy measures is estimated at RUR 900-1,000 billion (2.3-2.5% of GDP), and the budgetary policy measures (without the placement of sovereign wealth fund assets) at RUR 1,145 billion (2.9% of GDP). Thus, the total volume of anti-recession measures is RUR 2,045-2,145 billion (5.2-5.4% of GDP).

Moreover, in 2008 RUR 50 billion was allocated from the Housing and Utility Sector Support and Reform Fund to purchase apartments in buildings with a high degree of readiness, and RUR 32 billion was allocated from the federal budget to purchase

Table 4

Measures of the tax and budgetary policy aimed to overcome the consequences of the global financial crisis

	RUB billion	Equivalent amount in USD billion	% of GDP
1. Measures of the tax and budgetary policy, total	2,045.3-2,145.3	61.2-64.2	5.2-5.4
2. Measures of the tax policy, total	900-1,000	26.9-29.9	2.3-2.5
Reduction of income tax by 4 points	400-500	12-15	1.0-1.3
Increase of amortisation charges from 10% to 30%	150.0	4.5	0.40
Change in the procedure of levying oil import duty	250.0	7.5	0.60
Other, including increase of property-related tax deduction for citizens acquiring residential real estate, reduction of tax rates for small business, support of the fishing industry	100,0	3.0	0.30
3. Measures of the budgetary policy, total	1,145.3	34.3	2.90
Additions to authorised capital, total	439.0	13.1	1.10
increase of the authorised capital of Rosselkhozbank,	75.0	2.2	0.20
increase of the authorised capital of JSC Rosagrolizing	29.0	0.9	0.10
increase of the authorised capital of JSC Agency for Mortgage Lending	60,0	1.8	0.20
increase of the authorised capital of Vnesheconombank	75.0	2.2	0.20
property contribution to State Corporation Agency for Insuring Deposits	200,0	6.0	0.50
Subordinated loans provided to:	450.0	13.5	1.13
Vneshtorgbank	200,0	6.0	0.50
Rosselkhozbank	25.0	0.7	0.06
Other banks	225.0	6.7	0.57
Subsidisation of interest rates for agricultural companies	18.07	0.5	0.05
Support of airline companies	32.0	1.0	0.08
Support of the motor industry	39.0	1.2	0.10
Support of industrial products export	6.0	0.2	0.02
Development of small and medium business	6.2	0.2	0.02
Conduct of an active policy in the employment market and employment support	43.7	1.3	0.11
Increase of unemployment compensation	35.0	1.0	0.09
Defense and industry complex	50.0	1.5	0.13
Provision of possibility to use funds of maternity capital to repay principal amount and interest on credits and loans, including mortgage loans, for housing acquisition and construction	26.3	0.8	0.07

Source: Ministry of Finance of

apartments for military personnel and for socially vulnerable groups. A decision was made to provide state guarantees, amounting to RUR 300 billion, to companies in the real sector economy, in 2009.

At the beginning of 2009, it is planned to implement RUR 175 billion of tax and policy measures for budgetary balancing, aimed at overcoming the consequences of the global financial crisis, while the rest of the measures will involve a re-distribution of spending within established budget parameters.

During the initial stage, in order to support bank liquidity, the Russian Ministry of Finance will place free funds from the federal budget on deposit at commercial banks (see Figure 10). Moreover, in 2008 funds from the State Corporation Fund of the Housing and Utility Sector (RUR 180 billion), the State Corporation, Rosnano (RUR 130 billion) and the National Wealth Fund (RUR 175 billion) were placed on the internal financial market.

Balance of the federal budget placed on deposit in credit institutions *(RUR billion)*

Ю00

900 800 700

600 500 400

300 200 100

O

NCHNN

Source: Federal Treasury.

Figure 10

Prominent amongst the urgent measures to support bank liquidity were loan provision transactions by the Bank of Russia to commercial banks, without collateral. These transactions cover a wide range of banks with credit ratings from international and/or Russian rating agencies. As of 19 January 2009 their volume is estimated at RUR 1.7 trillion.

In 2008, RUR 200 billion was allocated as a property contribution to the State Corporation Agency for Insuring Deposits (AID) for the capitalisation of problematic banks, and an unlimited credit facility was also opened to AID by the Bank of Russia, for the purpose of supporting banks facing problems. As of 14 January 2009, RUR 114.3 billion had been utilised from the credit facility of the Bank of Russia and RUR 32.2 billion spent at the expense of AID.

As an anti-recession measure, the volume of insuring deposits belonging to the public was increased from RUR 400 thousand to RUR 700 thousand, and the Bank of Russia was granted powers to insure interbank loans using its own funds. The RF Government also reduced the rate of growth of tariffs for gas and railway services.

Given the new macroeconomic forecast the Government will make adjustments to the budget. In 2009 there will not only be a budget deficit but its size will be considerable, taking into account the necessity for the anti-recession measures. 2010-2011 should be the years of achieving a more acceptable deficit value from the perspective of long-term macroeconomic stability. In 2010 the deficit should not exceed 5% of GDP and in 2011, 3% of GDP.

When developing anti-recession programmes it is necessary to take into account the accumulated global experience in combating crises. This evidences that assistance should be provided only to those companies and banks which have temporary difficulties, but which still remain solvent. Practice shows that non-selective provision of state assistance to companies and banks regardless of the condition of their balances does not accelerate the recovery from a crisis and does not mitigate its consequences[6]. Quite the opposite, such a policy increases both the losses from the current crisis and the probability of a new crisis in the future, because it undermines the incentives for economic agents to conduct responsible policies with realistic assessments of all the risks. Moreover, the cost of the support provided should be distributed between the state and the owners of the companies to be saved. If the state undertakes the full support, it actually carries out an unjustified transfer of taxpayer funds to the owners of these companies.

The question of increasing the share of state ownership in the financial sector, globally, deserves a separate discussion. Under anti-recession programmes a substantial proportion has passed from private owners to the state. By the end of 2008, in most developed countries the governments had become the largest owners of financial institutions: with about1/4 of this sector under their control[7]. The question naturally arises: if it was the excessive risk appetite of the private banks which eventually led to the crisis and required extraordinary measures from the state, would it not be expedient to increase the state's role as a financial intermediary?

The experience from a range of countries allows us to provide a substantiated answer to this question. Many cross-country studies[8] prove conclusively that private banks distribute financial resources much more efficiently within the economy than the state ones, they have lower margins (the difference between the cost of raising credit and the cost of that provided) and, moreover, they reduce the degree of financial instability (including the probability of a banking crisis). This is why many countries strive to privatise their banks. Analysis confirms that, after privatisation, the performance indicators of banks improve significantly[9].

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Thus, although the state has to intervene actively in the financial sector when there is the threat of a systemic crisis, at this stage it should already be thinking not only about countering the immediate threats but it should also have a long-term plan for the subsequent return of the lead role to the private sector.

The global financial crisis revealed the necessity to carry out joint and coordinated actions by the governments of developed and developing countries to overcome it and to reform the international financial institutions. In particular, this was stated in the Declaration of the G20 Summit on Financial Markets and the World Economy, held on 15 November in Washington. The Declaration contains an instruction to governments of the G20 countries and the expert community to prepare proposals for joint action aimed at overcoming the global crisis.

Among the measures to be taken in the medium term, the following should be highlighted:

— development of new rules for the regulation of financial markets, in addition to requirements for the development of the macroeconomic parameters of countries, for example, the Maastricht treaties;

— expansion of the financial capability of the IMF, which is currently insufficient to meet the challenges in a crisis situation;

— increasing the role of the G20 and strengthening its status; the G7/G8 and G20 must complement each other;

— creation of a unified regulation system for rating agencies;

— the establishment of a new international financial sector organisation (or the transformation of an existing one) whose members would adhere to unified rules for the implementation of regulatory, financial and, possibly, fiscal policy. At the moment countries are united around the Financial Stability Forum. However, this does not embrace developing countries, including the BRIC countries. Today, there is a need for an international authority whose guidelines would be mandatory.