

## Crisis and Russia<sup>1</sup>

"Economic Policy" journal has already published my articles on the impact of cyclic nature of global economic growth on the Russian economy and policy<sup>2</sup>. Making analysis of an ongoing economic crisis is the task dangerous to professional reputation. Nevertheless, the impact of the crisis on the life of the country is too serious to leave the analysis of current economic situation to historians of the future.

Institute for Economy in Transition has prepared and published two books on the impact of processes of global economic slowdown in Russia<sup>3</sup>. The World Bank took a similar decision and in November 2009 presented a book on the impact of the crisis on the economies of emerging markets. It was originally designed as a book about twenty years of transition, but the severity of problems caused by the crisis led the authors to revise priorities<sup>4</sup>.

The global economic crisis, especially as deep as the current one is a dynamic process. The economic situation is changing, it is not easy to predict it. Let me once again address the issue, how the events in the world economy affect Russia.

For the majority of Experts the economic crisis was a complete surprise, they failed to predict it. This is not a result of the lack of effort or low expertise of economists. It is rather a natural result of fundamental changes in the global economy that emerged at the turn of XVIII-XIX centuries, characterized as modern economic growth by Simon Kuznets. Now the global economy is changing rapidly (and it is often unpredictable). Acceleration of growth of per capita GDP and related changes in social indicators are followed by new challenges. One of them is the impact of cyclical economic development of individual countries - leaders of economic growth on the situation in the global economy in general. The other one is transformation (primarily - globalization) of the world financial system, which determines the nature of the crises of recent time.

The Bretton Woods system, formed in 1944, proved to be unstable. It implied a high level of responsibility of the country, which has the world's dominant reserve currency, i.e., the USA, for the quality of its fiscal policy. Against the background of the expansion of social obligations, the war in Vietnam, weakening of monetary policy, the country failed to maintain the level of confidence in the dollar, comparable to the confidence in gold before the First World War.

Since early seventies, after the refusal of the US authorities to exchange dollars for gold at a fixed price, a new monetary regime was actually set up in the world. Although formally the Bretton Woods system was not abolished, its basic characteristics have been changed. Now it is based on floating rates of the world leading currencies and on the open channels of capital

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<sup>1</sup> This is the last article of Yegor Gaidar, Director of the Institute for Economy in Transition. He wrote it shortly before his death. The article was published in the journal "Economic Policy" (No. 6, 2009). It was expected that a revised, completed with the annual statistics material will be used as an introduction to the annual report "Russian Economy in 2009". The Editorial Board does not consider itself authorized to make changes, so the text is published in its original wording.

<sup>2</sup> E. Gaidar. "Dizzy with success"// Economic policy. August 2008. No. 3. PP. 5-19; E. Gaidar "The global economic crisis: implications for the Russian policy"/ Economic policy. August 2009, No. 4. PP. 37-46.

<sup>3</sup> Financial crisis in Russia and in the world/ Ed. By E. Gaidar. M.: Prospect, 2009; World financial crisis: Historical parallels and the ways out/Ed. by E. Gaidar, V. Mau. M.: Alpina Publishers, 2009.

<sup>4</sup> Mitra P., Selowsky M., Zalduendo J. Turmoil at Twenty: Recession, Recovery, and Reform in Central and Eastern Europe and the Former Soviet Union. Washington: The World Bank, 2010.

cross flow. This organization of the financial world has arisen recently, its arrangement is unclear. The number of indicators available for understanding how it works, is limited.

The nature of the slowdown periods in economic growth in the leading countries with fastest economic growth in the first decades after the World War II was understandable in general. The events in America in many ways defined the economic situation of all countries in the world, because the US role in the global economy at that time was dominating (see Fig. 1).



Source: A. Maddison. Historical Statistics of the World Economy: 1-2006 AD, March 2009 (<http://www.ggdc.net/maddison/>).

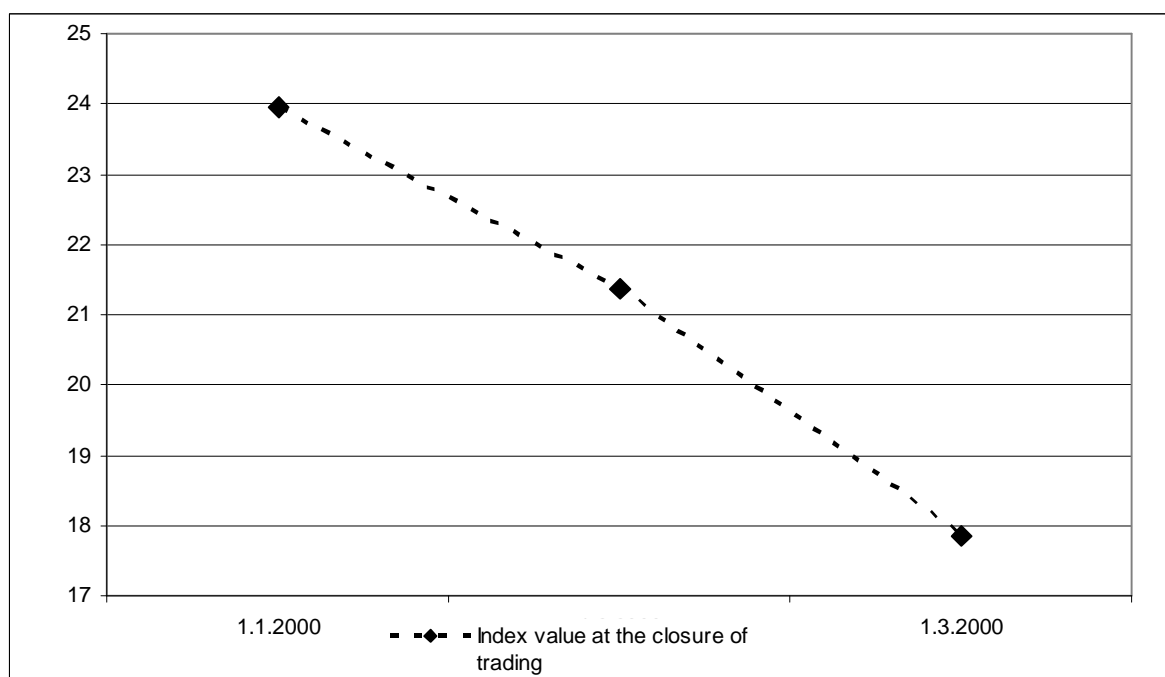
*Fig. 1. The Share of the US Economy in the World GDP in 1950, 1960, 1970, 1980, 1990 (in %).*

A major role in the development of the economic situation in the world were playing by the expansion of the US government obligations, weakening of monetary policy, growing inflation rates, followed by anti-inflationary measures, higher unemployment level, and then the new abatement of fiscal policy.

After the opening of capital markets in many countries and globalization of the world economy it became more difficult to predict changes in market conditions, including crises. Qualified experts who worked in the 1990-s in the US Treasury, the International Monetary Fund, until the last moment did not foresee neither the Mexican crisis in 1994, nor the crisis of 1997-1998, which began in the Southeast Asia, further spread to the CIS and Latin America countries<sup>1</sup>.

<sup>1</sup> DeLong J.B., Eichengreen B. Between Meltdown and Moral Hazard: The International Monetary and Financial Policies of Clinton Administration. University of California at Berkeley and NBER, July 2001; Crafts N. East Asian Growth Before and After the Crisis. IMF Staff Paper. Vol. 46. № 2, June 1999; Berg, A. The Asia Crisis: Causes, Policy Responses and Outcomes. IMF Working Paper, 1999; Kochhar K., Loungani P., Stone M.R. The East Asian Crisis: Macroeconomic Developments and Policy Lessons. IMF Working Paper 99/28. August 1998; Balino T.J.T., Ubide A. The Korean Financial Crisis of 1997 – A Strategy Financial Sector Reform. IMF Working Paper 99/28. March 1999. Of course, this did not mean that none of the experts paid attention to the problems accumulated in the Southeast Asian (See, for example: P.Krugman. The Myth of Asia's

In the late 1990-s - early 2000-s there were published works expressing concern of the rapid growth of stock prices of high-tech companies in the US<sup>1</sup>. But only few people could imagine that the collapse of the “soap bubble” (see *Fig. 2*) will lead to a recession in the United States and the general slowdown in the global economic growth.



Source: [www.nasdaq.com](http://www.nasdaq.com).

*Fig. 2.* NASDAQ-100, 1 Index Dynamics, January 1, 2000 - March 1, 2000

The attack against the US economy caused by the collapse of the market of high-tech stocks, was aggravated by the economic consequences of the terrorist attacks of September 11, 2001.

It is virtually impossible to predict the combination of these events. Meanwhile, the slowdown in the US economy growth has seriously affected the situation in the world (see *Fig. 3*).

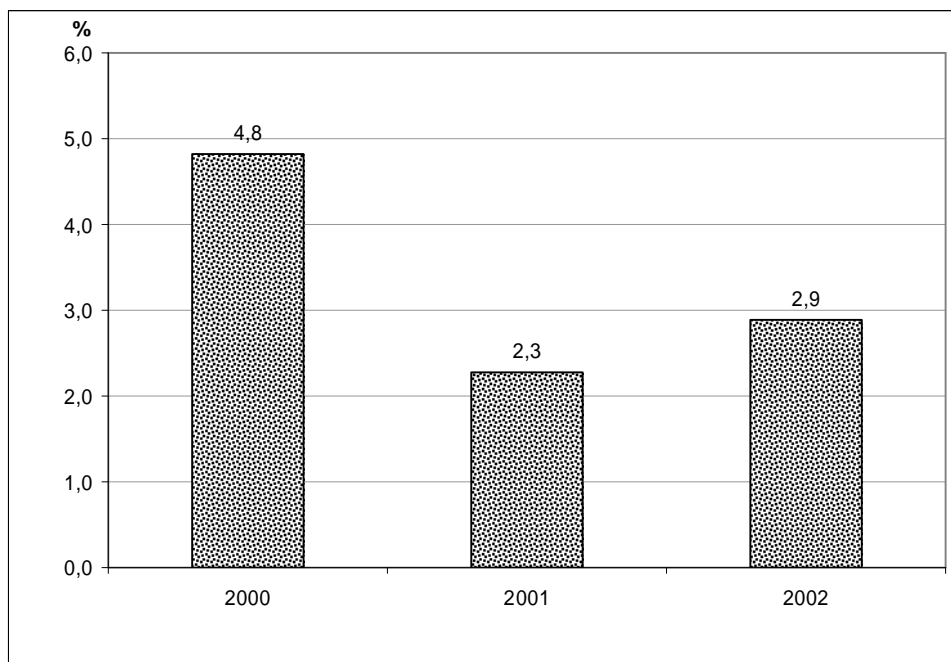
Miracle // Foreign Affairs. Nov. / Dec. 1994. Vol. 73. P. 62-78.) However, the markets, and most of the expert community did not believe in the probability of a deep crisis of the Southeast Asia.

<sup>1</sup> Warren Buffett: 'I told you so'. BBC News world edition. Tuesday, 13 March, 2001.

<http://news.bbc.co.uk/2/hi/business/1217716.stm>; IMF world economic Outlook (WEO). Recessions and recoveries. April 2002. <https://www.imf.org/external/pubs/ft/weo/2002/01/index.htm>

## RUSSIAN ECONOMY IN 2009

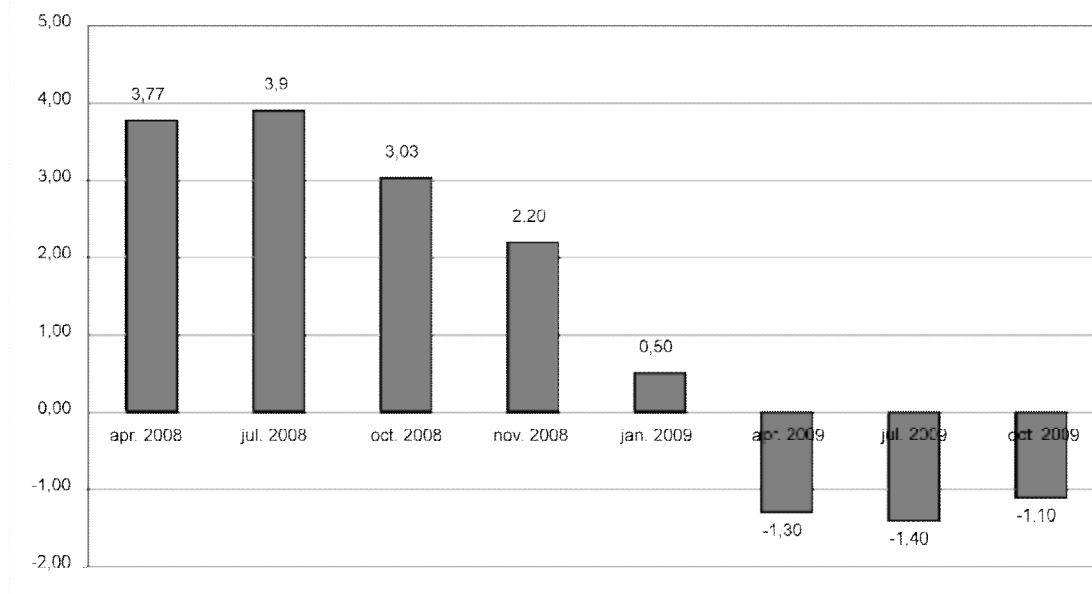
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Source: IMF World Economic Outlook, October 2009 (<http://www.imf.org/external/pubs/ft/weo/2009/02/weo-data/download.aspx>).

Fig. 3. Growth Rate of the World GDP in 2000-2002 (in % Versus Preceding Year)

The crisis of 2008-2009 was a surprise to the leading international financial institutions as well (see Fig. 4).



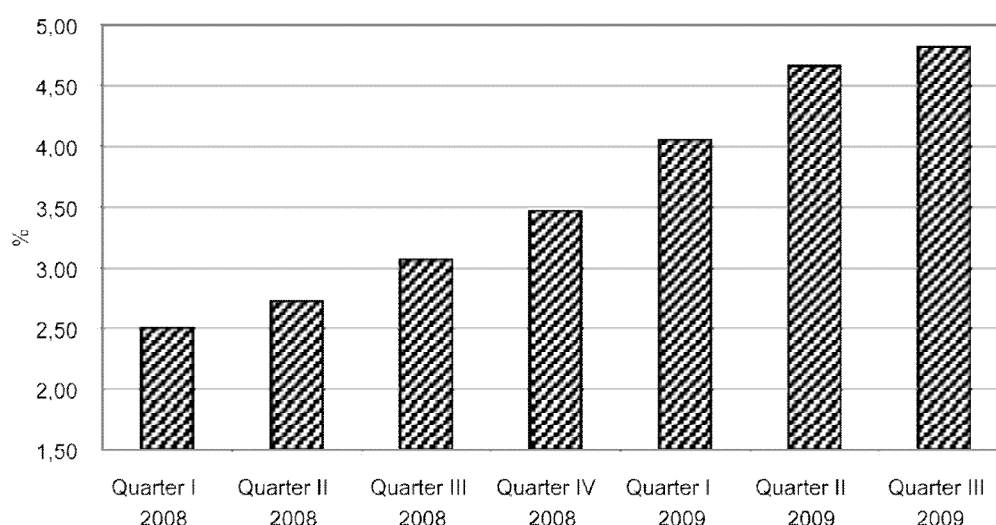
Note. The horizontal axis - the dates when the forecasts were made.

Source: IMF, World Economic Outlook for several months of 2008–2009 ([www.imf.org](http://www.imf.org)).

Fig. 4. Adjustment of IMF Forecasts of Global Economic Growth in 2009 (in % Versus Preceding Year)

In late 2007 - early 2008 there was a widespread opinion that there will be no recession in America, but if it happens, it will provide no major impact on what is happening and the global economy will continue to grow<sup>1</sup>. Back in the late summer of 2008, many people in Russia had the same opinion<sup>2</sup>.

These hopes proved to be illusive. In autumn 2008, when the bank "Lemon Brothers" turned bankrupt, and the US National Bureau of Economic Research announced that the US economy since late 2007 is in a recession<sup>3</sup>, there came a common understanding that we are probably facing the deepest crisis of the world economy since the Great Depression (see Fig. 5)<sup>4</sup>.



\* Adjusted with regard to seasonal factors.

\*\* Quarterly data are estimated as the arithmetic average based on available monthly indicators.

Source: Federal Reserve Bank of St-Louis (<http://research.stlouisfed.org/fred2/series/UNEMPLOY/download-data?cid=12>).

Fig. 5. The Number of Unemployed in the US \*, Quarter I of 2008 - Quarter III of 2009 \*\* (% of Total Population)

<sup>1</sup> Chandra S. U.S. September Retail Sales Rise More Than Forecast. <http://www.bloomberg.com/apps/news?pid=20601087&sid=ajcgcopCXqkA&refer=home>

<sup>2</sup> "First of all, it looks that the mortgage crisis in the US is coming to an end. Its peak was in February of this year, and over the past four months the situation is gradually improving. In addition, there was no recession in the US and very likely, it will not happen in 2008. When Gaidar started to speak of recession in January 2008, its likelihood was estimated by futures market at 80 percent. Then I did not dare to express a disagreement with Gaidar's forecast and suggested that the recession probably will not happen. Over the past 6 months, the recession did not come". See: As a liberal to a non-liberal. Interview of A. Illarionov to L. Telen. 01.08.2008. <http://www.izbrannoe.ru/43508.html>

<sup>3</sup> November 28, 2008. Committee on the dates of the business cycles of the National Bureau of Economic Research, the most authoritative body dealing with the chronology of the beginning and end of a recession in the US, decided that the peak of economic activity in the United States was reached in December 2007. Since then, the domestic economy of the country is in recession. See: Determination of the December 2007 Peak in Economic Activity. Version of December 11, 2008. <http://www.nber.org/cycles.html>.

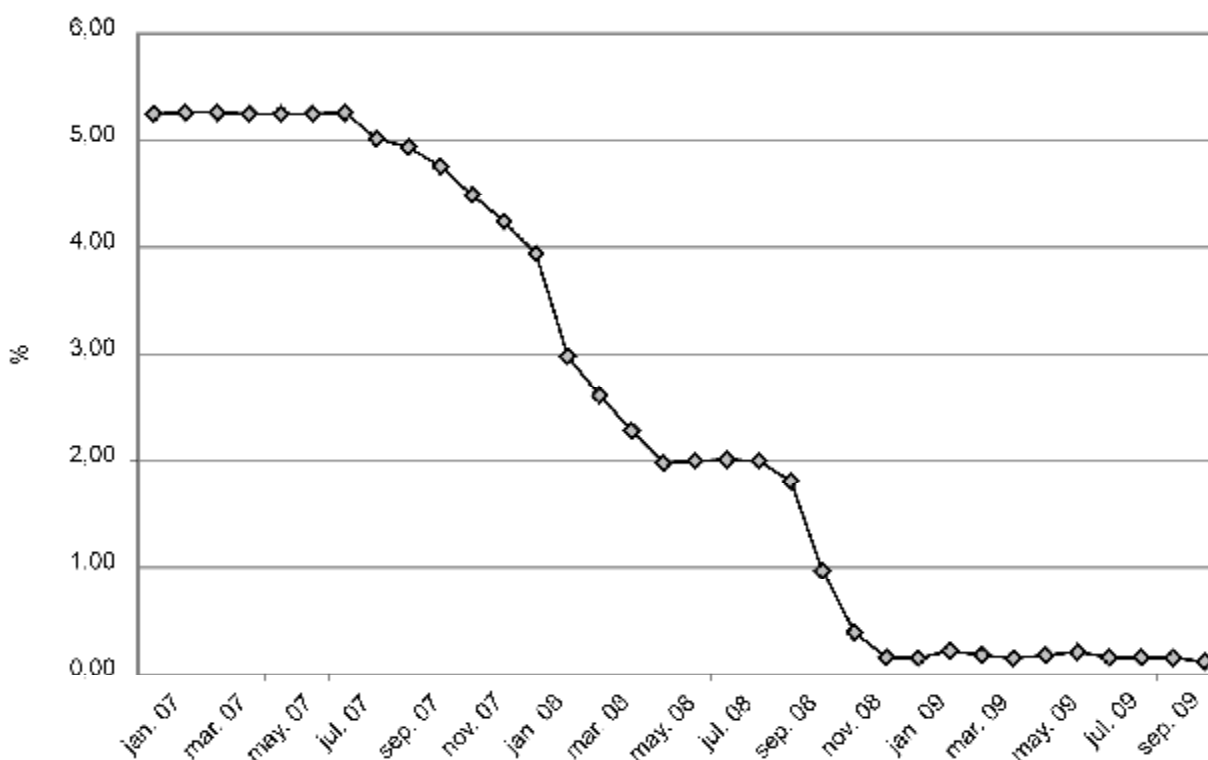
<sup>4</sup> Stanton E. U.S. Stocks Post Steepest Yearly Decline Since Great Depression <http://www.bloomberg.com/apps/news?pid=20601087&sid=a5RkfQG30k1k>; Kueffner S. Andean Region Must Integrate to Face World Crisis, Leaders Say. [http://www.bloomberg.com/apps/news?pid=20601086&sid=aV1G7GCvfwew&refer=latin\\_america](http://www.bloomberg.com/apps/news?pid=20601086&sid=aV1G7GCvfwew&refer=latin_america)

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In January 2009, the famous American economist N. Roubini, who was one of the first to speak about the likelihood of a deep economic crisis, was writing that the United States were certainly facing a dramatic recession, happened within the past decades and there was a high probability of deep downfall in production, which will last at least until the end 2009, and that even in 2010 the economic recovery may be extremely weak, one per cent or close to it. Later, those predictions have become even more pessimistic<sup>1</sup>. N. Roubini spoke about the likelihood that the recession will last until the end of 2010<sup>2</sup>.

The reaction of the US monetary authorities to those events was prompt and energetic<sup>3</sup>. The base interest rate was sharply reduced. However, the ways of monetary policy mitigation in the crisis situation are limited. By January 2009 they were exhausted (see Fig. 6).



Source: Federal Reserve, Federal Reserve Statistical Release (<http://www.federalreserve.gov/releases/h15/data.htm>).

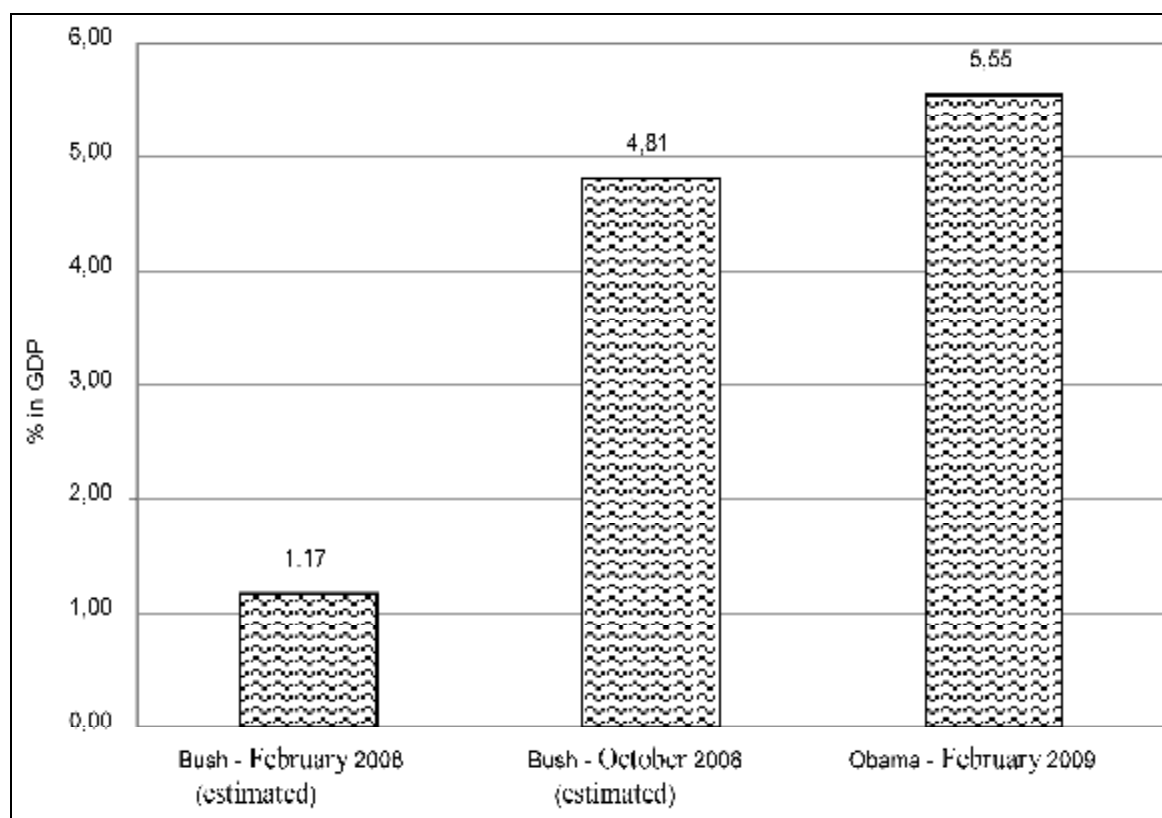
Fig. 6. The Base Interest Rate of the US Federal Funds, January 2007 - October 2009 (%)

<sup>1</sup> Roubini Says Worst Still Is Ahead of Us: Year in Review. <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aUy55wEBqrB8> Last Updated: January 1, 2009.

<sup>2</sup> Thomas Ch. Roubini Says Recession May Continue Until End of 2010 (Update1) [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ayVsI\\_55G8.0](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ayVsI_55G8.0) Last Updated: March 6, 2009.

<sup>3</sup> Perhaps it happened under the impact of the fact that Ben Bernanke, Federal Reserve Chairman was an Expert during the Great Depression. In 1979, Bernanke received his Ph.D. from the Massachusetts Institute of Technology. During post-graduate course, Bernanke studied monetary economy. His thesis was «Long-term Commitments, Dynamic Optimization and the Business Cycle»). The most famous of his works was devoted to the Great Depression. *Bernanke Ben S. Essays on the great depression.* Princeton: Princeton univ. press, 2000.

This made the US authorities increasingly using fiscal incentives to increase aggregate demand (see *Fig. 7*).

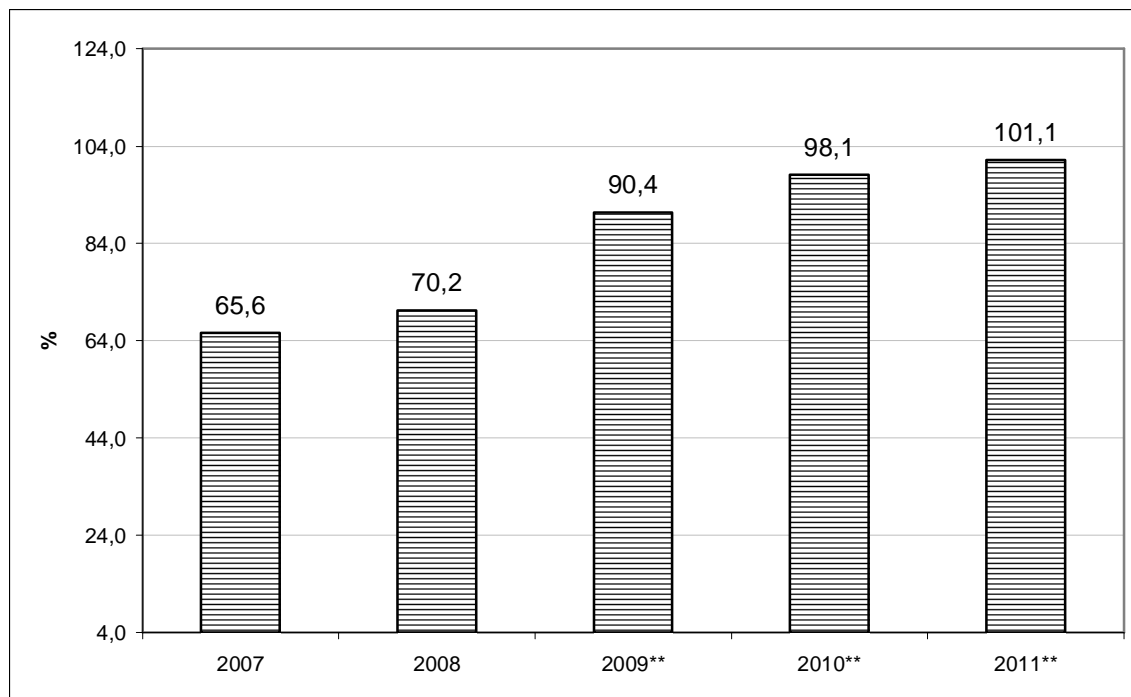


\* Given the lack of data on the volume of GDP in terms of one month, February 2008 corresponds to the GDP in the I quarter of 2008, October 2008 and 2009 - GDP in III quarter, respectively.

*Note.* The package of budget and financial incentives proposed by Bush Administration in February 2008 amounted to 168 billion dollars in October, its volume was increased in October to 700 billion dollars by the administration of Barack Obama and in February 2009 - up to 787 billion dollars [http://www.rian.ru:80/us\\_news/20081124/155800218.html](http://www.rian.ru:80/us_news/20081124/155800218.html); <http://top.rbc.ru/economics/14/02/2009/280613.shtml>

*Fig. 7.* The Package of Budget and Financial Incentives Proposed by Bush Administration in 2008 and the Administration of Barack Obama in 2009 (in % of GDP\*).

However, the possibilities for maneuver in fiscal policy are limited. This is confirmed by the rapid growth of the public debt ratio to GDP in the US (see *Fig. 8*).



\* Gross federal debt.

\*\* Estimates.

Source: Federal Office of Management and Budget: Budget of the US Government Fiscal Year 2010, Updated Summary Tables (<http://www.whitehouse.gov/omb/budget/fy2010/assets/summary.pdf>).

Fig. 8. \* US Government Debt in 2007-2011 (in % of GDP at the End of the Year).

Russia has faced the challenges posed by the global economic crisis under peculiar circumstances. In the late 1980-s - many of the 1990-s our country was experiencing severe consequences of bankruptcy and collapse of the Soviet economy. Only in the late 1990-s, when the basic institutions of private and market economy were established, when the participants of the economic process have adapted to them, the national economy started to grow. Interrupted for a short time by the 1998 crisis, this growth generally continued for 10 years. There was a financial stability, the budget was executed with surplus. A major problem has become a high growth rate of foreign currency and gold reserves, which has complicated the anti-inflationary policy for monetary authorities. At this background, it was easy to understand the aggressive atmosphere of optimism, clearly observed in the official documents of the early-mid 2000-s<sup>1</sup>.

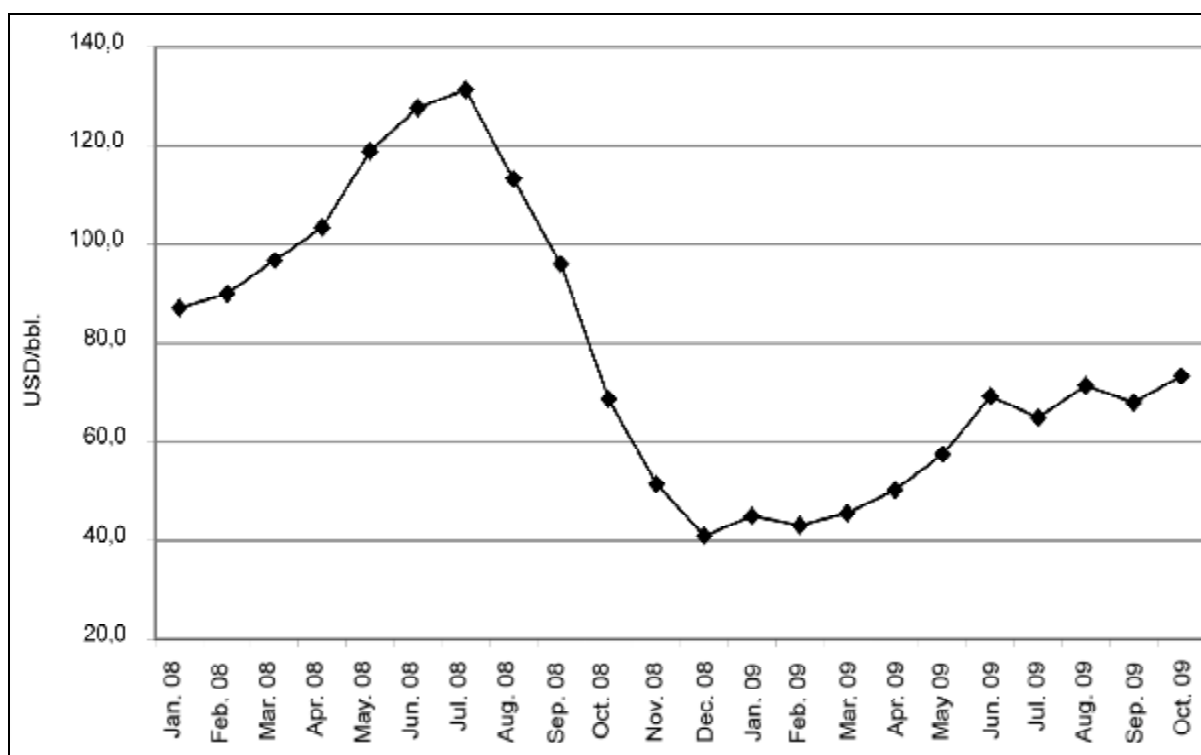
<sup>1</sup> "Over the decade we should at least double the gross domestic product. Doubling of GDP is a systemic and of course a major challenge. It will require a thorough analysis and refinement of existing approaches to economic policy. ... I am convinced that Russia already has all the conditions for the identification and implementation of such objectives, there is a real opportunity to accomplish large-scale construction of a modern and strong economy, and as a result, to form the state competitive in all senses of the word". See: Message from the President of Russia V. V. Putin to the RF Federal Assembly on May 16, 2003.

<http://archive.kremlin.ru/text/appears/2003/05/44623.shtml>; concept of long-term socio-economic development of the Russian Federation of October 31, 2007 <http://www.economy.gov.ru/wps/wcm/myconnect/economylib/mert/welcome/legislation/documentsofministry/doc1193835322297>



However, some lessons from the collapse of the Soviet economy were learned. In late 2003, it was decided to establish the Stabilization Fund, later transformed in the Reserve Fund and the National Welfare Fund. Fiscal policy has remained conservative. The budget was split into two parts, one of which was independent on oil and gas market, another part of the budget was formed from oil and gas revenues. There was established an upper limit of subsidies provided to the national budget from oil and gas revenues<sup>1</sup>.

A slowdown in global economic growth has provided an impact on the Russian economy by two main trends. This is, firstly, the reduced demand for primary commodities that form the basis of the export potential of Russia, and the consequent decline in their prices (see *Fig. 9, 10*).



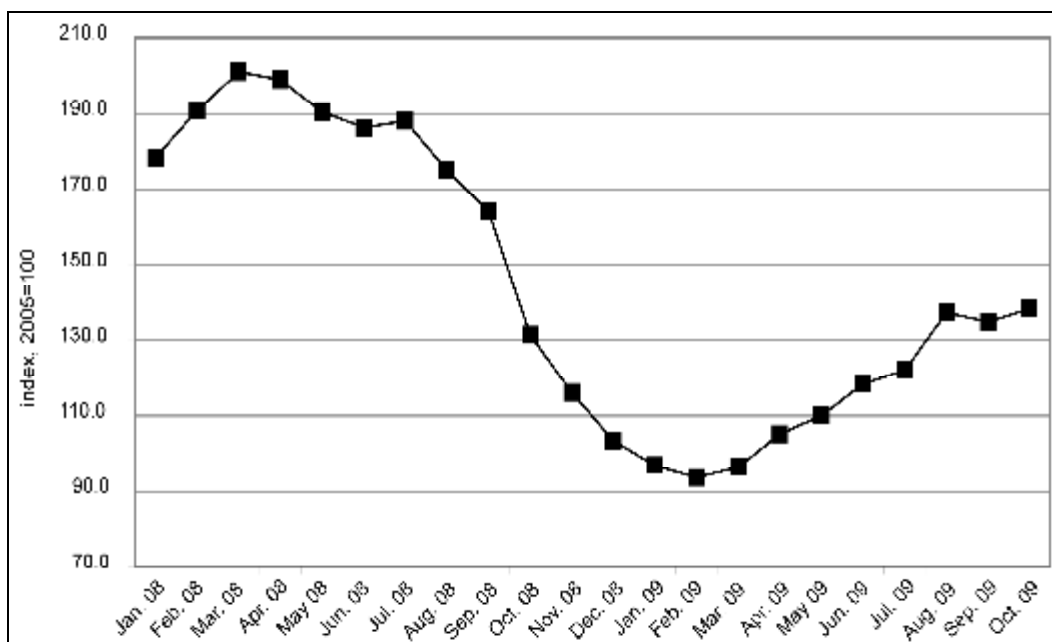
Source: IMF.

Fig. 9. The Actual Price of Crude Oil Brent, January 2008 - October 2009 (USD per barrel)

<sup>1</sup> See: The main activities of the Government of the Russian Federation for the period until 2012. Russian Federation Government Decree No. 1663-r dated of November 17, 2008. On the concept of the long-term socio-economic development of Russia for the period until 2020. Decree of the Russian Federation Government No. 1662-r dated of November 17, 2008.

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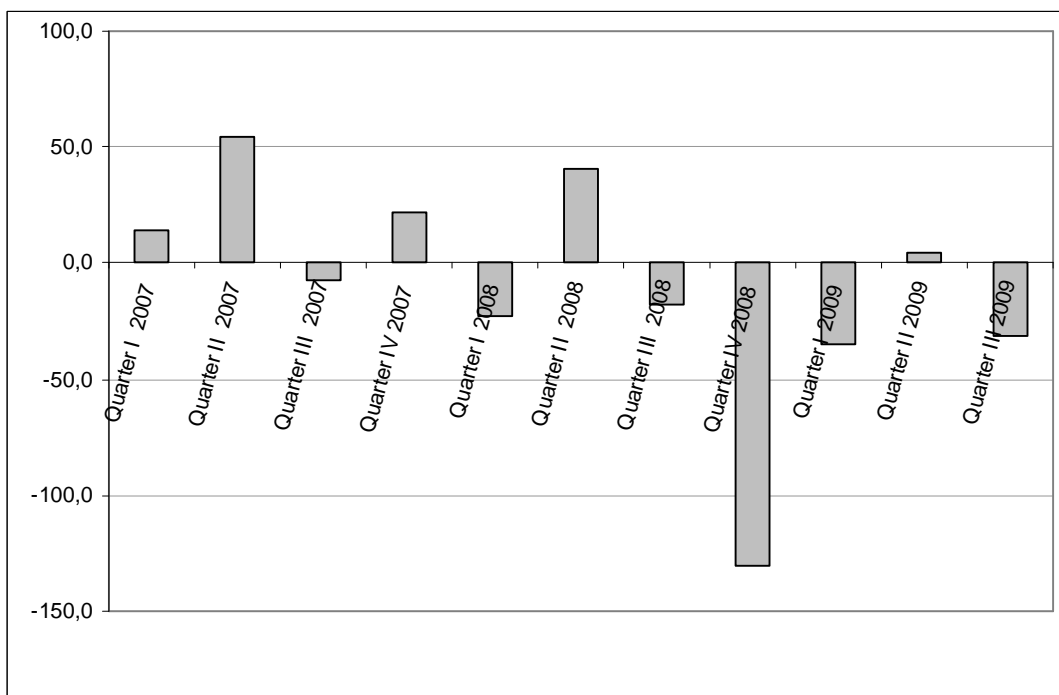
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Source: IMF.

Fig. 10. Price Index of the World Metals Market, January 2008 - October 2009 (2005 = 100)

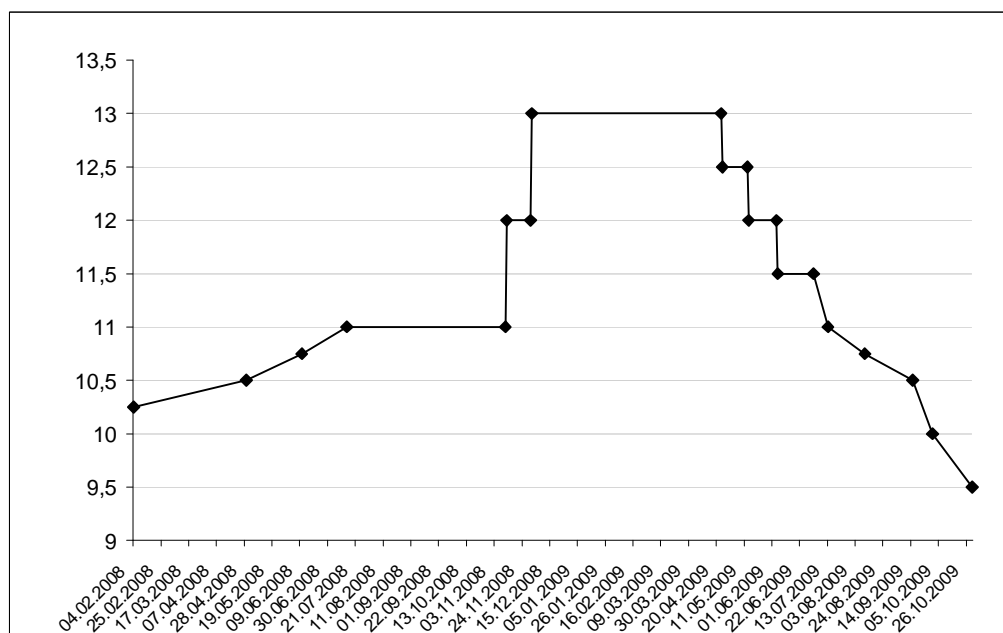
Secondly, the change of direction of capital flows (see Fig. 11).



Source: RF Central Bank.

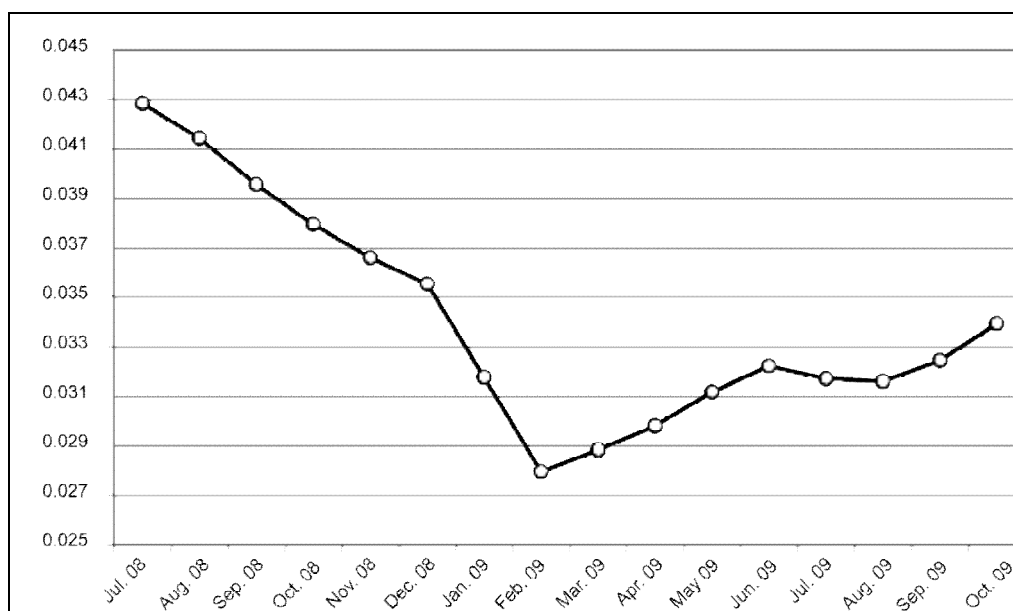
Fig. 11. The Amount of Capital Inflow / Outflow to/from the RF, Quarter I of 2007 - Quarter III of 2009 (USD bn).

The reaction of Russian authorities to the crisis was late by 6-9 months. It was reasonable, but asymmetric in relation to the economic policies of the countries with reserve currencies: raising interest rates, rather than reduction thereof, lowering the exchange rate of national currency against the US dollar (see Fig. 12, 13).



Source: RF Central Bank ([www.cbr.ru](http://www.cbr.ru)).

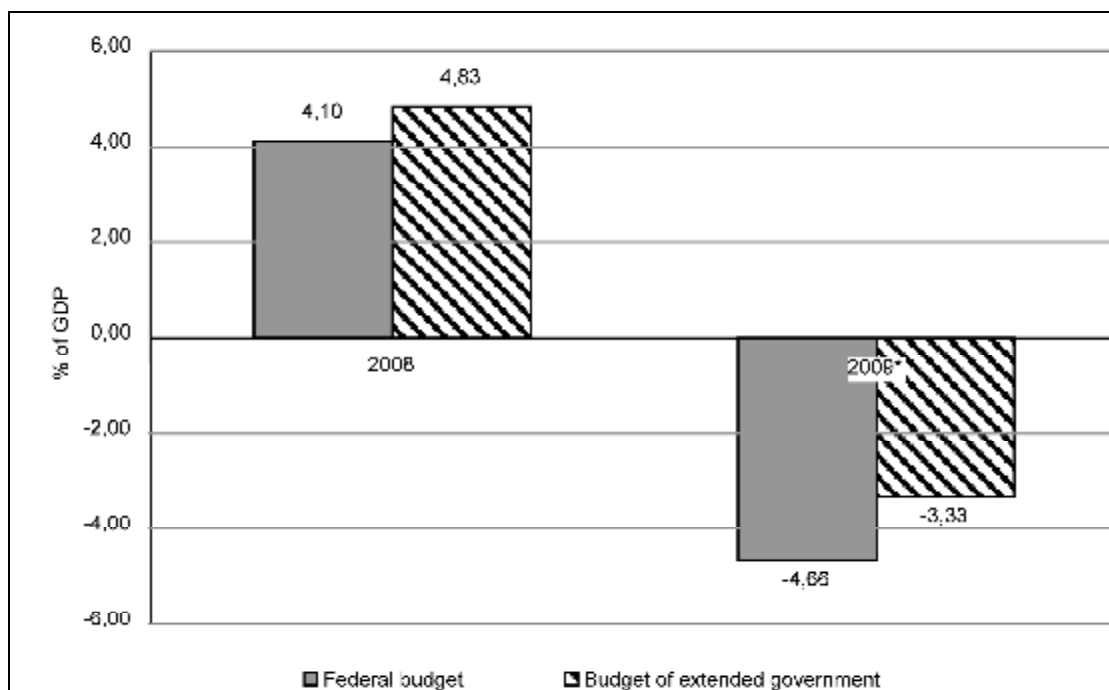
Fig. 12. Refinancing Rate of the RF Central Bank, January 2008 - October 2009 (%)



Source: RF Central Bank.

Fig. 13. Nominal Exchange Rate of Ruble Against US Dollar (USD for Rb), July 2008 - October 2009 (Average for the Period)

It is easy to understand the reasons for the asymmetric reaction of interest policy in Russia to the crisis in comparison with the events happening in the world's largest economies, primarily in the United States and European Union. Ruble is not a global reserve currency, so the possibility of weakening monetary policy in Russia was limited. In the situation of capital outflow from emerging markets and continued high inflation, the most important tasks were to preserve foreign currency and gold reserves and to curb inflationary processes. Against the background of the changed market, the situation with the budget has drastically deteriorated (see Fig. 14).



\* Nine months of 2009.

Source: Russian Treasury, Russian Statistical Service.

*Fig. 14. Deficit (-) / Surplus (+) of the Federal Budget and the Budget of Extended Government of Russia, 2008–2009 (in % of GDP)*

The impact was provided also by a downfall of taxes for minerals production and export duties, most closely related to the commodity markets situation, and the unwillingness of the authorities to implement measures aimed at restraint of budget expenses beyond the financial capacity of the state in the radically changed conditions.

However, the refusal from actively discussed at the highest level measures of rates reduction or changes in the structure of taxes, less dependent on oil prices<sup>1</sup> (VAT, income tax of indi-

<sup>1</sup> "First, as recently mentioned by the President: as soon as possible it is needed to adopt a law defining the period of transition to a unified reduced rate of VAT. In parallel, further analysis of the feasibility and other steps could be made. Namely - the replacement of VAT by sales tax. Based on the fact that complete resolving of VAT refund or, in fact, stealing the VAT from the budget, which affect our taxpayers and tax authorities and which are not completely resolved even by the most advanced European Union countries". From the shorthand report of the First Deputy Prime Minister Dmitry Medvedev report at the V-th Krasnoyarsk Economic Forum on February 15, 2007. <http://krsk.kp.ru/daily/24049/103037/>; «At the meeting of President with the leadership

viduals), allowed to avoid the budget collapse. With changes in the external economic environment those taxes served as a basis of the budget stability (see *Table. 1*).

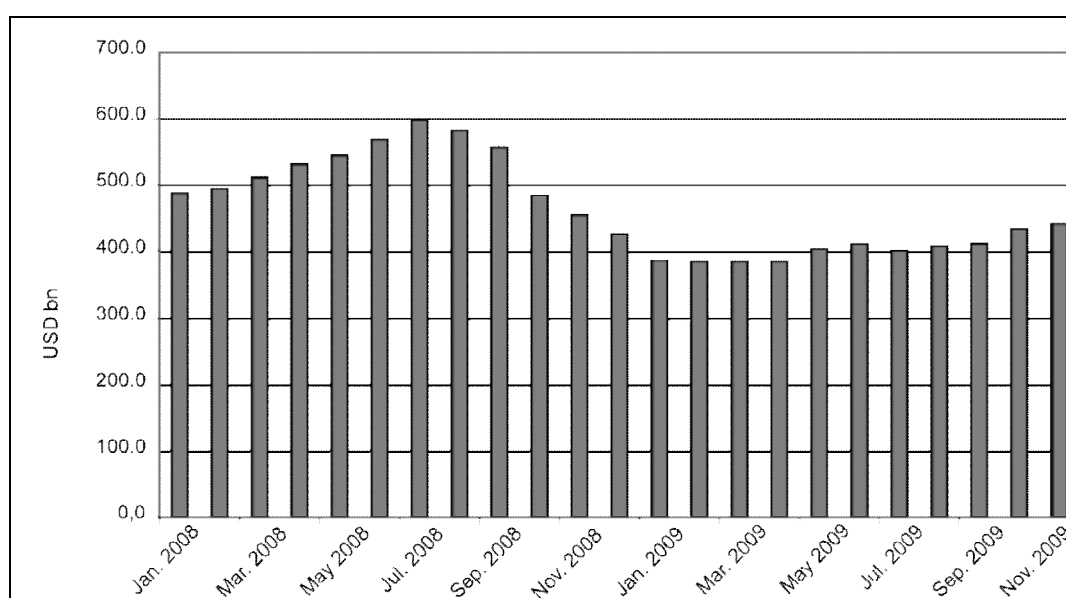
*Table 1*

**Tax revenues of the RF budget system within  
January-October 2008 and 2009. (in % of GDP)**

	January-October 2008	January-October 2009
Corporate income tax	6.56	3.29
Personal income tax	3.87	4.13
VAT	5.30	5.29
Royalty	4.49	2.56
Export customs duty	6.65	4.07

Source: Russian Treasury.

As a result of taken measures, in the first place of interest rate increase, there was no substantial devaluation of the ruble against the basket of major reserve currencies, and since mid-January 2009 it was possible to stop the decrease of foreign currency reserves (see *Fig. 15*).



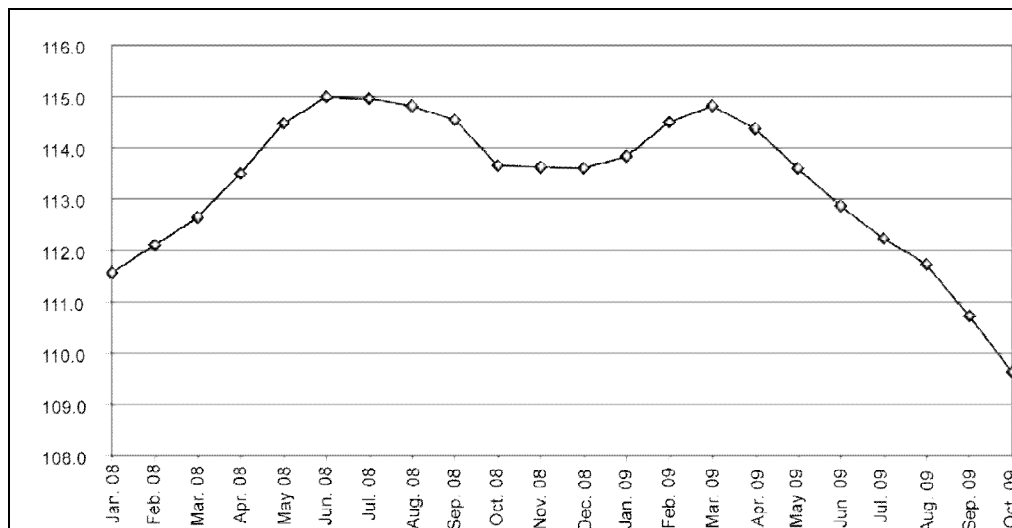
\* As of November 13, 2009.

Source: RF Central Bank.

*Fig. 15.* RF International Reserves, January 2008 - November \* 2009 (Billion Dollars)

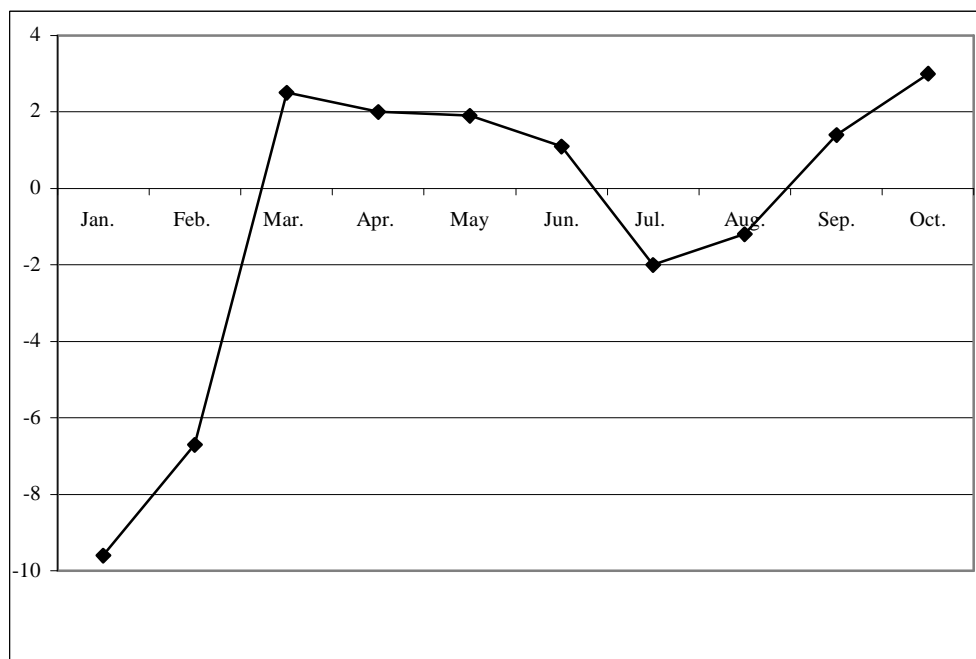
of the State Duma Speaker Gryzlov and President Vladimir Putin have exchanged views on the preferred rate of VAT. Gryzlov proposed to reduce the VAT rate as a primary measure of the future Cabinet of Ministers: "The rate should be uniform and not exceed the current beneficial VAT rate, that is, 10%. We should be really prepared to reduce VAT rate to 10%", said the Speaker. See: Putin proposed a "very cautious" approach to the VAT reduction. March 11, 2008. <http://www.newsru.com/finance/11mar2008/nds.html>; «Head of Expert Department of the President Arkady Dvorkovich believes that the VAT rate may changed from 18% to 12-13%. See: A. Dvorkovich: VAT rate can be reduced to 12-13% from February 8, 2008. <http://www.newsru.com/finance/08feb2008/dvorkovitch.html>; Dvorkovich A.: Reduction of VAT should be considered as an investment project. <http://kp.by/daily/24124.4/345319/>

Another consequence of the changing fiscal and monetary policy were the reduced inflation, stabilization of the national currency (see *Fig. 13*) and prevention of banking sector panics (see *Fig. 16, 17, 18*).



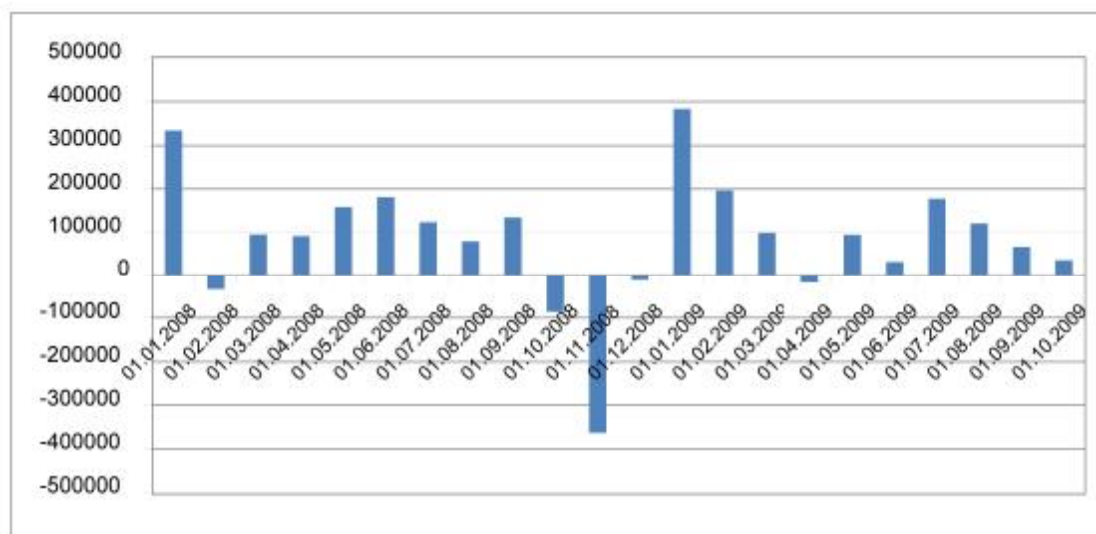
Source: Russian Statistical Service.

*Fig. 16.* Inflation in Russia, January 2008 - October 2009 (in % Versus the Relevant Period of Preceding Year)



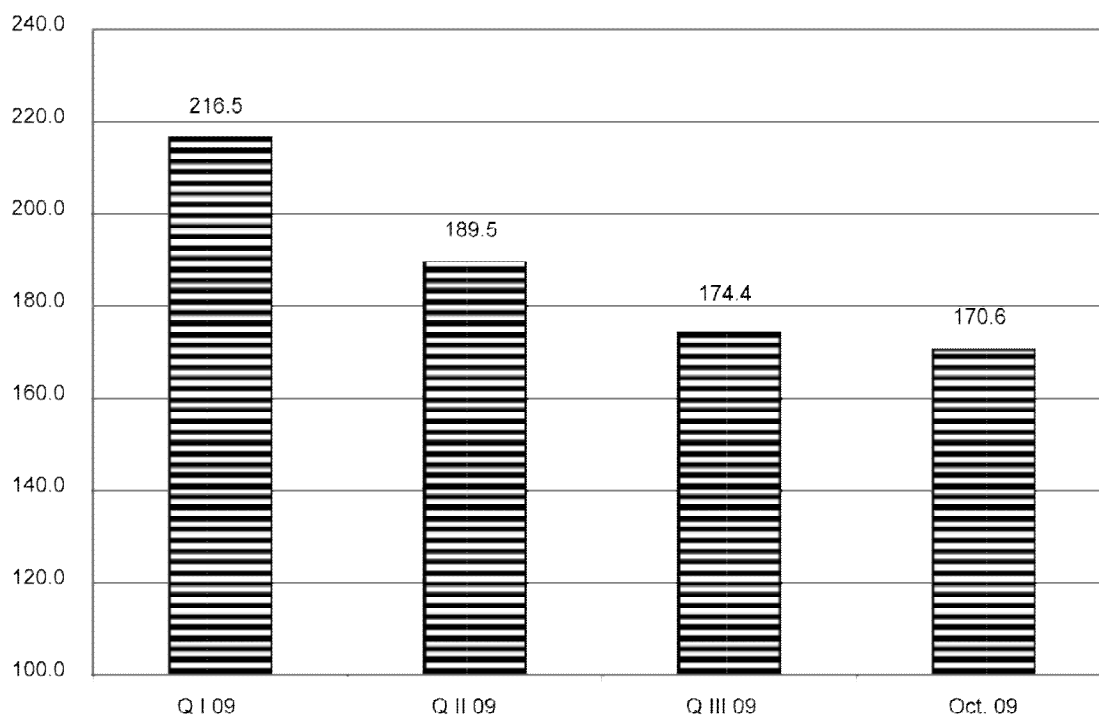
Source: RF Central Bank ([www.cbr.ru](http://www.cbr.ru)).

*Fig. 17.* Index of Nominal Effective Exchange Rate of Ruble Against Foreign Currencies in January-October 2009 (in % of Growth Versus the Preceding Period) .



Source: estimates based on RF Central Bank data.

Fig. 18. Growth of Population's Deposits in the RF Banks, January 2008 - October 2009 (Million Rubles on the 1st Day of Each Month)



Source: estimated as the arithmetic mean based on monthly data of the Ministry of Finance of Russia.

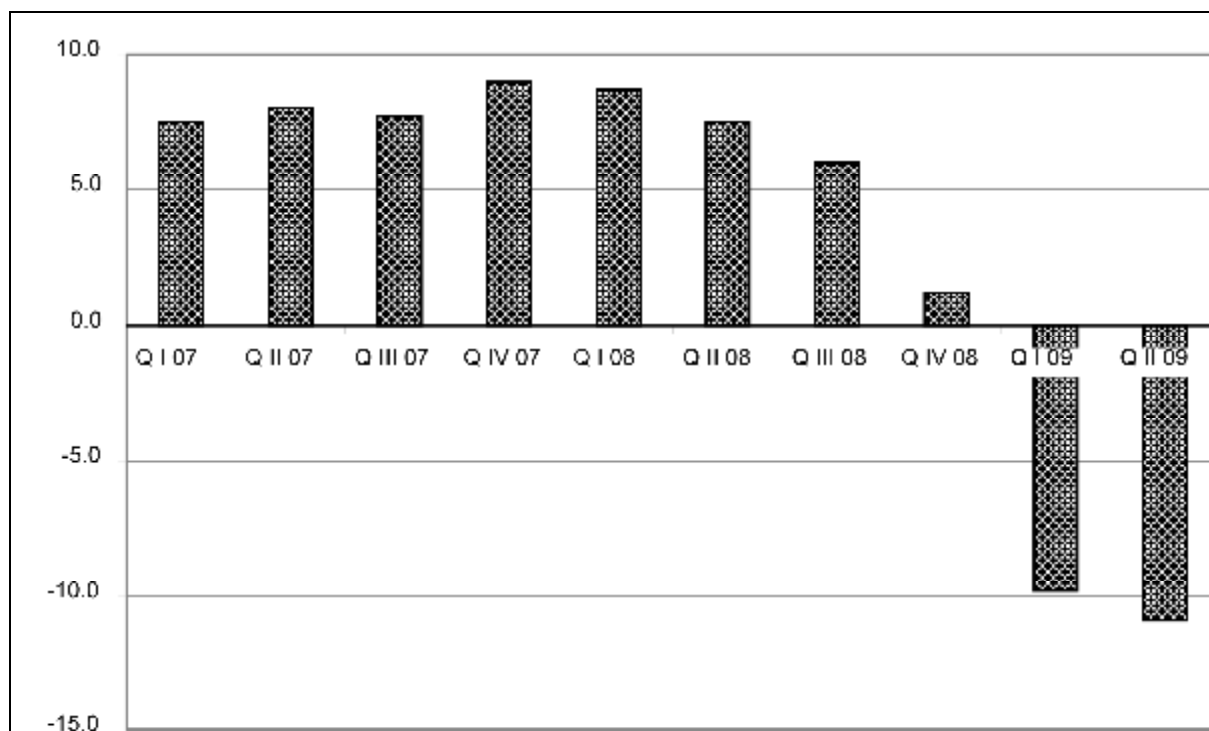
Fig. 19. Aggregate Reserve Fund and National Welfare Fund of Russia, Quarter I, 2009 - October 2009 (Dillion Dollars - at the End of Period)

Meanwhile, Russia has managed to avoid the development of the crisis under catastrophic scenario similar to what happened and is happening in Latvia or Ukraine<sup>1</sup>.

The fee for the preservation of financial stability was significant. Developments in 2008-2009 have outwardly demonstrated how timely it was to establish the Stabilization Fund (see Fig. 19).

Until recently the Funds ensured the Russian budget adaptation to the conditions of sharply decreased revenue from mineral extraction tax, corporate profit tax and export duties.

The damage inflicted by the crisis to the real sector of the Russian economy has been severe (see Fig. 20, 21, 22).

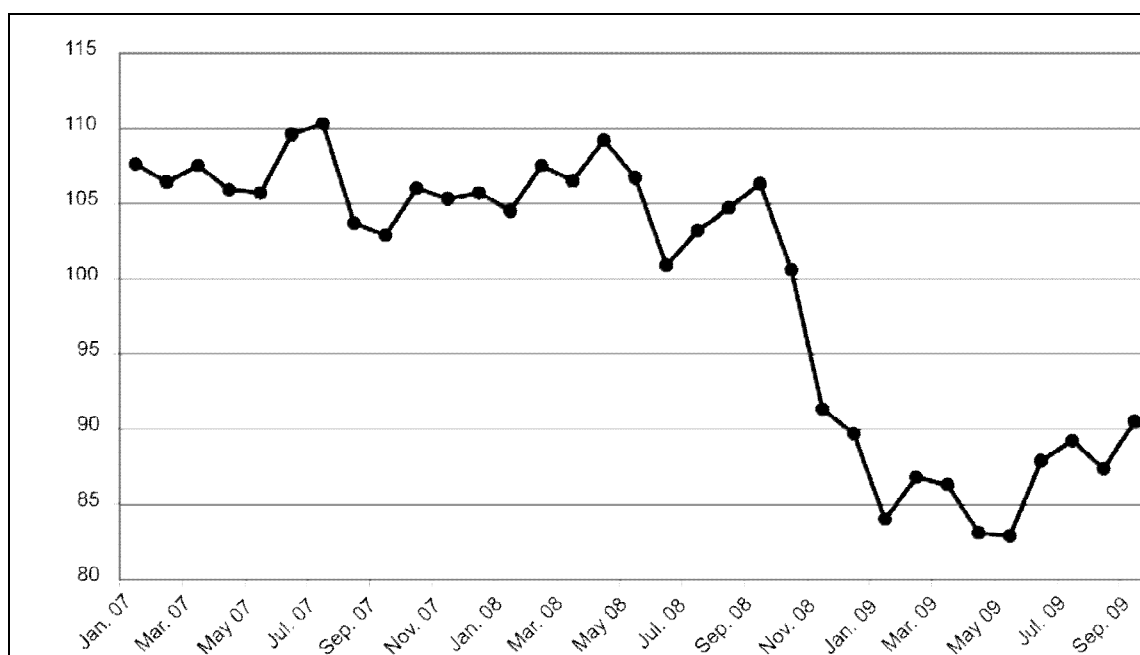


Source: Russian Statistical Service.

*Fig. 20. Growth of Real GDP of Russia, Quarter I, 2007 – Quarter II, 2009  
(in % Against the Relevant Period of Preceding Year)*

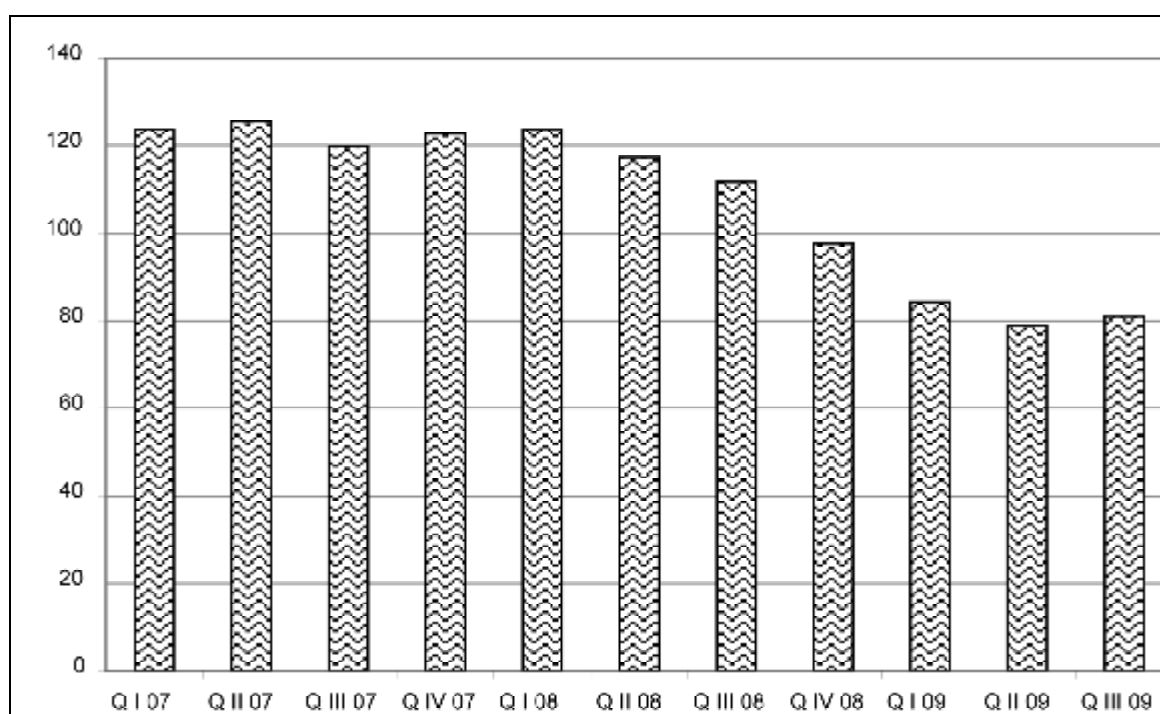
<sup>1</sup> In Latvia, in the I-st quarter of 2009, real GDP has declined by 18%. By the end of June, the number of registered unemployed rose to 11.5% compared with 7% in late 2008. In Ukraine, according to IMF estimates, the GDP in 2009 will decrease by 14%. The total financial liabilities of Ukraine for 2009 make approximately 41 billion dollars. With the optimistic forecast, the overall ability to mobilize financial resources to fund the liabilities do not exceed USD 31 billion. See: Republic of Latvia: First Review and Financing Assurances Review Under the Stand By Arrangement, Requests for Waivers of Nonobservance of Performance Criteria, and Re-phasing of Purchases Under the Arrangement. <http://www.imf.org/external/pubs/ft/scr/2009/cr09297.pdf>; Ukraine: Second Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria – Staff Report; Press Release on the Executive Board Discussion. <http://www.imf.org/external/pubs/ft/scr/2009/cr09270.pdf>





Source: Russian Statistical Service.

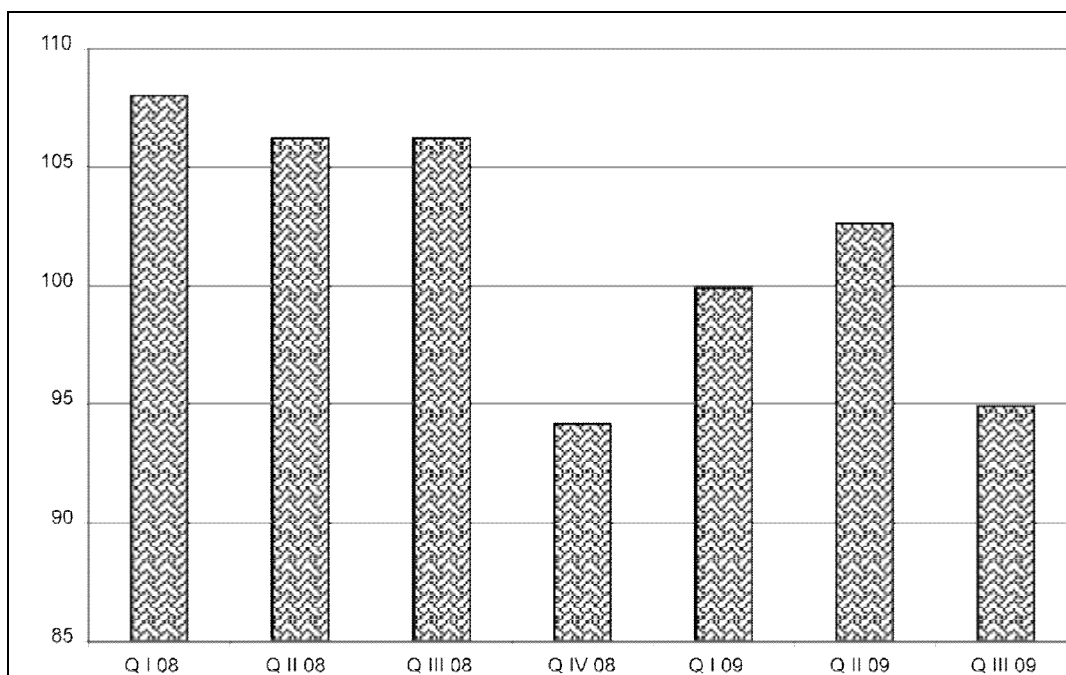
Fig. 21. Index of the RF Industrial Production, January 2007 - September 2009  
(In % Versus the Relevant Period of Preceding Year)



Source: Russian Statistical Service.

Fig. 22. Investment in the RF Fixed Capital, Quarter I, 2007 – Quarter III, 2009  
(In % Versus the Relevant Period of Preceding Year)

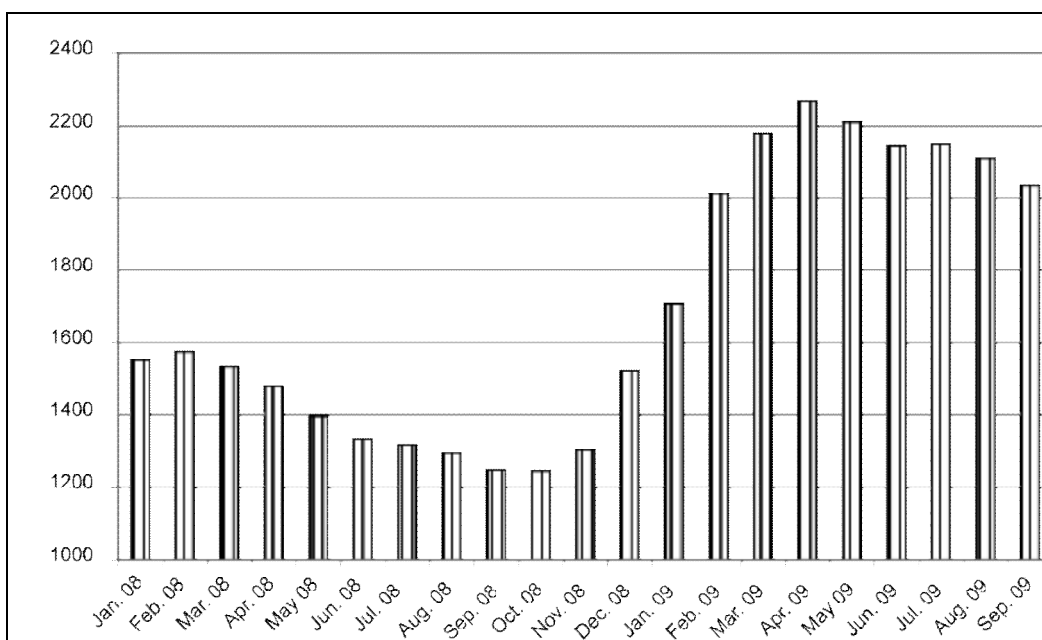
Naturally, this could not affect the income of the population (see Fig. 23).



Source: Russian Statistical Service.

*Fig. 23. Real Disposable Monetary Income of the RF Population, Quarter I, 2008 - Quarter III, 2009 (in % Versus the Relevant Period of Preceding Year)*

And the labor market situation (See *Fig. 24*).



Source: Russian Statistical Service.

*Fig. 24. The Number of Officially Registered Unemployed in Russia, January 2008 - September 2009 (at the End of the Month, Thousands of People.)*

Against the background of falling real incomes, growing unemployment, public reaction to the challenges associated with the crisis was peaceful according to international standards. The number of persons who participated in strikes was minimal.

It is too early to speak of the reasons for such a calm reaction to changes in the economic situation and how stable it is. One can only express a hypothesis. The society, which experienced a deep social and economic crisis due to the collapse of the Soviet Union, can understand what is happening better than the citizens of those countries which have been stable and prosperous for decades. However, one should have no illusions. Such peaceful situation during the crisis is not eternal. As demonstrated by the experience of the Soviet Union, with a sharp deterioration in economic conditions it is difficult to keep up peaceful situation, even with well-organized public relations. Sooner or later, if nothing is changed, people can go out to the streets with the words, repeating those that were heard in the popular film "Assa": "We are waiting for changes!". The only question is whether these changes are going to be orderly, gradual and non-violent, or we will be faced with the threat of a new revolution. The second scenario must be avoided. Russia has enough experience of the two revolutions that we have overcome in the past century.

Now the depth of the crisis, which began in autumn of 2007 is doubtless. Like in 1998 and in 2001, it had a greater impact on Russia than on the totality of all (other) CIS countries<sup>1</sup>.

For the development of economic policy of our country it is important to have an answer to the question: how long will the crisis last? What impact will it provide on the medium-term prospects for economic growth, the financial situation in the world?

There are Experts who believe that the peak of the crisis over, that measures taken in the United States, Europe, China on an unprecedented scale over the last decade to inspire aggregate demand, allowed to overcome the decline in production, have created conditions to restore economic growth<sup>2</sup>.

Perhaps this hypothesis is correct. After the adoption in the US a package of anti-crisis measures, the situation in the stock and commodity markets began to improve gradually (see Fig. 25, 26).<sup>3</sup>

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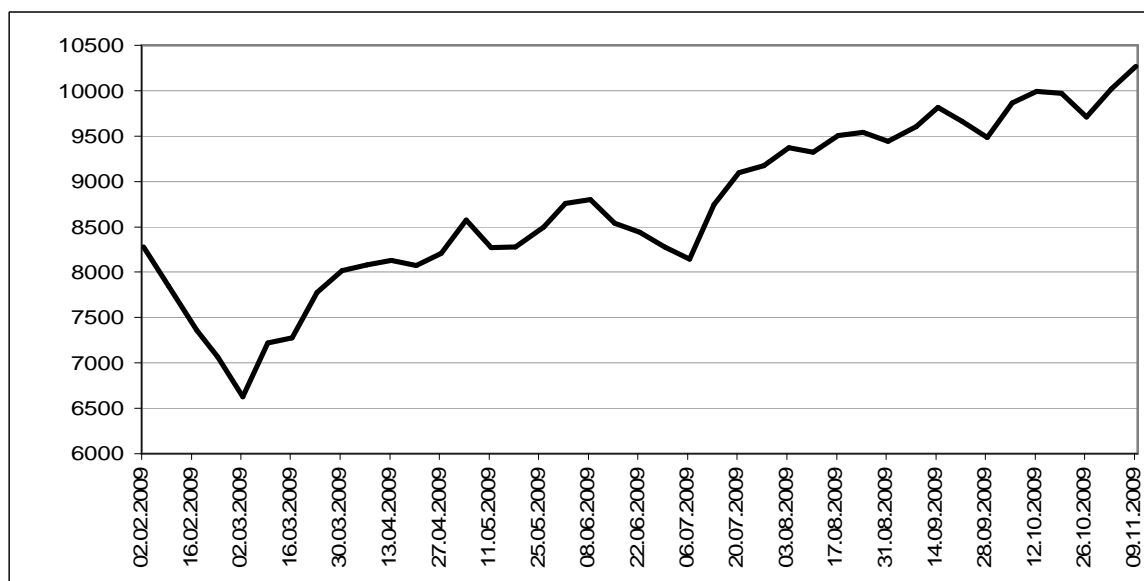
<sup>1</sup> E.T. Gaidar, A.B. Chubais. Economic notes. M.: ROSSPEN, 2008. P. 62.

<sup>2</sup> "Economic has activity started to straighten in the United States and other countries. Herewith, the prospects of a returning to the growth in the short term are quite good". Bernanke, B. <http://globalist.org.ua/?p=22189>: «Apparently, the recession in the US is over." B. Bernanke. Recession likely over in US, says Bernanke. 15.09.09. <http://www.ft.com/cms/s/0/91439968-a224-11de-9caa-00144feabdc0.html>; V. Kudinov, A. Ulyukayev: "The bottom of the crisis is passed, the rate of the Central Bank continues to decline. Vedomosti. November 25, 2009 <http://www.vedomosti.ru/tnews/news/2009/11/25/434>; A. Illarionov, The recession is over. What does it mean? April 30, 2009. [http://www.iea.ru/econom\\_rost.php?id=29](http://www.iea.ru/econom_rost.php?id=29)

<sup>3</sup> A package of anti-crisis measures was adopted on February 14, 2009. See: <http://top.rbc.ru/economics/14/02/2009/280613.shtml>

## RUSSIAN ECONOMY IN 2009

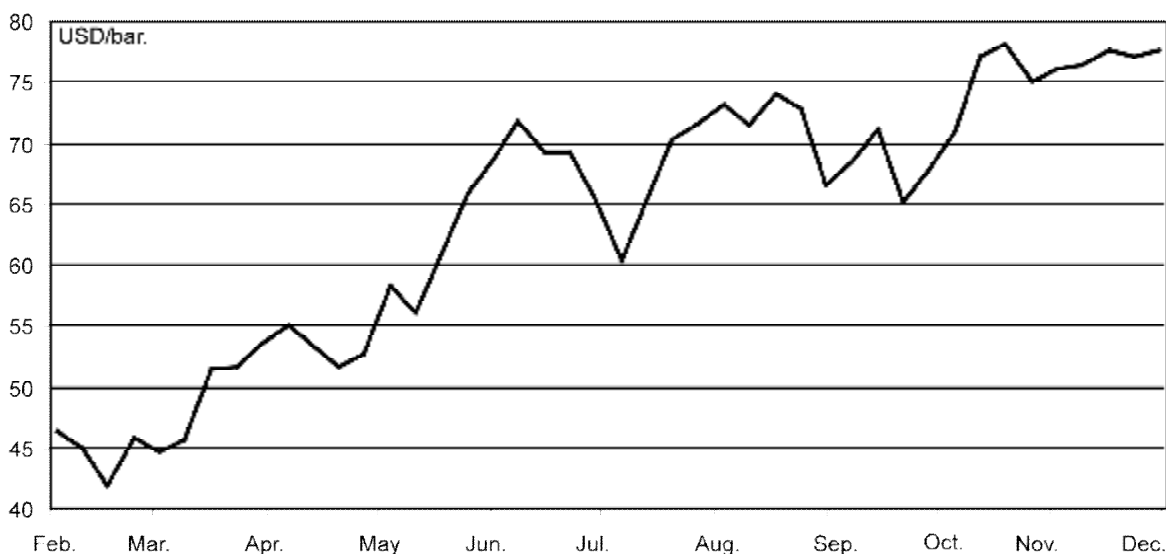
trends and outlooks



\* Index Dow Jones Industrial Average.

Source: Yahoo! Finance (<http://finance.yahoo.com/>).

Fig. 25. Dynamics of the US Stock Market \*, February-November 2009 (Points)



Source: [www.finam.ru](http://www.finam.ru)

Fig. 26. Dynamics of Prices for Crude Oil Brent, February-December 2009, Weekly (USD per Barrel)

If you believe that the bottom of the crisis is overcome, then the priorities of economic policies in the countries dependent on commodity markets, can be changed: budget policy can be mitigated, a large-scale package of measures can be approved to stimulate demand and to finance infrastructure projects. For Russia the issues under discussion are the decisions involving the expenditure of tens and hundreds of USD billions. It is easy to understand: when such monetary funds are involved, such proposals provoke serious interests.

The adoption of those decisions would allow temporarily to improve the dynamics of GDP. However, it is dangerous to take such decisions before there are signs of sustainable improvement in the leading economies in the world. Experts are arguing, if a recession will take place in the shape of letters U, W, L, i.e., whether the period of the downfall will be short, and it will be replaced by rapid recovery of growth, two-humped, accompanied by two waves of crisis or the crisis, not followed by economic growth recovery. All participants in this dispute have their own arguments, but these are unproven hypotheses<sup>1</sup>.

The fact that the crisis might have a second wave, attributable to the first half of 2010, is widely discussed in the expert community<sup>2</sup>. It is unclear how deep the problems in the banking system of the European Union<sup>3</sup>. The largest corporations are going to face substantial payments on fixed-income securities in 2010<sup>4</sup>. Would it be possible to implement them in view of the tension in the market of credit resources will be seen with time.

China has made vigorous efforts to boost the demand. If at the end of 2007 the Chinese leadership chose the fight against inflation as a top priority and was ready to solve this problem at the expense of a slowdown in economic growth<sup>5</sup> in 2008, now the Chinese economic policy has changed. Priority is in maintaining economic growth and fighting against unemployment<sup>6</sup> (see *Fig. 27*).

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<sup>1</sup> See, for instance: *Jefferson R., Woodfield P.* Edinburgh Money Managers Forecast 'Volatile' Recovery (Update3) <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a8rCYuClOdWA>; *Authers J.* The Short View. Published: June 2 2009 The Financial Times Limited 2009. [www.ft.com/shortview](http://www.ft.com/shortview); *Wilson J.* 'Robust' business for Deutsche Bank. Published: May 26 2009. The Financial Times Limited 2009; *Hume N.* On London: Rally's end leaves investors at a crossroads. Published: May 15 2009. The Financial Times Limited 2009; *Giles Ch.* Darling gambles on growth. Published: April 23 2009. <http://www.ft.com/cms/s/0/f0846a1a-2fa1-11de-a8f6-00144feabdc0.html>

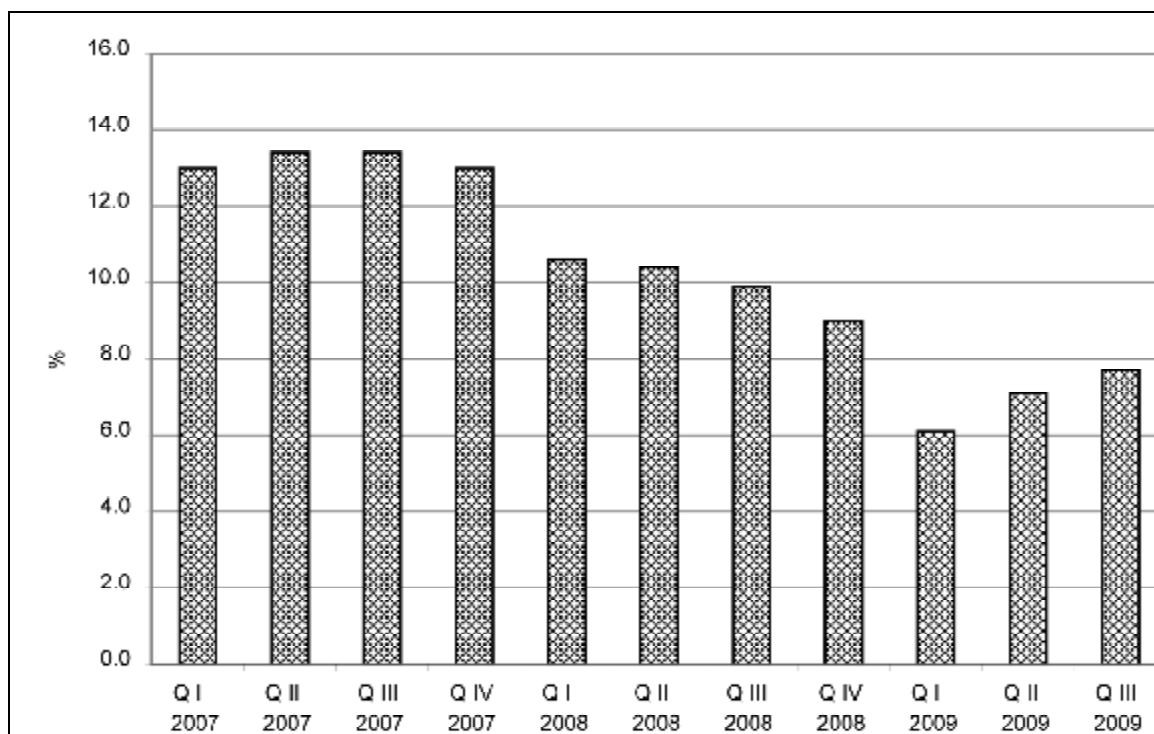
<sup>2</sup> *Goodman W.* Pimco Says World Economic Crisis Faces 'Second Wave' (Update4) <http://www.bloomberg.com/apps/news?pid=20601087&sid=anA4PQ48RFhI>; *Logutenkova E.* Ackermann Says Bad Loans Are 'Next Wave' of Crisis (Update2) <http://www.bloomberg.com/apps/news?pid=20601206&sid=aUKAk1bKBV18>

<sup>3</sup> *Bender Y.* European banks cut access to external fund providers. Published: September 6 2009. <http://www.ft.com/cms/s/0/76abe988-9979-11de-ab8c-00144feabdc0.html?SID=google>

<sup>4</sup> См., например: Official site of Erste Bank <http://www.erstebank.ua>; *Kommersant.* No. 42 (4097). March 11, 2009 г. [www.kommersant.ru](http://www.kommersant.ru).

<sup>5</sup> *Cao B.* Yuan to Rise Versus Major Currencies, Researcher Says (Update2) <http://www.bloomberg.ru/apps/news?pid=20601087&sid=aQYRO9fjayFk&refer=home>

<sup>6</sup> Is the party over in China? Massive unemployment looms. [http://www.worldtribune.com/worldtribune/WTARC/2008/ea\\_china\\_02\\_15.asp](http://www.worldtribune.com/worldtribune/WTARC/2008/ea_china_02_15.asp); *Lawrence D.* China Pledges Faster Labor Mediation as Employment Turns 'Grim'. <http://www.bloomberg.com/apps/news?pid=20601089&sid=afK0sP5rT6IY&refer=china>; *Hamlin K., Yanping L.* China Rate Cut Highlights Concern Over Slowdown, Jobs (Update1). <http://www.bloomberg.com/apps/news?pid=20601087&sid=aQrG9UlthDHo>; *Adam S.* Yuan 'Straitjacket' Risks Inflating China Bubbles (Update2). <http://www.bloomberg.com/apps/news?pid=20601109&sid=awHX2QPENKqQ>



Note. Data for Quarter II–IV of 2007–2008. National Bureau of Statistics of China publishes only in terms of accumulated GDP growth.

Source: National Bureau of Statistics of China (<http://www.stats.gov.cn>).

Fig. 27. GDP Growth Rates in China, Quarter I, 2007 – Quarter III, 2009.  
(In % Versus the Relevant Period of Preceding Year)

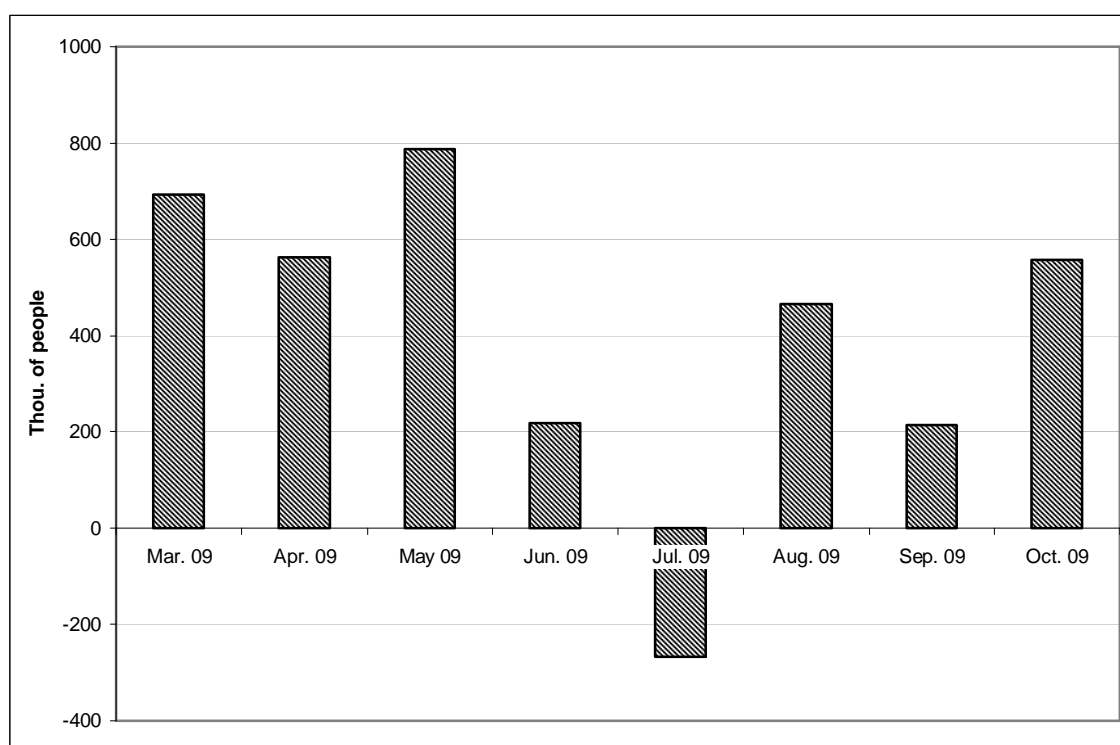
The Chinese authorities have chosen the same macroeconomic policy, which was used by the US administration to combat the recession in 2001. It is difficult to predict, whether such policy will result in a crisis of a "soap bubble"<sup>1</sup>.

The scale of financial and banking system problems of other emerging markets is difficult to be assessed as well. By the time this article was submitted for editing, it was impossible to accurately assess the extent to which the risk of default of Dubai guaranteed government bonds

<sup>1</sup> Shamim A. Yuan ‘Straitjacket’ Risks Inflating China Bubbles (Update2). <http://www.bloomberg.com/apps/news?pid=20601109&sid=awHX2QPENKqQ&pos=10>; Anderlini J, Tucker S. CIC head warns of asset price bubble. <http://www.ft.com/cms/s/0/47ac3d54-c39a-11de-a290-00144feab49a.html>; Tasker P. China is heading for a Japan-style bubble. <http://www.ft.com/cms/s/0/78e2eae4-c7af-11de-8ba8-00144feab49a.html>; Chinese sovereign wealth unit planning \$11.7bn bond issue. <http://www.ftchinese.com/story/001029668/en>; Xie A. Insight: Is China due a reality check? <http://www.ft.com/cms/s/0/1ed429aa-b99f-11de-a747-00144feab49a.html>; Brown K. Asia warned over emerging asset bubbles. <http://www.ft.com/cms/s/0/236ef0c2-c9ac-11de-a071-00144feabdc0.html>; Dyer G. Top China banker calls for urgent shift in Beijing's monetary policy. <http://www.ft.com/cms/s/0/b4217eba-bea2-11de-b4ab-00144feab49a.html>; Authers J. Short View: China's bubble. <http://www.ft.com/cms/s/0/ba76495c-f05a-11dc-ba7c-0000779fd2ac.html>; Dyer G. Top China banker urges shift in policy. <http://www.ftchinese.com/index.php/ft/story/001029313/en>; China's role in the global recovery <http://www.ft.com/cms/s/0/2df3ea66-9716-11de-83c5-00144feabdc0,s01=1.html>; Pesek W. China Risks Bubbles With ‘Bernie Madoff Data’. <http://www.bloomberg.com/apps/news?pid=20601039&sid=ab99AWGFCBsU>; China Must Avert Loan-Fueled Bubbles, World Bank Says (Update1). <http://www.bloomberg.com/apps/news?pid=20601080&sid=aRi.90ENYi.s>

with fixed income could affect other markets under the scenario of 1997-1998 in South-East Asia<sup>1</sup>. Moreover, Dubai is not the only important point of the stability for the financial systems of emerging markets, which may face difficulties in meeting their financial obligations.

Economic statistics of the United States in recent months is controversial. It does not give grounds for confidence that the world's largest economy is on the path of sustainable recovery (Fig. 28).



Source: Federal Reserve Bank of St-Louis (<http://research.stlouisfed.org/fred2/series/UNEMPLOY/download-data?cid=12>).

Fig. 28. Growth / Decrease in the Number of Unemployed (Data Adjusted for Seasonal Factor), USA, March-October 2009 (Thousand of People. As of the Beginning of the Month)

In the recent work of the World Bank devoted to the crisis, the authors defend the thesis that even in case of recovery of global economic growth in 2010, in the medium term, the growth will be slower than in the years preceding the current crisis<sup>2</sup>.

All the above-said may seem too pessimistic. However, the experience of our country shows that the risks of such developments should be taken into consideration.

Mitigation of monetary and fiscal policy obviously would be popular. It will be easier, when and if there appear clear indications of the world economy recovery, there will be sustained growth in demand for major export commodities of Russia. However, it is a mistake to take such decisions in the situation of continuing uncertainty.

<sup>1</sup> <http://www.ft.com> Last updated: November 30 2009.

<sup>2</sup> Mitra P., Selowsky M., Zalduyendo J. Turmoil at Twenty: Recession, Recovery, and Reform in Central and Eastern Europe and the Former Soviet Union. Washington: World Bank, 2010.

The obvious short-term priorities are anti-crisis measures. However, the current economic crisis has once again highlighted the vulnerability of the domestic economy, the extent of its dependence on factors beyond our control. This brings to the agenda the issue of diversification of the economy as a top priority (to avoid focusing only on investing public funds in large-scale projects that do not always give reasonable feedback, especially rare in the country with highly corrupted public authorities). There are discussions on the need to diversify the economy for two decades. This problem was posed as early as in the first national program for economic reforms extension (in summer 1992). But nothing is changed till now. Perhaps the current crisis will force our government, the national elite, all the people finally to take active measures?

Commodity prices vary in a wide range, it is difficult to predict, much less to manage them. Of course, there will always be found volunteers to invest in oil and gas in the country where it is difficult to speak of the guarantee of private property or an independent and fair judicial system. When the issues in question are high-tech industries, the situation is different. In this case the guarantees of property rights, effective judicial system, fair government authorities are necessary conditions for both domestic and international capital to be invested in them. It is easy to declare this. To create such conditions is more difficult. But this is a task that has to be resolved, if we want a long-term sustainable economic development in Russia.

The crisis is a period of turbulence, uncertainty. Given these conditions, making decisions on the key issues of economic policy, one can make mistakes and get a reverse result. The crisis is like a storm. In the time of sailing fleet, during the storm the ships would pull down the sails and hove-to. This is useful to remember when making decisions today. But the history of the last two centuries shows, that crises, even such deep ones as the Great Depression or the current crisis, sooner or later come to an end. Already today one should think how to ensure the competitiveness of the domestic economy after the crisis.

After the crisis the world will be more tough than in the early 2000-s. Russian companies will have to compete with those corporations that will survive, and thus will be able to restructure production, to focus it on the most efficient facilities and activities, to reduce the number of employees, to increase productivity, quality and competitiveness of their products. If we don't do the same in Russia, it will be not easy to compete in this market. Hence, one can make two conclusions for the long-term economic policy in Russia

First. At least not to impede the Russian companies to operate in the same way as the corporations, which survived during the crisis, let them to get prepared for competition in the tough post-crisis environment, and to adapt social policy to solve that task.

Second. Make a top priority the creation in Russia a competitive sector of the innovation economy.

Skeptics may say that this objective could never be achieved in Russia neither under the czarist regime, nor under the communists, nor after the collapse of the Soviet Union (the military-industrial complex is the only exception to the rule). But this does not mean that it is unresolvable at all. Neither Finland, nor South Korea or Taiwan in the 50-s of the XX century could not be included in the list of countries with the innovation economy. Over the past 60 years there has been accumulated a rich international experience in policies to support the



innovation economy. Many of these programs have been successful<sup>1</sup>. This experience should not be copied literally. Program for the support of innovation economy were specific, adapted to the domestic specifics. For Russia, this experience suggests that the essential conditions for the success of this policy are the amendments to the legislation (tax system, budget legislation, regulations on patent rights, facilitation of foreign trade activities for everyone, who is involved in the innovation economy)<sup>2</sup>.

These measures should be complemented by an effective infrastructure for innovation support. I am referring to the active government policy aimed at creation of business incubators focused on the innovation economy, venture capital funds, promotion of the banks incentives to invest in the targeted innovation loans.

Innovation economy is by nature largely different from the standard one. There is a great risk of failure. But in case of success, the results can exceed the expectations by orders, rather than by times. That is why the government economic policy in this area cannot be standard. It requires innovative solutions. The extent to which Russia will be able in the next decade to move in this direction and long-term prospects of our country, largely depends on the situation, in which Russia will come to the next global world crisis.

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<sup>1</sup> See, for instance: National Innovation System. A Comparative Analysis. R. R. Nelson (ed.) New York Oxford: Oxford University Press, 1993.

<sup>2</sup> For Russia, this is something that belongs to the commodity group 84-90 (by foreign economic activity - classification of goods).