Spasskaya Tower of the Kremlin, Moscow.

A Tale of Two Crises

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Russia is still a resource-dependent economy that must diversify in a market-friendly way

RUSSIA'S reversal of fortune is striking. Just before the global financial crisis hit the country with full force in late 2008, Russia looked invincible. Nearly 10 years of impressive economic performance, prudent macroeconomic management, fiscal and current account surpluses, the third-largest foreign exchange reserves in the world, and a growing middle class were just some of its achievements.

But now the picture has changed dramatically. A sharp reduction in output in the fourth quarter of 2008 and the first quarter of 2009, the near-failure of a few sizable banks, and struggling major industrial groups coupled with an alarming rise in unemployment, have put things in an entirely new light. And then there is the fact that nearly one-third of the country's reserves—used mainly to prop up the ruble during its gradual slide—have evaporated.

Déjà vu

Where have we heard this story before? The whipsaw shift in sentiment and economic performance as well as several other features of the current crisis are strangely reminiscent of the 1998 financial meltdown. From 1995 to early 1998, Russia was described by many respected western analysts as a major global success story. Thanks to the early efforts of the first reform team, under President Boris Yeltsin and Acting Prime Minister Yegor Gaidar, Russia, according to these analysts, had become a market-oriented democracy in less than five years.

Then, as in 2008, Moscow had the feeling of a boomtown to which young profes-

sionals flocked to make their fortune. The stock market, although small and illiquid, was one of the best performing in the world, and a middle class was taking shape. Russia was thought to be too big and too important (and too nuclear) to fail, so fears that it would become infected by the Asian crisis—which was spreading throughout emerging markets in the second half of 1997 and early 1998—were thought to be unfounded. We know the rest of the story. In August 1998 came default, devaluation, despair.

What then can be learned from these two crises, which occurred almost exactly 10 years apart? Russia has moved on in many ways since the last major crisis hit. What we may gain by looking back at the events of 1998 is some comfort, knowing that Russia today is more robust now than it was back then. But some apprehension is also warranted: the economy's rebound may be less immediate and profound this time.

What we are certain to find is that Russia has not done enough to inoculate itself from recurring crises that stem, in large part, from a sharp drop in the price of oil. Russia is still a resource-dependent economy that must take meaningful steps to diversify in a market-friendly way.

Continued importance of oil

Both crises were caused primarily by a sharp drop in the price of oil, the key external variable for the Russian economy, whose diversification away from oil, gas, and other commodities remains a key long-term challenge.

Prior to the crisis in 1998, oil and gas accounted for almost half of Russia's export revenues and directly for one-fifth of federal government revenues. By 2008 the share of oil and gas in export receipts had reached 68 percent, and natural resources directly accounted for half of federal government revenues. Extraction industries accounted for more than 10 percent of the total value added, and their true contribution to GDP was much higher, because about 60 percent of industrial production was concentrated in closely related sectors, such as oil refining and fertilizer and metal production. Rough estimates suggest that the overall direct share of natural resources and related sectors in the economy's total value added has actually increased from about 15 percent in 1997 to about 20 percent in 2007. In addition, a significant share of value added in services is accounted for by trade in natural resources and transshipment of oil, gas, and minerals.

Given that Russia today is even more dependent on natural resources than it was in 1998, how has its economy been affected by the oil price shock? Following the Asian crisis, the price of Urals brand oil fell from $23 a barrel in early 1997 to less than $9 in mid-June 1998, a drop of more than 60 percent. The current oil price level is far from historical lows: it is almost three times higher in real terms than in mid-1998 and is comparable to prices in early 2005, when the Russian economy was steaming ahead at a rate of 7 percent a year and accumulating foreign currency reserves (see Chart 1). But the price adjustment in relative terms was even faster and larger this time: the Urals price fell from the August 2008 high of $138 a barrel to an average of $44 in the first four months of 2009, a drop of almost 70 percent.

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Common theme

The importance of oil to the economy is a common theme in both the 1998 and 2008 crises. Another similarity is that the real sector, the financial sector, and government finances all were severely affected. However, the initial conditions in these three sectors, the linkages between them, and the sequencing of events that led to the crisis in 1998 and the downturn in 2008 differ substantially.

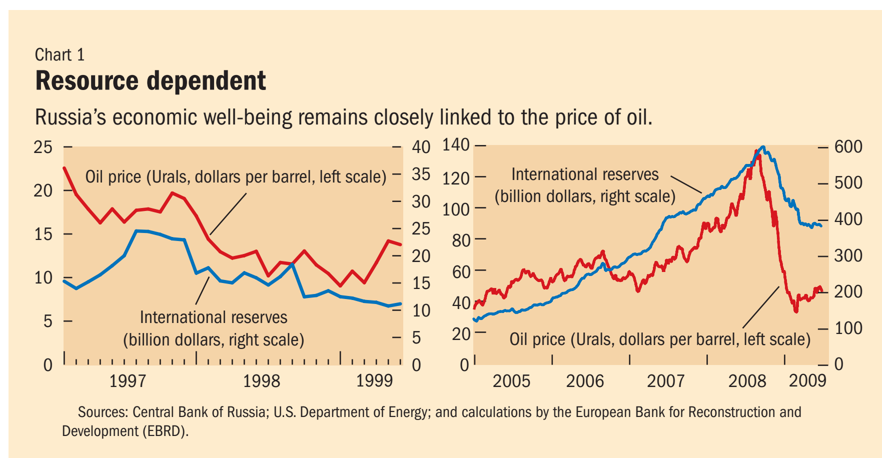
The real economy. Even before the 1998 crisis hit, Russia experienced a recession. Although Moscow's economy had returned to rapid growth by mid-1997, output is estimated to have contracted in 43 out of 79 regions in 1997. By contrast, the past decade has seen fast, robust, and geographically broadly shared growth. In the first half of 2008 output grew at an annual rate of 8.2 percent, increasing by 82 percent during 1999–2008. By many accounts the economy was overheating.

In 1998, the problems in the real sector started long before the August default hit the financial system and triggered serious ruble depreciation. Official seasonally adjusted data are not available, but rough calculations suggest that output contracted

Chart 1

Resource dependent

Russia's economic well-being remains closely linked to the price of oil.



Sources: Central Bank of Russia; U.S. Department of Energy; and calculations by the European Bank for Reconstruction and Development (EBRD).

sharply in the first three quarters of 1998, after which a robust recovery started almost immediately after the financial crisis (see Chart 2). In simplified terms, a drop in oil prices aggravated the situation in the already struggling real economy, making a large dent in public finances, which was temporarily filled by issuing short-term debt (GKOs) at very high interest rates in which nonresidents as well as resident financial institutions became deeply invested. Collapse of the GKO market triggered the financial crisis and sharp depreciation of the ruble.

Unlike in 1998, when the malaise gradually spread from the real sector to the public finances to the banking system, in 2008 all three sectors of the economy were hit simultaneously. A rapidly growing real sector was dealt a double blow by a sharp fall in commodity prices and a pronounced reduction in global demand for manufactured goods, including finished and semifinished steel products. The syndicated loan markets seized, making refinancing of external liabilities very challenging for some private sector borrowers and impossible for others. Many portfolio investors fled Russia, and emerging markets more generally, and trade finance started drying up. Fiscal revenues contracted sharply: in January-February, year-over-year general government receipts were down 9 percent in nominal terms, which corresponds to an almost 20 percent reduction in real terms.

Government finances. In 1998, the real sector malaise predated the financial crisis, and after the crisis had blown over there was little feedback from the banking sector and government finance to the real economy. General government revenues (including extrabudgetary funds) accounted for only 27 percent of GDP in 1997, of which federal government revenues were less than half. There was therefore only limited room for fiscal stimulus.

By 2008, the role of the government in the economy had increased dramatically. General government revenues totaled 39 percent of GDP, of which the federal government accounted for 58 percent. In 2004, Russia set up the Oil Stabilization Fund, which later was split into the Reserve Fund and the National Wealth Fund, to set aside part of the country's oil revenues. By early 2009, this fund had accumulated $225 billion—amounting to 17 percent of GDP—and external public debt has been largely repaid. Despite the large drop in fiscal revenues, the government has much more room for fiscal stimulus than it had in 1998.

Financial sector. While the financial sector in 1998 was heavily invested in GKOs, credit to the private sector totaled only 9 percent of GDP, with a loan-to-deposit ratio of 76 percent. Consumer credit was all but nonexistent, and project financing with terms of more than one year added up to less than 2.5 percent of GDP. In these circumstances, the banking system collapse had a limited impact on the real sector. If anything, the crisis helped reorient the banking model toward financing enterprises and consumers.

By mid-2008, however, domestic credit to the private sector had reached 42 percent of GDP, about one-quarter of which was granted to consumers. With a loan-to-deposit ratio at about 150 percent, a major part of the loan book was effectively financed by banks' external borrowing ($200 billion as of end-September 2008), largely in the form of syndicated loans or credit lines from foreign parent banks. Large firms have also been actively tapping into international financial markets and accumulated about $300 billion in external debt.

Between end-2000 and the third quarter of 2008, banks' loan books grew at an average annualized rate of more than 50 percent, almost as fast as in Ukraine, where the private sector credit-to-GDP ratio reached 63 percent and the banking system already faces serious difficulties. In this sense, Russia's still relatively modest credit-to-GDP ratio is somewhat misleading, because it reflects the unprecedented high growth of nominal GDP, which increased eightfold in dollar terms between 1999 and 2008 on the back of rapidly rising commodity prices.

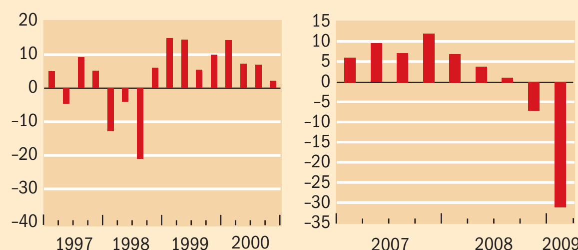
Such high rates of credit growth make it difficult for banks and supervisors alike to ensure that appropriate risk management models and procedures are in place. Liquidity support by the central bank may temporarily enable banks to roll over problem loans, but ultimately the underlying quality of assets

Chart 2

Anatomy of a crisis

Russia's economy rebounded quickly in 1999. Whether the same will happen in 2009 remains to be seen.

(GDP quarter-on-quarter, seasonally adjusted, annualized, percent)



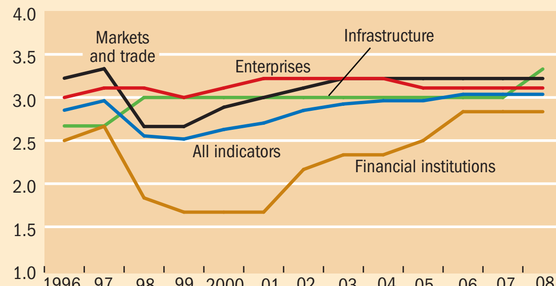
Sources: Rosstat; Russian authorities; and estimates by the EBRD.

Chart 3

Transforming the economy

Some reforms ground to a halt after the crisis in 1998.

(transition indicators, 1996–2008, min=1; max=4.33)



Source: EBRD Transition Indicators.

Note: The EBRD tracks reforms in transition countries along several dimensions—enterprise restructuring, markets and trade, infrastructure, and financial institutions—and compiles respective indices of reforms on a scale of 1 to 4+, where higher values correspond to deeper reforms.

will depend on the state of the real economy. Therefore, it is important to develop contingent plans for restructuring and recapitalization of the banking system.

Efforts to shore up the now much larger banking system have so far centered on the provision of much-needed liquidity, as banks have found themselves largely cut off from international markets. In addition, in September 2008 a large number of banks, in particular medium-sized and regional banks, faced rapid withdrawal of deposits by retail and corporate customers. The authorities responded by extending deposit insurance coverage and injecting liquidity on a large scale through collateralized and uncollateralized loans to banks.

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On the positive side, Russia has not had a big problem with debt denominated in foreign currency. Only 25 percent of domestic corporate loans and about one-ninth of consumer loans were denominated in foreign currency, much less than most other emerging markets in Europe. This stands in contrast to the situation in July 1998, when the dollarization ratio stood at 42 percent.

Therefore, the recent depreciation of the ruble has not had an immediate strong negative impact on the quality of medium-sized firms' balance sheets and bank loan books. At the same time, the severity of the economic downturn and very rapid growth of the banking system point to a possible rapid increase in the incidence of nonperforming loans in the future.

Different times, different policy responses

The different circumstances explain, in part, another important difference between 1998 and 2008: the policy response. In 1998, Russia lacked the resources and probably the political will to respond to the crisis. In fact, what was most important at the time was what the government did not do; that is, to try to ease its way out of the crisis quantitatively. The government, and somewhat surprisingly the central bank governor, Viktor Gerashchenko, resisted pressure from many stakeholders to print money, and the real economy quickly rebounded.

This time, the nature of the crisis is fundamentally different, with its origin outside Russia, and the government's resources much larger. The authorities' response has also been much more forceful, in monetary as well as fiscal terms.

The revised 2009 budget provides for substantial fiscal stimulus, with the federal budget expected to run a deficit of up to 8 percent of GDP in 2009, likely followed by a deficit of 5–6 percent of GDP in 2010, financed primarily with accumulated fiscal reserves. The additional discretionary spending of 4.1 percent of GDP combines a demand-side package of about 2 percent of GDP of mostly social spending, a supply-side package of up to 1.3 percent of GDP made up by targeted support to individual enterprises and industries, and a package for banks of about 0.8 percent of GDP.

The 1998 crisis led to a number of structural reform reversals—mainly in the financial sector, but also in terms of free markets, trade integration, and enterprise privatization and restructuring (see Chart 3). But the crisis also arguably gave rise to a number of significant medium-term structural reform initiatives, including restructuring of the electricity sector, tax reform, introduction of deposit insurance, and pension reform.

It is too early to assess the impact of the current crisis on the reform agenda. Surging unemployment (estimated at 9.5 percent in February 2009), falling incomes, high inflation (13 percent year over year), weak demand for manufactured goods, and fewer pressing short-run infrastructure needs may make administrative measures, such as price controls, tariff controls, trade barriers, and targeted subsidies to failing enterprises, politically tempting. Some of them have already been tried on a small scale. For instance, import tariffs on used cars were recently increased.

How will it all play out?

As in 1998, the speed of the recovery from the current crisis will depend on external factors, mostly the pace of global recovery, the trajectory of oil prices, and the cost of capital in the international markets, given Russia's vast investment needs in its industrial sector and in infrastructure.

But the pace of recovery, much more than in 1998, also depends on the policy response, given the government's more prominent role and considerably stronger links between the financial system and the real economy.

Unlike the situation 10 years ago, the government now has sufficient funds to administer sizable demand-side fiscal stimulus and provide targeted social transfers to those hit particularly hard by the crisis. However, allocating public spending in a way that is productive and stimulates aggregate demand without creating new bottlenecks remains a challenge in Russia. In particular, the government's capacity to manage large infrastructure programs is still limited. With the financial sector now playing a much more prominent role in the Russian economy compared with the 1990s, the potential costs of a banking system collapse for the real economy could be very high, as could be the cost of misguided fiscal policies. Russia's government will have to tread carefully in the months ahead. ■

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