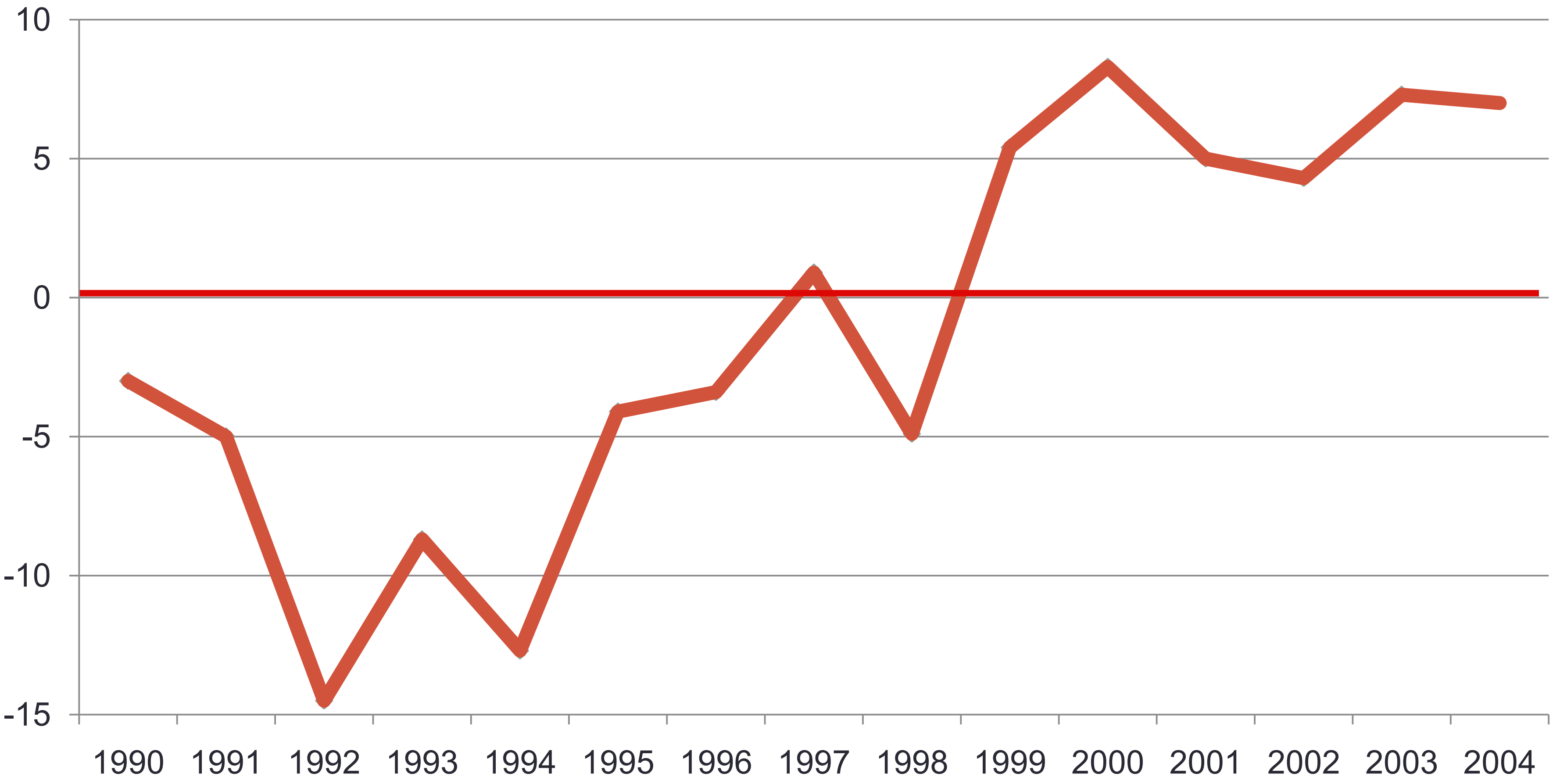
ECONOMIC TRANSITION OF RUSSIA

Lecturer – Oleg Deev
oleg@mail.muni.cz

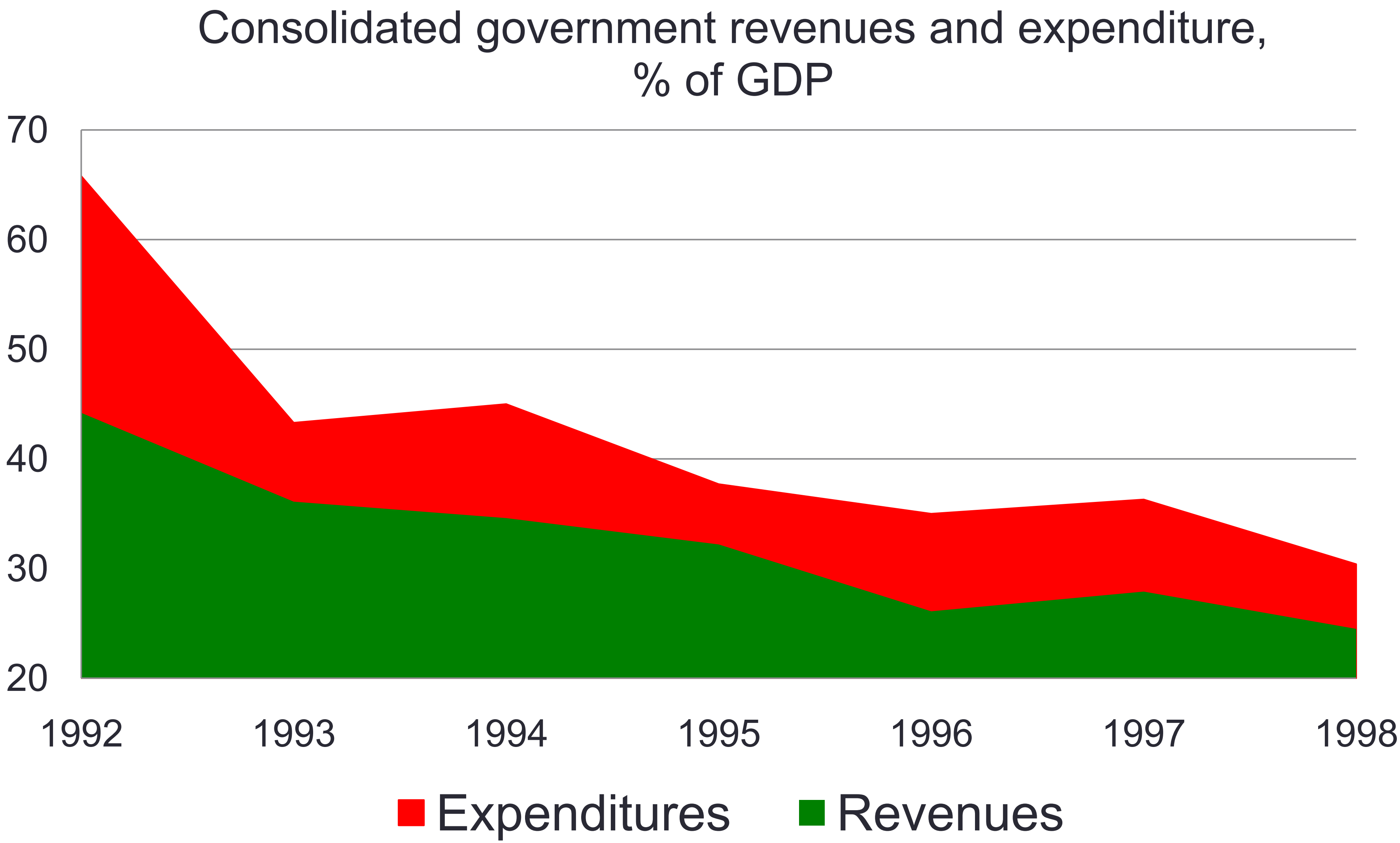
Results (1991-1998)

- Free market
- Private business – 70% of GDP
- Huge fall in output
- High inflation
- Income redistribution
- Privatization – controversial results
  - people’s disapproval & emergence of oligarchs
- Organized crime and corruption
- Capital flight – $20 billion a year
- The development of barter economic relations and dollarization
- Unemployment and poverty
- Deterioration of education system, health care, demographics
- Inadequate pension system
- Inefficient legal system
- Existence of shadow economy

GDP growth rates, %



Russian financial crisis – August 1998



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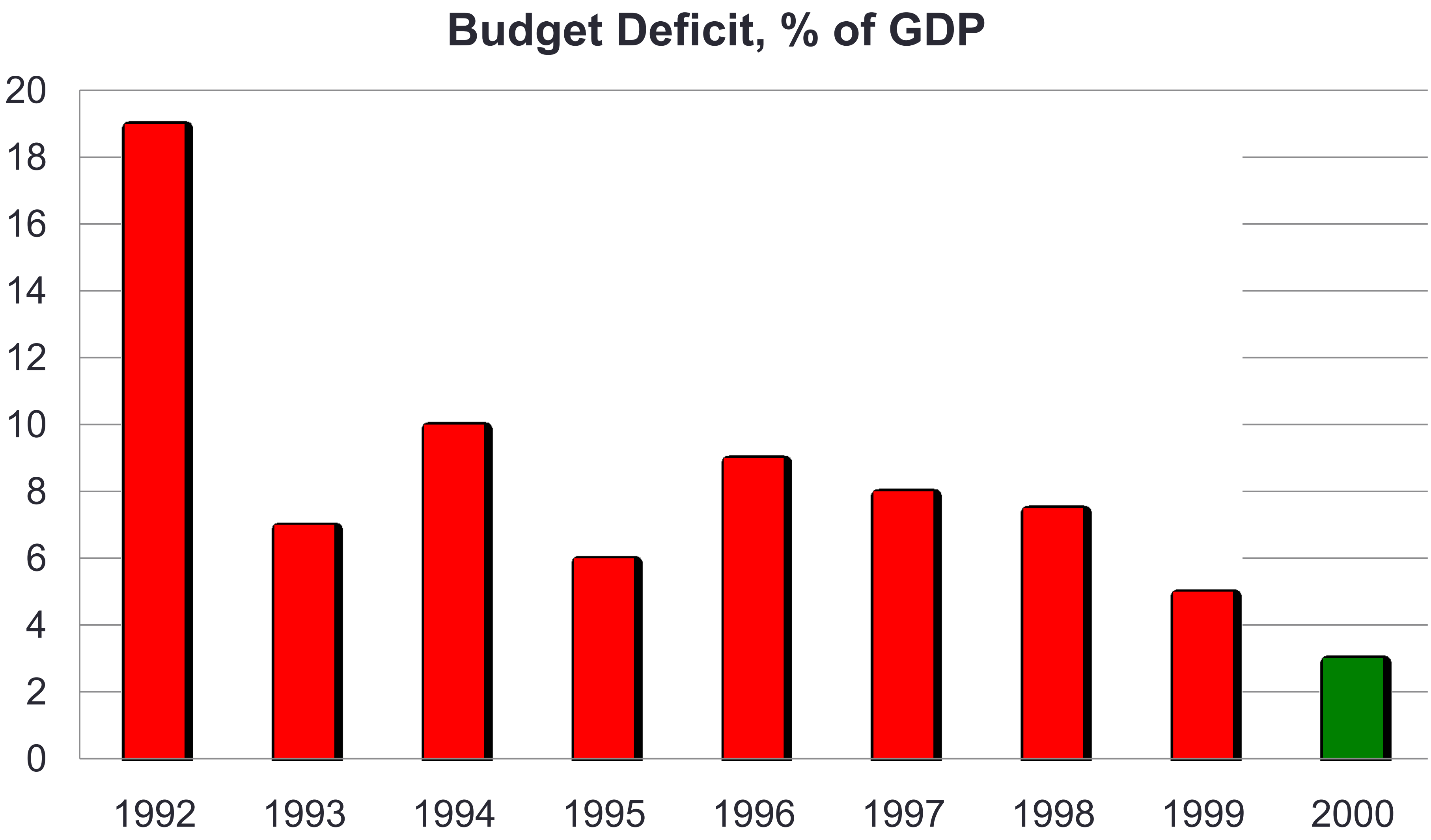

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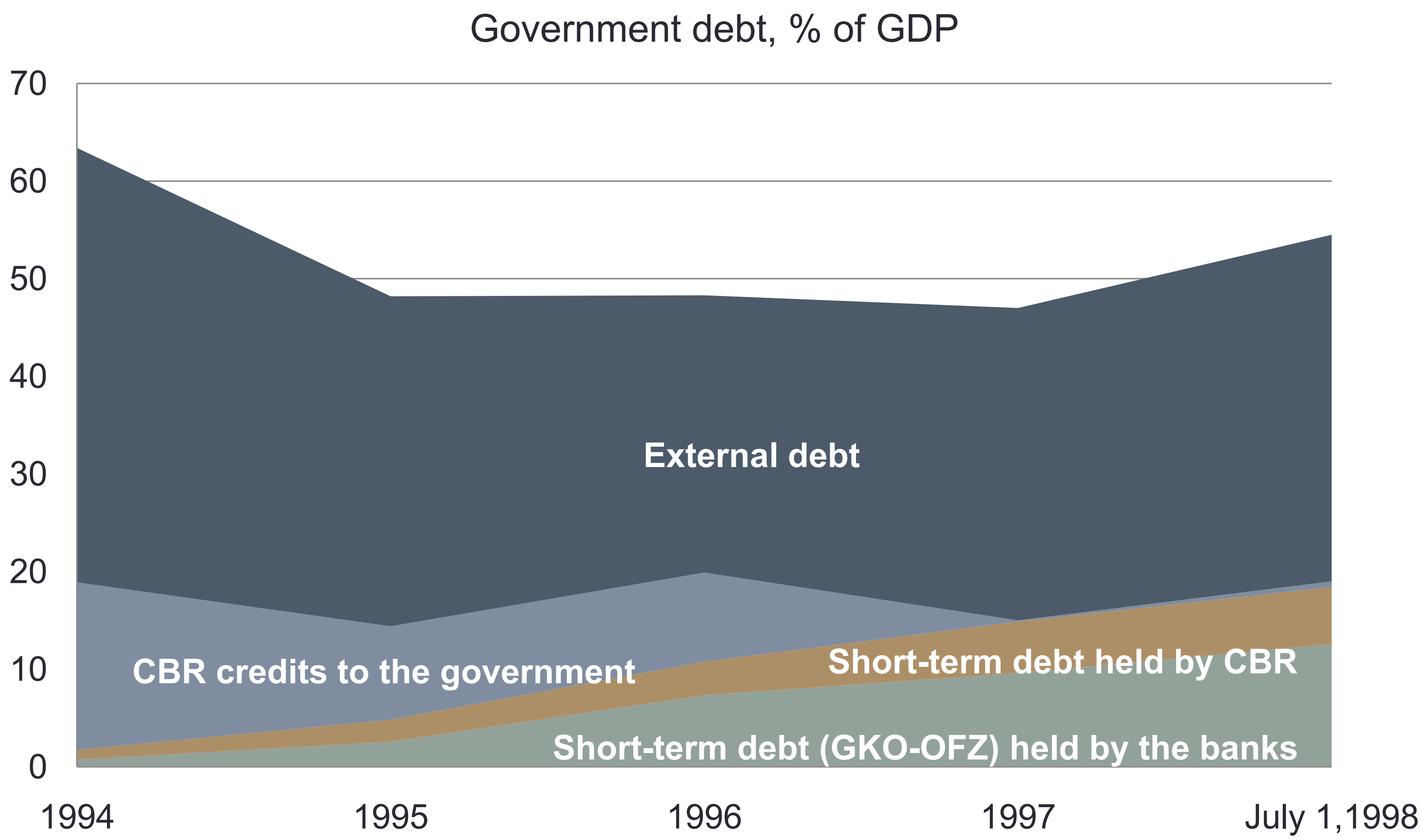


Russian financial crisis – August 1998

- 1997 - Inflow of portfolio investment of $46 billion or 10% of GDP
- High volatility of exchange rate – ruble/USD (high valuation of ruble)
- Extremely high interest rates
- 1998 – world price for Russia's oil – 10$ per barrel
- The government was not able to refinance it's debt

Measures – August 1998

- Devaluation of the ruble
  - At the moment the ruble/dollar trading band was expand from 5.3-7.1 RUR/USD to 6.0-9.5 RUR/USD
  - Later the RUR/USD rate was set to move freely within the wider band
- Default on domestic debt
  - To prevent mass Russian bank default Russia's ruble-denominated debt would be restructured
- A moratorium on payment to foreign creditors
  - A temporary 90-day moratorium was imposed on the payment of some bank obligations, including certain debts and forward currency contracts

Russia's 1998 financial collapse

- In a matter of days the exchange rate lost over 60% of its value
    - more than in all most Latin American and Southeast Asian countries (except for Indonesia)
- Prices increased by nearly 50% in only 2 months after the crisis
    - as compared to less than 6% annual inflation July 1998 to July 1997 before the crisis
- Real output fell by about 6% in 1998
    - after registering a small increase of 0.6% in 1997 for the first time since 1989, it fell in January - September 1998, i.e. mostly before the August 1998 crisis

Why was the drop so drastic?

- Some of the standard explanations
  - Bad institutions
  - Natural resource dependence
  - Bad policies
- For a medium income level country, Russia is trade wise open
- Financial dependence proved important
  - Short-term debt was concentrated and fast growing
  - Dependence of financial intermediation on foreign funding
  - The dual financial system: households and most companies using domestic markets; some big companies and banks dependent on foreign markets

Measures 1998-1999

- Budget reform
  - Expenditures and arrears reduction
  - Revision of expenditures
- Taxation reform
  - The creation of efficient taxation system
- Changes in banking sector
  - The worst half of the banks was closed
  - Strengthening the governance of banks
  - The payment system improvement

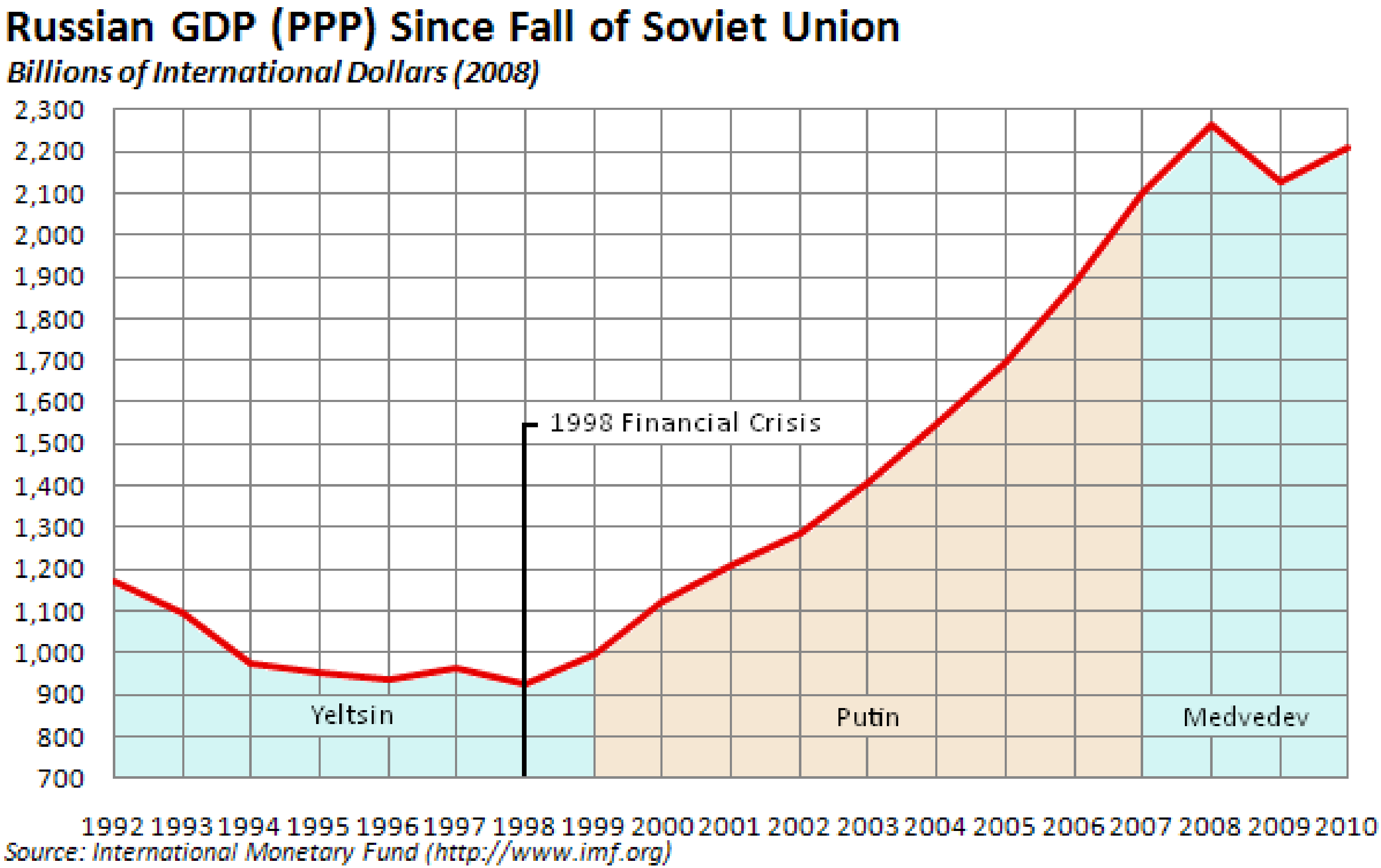
So why the talk of a safe haven?

- Politicians were not in the business of doom-saying
- Shifting blame to where it belonged: global imbalances
- Good grounds why a pure financial crisis might handle Russia softly
  - Small financial sector with limeted role in investment finance
  - Strong public sector financial position – taxation reform
  - Households with no financial wealth, little debt: no wealth effect on consumption
  - Labor markets expected to be very flexible

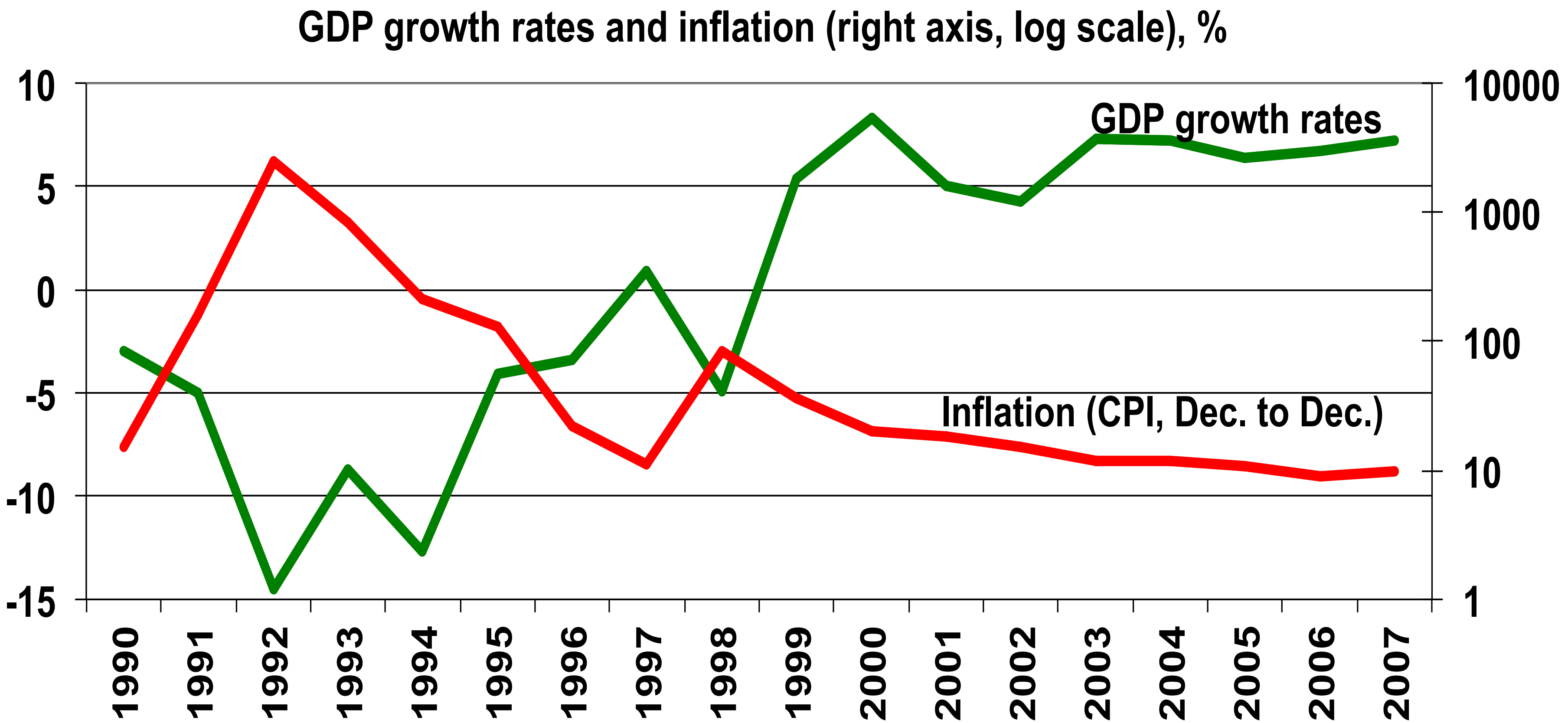
After the crisis

- Boom in industry
- After devaluation, domestic producers were taking advantage of new export opportunities and made shift from foreign to Russian made goods
- Devaluation of the previously overvalued currency restored the previously lost competitiveness
- Output was falling in the beginning of 1998, but started to grow in October (unlike in East Asia, where output fell after the currency crises)

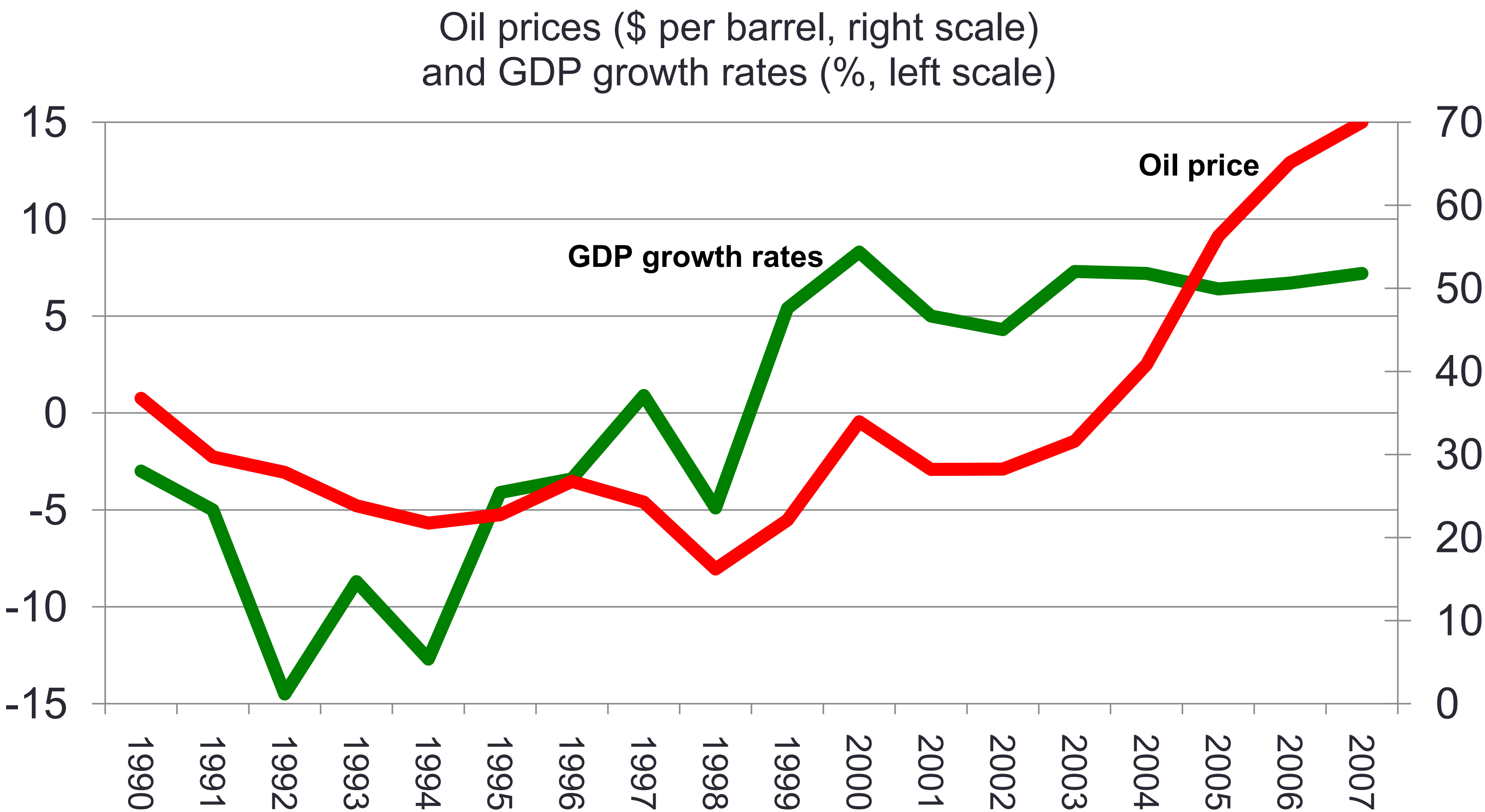
Economic growth – 1999-2008



Output is growing, inflation is under control



Oil price grows, GDP does not accelerate



Russia’s anti-crisis policies – 2008-2009

- Basically similar to those in other countries
- Package of tax reforms, reducing the tax burden
- Emphasis on monotowns, pensions, minimum wages - crisis fighting as a social policy measure
  - Since 2005 - emphasis on social policy, with view on demography (national priority programs). In practice - expenditure on health, education and housing are stable as share of budget, increasing in line with total expenditure
  - Since 2007 - decisions to increase pensions, minimum wages, public sector salaries were made
- Structure of the banking system left no alternative to ”favoring” state-controlled banks as liquidity channels

Challenges for the future

- Unpredictable export revenue
  - Oil price
  - Energy efficiency needed for maintaining export volumes
  - Changes in gas markets
- Regaining budget surplus
  - Re-accumulating reserve funds is a high priority
  - Expenditure pressure due to recent hikes, long-term needs
  - Revenue problem due to declining share of energy sector in GDP
- Exchange rate policy
  - Increased flexibility of nominal rate, no pure inflation targeting
  - Real exchange rate appreciation pressures as financial inflow resumes
- Financial system development
  - Rolling back the state
  - Need for long-term domestic funding
- Pension reform
  - Increasing dependency ratio
  - Previous failures to depart from pay-as-you-go
- Competitiveness of jobs