Russia – Managing Russia After The Crisis

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The international crisis dealt a severe blow to the Russian economy. The lower prices on oil and reversal of international capital flows to emerging markets hit hard, because the shocks struck just as the economy was on a steep upturn and because the dependence on oil made Russia particularly vulnerable. Economic activity fell precipitously. Faced with this challenging turn of events, the Russian authorities mounted an economic policy response that - as in many other countries – was swift and unprecedented in its scale and contents. The banking pressures were addressed through large-scale liquidity injections and problem bank rescue, while fiscal policy became expansionary. The central bank at first allowed a gradual exchange rate depreciation into early 2009, drawing on its foreign reserves to moderate the pace, which allowed banks and corporates to bolster their foreign exchange positions and brought the ruble in line with the new fundamentals implied by lower oil prices.

Looking forward, the international backdrop suggests a slow recovery, as the world economy will be facing deleveraging, corporate restructuring, and slow job growth. By the same token, Russia cannot expect a rapid return of high oil prices or large capital inflows. We should therefore foresee a fairly modest recovery also in Russia, combined with a weaker balance of payments than in recent years.

This sobering outlook has important implications for Russia's economic policy strategy. Clearly, the government's response over the last year has helped preserve stability, which is a prerequisite for the resumption of growth. In fact, since mid-2009, there have been signs of economic stabilization. But challenges remain. The central goal will be to turn the tentative signs of a rebound into lasting economic growth, while preserving the stabilization gains. In this regard, looking ahead, Russia faces delicate tradeoffs, as well as room for improving the boost to economic growth, both in the short and longer term.

Consider first the short-term policy priorities. Ensuring a healthy banking system will be critical for the resumption of credit supply. This underscores the need for a proactive and comprehensive strategy, so that banks have the capacity to lend once the economy recovers. Key elements of such a strategy include mandatory stress tests of major banks to obtain better assessments of their viability; on this basis, making sure that banks have adequate capital or raise more if needed, either from private sources or from the envisaged bank recapitalization by public funds; regulatory guidance regarding the actions that the CBR will take as banks' balance sheets deteriorate; and broadening the CBR's supervisory authority.

Turning to budget policy, the cautious fiscal policy of the past has left Russia with a low public debt level and sizable buffers, creating "fiscal space" for relaxation. Having said that, the size of the relaxation should not be so large as to undermine the quality of public spending. Moreover, the use of the Reserve Fund for budgetary financing is in effect the same as printing money for this purpose, which has the potential to threaten the stability of the ruble. The good news is that with a better composition of the fiscal stimulus, Russia could achieve the same boost to domestic demand with lower fiscal deficits. To this end, the fiscal stimulus should enhance social safety nets, frontload infrastructure projects, and accelerate maintenance outlays. Also, in designing its short-term fiscal policy response, the government should keep in mind longer-term fiscal policy objectives; emphasizing self-reversing spending categories now would allow more flexibility in budget policies later. The more convincing the medium-term fiscal plans are, the stronger the fiscal boost will be today.

On the monetary policy side, the central bank is facing a balancing act. On the one hand, inflation is coming down, and may undershoot the target this year. Meanwhile, the ruble remains vulnerable to swings in oil prices, banks are still liquid, and the fiscal expansion may renew pressures. On balance, for the near term, the gradual relaxation of monetary policy envisaged by the CBR would seem appropriate. But, at the same time, there is clearly a need for careful implementation to avoid instability – while keeping an eye on capital flows, the exchange rate, and depositor confidence.

Finally, looking beyond the crisis, there is broad consensus on the need for Russia to achieve economic diversification. This would help Russia realize its economic potential and also make the country less vulnerable to the vagaries of financial and commodity markets. Diversifying would not necessarily mean an increase in hi-tech industries, but could equally well involve such sectors as light industry and tourism. For diversification to happen, however, Russia will need new investment. The reform agenda is well known; the priorities include roll-back of state control, easing of entry for new firms, reforms of the public sector, anti-corruption efforts, and WTO accession. While the commentary on Russia's medium-term policies tend to focus on these structural reforms, we should not lose sight of the macroeconomic foundations for balanced economic growth. In this perspective, both medium-term government budget policy and monetary policy come into focus.

First, medium-term budget policies. The central issue here is how Russia over time would best benefit from its natural resource wealth. One option would be to conservatively aim for a public spending level consistent with the income that the government will derive from petroleum over the long haul. Taking the 2009 budget as the starting point, this would require considerable restraint in government spending once the economy recovers, in turn underlining the urgency of moving forward with deep and comprehensive public sector reforms. Other options towards fiscal viability likewise entail large fiscal adjustments. Whichever option is pursued, conservative fiscal policies will preserve Russia's competitiveness and limit so-called Dutch Disease, helping avoid excessive reliance on natural resources. Such policies would also rebuild buffers, in the process restoring Russia's fiscal space and enhancing the credibility of budget policy.

The second important condition for achieving sustained growth – through higher domestic saving and investment - is to anchor inflation at a low and stable level. To this end, the eventual adoption of formal inflation targeting is the goal of the Russian authorities. The CBR has been making progress on the technical preparations for formal inflation targeting –

encouraging recent examples include more exchange rate flexibility, and issuance of public statements explaining interest rate decisions.

All told, Russia's economic policy response to the international crisis has helped preserve stability. This is a necessary first step towards the resumption of sustained growth, and the signs so far are encouraging. For the near term, the government's strategy on the banking and budget sides should aim to facilitate an early recovery and at the same time protect stability. Looking further ahead, Russia has vast economic potential - unleashing it will require a deliberate and broad economic strategy, encompassing sound macroeconomic policies alongside structural reforms..