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Research Note

Russia and the world financial crisis:
Impact, opportunities and risks.

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The present research note elaborates on various presentations made by Dr. Jacques SAPIR on the same topic, including one at the Russian-French Seminar at Vologda in December 2007, one before the Moskovskaya Shkola Ekonomiki's faculty also in December 2007 and one at the Troïka-Dialog organized RUSSIA-FORUM during the workshop on structured finance on January 31st, 2008.
This research note has much benefited from the statistical research done by Mrs. Tatiana SPERANSKAYA, currently PhD. Student at EHESS and Junior Fellow at CEMI-EHESS, as well as from various discussions with colleagues in France, United States, Germany and Russia.
The author bears alone responsibility for opinions here expressed and for mistakes this note could contain.

Russia and the world financial crisis:
Impact, opportunities and risks.

As the current world economic and banking crisis is spreading, threatening the US economy with recession, its impact on the Russian financial system is to be investigated. There is so far no indication that Russia could be directly threatened by this crisis. Indeed, Russian banks have not been involved in the Mortgage-Based Securities (MBS) trade, which developed thick and fast from 2001. The MBS trade, with its specific tools (CLOs and CDOs) has been instrumental in spreading what was at the very beginning a clear US economic and social crisis into a world financial crisis.
Indirect impact of this crisis on Russia could however take shape during spring 2008 most probably through the RR vs USD exchange rate. To maintain the fast growth path Russia is experiencing, a specific policy is to be implemented to shield Russia from the worst of the current world financial crisis. The current crisis is then presenting Russian authorities with opportunities but also risks. This paper focuses then on mechanisms behind the current crisis, how this last could affect the Russian economy and what macroeconomic and institutional responses could allow Russia to make the best of the current situation.

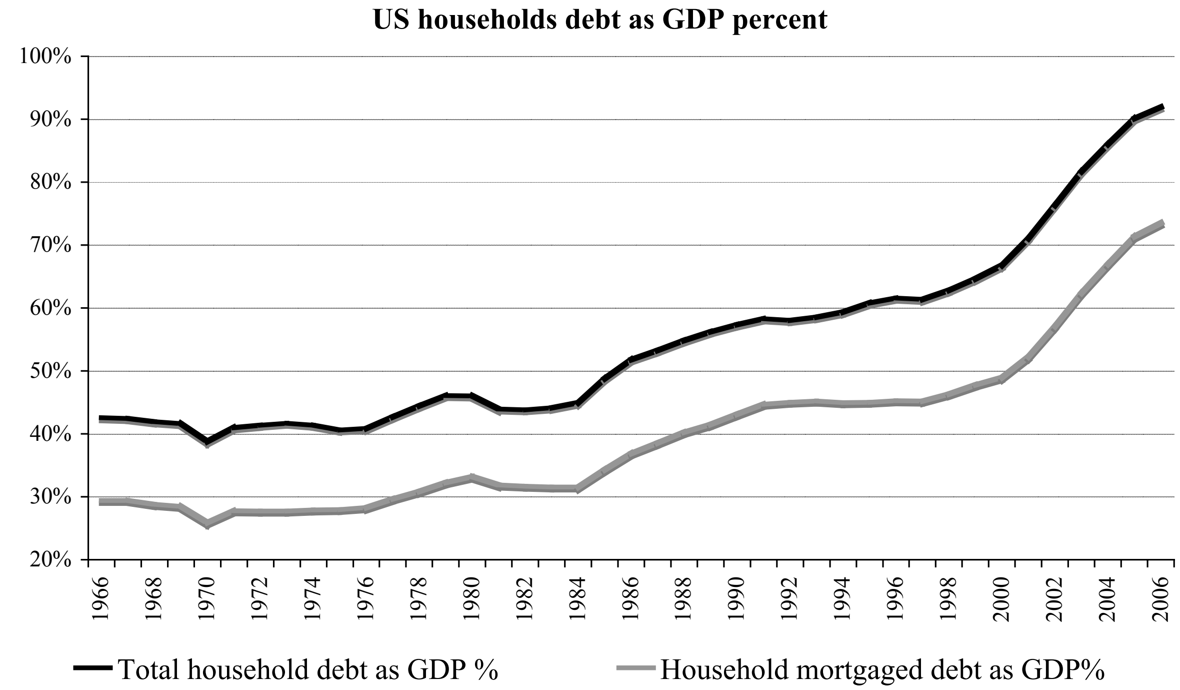
I. From the US Mortgage-market to a world financial crisis: securitization on the brink.

The current crisis began on the US mortgage-market when delinquencies and foreclosures on mortgaged loans began to multiply by winter 2006-2007. This has largely been the result of a mortgage lending policy, which has induced households in taking a much too heavy debt burden, through adjustable rate mortgage mechanisms (ARM) and the development of "special compartment" mortgages, that is *Subprime* and *Alt-A*. Between 2001 and 2006 not only households with incomes barely able to sustain a debt burden where enrolled in this system but more wealthy middle-class households began to use mortgage refinancing to raise money for other purposes (mostly to pay University fees). This created a credit bubble, which led to a regular rise in real-estate prices, making even more easy to get mortgaged loans and opening to middle-class households a speculative window (some households entering the ARM process in the hope they could re-sell the house before the planned rate hike and still make a large profit).

Subprime and *Alt "A"* had initially a relatively low share in the US Mortgage market. But Subprime and other "specials" developed thick and fast since 1998. Subprime loans were over 1300 billions USD by March 2007. They were at 150 Billions in 2001 and 600 Billions in 2005. As a result by 2007 *Subprime* were weighting as much as 15% of the mortgage market, with *Alt-"A"* mortgages at a similar level. The traditionally subsidised mortgage brokers *Fanny Mae* and *Freddie Mac* where still making more than 55% of mortgages, but this is a much lower ratio than in the 90's. So called "special compartments" have then been instrumental in the real-estate boom and the credit bubble.

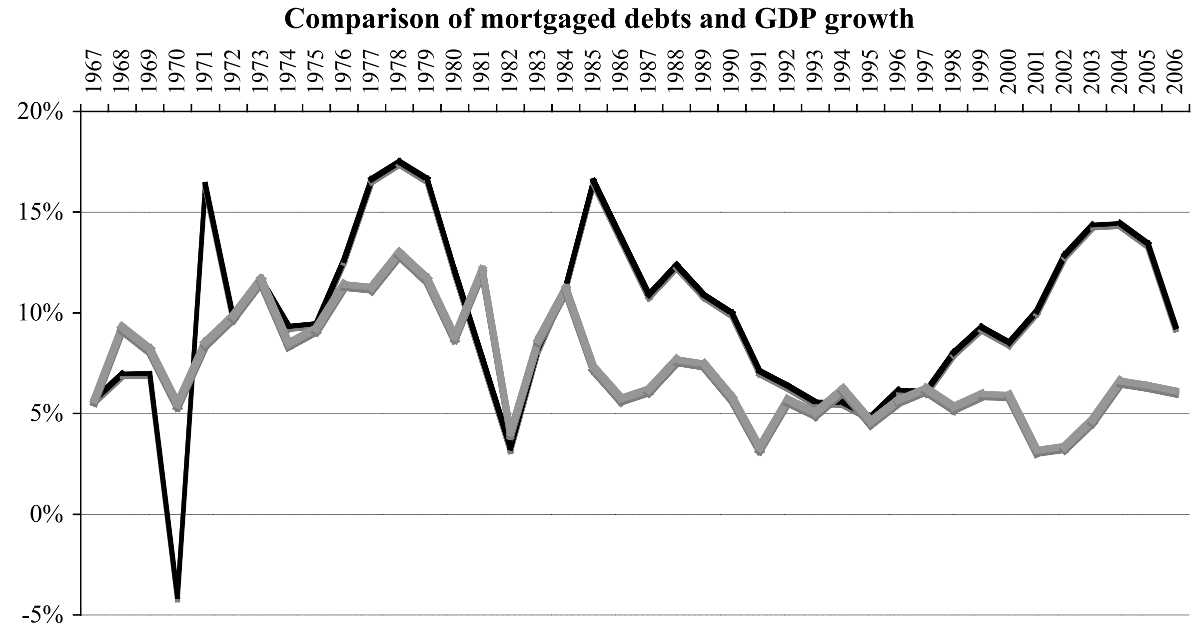
This is mostly the result of the conservative fiscal and income policy the Bush administration implemented, which dramatically curtailed "middle-class" income growth to the benefit of the wealthiest part of the US population. It has been computed that 0.1% of the population is earning 7% of the national income (the equivalent figure is 2% in France and Germany). As a result of Bush's administration conservative policies, if the *average* per capita income increased by around 3% a year from 2001 to 2007, the *median* per-capita income did not increase at all. This is a clear signal that US economy growth had been mostly captured by the upper-wealthiest part of the population (in France and Germany where growth had been much lower, the *median* per-capita income increased by 2% in the same period). Because of the relative impoverishment of the US middle class under the Bush's administration, credits were instrumental in sustaining the US economic growth from 2001 to 2007. But as a result the total household outstanding debt jumped from 61% to 94% of US GDP during the same period of time.

Figure 1



Source: NBER and US Joint Economic Committee.

Figure 2



Source: NBER

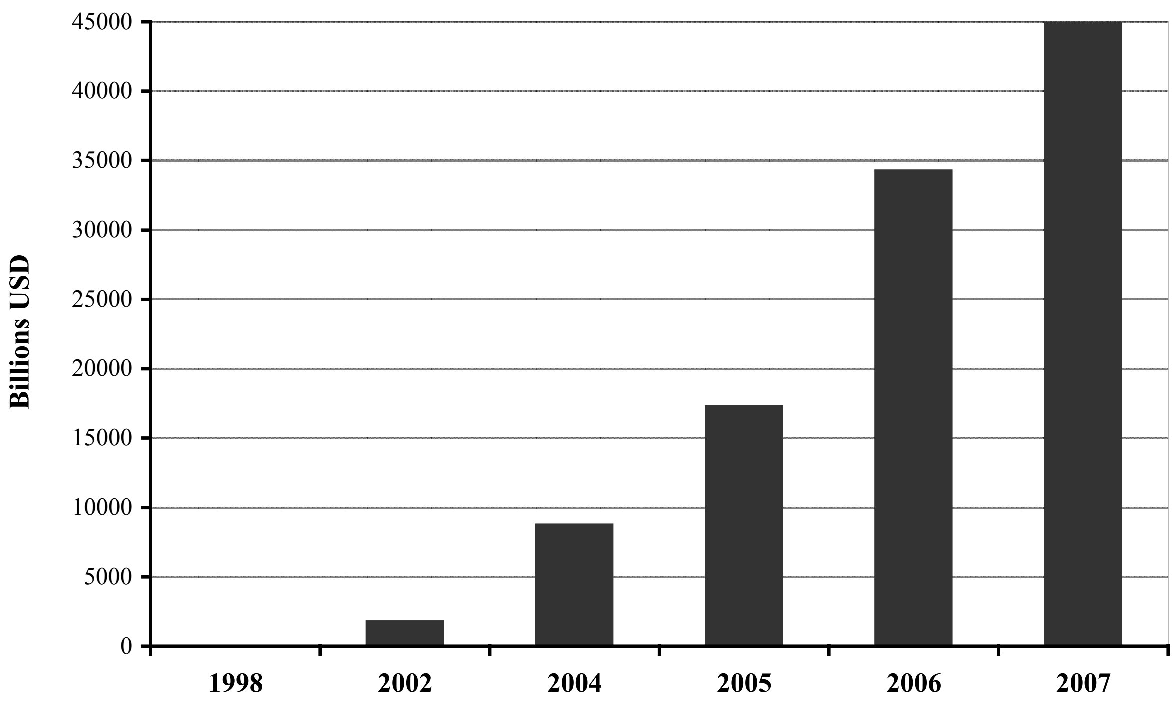
The up jump of US household debt after 2000 is a clear departure of the long-term trend as shown on figure 2. Movements of the mortgaged debt growth were clearly linked to the GDP growth in nominal value (including the inflation factor) till the mid-90's. The situation then changed dramatically and the household mortgaged debt exploded without a similar GDP growth movement.

The post 2000 credit-bubble had quickly dramatic consequences. First, credit leverage increased fast (reaching 99% of transaction amount by last quarter 2006). The adjustable rate mechanism implied that the interest rate burden would begin to be felt only 20 to 27 months after the mortgage loan had been issued. Prime delinquencies began to increase progressively and most of them ended in mortgage foreclosures, with households having to leave their houses and a significant increase of houses put on the market. Real-estate prices began to drop significantly, which destroyed the strategy of some middle-class owners who were expecting to sell their houses before the prime hike and make a profit on the real-estate prices growth.
As a result, defaulting increased steadily from early 2007 on. The reached nearly 16% of the outstanding *Subprime* portfolio by late 2007 and by late January 2008 we reached 24% of *Subprime* mortgages which were in delinquencies or in foreclosure. However, the impact of precipitous selling of houses, which was linked to the crisis in the *Subprime* compartment impacted on the whole mortgage industry. By late September 2007 nearly 4% of prime mortgages were delinquent or in foreclosures, which implies that in all *non-Subprime* compartments the average rate was 2% against a traditional 0.5% delinquent rate. By late January 2008 we reached 7.3% of all mortgaged loans, which implies that for all *non-Subprime* compartments, the rate of delinquencies and foreclosures had reached now 3.7% or nearly doubled till last September. This rate is seven times higher from what a "normal" rate of delinquency is expected on *non-Subprime* compartments.

The relevance of "special compartment" mortgages increased quickly because they were backed by a powerful string of financial derivatives. It is the "collateralization" process, which gave Subprime mortgages their relevance in the current crisis.

Figure 3

MBS issuing since 1998



Source: Joint Economic Committee.

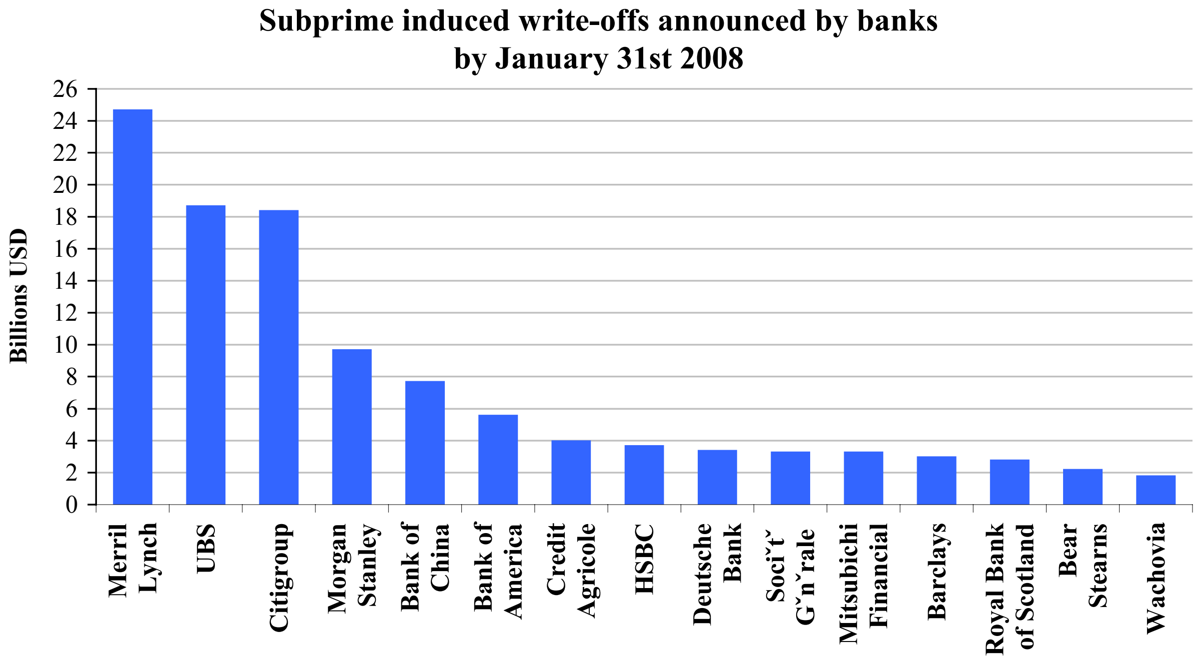
The current crisis began on the US mortgage market but spread quickly into the world banking sector because of the very fast (too fast) growth of MBS trade between 1998 and 2007 (figure 3). If there is nothing wrong theoretically in financial derivatives, the process of issuing "derivatives of derivatives" and even farther destroyed completely accountability and transparency of the process. The development of SPVs increased these problems. *Special Purpose Vehicles* have progressively supplanted banks in the MBS trade, but banks and insurance companies have been eager to buy securities with an higher than average rate of return even if it was becoming more and more difficult to assess what was the precise composition of collaterals.

The combination of a fast developing MBS trade and of very active SPVs had the result of infecting most of Western and Asian banks. The US crisis spread all around the world through a bank crisis. Since April 2007 several US banks have defaulted and one medium-sized British bank went bankrupt (*Northern Rock*).

Table 1
Initial bank failures in the USA in 2007

Bank	Field	Failure date
New Century Financial	Subprime Lender	April, 2nd 2007
American Home Mortgage	Idem.	August 6th 2007
Ameriquest	Idem	August 31st 2007
NetBank	Internet Bank	September 30th 2007

Figure 4



Source: Bloomberg and various Press agencies.

Banks at first were very reluctant to admit losses they suffered in the process and, from September 2007 up to February 2008 we are seeing a constant process of "surprise disclosure" and reluctant admission of losses significantly higher than previously foretold. This was adding its own element of uncertainty and dramatically impacted on the inter-bank monetary market. Elements of a generalized Credit Crunch began to manifest by October 2007 forcing central banks (the FED and the ECB) to significantly increase their short term liquidity supply.
By January 31st several banks have announced for more than 107 USD Billions of write-offs (Fig.4) including Merril Lynch (24 Billions), CityGroup (18 Billions), UBS (18 Billions), Morgan Stanley (9.5 Billions) and Bank of China (7.5 Billions). This is just the beginning as potential bank losses

could be as high as 250 USD Billions without including defaults in the credit-cards sector. On February 9th, 2008 the German Ministry of Finance warned that up to 400 Billions USD could have been lost in the *Subprime* crisis, of which between 50% to 55% for banks alone. Even this figure could be under the actual situation.

It is quite clear that we are far away to have seen the end of this crisis, the more so because mortgage defaults are to peak during 1st Quarter 2008 and households insolvencies is to spread on the credit cards market.
By early February 2008 it was announced that credit card companies were to write-off 5.4% of their prime card balances against 4.3% in January 2007[1]. More than 7.1% of loans related to personal vehicles and cars were in trouble against 6% by January 2007 and personal bankruptcy filings, which had significantly decreased after the 2005 Federal law making much harder for households to wipe out their debts, are again increasing significantly.
There is then no surprise that most analysts are now expecting the US economy to enter a recession by early spring 2008, the real issue being to know if it is to be a "mild" or "severe" depression. The FED acted strongly, moving interest rates from 4.25% to 3.0% in 10 days. This is probably to save most US banks and insurance companies but the FED is probably to lower again its rates as banks and insurances companies assets side is to suffer from both the downward turn in stock-markets and real-estate markets and the Basel-2 rules implementation (*mark to market*).

The crisis is now spreading both in Asia, Europe and possibly Latin America.
Some Asian banks (mostly Chinese and Japanese) have suffered significant losses in the MBS trade. This has depressed Asian stock markets. However foreign currency exchange reserves are so high in Asia-Pacific countries that the possibility of a major financial local crisis is quite remote. The financial situation is here much better than in 1997/98. Asian countries would be more affected by a strong depression in the USA because the US market is certainly a central place for their exports. However, would the US economy know a -3.5% depression (which would qualify as "severe") this would reduce the current Chinese growth from 11.5% to 6.0%. Would the US economy kwon a "mild" recession (with a -0.5% GDP result), the Chinese growth would go down from 11.5% to 10.0%/9.5%[2].
The situation is a bit different in Europe. The Euro-Zone is already suffering of low growth. An US recession would probably translate into a mild European recession or stagnation (from -2.0% to +0.5% according to the US recession severity). The main issue in Europe is however to possibility of a mirror mortgage crisis in Great-Britain and Spain. This country is certainly the most vulnerable to a real-estate market down turn. Real-estate prices have increased over 10% a year from 2001 to 2006. They are now decelerating extremely fast. Mortgage based securities have increased from 25 to 200 billions Euro between 2001 and 2006 and topped at 247 billions by 2007 third quarter. Spanish households solvency is decreasing fast. The average weight of yearly loan payments (prim and capital) was at 32% of the yearly average income. It jumped to 45% early 2007 and total Spanish household debt has reached 124% of GDP by fall 2007[3]. As Spanish banks are vulnerable to the current crisis and could also be weakened on their "internal front", Spain looks like the weakest link in Europe for 2008.
Because Spanish banks are extremely active in Latin America, a major crash in Spain could have serious results in this zone where FOREX reserves are relatively lower than in other emergent markets (but for Venezuela and Bolivia, which are standing much stronger than other countries from this point of view).

To sum up, the current crisis began as a crisis of the US economic and social policy, which directly resulted from Bush's administration conservative options. This crisis became a world one because of banks implication in the MBS trade and also because of the world financial market

[1] Moody's Economy.com
[2] Different scenarii are covered in Institute of International Finance, *Global Economic and Capital Market Forecasts*, Washington, January 2008, and by several East-Asian research institutes to which the writer had access late January 2008.
[3] Data from the quarterly bulletin of the Spanish Central Bank.

deregulation. This crisis is already having an impact on various economies. The crisis impact can then be traced to either a financial mechanism or a demand shock.

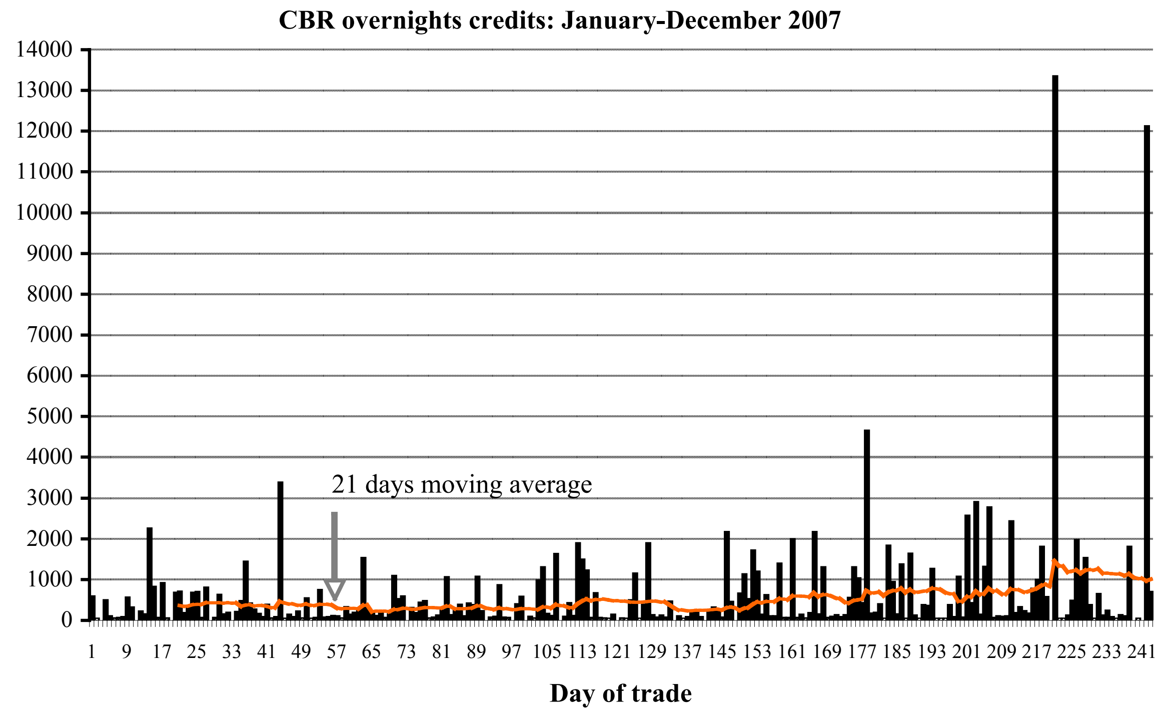
II. What impact of the world crisis on the Russian economy?

The world financial crisis happens at a time when the Russian economy is enjoying a particularly high growth (more than 8% for GDP and 10% for the manufacturing industrial sector). This crisi can impact on Russia's economy either through financial or "real-sector" links. Temporality is obviously not the same as a financial shock is generally moving at a much faster speed than a real sector demand one. This is an important point as far policy responses to a possible impact is concerned.
Another point to be highlighted is the fact the situation of Russia, but also of some other countries in East-Asia is radically different from the 1997-1998 crisis. Trying to relate the current situation with the previous financial crisis, as traumatic this one had been, would be a deep mistake.

A. Financial impact.

The current world financial crisis had so far only a very limited impact on the Russian banking system. This to some extent is a result of the so-called "backwardness" of Russian banks, which have not much played with advanced financial instruments.
The MBS trade has not affected Russian banks, because they were not very active in CDOs and CLOs. However a comprehensive study of year 2007 very short-term demands for liquidity (overnights) shows that the liquidity situation of Russian banks somewhat deteriorated after June 2007.
However, some liquidity shocks can be seen, mostly on the ultra-short credit market (overnights).

Figure 5



Central Bank of Russian Federation

Part of these fluctuations has been induced by the CBR policy. However, as Russian banks were also seeking some financing on the international markets, part of liquidity shocks described in figure 5 are the translation into the Russian system of the liquidity crunch Western banks were suffering.

A specific analysis of overnight movements shows that the average amount steadily increased after August 2007 and, even more significantly the amount of the maximal value increased nearly six fold as the number of trade days when a large overnight was called for increased significantly after June 2007.

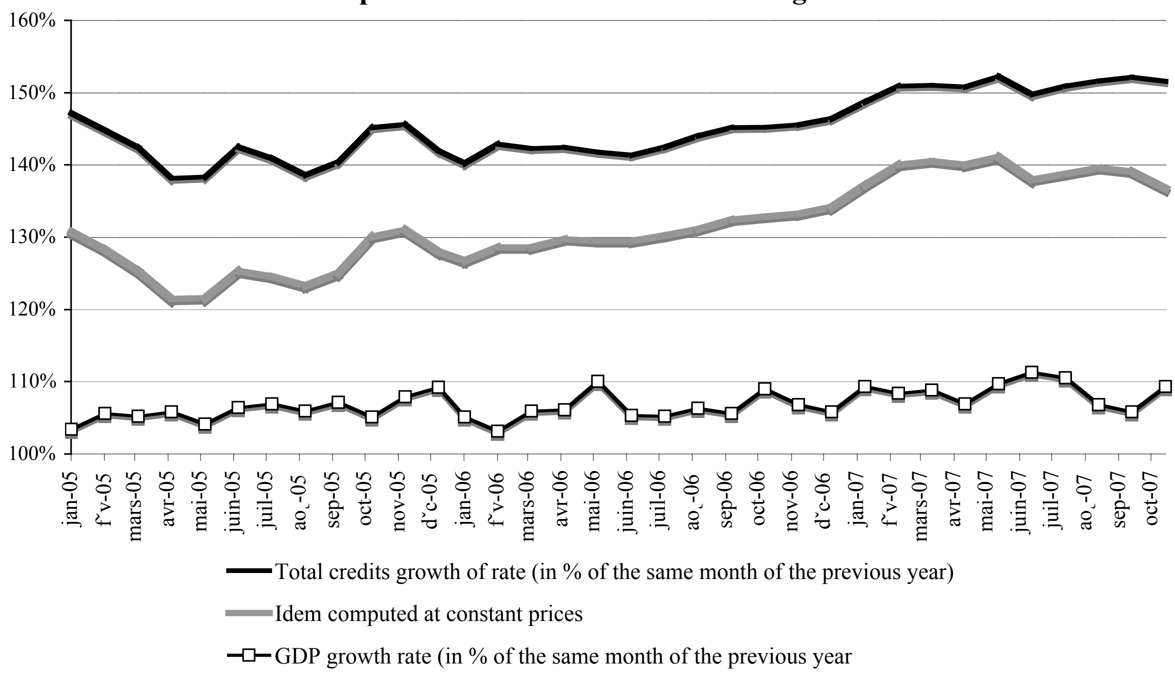
Table 2

2007	Average amount of overnight (Mln RR)	Maximum overnight amount (Mln RR)	Number of trade days in the month	Number of days where overnights exceeded 1 Bln RR
January	335.025	2222.60	16	**1**
February	330.787	879.46	19	**0**
March	369.257	3346.56	21	**2**
April	304.519	1495.16	20	**2**
May	263.567	1040.26	21	**2**
June	538.622	1858.68	20	**5**
July	236.365	1856.36	22	**2**
August	550.653	2133.06	23	**6**
September	631.182	4625.47	20	**4**
October	715.235	2871.30	23	**8**
November	1235.734	13310.18	21	**5**
December	1093.470	12090.58	17	**4**

This is a clear indication that the Russian financial system was impacted, even if marginally, by liquidity shortages happening in the wake of the world financial crisis. However, this had nearly no influence on the Russian credit situation. Lending to households and enterprises has increased at a faster rate than the GDP. However, since late spring 2007 one can see that this growth is stabilising and that its pace could even somewhat reduce.

Figure 6

Comparison bewteen credits and GDP growth



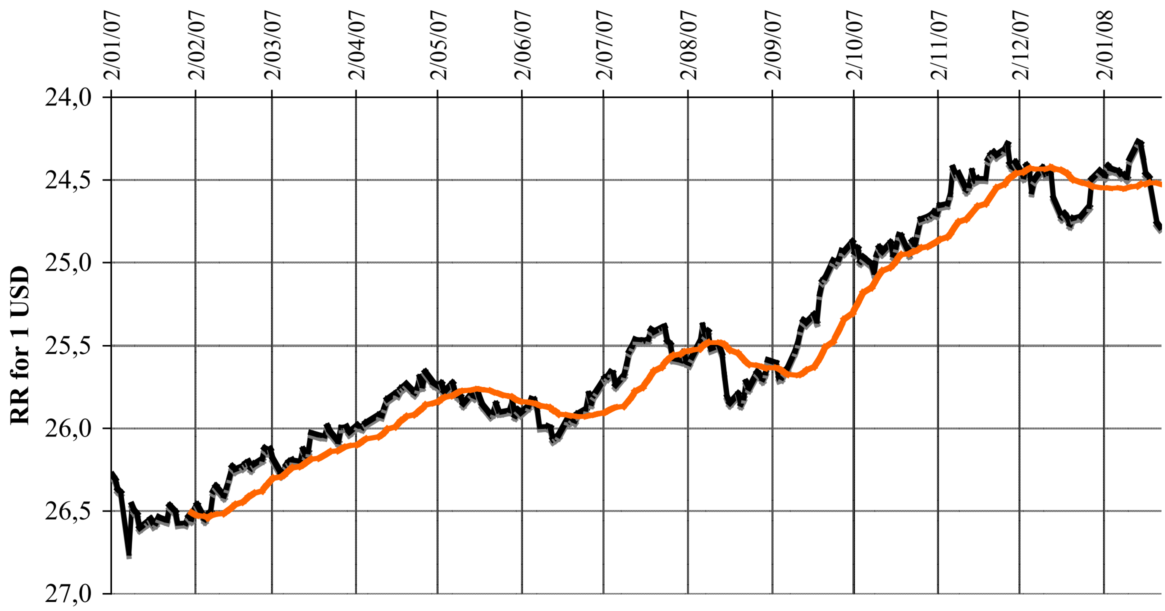
Source: Central Bank of the Russian Federation

The share of RR denominated credits has increased till early fall 2007 reaching more than 75% of all credits. The above noted increase in short-term demand for liquidity (overnights) does not seem to have affected in a significant way the Russian financial structure.
Paradoxically Russian banking system backwardness has shielded Russia's economy from the worst of the world crisis.
It is however important to note that lending relatively slowed down at the same time that inflation accelerated as it deed in most of European countries because a strong hike in agricultural commodity prices. This hints to structural and imported factors in the Russian inflation something one can see through the fact the CPI is closely following a seasonal curve.

If the world financial crisis does not seem to have significantly weakened Russian banks it had however a strong impact on the RR vs USD exchange rate both in nominal and actual terms.
The movement on the daily trade is here extremely interesting. The upward movement accelerated strongly after summer when news about bank bankruptcies in the USA began to spread out. The Russian Rouble gained more than 4% in two months. The process stopped early 2008 mostly because US and Asian banks, short of liquidity, were selling out their positions on the Moscow stock market as well as on other ones, and were repatriating amounts in the Dollar zone. This process is to go on for some weeks, and possibly till late March 2008. It explains losses suffered on the Moscow stock market. However, this process is in no way a defiance signal toward Russia but the simple result of difficulties US financial institutions have been facing till last December.
This is an important point to remember. So far RR exchange rate increase had been contained because Dollar Area based financial operators have repatriated gains they made in Russia to face losses suffered in the mortgage and MBS trade and also to comply with Basel-2 rules (*mark to market*). This situation is however not to endure for very long.
The combination of low US interest rates after last January 2008 FED decisions and prospects for a US economy recession, good profit ratio in Russia, political stability after March 2008 is to probably reverse short-term capital flow movements and induce a strong flow into Russia. This is a major difference with the 1997-1998 crisis scenario.

Figure 7

RR vs USD change rate
daily evolution

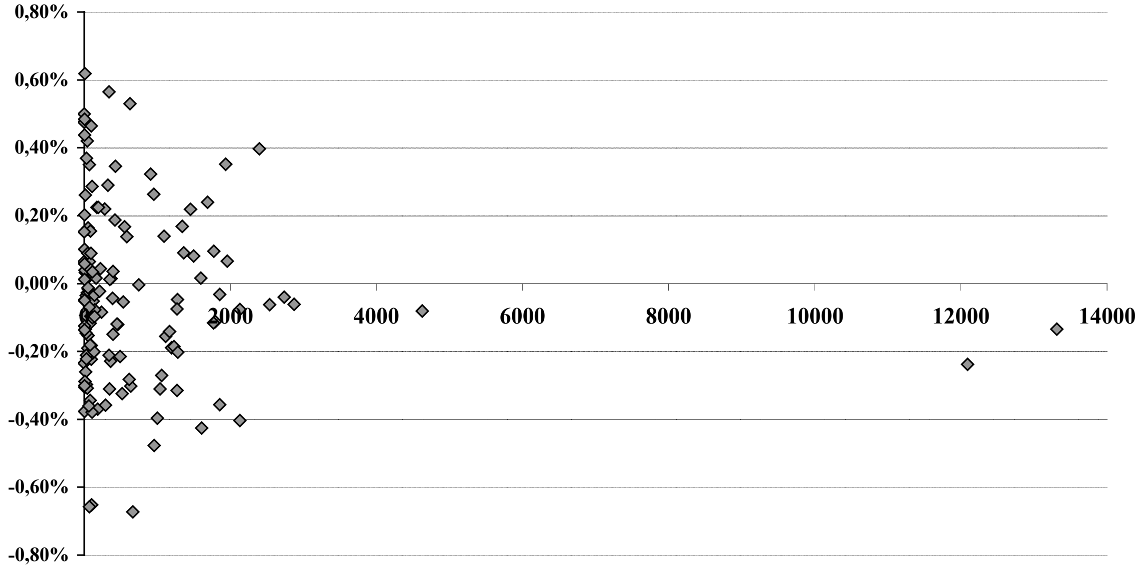


Trade days data and 22 days (one month) moving average.
Source: ECB daily data.

So far, and at least for 2007, it does not seem that Russian banks have speculated on the exchange market, and this is too another important difference with the 1997-1998 situation.

Figure 8

Relation between daily overnight movements and exchange rate movements (June-December 2007)



Source: Central Bank of Russian Federation and ECB.

There is no correlation between day-to-day spot variations of the RR vs USD exchange rate and day-to-day overnights (figure 8). However this is not to imply that such a speculation could not develop at the end of winter and by spring 2008. Nonetheless one can affirm that if Russian banks (and non-financial enterprises) have increased their borrowing on the international market during 2007 this was not linked to short term speculation.

As a concluding comment on a possible financial impact of the world crisis on the Russian economy it is important to remember that Banks (and financial markets) are so far playing a minor role in investment financing. Investment in Russia is mostly financed through enterprise profits (either as self-funded investment or through intra-group finance) and by public subsidies (Federal and local). This situation inherently reduces Russia direct exposure to a general financial crisis.

B. The real-sector, demand-shock impact.

Much concern has been displayed by various Russian authorities about a possible demand-shock induced by the world financial crisis, which could induce severe unbalance of the Russian economy. This point mostly focuses on world commodity prices, and above all on hydrocarbon prices.

If a generalized world recession is to have serious an impact on commodity demand and prices, to some extent this factor is currently overemphasized in the Russian debate for several reasons.

(i) Even if the US economy is to know a “severe” recession (that is -3.5% of GDP for 2008) its impact on other economies is to be less strong than usually assumed. Chinese growth could slow down from 11.0% to 6.0% and the Euro-Zone from 2.5% to 0%.

(ii) Even with a reduced growth, China and India demands for hydrocarbons are not to reduce significantly as structural inertia in both cases is very strong. The process of urbanization we are seeing in both countries induce an increase of the per-capita demand for hydrocarbon fuels.

(iii) Linked to (ii) is the fact we are seeing emerging "middle-classes" in most emerging countries. These populations have traditionally a quite high energy demand, with a strong bias for hydrocarbons (cars).

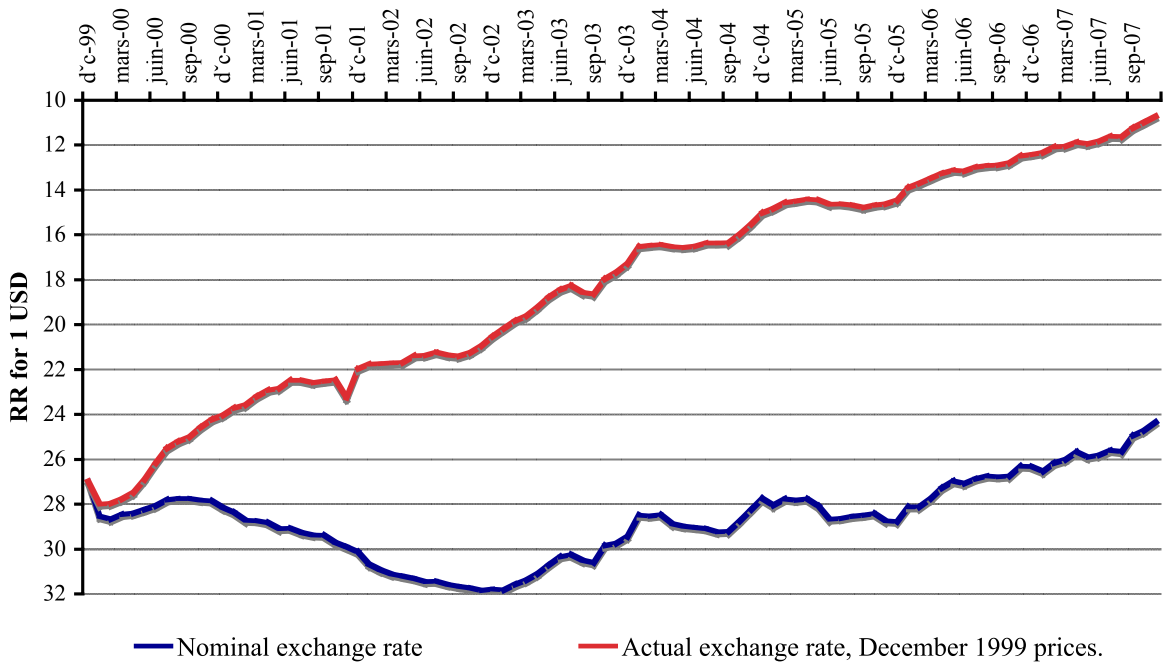
In the same time, one can expect that supply is still to be constrained in mid-term future. Most Oil fields have passed their *Hubbert's Pike* and have declining results. Investments in exploration but also in alternative energy sources have lagged behind schedules. The only alternative source where we could see important developments for the next 5 years is nuclear energy, a field where the Russian industry, through ROSATOM and TVEL' is quite well positioned.

There is then no substance in fears that the Oil Barrel price could go down for a significant time under 60 or even 70 USD. Actually, prices for future contracts during the first February 2008 decade were stabilizing at 89 USD for 6 months and 82 USD for 2 years.
A similar trend can be seen on other industrial commodities the Russian economy is exporting (Steel, Non-Ferrous metals).

If we look at the demand-shock issue from a mid-term perspective it is obvious that both China and India could substitute their own internal markets for a weakening US market. This transition could take between 12 to 18 months, but no more. In China the current "Olympic games Boom" is a powerful factor alleviating any slow down of the US demand.
Then, if East-Asian economies are not fully "uncoupled" with the US economy the extent of uncoupling is already quite important and is to significantly increase in the next 3 years.
The most threatening factor then for the Russian economy is not coming from a demand-shock induced by a major recession in Asia following the US recession in the USA, but a change-rate induced demand-shock similar to the one the Russian economy suffered in the 90's.

Figure 9

Nominal and actual exchange rates movement since December 1999



Source: ECB and CEMI-EHESS data base

Till early 2000 the Rouble has known a steady movement of actual change rate valuation against the US Dollar and the Euro. This movement has accelerated since late 2005 and then summer 2007 when

nominal change rate appreciation itself accelerated. This has been recently linked to the world financial crisis. Uncertainties about the US financial system have strongly played against the US dollar. As explained before, this process had been interrupted by the need for US Banks and investment companies to repatriate assets and make good losses suffered at home. This explain why in January 2008 we had a capital net outflow from Russia after a massive inflow during 2007.
<u>However this situation is clearly a provisional one and with low interest rates everything is pointing toward a very weak USD for months to come</u>.

Such a process is raising the prospect of a true demand-shock on the Russian economy through a massive loss of competitiveness. It could induce:

(i) Massive increase of imports to the detriment of Russia-based producers.
(ii) Strong decrease of the profit margin in manufacturing sectors inducing then a drop in internal investment as enterprise profits are funding a large part of Russian investments.
(iii) Fall of FDI in the manufacturing sector through a loss of competitiveness and a brutal drop in profit expectations.

If the crisis is to go on during 2008, and with the prospect of recession in the US economy, international investors are to target "emergent" markets and specifically ones called BRIC (Brazil-Russia-India-China).
However the Chinese banking system is highly non-transparent and could be affected by losses suffered on the MBS trade. Write-offs the Bank of China announced in January 2008 could be the harbinger of bad news to come. Brazil is far overvalued and India, if open to FDI has maintained some restrictions to the entry of portfolio investments. Russia could then well be a target for international speculators.
The recent Russian Central Bank decision to announce an increase of interest rates by March 1st, 2008 at a time when there are no hints that credits are accelerating has been extremely ill-advised in this context.
A growing short-term capital inflow is to be expected by spring 2008 and it could propel the RR up to a point it would be highly destructive for industry and FDI. Any Central Bank intervention on the FOREX market in this context is to be hugely expensive as far liquidity increase is concerned. Even if in 2007 Russian inflation was NOT mostly monetary, if the liquidity ratio is to increase on a quarterly basis by 15% against 5.9% as an average between 2001 and 2007, this could propel the CPI from 12% a year up to 18%.
Without a CBR intervention, the nominal interest rate could be up to 22 RR for 1 USD by end of spring 2008 and possibly higher (20 RR to 1 USD?) by summer 2008 with all its economic consequences.

To sum up, if there is no indication of a world crisis significant direct financial impact on Russia, so far vindicating Mr. Alexeï Kudrin's declaration in Davos-2008 that Russia is a "haven of stability" and if some highly dramatized assessments of a possible real-sector impact have been over-emphasized, it would be mistaken to think that Russia is absolutely safe from any negative consequences.
The exchange rate is the most probable transmission belt of a world crisis negative impact on the Russian economy. This could take place during spring 2008, with a brutal resumption of nominal exchange rate valuation. A speculative move of short-term *hot-money* toward Russia is not to be excluded the more so if we are to learn more bad news about US banks and financial institutions but also about East-Asian ones.
In this context the whole Russian economic strategy of economic diversification and high investment could be destroyed by a brutal loss of competitiveness. Then needed FDO would dry up and be replaced by highly volatile portfolio investments. At first this move could be seen as quite favourable as it would open up for Russian banks new prospects of expansion and the Moscow stock-market would probably significantly rebound. However mid-term consequences could be disastrous for economic growth sustainability and the trade balance could deteriorate quite quickly.

III. Russia and the world crisis: opportunities, risks and policies.

The current world crisis is confronting Russia with a new set of opportunities and risks. They are requiring some kind of economic policy responses to allow for opportunities to be exploited, risks to be contained and sustainable growth to become a long-term economic characteristic of Russia.

A. Opportunities.

As strange as it could seem this crisis, as any crisis, is also offering its share of opportunities. As a process of partial de-coupling between East-Asian economies and the US one is taking shape, Russia could become part of the de-coupling process and then become a regional "growth-leader".
Russia is already a prime-mover of growth for its immediate neighbours, Ukraine, Belarus, Moldova in the CIS, but also – and this is frequently overlooked – Finland, Hungary, Slovakia and Bulgaria in the EU. As the Euro-zone is probably to be quite stagnant for the next 18 months because of ECB asymmetrical pattern of reaction compared to the US FED, the impact of Russia's high growth on the Eastern part of the EU is to increase.

The most important growth factor in the Russian economy is the scope of productivity and effectiveness gains possible through investments in the manufacturing industrial sector and in infrastructures. Most Western industrial experts assume that productivity gains of up to 10% a year are possible for the next 5 to 7 years assuming that investments would specifically target innovation and manufacturing. Massive gains in energy efficiency are possible because the Russian industry is quite backward in this field. These gains would significantly lower production costs and in the same time increase the hydrocarbon export potential.
Would the economic policy target these points, sustainable high growth up to 9%-10% a year is absolutely into Russia's reach. The very prospect of such growth is to attract to Russia a significant amount of FDI in the manufacturing sector, as already experienced with investments done by Renault in the car-making sector or Alenia in the aerospace one.

Table 3
GDP growth scenarios for 2008

	US Economy	Euro-Zone	China	Other Asian economies
Mild recession	+0.5% / -1.0%	+1.5% / + 1.0%	+10.0% / +8.0%	+6.0% / +4.0%
"Severe" recession	-2.5% / -3.5%	+1.0% / -0.5%	+6.5% / +5.0%	+3.5% / +1.5%

Source: Estimates collected from an international expert panel between February 4th and 12th, 2008. For each scenario are given extreme and not average forecasts given by panel experts.

High sustained growth at a time when the US economy is to enter a recessive time and the Euro-zone a stagnant one would make Russia a key part of any European strategy aiming as benefiting of the "de-coupling" process to re-launch growth in Europe. Russia then would be well placed to engineer a true partnership with the EU, something which has been much talked about but without results.
Becoming a regional "growth-leader" Russia could certainly foster economic integration at the CIS level.

B. Risks.

However, all these opportunities could be lost would Russia lose its industrial competitiveness through unchecked exchange rate overvaluation.

To the contrary of what has been sometimes claimed what could slow down FDI in Russia is not its Foreign Policy but low profit expectations.
In a capitalist economy investments are directly linked to profit expectations. Institutional barriers, like a dysfunctional administration of a high corruption level are relevant if and only if we have already good profit expectations. If profit expectations are bad, even if the country had the most perfect administration and is corruption free, it would never attract FDI.
A fast increase of the Russian Rouble exchange rate during spring 2008 could destroy profit expectations currently made by Western and Asian companies about Russia. This is one of the main risk induced by the world financial crisis.

However a brutal inflow of speculative *hot-money* into Russia could have another deep reaching consequence. Making indebtedness easy it would induce a specific form of the *Dutch Disease* both among the Russian financial sector and the industry.
Russian banks, with an easy and relatively cheap access to liquidity could foster a credit bubble in Russia with possible dramatic consequences two or three years later. Russian companies, seeing production in Russia becoming less and less competitive but finding credit-raising easy, would enter an irrational process of massive outward expansion and would end heavily burdened with debts and with a highly inefficient structure after a row of mergers and acquisitions.

C. Policy options.

Economic policy for 2008 and 2009 is then to aim at limiting risks and create conditions for Russia to exploit opportunities the crisis is now opening.

The main threat as identified in section (II) of this paper is destabilization through the exchange rate after a massive *hot-money* inflow. In this context monetary and interest rates based policies are inadequate and not effective. Raising interest rates is just to make Russia even *more* attractive to *hot-money*.
Implementing provisional capital flow regulation targeting speculative capital inflows, as done by Chile in 1997-1999 would be a better option to walk through the world financial crisis without undue effect on Russian economy growth and development. To some extent the Central Bank is to regain some control on the FOREX market, may be by re-introducing the so-called “two-sessions” system, to avoid short-term movements to lead to a massive exchange rate overvaluation.

If too strong a regulation policy is seen a potentially damaging for Russia’s international economic status, then tariffs on non-food imported consumption goods are to be increased to protect internal producers against the effect of the change rate increase. Capital control regulations and a tariff policy are to a large extent complementary.

If preventing the RR to make too much gain against the USD and the Euro is an immediate necessity, a strong investment policy is also needed to make Russia able to reap benefits of the world crisis. It is important here to remember that there are strong complementarities between national investments and foreign direct ones and between investments in infrastructure and investments in the productive sector.
Foreign investors are always looking at resident investment behaviour as confidence vote in future prospects of a given economy. Investing in infrastructures creates always-strong positive externalities for private companies and here to this kind of investment is much looked at by potential foreign investors as a signal for them to invest.

Increasing public investments both in infrastructure and in the manufacturing sector would send a strong positive signal to Russian and Foreign private investors, assuming that Russia’s competitiveness is protected by a mix of capital flow regulations and possibly import tariffs.