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Revisiting Island of Stability

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It might seem that the current economic downturn will be a repeat of 2008. As that crisis was quickly spreading around the world in early 2008, Russian officials claimed that the country was an "island of stability." As a result, they did not believe that the global financial crisis would affect many in Russia. But the current crisis is the exact opposite. Now everyone is talking about the contagion, while the crisis might have minimal effect on Russia.

The 2011 crisis is fundamentally different from the 2008 crisis. Now, there is no shortage of liquidity on the markets, and the main problems are connected with excessive government borrowing. While politicians take steps intended to win the public's trust, economists increasingly realize the need to maintain an extremely loose monetary policy and allow inflation to increase to help restructure debt.

These economists are correct. The United States and Europe cannot extricate themselves from the current situation without accelerating inflation. By simply allowing prices to rise while maintaining near-zero interest rates, citizens can be induced to spend and companies to invest.

The inevitable convulsions of the stock markets will also be felt in Russia, of course, but as major currencies devalue, investors will favor commodities such as gold that provide some protection against shocks given their steady increase in price over the past 18 months. At the same time, the real sector will begin a steady recovery, although it might initially suffer some problems. Thus, the new crisis is unlikely to cause a drop in oil prices, the bedrock of Russia's economy.

At the same time, the possible outflow of investment from foreign currency markets in Europe and the United States does not threaten a substantial appreciation of the ruble. Unlike the Canadian and Australian dollar — not to mention the Swiss franc — the ruble has not risen in price as the dollar and euro have declined. Because it is not a convertible currency, the ruble does not attract speculators, even though Russia's economy depends more on raw materials than Australia or Canada.

What's more, the extremely high level of capital flight that hammered Russian markets in 2008-09 will likely not be repeated this time because a large portion of debt held by major private companies has been refinanced by the state. In addition, most investors who wanted to leave Russia have already done so.

The main risks for Russia are internal rather than external factors. First, Russia has not had to make budget cuts since the early 2000s. The government austerity measures that Western countries like Greece, United States and Britain face have never even been considered in Russia.

The economic stability achieved by Vladimir Putin during his decade in power allowed for budgetary expenditures to grow by 18 percent to 23 percent annually since 2000. But if Russia remains dependent on commodity exports, it will be unrealistic to maintain that path of growth in state expenditures over the next five to six years. Such growth would depend on oil prices being well above $110 a barrel, which looks like a long-shot now given the overall slowdown in economic growth.

Further, it can be expected that Russia will increase imports by 30 percent to 35 percent annually, even while export value will grow only 10 percent to 12 percent. This negative trade balance will likely continue to grow through 2014-15, even with all other factors being favorable. This will encourage growth in the country's national debt, and because Western countries will certainly find ways to lighten their debt burden in the coming years, the perceived risk of borrowing will decrease, sparking rapid growth in Russia's debt load.

All of these factors will make it possible for Russia's leaders to maintain a semblance of stability through 2018. Even if they are successful, however, Russia will emerge from this period being more dependent on commodities exports and less competitive in the global economy.

In five to seven years, the West will have resolved its current problems, and the energy efficiency measures it implemented in 2006-08 will have already started to shift the energy balance. When this happens, Russia will be faced with a major test, but thankfully for Putin and his circle that day of reckoning is still years away.

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