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Signs of an Island of Stability — for Now

By Martin Gilman

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Upon leaving Cannes this past weekend after two days of fruitless discussions at the Group of 20 Summit, President Dmitry Medvedev was no doubt in good company. Along with Chinese President Hu Jintao and U.S. President Barack Obama, they were all probably wondering why they had even bothered to come. As it turned out, the singular focus of the summit, chaired by French President Nicholas Sarkozy, was the sovereign debt crisis in the euro zone.

Instead of dealing with urgent issues to redress global imbalances that are fostering politically unsustainable levels of unemployment and dangers of recourse to trade and capital controls, the unfortunate non-European powers in attendance were put in the embarrassing position of being asked to contribute money to help forestall the contagion of the euro-zone crisis from Greece to Italy, Portugal and Spain. The assembled leaders failed to agree on even the easy issues such as increasing the resources of the International Monetary Fund, dashing the hopes of European governments keen to tap the world's new creditors to buttress their crisis-fighting efforts.

Put on the spot about his contribution, Medvedev, like his Chinese counterpart, did say money could be considered later, once the Europeans have implemented a credible plan to resolve the euro-zone crisis.

Prior to the G20 meeting of finance ministers, scheduled for February, the Russian leadership should perhaps refocus its attention on a smaller group of like-minded creditor countries that share a common interest in protecting their assets. Russia should take the lead. Medvedev laid down the appropriate marker at Cannes by noting that the BRICS nations of Brazil, Russia, India, China and South Africa expect more voting rights at the IMF in exchange for their support.

Fortunately for Russia, the inconclusive meetings in Cannes entail no immediate risks — at least in the short-run.

Lost in the Greek tragedy and the subsequent flight to safety to U.S. dollar assets, Russia's performance has continued to improve. Despite growing pessimism over the prospects of the global economy, the most recent statistics suggest that growth remains robust in Russia. The Economic Development Ministry has raised its estimate for third-quarter 2011 real gross domestic product growth to 5.1 percent. Moreover, according to Troika Dialog, there is increasing evidence that growth has been stronger than officially reported, especially earlier in the year and even in 2010. The numbers for some sectors have just recently been revised upward such as construction, investment and wholesale trade, though the aggregate national accounts remain unrevised and puzzling.

From the perspective of the G20, one of the main economic policy concerns is unemployment. In Russia, the monthly unemployment rate decreased further to 6 percent in September, from 6.6 percent a year earlier and 7.6 percent in September 2009. Meanwhile, gross monthly wages are growing by 14 percent this year, which means that, even after average annual inflation of just over 7 percent, there is a real gain of around 7 percent. With real disposable income buoyant, it is not surprising that retail sales recorded a 9.2 percent real increase in September over a year earlier.

Another main concern globally is whether there is a banking sector that can support this growth. In Russia, both the supply side and the demand side of the banking sector look benign relative to many other countries. On the supply side, the country's banking sector actually does not have any net foreign financing. Commercial banks on the whole are actually net creditors to the rest of the world, unlike many banks in the Baltic states or Eastern Europe that have to worry about refinancing wholesale funding or shrinking their balance sheets. Furthermore, because household income is actually growing rapidly, Russia also has strong growth in bank deposits — so strong that the savings rate has moved to record levels.

On the demand side, Central Bank data show that retail and corporate loan growth has recovered from the impact of the early 2009 global crisis.

In terms of the sustainability of growth, a third issue in many countries — especially in Europe, Japan and the United States — is the fear that budgets will have to be curtailed because public finances are inherently unsustainable. But this is not the case in Russia; at least not while oil prices are high. Most important, there are no spending cuts. Government expenditures have increased during 2011, and this has provided crucial support for the economy. As a whole, the expected balanced budget for the year is driven by higher-than-expected revenues and is a sign of robust growth.

Since Russia has less than 10 percent of GDP of public foreign debt and more than $500 billion in foreign exchange reserves, of which $140 billion are in sovereign funds, it does not have any problem financing itself. From a classic sustainability perspective, there is no need for concern.

On the whole, macroeconomic performance is strong, and growth is reasonable in the short-run. Thus, annual GDP growth could easily reach 4.5 percent or higher this year.

If the political leadership is prepared to slash budgetary spending should oil prices start to slump, the country's financial future will be still be in better shape than many other countries. In any event, its relatively robust growth will serve as a modest driver of the global economy.

The risk is that Russia's politicians may succumb to the usual temptation to bloat spending, as if high oil prices were a permanent and stable feature of the global economy. This is the country's Achilles' heel in the medium term. Understandably, both Russian and foreign investors view the country as risky from a macroeconomic standpoint — not to mention the country's other institutional weaknesses, such as substandard rule of law, poor protection of property rights and the general weak legal framework.

Some tough political decisions after the elections will be needed to control budgetary spending, and the country's future prospects will depend more than ever on structural measures to diversify the economy away from its high dependence on natural resource exports. Membership in the World Trade Organization should support this process.

Russians may not appreciate it yet, but they are enjoying a sweet spot, which stands in sharp contrast to the immediate austerity and decline facing Greece and other heavily indebted countries.

Martin Gilman, a former senior representative of the International Monetary Fund in Russia, is a professor at the Higher School of Economics.