

Russia's 'Island of Stability' Could Sink Again

By [Martin Gilman](#)

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It is unlikely that anyone who follows the news is unaware that the global economy has entered “a dangerous new phase” as Christine Lagarde, the managing director of the International Monetary Fund, stressed last month. World financial markets have displayed a schizophrenic reaction. They cannot seem to figure out whether the global economy, after an indecisive summer pause, is on the road to a gradual, albeit uneven, recovery, or whether it is on the verge of a new downturn, perhaps even more devastating than the great recession of three years ago.

At this inflection point, the markets just cannot decide whether the global economy is proceeding with a smooth rebalancing of accumulated debt and payments problems, or whether now the risk is of an abrupt contraction in global liquidity, a sharply rising risk premium, substantial deleveraging and a sharp contraction in international trade and capital imbalances.

If we are truly honest about it, no one really knows. Even the best experts express divergent views, grasping whatever data tend to support their often preconceived arguments. To play it safe, some have argued for a broad range of possible outcomes — for example, the IMF when it published its biannual world economic outlook on Sept. 20. If we judge by the last three weeks, it would seem that even the bottom of the IMF's range may be too optimistic. But, in reality, it is unclear when — within weeks or, indeed, months — we will have a clearer idea of what the outcome will be.

In the meantime, most of us proceed as John Maynard Keynes described in the atypical Chapter 12 of his “General Theory of Employment, Interest and Money,” which observes that human behavior, notably in financial decisions, tends to follow the conventional wisdom. That is, we assume at least implicitly that the past and current trends will continue for the indefinite future unless there is some obvious reason to change.

We can see this assumption being played out as we watch world leaders, from U.S. President Barack Obama to German Chancellor Angela Merkel and French President Nicolas Sarkozy, trying to provide reassurances about economic prospects. But British Prime Minister David Cameron warned more menacingly that time is short for the euro zone, which has just weeks to avert disaster, according to Monday's Financial Times.

Prime Minister Vladimir Putin certainly tried to appear optimistic last week at the VTB investment conference. Although acknowledging that there is “uncertainty over the prospects of the global economy,” Putin said he does not think a second wave of crisis is possible and that Russia is prepared for any global economic development scenarios. He also called for taking “well thought-out measures” to prevent a new recession.

At the same conference, Central Bank First Deputy Chairman Alexei Ulyukayev also sought to reassure investors that Russia was in a better position to resist adverse consequences should the world economy start to slow down further. He noted that the economy is currently facing a correction as it “has entered a new macroeconomic reality” based on lower growth rates. In contrast, Ulyukayev said, the previous crisis in 2008 arose from an overheated global economy, which is no longer the case.

Attempts to boost confidence are necessary to counter the pervasive pessimism of many economists, analysts and consumers, but such attempts may not stimulate risk taking by themselves. It may take more than encouraging words to prompt business to invest and hire. In other words, pessimism can feed on itself. It certainly seems that the global picture is getting worse, and there may be signs of a “perfect storm” combination: a euro-zone debt crisis, a possibly long period of stagnation in the United States, a slowing Chinese economy, consumers not spending in an effort to save and pay down debt and companies hoarding cash rather spending.

Not surprisingly, the RTS stock index has been hit harder than elsewhere in the world, and the ruble has declined against the dollar as the Central Bank had to intervene to offset substantial capital outflows. But investors are avoiding Russia despite the fact that the country's balance sheet is in much better shape than was the case in 2008 and is in a much better position than most advanced economies. Russia's sovereign debt is less than 9 percent of gross domestic

product. Even its total debt, including the private sector, is fully covered by the value of foreign-exchange and gold reserves. Its economic performance has been at least on a par with Brazil and India, according to recent analysis by UBS investment bank.

The fear among Russian and foreign investors alike is that despite a relatively robust performance so far, the high level of budget spending, as underscored by former Finance Minister Alexei Kudrin more than two weeks ago, and the budget's reliance on energy taxation for 60 percent of its revenue could quickly deteriorate if a gloomier world outlook prevails in the period ahead. It is this excessive budgetary dependence on oil prices that differentiates Russia from most other countries. Understandably, global markets view the country as riskier from a macroeconomic standpoint, not to mention issues such as lack of rule of law, poor property rights and an unpredictable legal framework. And who is to say that they are not right?

At last week's VTB conference, Putin said the government prediction that oil would stay at the level of at least \$100 per barrel next year is a "conservative" assumption, even as the global economy slowed down. But perhaps Putin should be reminded that three years ago, oil prices plummeted from a peak of \$144 per barrel in July to \$34 per barrel by late December.

Already Citibank is projecting Brent oil at an average price of \$86 per barrel next year. With a break-even price of about \$115 per barrel, the budget is vulnerable. Fortunately, during Kudrin's time, a part of the oil income was set aside and could be drawn down if needed — but only for a year or so. After this, it is assumed that superfluous spending would have to be cut. But that might be Russia's blessing in disguise. It may be the only path to restore growth while shedding the corrupt superstructure of the state.

After all, when Russia was delivering average annual growth rates of 7 percent from 2003 to 2005, the oil price was only \$37 per barrel.

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