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The Russian economy in 2009: Steep decline despite crisis management

Susanne Oxenstierna

Cover Photo: Scanpix. President Dmitry Medvedev and Prime Minister Vladimir Putin skiing outside the Black Sea resort of Sochi on 4 January 2009.

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Sammanfattning

Trots kraftfulla antikrisåtgärder kommer Rysslands BNP att falla med drygt 8 procent 2009. Minskningen utgör ett trendbrott mot närmare ett decenniums tillväxt med i medeltal 7 procent per år. Budgetunderskottet 2009 uppskattas till 8,9 procent av BNP och den federala budgeten förväntas gå med underskott till 2012.

Den främsta konsekvensen av den ekonomiska krisen är nedgången i levnadsstandarden och ökningen av antalet fattiga i Ryssland. Under 2009 beräknas antalet fattiga öka till 25 miljoner personer och fattigdomskvoten blir enligt Världsbanken 17,4 procent.

Militärutgifterna via Försvarsministeriet har minskats med över 10 procent i löpande priser och det är endast poster som avser internationella åtagande som har ökats. Det militärindustriella komplexet har prioriterats i antikrisåtgärderna och dess företag har fått subventioner för att klara krisen. Regeringen har också gett företagen nytt kapital. Trots dessa åtgärder är resultaten magra. President Medvedev har kritiserat det militärindustriella komplexet och sagt att de måste börja producera moderna vapen av hög kvalitet till lägre priser. Stora delar av det militärindustriella komplexet skulle behöva läggas ned eftersom teknologin härrör från Sovjettiden och inte kan användas i produktion av moderna vapen och vapensystem.

Antikrisprogrammet har kritiserats från olika håll för att det gett stöd till de stora gamla sovjetiska företagen utan konkurrenskraft istället för att satsa på små och medelstora företag. Regeringen har inte använt infrastrukturprojekt i sin krishantering och saknar helt en politik för strukturomvandling.

I sitt program *Framåt Ryssland!* lägger President Medvedev fram sin vision för Rysslands utveckling inom de närmaste decennierna. Han vill se en intellektuell utveckling där högteknologisk industri är ledande. Det största hindret för moderniseringen är den privilegierade nomenklatura som tjänar på nuvarande system.

Fortsatt integration i den globala ekonomin är avgörande för Rysslands fortsatta ekonomiska utveckling. Ett WTO-inträde skulle tvinga Ryssland att bli konkurrenskraftigt och följa gängse lagar och avtal. Men det ska noteras att bättre eller sämre politiska relationer med Väst inte är direkt korrelerade med hög eller låg tillväxt. Sedan 1991 har vi kunnat konstatera att Ryssland är mer benäget att genomföra ekonomiska reformer när ekonomin gått dåligt. Vad som skulle kunna generera genomgripande demokratiska reformer är en annan och fortfarande öppen fråga.

Nyckelord: Ekonomisk tillväxt, Ryssland, finansiell kris, arbetslöshet, levnadsstandard, militära utgifter, militärindustriella komplexet, modernisering, strukturomvandling.

Summary

Despite a massive anti-crisis programme, Russian GDP will drop by around 8 percent in 2009. This steep decline stands in sharp contrast to the average annual growth in GDP of 7 percent observed during the early 2000s. The budget deficit for 2009 is estimated at 8.9 percent of GDP and an underbalanced budget is expected up to 2012.

The most serious consequence of the economic crisis is the drop in living standard and increase in the number of poor people in Russia. By the end of 2009, Russia will have almost 25 million poor and a poverty rate of 17.4 percent.

National defence was cut by over 10 percent by the anti-crisis programme, and among its budget lines it is only those linked to international commitments that have been increased quite substantially. The companies of the military industrial complex are among the priority companies that have received substantial support from the government. The government has also pumped new capital into several strategic companies, but despite substantial support the results are meagre. President Medvedev has severely criticised the military companies and indicated that they must start producing contemporary arms of high quality at lower prices. Large sections of the military industrial complex need to be scrapped, since the technology dates from Soviet times and cannot produce contemporary arms.

The anti-crisis programme has been criticised for giving huge support to large uncompetitive Soviet-type companies and not to small and medium sized companies. The programme has largely been geared at labour hoarding and keeping unemployment down. The government has not embarked on infrastructure projects to create public works and lacks policies for enhancing structural change.

In his programme *Russia go!* President Medvedev suggests that during the coming decade Russia should become a country with its wellbeing largely provided by intellectual resources. Sectors to be developed include the pharmaceutical industry, nuclear power, nano-techniques and IT. The major impediment to real modernisation in the Russian economy and society is the rent-seeking *nomenklatura*.

Further integration into the global economy is a crucial element for success in Russia's future economic development. By joining the WTO Russia must become more competitive and follow common rules. It should be noted, however, that both high growth and low growth might be related to better or worse political relations with the West. On the evidence since 1991, it can be concluded that Russia has more drive in its economic reforms when the economy is weak. The potential trigger for serious democratic reforms is a different matter and remains an open question.

Keywords: Economic growth, Russia, financial crisis, unemployment, living standard, military spending, military industrial complex, modernisation, structural change.

Preface

When the financial crisis first started in the U.S., Russia appeared convinced it would not spread as far as to Moscow. With time, it became obvious that Russia would be hard hit and then no least by the falling oil price. At first, Russia concentrated its efforts on acute crisis management in terms of injecting much-needed funds in its financial system. However, the financial crisis developed into an economic one and Russia faced having to manage a budget deficit for the first time since Putin came to power. The crisis also exposed the hazards of being an economy that is heavily dependent on the price of energy on the international market.

In this report, Susanne Oxenstierna, senior researcher at FOI, analyses the effects of the crisis on Russia's economy as well as the measures taken so far by the Russian leadership to combat the crisis and find ways of modernising Russia's economy. She reaches the conclusion that so far, little has been done to prioritise sectors other than large industries and that one of the most troubling effects of the crisis so far has been the increasing level of poverty. She also assesses the impact of the crisis on the defence budget and the military industrial complex. In her analysis, the defence budget has contracted, but at the same time defence spending constitutes a growing share of GDP. The military industrial complex continues to be prioritised, while Russia's economic base to support it has become smaller. These factors will all have serious implications for the possibilities of modernising Russia's economy and, thus, for Russia's future development overall.

The report has been written within the project on Russian Foreign, Defence and Security Policy (RUFS) at FOI, which is financed by the Swedish Ministry of Defence. The RUFS Project aims to study Russia's military development in a very broad context, where the economic base plays a vital role.

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Head of the RUFS Project at FOI

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1 Introduction¹

After the collapse in 1998, the Russian economy emerged as one of the major rising economies in the world. During the 2000s, Russian economic growth was spectacular, around 7 percent per year. According to the International Monetary Fund (IMF, 2008), Russia is the eighth largest economy in the world, measured by GDP in current dollars. If GDP is measured in purchasing power parity (PPP), Russia is already the sixth largest economy. Among the BRICs², Russia has the highest per capita income – \$12,000 in current dollars and \$16 000 in PPP terms. In the country's economic strategy up to 2020, the goal was to raise GDP per capita to \$ 30 000 in 2020 – i.e. from the present 25 percent of the US level to 50 percent.³

In autumn 2008, however, the Russian financial sector was overleveraged and the Russian economy was seriously affected by the worldwide financial crisis. Russia's corporate sector had a huge, mostly short-term, debt of almost \$500 billion (bn) to foreign creditors that had to be refinanced. The oil price plummeted from \$147 per barrel in July 2008 to \$35 at the end of the year and demand for natural gas shrank due to the declining world demand. Investors withdrew from important investment projects and the stock market fell by 80 percent. Thus, very soon the problems were not limited to the financial sector but affected the real economy, with falling production and rising unemployment as a result.

In Russia the crisis has brought a serious negative turnaround in economic development that was extraordinary for almost a decade. The fall in the oil price, which had been a driving force behind the exceptional growth, has affected export and federal revenues. Oil and gas had accounted for 18 percent of Russia's GDP, around 60 percent of Russia's exports and 50 percent of revenues to the federal budget (Åslund & Kuchins, 2009, p. 43).

The credit crunch that precipitated and followed the debt crisis affected the whole economy in 2009 and economic activity dropped considerably in all sectors. In response, the Russian government launched an anti-crisis programme mainly involving huge state subsidies to major business corporations, substantially increasing the role of

¹ I am most obliged to the project leader of RUFSS, Dr Carolina Vendil Pallin, and all my project colleagues at FOI for their support during the work on this paper. Dr Torbjörn Becker, director of SITE at Stockholm School of Economics, provided me with most valuable remarks and suggestions on how to develop the paper at a FOI seminar on 12 November 2009. I am grateful for comments from Professor Silvana Malle, Verona University and Dr Carol Scott Leonard, Regional Studies of the Post-Communist States, Oxford University. Dr Vasily Zatsypin, from the Institute for the Economy in Transition in Moscow, helped me get some important figures right. I am also indebted to Fredrik Westerlund, Jan Leijonhielm, Ann Mari Sätre, Eva Mittermaier and Ingmar Oldberg for detailed comments on the text. I am grateful to Mary McAfee for having improved my English. All remaining views and errors are my own.

² The acronym BRIC refers to the emerging economies Brazil, Russia, India and China.

³ For a clear analysis of the economic development up to the present crisis see Åslund & Kuchins, 2009, particularly Ch. 3.

the state in the economy. Government subsidies to the business sector have increased from around 18 percent of GDP to over 25 percent during 2009.

In June 2009, the World Bank (2009a) estimated that world output would decline by 2.9 percent in 2009 and that Russia's GDP would contract by 7.9 percent. In November 2009 that forecast worsened to -8.7 percent. What began as a financial crisis in the United States in 2007 has evolved into a serious worldwide economic crisis affecting production, employment and living standard everywhere. Since August 2009, however, there have been some signs of a turnaround in major economies. Some of the BRICs might experience an early recovery.

The initial financial crisis was not the first in recent years, but it appears that it is more global and more serious than the crises in the 1990s. The Swedish Central Bank calls the crisis 'the worst crisis in the world economy since World War II' (Riksbanken, 2009, p. 2). The recurrence of such crises and their repercussions on the real economy have raised questions regarding what can be done to avoid them and how to make the global financial system more stable. In September 2009, the EU27 decided to impose stricter rules on the financial sector, in particular regarding the bonuses that enhance short-term risk-taking.

For Russia, the crisis and its aftermath mean that a new era of economic development will emerge. After having rested quite comfortably on an economic development conditioned by rents from hydrocarbon exports, the leadership must make new decisions on how to develop the economy: Will Russia remain mainly a commodity exporter and be dependent on the oil price for its development? Alternatively, is it through innovations and technical change that the economy will recover? The government has proposed innovative programmes of growth but if the country is going to diversify its production and export, which has been proposed in several government documents, how is this diversification to be achieved? Prime Minister Putin's idea appears to be that innovations are best stimulated in a centralised process and that they will emerge in huge state-controlled corporations. However, Russia could start a new round of economic reforms and develop its market economy from the aspects of competition, rule of law, private ownership and more democracy. President Medvedev's recent public proposals and his latest address to the Federal Council on 12 November indicate that he, and probably others, have a vision of a developed Russia through modernisation in all societal fields during the next decade.

Official crisis management in 2008-2009 has favoured state-prioritised sectors and companies, such as the military industrial complex. High priority companies with huge debts have been bailed out, which is a continuation of the soft budget constraint that prevailed during Soviet times, while small and medium-sized private sector companies have not been supported in these difficult times.

President Medvedev has strongly emphasised the goal of increasing the living standard of the population, a goal that demands a strategy of growth as opposed to a passive

reliance on the oil price. He has also announced that corruption must be fought and that the rule of law should be implemented in Russia as elsewhere. Reforms in these areas are vital for economic growth. The legitimacy of the present regime has largely rested on strong economic growth and increased prosperity for all parts of Russian society (even if there are certain parts that have seriously enriched themselves). If the government cannot deliver material welfare, it could lose its popular support and the population might reconsider the present social contract.

1.1 Purpose

The primary purpose of this paper is to describe the causes and development of the financial and economic crisis in Russia and to discuss its implications for future economic development in Russia. The macroeconomic development in 2009 and the consequences for the federal budget for 2009-2010 are analysed, as well as the repercussions on the military budget and military industrial complex. The paper presents and discusses the anti-crisis measures introduced by the Russian government in 2008 and 2009. It also looks at possible future developments in light of President Medvedev's proposals during autumn 2009 and provides some comments regarding the implications for EU-Russian relations. A secondary purpose of the study is to examine some general elements of the financial sector and financial crises during the transition.

1.2 Method

In general, critical appraisal of Russian and international sources is used to form a holistic picture of Russian economic development. This method, used widely by scholars studying Russia and other former Soviet republics, has been adopted in the publications of the FOI RUF⁴ project since the 1990s. For the analysis of the financial sector and crisis, mainstream financial analyses presented by the IMF and BIS (Bank of International Settlements) is taken as a starting point. The analysis of the effects on the real economy and the fiscal response follows standard macroeconomic theory and comparative economic systems approach when appropriate. In the analysis of the crisis program, the point of reference has been the original 2009 federal budget in order to reflect the changes in political intention over the year.

1.3 Limitations

This study was carried out during a period of time when the subject area was undergoing sweeping changes and developments. The collection of materials and facts used in this study started in June 2009 and finished on 15 November 2009, and as a rule events occurring after the latter date are not covered or taken into account.

⁴ The main project on Russia and the CIS (Commonwealth of Independent States) at FOI is called 'Rysk utrikes, försvars- och säkerhetspolitik – RUF⁴' (Russian foreign, defence and security policies). RUF⁴ is financed by the Swedish Ministry of Defence.

1.4 Outline

The study starts with a description of an economy's financial system, its role in the economy and special features of the financial system in Russia during the transition (Section 2). The next section discusses the causes of the financial crisis in general and in Russia in particular, including a comparison with the crisis in 1998. The macroeconomic development and the consequences for the real economy are examined. (Section 3). Section 4 is devoted to the fiscal response and crisis management of the Russian government. Section 5 analyses the effects on the federal budget 2009 and the budgets of 2010-2012. Section 6 deals with the repercussions of the crisis on the military budget and military industrial complex. In section 7, the implications of President Medvedev's new programme and his address to the Parliament 12 November 2009 are discussed, while in section 8 the conclusions are presented.

2 The Financial System

2.1 Why is the financial system so important?

The financial system is to an economy what blood circulation is to the body. *First*, the financial system makes an economy liquid, which means that transactions can be done quickly and on time, despite individuals being temporarily non-liquid. Even if an economic activity is in principle profitable, there are times when outgoings exceed income. Thanks to the financial system, agents can borrow to meet their obligations, e.g. wages can be paid on time despite a temporary lack of funds. Most firms have an open credit line with their bank to cover this kind of fluctuation in costs and revenues over the year.

Secondly, the financial system is a prerequisite for investors to take actions for the future. When able to borrow money against the prospect of future yields, economic agents can make investments that will start paying back only in several years to come. The financial system provides a structured way for savers and borrowers to meet, and it decides the market price (interest) for loans of different maturity and different risks.

Third, the financial system improves the efficiency of savings. Instead of putting money into the mattress, people and institutions can save it in the bank, where it is made available to borrowers and savers can earn interest. Today there are many products, beside bank accounts, with different risks that savers may use to hopefully improve their wealth and make their idle money work, such as state and corporate securities, pension funds, life insurance, etc.

Thus, a developed financial system makes the economy run smoothly and it provides market prices for money as a good: If a business needs money today that it does not have at hand, there is a price at which it can borrow this money and pay back later.

2.2 Financial institutions

Banks are the main institutions in the financial system. The hub of the financial system is the Central Bank of a country. The Central Bank is responsible for monetary policy and regulates the money market, monitors the banks, issues the local currency, monitors the exchange rate to other currencies, and conducts open market operations in accordance with the general directives for monetary policy set by the Parliament. A state has some type of additional Financial Inspection that monitors financial and security markets and their actors. The state's activities – mainly the issuing of public debt – on the financial markets are usually managed by some agency under the Ministry of Finance, e.g. the Treasury or a National Debt Office.

The commercial banks fulfil several functions and their main activities are:

- Settlements of transactions between different actors.
- Savings in different products.
- Equity and other security transactions.
- Loans to companies and individuals.

Apart from banks there are other institutions that are essential for the working of the financial markets:

- Stock exchanges, which are vital for the market valuation of companies and trade in company equities.
- Money markets.
- Clearing houses.
- Insurance companies.
- Pension funds.
- Other financial companies, such as investment banks.

2.3 The financial system during the transition

During the first years of the transition from the Communist era, a financial system had to be developed, since it is a prerequisite for a market economy to work. In the Soviet Union there was no financial system filling the functions described in Section 2.1. Money was officially a passive element in the command economy. It was necessary to attach monetary values to products so that the total values of different products could be added. The monetary value was also intended to reflect the relative cost of producing different goods. Often the state-set price at which the product was sold was below this administrative cost value. While transactions between enterprises were cleared on accounts, workers' wages had to be paid in cash. A large part of workers' remuneration was paid in kind, in the form of subsidised housing, private plots and *dachas*, social services, food and other products, but some part had to be paid in cash since different people need different things. Manipulating the size of the wage fund⁵ was a way for enterprise managers to extract cash for other needs. The difference between different kinds of money, depending on what they were earmarked for, persisted for a long time in the old Soviet-type sector⁶ and only the new private sector worked with money as money.

The beginning of financial sector development in the late 1980s was largely a *laissez-faire* process and thousands of banks opened. By 1991, when the Soviet Union broke up, there were already 1,600 private banks in Russia and the number grew steadily over the following years (Gustafson, 1999, p. 81). Main actors in this development were Soviet state bureaucrats, who saw their opportunity when the state monopoly on foreign trade disappeared. In order to manage foreign trade flows, they needed a bank. Another

⁵ Such as listing 'dead souls', people not working at the company, as employed.

⁶ For instance, old enterprises largely used barter to settle their debts.

common type among the new banks were those that grew out of the Soviet industrial enterprises (*ibid.*).⁷ Some early banks had entrepreneurial cooperatives as their origin, such as *Stolichnyi bank* (now *SBS-Agro*), which was formed by Moscow construction cooperatives. In addition, entrepreneurs backed by the Communist Party's youth organisation *Komsomol* founded their own banks *Menatep*⁸ and *Most* (*ibid.* p. 82). There were also banks that were started by criminal groups (Varese, 2001).

These early banks performed transfers among enterprises and between the enterprise and the state. The latter was to exploit opportunities when financing trade operations and using all other possibilities to enrich themselves. The years 1992-1995 may be called the 'golden years' of Russian banking. The banks used their clients' low-interest rates rouble deposits, exchanged these into dollars, and lent to other customers at high interest rates.

Table 2.1 Financial organisations in Russia 2001 -2008

	2001	2003	2004	2005	2006	2007	2008	
Number of credit organisations registered with the Bank of Russia	2483	2126	1828	1668	1518	1409	1345	1296
of which having the right for banking transactions	1476	1311	1329	1329	1299	1253	1189	1136
Registered charter capital; bn RUR	52.5	207.4	300.4	362.0	380.5	444.4	566.5	731.7
With licences giving right to:								
attract deposits from the public	1372	1239	1202	1190	1165	1045	921	906
operations in foreign currency	634	764	839	845	839	827	803	754
general licences	263	244	293	310	311	301	287	300
operations with precious metals	136	163	175	181	182	184	192	199
With foreign participation in charter capital	142	130	126	128	131	136	153	202

Source: Rosstat, Russia in Figures 2009. RUR – Russian roubles. bn – billion.

Russia inherited *Gosbank* (the Soviet Central bank) which became the Central Bank of Russia – *Bank Rossii* (CBR) and the national *Sberbank*, the giant savings bank with outlets all over Russia. In addition, there were *Promstroybank* (Bank of Industrial Construction), *Zhilstroybank* (Bank of Residential Construction), *Agrobank* (Agricultural Bank) and *Vneshekonombank* (VEB, Russian Development Bank). These were formed under the *perestroika* programme by Gorbachev. At present, the dominant state banks are Sberbank, VTB, Gazprombank, VEB and Bank Moskv.⁹

⁷ These are often called 'pocket banks' and many big corporations still have their own bank.

⁸ This bank was established by Mikhail Khodorkovsky in 1990 (Gustafson, 1999, p. 121). Khodorkovsky was a Russian oligarch and the owner of Yukos. He was arrested in October 2003 and sentenced for fraud to 9 years in prison.

⁹ According to Åslund & Kuchins (2009, p. 51), these five state banks own half of the Russian banking system, and the fact that they are politicised makes the banking system inefficient and unreliable.

After the crisis in 1998, the number of banks diminished. However, there were still over 1,200 banks in Russia in 2008 (Table 2.1). The 2008-2009 crisis will probably lead to further liquidations. New amendments to the banking laws might lead to the CBR closing down as many one-third of the existing banks. The requirements on banks have been increased. From 2010 a bank must have at least 90 million roubles in own capital and from 2012, 180 million roubles. CBR data from May 2009 show that 179 banks do not meet the first requirement and 321 banks cannot meet the second (rb.ru, 2009-06-19).

The rest of the financial sector is underdeveloped in Russia. There are two main financial exchanges in Russia:

MICEX – Moscow Interbank Currency Exchange was established in the early 1990s originally to facilitate trading in USD. When the Russian government started issuing debt, MICEX was the primary trading platform and depository. Today MICEX is a universal financial exchange which trades in currencies, government and municipal bonds, corporate bonds and derivative instruments. MICEX is the largest exchange market in the former Soviet Union and Central and Eastern Europe. Daily trading turnover was \$10 bn in 2007.

RTS – Russian Trading System is the first regulated stock exchange, which was opened in 1995. The RTS lists all major Russian public corporations. Today RTS trades with the full range of financial instruments from cash equities to commodity futures.

Private pension funds have developed since the beginning of the 2000s. In other countries pension funds are large institutional investors and important players on the financial markets, but in Russia they are of minor importance. Russians can ask for part of their pension payments to be moved to a non-state pension fund from the Pension Fund of Russia. So far few people have used this opportunity and these pension funds are small and do not play any major role in financial markets (see further www.raexpert.org, 2009-10-15).

Insurance companies are other commonplace institutional investors in the West, but they do not play that role in Russia.

2.4 Weaknesses and crises in the financial system

The modern literature on financial markets points at different causes of the recurring financial crises since the 1980s and 1990s (see e.g. Cooper, 2008 and BIS, 2008a):

1. *Liberalisation of capital markets.* After the collapse of the Bretton Woods system in 1971¹⁰, when currencies started to float, many countries lifted their regulations on capital movements over borders and on capital operations in general, which means that the world economy is more integrated and interdependent. This means in turn that capital is available over borders, which has improved economic opportunities and performance. However, it also means that economies are more vulnerable to shocks from elsewhere and are unable to foresee and mitigate risks.
2. The use of *collateral to secure loans* has a destabilising effect when the market value of the collateral asset falls (or increases). This is what happened in the US subprime housing market in 2007. The problem is that when values start falling (increasing) in these markets there are no automatic breaks and instead the process becomes self-enforcing (see further Cooper, *op.cit.*).
3. Actors tend to *underestimate the risks* in financial deals and transactions. Only the risk of the transaction in question is taken into account, while underlying risks attached to actors not present at the table tend to be forgotten. This means that economic actors may be exposed to considerably higher risk than they anticipated.
4. Emerging markets economies (EMEs, such as Russia) are characterised by a combination of high returns to investment and underdeveloped banking and financial markets infrastructure. *The attracted debt is mainly short-term.* An external shock leading to withdrawals of short-term credit hits these economies harder than more mature economies that have a better debt structure. In addition, investors seem to underestimate the high risks underlying the high yields.
5. Currencies are in principle floating even if sometimes Central Banks try to intervene to keep relative exchange rates stable. This leads to speculation when the currency is perceived to be under- or over-valued. Currency risks are substantial and need to be better anticipated.
6. Apart from uncertainties and risks regarding the future, financial activities are dependent on economic agents having *trust* in each other. When agents start distrusting each other and institutions, it appears that the financial world easily destabilises.

In the 1980s and 1990s there was a revival of capital flows to the EMEs as growth in the industrial world picked up. In the mid-1990s, international lending moved from Latin America to the rapidly growing Asian developing countries. The issuance of debt securities, mostly denominated in dollars, in international capital markets increased. East Asia and Russia benefited from the declining risk premium on sovereign (state)

¹⁰ In the Bretton Woods system, each country was obliged to maintain the exchange rate of its currency within a fixed value - plus or minus 1% - in terms of gold. The US dollar was fixed to gold and other currencies fixed to either the US dollar or directly to gold. The system was introduced after WWII to stabilise the monetary system and to stop individual countries from devaluing their currencies in order to gain an advantage in trade over other countries.

and even bank debt. This period of expansion in capital flows came to an end only with the Asian and Russian crises in 1997-98. (BIS, 2009, p.10).

These crises demonstrate that capital flows into countries with weak banking systems and underdeveloped capital markets create huge risks. In particular this is due to:

- Local banks financing a major expansion of bank lending by short-term borrowing in foreign currency from international banks, creating both maturity and currency mismatches (either directly or on the balance sheets of their creditors).
- The lack of long-term local currency debt (e.g. state securities of longer maturity) markets, meaning that debt securities were either too short-term or denominated in foreign currencies.
- Equity (corporate securities) and other financial markets being thin, leading to disruptive boom-and-bust cycles. In some cases, foreign capital was diverted into non-tradable instruments that were easily collateralised (e.g. with real estate) (*ibid.* p. 11)

The crises of the 1990s shifted policy attention from arguments of capital account liberalisation *per se* towards the need to strengthen the local banking systems and to develop capital markets. Most crises were preceded by imprudent lending by international banks and over-borrowing of clients. There was a renewed emphasis on better risk appraisal and safer forms of lending. Yet, despite renewed attention to these matters, it appears that until these issues are seriously dealt with by the international monetary institutions, such as the IMF and BIS, and in the forums for political cooperation, such as the EU, G7, G8, G20, the world will see more financial crises that will destabilise the real economies.

3 The Russian Crisis 2008-2009

3.1 Causes of the crisis

In the case of Russia, there appears to be a combination of factors that triggered the financial crisis in 2008:

- Russia was more dependent on foreign capital markets than the Russian leadership and observers thought. The Russian state did not have major debt abroad but the private sector and private banks had huge credits (around \$500 bn) and were dependent on foreign credit lines that suddenly collapsed.
- Despite the clean-up after the 1998 crisis, the Russian banking system was still fragile and there was considerable 'bad debt'¹¹ in the system.
- Both domestic and foreign investors had underestimated the risks of investing in Russia. When prospects changed, foreigners quickly pulled out. Collapsed investment projects led to bad debts in both Russian and foreign banks.
- The sharp decline in the oil price hit the Russian economy, which is very highly dependent on oil incomes.
- The Central Bank kept the rouble/dollar and rouble/EURO exchange rate stable at a high cost and then devaluated stepwise by 35 percent between November 2008 and January 2009. This increased the non-payment of loans and arrears since companies exchanged to dollars/EURO and held dollars/EURO expecting further rouble devaluation and more roubles for foreign exchange currencies in the future.

3.2 The 2008 crisis compared with 1998

Both the crisis in 1998 and the one that emerged in 2008 were fundamentally debt crises. The difference is that in 1998 it was the public sector debt that led to repayment difficulties, sovereign default and a currency crash. In 2008, Russia's industrial sector had accumulated huge short-term debt abroad and the banks had systematically borrowed abroad at low interest rates, fuelling a domestic lending boom that led to financial difficulties. The falling oil price played a major role in 2008 (World Bank, 2009, p. 11), whereas in 1998 the oil price was already low. In both cases, the artificially high rouble exchange rate led to devaluation expectations and currency speculation.

In 2008, unlike in 1998, economic activity was largely monetised and supported by credit. Hence financial disruption had to have a greater real impact. The leading firms and sectors had engaged in extensive foreign borrowing for business expansion. All leading oligarchs were heavily leveraged and deep in debt, with their real assets – Russian companies – pledged as collateral. The corporate foreign debt of nearly \$500

¹¹ The expression 'bad debts' refers to debts that have a high risk of not being repaid.

bn was about 10 times the state debt (\$40 bn, 2.8 percent of GDP) and gave foreigners potential equity claims on key Russian strategic industries (Ericson, 2009, p. 217).

The crisis in 2008 had been preceded by 9 years of stable high growth and federal budget surpluses. The Russian crisis in 1998 was largely caused by internal imbalances in the Russian economy. GDP was contracting at 4-5 percent a year and the oil price was as low as \$10 barrel in 1998. The federal budget ran huge deficits of around 8 percent of GDP between 1992 and 1998 (Åslund, 2004, p. 399). The Russian 1998 crisis occurred as a result of unsustainable public debt dynamics and an overvalued real exchange rate (Pino *et al.*, 2004, p. 3). The Russian economy quickly recovered after the collapse in 1998. The rouble was depreciated to one-third of its 1998 value and already in 1999 real GDP grew by 5.3 percent and inflation fell to less than 40 percent (*ibid.*).

Thus, the 1998 crisis became a positive turning point in Russia's transition to a market economy. Macroeconomic policy and government behaviours changed radically. Budget constraints started hardening for all levels of government and for enterprises. As a direct result, measures were taken to dismantle the costly non-payments system (i.e. barter, arrears and off-sets). Most significantly, Russia finally assumed 'ownership' of its reforms and in 2000-2002 a new wave of reforms took place. We will know in two-three years whether the present crisis will spur the same kind of policy response.

3.3 Macroeconomic development

By 2009, the financial crisis had become an economic crisis that resulted in a serious contraction of the real Russian economy. As shown in Table 3.1, the GDP contracted by 9.8 percent in the first quarter a tendency that deepened in the second quarter. Forecasts for the year of the decline range between 7-9 percent. Industrial production began to recover in the second quarter. Investments have dropped considerably but unemployment that was initially expected to rise to 12 percent by the end of the year, fell to under 8 percent in the third quarter.. The oil price, which dropped from over \$100 per barrel in 2008 to around \$40 per barrel, has risen to around \$70 barrel and this will cushion the federal imbalance.

Table 3.2 shows the breakdown by industry. Tradable sectors have suffered more than non-tradable. Construction has suffered severely and, instead of being the growth engine it had been during a decade, the sector declined by over 20 percent during the first and second quarters. Manufacturing has declined even more, although at a slower pace during the second quarter. Both these sectors have suffered greatly from the credit crunch and decline in demand.

Table 3.1 Macroeconomic development in the Russian economy 2006-2009 (y-o-y change)

	2006	2007	2008	Q1 2009	Q2 2009	Q3 2009	Fore cast 2009**
GDP growth percent	7.7	8.1	5.6	-9.8	-10.9	-9.4	-7.5** - 8.7*
Industrial production growth percent	6.3	6.3	2.1	-14.3	-15.4	-11.0	
Fixed capital investment growth percent	16.7	21.1	9.8	-15.8	-21.0	-19.0	
Federal government balance percent GDP	7.4	5.5	4.1	-0.4	-4.0	-4.0	-6.9*
Inflation CPI percent change e-o-p	9.0	11.9	13.3	5.4	1.9	0.6	11
Current account, bn USD	94.7	77.0	102.3	9.4	7.6	15.0	3.6
Unemployment percent ILO	7.2	6.1	6.4	9.1	8.6	7.9	
Oil prices, Urals (USD per barrel)	61.2	69.5	95.1	44.1	58.6	67.9	
Reserves (incl gold) bn USD, e-o-p	303.7	478.8	427.1	383.9	412.6	413.4	380.7

Source: World Bank 2009b; *World Bank 2009b p. 2; 15; **IMF2009b pp. 174; 180; 189; 194. y-o-y – year over year; e-o-p – end of period; bn – billion

Table 3.2 Industrial production 2006-2009, y-o-y growth percent

	2006	2007	2008	Q1 2009	Q2 2009
Total GDP growth	7.7	8.1	5.6	-9.8	-10.9
Tradable sectors	3.4	3.9	1.8	-14.4	-12.6
Agriculture, forestry	3.8	2.6	8.4	-2.4	-1.8
Extraction industries	-3.3	-2.6	0.2	-2.2	-5.1
Manufacturing	7.3	7.8	0.9	-23.5	-18.7
Non-tradable sectors	9.7	10.3	7.4	-5.7	-8.6
Electricity gas, water	5.7	-0.7	1.2	-5.3	-6.7
Construction	11.8	9.3	13.2	-20.9	-20.5
Wholesale and retail trade	14.1	13.7	8.4	-4.9	-11.3
Transport and communication	9.6	3.4	6.9	-7.4	-10.2
Financial services	10.3	12.5	6.6	0.3	-5.4

Source: World Bank 2009a p. 4; World Bank 2009b p.4; y-o-y – year over year

The credit squeeze also shows up in the accumulation of arrears (Table 3.3). The Russian economy has suffered from arrears and in particular wage arrears ever since the beginning of transition. The main cause is that a large part of the economy is not reformed and not competitive. What happens when employers are short of cash is that

they use available money to speculate in currencies and barter and postpone wage payments. Now, these tendencies have been aggravated again by the crisis.

Table 3.3 Wage arrears in selected branches 2005-2009, bn RUR

	2005	2006	2007	2008	Q2 2009	Increase by factor
Total	14315	5756	4159	2668	7194	3
Agriculture, hunting and forestry	3889	1778	1112	495	350	1
Mining	640	144	220	197	250	1
<i>Manufacturing</i>	<i>4176</i>	<i>1955</i>	<i>1083</i>	<i>833</i>	<i>3700</i>	<i>4</i>
Electricity, gas and water supply	1118	521	695	465	350	1
<i>Construction</i>	<i>1300</i>	<i>346</i>	<i>215</i>	<i>114</i>	<i>1000</i>	<i>9</i>
<i>Transport</i>	<i>842</i>	<i>316</i>	<i>266</i>	<i>205</i>	<i>1200</i>	<i>6</i>
Real estate	1042	259	195	95	100	1

Source: Rosstat, 2009. bn – billion; RUR – Russian roubles

As shown in Table 3.3, the wage arrears decreased up to 2008, but now they have increased three-fold in the economy as a whole, while in manufacturing and transport they have increased four-fold and six-fold, respectively. In construction the increase is *nine-fold*.

The non-payment of wages and wage reduction is still a salient feature of labour market adjustment in Russia. Instead of shedding labour in a recession, employers hoard labour, just like in Soviet times. A special problem are the monotowns, where the whole municipality can be dependent on one or two companies and where it is socially difficult to lay off workers. Despite considerable technical assistance from the West in addressing this problem and trying to give the Russians instruments to diversify in regional labour markets and use labour market policies that enable structural change, the old Soviet-type industrial structure produces labour hoarding and wage arrears rather than unemployment and structural change. If Russian companies were competitive, unemployment would be higher than the current 7.6 percent (Table 3.4).

From Table 3.4, it appears that the anti-crisis measures adopted in May have had the effect of stopping the decline in employment and the rise in unemployment.¹² In fact, unemployment declined from over 9 percent to 7.6 percent between the first and third quarters. The average real wage has decreased by almost 30 percent in the first quarter, but has recovered slightly after that. The fall is partly a result of the devaluation of the rouble to the US dollar, but it also reflects that in Russia wages are still flexible downwards. It appears that during the later part of the year, the adjustment has mainly taken place through reduced hours and lower wages, i.e. labour hoarding has increased.

¹² To some degree the increase in employment may reflect seasonal factors affecting employment.

Table 3.4 Labour productivity, disposable income, wages and unemployment 2006-2009

	2006	2007	2008	Q1 2009	Q2 2009	Q3 2009
GDP growth; percent ;y-o-y	7.7	8.1	5.6	-9.8	-10.1	-9.4
Total employment; million of people	68.8	70.5	70.9	68.2	69.4	70.4
Employment growth; percent; y-o-y	0.8	2.4	0.5	-2.3	-2.9	-2.1
Labour productivity: percent; y-o-y	6.9	5.5	5.0	-6.7	-6.6	
Real disposable income; percent;y-o-y	13.5	12.1	2.9	-0.1	2.6	-5.1
Real wage growth; percent,; y-o-y	13.3	17.2	11.5	-0.8	-3.9	-5.4
Average monthly wage,; USD	391.9	532	692.1	497.7	578.5	597.6
Unemployment, percent, ILO; e-o-p	6.9	6.1	7.8	9.2	8.3	7.6

Source: World Bank 2009a, p. 5; World Bank 2009b., p. 5. y-o-y – year over year; e-o-p – end of period.

Labour market policy

In response to the high unemployment at the beginning of the year, the government introduced labour market measures corresponding to 0.11 percent of GDP (World Bank, 2009b. p. 5). These programmes have hardly had much effect on aggregate unemployment, but may have had effects on local and regional labour markets. Reports indicate that these programmes have not been used in the first place to enhance structural change and help those already unemployed, but primarily to prevent lay-offs, and have therefore mainly helped large enterprises to keep their workers (*ibid.*).

Living standard and poverty

The crisis has increased the number of poor in Russia. The national poverty line is defined as the percentage of the population living under the subsistence level set by the government of Russia. In the third quarter 2008, this line was set at on average 4 630 roubles (about \$185) per person and month. The World Bank estimates that according to this definition, the number of poor people in Russia will rise by 7.45 million to 24.6 million in 2009. This results in a poverty rate of 17.4 percent, compared with the 2008 pre-crisis level of 12.6 percent (World Bank, 2009a, p. 13). Another 20.9 percent of the population will be in the category *vulnerable* (instead of 18.3 percent according to previous estimates) which follows from an increase of 3.6 million people falling into this category. The Russian middle class will shrink by 10 percent to 51.2 percent of the population. The highest reduction in comparison to the pre-crisis level will be among the ‘world middle class’¹³ category, which will shrink by 25 percent from 12.6 percent to 9.5 percent of the population (*ibid.*)

¹³ The World Bank uses two middle-class categories in its description of living standard in Russia. The ‘world middle-class’ is a category that corresponds to an international middle-class level as defined in the World Bank’s GEP, 2007. The ‘Russian middle-class’ is a category of people that correspond to middle-class in the Russian environment with consumption at least at 1.5 times over the official poverty line.

External sector

The plummeting of the oil price caused a terms-of-trade shock and a drastic cut in the current account in the last quarter of 2008. Before that, oil and gas exports accounted for more than two-thirds of export revenue and more than 15 percent of GDP. Capital outflows from the private sector were high in January 2009. Since the end of February capital outflow slowed down and since September 2009 Russia has experienced capital inflows, which reflects expectations about future rouble appreciation. The external debt that had amounted to \$547 bn in October 2008 had declined to \$454 bn in the first quarter of 2009. The private sector, which holds the lion's share of the debt, should pay off about \$90 bn during 2009. Specialists have estimated that the Russian banking sector needs an additional approx. \$40 bn from external sources during 2009 (*ibid.*)

In connection with the work on the federal budget 2010, the Russian Ministry of Finance presented a forecast in September regarding developments in the external sector and the oil and gas sector during the coming years, which is presented in Table 3.5.

Table 3.5 Forecast external sector and oil and gas developments 2009-2011

	2009			2010			2011		
	Law Nov	Forecast	Change percent	Law Nov	Forecast	Change percent	Law Nov	Forecast	Change percent
GDP bn	51	38 461	-25	59	42 372	-28	67	46 783	-31
RUR	475			146			610		
Export bn	507	274	-46	502	276	-45	509	282	-45
\$									
Import bn	370	190	-49	434	195	-55	490	205	-58
\$									
Oil price (Ural) \$/barrel	95	54	-43	90	55	-39	88	56	-36
Gas price \$/1000 cubic metres	421	229	-46	363	219	-40	358	215	-40
Oil export million tons	255	245.5	-4	261	243	-7	262	241	-8
Gas export bn cubic metres	213.5	160.8	-25	222.7	170	-24	227	181.5	-20
Production of oil million tons	503	488	-3	514	485	-6	518	483	-7
Production of gas bn cubic metres	700	580	-17	715	596	-17	725	610	-16

Source: Ministry of Finance RF (2009), p. 2; bn - billion

The forecast data are compared with the data on the 2009 budget law of November 2008. As shown by Table 3.5, GDP in 2009 is assumed to be 25 percent lower than originally expected. Both exports and imports are down by almost 50 percent. The oil price and gas price are down by over 40 percent of what was expected before the crisis. Gas production and export has been more severely hit by the crisis than oil, and neither production nor export will reach the original forecast levels in 2009 or 2011. Oil production and export are assumed to stay more stable, but the oil price is expected to be around 40 percent lower during the whole period than was envisaged in late 2008. On the whole, this shows that Russia cannot expect oil and gas to be drivers in economic development as before, and even if modest growth of GDP is anticipated, the Ministry of Finance cannot rely on windfall oil and gas incomes to finance the commitments of the Russian government to the population, but needs to go elsewhere (Minfin, 2009).

4 Crisis management

4.1 Initial policies during autumn 2008

The initial rescue package of the Russian government was announced on 17 September 2008, followed by additional packages during late September to late November as the situation grew more serious (World Bank, 2008, p. 22). Table 4.1 gives a summary of the main government measures undertaken to provide liquidity to the financial system.

Table 4.1 Policy measures announced in September 2008

Policy measure	Objective	Finance source	Implementation	Cost
Increasing the amount of funds available through REPO	Providing liquidity for the banking sector	CBR	Immediate	Monetary impact of 430 bn roubles
Cut in the reserve requirements	Providing liquidity for the banking sector	Reserves held by CBR	Effective from 18 September	Monetary impact 300 bn roubles
Cut in the crude export duty	Mitigating the impact of oil price decline for oil companies	Lost tax revenues	Effective 1 October 2008	Fiscal cost: 140 bn roubles
Increasing the grace period for VAT payments	Providing additional liquidity to private companies	Tax credit	October VAT payments extended for 3 months	Quasi-fiscal cost of approx. 115 bn roubles (3 month credit)
A capital injection into the Agency of Home Mortgage Loans (AHML)	Capitalising AHML	Federal budget	Implemented	Quasi-fiscal cost of 60 bn roubles
Temporary allocation of federal budget funds into the 3 month deposits at selected banks	Providing liquidity for the banking sector	Federal budget		Quasi-fiscal cost of up to 1,514 bn roubles
A decrease in deposit insurance premium payments	Providing liquidity for the banking sector	Deposit insurance agency	Decrease in the transfer fee banks pay to the deposit insurance fund	
A ban on short-selling of stocks	Limiting large price fluctuations on the stock exchange			
Temporary closure of stock exchanges (MICEX and RTS)	Limiting large fluctuations of the stock exchange		Regulators from the Federal Financial Markets Service have repeatedly suspended trading	

Source: World Bank, 2008, p 23.

The initial government response to the crisis was thus pro-active and mainly geared at keeping the financial system afloat, essentially by pouring liquidity into the banking system. At this stage no special measures were geared at the real sector. The estimated direct fiscal costs for these policies were only 190 bn roubles (\$7.6 bn), which corresponds to 0.6 percent of GDP, but the implicit fiscal and contingent costs could reach up to about 4 639 bn roubles (\$185 bn, or about 15 percent of Russia's 2007 GDP)¹⁴ (World Bank, 2008 p. 25).

4.2 The anti-crisis programme

In response to the deepening crisis during autumn 2008, the government proposed a crisis plan on 7 November 2008, which was signed into law three days later. This plan substantially increases government involvement in the real economy and can be divided into four major components (Ericson, 2009, pp. 223-224):

1. The plan established five sectoral priorities for state funding and credits, with allocations to be decided and managed by CBR and Ministry of Economic Development (MED). These priorities are (in order):
 - i. Military Industrial Complex
 - ii. Agriculture
 - iii. State projects
 - iv. Strategic 'machine-building' industries (especially automobile, aircraft, agricultural machinery)
 - v. Construction
2. The federal budget for 2009 was restructured to reflect the changed external conditions (see further below, Section 5).
3. Acceleration of payments of the state defence orders (SDOs) to strategic industries. In principle this entails offering advance payments of 70-80 percent for a price premium so that producers do not need to take commercial credits.
4. Direct and indirect support/subsidies to businesses, particularly in the financial sector. These measures (some of which are already included in Table 4.1) include:
 - Export tariff reduction on oil and oil products.
 - State investment in stock markets.
 - \$62 bn to VEB to support business capital and refinance foreign debt.
 - Direct subsidy to financial institutions.
 - Mortgage support.

¹⁴ Ericson (2009, p. 224) reports that the full cost of the announced financial support of 21 October 2008 was 5918 bn roubles, or about 13.6% of GDP (corresponding to over \$215 bn). Beginning in November 2008, the CBR launched a gradual devaluation, allowing the rouble to depreciate by more than 50% against the dollar compared to the July 2008 exchange rate. Thus figures can vary slightly depending on time period referred to.

Ericson (2009) stresses the systemic impacts of the strong state involvement in the Putin plan, which is reflected in the strongly increased share of subsidies to the business sector in the budget. In other countries governments have also provided massive liquidity injection and financial stimulus to their economies. However, Russia is special in the way that its government has centralised the provision and control of all support. Funds are transferred through a 'transmission belt' with the five state banks as key players and a new financial planning organ, the Presidential Council for Development of the Financial Market, at the top of the financial vertical (*ibid.* p. 228).

The Russian Central Bank and the Ministry of Economic Development allocate and exercise control over the use of credits through quotas (*goslimity*). The problem with this system is that the Russian market economy, which already had considerable state involvement before the crisis, will be further turned away from economic efficiency goals as resources are directed towards the priorities of the Russian state, which are not necessarily what is best for the economy and the population in the long run.

It should also be stressed that government funding has been made available to large enterprises only, with SMEs not benefiting. Russia's SMEs account for 20 percent of employment and contribute 12-15 percent of GDP (Yurgens, 2009, p. 50). This can be compared with the situation in developed countries, where SMEs account for 20 percent of employment and on average more than 50 percent of GDP (*ibid.*). Thus, Russia's SME sector is most underdeveloped, despite a steady rise in registered enterprises of 7 percent a year (Åslund & Kuchins, 2009, p. 46).

In June 2009, the government presented its additional anti-crisis programme for the rest of 2009 (Putin, 2009). The changed conditions from the Federal Budget Law (confirmed 24 November 2008) are that the forecast income in the budget will fall from 10 927.1 bn roubles to 6 713.8 bn roubles, or by 39 percent, and the costs will rise, due to the need for government support in the economy, from 9 024.7 bn roubles to 9 692.2 bn roubles, or by 7.4 percent (*ibid.*).

The budget has been restructured so that tasks with lower priority have been reduced by 943.3 bn roubles and high priority tasks have been increased by 1 379.9 bn roubles. Thus, about 230 bn roubles of the increase in spending has been gained by restructuring the budget and 668 bn roubles have been added by increasing the budget deficit. (*ibid.*)

The priorities of the programme in this version are much more geared towards improving the social situation of the population (*ibid.*) than the November plan:

- *The first priority* is to fulfil all obligations that the state has towards the population. This includes assistance to families who have suffered most from the crisis; modernised and improved pensions; improved assistance to the unemployed; improved healthcare, education and retraining. State assistance to solve the housing programme is foreseen.

- *The second priority* is to save and develop the technical and industrial potential for the future. The idea is to assist modern, efficient and competitive enterprises that are temporarily having a difficult time due to the weak demand and the credit crunch.
- *The third priority* is to support the demand for domestic goods in the economy. This will be done through public investments in the areas of housing, infrastructure, transport, preferential treatment of domestic providers, subsidised credits.
- *The fourth priority* is to stimulate innovation and structural change. The state will increase its support to innovative projects and resource and energy saving. The state involvement in high technology branches such as aviation, shipbuilding, space industry, nuclear industry will increase. Special emphasis is placed on transport infrastructure and the modernisation of passenger transport vehicles.
- *The fifth priority* is to improve the conditions for economic recovery by strengthening entrepreneurship and competitiveness.
- *The sixth priority* is to form a sustainable financial system.
- *The seventh priority* is to provide macroeconomic stability and to regain the trust of domestic and foreign investors.

According to the additional anti-crisis programme in June, the increased (compared with the original budget law) social support from the federal budget is 1143.7 bn roubles. Added to this are extra payments to the Pension Fund to cover its deficits and some minor social assignments. In comparison to the amounts that have been given to the financial and industrial sectors, the direct support to the population is quite small.

4.3 Assessment

Judging from the macroeconomic developments described in section 3, the Russian government has been successful in responding to the crisis and has avoided rising unemployment and social unrest in the aftermath of the crisis. The negative effects of the crisis are severe, but the government has appeared to the public to be in control of the situation.

Several points of the crisis management policies may be criticised, however. *First*, protecting the rouble exchange rate for over half a year was a costly project with severe distributional effects. The market knew the rouble would be devaluated and this led to speculation. Those who could exchange roubles for dollars or Euros did so and earned plenty of money when the rouble was eventually devaluated. The artificially high rouble rate is a decisive factor behind rising arrears and it did not help Russian exports in the beginning of the crisis.

Second, the massive increase in subsidies to the economy as well as increased stakeholdings of the state in private companies have increased state involvement and state priorities in economic management. In the presence of exceptionally powerful interest groups such as the *Russian Union of Industrialists and Entrepreneurs* under Alexander Shokhin or regional governors appointed by the president, it cannot be

assumed that the allocation of grants, credits and credit guarantees has been managed by economic criteria. Rather, it is the relative negotiating strength of different parties and the *relational capital* that has been decisive. Personal links and corruption play a major role in resource allocation in Russia and this has certainly been aggravated by the increased state involvement during the crisis. The consequence of this is more conservation of non-competitive enterprises and less efficient performance of the economy. The high priority to the military industrial complex and *Rostekhnologia* during the first round of the anti-crisis programme is a good example of how resources are given to agents with low productivity and low performance because of non-economic considerations. The Russian economy's performance is being seriously impeded by these old Soviet-type corporations, and the government chose to save non-competitive production during the crisis instead of developing mechanisms to move the labour force into activities with growth potential.¹⁵

Third, there is a need to develop the domestic banking system so that all potential borrowers have access to credit. Up to now the big companies have been given priority in terms of access to credit, since they have the contacts and leverage, while the small and medium-sized enterprises have had difficulties and have needed to resort to borrowing outside the banking system. Before the crisis the majority of Russian companies did not seek credit in the banks but organised this in another way. The heavy emphasis on the state corporations, military industrial complex and other strategic sectors in the anti-crisis programme has made the situation even worse for the rest of the economic actors in terms of credit.

Fourth, although it is mentioned as a third priority among the June measures, development of infrastructure, which is a classical measure for governments to use when in recession, does not appear to have a very important role in the programme. Major government investment projects in public goods,¹⁶ such as building and repairs of roads, railroads, airports, electricity and communication facilities, are difficult, if not impossible, to develop under private ownership and need state initiative to be realised. Because of their public goods character, government infrastructural investments in public goods and services are much less disturbing to economic development than support to individual industries. In fact, well-developed infrastructure is a prerequisite for private investments and businesses and an important factor behind high growth. Some resources have gone into this kind of project, but it is clear that the Russian government has preferred to help its friends in various non-competitive industries instead of building infrastructure for the future.

Within Russia, the anti-crisis programme has been criticised from different sides, one being that it is too paternalistic and based on supporting the old industrial structure. The

¹⁵ See further Ickes & Ofer (2005) on the problems of structural change in Russia.

¹⁶ Public goods are goods and services with the characteristic that consumption of the good by one individual does not reduce availability of the good for consumption by others. No-one can be effectively excluded from using the good, which makes it difficult for private actors to extract profits from an investment.

political party Yabloko (2009) considers the present programme to be a product of a paternalistic, reactionary 'Euroasian ideology' and suggests a bottom-up approach to crisis management. The key strategy in their programme is to prop up final demand by a mass-scale housing programme called 'Housing for Every Family'. The idea is that all government resources should be channelled into this programme and that in the next seven years the construction of housing should receive over 50 percent of all investment in Russia.

This strategy may not be altogether realistic, but it makes the point that if money is to be spent, why not build something useful for the people? Housing is a vast problem in Russia and speeding up a housing programme could certainly be a valid part of an anti-crisis policy. Lack of appropriate housing is one of the main factors behind the obstacles to structural change and labour mobility in Russia.

Sheinis (2009, p. 5) points out that of the 2 920 bn roubles (his estimate) that were assigned to finance the programme, 46.4 percent were to stabilise the financial system, 26.6 percent for direct support to industry, 15.9 for social support and 10.3 percent for support to the regions. In his view the relative proportions of these figures speak for themselves, i.e. the main bulk of money went into the banking system and it is unclear how much of that found its way to the real economy where credit was needed. Almost 27 percent went directly to the real sector to targeted industries. About the same amount was reserved for social support and support to the regions.

It would be interesting to see an account of the extra money spent on anti-crisis measures during 2008 and 2009. Particular problems in Russia are: a) money does not reach its final destination due to speculation and corruption; and b) due to different imperfections in the system it is not used in an efficient way. It would also be interesting to see an evaluation of the different measures in terms of short-term and long-term effects. Subsidising industries that have in fact no perspective is just throwing taxpayers' money into a black hole. The alternative could have been to develop infrastructure in areas where both industries and people could move and build for the future.

The government's anti-crisis programme has involved massive government involvement in the economy and selective bailouts suggest government favouritism to outright corruption. If and how the government is going to withdraw its involvement as the economy recovers is not quite clear today.¹⁷ Medvedev (2009b) calls for state corporations to be reorganised into joint stock companies. However, this is just another form of state control over production units. Unfortunately, the Russian population does not seem to mind major parts of the economy being nationalised. According to Charap (*op. cit.*, p. 338), over 80 percent of Russians are in favour of nationalising major enterprises. It follows that understanding of the importance of competition and private ownership is still weak in Russia.

¹⁷ Silvana Malle (2009) discusses this issue.

5 The Federal Budget

5.1 Three-year budget strategy

Since 2008, the federal budget is included in a three-year fiscal plan – the budget strategy (Minfin, 2007). The main lines in the budget strategy follow the priorities in the President's *budget address*. The three-year strategy should in principle allow the government to have a medium-term view of economic policy, while economic actors have a better idea of what to expect. For the period 2008-2010, the priorities of economic policies were:

- Improved standard of living of the population. The difficult living conditions during Soviet times and during the transition have resulted in Russia having a decreasing population.
- Rapid and stable growth to make improved living conditions possible.
- National security and public safety.
- Facilitating long-term growth through innovation, competitive education and fighting corruption.

The expenditure of the tentative three-year budget for 2008-2010 is presented in Table 5.1.

Table 5.1 Federal budget of the Russian Federation – Planned Expenditure 2008-2010

	Plan 2008 Nov 2008	percent of total budget	Plan 2009 Nov 2008	percent of total budget	Plan 2010 Nov 2008	percent of total budget
Total expenditure	6 570.3	97	7 451.2	97	8 089.9	97
Federal obligations	907.1	13	977.0	13	1042.5	13
Government debt service	187.9	3	212.6	3	247.1	3
Defence	959.6	14	1 061.5	14	1 191.0	14
Security and legal enforcement	771.2	11	932.1	12	999.6	12
Economy	718.2	11	802.9	10	544.2	7
Housing, utilities, infrast.	56.9	1	79.2	1	71	1
Environmental protection	9.3	0	10.2	0	11	0
Education	308.9	5	315.5	4	3 41.1	4
Culture, film, media	82.8	1	70.3	1	67.5	1
Health, sports	218.3	3	234.2	3	274.6	3
Social policy	273	4	362.4	5	427.5	5
Interbudgetary transfers	2 272.4	34	2 421.0	32	2 715.8	33
Provisional		0	186.3	2	404.5	5

Source: Ministry of Finance RF (2007).

As can be seen from Table 5.1, the Russian government still uses a large part, around 25 percent, for national defence and security issues. However, quite a large part of the social commitments lie in interbudgetary transfers that include the federal budget support among other things to the Pension Fund, besides the redistribution of means from rich regions to poorer regions. In addition, a large part of social policy is the responsibility of the regions. In 2008, national defence and security corresponded to about 4 percent of GDP (see further section 6).

5.2 Amended budget for 2009

The Federal Budget Law for 2009 was adopted on 24 November 2008. The budget reflected the optimism that Russia would not be so severely affected by the crisis. During the spring 2009, however, it became clear the budget had to be revised to reflect the new conditions and the additional spending that the government had decided on (Table 5.2).

Table 5.2 Changes in the federal budget during 2009

Type of costs in bn RUR or percent	(1) 2009 Law	percent GDP	(2) 2009 Amended	percent GDP	Change bn RUR	Change percent	Share of Budget (1)	Share of Budget (2)
Total costs of the federal budget	9 024.7 *	17.5	9 778.4**	25.4	753.7	8.4	100	100
General federal obligations	1 209.2	2.3	1 042.7	2.7	-166.5	-13.8	13.4	10.7
Defence	1 336.4	2.6	1 216.5	3.2	-119.9	-9.0	14.8	12.4
Security and judiciary	1 093.2	2.1	1 023.9	2.7	-69.3	-6.3	12.1	10.5
Economy	1 074.7	2.1	1 620.0	4.2	545.3	50.7	11.9	16.6
Housing and municipal services	99.9	0.2	112.5	0.3	12.6	12.6	1.1	1.2
Environment	13.8	0.0	13.4	0.0	-0.4	-3.2	0.2	0.1
Education	424.0	0.8	410.0	1.1	-14.0	-3.3	4.7	4.2
Culture and information	114.3	0.2	114.6	0.3	0.3	0.2	1.3	1.2
Health care and sport	361.8	0.7	347.5	0.9	-14.3	-4.0	4.0	3.6
Social policy	310.3	0.6	321.6	0.8	11.3	3.6	3.4	3.3
Interbudgetary transfers	2 987.1	5.8	3 555.8	9.2	568.7	19.0	33.1	36.4
Deficit/Surplus	1 877.9	3.6	-3 064.6	-8.0	-4 942.5	-263.2	20.8	-31.3
GDP	51 475.0	100.0	3 8461	100.0	-13 014.0	-25.3		

Source: (1) & (2) Accounting Chamber RF (2009), Annex 4. * Corresponds to \$335.5 bn at the exchange rate of 26.9. ** Corresponds to \$297.2 bn at an exchange rate of 32.9.

The most striking thing to note in Table 5.2 is that the size of the federal budget in the economy has jumped from around 18 percent of GDP to over 25 percent. This reflects the increased state intervention in the economy. The other important change is that instead of a surplus in the government sector of 3.6 percent, there is now an expected deficit of 8 percent.

Table 5.2 shows that the support to the economy, i.e. to the major companies in the high priority sectors, has grown by astonishing 51 percent, or almost 550 bn roubles, between the original budget and the amendments made in the early summer. The support to the economy corresponds to 17 percent of the budget or 4.2 percent of GDP, i.e. the support has doubled in terms of share of GDP. Social policy has grown marginally by 0.8 percent and housing services have grown by 12 percent and the interbudgetary transfers by 21 percent. All other sectors, including defence, have experienced substantial reductions in their budget assignments. Disregarding the difficult health situation in the country, the government has cut health care and other sectors, such as education, primarily servicing the population.

The original idea over the three-year period was that the proportions would be kept quite constant, with a *decrease* of subsidies to the business sector to 10 percent of the total budget and a slight increase in defence and security spending in 2009. Instead subsidies to loss-making business has taken an increasing share of public resources.

5.3 Budget for 2010-2012

The goal for the period 2010-2012 is first of all to stimulate domestic demand and to protect the government's social commitments. In particular, this regards raising labour pensions. Massive support to the economy, to the chosen enterprises on the priority list of 2008, and to branches (Minfin, 2009, p. 11) is another priority. The support will be in form of straight budget transfers, state guarantees and tax relief. Despite the demands on the federal budget, the Ministry of Finance anticipates a declining budget deficit over the period (see Table 5.3).

Table 5.3 The federal budget 2009-2012

	2009 estimate	2010 forecast	2011 forecast	2012 forecast
Incomes, bn RUR	6 561.3*	6 636.2	7 346.9	8 097.4
<i>percent GDP</i>	17.0	15.7	15.7	15.5
Costs, bn RUR	9 980.1	9 822.8	9 358.6	9 661.1
<i>percent GDP</i>	25.9	23.2	20.0	18.5
Deficit, bn RUR	- 3 418.8	-3 186.6	-2 011.7	-1 563.8
<i>percent GDP</i>	-8.9	-7.5	-4.3	-3.0

Source: Minfin, 2009, p. 19. * Corresponds to \$ 227 bn at an exchange rate of 28.8; bn – billion; RUR- Russian roubles

One of the greatest challenges during the coming years is to make the pension system sustainable. Even if the pension contribution is raised from 20 percent to 26 percent in 2011, the Pension Fund will not be able to cover its pension payments. Pensioners are a

substantial part of the poor because replacement rates in the pension system are far too low, around 25 percent, and declining. The pension reforms in 2002 were intended to improve pensions and find a better payment mechanism with a link between contributions and payments. Yet each year, the government must subsidise the Pension Fund's payments from the federal budget. The demographic development resulting in a smaller labour force and smaller contributions to the pension system will increase the pressure on both the pension system and the federal budget. If the government wants to increase the average pension to 2.5 times the subsistence minimum, as it promised before the crisis, the necessary transfer from the federal budget will amount to 6.5 percent of GDP (*Vedomosti*, 2009-10-14).

5.4 Financing the budget deficit

The Russian government accumulated a greater part of the oil income from the good years into the Reserve Fund and the Welfare Fund, which are to be used to finance part of the budget deficits expected up to 2012. The Welfare Fund is mainly used to cover the deficit in the Pension Fund (Table 5.4).

Table 5.4 Financing of budget deficits 2009-2012

	2009	2010	2011	2012
Federal budget deficit bn RUR	3 418.8*	3 186.6	2 011.7	1 563.8
<i>percent GDP</i>	8.9	7.5	4.3	3.0
Reserve Fund bn RUR	3 028.3	1 674.6	5.6	0
<i>percent GDP</i>	7.9	4.0	-	-
Welfare fund bn RUR	-	681.7	737.0	712.1
<i>percent GDP</i>	-	1.6	1.6	1.6
Other sources bn RUR	405.2	830.3	1 269.1	851.7
<i>percent GDP</i>	1.05	2.0	2.7	1.6
Of which bn RUR:				
State securities, Domestic bn RUR	604.3	394.2	722.2	232.6
External sources bn RUR	-199.1	436.1	546.9	619.1

Source: Minfin, 2009, pp. 20-22. *Corresponds to \$118.7 bn at an exchange rate of 28.8. bn – billion; RUR – Russian roubles

As can be seen from Table 5.4, the government intends to exhaust the Reserve Fund to finance the budget deficit in 2009 and 2010. The Welfare Fund will provide a limited contribution of about one-third of the deficit in 2010-2012. During the latter period, the Russian government intends to increasingly use external financing, mainly in the form of issuing currency-denominated state securities. So far the Russian government has refrained from obtaining financing from the IMF, since this comes with conditions.

Keeping the budget deficit within a reasonable size is important for the balance of public borrowing and corporate borrowing. In 2009, Russian corporations borrowed by

emitting corporate securities, which have higher yields than Russian state bonds.¹⁸ In the late 1990s, state borrowing crowded out the borrowing needs of the private sector.

¹⁸ Corporate bonds are sold both domestically and as Eurobonds. In 2009, 21 corporate emissions were registered to the value of \$10,4 bn (Minfin, 2009, p. 13).

6 Military Spending

6.1 National defence

The military gets funding in different ways, first of all through the Ministry of Defence (MoD), under the heading 'National defence' in the federal budget. This budget line covers:

- Personnel
- Operations
- Procurement
- R&D
- Transformation
- Nuclear
- Other

National defence spending has been kept under 3 percent of GDP since 1997. In 2009, it seems that the spending will creep slightly over that due to the decline in GDP. Although national defence received almost 11 percent less money than was anticipated in the original 2009 federal budget in November 2008, the contraction in GDP has resulted in spending on national defence now corresponding to a higher share, 3.1 percent, of GDP (Table 6.1). This is higher than the average 2.7 percent noted during the early part of this decade (see Leijonhielm *et al.*, 2009, p. 129).

Table 6.1 shows that after the revisions of the budget during 2009, all budget lines in the national defence budget have been reduced except those regarding international commitments, which have increased. Collective security/peacekeeping has increased two-fold and the budget line for international obligations by over 50 percent. This substantial increase might be a reflection of additional resources to CSTO, troops being stationed in Abkhazia and South Osetia and operations against pirates in the Gulf of Aden.¹⁹ The greatest declines in absolute terms have been in the funding for the Armed Forces, other unspecified national defence costs and R&D, corresponding to reductions of 7.8 percent, 32 percent and 6.5 percent, respectively, compared with the original budget.

Thus, the MoD has had to accept reductions in its spending in response to the crisis. In current roubles, the decline is 10.7 percent compared with the original assignment in the 2009 budget. Because of inflation, the reduction in real terms is larger. The share of national defence in the federal budget has also declined, to 12.1 percent.

¹⁹ These interpretations of the increase was suggested to me by Fredrik Westerlund and Carolina Vendil Pallin.

Table 6.1 National defence spending in the federal budget 2008-2009*(billion roubles; percent)*

National defence (ND)	1 2009 Budget Law bn RUR	2 2009 Budget Amended bn RUR	Change in bn roubles	I Change in percent	percent of Federal budget	percent of GDP
Armed forces	962.6	887.9	-74.7	-7.8	9.02	2.31
Mobilisation prep. of economy	3.5	3.4	-0.1	-2.9	0.03	0.01
Collective security/peacekeeping	0.1	0.3	0.2	200.0	0.00	0.00
Nuclear-weapon complex	22.4	19.1	-3.3	-14.7	0.19	0.05
International obligations	2.9	4.5	1.6	55.2	0.05	0.01
Applied R&D field of national defence	174.2	162.9	-11.3	-6.5	1.65	0.42
Other in the field of ND	164	111.3	-52.7	-32.1	1.13	0.29
Total national defence	1336.4*	1192.9**	-143.5	-10.7	12.12	3.10

Source: (1) & (2) Accounting Chamber RF (2009), Annex 4. * Corresponds to \$ 49.7 bn at an exchange rate of 26.9. ** Corresponds to \$ 36.3 bn at an exchange rate of 32.9.

6.2 Total military spending

Until 2005, the MoD's proportion of the total defence budget ranged from 89-95 percent. Since then, the MoD's reported share of total defence spending has dropped (Rand, 2009, fn. 26, p. 64). It follows that apart from the MoD assignments there is other expenditure in the federal budget that would be counted as defence spending in the West, but not in Russia (*ibid.*, p. 65). According to Rand such expenditure includes:

- Border troops and internal troops.
- Certain spending by the Ministry of Emergency.
- Certain spending by the State Security apparatus.
- Subsidies to closed towns – towns that manufacture weapons, including nuclear weapons.
- Military pensions.

When this spending is added to the national defence line in the federal budget, the Russian defence spending can be calculated and compared with spending in the West (*ibid.*). Between 2000 and 2007, increases in defence spending in real terms kept pace with the rate of growth of GDP (*ibid.* p. 68).

Unfortunately, a growing part of this spending is classified information in Russia, which means that it is rather difficult to get a full picture of Russia's total military costs. Nevertheless, Julian Cooper, the long-term specialist on the Russian military economy, has in several research works reconstructed the Russian budgets during the latter part of the 2000s to give an idea of total military spending. In Table 6.2, the results for the

original 2009 federal budget of November 2008 and the amended 2009 budget of April 2009 are compared.

As Table 6.2 shows, among the budget lines in the additional military budget it is only military pensions that have not decreased, but increased by 1.5 percent. Other total expenditure has decreased by 5.6 percent, which is less than the decline in national defence expenditure. Total military expenditure (TME) according to this calculation has fallen by 8.8 percent. Taking account of inflation this decrease is steeper.

The reshuffling of the budget and the declining GDP mean that TME, as defined in Table 6.2, has increased to 4.6 percent of GDP, which is an increase in the military burden on the economy compared with the approx. 4.1 percent that had been the median during the early 2000s (see Leijonhielm *et al.*, 2009, p. 129). GDP is now estimated to be even lower (Table 6.1), which means the share of TME may rise if these costs are not cut proportionally.

6.3 The military industrial complex

The military industrial complex has been hit by the crisis despite many of its companies belonging to the “strategic” companies and having been supported by the state’s anti-crisis programme. According to the government’s anti-crisis programme of June 2009, the military industrial complex should receive 969 bn roubles from the federal budget in 2009, which in nominal terms is 38% more than in 2008 (Putin, 2009). To the companies that are producing the State Defence Orders (SDOs), the government will give a subsidy of 15 bn roubles to compensate for the interest payments on commercial credits. The government will also compensate for costs or missed income in connection with the production of SDOs or fulfilment of Russia’s external commitments. (*ibid.*) In addition, the government will also give the military industrial complex credit guarantees in Russian banks of up to 100 bn roubles. A special subsidy of 3 bn roubles is available for strategic companies that risk bankruptcy.

The government is also supporting the military industrial complex by increasing its stake in its companies. The government has bought up a new emission in the company “MiG” for 15 bn roubles. Next is a new emission in “KAPO im. S.P. Gorbunova”, a large aeroplane producer in Kazan the capital of Tartastan, of 4128 bn roubles. The federal company “GKHPTs im M.V. Khrinicheva” will receive gets 8 bn roubles and “Moscow machine building company im. V.V. Chernysheva” gets 2.9 bn roubles. (Putin, 2009).

Table 6.2 Total military spending in 2009. Million roubles and percent

	2009 B	2009 B	April-Nov	April-Nov
	Nov-08	Apr-09	mn RUR	percent
	mn RUR			
National defence (ND), total	1 336 356	1 197 015	-139 341	-10,4
Other military expenditure (OME)				
Other MoD (housing, education etc.)	127 189	122 297	-4 892	-3,8
Housing	48 201	44 436	-3 765	-7.8
Education	42 360	42 315	-45	-0.1
Health and sport	32 952	32 031	-921	-2.8
Other, e.g. culture, media	3 676	3 533	-143	-3.9
Military pensions	1 10 425	112 053	1 628	1.5
MVD troops	65 048	58 843	-6 205	-9.5
Incl SDO*	5 850	4 725	-1 125	-19.2
Housing, education etc MVD	6 550	6 173	-377	-5.8
FSB border troops	92 435	80 134	-12 301	-13.3
Security services (FSB, SVR, FSO)	185 096	179 005	-6 091	-3.3
Other security and border	57 276	51 016	-6 260	-10.9
Additional military-related R&D	31 418	28 025	-3 393	-10.8
Subsidies to closed towns	19 184	18 236	-948	-4.9
Baikonur **	1 298	858	-440	-33.9
Concealed budgetary transfers	NA	NA		
OME, total	695 919	656 640	-39 279	-5.6
Total military expenditure (TME = OME+ND)	032 275	1 853 655	-178 620	-8.8
Total federal budget (FB)	9 024 655	9 692 219	667 564	7.4
TME/FB percent	22.5	19.1		
GDP	51 475 000	40 420 000	-11 055 000	-21.5
TME/GDP percent	3.9	4.6		

Source: Cooper, 2009, p. 7. *SDO – State defence order. **Baikonur Cosmodrome, on the right bank of the Syr Darya River in Kazakhstan. Originally dubbed simply as 'Desyataya Ploshadka' (Site 10), this closed military town was called Zarya, Leninskiy, Leninsk and Zvezdograd over the four decades after its founding in 1955. In the mid-1990s, President Yeltsin's decree named the town 'Baikonur', as it had previously been identified in the Soviet press.

Prime Minister Putin has announced that the SDO for 2010 will be 1.175 trillion 175 bn roubles, i. e. in nominal terms 8.5% higher than in 2009 (*Nezavisimoe voennoe obozrenie*, 42, 2009, p. 3). This is so despite quite tough criticism of the performance of the military industrial companies by President Medvedev at a meeting in Reutov on 26 October. The results of 2009 are weak. According to Putin, the military companies' output has grown by 4% in 2009, which is not much compared to with the 38% increase in the amount of money put into the production. The military industrial complex's performance has obviously not been improved through the concentration of 500 of its companies in *Rostekhnologiya* under Sergei Chemezov.

On the whole, the military industrial complex's situation is very serious due to the neglect of investments and modernisation of their equipment of over 30 years. The big companies with thousands of employees (AvtoVAZ in Tolyatti has redundancies of 25 ,000 people, *ibid.* p. 9) do not need single machines to become contemporary producers, they need whole systems of production and new factories. As many observers note, current: present weapons are being produced by Soviet technology. To produce the weapons of tomorrow Russian producers need completely new technology and organisation. It is clear that the government must initiate scrapping of parts of the military industrial companies, choose a handful of companies with the scope to develop and also encourage new companies with new technology, if Russia wants to become competitive in this area

The appearances of the French aircraft carrier *Mistral* in St. Petersburg in November 2009 started speculations as to whether Russia is now going to buy ships from a NATO country instead of building their own. Russia already has partnerships within the military complex area with foreign companies, e.g. French and German. Whatever happens with *Mistral*, it is clear that technology transfer and cooperation with other countries in developing new weapon systems is quite necessary if Russia wants to keep up with Western standards.²⁰

6.4 The defence budget 2010

In the 2010 budget draft, the SDO of 2010 is planned at a level of 101.2% of the 2009 level. According to RiaNovosti (2009-08-20), Russia will spend 470 bn roubles (\$15 bn) on arms, equipment and maintenance of its Armed Forces in 2010. The expenditure on R&D, construction, procurement and repair of weapons and weapon systems will be at 99.3% of the 2009 level. Expenditure on the provision of foodstuffs will be increased by 25.6% compared with 2009, which is related to the increase in the number of servicemen and inflation. The provision for clothing will be increased by 8.8%. According to Minfin, this budget will allow the provision of clothing to servicemen according to norms and it is specially mentioned that it will cover parade uniforms for the participants in the parade for the 65th anniversary of WWII. The budget for special fuels and oil materials will be raised by 22.3%. Other spending in the SDO for 2010 will be cut and it will amount to 76.2% of the 2009 figure (Minfin, 2009, pp. 57-58).

President Medvedev (2009a) in his budget address on the 2010 budget especially stressed that the living conditions of the military have to be improved. People who have left the army have the right to appropriate living space, and it appears that the Russian

²⁰ See further Westerlund (2009a) and (2009b) on the development of Russian industrial defence production and the problems of management and organisation in this area.

state has still not fulfilled its promises to provide all veterans from WWII with apartments. Medvedev (*op.cit.*) also stresses army reform and the need to give the army a new image so it meets the demands of the new strategy for national security 2020. Again he comes back to the necessity to provide both retired and active military with decent housing. The amount by which military pensions should be raised is something the President considers can be determined 6 months into the budget execution period.

7 Outlook

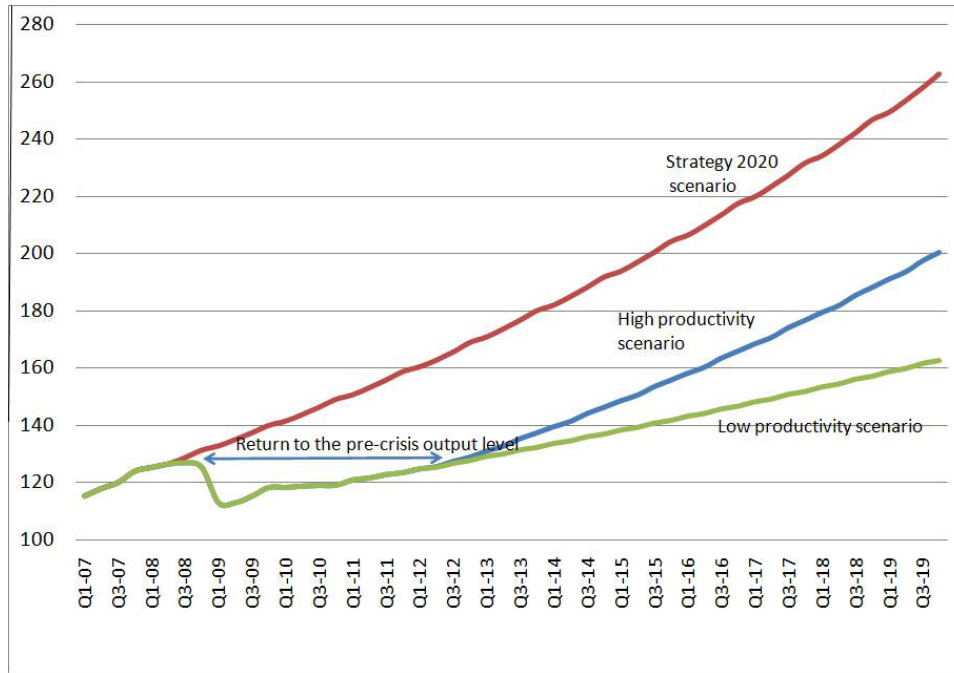
How will Russia get out of the crisis and what will be its economic policy in the future?

The long-term programme that all forecasts and scenarios were based on before the crisis was Putin's *Russia 2020* (MED, 2008). This programme was developed by the MED with three economic scenarios: One was based on growth driven by oil and gas, one based on technical innovations and one depicting inertia development with low growth and no changes (*ibid.*). The innovation scenario was the lead scenario of *Russia 2020*, with average growth of 6.5 percent. The vision of *Russia 2020* was to make Russia a leader in innovation with a middle-class society. Russia's per capita income was to rise from \$12 000 in 2008 to \$30 000 in 2020, which corresponds to 25 percent of the US per capita income and 50 percent respectively. This would make Russia the fifth largest economy in the world behind the US, China, India and Japan (Åslund & Kuchins, 2009, p. 43).

Now growth will be much lower in the near future and the *Russia 2020* programme with its growth and technological innovation focus will not materialise. Furthermore, this programme was characterised by a strong belief in centralised solutions with resources concentrated to the large state corporations that have developed under Putin. In other countries with strong growth, SMEs usually play an important role in development since they can be dynamic and adjust quickly. The PC revolution is an example of such development.

Even though the Russian economy was not as severely hit as some other economies and there are signs of a modest recovery in 2010, the long-term implications of the crisis are quite dramatic. As seen in Figure 7.1, at best GDP can be expected to be back at the 2008 level by 2012. However, that is not the sole economic loss. The economy has fallen to a lower growth trajectory, which means that even with high growth the economic development will be weaker than was anticipated in Putin's *Russia 2020* programme. This is not a unique development for Russia. All economies that have undergone this kind of deep crisis suffer negative repercussions on the level of economic development.

Figure 7.1 Growth scenarios 2008-2019
Index GDP



Source: World Bank (2009b, presentation & data)

7.1 Modernisation

On 10 September 2009, the Russian President Medvedev published '*Russia, Go!*', his own vision for the coming around 10 years of Russian development (Medvedev, 2009b). This document takes a much more liberal and democratic approach to Russian development than has been seen in Putin's documents, and it stresses the wellbeing of the citizens and improved living standard as its main goals. At the same time, Medvedev's analysis of the problems are in many respects a strong criticism of Putin's rule: the economic structure is backward, corruption is rife, the society is too paternalistic, i.e. all those things Western analysts usually point at.

President Medvedev suggests that during the coming decade Russia should become a country whose wellbeing is not only provided by oil and gas but to a greater extent by intellectual resources. Instead, the leading concept should be five 'I's' – institutions, investments, infrastructure, innovation and intellect. The President states: 'We must be the cutting edge of innovation in the main economic complex and in public life' (*ibid.*). Medvedev wants to see a 'smart' economy that is based on unique knowledge

and that exports new technology and innovative products. He presents five areas that should be the core in the modernisation of Russia:

- *Energy*. Russia should become a leader in efficient production, transportation and use of energy. New types of energy should be developed and introduced domestically and in foreign markets.
- *Nuclear energy* should be developed to a new level.
- *IT technology*. Russian specialists should develop IT technology to new highs.
- *The infrastructure of IT* should be developed to enhance information distribution. Russian ‘satellites should see the whole world and help Russians and people from other countries to communicate, travel, engage in science, agriculture and industrial production’ (*ibid*).
- *Pharmaceutical industry*. Russia should be a leader in production of certain medical technology and medication.

Medvedev does not say how these goals should be achieved and the document is a vision of Russia a decade from now. There is no consistent action plan yet for how the changes should be initiated in practice and implemented. Medvedev (2009d) gives some initial instructions to the Government. The ideas of *Russia, Go!* were further developed in the President’s annual address to the Federation Council of the Parliament (Medvedev, 2009c) on 12 November 2009. In this speech the President devotes a large part to the role of civil freedoms and democracy. He also spells out the difference between a strong state and an all-powerful bureaucracy, stating that: ‘..an all-powerful bureaucracy is a mortal danger’ and ‘Corruption is the greatest enemy of a free and democratic society.’ (*Ibid.*)

The bureaucracy and the powerful interest groups taking advantage of the present state of affairs will probably put the brakes on Medvedev’s modernisation plans. Sergey Guriev, Rector of the New Economic School in Moscow suggests that ‘the reason Russia has failed to modernise is that its ruling class can pocket rents from things as they are. Serious modernisation threatens them because it would produce stronger institutions that would make this harder. This rent-seeking psychology is transmitted right down the bureaucratic chain, with each man taking a slice for himself’. (Economist 2009, 26 November).

Another specialist, Igor Yurgens (2009, pp. 72-23), calls for a new round of privatisation. The state starting a new round of privatisation would send an important signal to actors that economic development will be driven by private business and competition. Privatisation would also give a welcome contribution to the federal budget. Yurgens (*op.cit.*) argues that if this is not done the state-owned economy will fall apart. He is also quite clear that there is a need to move people who have been sitting comfortably in corporate management positions too long, with a lot of influence, and let in some new air. The problem with privatisation in Russia, judging from past experiences, is that it tends to produce new elites that enrich themselves rather than contemporary, efficient companies.

Different scenarios of the future of the Russian economy have been discussed (see e.g. Oxenstierna, 2009). It appears that there is a better understanding now of the consequences of pursuing the oil and gas-driven path, which was a dominant element in the growth up to the crisis. It seems that the Russian leaders want to avoid being subjected to this risk to such an extent in the future and are therefore striving for a more innovative and dynamic economy.

7.2 How does the crisis and its aftermath affect relations with the EU?

As could be seen at the 24th EU-Russia summit in November 2009, the EU-Russia relationship is quite amicable and constructive in many fields, and decisions were taken to improve the situation in the areas of energy security, greenhouse gas emissions and trade. In addition, Russia stated that it aspires to join the WTO. Finding solutions to economic and technical issues is thus not a problem in the long run, even though the parties may encounter difficulties on the way. All countries have experienced severe problems during the financial and economic crisis, and Russia has managed its crisis quite well and, like the others, now has new conditions and constraints incorporated into post-crisis economic policies. However, some issues are more difficult to solve due to fundamentally different values.

The main obstacle to closer relations between Russia and the EU is human rights issues, where EU and Russia stand very far apart. President Medvedev's attempts to raise the issues of the civil society, stress the importance of the rule of law and advocate modernisation of the economy and Russian society as a whole sound 'Western' and any change in this direction will improve relations. As Carolina Vendil Pallin writes:

....., the degree of practical exchange between the EU and Russia is far greater today than it ever was in the 1990s, and if Medvedev's modernization programme for Russia becomes a reality there should be ample scope for constructive economic relations. (Pallin, 2009).

If corruption is not fought and independent courts and the rule of law cannot be imposed in Russia, there are clearly negative consequences for long-term deeper economic integration between Russia and the EU, as well as for cooperation within the security area:

.....Russia will not be able to offer a better investment climate for EU investors as long as fundamental principles of the rule of law are not adhered to. (Pallin, op.cit.)

Further integration into the global economy is a crucial element of the remedy for Russia's future economic development. By joining the WTO Russia must become more competitive and follow common rules. It should be noted, however, that both high growth and low growth might be related to better or worse political relations with the West. From what has been seen since 1991, it can be concluded that Russia has more

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drive in its economics reforms when the economy is weak. The factors that could trigger serious democratic reforms once again are a different matter and quite an open question.

8 Conclusions

Despite massive measures to save corporate Russia, the Russian government will have to accept a drop in GDP of around 8 percent in 2009. This is a steep reverse and stands in sharp contrast to the average annual growth of GDP of 7 percent per year during the early part of this decade. Compared with the expectations in the original budget plan for 2009, GDP will be 25 percent lower. The declining income to the federal budget and the need to raise public spending to fund the anti-crisis measures mean that Russia will experience its first federal budget deficit since 1999. The deficit for 2009 is estimated to be 8.9 percent of GDP. A declining budget deficit is the plan up to 2012.

The most serious consequence of the crisis is the drop in living standard and increase in the number of poor people in Russia. Russia has developed a Russian-type middle-class of around 50 percent of the population, but under this level there are another 20 percent living over the official poverty line but vulnerable to negative changes in development. The idea was for these people to also become part of the middle class, but instead they have now become part of the poor population. In 2009, Russia will have almost 25 million poor and a poverty rate of 17.4 percent. The Russian government has social programmes for supporting the vulnerable population but they are not enough. A main problem is that many pensioners live under the subsistence level due to deficient pensions. The only way of lifting the majority of the population into prosperity is stable economic growth and equalising distribution of incomes. So far high growth has not resulted in any substantial increase in equality in Russia.

Despite the social consequences for the population being extremely hard, the Russian government has focused its crisis policies on supporting the financial sector and large-scale industry and agriculture. At first massive injections of liquidity were made into the banking system to alleviate the credit squeeze and to support the refinancing needs of the huge foreign debt held by the private sector. As the crisis deepened, the government initiated a programme of direct subsidies to strategic sectors and prioritised industries. The idea behind these measures is of course to conserve employment inside enterprises in order to avoid extremely high levels of unemployment and to save industries that might become profitable after the crisis. During the third quarter of 2009, unemployment fell to 7.9 percent. Labour policies have been geared at limiting lay-offs, and labour market adjustments have largely taken place through wage cuts and wage arrears. The old and strong industrial and regional lobbies have played an essential role in influencing the design of the programme, but it is also a result of the Russian government lacking labour market and regional policies for much needed structural change and enhancing labour mobility from unproductive industries to productive.

The crisis and the policies have resulted in the costs of the federal budget having risen by 8 percent compared with the original budget for 2009. All sectors except the subsidies to the economy, housing and municipal services, social policy and interbudgetary transfers have been cut in the budget. National defence has been cut by

over 10 percent, and among its budget lines it is only those linked to international commitments that have been increased quite substantially. As a result of the cut and the smaller GDP, national defence now corresponds to 3.1 percent of GDP, which is a slight increase compared with the 2.7 percent of recent years. The decrease in spending on R&D will probably make it more difficult to modernise armament for the Armed Forces. Estimates of the total military budget indicate that it now comprises 4.6 percent of GDP.

The military industrial complex has been among the high priority companies that received substantial support from the government's anti-crisis programme. For example, the military industrial complex companies that produce SDOs have received special subsidies to cover interest payments and credit guarantees. The government has also pumped new capital into several strategic companies. Despite this support, the results are meagre. President Medvedev has severely criticised the military industrial complex companies and indicated that they must start producing contemporary arms of high quality at lower prices. Large parts of the military industrial complex need to be scrapped since the technology dates from Soviet times and cannot produce contemporary arms.

In Minfin forecasts in early fall 2009, the expectation for the external sector is that the oil price will be \$54 in 2009 instead of the almost \$100 cited in the original MED plans.²¹ The gas price, which is linked to the oil price, has dropped to half the expected price, as have exports. The effects of the dramatic drop in the oil price again show how sensitive the Russian economy is to its high dependence on export of hydrocarbons. The crisis has been a wake-up call to the Russian leadership and understanding of the need for a diversified economy for long-term stable growth has increased. President Medvedev (2009b) has clearly stated that he does not want the oil market to determine development in Russia:

It is not the commodity exchanges that should decide the fate of Russia, but our own idea of us, our history and of our future. Our intellect, our strength, our feeling of self esteem, entrepreneurship

He launches a programme of modernisation and paints a vision of a modern economy and society. He is very outspoken when it comes to corruption, the inertia of relying on the commodity trade and the historical paternalistic drives to growth with no consideration for the human beings involved.

The continuing need to support the economy and to fulfil the social obligations towards the population means that the 2010-2012 budgets are underbalanced. The Reserve Fund and the Welfare Fund will be used to finance the budget deficit. The Reserve Fund will

²¹ In November 2009, the oil price was already over \$70. This might improve the actual results of the economy.

be used in full in 2010, and the Welfare Fund will be used to supplement the Pension Fund throughout the period. For the rest, the government will issue debt on the domestic and foreign markets. The Russian government does not want to use the loan facilities of the IMF or the World Bank since these come with conditions and monitoring of economic policy.

Several observers have questioned the crisis management of the Russian government since it has been given in a very centralised way and the main line has been to give massive support to high priority sectors and the large Soviet-type companies of the economy. The sectors and companies that the government has prioritised are frequently companies in need of serious restructuring or closure. It follows that much of the support has been given just to keep unemployment down and limit staff lay-offs. The SME sector, which is vital to growth in other countries, has not shared the bonanza of the anti-crisis programme. The SME sector is small in Russia and employs only 20 percent of the workforce. The growth of this sector should be an essential part of any growth strategy. Russia currently does not have any policies that would enhance structural change, in which mechanisms for moving labour between companies, sectors and regions would be central. In order to close the gigantic unprofitable companies in the military industrial complex or in other sectors, the government must be able to offer the workforce a smooth transition between the old workplace and the new. This requires a coherent labour market policy, regional policy and industrial policy that Russia must develop if there is to be any modernisation.

The anti-crisis programme also failed to emphasise the development of infrastructure, which is traditional for governments to use in times of recession. Russia's infrastructure is in many respects outdated and in need of modernisation. Again, however, the lack of existing programmes for moving labour and providing retraining and housing makes it difficult for the Russian government to use this tool, although these activities would produce value-added rather than obsolete goods at some state corporations. The government's choice to increase its involvement in the financial and large-scale corporate sector has already produced disturbances and there are doubts as to whether the state will withdraw as the economy starts recovering.

The Russian economy faces new challenges during the years to come and the crisis has in many respects been a wake-up call and changed the scene for economic development rather drastically. On the positive side, it may be noted that reforms have taken place in Russia when economic growth and export incomes have been low. On the negative side, there is the rent-seeking *nomenklatura* that does not want to lose its privileges.

Medvedev's own think-tank, the Institute of Contemporary Development, stresses the role of interest groups in Russian development and the potential of the crisis to change the terms of the social contract under Putin. (Yurgens, 2009a) Growth will not be spectacular during the next few years and if the leadership does not manage to modernise the economy so that it can deliver a higher living standard to the population with less resources, the population might no longer cherish the social contract and the

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situation might become unstable. The next presidential election takes place in 2012, which should give the leadership a strong incentive to implement the new course in economic policy.

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10 Acronyms

BIS	Bank of International Settlements
bn	billion
BRIC	Brazil, Russia, India and China
CBR	Central Bank of Russia
CSTO	Collective Security Treaty Organisation
EME	Emerging market economies
EC	European Commission
EU	European Union
DFID	Department For International Development, UK
FC	Federal Council RF
FS	Federal Council RF
FSB	Federal Security Service
GDP	Gross domestic product
IMF	International Monetary Fund
MED	Ministry of Economic Development of the Russian Federation
MICEX	Moscow Interbank Currency Exchange
Minfin	Ministry of Finance of the Russian Federation
MoD	Ministry of Defence of the Russian Federation
MVD	Ministry of Internal Affairs of the Russian Federation
ND	National defence
Q1, Q2	First quarter of the year, second quarter, etc.
RF	Russian Federation
Rosstat	Federal Statistical Agency of the Russian Federation
RTS	Russian Trading System
RUR	Russian roubles
SME	Small and medium-sized enterprises
TME	Total military costs
VEB	Russian Development Bank
VTB	Russian Foreign Trade Bank
WTO	World Trade Organisation

About the author

Susanne Oxenstierna obtained her PhD in economics at Stockholm University in 1991 with a thesis on the Soviet labour market. In 1992, she was recruited by the Swedish Ministry of Finance to set up a project office in Moscow and form part of a team that assisted the Russian Ministry of Finance to reform the budget process, debt management, and to develop a tax administration. In 1997, she started a four-year Sida-funded project on reform of research and teaching of Public Economics at St. Petersburg State University. In addition, she worked in Sida, DFID and EC financed projects in different East European economies. She has also taught at Uppsala University and at the Department of Economics of Stockholm University. Since 2001, Susanne has been working for several international consulting companies on issues linked to public sector reform in transition economies. In February 2009, Susanne took up the post of Senior Researcher at the Department of Defence Analysis of FOI. Her recent publications are listed on:

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