

Preserving economic stability

INTERVIEW WITH ALEXEY KUDRIN

DEPUTY PRIME MINISTER AND MINISTER OF FINANCE OF THE RUSSIAN FEDERATION



ALEXEY KUDRIN is a graduate of Leningrad State University. From 1983-90 he worked at the Academy of Sciences of the USSR, and from 1997-2000 served as First Deputy Finance Minister, with an interlude in 1999. In May 2000 he was appointed Finance Minister and Vice Chairman of the Russian Government. He is Deputy Chairman of RAO UES, Governor from Russia at the IMF and Co-Chairman of the Russia-British Committee on Trade and Investment

The Russian economy appears to be making progress despite the harsh global economic environment. What are the main policy initiatives behind this?

The recent development of the Russian economy is due to better financial discipline and to our strong financial reserves. This position has been helped by political consolidation supporting several measures in the fiscal sphere. I should tell you that it was difficult to maintain a restrained and conservative policy in the midst of high oil prices to create the stabilisation and reserve fund and the national Commonwealth fund, the systems of goal-oriented budgeting, and the targeted policies that have provoked criticism in certain quarters. Some believed that we were simply creating reserves instead of establishing major industrial enterprises that will help liberate the country from its dependency on oil. However, given the support of the leadership of the country, we have managed to maintain this restricted and restrained economic policy.

I think, though, that in terms of fiscal and monetary policy, it was still too mild. I believe that we need to have a tougher fiscal policy. Over recent years the money supply grew to 50 to 60 per cent – too much, in my view – which means that we had a fiscal policy that was too relaxed. And the growth of loans to the real estate sector in 2007 amounted to 50 per cent in one year, and in 2008, when we felt the first indications of the financial crisis, it was 35 per cent. I cannot say that all these loans were good or unproblematic. We have difficulties assessing risks related to the cyclical nature of the economy, especially with regard to the acute crisis that we face today.

To what extent have these policies and the country's financial reserve position helped to mitigate the worst effects of the global recession?

It is still not easy for the government and for the Ministry of Finance to act, despite the availability of these major reserves. Russia's over-dependency on the export of oil, natural gas, metals and other raw materials has created reduced demand inside Russia. Judging from the outcome of the first quarter of 2009, the shrinkage was worse than we expected. We thought that the drop in GDP in the first quarter would be 7.5 per cent, but it turned out to be 9.5 per cent. We thought that industrial output would drop 10.6 per cent, but in fact it dropped 14.3 per cent. Investments

decreased 15 per cent and the biggest fall was seen in the processing industry, 22.8 per cent and in construction and building, 19.3 per cent. Unemployment is growing and this has forced us to reconsider our assessments and forecasts for this year's prospects.

To what extent is the Russian economy now linked to the global economy? Are domestic policies designed to reflect Russia's global integration?

We are certainly dependent to a great degree on the world economy. The first glimmers of hope for positive growth in the United States and in the world economy have emerged and there is a feeling that the situation will improve. The measures adopted by the United States have had an impact on what is happening in global and developing markets, including Russia.

In Russia, we are planning our measures based on the assumption that we will face longer term volatility. So, we intend to keep our reserves strong at 7.5 per cent, despite the budget deficit this entails. Perhaps there will be a need for even greater deficits if we want to avoid replanning major programmes which the government has already announced. Next year, in 2010 and in 2011, we are going to reduce this deficit, and we have announced preliminary deficit figures of 5 per cent in 2010 and 3 per cent in 2011. This is a challenge, but we are going to keep to this promise to preserve macro-economic stability so as not to deplete our resources too rapidly.

What measures have you taken to stabilise markets?

The measures we took in the markets were measures to maintain financial stability. Last October, when we understood that we would face the prospect of devaluation and when the first indicators of crisis appeared, the market's confidence in banks decreased considerably, and people, remembering their experiences of 1998, made a run on the banks, withdrawing up to US\$22.5 billion from their accounts. For some banks, this was more than 10 per cent of deposits and accumulated assets. Russia issued subordinated loans to the banks of US\$40 billion that helped save the banking system and maintained its stability. Moreover, those subordinated loans were allocated from the National Commonwealth Foundation and from the budget. We offered greater liquidity to the market, which supported the banks but

also contributed to the outflow of capital. The central bank opted for a strategy of smooth devaluation. That strategy was widely debated, but again we took into account two considerations: first, the concern that a shock devaluation could produce a run on the banks; and second, corporate clients' large amount of external foreign debt. This would have created the risk of non-payment and non-return of credit for major enterprises. In the smooth reduction, the banks restructured their portfolios and in October foreign liabilities surpassed foreign assets. In February, they reconstituted 100 per cent of the banks' liabilities, restructured in such a way as to be combined with 100 per cent of their foreign assets. The banks accumulated or repaid part of their foreign debts or accumulated reserves in foreign exchange so as to repay their debts and to protect themselves from currency exchange risks. Those measures turned out to be quite expensive but they helped to maintain stability and permitted us to continue this work.

So, the situation is quite satisfactory at this initial stage, especially as far as it concerns the financial sector.

The banking system in Russia has not been immune from the effects of the global crisis. What are the key challenges in mitigating its impact on this sector?

The main challenge lies in the bad loans and the increasing volume of non-performing or non-returnable loans. These non-performing loans account for 3 per cent of loans in the Russian system but Russian standards are different from international standards. These problematic loans represent more like 7.5-8 per cent of loans according to international standards. 10 per cent for us is a threshold beyond which we will need to provide some additional support to the banking sector and therefore the government has announced a new programme to support the banks, with an additional US\$28 billion in the form of subordinated credit. I think that 10 per cent may not be the last boundary, the last threshold of bad loans that we will have. In such a deep crisis, it may be more and the resources of the state will allow us to provide additional support should the risks increase.

You have also undertaken a major reform of tax measures. Please explain these developments.

We reduced income tax from 24 per cent to 20 per cent, and increased the amortisation premium for upgrading and modernisation from 20 per cent to 30 per cent. In other words, 30 per cent of equipment supplied this year will be equal to a 30 per cent reduction in taxable income. This acted as a stimulus for re-equipping industrial enterprises.

We have also adopted a major programme to support small businesses including reducing taxes,

and providing fiscal facilities. Furthermore, we have increased, by several billion dollars, the guarantees on lending facilities, allocated additional resources to support regional small-business foundations, and adopted a package of legislation limiting inspections by law enforcement and fiscal agencies during the coming years, especially this year.

The total volume of tax reductions has reached approximately 1.5-2 per cent of GDP. This is the element of the anti-crisis package related to easing the taxation burden, while other parts of this package relate to supporting the pension system, since the proceeds in the pension system have decreased both as a result of the crisis and also the reduction in wages. So, we have adopted a number of measures to support individual industries, such as the auto industry, the aircraft manufacturing industry, shipbuilding, and some others. We are also supporting export industries and stimulating exports through the provision of additional guarantees.

What has been the overall effect of this fiscal package?

The fiscal package has increased the initial budget by approximately 6 per cent of GDP. Quite often in Russia, a figure of 10 per cent, or 12 per cent of GDP has been mentioned but that's not quite accurate because it includes the volume of liquidity that has been provided to the market by the central bank and the government on a temporary basis. The volume of the fiscal package

Russia has adopted a major programme to support small businesses including reducing taxes, and providing fiscal facilities

Russia's Deputy Prime Minister and Minister of Finance, Alexey Kudrin, outlines his proposals for tackling the economic crisis and maintaining stability



The meetings that we had in London in April are helping to create a new and very different world financial architecture

in Russia including taxes amounts to approximately 6 per cent of GDP and we believe that this is an adequate package. Increasing it now could result in a greater risk of inflation and capital flight and could deplete reserves. So, we believe that the chosen strategy is well balanced and that it will help us to maintain the stability of the Russian economy and of the financial system for this year and the years to come.

What is the current situation in respect of state expenditure?

We have an important challenge regarding the optimisation of state spending. It covers all areas such as roads, culture, education and defence. We are preparing a new programme for the coming three years, starting from 2010 until 2012, and these programmes will provide some priorities for this government. In 2009, the budgetary revenues decreased by 30 per cent compared to 2008, due mainly to the oil and gas sector and the rapid shrinkage of GDP. This shows that Russia is more vulnerable than other countries given the structure of its exports and the structure of its economy, and this increases the need to promote diversification in the future. Therefore, taxes will be restructured to stimulate innovation and technology. We are also preparing a major programme on energy efficiency and the economic use of energy resources. We will provide additional programmes to reform the housing and utility sectors to make them more

efficient, and I should say that expenditures on state management will be cut by 12 per cent. I repeat that these programmes are intended to optimise our life and they will be implemented in many different areas.

How do you see the outcome of the recent G20 London Summit which addressed the global crisis?

After the London Summit, the role of emerging markets in world regulation has grown and a serious programme was developed to improve the regulation of the world financial markets. The discussion was between the European representatives and those of the United States and the United Kingdom at the G20 Summit in London. I think that it was not an empty discussion. There are objective differences in approaches to the crisis and on how to maintain financial discipline and how to regulate markets. Countries such as Russia and China have a new format for our work that provides a break from our normal discussions on this topic with Brazil, Russia, India and China.

So the questions that were raised, not only during this crisis but before the crisis, were whether or not the IMF is sufficiently representative of all groups of countries, especially stronger countries such as the emerging markets, and the extent to which IMF decisions take account of the interests of all countries. But I think the IMF, the World Bank, and other financial institutions should increase the role of developing and emerging markets to reflect their capacity and influence. Therefore, we note with satisfaction that we have been included in the Financial Stability Forum, which is now called the Financial Stability Board and the Basel Committee. This process has now been launched and by next year in the World Bank and by 2011 in the IMF, we will see more decisive changes in quotas and the representation of our economies within these institutions. Accordingly, we think that the responsibility of world markets is growing, not only with developing nations but developed nations too. We would also like to know the prospects of the euro area and we must be sure about these prospects. There is also the issue of whether regulation is going to be voluntary, soft, mild and whether regulation will cover financial markets and instruments as well as macro-economics. We also discussed the extent to which the developed nations will bear responsibility for their macro-economic fundamentals, what is going to be regulated, and who will have responsibility. These important issues will probably require further discussion and debate in order to work out new rules. I think, therefore, that the meetings that we had in London are helping to create a new world financial architecture that will be very different from the financial architecture that currently exists. Russia will be involved in these processes.

Russian GDP growth by main sectors, 2006-08 (value added)

Year	2006	2007	2008
Total GDP growth	7.7	8.1	5.6
Tradable sectors	3.4	3.9	1.8
Agriculture, forestry	3.8	2.6	8.4
Extraction industries	-3.3	-2.6	0.2
Manufacturing	7.3	7.8	0.9
Non-tradable sectors	9.7	10.3	7.4
Electricity, gas, water production and distribution	5.7	-0.7	1.2
Construction	11.8	9.3	13.2
Wholesale and retail trade	14.1	13.7	8.4
Financial services	10.3	12.5	6.6
Transport and communication	9.6	3.4	6.9
Source: Rosstat; World Bank staff calculations			