

# Planning for the post-crisis future

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Capital flows are returning to developing countries, including Russia, albeit not in the amounts seen before the crisis

President Medvedev addresses 2009's SPIEF

**L**aying the Foundations for the Future is the theme of this year's St Petersburg International Economic Forum (SPIEF), and in the light of changes brought about by the recent financial crisis there is a sense of urgency for such planning by politicians and business leaders who are attending the conference that will take place between 17-19th June in Russia's second city. It has been a difficult year for the world and Russia.

By late 2008, despite having registered a 5.6 per cent increase in GDP that year, the tidal waves triggered by the global financial tsunami could be held back no longer. By June 2009, they had hit the economy hard.

Indeed, the worst of the crisis was concentrated in the first two quarters of 2009, and the extent of the economic and social deterioration in the first five months of 2009 was deeper than feared. Real GDP in that period dropped by around 10 per cent, unemployment reached close to 10 per cent, and the poverty rate rose dramatically. However, by the third quarter, green shoots were beginning to emerge, and the fall in GDP growth eased back to 7.9 per cent for the year overall.

A year later, Russia's output, employment, and real wage losses are significant – the World Bank says that the country lost half a decade of growth in 2009 – but

are lower than had been feared early in the crisis. The Russian economy has proved resilient. This has been largely due to strong fiscal fundamentals, along with the Russian leadership's effective anti-crisis policy response, which amounted to 6.9 per cent of GDP, and helped to stabilise the financial sector, avoid a currency crisis, and assisted the recovery of output and incomes. Growth forecasts for 2010 rose from 3.5 per cent in November 2009 to the current estimate of around 5.2 per cent.

"The real damage to our economy was far greater than anything predicted by ourselves, the World Bank and other expert organisations," Russia's President, Dmitry Medvedev, said in a recent television interview. He pointed out that, unlike some other countries, and against the predictions of some analysts, Russia's banking system had survived the crisis fairly well. "Our banking system withstood the stress, and now it is doing just fine," he added. Furthermore, the social impact has turned out to be less severe than feared, with unemployment and poverty currently standing at 8.2 and 14 per cent, respectively.

"Russia's overall anti-crisis policy response has helped the country weather the crisis. Increases in wages, pensions and unemployment benefits have cushioned the impact on the middle class and the poor. Nevertheless, certain components of the policy response could have been more effective and less costly if they had been more focused on infrastructure and targeted social assistance that are believed to have higher expenditure or employment multipliers," said Pedro Alba, World Bank's Country Director for Russia in a March 2010 report.

Although the global economy is expected to expand by 2.7 per cent in 2010, led by emerging and developing countries, growth will be more constrained in high-income countries due to high unemployment, credit conditions and the need to unwind fiscal stimuli. Capital flows are returning to developing countries, including Russia, albeit not in the amounts seen before the crisis. Oil prices are expected to remain stable for the rest of the year at around US\$76, which bodes well for the stability of Russia's export and tax revenues.

Furthermore, with reserves running at US\$400 billion, Russia has enough cash to finance its US\$16.6 billion budget deficit, which amounts to 6.8 per cent of GDP with plans to reduce it to 3.3 per cent by 2012. The country is in the process of issuing its first



Photo: RIA Novosti

international bond in a decade, which analysts say should raise around US\$10 billion.

Russia is likely to witness a robust but relatively jobless recovery in 2010-11. This means that – given the current global outlook – a double-dip recession in Russia is unlikely and recovery will be sustained, primarily driven by the revival of domestic demand – consumption and investment.

### SPIEF priorities

Working on the basis that the worst of the crisis is now behind Russia, much of the agenda of this year's SPIEF focuses on the post-crisis future, and will be looking at the role finance can play in supporting accelerated and sustained growth, particularly from the BRIC nations. Delegates will be discussing how the crisis has changed thinking towards sustainable development and the need to innovate, as well as the steps that business and government leaders are taking to adjust to the altering competitive landscape, and the difficulties in undertaking structural economic changes.

As the past year has shown, policy makers and business leaders have to find ways to balance short-term priorities with the need to establish long-term growth strategies. In working out its post-crisis strategy, the Russian leadership has decided to give business a bigger role, following a request by Alexander Shokhin, head of the Russian Union of Industrialists and Entrepreneurs (RSPP) to allow the Russian business elite to officially attend government sessions.

Shokhin says that the next year will still be very challenging. "Many RSPP members are drawing up business strategies that focus on post-crisis development and modernisation. It is very important to ensure close cooperation with the government on routine issues, as well as with leading ministries and agencies," he says.

Innovation is a recurring theme throughout the Forum's agenda. Russia's pre-crisis decade of prosperity was built on strong macro-economic management – especially, fiscal policy reform – and a confluence of high oil prices, surging capital inflows, and access to low-cost external financing. For the short- to medium-term, the post-crisis world is proving to be very different. In response to sluggish global growth, low capital flows, and more limited access to foreign financing, President Dimitry Medvedev and Prime Minister Vladimir Putin are implementing fiscal adjustment and pushing to diversify Russia's economy, as well as addressing long-term structural issues such as: improving the investment climate, reforming the public sector, further strengthening the financial sector, and improving competitiveness and diversification in an economy where 80 per cent of exports come from oil and metals, making Russia susceptible to their price swings.

In short, Russia is keen to convince the business

community that the country is serious about modernisation, with President Medvedev making innovation a focus of his tenure. The President believes that Russia's economy can be turned around within a decade. "That is a perfectly plausible time frame in which to create a new economy, an economy that will be competitive with other major world economies. Once a significant portion of our revenue is generated by something other than energy exports, let's say at least 30 or 40 per cent of it, then we would already be living in a different economy and a different country," says Mr Medvedev.

Alexei Kudrin, the Finance Minister, says that Russia will be transformed into a 'new country' by 2020 through innovation and investment in 'human capital'. One government effort is a fund for nanotechnology, Rusnano, which is trying to leapfrog the West's lead in semiconductors with the next generation of technology products. Its director, Anatoly Chubais, a former finance minister, believes that Russia now lags 30 to 40 years behind developed countries in technology. "We have to admit we have fallen very far behind," Mr Chubais says, adding: "Not to understand this would be a very grave, historic and political mistake."

Mr Chubais, Russia's privatisation tsar in the mid-1990s, says the country needs to make progress on converting knowledge into money-making businesses, despite its rich scientific heritage. "We know how to turn money into knowledge, but we still have problems turning knowledge into money," he says.

Elvira Nabuillina, Minister of Economic Development and Chairwoman of the SPIEF Organising Committee, has repeatedly stressed the need for modernisation of the Russian economy. "The

**With reserves running at US\$400 billion, Russia has more than enough cash to finance its US\$16.6 billion deficit**

Russia's Minister of Economic Development, Elvira Nabuillina addresses the media at the 2009 Forum



Photo: RIA Novosti

**Russia plans to build eight industrial technoparks by 2012 that will incorporate high-tech enterprises, as well as scientific research organisations**

emphasis should be on modernising the economic structure, developing sectors with a high intellectual input such as communications, telecommunications, pharmaceuticals, aviation, space and nuclear energy, in short, everything that involves innovation,” Mrs Nabuillina believes. “The combination of growth and development means that we should put our stake on the innovation development model. It must be an investment model, not just a growth of investments, but investments in efficiency,” she says. To give further clout in the push for high-tech solutions the government has set up a commission headed by Prime Minister Vladimir Putin.

Prime Minister Putin says that the commission will take on wide-ranging new powers to enforce its modernisation agenda, significantly raising the body’s profile on his first day as its chairman. “The scale of the goals to be achieved requires an expansion of its authority,” Putin said in March.

Mr Putin says the government would spend more than a tenth of its budget on science and innovation this year, with funding for major scientific projects to be carried out on a competitive basis. He adds that the measures to promote high-tech businesses will include changes in the way the state buys products and services. Officials must start giving preference to innovative options when they choose winners of tenders.

The premier also points out that a key focus of the commission will be finding long-term investment in scientific sectors that would not rely on budget funding. “We’ll tend to increase expenses on development in the future, but this will not have the required effect if we don’t learn to make use of existing resources in a more organised and competent way.”

Budget expenses should be distributed on a competitive basis, including spending on the projects in

fundamental science,” he said. “We can’t pay for research that is not up-to-date, that duplicates other work and, in some cases, has literally been pulled from dusty closets. This is wrong. This is flawed, costly and inefficient.”

Russia plans to build eight industrial technoparks by 2012 that will incorporate high-tech enterprises, as well as scientific research organisations, educational institutions providing staff for such enterprises, and other related ventures. The state will allot approximately US\$1.3 billion for the project, around 15 per cent of all construction costs. Private investment is expected to exceed US\$6 billion.

This year the government announced plans to establish Russia’s equivalent of Silicon Valley at the Skolkovo Business School, near Moscow. Aiming to reduce the economy’s reliance upon raw materials, the new centre will focus on Mr Medvedev’s five priorities for modernisation: energy, information technology, telecommunications, biotechnology and nuclear technology. Billionaire Viktor Vekselberg has been named chair of the council that will oversee the centre’s creation, and Mr Medvedev has pledged to attract well-known scientists to work in the innovation hub.

Skolkovo will provide Russia’s first dedicated platform for innovation in information technology. Mr Vekselberg’s appointment indicates that Mr Medvedev wants the research centre to be developed by the Russian private sector. It is hoped that Skolkovo will attract prominent Russian and foreign scientists and businessmen.

Ukrainian-born Mr Vekselberg, 52, chairman of the board of directors of the Renova Group of Companies, who is estimated to be Russia’s 23rd richest man, believes that this ambitious project will be successful if international companies participate in it. The task of creating a self-sufficient hi-tech research and production centre will take between five and seven years, he says. Skolkovo will have a special legal regime to stimulate investment, including tax holidays of up to 10 years and special privileges in state tenders.

The St Petersburg gathering comes just days after Russia hosted EU leaders at a summit in the southern city of Rostov-on-Don at the end of May. President Medvedev held his first summit with the European Union’s new leadership as the 27-nation bloc sought to develop a unified foreign policy. Medvedev met EU President Herman Van Rompuy, foreign policy chief Catherine Ashton and European Commission President Jose Manuel Barroso at the two-day summit.

The focus was on the new EU-Russia Partnership for Modernisation, which was first discussed at the Stockholm summit. The operational launch of this partnership with a concrete set of priorities is an opportunity for the EU and Russia to build on the achievements made in implementing the Four Common Spaces, and will further encourage growth and increase competitiveness.

Rusnano CEO Anatoly Chubais addresses a FIRST Executive Briefing



## The new environment provides an opportunity to accelerate structural reforms that can raise productivity and diversify the Russian economy

SPIEF Chairwoman Elvira Nabiullina meets with the Chairmen of Russia's largest banks, and the head of the Federal Anti-Monopoly Service

The two sides also made progress with the aim of nurturing a new partnership for modernisation while tackling the global financial and economic crisis, climate change and energy security. Russia supplies 45 per cent of the EU's natural-gas imports and 33 per cent of its crude oil imports. At the same time, 70 per cent of Russian gas exports and 88 per cent of its oil exports are shipped to the European trade bloc.

The past year has also seen the Russian president meet with the new leadership of the United States. In July 2009, US President Barack Obama visited Moscow for the first time, discussing a range of issues with his Russian host. The two sides agreed in principle to cut their nuclear arsenals by roughly a quarter in seven years. The Russians and Americans also agreed to renew military cooperation and work on non-proliferation. A dozen American aircraft a day will fly through Russian airspace carrying troops and equipment to Afghanistan. This will save time and money and also make Russia's southern border more secure.

### World Trade Organisation membership

Russia finally looks set to join the World Trade Organisation, after more than 15 years of talks. In May, Vladimir Putin announced that the country would join in tandem with neighbouring Kazakhstan.

As a WTO member, Russia will have easier access to foreign markets, bypassing tariff and non-tariff barriers that currently deter trade. Now, Russia loses up to US\$2.5 billion annually from discrimination practices in foreign markets. Open access to these markets could also encourage the production of knowledge-based products in Russia, which its authorities have long been advocating.

Russian companies are waking up to the idea that, after years of baby steps towards reform and shielded from international competition, they may soon be plunged into the deep end of the pool. Once in the WTO, Russian industries will have to modernise swiftly or face the consequences. Overall tariff rates will come down from 10.1 per cent on average to 7.1 per cent seven years after joining, say analysts.

Another positive aspect is participation in the development and reform of international trade rules. So far, Russia cannot take part in this process, which means that the rules that other countries adopt may contradict its interests in terms of competition, investment and energy policy. On the other hand, opponents of joining the WTO argue that as a member, Russia will be unable to approve prohibitive duties, thus allowing foreign goods to replace some of its own commodities. They also say that the strictly outlined tariff policies of the WTO member countries will lower budget revenues from import duties.

The consequences of joining the WTO would differ from one economic sector to another. For example, the

Russian chemical and steel sectors expect huge benefits because other member countries will have to lift their anti-dumping customs duties which are currently protecting their markets from Russian goods.

The sectors competing with foreign producers, above all mechanical engineering, food and light industries, and agriculture, are fiercely opposing WTO entry because open competition with foreign producers may bankrupt them. The Russian financial structure also fears competition from foreign banks.

However, Russian consumers would certainly benefit from WTO membership because this would open the Russian market to foreign banks, construction and food companies, and would also lower duties on imported cars. And lastly, open competition with foreign companies may force Russian producers to lower prices by cutting both outlays and profits, if they want to survive.

### Conclusion

Many analysts agree with, Valentina Matvienko, St Petersburg's governor and deputy chairwoman of the SPIEF Organising Committee, who says: "The crisis has not decreased Russia's investment attractiveness. Quite the contrary, it has offered new opportunities, such as undervalued assets, new investment spheres, and a strengthening national currency."

However, downside risks remain, associated with weak domestic demand and remaining structural constraints. On the policy front, Russia faces difficult fiscal, financial, and social challenges to sustain the economic recovery and cushion the social impact in a more constrained, post-crisis world. The new environment provides an opportunity to accelerate structural reforms that can raise productivity and diversify the Russian economy. **F**

