

GLOBAL TURMOIL: RUSSIA'S CHALLENGES

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1. This is the first crisis of the era of globalization. So there are many uncertainties. But it seems the bottom of the crisis is already achieved. Our minister of finance declared that our economy is out of recession. If we look at the past, year ago, every new forecast of international organizations was more pessimistic than previous one.

Let me show you, how the IMF forecasts have changed. Each months their estimates decreased and decreased quite substantially. That is unprecedented for prognosis-makers' reputation. All that reveals uncertainty – if not perplexity, confusion, incomprehension of the causes and real depth of the current crisis.

2. That is why we have to be very cautious regarding forecasts for the future. Many uncertainties preserve. When credit markets will recover? What will happen with the toxic assets? What like will be recovery of American economy: quick or lingering? What will happen to Chinese economy? It is obvious already, that China, notwithstanding high growth rates, dumped into difficult social and political problems and challenges. Suffice to say, that there is 25 million of migrating workers from rural areas who cannot find jobs in the cities, but nobody looks for them in the villages anymore. To that add 1 million unemployed university graduates of the last year and 5 million more of year 2009.

3. In IMEMO our analysis demonstrates significant parallels between current geo-economic and geopolitical situation and the one, which the world lived through in the 1970-ies.

I categorically disagree with the thesis, that the crisis of 2008-20XX can be compared to the Great Depression of 1929-1930. Unfortunately, we have no time for this discussion.

It is likely we have entered into the next crisis era, era of changes in the world order. We know, that the future grows out of the present, while the present – out of the

past. After each serious crisis reshuffle the balance of power in the world and in international relations. That happened after the crisis of 1929 – 1932 and the Great Depression, which followed it. Or – after the crises of 1969 – 1970. In the first case started, the Second World War, which resulted in a “bipolar world”. In the second case the crises were conducive to the mobilization of American society and economic renewal. As a result the United States managed to take up a position of the sole superpower. It is likely that new global changes in international politics will take place now as well.

Will a new world order be more stable? What a new world order be like? How the leading positions of the US in the world will change? We may come closer to the answers to these questions by analyzing political consequences of the crisis of the beginning of 1970-ies. Of course, all historical parallels are relative. Their uncritical usage is dangerous. Nevertheless, the researches have practically no other possibilities for the analysis and prognosis, but comparison with the historic precedents.

It is well known, that financial crisis, which shook the United States and other countries in 1969 – 1970 was preconditioned, on the one hand, by the increased competition between the United States and Japan and Germany, on the other hand, by overstrain of American economy during Vietnam war. The current crisis of 2008-2009 in many respects is also caused, on the one hand, by economic rivalry of the United States with China and other Asian countries, but on the other – by financial overstrain of the US in the course of lingering warfare in Afghanistan and Iraq. Still, as well as in 1970-ies, nobody can seriously contend American economic, political and military leadership. But today, as almost 40 years earlier American Administration seems to run of cash.

Violent economic development of China and gradual growth of its political impact is an important factor. But in the 1970-ies the situation was more or less similar: on the one hand it was rapid, based on exports, economic growth of Japan, then – Republic of Korea, on the other hand – the growth of political and economic might of the Soviet Union. Nevertheless, after temporary decrease of American political role in the world in 1970-ies, we saw recovery of the US might. Of course, it was achieved by mobilization and reforms in different spheres of social life, but nowadays, American society seems also to be ready for implementation of new set of important reforms.

It is well-known, that the crisis of 1969-1970 caused significant changes in international financial system, in particular, the refusal of the United States from dollar-

gold exchange and the abolition of Bretton Woods System gold-exchange standard. But no dramatic shifts in financial system happened: dollar has remained the world reserve currency. It is likely, that nowadays the world is moving rather to the bi-currency (dollar, Euro) system, than to a new supranational world reserve currency. The situation on the world financial markets won't change radically, if, of course, nothing extraordinary happens.

It is true, anyway, that this time the situation is more dangerous, than in the 1970-ies. Terrorism has obtained global scale; the "arc of instability" has extended from Northern Africa and Palestine to Northern Korea, Indonesia and Philippines. The biggest concern causes the activities of terrorists in Afghanistan and Pakistan and eventual conflicts in the countries of Central Asia. The economic and social crisis in Central Asian states may already in the nearest future lead to the situation, when many young unemployed people become members of international terrorist networks. In Russia, in the Northern Caucasus the situation also worsens. Probably, we already hear the first shots of the civil war between valiant Islamic fundamentalists and moderate Muslims, supporting Moscow. All these factors make necessary more close cooperation between all market democracies: the United States, European Union, Russia, Japan and Republic of Korea to rebuff terrorists and to stabilize the situation in the world.

More, whatever paradoxical, notwithstanding all shifts and changes, the arrangement of the main political forces in the world in 2000-ies reminds in a way the 1970-ies. International revolutionary communism has been in fact replaced by Islamic fundamentalism. The role of the second superpower – instead of the USSR – plays China. The ambitions of Germany and France are implemented by European Union. While for the role, which in 1970-ies was played by rapidly developing Japan, nowadays aspire South Korea, India and Brazil. Naturally, the world has become more complex, globalized, interdependent and transparent, than in the 1970-ies. But political *mise en scene* remained mostly the same, though the actors have partly changed. That witnesses for a certain conservatism (or continuity) in the development of the very structure of international relations and world politics.

3. The global financial crisis hit Russian economy in its most prosperous period of development since 1991. Since 2000 till the autumn of 2008 the Russian economic rate of growth was about 7% at the annual level. Budget profit was about \$80 billion. Russia in 2008 had a record export (\$468 billion) and payments balance (\$200 billion).

Its international reserves in August 2008 were equal to \$597 billion. The exchange rate of the ruble rose steadily since 2001.

At the end of the year the situation dramatically changed.

4. A few words about national specifics of the crisis. Russian financial institutions did not fall for the game with financial derivatives. Thus, the impact of the crisis differs from that, which is taking place in the advanced market economies. Starting from August 2008 our economy has suffered from three simultaneous shocks.

Firstly, the fall of the oil prices – and in Russia export of hydrocarbons gives up to 40 % of the budget revenues

Secondly, the capital outflow from the stock market. Some of our politicians and experts were very proud of the fact, that before crisis stock market capitalization was higher than the GDP volume. Anyway, the professionals were fully aware, that Russian stock market is rather shallow: the bulk of its value is set up by the shares of 15 – 20 blue chips, predominantly of the mining and quarrying. To that in a free float are no more than 15% of shares of each company. Such markets are notable for high volatility. The capital massively rushes to such markets in the time of boom and no less rapidly outflows when problems start.

It may be interesting for you to know, that the number of individual investors at the Russian stock market is 850 thousand people. To compare – in China 100 million are keen on it.

Finally, thirdly, Russian companies appeared to be very much over-credited. They've got abroad credits almost up to 600 billion dollars. When the price of loans, the value of money has sharply increased Russian companies faced "margin calls" and rushed to the Government for support. Of course, massive borrowing abroad has been partly forced by the rigid credit and monetary politics in the country for the last years.

5. During the last 6 months the Central Bank sold \$210 billion of international reserves. Approximately 60% of this sum represents capital outflow. Substantial amounts of foreign currency were bought by domestic banks, non-financial sector companies and households. The raids of customers on the banks were successfully

managed, though this threat was actual for a short period in October, when ruble drastically went down.

The stock prices dropped by 80%. Ruble was depreciated to the dollar since July by 60%. The recent GDP rate of growth forecast for 2009 is minus 7-8%. Budget revenues, according to the Ministry of Finance estimations, will fall down by mostly 40%, budget deficit will be about 8%. The decline of the production up to 20-30% is expected in many sectors, including steel, non-ferrous metals, housing construction, textiles, retail, bank credits.

Still, the trade balance is positive, as well as current balance of payments. Unemployment is a very serious problem. Now it is at 7% (unofficial data).

6. For Russia a question of crucial importance is, whether financial speculations on the oil futures will stop. Generally, at least in Russia, there were many talks about “the end of the epoch of cheap oil”. Is that true? What will be the global financial architecture and correspondingly the security architecture? Will G-20 countries manage to come to agreement and what this consensus will look like? The summits in Washington, London were not much successful. According to the World Bank data, after November 2008, when G-20 met in D.C. 17 countries of 20 (Russia included) introduced protectionist measures. Pittsburgh looks like more productive, despite disagreements about off-shore zones. Maybe the 5th meeting in Seoul will put this important grouping of leaders on track. In the IMEMO our economic outlook for 2020, published in 2008, we have made prognoses of average annual growth of world economy in 2005-2020 at the level of 4,1 – 4,2%. But we made a reservation, that in case of outburst of protectionism, the tempo will be 2,1 – 2,2% lower. When I send the book to the publishing house in the very end of 2007, it seemed to me, that this reservation was abundant.

Thus, we may go on with the questions, but it looks like nobody has the answers.

7. There are several reasons why the Russian economy has proved to be so vulnerable in the face of the crisis:

- ✓ weak financial system,
- ✓ high share of foreign capital in the stock market, (around 60%)
- ✓ heavy debt of Russian banks and companies to foreign investors,

- ✓ dependence of social and economic development on export oil prices; energy exports accounts for 40% of budget revenues, and 70-80% (with gas) of all exports earnings,
- ✓ extremely high reduction of the liquidity of Russian banks and companies on the eve of the crisis due to the Russian Central Bank's struggle with inflation by tightening the money supply
- ✓ excessive budgetary expenditures due to the huge inflow of foreign currency in 2003-2007 and the first half of 2008 as well as high social commitments made by the state,
- ✓ overvaluation of ruble. Since 2001 its real effective rate rose by 145%.

The situation in Russia resembles one in the countries with relatively developed financial markets (India, Brazil, South Africa). On the other hand, there are many similarities with the countries highly dependent on commodity exports.

The impact of crisis is also similar to many developing countries:

- ✓ slowdown of production activity,
- ✓ domestic credit crunch,
- ✓ capital outflow,
- ✓ depreciation of the national currency and increased inflation.

The main distinction with the developed and some developing countries is high inflation.

8. Russia by a number of factors stays apart from the world anti-crisis trend, apart from the logic of anti-crisis measures of G-20 countries.

First and foremost, this is the problem of Central Bank discount rate. In Russia it is still two-digit, though it was lowered a bit. Meanwhile in the world economies dominates an obvious trend to decrease it down to the level from points of per cent (in the US, Japan, Great Britain) to 5 and few points of per cent (China, Mexico).

Russia in this aspect of anti-crisis measures till this spring, went along a way of such countries as Iceland, Ukraine, Belarus, Indonesia, Turkey, Azerbaijan. And we know where Iceland "came" along this way.

The logic of such approach is simple. The increase of the interest rate restrains inflation and – by making credits more expensive and less available – impedes drawing out of capital abroad.

But simultaneously such policy heavily blows an economy, limiting the increase of goods and services supply.

The limitation of supply naturally aggravates the problem if inflation, which remains the most important targeted by the Ministry of Finance indicator.

Our economy did not manage to diversify. On this background and taking into account the fact, that during the years of “oil and gas prosperity” the households accumulated certain savings, in Russia, notwithstanding crisis we see effective demand, oriented towards imported goods. Nevertheless, in 1Q of 2009 compared to 1Q of 2008 the import of plasma TV sets decreased by 75%, and the import of cars - by 34%. The fall of the world energy prices caused the devaluation of ruble. At the same time more expensive imports put additional pressure on the ruble exchange rate.

As a result in Russia – unlike in the majority of the other G-20 countries, which suffered deflationary pressure on the economy – the crisis caused stagflation. In other words the growth of prices along with the fall of production.

9. The combination of the above mentioned factors gives grounds for assumption, that the period of stagflation in Russian economy will last for minimum two more years.

Unlike many other countries Russia accumulated large foreign currency reserves, which now are a main source of financing for anti-crisis measures. The bulk of anticrisis financial support was channeled in the banking system to overcome domestic credit crunch. The result was not encouraging in comparison with many other countries. The banks prefer to buy dollars and Euro and draw them out abroad, instead of crediting real sector of economy. In the situation when ruble devaluates, the non-financial sector companies, as well as households, save their actives, avoiding the falling ruble and two-digit dollar inflation. In general, bi-currency mentality is typical for the majority of economic agents and companies and households.

Simultaneously support is extended to the producers. Some production taxes were reduced. Credits were extended to large companies (mainly in energy and metallurgy sectors) with big foreign exchange denominated debts.

Selective financial support is in progress approximately 300 enterprises whose activity is crucial for regional employment. Imports tariffs (automobiles, steel, tubes) were increased (not substantially).

As for stimulating domestic demand, it is rather limited (some schemes were adopted for refinancing mortgage and domestically produced automobiles credits) because of the danger of inflation and import rise.

Emphasis in stimulating business activity will be made on public demand through financing large - scale projects. So we began this year intensive construction works in the region of Sochi where in 2014 Winter Olympic Games will take place as well as in Vladivostok for 2012 APEC summit.

Up to now social protection schemes are comparatively modest, but are expected to be increased in line with changes in unemployment situation.

10. At the end of 2009 the costs of the planned measures was equal to 15% GNP. Next 1 or 2 years their overall costs may double.

Heavy volume of anticrisis measures is explained by the fact that crisis has aggravated Russia's acute longstanding structural problems. Besides, modernization which began in many sectors (food processing metallurgy, for example) was not completed.

Anti-inflationary credit and monetary policy in Russia, as I have already said, substantially differed from the world trend and only since April started the turn in the correct direction.

Apparently, Russia needs dosage use of what in the economic literature is called supply side economy. Its standard levers are: 1) cheap credits; 2) low taxes. This last point is most important.

The stimulating of supply requires changes not only in our monetary policy but in the budget policy as well.

Russia - South Korea Relations: Main Trends and Prospects

11. There are several factors influenced on Russia's policy towards the Korean peninsula: security issues, nuclear weapon proliferation, political activity of the great powers, and access to the markets. Political relations between Russia and the Republic of Korea improved significantly, especially since the beginning of the 2000s. Moscow and Seoul views on key issues of political and security stability on the Korean Peninsula and in North East Asia are coincide or are very close. Both sides oppose North Korea nuclear and missile program and support six party talks. At the same time Russia is ready to support inter-Korea cooperation.

12. During the 1990s economic ties between Russia and the ROK were unstable while bilateral trade fluctuated at a point of \$3 bln. Nevertheless joined efforts and improvement of domestic economies in Russia and the ROK were the main reasons of positive trends in economic relations between two countries after 1998, when both Russia and the ROK were under the crisis. In a result, a debt problem has been successfully resolved, bilateral trade reached \$18 billion in 2008 or increased in six times since 2000. But an average trade with Russia makes up only 1,2-1,5% of South Korea's foreign trade, and trade with South Korea makes up of 2,2%-2,5% of Russia's foreign trade.

Total South Korean investment in Russia in 2008 reached \$1,2 bln (70% were carried out during 2006-2008), while envisaged investment are estimated as \$3 bln. Insignificant scale of Russian investment in the ROK (estimated as \$20-30 mln) is an important symbol of misbalanced economic relations between two countries. It is an evidence of low level of Russian business involvement in North East Asian economies as well as in regional economic cooperation.

There is a difference in involvement of European Russia and the Russian Far East in economic exchange with the ROK. South Korean car producers, leading electronics companies and some others firms pay more attention to European part of Russia. Role of South Korea direct investments in the Russian Far East has been insignificant during two last decades and was inadequate to the regional economic potential.

Meanwhile the Russian Far East began to play a prominent part in accumulation of foreign investments in Russia: the share of the Russian Far East increased from 7% in the 1990 to 18% in the middle of the 2000th – mainly because of foreign investments into Sakhalin 1 and Sakhalin 2 oil and gas projects. Hence among the main investors into the Russian Far East are Japan, the United States, European Union and India, not the Republic of Korea yet.

It is necessary also to stress that dynamic bilateral trade exchanges in 2002-2008 were closely connected with the period of high prices on oil and raw materials as well as with unprecedented growth of demand on consumer goods in Russia. World economic crisis in 2008-2009 undermined positive trend in Russia-Korea economic relations. Bilateral trade in 2009 January-June period decreased to 47,5% of the level of Russia-South Korea trade at the first half of 2008 while Russia's total foreign trade consist of 55% of the figure of 2008. The problem is that Russia-South Korea trade is

based on very limited number of goods and services. Non-ferrous metals (aluminum and nickel) and oil make up about of the half of total export from Russia to the ROK. Another part of export consists of fertilizer, wood and pulp, fish and marine products, coal and steel. Car, consumer electronics and IT products prevail in South Korea export. Besides it, Russia imports some other consumer goods, chemical products and sea ships. Russia supplies the ROK with 5 mlt t of oil (4,2% of total South Korea's import in 2007), 6 mln t of coal (7,4% in 2007), 1,5 mln t of LNG (5% in 2009, preliminary estimate).

It is clear that the world economic crisis stimulates two countries to find out non traditional ways of cooperation under new situation in the world economy.

13. During president Lee Myung-bak's visit to Moscow and his negotiations with president D. Medvedev in September 2008 some significant projects were discussed. Thus, both sides agreed to cooperate in energy industry: South Korean company KOGAS together with Russian partners intends to take part in joined development of Kamchatka oil and gas fields, LNG production and transportation, oil refining complex, construction of gas pipeline. Russia and the ROK agreed also to cooperate in production and export of raw materials in Siberia and in the Russian Far East. At the same time both sides intend to realise joined programmes in nanotechnology, aerospace industry, protection of environment, etc. South Korean business also will participate in construction of facilities for APEC Summit in Vladivostok.

In this case it is necessary to mention that president D. Medvedev and President Lee Myung-bak agreed to upgrade bilateral relations between the Republic of Korea and the Russian Federation to "strategic partnership" level. But this kind of declarations must be confirmed by some political and economic measures.

However, some of the important projects are postponed now mainly because of financial and political reasons. Thus, project of TSR and TKR linkage as well as the project of construction of gas pipeline between the Russian Far East and South Korea can be realized successfully if only Pyongyang agrees to be involved in cooperation with Moscow and Seoul. But this triangle cooperation is closely connected with political and security issues on the Korean peninsula. It will depend on situation in DPRK and inter-Korean relations, which are characterised since the begging of 2008 by negative trends.

Construction of oil pipeline from East Siberia to Russian Pacific Coast is one of the most important national strategic project in Russia. When this project is realized it

will be possible to export 30 mln tones of oil directly to Daqing and 50 mln tones of oil from Pervoznaya to Pacific countries. There are several possible consequences of this project for Russia-South Korean cooperation: export of oil to South Korea, new investment opportunities for South Korean investors, new demand for capital and consumer goods in Siberia and in the Russian Far East.

It is necessary to note that cooperation between two countries in R&D, education, medicine is underdeveloped. Russia and South Korea cooperation in science and technology are developing at corporate level mainly (Samsung research center in Moscow, etc), but still is limited. One of the most urgent reasons of upgrading the level of bilateral (as a part of international) cooperation in medicine is a real danger of spread of mass diseases across the borders in NEA. Separated measures by any country are not enough to prevent the danger of "import" of such disease as bird or pig flu. It is impossible to be sure that any disease can be stopped at the border. Cooperation in medical care and in medical R&D may be more efficient mechanism than administrative measures. Russia understands this reality and is ready to cooperate with the ROK and other North East Asian countries.

14. New type of institutional, legal, administrative and information conditions would be created in order to stimulate bilateral economic, science, cultural and humanitarian exchanges. Coordinated measures of two administrations are at the agenda. There is a deficit of information on economic and business of the two countries. It is necessary to determine the goal and stages of development of Russia – South Korea cooperation taking into account priorities of bilateral exchanges as well as main trend of multilateral cooperation in NEA.

Although recent trends in economic cooperation between Russia and the ROK should be characterized as *positive* it is ought to be said that Russia involvement in bilateral as well as in regional trade and investment cooperation in NEA is insignificant yet. Russia's economic ties with the ROK and NEA countries are very traditional by nature. Although Russian companies are expanding actively in Europe and in the United States, Russian business isn't involved deeply in economic partnership with the South Korean, Chinese and Japanese business. Economic relations between Russia and NEA countries have not been institutionalized yet. Consequently there is a danger that trade and economic exchanges between Russia and the Republic of Korea will be stagnated in the future.

It is necessary to analyze regional economic trends and find out institutional

basis for Russia-South Korea economic relations as an adequate element of the regional economic cooperation in NEA. Special studies of Russia-Korea cooperation (including government, business and academic experts analysis) should be initiated. Prospects for Free Trade Agreements and NEA economic cooperation, energy and transport projects, investments exchanges, etc may be among the primary themes.

15. Cultural exchanges and tourism could play an important role in bilateral relations. After the establishment of diplomatic relations cultural exchanges increased greatly, but some periods later were not so impressive. Because of the 20th anniversary of diplomatic relations cultural ties in 2010 will increase. But it is necessary to create long run program of cultural and humanitarian cooperation in order to prevent slow down of exchanges in the future.

The tourist exchanges between Russia and South Korea are not significant yet. The real problem is that tourist industry is still underdeveloped in Russia, especially in the Russian Far East and in Siberia. South Korean business will have a chance to take part in development of tourist infrastructure. There are some evidences that South Korean business began to pay more attention to Russian tourist, trade and services. Thus Lotte constructed tourist, business and trade center in downtown of Moscow. But it is just the beginning.