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the Global Policy Institute

Policy Analysis in a Changing World

Policy Paper

Number 18
April 2011

Impact of the Global Financial Crisis on Russia, Ukraine and Belarus

Author

Marko Bojcun
London Metropolitan University

Marko Bojcun (BA, M.Litt, PhD) is senior lecturer teaching International Relations, European Studies and Peace and Conflict Studies at London Metropolitan University. He is also Director of two projects, funded by the European Union and the British Government, to develop training on European Union issues for civil servants in Ukraine. Marko's research interests and publications are focused on contemporary Ukraine and the challenges of development in the broader region of Eastern Europe.

Introduction

Russia, Ukraine and Belarus lie geographically and geo-economically between the Atlantic core states and the Far East. They are attracted in two directions – by the capital rich Atlantic core, which seeks new locations for investment and by East Asia which wants these countries' energy supplies, primary and semi processed goods. Thus it is understandable that the present global crisis should have appeared in these countries in the summer and autumn of 2008 first as a collapse of their external commodities markets located mainly in the East, followed quickly by the collapse of their external sources of credit from the West.

My task here is to examine how the present global crisis unfolded in these three countries, what their common experience has been, and in what measure it has been distinct for each of them. I don't believe that the current crisis is over, far from it. I'll be looking mainly how at these countries have faced the crisis and responded to it so far. All of them are now recovering in terms of GDP output, but insofar as this is a truly global crisis, no one country, no region, let alone one that accounts for less than 2% of world GDP1 can find a lasting solution to the problems the crisis has thrown up.

What Russia, Ukraine and Belarus shared in common in the 1990s

As successor states to the USSR Russia, Ukraine and Belarus shared in common their exclusion from the process of European integration at an institutional level since the early 1990s and consequently their greater vulnerability to competitors on world markets of labour, services, commodities, and capital. They suffered devastating domestic economic and social breakdowns during the 1990s and the 1998 financial crisis. Their leaders were confused about how much the West wanted to help them and how much to exploit them. They had no viable strategies of their own during that decade to integrate into world markets on advantageous terms. They therefore were much more cautious and defensive about entering world markets than the Central Europeans who were offered EU membership and were supported with G24 resources to prepare for it. After accession to the EU they became part of a massive single market and trading bloc, which naturally smoothed their path onto other regional markets.

Their distinct experiences

Russia, after its bout of deep indebtedness to external creditors in the 1990s and the 1998 financial crisis was particularly cautious about the terms of its further co-operation with them and was careful to limit foreign capital's access to its own national economy. Under Putin it re-imposed central state controls on FDI and on the export of oil and gas, while actively promoting Russian private capitals penetrating neighbouring national economies in its near abroad. Russia chose a strategy to achieve regional hegemony and to resist Western penetration of all kinds – military, ideological as well as economic. And it built up a sizeable sovereign fund during the boom years (2000-2008) which was earmarked as insurance against any possible repetition of its subordination to Western creditors and its sovereign default in 1998.

Belarus under Lukashenka from 1994 chose to exclude Western capital from its economy and to admit Russian capital instead. Belarus sought institutional integration with the Russian state, economy and regional security system, offering itself as a reliable transit territory for Russia onto world markets and as a frontline state against NATO. Russia, in turn, secured Belarus's borders and provided it with subsidized oil and gas, which contributed enormously to Belarus's export earnings and its state budget.

Ukraine under President Leonid Kuchma recognized by the late 1990s that it would not be helped by the EU or the USA to join world markets on advantageous terms. It then chose to resist foreign penetration of both Western and Russian capital until it created its own national capitalist class through privatisation of its state owned assets. Yet it could not resist considerable Russian capital penetrating its processing and manufacturing industries.

Under Yushchenko, who succeeded Kuchma after the 2004 Orange Revolution, Ukraine opened up wide to Western capital investment in the belief that such investment would stimulate its economic-technological modernisation, giving it a higher niche in the international division of labour, and would act as a counterweight as well to Russian influence. By 2008, Ukraine was receiving record inflows of FDI. Over half of its banking capital became foreign owned – mainly by West European banks, but also (10%) by Russian state banks.[2]

How did the crisis impact on Russia, Ukraine and Belarus?

The crisis came in a succession of waves to Eastern Europe: first in July-August 2008 the bursting of commodity asset bubbles on world markets and the collapse of critical exports, leading to sharp cutbacks in production; then in September-October 2008 the freezing of credits to exporters, producers and consumers; and finally down to the end of that year the devaluation of their national currencies.

These states subsequently assumed responsibility for private sector debt in various ways and their state budgets were thus put under strain. But while Russia, Belarus and Ukraine shared much in common in terms of the impact of the crisis upon them they diverged quite a lot in terms of their policies for dealing with it. How they have responded so far would appear to have been a function of three variables:

- their relative degree of exposure to global markets in capital, goods and services,
- the adequacy of their domestic resources and domestic demand to substitute for external stimuli to economic growth,
- their individual state-economic strategies .

All three countries had enjoyed strong rates of growth leading up to the crisis in the summer of 2008. Growth was driven above all by their exports of fossil fuels, steel and chemicals onto far abroad markets, but also to each other (their common near abroad). Russia was at the heart of this exporting engine with its oil and gas, while Belarus and Ukraine served both as consumers of Russian energy resources and as providers of its transit routes further west. Belarus and Ukraine also had commodities of their own to send onto world markets, especially steel, machinery, chemicals and agricultural products. Apart from the heavy equipment and machinery that Ukraine and Belarus supplied to Russia, the bulk of the exports and re-exports of all three states were primary and semi processed goods. It was precisely the global markets of such goods which boomed in the years leading up to their collapse in August-September 2008.

The corollary of dependency on external demand for these commodities was of course the insufficiency of domestic demand. All three countries' economies have been shaped since 1991 mainly by the collapse of internal demand on the one hand and reorientation to external demand on the other. Their domestic markets are as a result insufficiently developed or diversified to either absorb and process these primary goods or substitute them with domestically produced goods of higher capital content.

When the crisis struck and the asset bubbles on global markets burst, all three countries suffered big falls in external demand : for Russia – oil, gas, steel; for Belarus – refined oil products, transited Russian crude oil, chemicals, machinery and heavy equipment; for Ukraine – steel, non-ferrous metals, chemicals, transited Russian oil and gas. As for the Ukrainian machinery and heavy equipment traditionally exported to Russia, their production had already declined markedly during the boom years in the face of intense competition from Western suppliers who came onto the Ukrainian market in force after the Orange Revolution.[3]

Exposure to capital markets

The collapse of external trade was followed quickly by a freezing up of credit to producers, exporters and retail consumers in all three countries.

In terms of their exposure to capital markets, Belarus was the least exposed of all three countries prior to the outbreak of the crisis. It did not rely much on external financing and it had, and still has, the least privatised, least marketized, least capitalist economy. However, Belarus was deeply dependent on the Russian economy for its receipts from trade and transit and for cheap energy inputs to its economy and society. And so it felt the impact of the global credit crunch through the medium of the Russian state and Russian industries with which its enterprises traded.

Belarus suffered a trade deficit of $5bn in 2008 largely as a result of Russia reducing even further (after a 2007 reduction) its price subsidies for oil and gas exports to Belarus, as well as from the collapse of Belarus' own exports – mainly to Russia,. It then used significant hard currency reserves to hold up the national currency - Rubel - and to close the gap in state finances.

But Russia then took advantage of the crisis and applied the screws for its own strategic goals: Belarus was forced to sell a share of Beltransgas, its national pipeline, to Russia's Gazprom for $625m. It also lost state control of the re-export of refined oil products to Russian private traders. It sold the state owned Belpromstroibank to Russia's Sberbank. These developments led to a deep aggravation in Russian-Belarusian relations. And so at the end of 2008 Belarus was forced to make a major foreign policy turn away from Russia to the IMF and the EU for help.[4]

When global prices and demand for Russian oil, gas and steel collapsed, the productive-exporting sector stopped producing and external credits quickly dried up.

Belarus took out $1bn in Eurobonds. In 2009-10 the IMF provided $3.44bn in external financing. In return Belarus devalued its currency by 20%, agreed to initiate privatisation of big state banks and enterprises, and to liberalise its markets, giving more access to western capital, and to delay increases in pensions and wages of state employees. At the same time Belarus also got from Russia in 2009 a loan of some $200m plus $2bn in subsidies on the world price of imported oil and gas. The authorities in Belarus have used state funds, supported by external financing, to maintain living standards. These are comfortably high – in 2008 only 6% of its people lived below the poverty line. In 2010 Belarus' government agreed with the IMF to hold annual wage increases to 11%, a rather generous margin. But this situation can only be temporary unless Belarus can produce its way out of the downturn. With the government's current account financed mainly through loans, Belarus' gross external debt is growing rapidly – from 25% of GDP in 2008 to 44% in 2009 and to an estimated 52% in 2010.[5]

Russia had no state debt to speak of, and a fairly low private sector debt. It was exposed to the global financial crisis, however, via the big Russian exporters who rely on international finance for the expansion of their production and foreign trade. When global prices and demand for Russian oil, gas and steel collapsed, the productive-exporting sector stopped producing and external credits quickly dried up.

Foreign investors in Russia were also spooked by the August 2008 invasion of Georgia, contributing to a huge capital outflow. The credit freeze set in fully when the banks went into crisis in the Atlantic core states. With the collapse of world oil prices from $150 to $40 a barrel the Russian state finances faced the prospect of mounting deficit spending: annual budgets were based mainly on proceeds from fossil fuel exports rather than any broad tax base.

However, the Russian state had $600bn

in currency reserves (sovereign fund) built up during the boom years. It used these reserves to step down devaluation of its Ruble, recapitalise its banks (the top 5 are state owned), subsidize large firms in some 460 one company towns under real pressure from the downturn, and to raise pensions by 25% in 2009 and 50% in 2010. By stepping down the ruble slowly the state gave households and firms enough time to switch their savings into hard currencies at an advantageous exchange rate. In this way state reserves were partially privatized to maintain living standards and social stability. "As a consequence, Russian household incomes increased during the Great Recession, a situation unique in global comparison." [6]

As we shall see, the opposite happened in Ukraine: private sector debt was partially nationalized, leading to a decline in living standards and heightening social tensions. Ukraine was deeply exposed to international capital markets. On the eve of the crisis in 2008, with a fairly modest declared public debt of around 20% of GDP, it had small hard currency reserves for its size ($30bn) and a private sector debt equivalent to the 2008 annual GDP – about $104bn. Approximately 40% of private sector debt was short term, due for repayment within one year.[7] Much of this private sector debt was placed by West European and Russian banks that set up in Ukraine after 2004 with exporting industries, importers, the domestic trade and real estate, as well as with the first generation of ordinary people to have credit cards and mortgages.

Cheap credit from abroad combined with rising wages and state social expenditures all depended on the export boom in steel, chemicals and a few other products. When their bubbles burst, production collapsed, the credit system seized up and the private sector could not pay its debts, the Ukrainian state was under enormous pressure from foreign banks and their governments as well as domestic banks to step in. But, unlike Russia, it had no sovereign fund to speak of, so turned to a number of foreign governments (including Russia and Japan), and finally went to the IMF. Taking a $16.4bn loan from the IMF in October 2008 the government recapitalized the banks, nationalised five of the smaller Ukrainian ones outright, settled their outstanding loans to foreign creditors, and replaced the deposits of ordinary domestic savers they had lost. In this way the Tymoshenko-Yushchenko government partially nationalized the debts incurred by the private sector in the wake of the global economic downturn and financial crisis.

By the end of 2008 Ukraine's currency – hryvnia – fell against the US dollar by 40%. In 2009 Ukraine's GDP fell by 15.1%, the second deepest fall that year in Central and Eastern Europe.[8]

The Azarov-Yanukovich government which succeeded the ruptured Orange regime in 2010 took out more loans – another $15bn standby credit from the IMF, some $2bn raised in Eurobonds, and $2bn from the Russian VTB Bank. The new government also made an about turn in its foreign policy by trading an extension on the Russian Black Sea fleet lease of Sevastopol port to 2041 for cheaper energy supplies. It also entered into discussions – reluctantly – about "merging" the Ukrainian and Russian oil and gas trunk lines and some other strategic economic assets.

In contrast to Russia , the Ukrainian state nationalised the private sector debts arising in Ukraine from the global financial crisis. And it had much bigger private sector debts to deal with than Belarus, whose private sector remained very small. As a direct result of this strategic decision the public debt and the total external debt of Ukraine have shot up, leading the government to take new measures that are generating social tensions and protests: against cuts in social expenditure, against a new Labour Code directed squarely against labour, and against a new Tax Code (temporarily in abeyance) targeting small and medium businesses, while Ukrainian big business banks its earnings offshore in low tax Cyprus.[9]

Conclusions

In the current phase of the global financial crisis, Russia, Ukraine and Belarus face the following kinds of pressures:

- all of them are experiencing a revival of export demand and are responding positively to it, but none of their governments are working to diversify their economies to respond to and stimulate domestic demand.

-Ukraine and Belarus face big public debts, while Russia has failed to invest its remaining sovereign fund into domestic economic diversification and upgrading of infrastructures.

-all of them have seen their currencies recover against the dollar, but are now facing even more revaluation pressures as a result of renewed inflows of capital from the Atlantic core via the carry trade (provoked now by the latest QE in the US).

The QE in the USA and the ongoing crises of sovereign debt in the Eurozone shows the global financial crisis is not over. It hasn't been resolved. Finance capital continues to roam in and out of national markets and state finances looking for higher returns.

Therefore, the present recovery of GDP output in Russia, Belarus and Ukraine seems to represents the start of another cycle like the last one – i.e. reliant on external capital and external market stimuli. Without altogether different public policies and strategies of development to guide it, this cycle will not lead to a positive improvement in the structures of production and consumption of these countries, in their economic security, or in the living standards of their people.

Endnotes

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The Global Policy Institute
London Metropolitan University
31 Jewry Street
London EC3N 2EY
United Kingdom

Tel **+44 (0)20 7320 1355**
Fax **+44 (0)20 7320 3018**
Email **office@gpilondon.com**
Web **www.gpilondon.com**

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