SKOLKOVO
Moscow School of Management

THE GLOBAL FINANCIAL CRISIS: IMPACT AND RESPONSES IN RUSSIA AND CHINA

SIEMS MONTHLY BRIEFING

SKOLKOVO Institute
for Emerging Markets Studies

February, 2009

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RESEARCH

CONTENTS

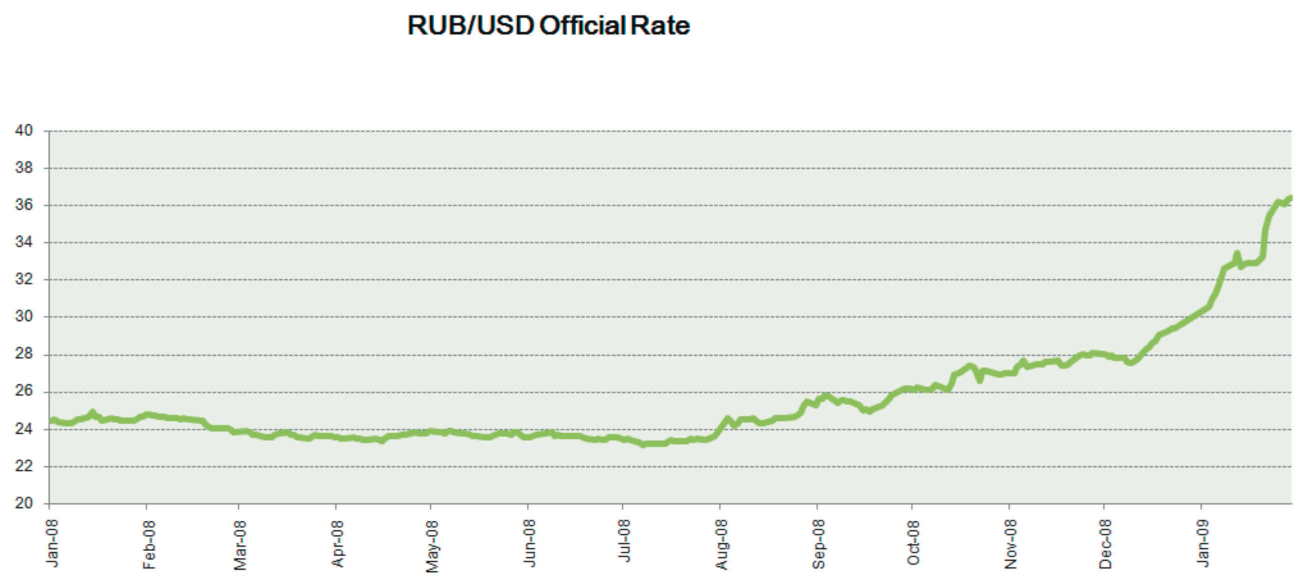
RUSSIA

The effect of the current financial crisis on Russia's economy is substantial, and it is still unclear as to how the situation will evolve in 2009. The Russian government began to address the deteriorating health of the economy in fall 2008 by implementing a number of measures, pledging more than $200bn to help businesses. However, even President Medvedev has criticized the slow implementation of the rescue package, stating that only 30% has been utilized before the end of last year. While the stock market began its slide in May, and oil prices started to recede in July, substantial capital flight did not occur until the aftermath of the war in Georgia, when approximately $35bn left the country in just 5 weeks. Industry across the board has been affected, from experiencing increased difficulty in obtaining funding to outright bankruptcy. The government's response to help businesses deal with the crisis has focused primarily on supporting large state companies, with lists of firms eligible for such support. The speed of recovery is difficult to predict, as much depends on the recovery in the price of Russia's main exports – commodities, which in turn depends on the pace of recovery in other nations.

IMPACT TO DATE

In mid-December, Deputy Economics Minister Andrei Klepach stated that “the recession has started already.” Indeed, Russian manufacturing shrank at a record pace in December. The latest figures by the Russian Industry and Trade Ministry, released at the end of January, show that industrial production in December dropped by 10.3% year-on-year, and annual industry growth was a mere 2.1%, the lowest in a decade. VTB’s Purchasing Managers’ Index contracted for a fifth month to 33.8, from 39.8 in November (above 50 means growth, below 50 means contraction), the lowest figure since 1998. The latest official GDP estimates put its growth at 5.6% in 2008, well below initial government forecasts. Net exports dropped 44% compared to 2007. December’s trade balance was positive, but at $4.6 billion it’s only a third of the December 2007 balance.

The ruble and subsequently the country's reserves have taken a beating due to the lower exports and capital flight. The Central Bank has estimated the net outflow at $129.9bn for 2008 (compared to a net inflow of $83.1bn in 2007), breaking previous records. The fourth quarter in particular pressured the ruble, when $130.5bn worth of rubles was either converted to hard currency or was used to meet companies' external obligations. The extent of the capital flight seems to have surprised even the Central Bank; at the end of November, Central Bank First Deputy Alexey Ulyakaev estimated the outflow at $100bn. In response, the Central Bank raised the refinance rate to 13% from 11% and has intervened repeatedly on the market to prevent any abrupt falls. Although over $210bn, or approximately 1/3, of the country's foreign-currency reserves have been spent to support the ruble since the start of August, the ruble has lost 40% vs. the US dollar. The Central Bank has declared in January that it would not let the euro/dollar basket, which it uses to guide exchange policy, slip beyond 41/ruble. That rate has held up thus far, with the dollar trading at around 35 rubles.



In line with what has been happening in the global financial markets, lending has become far more expensive, with short-term interest rates rising by 800 basis points in October-December 2008. This has impacted most large companies, which have relied on cheap credit to fuel growth. Government financing is therefore now crucial not only for state-owned organizations, but also for private firms. Large state-controlled banks, such as VTB and Sberbank, are the main conduits for government funds. The increment in VTB's credit portfolio in 2008 is reported to double that in 2007.

While direct nationalizations have not, so far, featured prominently among the government's responses to the crisis, its de-facto monopoly in large-scale lending clearly leads to an increased influence of the state on leading companies. One example is the NPO Saturn, the country's leading manufacturer of aircraft engines, which has reportedly agreed to a takeover by a state corporation to obtain over $250mn in loans from VTB. Another example is Norilsk Nickel. Two of its main shareholders – Vladimir Potanin (through Interros) and Oleg Deripaska (through Rusal, the aluminum giant) – currently have their stakes pledged to state banks. Because of this, the government is de facto arbitrating the conflict, and former government officials were appointed to both Chairman and CEO positions. A possible deal is being discussed in which Norilsk Nickel and several other heavily indebted mining corporations would merge. The debts to the state would then be converted into shares of the resulting group, which would control not only a large chunk of Russia's metallurgy, but also numerous mines and smelters around the world.

International expansion, which had been gathering tremendous pace in the years before the crisis (foreign assets of Russia's top 25 multinationals have increased four-fold in 3 years, according to a SKOLKOVO report), has been considerably stifled by the lack of external financing. Oleg Deripaska's debt-ridden holding Basel has been forced to sell its stakes in Magna, the international automotive company, and Holcim, the construction group. The long-planned purchase of John Maneely Company by Novolipetsk Steel for $3.5bn fell through (although the Russian steelmaker did complete the acquisition of Beta Steel, with a $50mn discount). Norilsk Nickel announced the discharge of about 1500 employees of its foreign units, along with a radical cut in overseas investments (down 34% in 2008 and 48% in 2009).

At the same time, many Russian multinationals are determined to continue the expansion and are finding ways to finance it. On November 7, for instance, Severstal completed the acquisition of PBS Coals for $830mn, $382mn less than previously agreed, paid by a syndicated loan at LIBOR+2.35% from ABN Amro, Barclays et al. Largely the same banks financed the purchase of Sicilian refinery assets for 1.3 bn by Lukoil, which was closed by the beginning of December. On December 29, KazakhGold agreed to the revised shares-only takeover by Russian gold miner Polyus. By February 3, Gazprom had completed the deal to purchase a controlling stake in Serbia's oil company NIS. State-controlled energy giants, such as Gazprom, Rosneft and InterRAO, are not only pushing on with previously planned international investments, but also are negotiating new projects in remote regions of Latin America, Africa and Southeast Asia.

Employment levels and real income have suffered as a result of the slowing economy. According to the Ministry of Health and Social Development, 132,000 new unemployed were registered between October 1 and January 28, over 60% of whom could not find a new job. This only reflects about one third of the real job loss; the actual total number of unemployed is currently estimated at 5.8 million.

As firms struggle, pressure on employment is mounting. However, large enterprises have been shunning, as far as possible, personnel cuts in production units, where qualified workers are often hard to find. Companies prefer instead to reduce headcount in headquarters, where wages are higher and social costs lower. For example, TNK-BP, a leading oil joint venture, reportedly dismissed 390 managers and canceled 200 vacancies, but so far the company has pledged to refrain from firing Siberian workers. Similarly, Gazprom plans to cut 10% of the holding company's employees; Russian Railways, which announced layoffs of up to 3% of total personnel, will also begin with executives.

Facing high labor costs, manufacturing companies turn to cutting working hours rather than headcounts: for instance, practically all automotive assembly workers got a month-long vacation in January, and the GAZ group obtained the agreement of unions to switch plants to 3-day working weeks as needed. Evraz, a leading steel producer, dismissed 15% of managers, but rather than lay off production workers preferred to decrease their salaries by roughly a third.

Overall, more than 673,000 people have had their working time cut in one way or another.

While most households have started to feel the impact of the crisis somewhat later than investors or major companies, their financial position is now being strongly affected. Wage arrears as of January 1 have grown 55% year-on-year in real terms. The Levada Center states that one-third of Russians are in debt, and 11% are trying to pay off their debt at the same time as their income is dropping. The Duma has even begun working on drafting personal bankruptcy protection laws as a result.

The severity of the crisis' impact on various sectors of the economy differs, as does the government's response to help the industries.

The **banking sector** has been among the hardest hit by the current crisis, with numerous banks going bankrupt (e.g., Globex, Svyaz Bank, Sobinbank, KIT Finance), others selling stakes on the cheap (e.g., Renaissance Capital), while some seeking a merger (e.g., MDM and Ursa Bank). Business has dried up, and investors are fleeing. Open mutual funds experienced a net outflow in 2008 of more than 16.4bn RUB (9.4bn RUB from mixed strategy funds, 5.3bn RUB from fixed income funds, and 4.7bn RUB from equity funds). In order to support Russia's banking sector, the government and the Central Bank have adopted measures to improve liquidity (lowering obligatory reserves, relaxing requirements for loans from the Central Bank, etc.) and recapitalize banks, most notably the leading state-owned ones. Also, regulatory steps have been taken to prevent a decline in retail deposits from turning into a full-fledged nationwide bank run. In particular, the deposit insurance limit has been raised from 400,000 RUB to 700,000 RUB, thus covering 98.5% of deposits; 200bn RUB has been allocated to the Deposit Insurance Agency to help troubled banks; and several failed ones, including Globex and Sviaz-Bank, were bailed out by state banks.

The drying up of financing from banks and capital markets hit Russia's leading companies, most of them active in **extracting and processing raw materials,** at the same time as did falling commodity prices. According to the World Bank, average prices for Brent oil in the last quarter of 2008 fell by 52% compared to the previous quarter, aluminum by 35%, copper by 50%, nickel by 43%, and phosphate by 10%. For several commodities, the volatility was much more severe in Russia than globally; for instance, the World Bank shows stubbornly high prices for hot-rolled steel at $1000/ton by the end of the year, however in Russia, according to Metal Courier, it decreased from $1500 (in the summer) to $620, reflecting a sharp drop in demand.

The immediate response to contracting demand from many leading companies has been, naturally, to reduce production volumes. In December 2008, for instance, steel production amounted to barely half of that in December 2007, with leading producers such as Magnitogorsk Iron & Steel Works and Severstal cutting output by about 60% y-o-y. The production of crude oil, a key indicator for Russia, decreased for the first time in the last decade. Companies were forced to close down those facilities that no longer turned a profit, including for example several of Norilsk Nickel's and Rusal's overseas operations. For a few companies, the initial contraction has even proved excessive; for instance, leading chemical companies Acron and Uralchem, which had pushed production down to 60-65% of capacity in December, are already bringing it back up to about 80%.

One of the main consumers of the chemical products, the **agriculture industry,** is also among the most exposed in Russia. Farmers have seen profits fall by a third in 2008 and will need to borrow 860bn RUB in 2009 according to Deputy Agriculture Minister Nikolai Arkhipov. As of December, farmers had outstanding debts of 1.2 trillion rubles, and the government has said that it will cover any shortfall in funding. To help the industry, the Kremlin cut poultry quotas in December and increased the duties on pork and poultry imports above quotas to prohibitive levels. As a consequence of the food producers' troubles, the makers of agricultural equipment have seen demand for their products nearly disappear. In response, a 15% temporary tax on imports of farm equipment will be imposed, although parts for machines that are already in Russia will be exempt.

The **automotive industry,** like the farm equipment producers, has also taken a hit. As recently as mid-November AvtoVaz announced that more cars will be sold in 2008 than in 2007; however, the company ended up 5.4% short of the 2007 total. By November, 1/3 of Russian car owners were reporting that they were delaying replacing or purchasing a car because of the economic situation. Sales of foreign-made cars increased 26% in 2008 – lower than the hoped-for 30%. Whereas sales fell by 15% in November, they fell by less than 10% in December. However, the latter could be attributed to people's rush to dispose of their rubles as well as the desire to purchase a foreign-made car before import duties were to be implemented in January 2009. In addition to the customs duty hike, the government is increasing its purchases of cars and buses, giving targeted loans to automotive companies, and subsidizing interest rates on individuals' loans taken out to buy popular Russian-made cars (priced at up to 350,000 RUB). In response to the tariffs on the import of used cars, street demonstrations erupted in areas that depend heavily on second-hand vehicles, such as the Far East.

Air travel also began to be affected in the fall. Whereas the **airline industry** had a record year since the collapse of the Soviet Union, November and December witnessed a contraction of the volume of transport by 6.5% and 3%, respectively. The government is ready to loan certain airlines up to 30bn RUB to help them weather the crisis. Federal and regional governments are also directly involved in some of the crisis management in the industry, notably integrating several bankrupt or heavily indebted airlines into a new international airline called Rosavia, which is intended to become a competitor to Aeroflot, the current market leader (also majority-owned by the state).

Despite the slowing economy and shrinking liquidity, **retail** sales in Russia grew by 14.1% during January-November 2008. While December's results are just being reported, the Russian retail industry has not suffered as much as its Western counterparts. Nikolay Vlasenko, Chairman of the Board of Directors at Victoria Retail Group, even states that, for many retailers, 2008 was still the best year in history. However, the Russian consumer is unlikely to continue spending at previous levels. PriceWaterhouseCoopers sees Russia's retail market growing by 20-32% in 2008, compared to the 25-35% growth in 2007. The government has committed to supporting the largest retail chain with loans, providing them with expedited registration of property as loan collateral, and offering VAT refunds to accelerate cash turnover. Retailers, in turn, have made a commitment to keep prices of staple foods low.

OUTLOOK FOR 2009

This year will undoubtedly be a difficult one for Russia. While Finance Minister Alexei Kudrin has stated that Russia could balance the **budget** in 2009 if oil is at or above $70 per barrel, the current price is below $45. The government expects the budget deficit to be over 6% of GDP, and it may go to as much as 8% if the oil price drops further, or if the stimulus and/or rescue expenditures need to be increased. The RUB 2.5 trillion gap will be mostly covered from the Reserve fund (now at RUB 4.9 trillion), accumulated in previous years of budget surplus.

Russia's currency is closely tied to the price of oil, so the continuously low oil price is dimming hopes for a rebound in the **exchange rate.** The boundary of the euro/dollar corridor recently defined by the Central Bank is standing so far, but its continued support of the currency is draining the reserves. Until the ruble stabilizes, both consumers and companies will favor foreign currency, thus putting pressure on the ruble. For example, the residential developers PIK Group and DSK-1 have begun pricing their property using the euro-dollar basket and not in rubles. Despite the ruble losing around 40% of its value vis-à-vis the dollar since August, billions are still being spent to support the currency. One of the big questions for 2009 is thus whether the ruble will be allowed to float freely.

Depending on the oil price and the amount of money spent to support the ruble, **GDP growth** in 2009 will range from negative 5 to positive 5%, according to Troika Dialog's Chief Economist, Yevgeny Gavrilenkov. He believes that depreciating the ruble is one step that could be taken to help economic growth, stating "in the past, the Russian economy grew even with oil prices of $30, $40 and $50 per barrel, but at a different exchange rate." RenCap's Chief Economist, Yekaterina Malofeyeva, sees GDP growth at 0-3% in 2009. BNP Paribas is predicting a 3.5% growth in GDP for 2009, as does the IMF, while Alfa is one of the most pessimistic and anticipates -5% to 0%. The United Nations sees it at 4.8% for the year, but the Center for Macroeconomic Analysis and Short-Term Forecasting thinks that GDP will actually shrink by 3.1% if oil is $32/bbl and will be flat if oil is $50/bbl. The government is forsaking hopes of a real GDP growth in 2009; according to Deputy Prime Minister Igor Shuvalov, Russia will be lucky if it sees zero growth this year.

Unemployment is set to rise to 7 million people in 2009 from the current 5.8 million, according to the Ministry of Health and Social Development, while the number of registered unemployed will grow to at least 2.2mn from 1.65mn in 2008. The government will respond with large-scale programs to create jobs, retrain the unemployed and relocate labor to where large federal investment projects are initiated (e.g., Sochi, the Olympics site in 2014). These measures, however, are only expected to help about a million people at best.

Real wage growth, while increasing by an estimated 7.6% y-o-y in 2008, will grow by only 0.5% in 2009 according to UralSib, although RenCap sees the 2009 figure at 4.7%. According to Mikhail Shmakov, the head of the Federation of Independent Trade Unions of Russia, most of the layoffs will come in metallurgy, construction, and the financial and banking sectors. Overall, companies are expected to slash 240,000 jobs just in the first two months of 2009.

This is no surprise, given that the dampened demand will certainly affect production. Overall for 2009, according to a consensus survey, analysts forecast a 0.4% decrease in manufacturing, while the Ministry for Economic Development expects a 3.2% drop. According to Automotive Statistics (Autostat), 2009 could see a reduction of 35-45% of new cars sold in Russia; PwC predicts a 15-45% decline, while the Association of European Businesses gives a figure of 19%.

The airline industry will see a 30% drop in the amount of passengers taking to the skies in 2009, according to UTair's General Director, Andrey Martirosov. However, the drop in fuel prices will make air travel more affordable, thus increasing demand. Transaero's General Director, Olga Pleshakova, for example, sees the number of passengers the airline handles as growing by 5-7% in 2009. So the net effect on air travel is unclear.

Real estate prices, however, are set to plunge. Sberbank sees real estate prices dropping by 47-60% by the end of 2009, both in Moscow and in the regions, citing such factors as the slowdown of income growth per head, capital outflow, and the credit squeeze. The Institute of Globalization & Social Movement sees a similar fall in real estate prices, predicting a drop of 55-65%. Alexei Chalenko, the General Director of Alliance Continental, sees a 40% drop over a span of 2-4 years.

One of the major concerns is uncertainty, such as the questionable quality of assets. David Nangle, Renaissance Capital's senior bank analyst, stated in December that "the outlook for the next 3-12 months is now very vague. Visibility is poor and the asset quality of the banks is deteriorating fast." According to UralSib, non-performing loans rose from under 1% to over 4% during the last few months of 2008. Analysts think that mortgages will be least affected, with NPLs on the order of 1-2%. Banks with a heavy retail focus will see NPLs rise to 5%+, while the banks in most danger are the consumer finance specialists, the NPLs of which will rise to over 10% according to Nangle. The consensus is that the number of banks in Russia will consolidate, falling from 1200 in 2008 to 800 in 2009, although there are rumors that the Central Bank would like to see the figure at 300.

The retail industry will likely suffer in 2009, as the slowing economy and the difficulty in obtaining consumer credit will have a negative impact on the sector. A weakening ruble will also hurt these companies, as all of their revenues are in rubles, but 10-40% of costs are in dollars. RenCap estimates retail companies experiencing a drop of 35-60% in earnings. However, a December study by RNCOS, a market research company, predicts that the retail industry will maintain current growth levels and regain past growth rates in 2010 (latest figures showed November's growth as 8%, lower than the January-November average of 14.1%). RNCOS cites the fragmented market, in which the top 25 retailers account for less than 15% of the total market, as an opportunity for expansion.

With revenue considerably down, companies in most industries will be forced to cut costs. The CEO of a leading telecom group said in an interview to SKOLKOVO that increasing efficiency will be his company's #1 priority in the coming year. While various measures to increase productivity and reduce waste are also on the agenda, the three main ways of cutting expenditures are, first, transferring the deflationary pressure to suppliers, second, reducing payroll, and third, postponing or reducing capex.

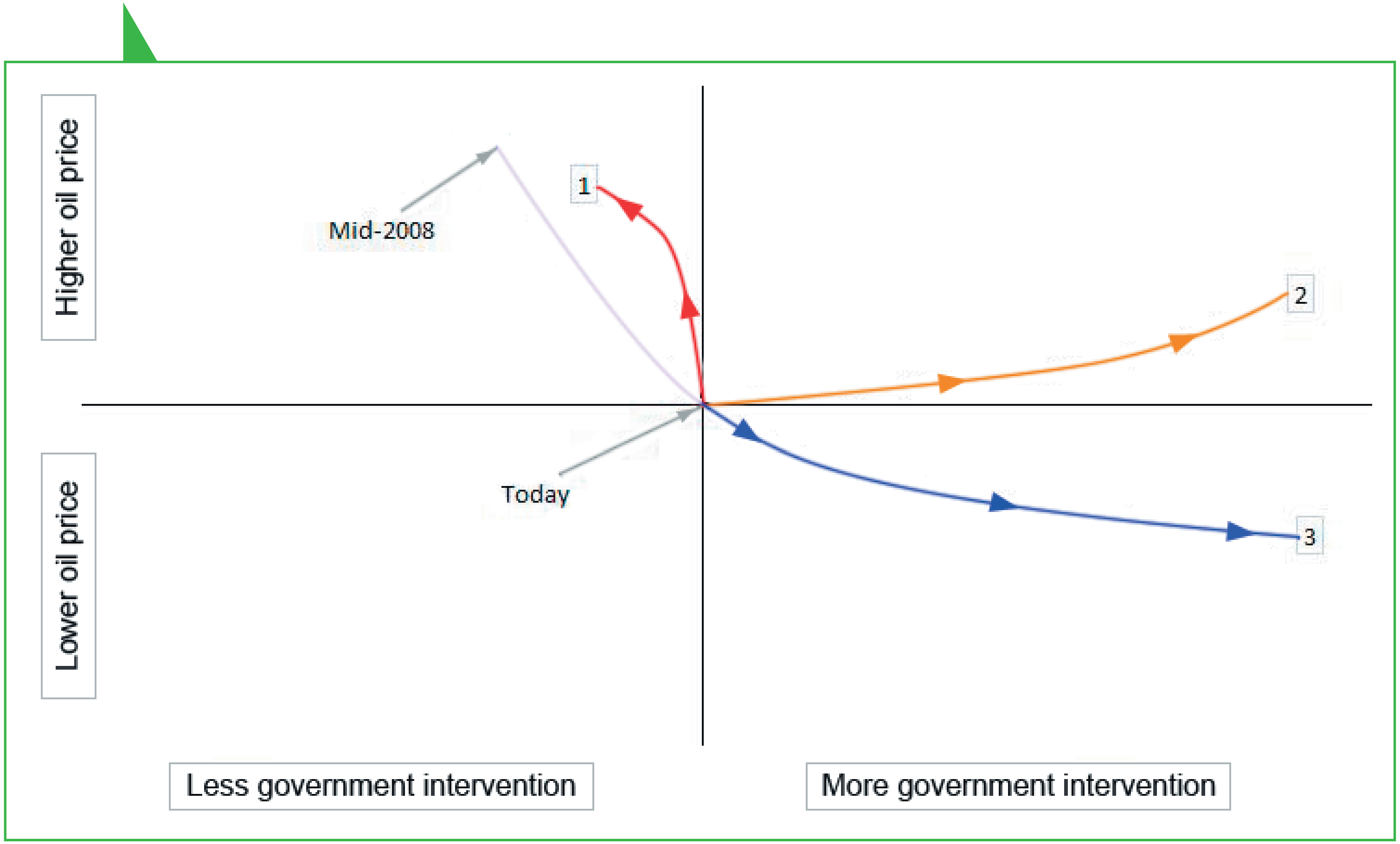
Rosneft, the largest state-owned oil corporation, has already revised its investment plan for 2009 based on an average Brent price of $50/barrel; given that the price has been below that mark continuously since November, further revision will likely be needed. At Lukoil, the largest private oil company, investment in 2009 may shrink to as little as a quarter of the $13bn invested last year. Norilsk Nickel, the mining and metals giant, has only spent $460mn on capex in 2008 instead of the $700mn planned, and plans for 2009 are just $240mn. TNK-BP has cut its yearly capex plan by 27%. Uralkali, a large fertilizer producer, has postponed the development of a new mine, even though it runs the risk of losing the license to it. According to the aforementioned consensus survey, capital investment in 2009 is expected to fall by 1.9%, while the Ministry for Economic Development forecasts a 1.4% growth, largely fuelled by state-financed projects.

As government money remains the main source of financing, state companies appear considerably more aggressive than most private ones. Gazprom, for instance, has so far declined proposals to cut its investment plan for 2009; TGK1, a power generation company it largely controls, is even expecting to double its capex as compared to 2008. Even among private players, some companies are looking at the current turmoil in terms of opportunities. Rosbank, a leading bank backed by the powerful Societe Generale, is betting on a 15% increase in retail loans in 2009, arguing that "many competitors are leaving." Eldorado, the #1 electronics retailer, expects to increase its market share to 40% (albeit in a falling market), benefitting from its discount model as price awareness grows. Sollers, a carmaker which has been assembling cars from kits supplied by SsangYong, has declared the intention to buy full rights to these models from the now bankrupt Korean supplier. As the ruble depreciates, many Russian producers are getting an advantage competing against imports, which may also improve their market positions.

POSSIBLE SCENARIOS

Much of Russia's fate is tied to how commodities perform, particularly the price of oil, which, in turn, depends on how quickly the rest of the world will recover from the crisis. While the oil price is widely seen as the most important external variable, the government's role is probably the key internal factor. Depending on how the oil price changes and how the government behaves, different scenarios are possible in the next two years.

Scenario 1. If the price of oil (and other commodities) recovers in the near future, companies may be able to repay their emergency loans to state banks. As non-governmental sources of financing return, the state may refrain from "manually controlling" the economy, allowing companies more freedom in choosing their strategies. Growing exports would ease pressure on the ruble, removing the need for massive interventions from the Central Bank. Wages and employment would stop decreasing. A recovery in the purchasing power of households would enable the government to transfer parts of such sectors as healthcare, education, utilities, transportation etc. to the private sector.



Scenario 2. Under this alternative scenario, while the price of oil begins to recover, the government becomes disappointed in free-market policies and chooses to further reinforce its influence over a number of major industries. Growing exports would gradually solve the double deficit problem Russia is currently facing. At the same time, interventionist policies would turn off private investors and cause capital flight. Because of the latter, the ruble exchange rate may stay de-facto determined by the Central Bank, with no significant rebound in the medium term. Domestic producers would enjoy a relatively rapid return to profits, thanks to the devalued ruble (in addition to the protectionist measures already in place). At the same time, they are likely to face an entrenched bureaucracy and an increasingly inadequate legal system. Because investment under this scenario would mostly be limited to government projects, recovery would be slow and long-term competitiveness may be compromised.

Scenario 3. If the price of oil continues to decline, the budget deficit may become large enough to completely drain the Reserve fund by the end of the year, while the Central Bank runs out of reserves to control the exchange rate, leading to a free-fall of the ruble. At the same time, a number of leading companies will fail to refinance their loans and will be forced to close down loss-making sites. Trying to regain control of the situation and prevent massive layoffs, the government may effectively nationalize many of the largest enterprises, using their debts to various state institutions as pretext. Disposable income would drop dramatically, and the social consequences of the crisis would be felt for years to come.

According to Sergey Aleksashenko, Director of Macroeconomic Research at the Higher School of Economics (Moscow), the probability of scenario 1 seems low: it would require significant institutional changes, which are unlikely to happen, and even less so if external conditions start improving. Commenting on scenarios 2 and 3, Sergei Guriev, Rector of the New Economic School (Moscow), points out that, contrary to widespread assumptions, nationalization and other forms of government interventionism, in particular in the oil industry, are more likely to occur when oil prices are high (scenario 2) rather than low (scenario 3)[1] . On the contrary, Kingsmill Bond, Chief Strategist at Troika Dialog, believes that the government is only getting involved because the businesses need it, and therefore is likely to intervene less if oil prices go up.

[1] See Guriev and Durnev, The Resource Curse: A Corporate Transparency Channel, 2007; Guriev, Kolotilin and Sonin, Determinants of Nationalization in the Oil Sector: A Theory and Evidence from Panel Data, 2007

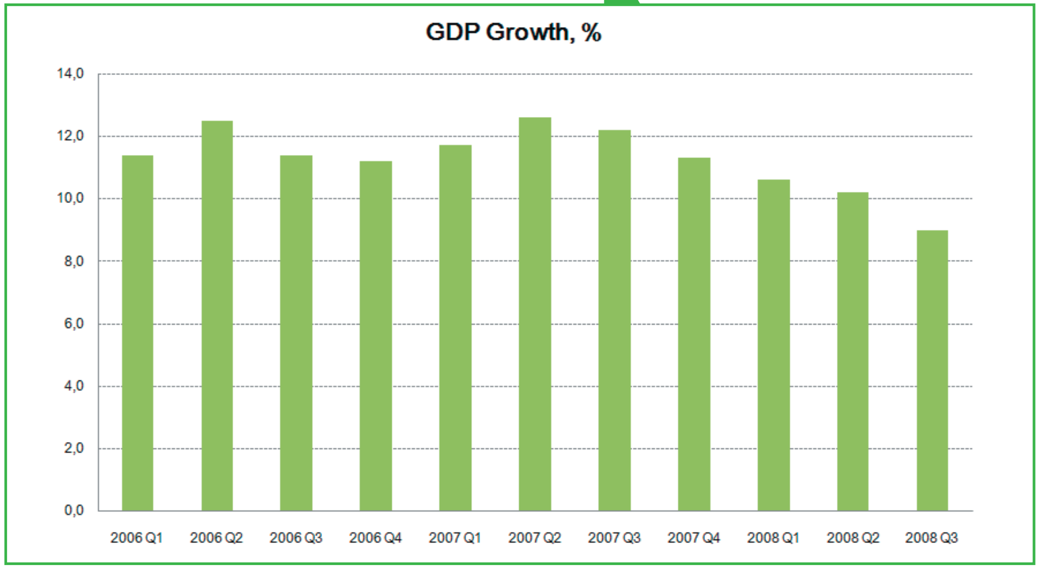
CHINA

As the world's largest developing economy and emerging market, China has long relied on export and investment for economic development. Its rapid economic growth in the past decade had been sustained largely by industrialization and urbanization. For example, in the past thirty years China has achieved the fastest urbanization in history—around 300 million people migrated from rural to urban areas, reducing the proportion of China's agricultural population from more than 80% in 1978 to 56% in 2008. China's manufacturing sector was fueled largely by cheap credit during the investment boom and over-optimistic expectations for the seemingly endless growth in demand from the global market. Industrial investment was highly skewed towards large enterprises, most of which are state-owned or state-holding companies. As a consequence, such a high rate of investment has led to an excess in industrial capacity.

The global crisis has exposed the imbalance of weak domestic demand and the oversupply of industrial output in China. China's economy started to slow down at a much faster pace than expected in the last quarter of 2008. Although China's financial system weathered the impact of the global financial tsunami quite well in the first couple of months, the slide in the export sector caused by shrinking global demand led not only to a serious decline in overall GDP growth, but to a sharp drop in business confidence towards the end of 2008. With declining exports and sluggish domestic consumption, the government is endeavoring to maintain the economic growth at a minimum of 8% per year. However, without boosting domestic demand via massive public works, China will not be able to meet its goal.

IMPACT TO DATE

As a result of globalization and China's own export-led development strategy, China has become increasingly reliant on foreign trade and therefore more exposed to external shocks. China's exports declined in December by 2.8% to $111.2bn year-on-year, which followed a 2.2% decline in November. In October export growth was 19.2% year-on-year.



The manufacturing sector was among the first to show signs of a serious slow-down in China's economy in 2008. Beginning in the second half of 2007, new taxes (from which foreign companies were initially exempt), greater pollution controls, the appreciation of the RMB against the US dollar, and the rise in labor costs have made it less advantageous to maintain production in China. The objective of these regulations, in the long run, is to modernize the manufacturing sector, which had won global market share using cost advantages, yet sacrificed the interests of labor, the environment and technology. However, the sector was already vulnerable, and it was hit hard by the dampening global demand. As a result of the weakness in exports, the industrial value added growth was 5.4% in November, a full 10% less than in January 2008.

In the export manufacturing base of the Pearl River Delta, about 3 million factory workers were expected to lose their jobs by the end of 2008 after foreign demand slowed dramatically for electronics and toys. About 10,000 of the 45,000 factories from this area were also expected to close by the end of Jan. To help the industries, on January 1, 2009, China once again increased the export tax rebates for 553 types of high-tech and high value-added mechanical and electrical products in a bid to alleviate cost burdens on companies in these sectors. This was China's fourth rebate hike on exported products in the past year.[2] Furthermore, the government is also planning to expedite the investment of RMB 600 billion into scientific and technological development, and there is another policy package to help some key industrial sectors that will be announced soon.

[2] On August 1st China increased the export tax rebates for textile, garment, bamboo products; China lifted export tax rebates for textile and garments again on November 1st, and rebates on exports of selected ceramic, plastics, mechanical, electrical and medicinal products will also be lifted by 1 to 2 percentage points. The most recent increase took effect on Dec.1, covering 3,770 items of labor-intensive, mechanical and electrical products, or 27.9 percent of the country's total exports.

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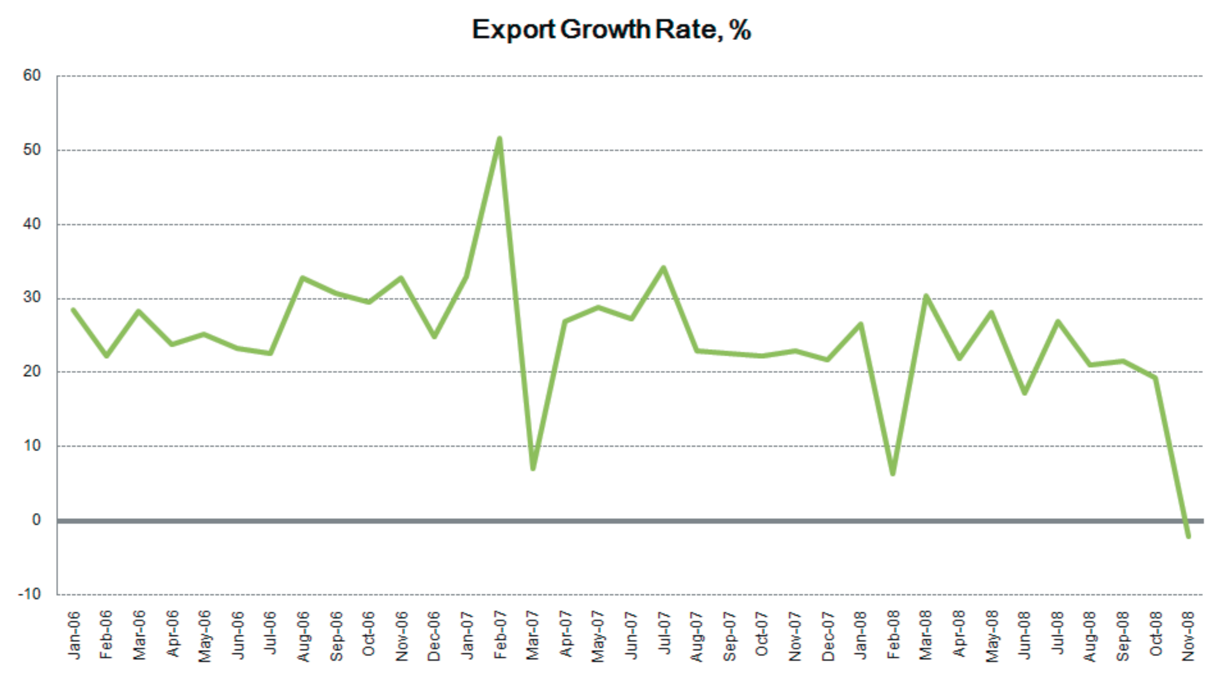

In the last several years, **labor** shortage was a problem that many companies experienced. However, as the Chinese economy slowed down in 2008, the shortage became a surplus. Official statistics show that in Q1 and Q2 of 2008 about 67,000 SMEs across the country failed, most of which were export-oriented labor-intensive firms. Although the announced unemployment rate in Guangdong province is still low at 4% (which is almost the same as in 2007), the reality is different. According to Chinese statistics, the unemployment rate only accounts for urban residences, but most employees in SMEs are rural laborers from inner provinces, such as Hunan and Sichuan, so the data are misleading. As of Jan. 31, the Director of the Office of Central Rural work Leading Group stated that around 20 million peasant workers have lost their jobs and returned home across the country.

Despite reports of rising unemployment, consumer demand has been surprisingly strong in recent months. Retail sales have continued to grow at 20%+ since March 2008. However, given the high reliance on export and investment, the current level of consumption is not enough to compensate the economic slowdown incurred due to the sharp drop in exports. Furthermore, after five years of unrelenting growth, real fixed investment, especially real private investment, has softened in 2008, driven by a nationwide decline in house prices.

In an effort to counter-balance the external shock, the government has passed a RMB 4 trillion stimulus package, to be spent over two years. Most of it is meant to boost consumer spending, which accounted for only 36% of GDP in 2007 — a much lower rate not only vis-à-vis other countries, but also when compared with China's own situation two decades ago. Of this sum, RMB 850 million is to be invested in healthcare. Given the fact that rural households' marginal propensity to consume is higher than that of urban households, the government's policy of raising agricultural products' procuring prices should help boost overall consumption. Furthermore, the Chinese government recently announced a plan allowing farmers to transfer their land-use rights,[3] which would also stimulate rural consumption.

Beginning in 2005, the **real estate** market had become one of the fastest growing sectors in China. From 2004 to 2007 investment in the real estate sector increased by 92.2%, completed floor space of buildings grew by 57.9%, and the total enterprises' capital increased by 54.9%. Excessive optimism and herding behavior pushed housing prices to an unreasonable level, and the housing bubble peaked in 2007. A similar situation took place on the stock market. From June 2005 to October 2007, the Shanghai Stock Index increased from around 1000 to more than 6000. At that time, the P/E ratios of most of the main companies were over 50, compared to the world average of about 15.

At the end of 2007, as the U.S. housing market crashed, the expectation of the Chinese real estate market changed, and demand for housing dropped sharply. As the U.S. subprime mortgage crisis began, banks started to reduce loans to real estate companies and began raising requirements for obtaining a mortgage. As a result, the demand for housing weakened further, and the liquidity problem for real estate companies increased. The financial turmoil after the fall of Lehman Brothers made the situation worse. The global credit crunch reduced foreign capital flow and even caused capital flight, which weakened real estate demand further. Some foreign companies began selling their real estate assets for cash reserves. For example, in September 2008 Morgan Stanley and Citigroup were reportedly planning to sell some Shanghai properties, which hurt market confidence further and helped push housing prices down. Whereas completed floor space of commercialized buildings grew 12.4% in the first half of 2008, the sold floor space decreased 10.8% during the same period year-on-year. In some cities, such as Beijing and Shanghai, housing prices decreased around 15%. During the last five years, the share of real estate development in total investment was about 20%; therefore, the slowdown in this sector will significantly impact economic growth, both directly and indirectly through lower demand for steel, cement and other building materials.

[3] In China, peasants do not own lands, i.e., lands belong to the nation and all people, but they are granted the "land-use rights" by the Chinese government according to their family sizes. Without the transfer of the "land-use rights," peasants could work on the special lands specified by the "rights" and profit only from the agricultural products of the lands. With the transfer of the "land-use rights", peasants could sell or rent out extra "land-use rights" to farmlands or others, and get cash income from the transfer.

The government became quickly aware of the changes in the real estate market. Between September 16, 2008 and December 31, 2008, the Central Bank had cut the benchmark interest rate five times, helping to relieve the pressure on home buyers and real estate companies. Several major state-owned commercial banks announced an interest rate discount plan for home buyers in 2009, and some other small banks followed. Some local governments are also planning to purchase houses as low-rent housing for low-income groups. Other possible measures include tax cuts, relaxing the loan restrictions, reducing the down payment ratio, and so on.

The Chinese **stock market** has lost more than 60% of its value since October 2007, with various factors playing a role, from the drop in exports to commercial banks' exposure to losses in the US. Because the effects of the Chinese stock market on the real economy are relatively weak, the Chinese government initially did not intervene. However, after the Shanghai Stock Index had dropped by half, the Chinese government decided to take some measures. In April 2008, the Chinese government cut the stamp duty on stock transfers. After the fall of Lehman Brothers, the government adopted expansionary monetary and fiscal policies, and some state-owned enterprises began to buy back their own shares. Those policies stabilized the stock market. At the end of 2008, the Shanghai Stock Index was at the same level it was before September 2008.

Government priorities have changed throughout 2008. At the beginning of 2008, the so called "double prevention" approach prevailed. That is, the government sought "to prevent inflation and economic overheating." By June, the policy shifted "to preserve the economic growth, and to control inflation." By early November, with the spreading of the global financial crisis, "active fiscal and relatively expansionary monetary policy" replaced the previous two policies. The structural weakness of the national economy has been revealed by the crisis. The sudden drop in external demand, the heavy reliance on the international market, and sluggish domestic demand have slowed economic growth and led to various policy shifts in an attempt to combat the crisis. Whether China's attempts to save the economy will be effective remains a question, and much depends on how long it takes the global economy to recover.

OUTLOOK FOR 2009

The Chinese government remains strongly committed to achieving 8% economic growth in 2009: only a slight cooling off compared to what the rest of the world is experiencing. The central government has dedicated RMB 4 trillion to the economic stimulus package, and local governments have pledged RMB 14 trillion in their plans. While the financial stimulus committed is significant, it is far from clear whether it will be fully funded and whether it will be sufficient. The majority of the government's revenue comes from taxes and the sale of land; in some regions, the latter is more than 60% of the local government's annual disposable revenue. However, the real estate industry has weakened considerably, and now both the local and the national governments are facing the pressure of diminishing fiscal revenues and more bankruptcies.

The way the package is spent will also matter. Chi Fulin, the director of the China Development & Reform Institute in Shanghai said that "the RMB 4 trillion should be invested in areas where social investment will be encouraged and consumption will be stimulated, particularly the tertiary industry should be emphasized. An extra 6.4 trillion may be needed to further improve the public services and decrease the rural-urban service gaps by 2010." Tarhan Feyzioglu, the IMF representative in Beijing, showed similar concerns about the package's direction, "the additional spending should be directed more towards consumption, especially healthcare and education...but at least the government has given a very strong signal to the market that they will do whatever it takes to ensure economic growth remains strong in China."

Given the deepening global recession and the uncertain impact of the stimulus package, further economic policies are likely to follow in the coming months. New tax cuts to individuals may be introduced, especially in rural areas, in order to boost consumption. With more bankruptcies and the accompanied increase in unemployment, "domestic consumption is decreasing," according to Zhang Wenkui, a scholar from the Development Research Center of the State Council.

In attempting to stimulate consumption in rural areas, the government is undertaking a land reform policy, which will allow farmers to transfer their land and will facilitate labor movement between rural and urban areas. However, given the wide gap between cities and villages, more subsidies will be given to farmers. The recent "Household Electronic Appliance for Farmers" initiative, for example, encourages electronic appliance manufacturers and dealers to focus on rural market via subsidies of 15-20%. More such policies are likely to be implemented in the near future.

The global financial turmoil and economic slowdown may lead free market economies back towards protectionism, thereby further hurting Chinese foreign trade. However, insofar as the Chinese government has an influence in the matter, it will attempt to stimulate exports. In the first half of 2009, the Chinese government may announce an expanded list of products qualifying for export tax rebates and increase the value of current rebates, along with a devaluation of the RMB to boost demand abroad. Since the whole world has entered a period of low interest rates, China may further loosen its monetary policy. Throughout 2009 the government is likely to cut interest rates.

As the economy slumps, the real estate companies and the stock market will continue to perform poorly. If the Chinese economy can maintain 8% growth rate and the government implements proper measures in 2009, the Chinese real estate and stock market may stabilize or even begin to recover at the end of 2009. Before that, the housing prices are expected to drop another 5-10%. The banks' non-performance loan ratio may rise about 1% due to the sluggish real estate market.

The unemployment problem will not get better in the near future. As more and more SMEs fail and college students graduate, the job market is poised to further deteriorate in the coming months. If the crisis persists and the economic growth rate falls to around 5%, the situation will be serious. Because China's social security system is still poorly developed and coverage is very limited, the unemployment problem may trigger social unrest. How to address the rising unemployment rate has become the most urgent question for the Chinese government.

With the sharp drop in external demand, domestic demand cannot sustain the high economic growth China has enjoyed in the past. While export is determined exogenously, the only option left for the country is government-led investment, at least in the coming two to three years. As a result, in the coming years government investment will have a dominant role in the national economy. One characteristic of the state investment will be an effort towards technological modernization. The government is already providing policy incentives to innovate, such as increasing the tax rebates for firms exporting technology-intensive products and improving the liquidity of SME financing to reinvigorate troubled manufacturing industries.

China needs technological innovation in order to continually improve productivity and efficiency, which will facilitate the country's integration into the global manufacturing value chain. During his 2009 New Year visit to China's eastern Shandong Province, Premier Wen Jiabao urged enterprises to stress innovation in combating the impact of the global economic turmoil. For example, during a visit to Qingdao's Kingking Group, the world's second-largest candle maker, Wen stated, "try to develop new types of candles to cater to different cultures, which would capture big market share." Wen remarked that opportunity lies in innovation, which will not only help shake off the impact of the crisis but will also increase the competitive advantage of companies. After Wen's visits, the State Council drew up two major economic plans. One involves ten programs to expand domestic demand, further detailing and specifying the stimulus measures announced late last year, while the other includes the readjustment and improvement of ten pillar industries. Plans for the development of the steel industry and the automobile industry have been rolled out and others are under way.

The contribution China can make to the recovery of the global economic downturn is to stabilize its own growth. However, China has entered an uncertain stage of economic development. There are three challenges that the Chinese government has to deal with immediately: financing the growth of small and medium-sized enterprises (SMEs), mitigating increasing unemployment, and solving trade conflicts and growing protectionism with its trade partners. As President Hu Jintao pointed out, the success of China's reforms is hinged upon grasping and utilizing strategic opportunities during the next 12 years.

COMPARATIVE SUMMARY

Neither Russia nor China has decoupled itself from the rest of the world, and the drop in demand for the countries' exports has been detrimental to both. The crisis has impacted the nations in different forms. Whereas Russia relied on its commodity exports to keep its economy booming, China's factories have served as the backbone for its economic growth. Both nations have seen their stock markets collapse, and although the real estate market has suffered more in China, Russia is quickly catching up. Local demand has not been enough to compensate for the fall in the countries' exports, and the governments of both countries are employing a number of measures to combat the crisis. Whereas Russia is attempting to address the issue by a "top-down" approach, China is utilizing more of a "bottom-up" method. China wants to stimulate local consumption, while Russia is seeking to support its economy by aiding the largest firms in different sectors. The difference in approach stems from the risks in each country – Russia views corporate debt, and financial instability, as the main risk to the economy, while China's chief concern is the diminished demand for its products and the subsequent unemployment. The Russian government is therefore more concerned about the devaluation of the currency than the Chinese government, as the risk of default on company debt is higher in Russian than in China, and the way the reserves have been spent by the two countries has thus differed. Whereas there is much talk of devaluing the yuan to stimulate Chinese exports, the Russian government has spent billions to support its currency.

The drop in the price of oil and other commodities has dried the Russian government of its main source of income, and the exchange rate has suffered as a result. Given the fact that Russian companies have approximately $500bn of foreign debt, servicing the loans has become a major problem, leading to numerous bankruptcies. To mitigate the problem and avoid a panic in the general population, the government has spent 1/3 of its foreign reserves to slow the inevitable decline of the ruble. The pain felt by commodities exporters has trickled down to the rest of the industries as well, and with the imbalance between salary and productivity growth over the last few years, wage cuts have resulted. The Russian government is attempting to support the economy mostly by using the approach of the West, i.e., the infusion of liquidity into the banking system, with the aim to have the money trickle down to the companies in need of finance. Furthermore, the government is also providing direct financial support, in the form of loans in return for (a guarantee on) the company's equity, to certain firms.

China, on the other hand, depends on commodity imports to fuel its economic growth. The drop in commodity prices is therefore beneficial; however, the fall in worldwide demand for Chinese goods has forced a general downsizing of its industries. The problem faced by Chinese firms is an oversaturated market, given the downward readjustment of worldwide consumption. The government is thus attempting to stimulate demand locally, turning its attention to the poorest regions, namely the rural areas. China wants its people to have an increased capacity to consume to make up for the drop in foreign demand and is targeting the population directly, via such initiatives as a modification in land-use rights. Russia, on the other hand, has made few overtures directly to the public and has focused on propping up the largest companies in the country, particularly within the financial services sector. The aim is to have these "industry champions" not only survive, but to help their employees and other companies weather the crisis.

The different approaches by Russia and China in tackling their economic crises need time to show their merits. Russia has burned through a considerable portion of its reserves, which has brought the country's ratings dangerously close to junk status. China, on the other hand, has considerable financial firepower left, but the 8% growth rate it aims to achieve is a far more ambitious goal than faced by Russia. The impact of the crisis on the countries has been different, and the way the nations come out once the world's economies recover remains to be seen. Whereas China might be forced to address some of the prevailing deficiencies in its system, especially in the rural regions, the Russian economy could see a deeper encroachment by the government in its industries, particularly in the commodities sector (three scenarios have been posited elsewhere in the paper). The longer the crisis lasts, the more profound the changes are likely to be.

While it is unfortunate that Russia and China are exposed to the current global financial crisis, it presents an opportunity to reevaluate and upgrade their economic systems. Their dependence on foreign markets, i.e., export of either commodities or cheap manufacturing goods, does not warrant sustainable growth. The current crisis is an awakening call to expedite the economic transition into a more balanced and sustainable growth model. Russia and China require a stronger domestic market and a substantial improvement of internal capabilities and systems.

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