

The global financial turbulence and Russia

By Simon-Erik Ollus

Russia is not an isolated country. The global financial turbulence has proved this fact in the recent months. When the American financial crisis started in summer 2007, Russia still appeared as a quite safe investment country with a high rate of return and a low risk. Russian firms did in 2008 still IPOs for a record of 18 billion dollars, and the cash flow to the country in dollars continued to grow, as the oil price climbed. The economy boomed and the market value of Russian firms grew rapidly in recent years. In the spring 2008, there were 13 Russian firms among the world 500 largest firms by market value, while still a year earlier there were only eight. Russian business seemed to enjoy a period of renaissance and rapid growth

In early 2008 we started to see some changes, and some Russian firms started to cancel their planned IPOs as the international demand fell. In 2008 Russian firms have done so far IPOs for only 1 billion dollars, all during the spring. Some Russian corporations complained already in spring that international interest rates started to climb and lending was harder, but any financial crisis in Russia was still far from expected. In May 2008, we started to see the first real signs of some disturbance. International oil prices started to decline and the problems with Fannie Mae and Freddie Mac showed us that the American crisis is worse than we first expected. American institutional investors started to withdraw capital from abroad and Russia, which was seen in modest decline of the two main Russia stock indexes: RTS and MICEX.

In the summer 2008, the Mechel and TNK-BP cases occurred, where the Russian *administrative resource* was used brutally against healthy businesses and which reminded us of the *political risk* related to the Russian market. The political risk was refreshed, when the conflict in the Caucasus started in early August, but still we did not see any panic on the financial market in Russia. The Russian political leadership also seemed to be sure that the domestically driven economy was not disturbed by the war. However, the shock for the economy came when the American crisis revealed much worse than expected in late August, when the problems around Lehman Brothers and AIG came up. The stock exchanges around the world plummeted, also the Russian exchanges. The Russian stock exchanges have fallen with nearly 60 % from May to early October, whipping 700 billion dollars out of the country.

Russian indebted firms and banks are in trouble

Russia has so far enjoyed strong capital inflows in recent years, as oil prices have climbed and investors have increased their investments to the country. However, in August we for the first time saw capital flight from the country. According to the central bank, 21 billion flew out from Russia in August and the central bank had to intervene using its currency reserve to keep the value of the ruble in the currency board. In September, some capital flight was also observed. But exact figures are still hard to get, as the central bank will first to publish the balance of payments figures of the third quarter in mid October.

The market turbulence has severely hit those Russian corporations and banks, which have expanded by foreign borrowed capital. The Russian large firms have borrowed liquidity abroad, using their owed shares as collateral for the loans. Now, as share prices have plummeted, the values of the collaterals have declined and many foreign banks now demand better collaterals or even call their loans back. Some Russian firms have managed to renegotiate their loans with higher interest rates. Other Russian corporations turn towards the Russian banks and try to transfer their obligations there. And for some firms the doors for borrowing are closed and market rumors spread in Russia about troubled firms.

Consequently, the period of cheap liquidity for Russian firms are definitely over.

The financial turbulence also strongly hit the Russian banking sector, whose growth is mainly driven by relending short maturity foreign borrowed liquidity. The domestic financial markets are still small and deposit funded borrowing is rear. The banking sector is quite static. Although, there are nearly 1 200 banks, only the 28 largest ones have access to central bank lending. Since August, the central bank and the ministry of finance have several times injected excess liquidity to the largest banks, but smaller banks still face serious problems, as the interbank market functions poorly and foreign borrowing is getting more expensive. In September, two mid-size banks were bought by larger banks and further similar actions are probably expected. Consolidation is good, but the bad part of the story, is that the sector is dominated by state controlled banks and consolidation means an increase of their market share.

Bad for the real economy, but still far from worse

The good news is that the effects so far are limited in the real economy. The Russian economy is largely concentrated on natural resource production and the financial sector is relatively small. In early July 2008, Russian firms and banks had external debts for 493 billion dollars, of which a fifth was short term. This corresponds only to about a third of the GDP, which in international comparison is very low. However, the private foreign borrowing has grown rapidly in recent years, by about 40% y-o-y, and some of the large players are heavily indebted.

The main driver of the Russian economy is the natural resource sectors and the economic growth is driven by increasing raw material prices. On an annual term, the oil price is still on a record level and GDP growth was 8 % y-o-y in January-July. Central forecasters expect the GDP growth to decline by a few percentage points until the end of the year, but we still talk about a relatively rapid growth.

The bad news is that the financial crisis will probably affect those sectors, which drive the modernization of the Russian economy; manufacturing, retail sale and construction. We have already seen a decline in construction growth during summer, especially housing construction. Also retail sale has been partly debt driven, and increased cost of borrowing will affect consumption, although August statistics still show a record level of sale. The August figure can be partly explained by the record high inflation that encourages consumption. Value added manufacturing will also suffer, if the cost of capital increases and the demand decreases.

How bad the situation will become depends much on the outcome of the American financial crisis. If the American crisis gets worse, the cost of international capital will increase and oil price continue to decline. This would also hit the Russian economy much more severely than what we have seen so far. But if the American crisis is nearly over, the effects on the Russian economy will be limited. Then, the crisis would function mainly as a welcomed reminder for Russian political leaders and businessmen that Russia is a part of the global economy.

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