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Laura Solanko: Why did the financial crisis impact so strongly on the Russian banking system?

The Russian banking sector has grown extremely rapidly in recent years. At the beginning of 2004 the combined sectoral balance sheet was equal to approximately 40% of GDP, but over the next five years this figure rose to over 65%. This rapid increase was based on two main factors. On one hand there was strong growth in the Russian economy plus development of the financial sector infrastructure, both driven by the high price of oil. The other factor was foreign borrowing. Banking sector growth has led to longer loan periods, increased confidence in the rouble and a multiplication of borrowing opportunities for Russian households.

The years of growth have seen Russian banks become stronger, and on average they have been highly capitalised and exceedingly profitable. In addition, the Russian banking sector had very little involvement in the financial instruments that triggered the international financial crisis. Why, then, did the crisis hit the Russian banking sector so very hard?

There were two basic causes. As hinted above, the Russian economy in general, and the financial sector in particular, are dependent on two external factors: the price of oil and the international financial markets.

The collapse in the price of oil

The full-blown crisis on the financial markets triggered by the collapse of Lehman Brothers also led to a collapse in the world market price of crude oil. In just a couple of months the price of oil fell 60%, which merely amplified the decline in share prices in Russia. This, in turn, had two dramatic effects. In the first place, a number of middle-sized Russian banks had linked a considerable proportion of their assets either directly or indirectly to the stock markets, and the collapse in share prices caused these banks serious liquidity problems. This reinforced the worldwide lack of confidence in counterparties and the consequent hoarding of liquidity by financial institutions.

The other shock came from the fact that major corporations which had taken on large amounts of debt in recent years and used their own shares as collateral now found those shares losing a substantial share of their value. In addition, the drop in the price of oil, and in consequence also the prices of Russia’s other important commodities, meant a contraction in corporate cash flows. The astonishing feature here is that the fall in prices would not have been expected to have a particularly dramatic impact on corporate earnings if the marginal tax rate on oil exports was truly 90%.

Dependence on foreign money

The Russian banking sector grew at an unprecedentedly rapid pace after the year 2000. With domestic savings not rising nearly as rapidly, a constantly growing share of banking sector growth was based on borrowing from abroad. Although the stock of foreign borrowing is not particularly large in international comparison, it grew very rapidly and the loans are relatively short-term. The interbank market, in particular, was highly dependent on foreign money. According to one study, over half the transactions on the interbank market involved a foreign financial institution as a counterparty. This means the banking system is very open and, as became clear in autumn 2008, dependent on the risk-taking propensity of foreign financial institutions.

The growing foreign borrowing was made particularly attractive by the exchange rate policy pursued by the Bank of Russia. In order to secure macroeconomic stability and domestic price-competitiveness, the nominal value of the rouble was held more or less stable until December 2008 despite pressures to let it rise. Domestic interest rates nevertheless remained well above the international level, meaning foreign borrowing was, if not actually free, at least very cheap.

In autumn 2008 the supply of foreign refinancing dried up and the banking sector’s already weak confidence became an outright lack of confidence. The Bank of Russia used all available means to increase liquidity, while at the same time holding fast to the rouble’s de facto fixed exchange rate. The collapse in the world market price of oil and other commodities together with the strengthening dollar (due to the ‘flight to security’) destroyed market confidence in the stability of the rouble. The fear of devaluation caused the financial markets to freeze. A substantial proportion of the increased domestic liquidity offered by the Bank of Russia presumably flowed into dollars, further fuelling the pressures for devaluation of the rouble.

Exchange rate pressures

This led to slower growth in the domestic loan stock, with many actors complaining the supply of finance had dried up completely. In addition, funding difficulties, growing payment arrears and the conversion of savings into dollars reduced growth in the stock of deposits to zero. At the end of 2008 the broad monetary aggregate (M2) also began to contract.

The collapse in the price of oil, the flight of foreign investors from both Russia and other emerging markets plus devaluation in neighbouring countries placed enormous pressures on the rouble. Concern over the future rate of exchange finally caused paralysis on the Russian financial markets. The banks did not want to lend in roubles, while borrowers no longer dared to borrow in foreign currency. A substantial share of the banks' rouble liquidity was exchanged for foreign currency. The decline in the stock of rouble-denominated deposits at the end of the year actually revealed more about lack of confidence in the exchange rate than in the deposit banks. Russia drifted into a step-by-step devaluation, as a result of which the currency depreciated approximately 30% against the dollar-euro basket between November 2008 and February 2009.

However, the step-by-step nature of the devaluation allowed all economic agents to prepare for the depreciation in the exchange rate. Of the banks' corporate loan stock, on average around a quarter of loans were denominated in foreign currency at the end of 2008, although the variations between banks were considerable. Almost 40% of corporate loans at the thirty largest banks were in foreign currency at the beginning of 2009.

Government support measures

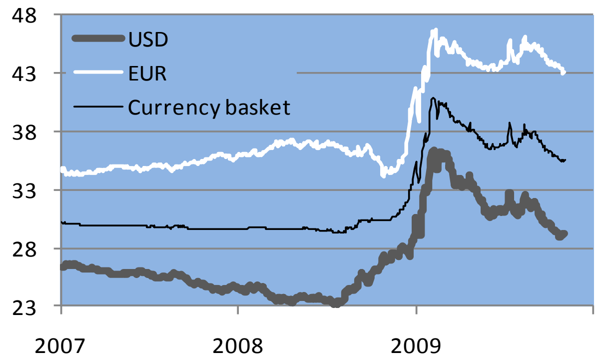
The rapid and massive support measures taken by both the government and the central bank at the end of 2008 prevented the collapse of the financial system. Taken together, the measures promised to secure the operations of the banking system amount to approximately 10% of GDP. The end of January saw the establishment of a new, clearly credible exchange rate. In recent months, since the return of oil to USD 60–80 a barrel, the rouble has rather tended to strengthen slightly. Russia's six largest banks, accounting for around 50% of the entire sectoral balance sheet, are all either directly or indirectly state-owned. During the crisis, the government has sought to use the banks in state-ownership to maintain at least some degree of lending activity. The stock of corporate loans has grown this year primarily in just a couple of the largest state-owned banks, meaning the loan stock for the banking sector as a whole remained more or less unchanged throughout the first half of 2009.

Time for new growth?

With the most acute phase of the financial crisis now over, the banking system is still hampered by a third source of uncertainty in addition to the uncertainty over the price of oil and the tightness of the international financial markets: namely the quality of the loan stock. Customers' payment difficulties have been reflected in a growth in problem loans and loan rescheduling. The level of non-performing loans recorded by the Bank of Russia is still relatively low, but there can be considerable variation between different banks. Moreover, according to international credit rating agencies, the share of non-performing loans has already risen substantially, being at present over 10% of the banks' loan stock. The banking sector is in need of recapitalisation to cover possible loan losses. To date, the measures taken by the central bank have been sufficient and there have been no significant banking bankruptcies. The deposit guarantee system set up in 2004 has worked without problems.

Acquiring capital and refinancing on the international market will, however, continue for a long time to be both more expensive and more difficult than during the last five years. For this reason, we cannot expect rapid growth in the Russian banking sector in the immediate years ahead. If the large Russian corporations also find themselves unable to draw on the international money markets for a prolonged period, the funding opportunities for small and medium-sized domestic companies in Russia could be considerably reduced as a result of the crisis.

The rouble exchange rate against the US dollar, the euro and the currency basket 2008–2009



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