

## Simon-Erik Ollus: How is financial market turbulence reflected in the Russian economy?

The turbulence in the global financial market arising from the US subprime mortgage crisis was also reflected in the Russian economy in late summer. Some foreign investors have repatriated their portfolio investment and rising global interest rates have contracted liquidity supply in the country. According to the Russian central bank, private net capital outflow stood at USD 5.5 billion in August, compared with substantial net capital inflow of some USD 67 billion reported in preliminary balance of payments statistics for January–June. The constrained situation is also reflected in the activities of the central bank. In June, it increased liquidity in the banking sector and sold currency reserves to support the rouble. In two weeks at the beginning of August the currency reserve shrank by nearly USD 7 billion to stand at USD 416 billion by the end of the month. Due to the events of August, recent statements by some investment banks have dramatised the situation and pointed to elements of crisis in the Russian banking sector.

### Russian banks as intermediaries of foreign finance

In recent years, Russian banks and companies have been able to enjoy the benefits of ample liquidity in the world economy combined with Russia's improved credit rating. They have had access to inexpensive finance on the international financial markets, and this has resulted in a substantial capital inflow into Russia. This has, in turn, led to lower interest rates in the country. Some banks providing finance to companies and households have taken out short-term loans from abroad in order to finance the granting of long-term loans in Russia. The recent turbulence in the global financial markets has pushed up short-term interest rates, making it more costly to access foreign liquidity and increasingly difficult to use the types of loan arrangements outlined above.

The tightening liquidity situation has been reflected in higher interest rates in the Russian interbank market, which also pushes up banks' cost of raising domestic finance. The constrained domestic liquidity makes things particularly difficult for small and poorly resourced banks. The Russian banking sector is fragmented into different categories depending on the size of banks and the type of operations they engage in. Only banks with solid capital ade-

quacy and good credit ratings are able to lend money in the interbank market. As risks increase, the price of money may become too high for some of the weaker banks.

### Uncertainty continues, but no sign of a crisis as yet

The uncertain situation in the United States may persist for quite a while, so the turbulence in the global financial markets is likely to continue. This will raise the cost of foreign borrowing for Russians and may further intensify pressures on foreign investors to repatriate their liquid investments. In addition, some tax payments fall due in early autumn in Russia and some major companies have large rouble-denominated bonds maturing in the autumn. The liquidity situation can therefore be expected to remain tight throughout the autumn. Furthermore, without active intervention by the central bank, the liquidity situation is likely to become even tighter.

Leading credit rating agencies (eg Fitch and Standard & Poor's) have recently confirmed their ratings for Russia. Russia's economics ministry and central bank have issued reassuring statements and announced that liquidity conditions are likely to continue to tighten slightly, but they do not expect any major adverse impact on economic performance or the country's rapid economic growth. Russia has, by international comparisons, an exceptionally large current account surplus and extensive currency reserves that are available to the central bank should it need to defend the rouble's exchange rate. In addition, the central bank can, if necessary, intervene to increase the supply of roubles in the market.

### Alternatives available to the central bank

Key objectives for the central bank are to safeguard the stability of the Russian banking sector and contain inflation. To put it bluntly, we could say that in the current situation the central bank can essentially choose between two courses of action. The first alternative is to do nothing. If it does not increase liquidity, the situation could deteriorate so as to cause major problems to those banks with limited liquid resources. This could eventually force it to withdraw authorisation from some banks. On the other hand,

the deposit guarantee scheme introduced in the aftermath of the banking crisis of 2004 accepted almost all the banks that applied (ie the scheme was made available to banks with only few resources and banks whose compliance with the capital adequacy requirements was highly questionable). The Russian central bank has not, at any stage, actively sought to withdraw authorisation from smaller and poorly resourced banks. Instead, the highest priority has been to safeguard the stability of the banking sector as a whole.

The second alternative available to the central bank is to take an active role in the market by increasing liquidity in support of the banks. Such interventions would, however, lead to higher inflationary pressures in the short term. In contrast, tighter liquidity conditions would be reflected in higher interest rates, which in the long term would alleviate inflationary pressures. In Russia, however, the link between interest rates and inflation is unusually weak.

If the tight situation persists for a long time, the rise in short-term interest rates will at some stage be reflected in demand, which is currently growing partly through credit. Concerns have been voiced recently in some quarters over a degree of overheating in the consumer credit sector, and the present tighter conditions offer the central bank an opportunity to calm the consumer credit market. On the other hand, a halt in the growth of lending would be detrimental to the most rapidly growing industries, ie

construction and retailing. Higher interest rates could also hamper to some extent growth in other areas of investment. Recent investment growth has been partly fuelled by borrowing and has outpaced growth in the real economy, which can be interpreted as a cautious sign of the economy becoming more diversified.

## Central bank likely to continue its active approach

If we look at what has it has done in the past, the central bank is likely in the current situation to prioritise safeguarding the stability of the economy and banking sector over other objectives. In other words, the second alternative, actively following developments in the market, is the more likely course of action, and this is in line with the central bank's recent activities in August. This would suggest the central bank will aim to contain interest rates and increase liquidity in the banking sector if need be, thereby safeguarding the operating conditions of smaller banks and more poorly resourced banks. If the outflow of capital continues, the central bank is likely to use its currency reserves to support the rouble. The current turbulence in the financial markets is therefore unlikely to have any major adverse impact on macroeconomic developments in Russia.

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