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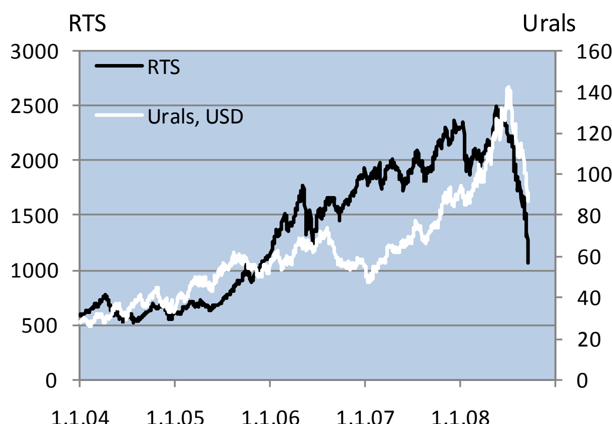
Mika Erkkilä: Impact of financial crisis on the Russian economy

Like other developing countries, Russia is in the grips of global financial market turmoil. The Russian stock exchange index RTS has fallen by around 50% from its peak in May 2008, reaching the level of summer 2006. After many years of strengthening rouble we have witnessed a slight weakening, and the central bank has had to intervene by buying the currency in order to prevent its excessive weakening against a currency basket made up of the US dollar and the euro.

According to some estimates, a capital drain of up to USD 20 billion has ensued since the start of the conflict in Georgia, although the central bank's own estimate is much lower. Following the support purchases of the rouble, the central bank's currency reserves have decreased by USD 37 billion. The domestic money market has tightened as bank and corporate borrowing from abroad has become more difficult. Operations on the Russian interbank market have become more difficult. The demand for central bank credit has increased, and since the beginning of September, the demand for money has also been greater than normal in the auctions of the Ministry of Finance.

Russian stock market (RTS) and oil price



Source: RTS, Bloomberg

Combined impact of many factors

Uncertainty in the Russian financial market is part of the global financial market turbulence, and conditions in the Russian market have not been particularly bad relative to those in other developing markets. Macroeconomic conditions are still sound. Foreign debt accounts for some 30% of GDP, and the Russian government has paid down its foreign debt in advance, thanks to the still-lofty crude oil prices, and is practically debt-free. This gives room for manoeuvre in times of uncertainty. The current-year budget is founded on the assumption of an oil price of around USD 90, and it is estimated that the budget surplus will disappear if oil falls to the USD 60–70 level. In the first half of 2008, the current account surplus amounted to 8-9% of GDP, according to preliminary estimates. The current account will move into balance if the oil price should fall to USD 80–90.

The uncertainty spreading from the US financial system is a major reason for developments in Russia, and the lower oil price since July is another key factor. Other contributing factors are more specifically Russian, such as the tug-of-wars over the TNK-BP and Mechel companies and the geopolitical risk relating to the war in Georgia, coupled with the potential expansion of the Nato, which has also kept the financial market tight. In this respect, the Nato summit in December, where the possible membership of Ukraine and Georgia will be discussed, is important.

Small banking system

Even if Russia were to avoid major hits to the real economy, declines in share prices, higher interest rates and a weaker currency are realised events, and it is unlikely that they will pass without consequences. If the small size of the Russian financial market has traditionally been a hindrance to a more efficient economy, it may actually prove to be an advantage in the current situation. There are deficiencies in the operations of the banking system, and it does not fulfil its function as finance intermediary. Hence the traditional channels of influence between financial market and real economy do not function in all respects. Cash flow financing remains a major source of funding for companies, with slightly less than 50% of investment financed in this way vs. 30–35% by borrowing. Acquisition of share capital through the stock exchange is not a significant source of funding. Share holdings do not account for a major part of household assets, so the direct impact of falling share prices on consumption is not likely to be substantial. A lack of confidence in banks has

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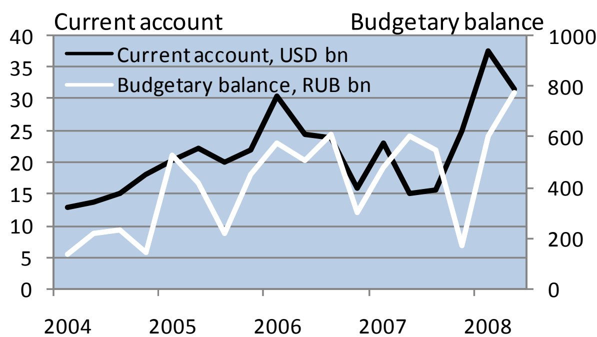
also traditionally prevented a significant sector of households from keeping their savings in bank accounts; hence one should not overestimate the impact on households of a possible burst in bank insolvencies. In addition, the majority of deposits are at the state-owned Sberbank, and nowadays Russia also has a deposit guarantee scheme. Household credits are a relatively new phenomenon, and the rapid growth of consumption over a period of many years has been financed mainly through increased income.

Indirect effects may thus become prominent in evaluating the consequences of the financial turmoil on the real economy. The psychological impact of the 50% decline in share prices should not be underestimated. Jolts to corporate and household confidence are possibly the most significant negative implications of these developments. According to the latest BOFIT forecast, Russia's GDP is expected to increase at an average annual rate of 7.5% in 2008–2009, driven by both consumption and investment. This forecast is based on an oil price of around USD 100.

Russian budget and current account



Sources: Russian central bank, Ministry of Finance, Rosstat.

Near-term outlook

In forecasting near-term developments, the key factors are developments in the global credit depression. If the turmoil persists, the Russian financial market is likely to remain lethargic. The second factor to consider is the price of oil. Currently at around USD 100, it has fallen around 30% from its peak level in the summer. An increase in the oil price would boost confidence. Higher oil prices boost Russian export income, thus adding to pressures for rouble strengthening, improving liquidity, lower interest rates and a build-up of the central bank's foreign currency reserves. Government tax revenues would also increase because taxation of the oil sector is tied to oil price developments in the world market, so the income would expand the oil funds. The stock exchange is sensitive to changes in the oil price, with roughly 60% of the RTS general index comprising shares of oil companies and other raw material producers.

The tight liquidity situation particularly hampers the operations of small banks and banks with limited resources, so the possibility of insolvency and bankruptcy cannot be ignored for some banks. In addition, a large amount of Russia's foreign debt falls due this autumn (USD 40 billion compared to USD 80 billion during all of 2009). Its refinancing may prove to be difficult, which will further tighten liquidity conditions and could lead to insolvencies for some companies and banks.

Authorities have taken measures to boost confidence. The Ministry of Finance announced a ca EUR 30 billion support package for three major Russian banks to safeguard the liquidity of the banking system and prevent a credit crunch. According to the Ministry of Finance, three major banks in combination can guarantee adequate funding for the Russian banking system. In addition, the reserve requirements for banks were lowered substantially.

The good central government position would make it possible to ease taxation in the oil sector in periods of economic stress and sluggish growth. The question now is will the current financial storm lead to a slowdown of growth, and if so, for how long; and do authorities have a sufficient understanding of crisis management. The situation is different now than it was in 1998 when the rouble collapsed and insolvency was imminent, which lead to severe cuts in public spending as part of the restructuring of public finances.

On the basis of the above, one must in part speculate as to how a 50% fall in share prices, higher interest rates and a capital drain will affect the real economy in Russia. It is likely that the impact will not be as big as in more developed economies in comparable circumstances. Russian economic growth may experience a temporary dip in the autumn, but its depth and length remain to be seen.

The author is an economist at BOFIT.

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