Analysis

The Impact of the Global Financial Crisis on Russia

Peter Rutland, Middletown, CT

Abstract

Russia's rosy economic development outlook has been thrown into question by the global financial crisis. The stock market has lost about 60 percent of its value. So far only two banks have fallen into bankruptcy, but industry has suffered from the twin problems of the slump in global commodity markets and the credit crunch. In the short term, the crisis may help Russia reintegrate into the international community following its invasion of Georgia, but in the long term, its fate depends heavily on the price of oil.

Commodities Connect Russia to Global Market

For the first few weeks, as the financial crisis unfolded in the United States and metastasized around the globe, the Russian reaction was rather calm. Only a small fraction of Russians, less than two percent of the population, personally hold shares or mortgages – in sharp contrast to the situation in the US, where a majority of the population could see the impact of the crisis on their pension fund, or on house prices in their neighborhood. As late as mid-September, a poll reported in *Ekspert* magazine found only 42 percent of Russian respondents felt that a crisis was coming.

The government, for its part, was also confident that the crisis was a "made in the USA" problem. All Russians remember the devastating impact of the 1998 financial meltdown, which led to a default on foreign debts, a 75 percent depreciation of the ruble, the collapse of most private banks and the loss of personal savings therein. But the situation in 2008 looked vastly different. Sitting on $560 billion of hard currency reserves, with low foreign debts and a huge current account surplus, the Russian Central Bank was confident that it could meet Russia's obligations and defend the ruble at its preferred rate of 24–25 to the dollar. Regulation of the banking system had been tightened since the 1998 crash, and the majority of personal deposits were secure in the state-owned Sberbank. More broadly, GDP had been growing at 7 percent a year for the past eight years, and living standards had been rising at an even faster rate. The future looked bright.

However, while Russia was insulated from the impact of the US financial crisis in some respects, it was dangerously vulnerable in others. It had less domestic exposure – but high international exposure, and limited institutional depth to cope. The Russian stock market (RTS) had been weakening over the summer well before the US crisis hit. In the two months after 18 May, the US stock market fell by 11.5 percent, and the Russian market by 13.1 percent. Then in the next two months, the RTS crumpled by 51.8 percent, while the US fell only 8.5 percent. Various factors combined to drag down the Russian stock market – the messy fight for control over TNK-BP; the outbreak of fighting in Georgia on August 8; and a tiff over the steel-producer Mechel. (On July 24 Putin casually accused the company of price-gouging, causing its stock to fall by one third.)

But the main factor was the plunging price of commodities – the backbone of Russia's export-led growth – due to the global economic slowdown. Oil fell from a peak of $147 in July to $86 by October 10. (These are prices for West Texas Intermediate.) Metals prices have also fallen considerably since the start of the year. The last time the world oil price fell by half was 1998, and prior to that 1986 – both of which triggered devastating political consequences in Moscow.

As US stocks plummeted, international investors cashed out their Russian holdings – which accounted for about half the Russian stock market – in a bid to generate cash and cover their obligations. Foreigners have now pulled $74 billion out of the market, and both the dollar-denominated RTS and ruble MICEX have fallen by more than 60 percent – while the US markets have fallen about 50 percent. Bloomberg rates RTS as the sixth worst performing out of the 88 stock indices it tracks. The Federal Financial Markets Service (FSFR) introduced a blanket ban on short-selling – one of the few countries to introduce a blanket ban (most limited the prohibition to financial companies). But this did nothing to stem the slide.

After Russian shares fell 20 percent on September 16, the exchanges were closed for two days, during which a $130 billion rescue package was assembled. The Central Bank and finance ministry would intervene to buy shares in Russian companies and strengthen bank balance sheets. The Central Bank and National Welfare Fund would loan the equivalent of $36.1 billion to Sberbank, VTB (formerly Vneshtorgbank) and VEB (Development Bank) at 7 percent interest for five years (later raised to ten). They in turn were to lend the money to banks and companies. *Ekspert* has estimated the total value of the rescue package at 3 trillion rubles, or 10 percent of GDP.

The market recovered 25 percent when it reopened on Friday September 19, but fell again the next week as a number of bank failures in Europe deepened the global crisis. On October 6 oil fell below $90 a barrel, and the RTS and Micex fell 19 percent on Monday October 7, leading to another two-day market closure. (Like the Asian markets, the Russians failed to enjoy a bounce after the US House of Representatives approved its $700 billion bailout.) On October 3 the State Duma introduced a bill authorizing a rescue package, which passed its second and third reading on October 10. The bill also raises the state guarantee on personal bank deposits to cover the first 700,000 rubles ($26,800, up from 400,000). There is no sign of organized political opposition to the government's actions, as even the Communist Party has refrained from criticism.

The bailout deal included an immediate cut in oil export tariffs, worth 140 billion rubles for oil producers. Still, on September 24 four Russian oil companies sent a letter to Putin, complaining that they hold $80 billion in foreign loans and asking for low-interest loans from the state to enable them to continue investment projects. It's hard to feel sorry for the oil barons, though. On October 10 TNK-BP paid out all of its first half year's profits, some $2 billion, in dividends. Surgutneftgaz, flush with $20 billion cash, did not sign the letter. Russian oil stocks have fallen by more than 60 percent, in contrast BP stock fell 38 percent since the start of 2008, and Exxon Mobil by only 17 percent (as of October 6). The total value of all Russian oil companies on October 6 was $128 billion – while Brazil's Petrobras alone was valued at $135 billion.

The nominal exchange rate against the dollar fell 3.2 percent in August and 4.5 percent in September, standing at 26.2 to the dollar on October 10. But the Central Bank spent $16.7 billion defending the ruble in the week ending October 3, leaving the total hard currency reserves at $546 billion, down from a peak of $596 billion on July 31.

The government has been able to hold the ruble steady and to prevent a rash of bank collapses. But it has not been able to stabilize the stock market: it has been pouring money into a bucket without a bottom.

Sectoral impact

So far only two banks have fallen into bankruptcy. Svyaz-bank was taken over by the state-owned Vneshekonombank, and after several weeks of rumors on October 8 it was announced that the investment bank KIT-Finans was being taken over by Alrosa and the Russian Railways for a nominal 100 rubles. In both cases the government took over their liabilities – which amounted to $6 billion in the case of KIT-Finans, including $1 billion lent to it by Gazprombank in September. It seems that KIT-Finans was handed over to Russian Railways simply because the giant state corporation wanted its own bank. There is clearly a danger that most of the bailout package will be channeled to well-connected state corporations, keen to strengthen their holdings. Such fears were expressed in an open letter published by Aleksandr Shokhin, the president of the Russian Union of Industrialists and Entrepreneurs, on October 9 ("An Appeal to the Country's Leadership"). He warned that an ongoing bailout could drain the Stabilization Fund (which now stands at $143 billion) in two years, with no discernable impact on the country's economic development. On October 10 Standard & Poor's lowered the rating of 13 Russian private banks from stable to negative, including Alfa Bank and Troika Dialog. People have been pulling money out of private banks and putting it into state-owned banks like VTB-24, which saw deposits jump from the equivalent of approximately $494 million to more than $8 billion. Some private banks, such as Renaissance and Standart, introduced limits on cash advances.

The industrial sectors affected by the crisis can be divided into two groups. First, there are those suffering from the slump in global commodity markets. Second, there are those who were exposed to the credit crunch – notably, construction and retailing.

The metals sector's output is expected to contract by 20 percent during the fourth quarter, and some companies (such as Magnitka) have already put workers on short-time. Steel-makers in China and India are facing similar cut-backs. Export markets are no longer profitable and Russian customers cannot afford to pay. The market capitalization of the top six firms (Norilsk Nickel, Evraz, NLMK, Severstal, Mechel and Magnitka) has fallen by 75 percent this year, from a combined total of $170 billion to $40 billion.

Construction and retail firms have been leading Russia's domestic economic growth, and were borrowing heavily to expand. With interest rates jumping from 12 percent to 20–25 percent in a matter of weeks, they immediately began delaying or cancelling new projects. On October 10 Sberbank and VTB agreed to provide loans to nine retail chains at 15–18 percent interest. Priority will be given to firms with a debt/cashflow (EBITDA) ratio of three to one or less. Although a slump in construction and retailing will affect GDP growth, labor economist Vladimir Gimpelson argues that adjustment will come through wage cuts and not layoffs, so it is unlikely that we will see an increase in the current reported unemployment rate of around 6 percent.

Among manufacturing industries, the hardest hit is likely to be auto sales – a big ticket item for consumers. Auto sales across Europe fell by one quarter in September. Inside Russia, sales of domestic brands such as Ladas have slumped 40 percent in the past two months, but half of the foreign brands did not experience a decline in sales, in part because they have been discounting heavily. Some auto producers have cut hours or temporarily closed production lines, including truck manufacturer Kamaz, hit by the construction freeze. Daimler may be having second thoughts about its plan to buy 42 percent of Kamaz.

Even firms with substantial cash flows were not immune if they had borrowed heavily to finance acquisitions. For example, Gazprom needs 400 million euros to buy Serbia's NIS; Lukoil $2.1 billion to buy the Italian ISAB refinery and $555 million for the Turkish distribution company Akret. The total value of foreign debt owed by banks and corporations is around $440 billion, with $48 billion falling due over the next four months (and another $115 billion next year). Such loans were often granted using company stock as collateral. Plunging share prices led lenders to issue margin calls – requiring the borrowers to increase their collateral. The primary case in point is leading oligarch Oleg Deripaska. In April Deripaska agreed to buy 25 percent of Norilsk Nickel from Mikhail Prokhorov for $13 billion, with the help of a $4.5 billion loan. By October the entire market capitalization of Norilsk had fallen below $12 billion (though the company did book first-half profits of $2.6 billion on revenue of $8.31 billion). Scrambling to meet his payment schedule, Deripaska sold a $1.4 billion stake in Canadian auto parts maker Magna and his 10 percent stake in the German construction firm Hochtief. The combined assets of the 25 top oligarchs on Forbes magazine's billionaires list are estimated to have shrunk by 62 percent, or $230 billion, between May and October.

Implications

The financial crisis may actually help Russia's re-entry into the international community after its ostracism following the Georgian war. One unexpected example was Iceland's appeal to Russia for a 4 billion Euro loan to avoid national bankruptcy. President Dmitry Medvedev has tried to make common cause with the Europeans in blaming the US for the crisis. In his speech to the World Policy Forum in Evian, France on October 8, he said that the crisis was caused "by the economic egoism of certain countries," and was "a consequence of the unipolar vision of the world and of the desire to be its megaregulator." He added that "Globalization must be accompanied by an increased role of states as guarantors of successful national development." At the same time, on October 10 Medvedev argued that "Europe understands that today no economic problems of a global order can be solved without Russia's participation, just as the global nature of the economy precludes Russia from resolving all the problems associated with the crisis in financial markets alone." Russia was excluded from the G7 finance ministers meeting in Washington on October 11 – that failed to come up with a plan – though it was included in the simultaneous consultations with G20 countries.

What of the long-term prospects? The main source of concern in the medium to long term is of course oil. Oil alone accounts for one third of Russian government revenues and 60 percent of export earnings. The budget is projected out three years ahead, based on a conservative price estimate of $70 a barrel. However, rising costs of production mean that some of the new fields may simply not be profitable at $70 a barrel. Some of those production costs – such as steel pipe – are now coming down thanks to the crisis. But the cost of capital has gone up. Compounding the problem is the fact that sluggish investment over the past decade has led to a slowdown in oil output. In the first half of 2008 Russia saw a decline in oil production of 0.8 percent and volume of oil exports by 5.2 percent. Finance Minister Aleksei Kudrin openly mused that Russian oil output may have reached its historic high (know as "Hubbert's peak"). These negative trends in oil output volume and price may erode the current account surplus, which was still a healthy $64 billion in the first half of 2008.

There are several reasons for believing that the Untied States is better placed than Russia to ride out the crisis – notwithstanding the fact that the crisis is of the US's own making. First there is the oil factor – lower prices for oil and other commodities ease the US trade deficit and bring immediate and visible relief to US consumers. Second, given the role of the dollar as the main global currency, and the credibility of the US government, there has paradoxically been a flight of frightened investors into US treasury bonds, and a strengthening of the dollar. In the long term, once the fear subsides, it may be replaced by greed – and a search for higher returns outside the US.

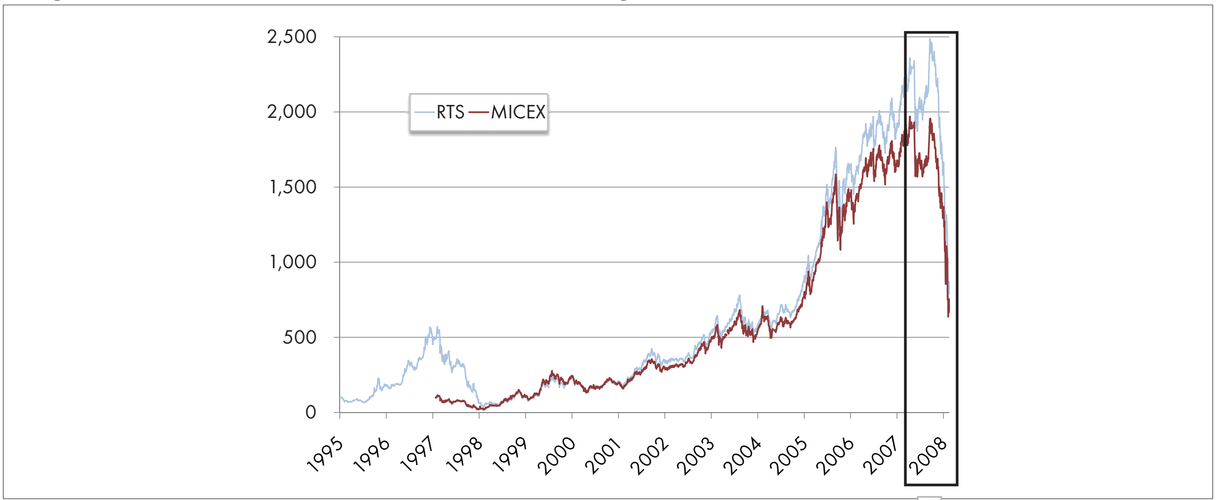
Third, there is the political dimension. The legitimacy of the US political system is not on the line, and the upcoming wave of elections will produce a new set of leaders. In Russia, however, the political system is ossified, and discontented citizens have few options other than taking to the streets. There have already been some unconfirmed reports of panic buying of consumer staples ("salt and matches"). The crisis will clearly increase an already excessively high level of state control of the Russian economy, which bodes ill for efficiency, growth and the battle with corruption. With wildly gyrating asset values, and vast flows of rescue cash, one can expect a fresh round of turf wars between newly-empowered banking corporations on one side and the old stalwarts like Gazprom, Rosneft and Russian Railways on the other.

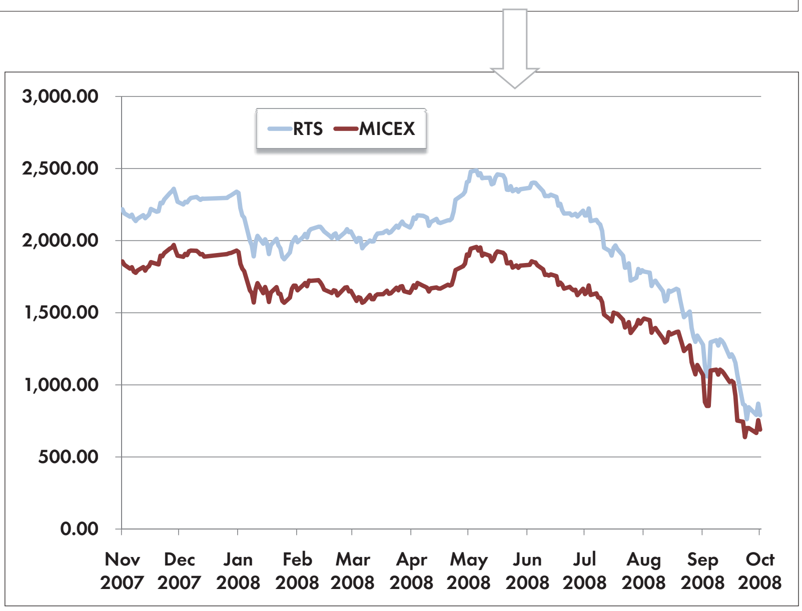
About the author:
Peter Rutland is Professor of Government at Wesleyan University.

Statistics

Financial Indicators

Diagram 1: Indices of the Russian Stock Exchanges 1995–2008





Sources: http://www.rts.ru/ru/index/stat/dailyhistory.html?code=RTSI *and* http://www.micex.ru/stockindices/data/