Analysis

Financial Vulnerabilities in Russia

By Richard Connolly, Birmingham

Abstract

The global financial crisis and the subsequent contraction in global economic output have resulted in a deterioration of Russia's financial position across each sector of the economy. While Russia's finances appeared healthy at the onset of the crisis, the dependence on commodity exports and high levels of external funding ensured that the crisis would affect Russia even more severely than other emerging market economies. Impaired balance sheets across the Russian economy now make it more vulnerable to any future shocks and may also place constraints on future growth.

The Global Financial Crisis and Russia's Financial Position

The global economic crisis which began in the USA in August 2007, and then spread and intensified in September 2008, has left few countries unaffected. Russia, however, has fared particularly badly. For some, this has been somewhat surprising given the ostensibly healthy position in which Russia found itself at the onset of the crisis. As of August 2008, Russia had experienced a period of nine consecutive years of economic growth at an average annual rate of 7 percent. Real incomes had risen sharply. The government was running consistent budget surpluses, the country as a whole was running a sizeable surplus on the current account, government external debt was at a very low level, the volume of foreign direct investment was increasing, and Russian companies were becoming more assertive abroad, acquiring a range of foreign assets across sectors. The price of oil, Russia's leading export product, had risen almost without interruption since 2002, causing a steady appreciation of the ruble and helping the country to amass around $590 billion of hard currency reserves, the world's third largest reserve of this kind.

This perceived economic strength gave the ruling elite more confidence to assert itself, both domestically and, increasingly, on the international stage, culminating in the brief war with Georgia in August 2008. Indeed, the Russian economy was considered so healthy that the prime minister and erstwhile president, Vladimir Putin, initially brushed off the potential for the global crisis to affect Russia in any serious way. Russia, it seemed, was strong enough to withstand the effects of the turmoil that was afflicting other parts of the international economy.

Yes, Commodity Prices Are Important…

Russia's nearly decade-long period of economic expansion did, however, mask a number of economic vulnerabilities that were rapidly exposed by the crisis. Not least is Russia's continued dependence on natural resource exports, particularly oil and gas, which have accounted for 60–65 percent of Russia's merchandise export earnings in recent years and around half of federal budget revenue. While commodity prices were high, this did not represent an immediate problem for the government. The rise in world oil prices improved Russia's terms of trade and increased the real value of income for all sectors of the economy: government, corporate and household. The unfortunate corollary of the benefits of oil price rises is, of course, the relative decline in income to the country's real output that accompanies any decline in prices. After reaching a peak of $137/barrel in early July 2008, the price of Russian (Urals) oil fell to $34/b in early January 2009, before rising again to just under $70/b in August. Consequently, Russian public finances, corporate profits and household income all suffered a sharp reversal of fortunes.

The correlation between the drop in the price of oil, and commodities more generally, and the deterioration of the Russian economy is clear. According to the Ministry of Economic Development (MinEkon), GDP dropped by 10.1 percent in the first half of 2009 compared with the same period in 2008. The budget has swung from a surplus of over 5 percent in 2007 to a projected deficit of 7.5 percent in 2009. The exchange rate has depreciated dramatically and reserves have fallen from nearly $600 bn to around $400 bn in August 2009.

…But Financial Imbalances Should Not Be Ignored

However, while Russia's dependence on natural resource earnings is a factor of considerable importance in assessing the outlook for the Russian economy, the focus of attention here will be on another area of vulnerability that has been exposed by the crisis: the financial health of the different sectors that make up the Russian economy. Of course, the level of income from natural resource

exports plays a significant role in determining the financial health of a large proportion of the Russian economy. In this sense, the role of commodity prices should not be dismissed. But while commodity prices are important to understanding the Russian economy, an appreciation of the importance of financial variables is also crucial to understanding: (a) if, and to what degree, Russia is vulnerable to any further turbulence in the international economy; and (b) what sort of path the Russian economy will be likely to take when the crisis subsides. Before examining how Russia's financial vulnerabilities have increased it is first necessary to briefly outline a framework through which one may identify financial vulnerabilities.

The Balance Sheet Framework

In order to assess the extent of a country's financial vulnerability it is useful to employ a balance sheet framework. It suggests that a useful way to analyse financial vulnerabilities is to conceptualize an economy as a system composed of the balance sheet of all its agents. First, financial *flows* that occur over a defined period of time are considered, such as the annual output, fiscal balance, current account balance or capital flows. However, balance sheet analysis also involves an examination of financial *stocks*, i.e. of assets and liabilities, such as debt and foreign exchange reserves. These two approaches are, of course, closely connected as the difference in a stock variable at two points in time is related to the flow in the period between them. This synthetic framework enables the analyst to consider the risk created by mismatches between a country's existing debt stock and its assets; two countries may display identical debt-to-GDP ratios but the degree of vulnerability will be a function of whether one country's debt is short- or long-term, or denominated in foreign or local currency.

It is especially important to distinguish between an economy's main sectoral balance sheets: the government sector (including the central bank), the private financial sector (mainly banks) and the non-financial sector (corporations and households). Each sector has claims on and liabilities to the others, as well as to external (non-resident) entities. When consolidating the sectoral balance sheets into the country's balance sheet, the assets and liabilities held between residents net out, leaving the country's external balance vis-à-vis the rest of the world (non-residents). Times of economic strain can see rapid changes across sectoral balance sheets. For instance, default on, for example, mortgage debt in the household sector can lead to the impairment of the balance sheets of the private financial (banking) sector. This in turn might lead to state-led bank bailouts which can reduce the debt and/or increase the assets of banks while increasing the stock of debt held by the government sector.

Russian Sectoral Balance Sheets Prior to the Crisis

In the period before the global financial crisis, the direction of financial flows and the general macroeconomic situation looked to be favourable. Nine years of strong growth based on commodity exports resulted in a series of consecutive fiscal surpluses and positive current account balances. The financial situation of the Russian government had improved dramatically since the 1998 crisis. A large portion of the government's windfall revenues from high commodity prices was channelled into Russia's Reserve Fund and the smaller Fund of National Prosperity, giving Russia a substantial cushion against any sudden economic shock. While commodity prices were high, the government could quite reasonably project expenditures to be less than revenues. Because of the relative conservative management of Russian public finances, federal government's debt burden had shrunk from 62.5 percent of GDP in 2000 to less than 10 percent in 2008. Although nearly half of this debt was denominated in foreign currencies, the meagre overall amount presented little cause for worry.

Domestic credit growth, which had increased from an annual rate of 15 percent in 2000 to around 44 percent in 2004, began to slow in 2008. Indeed, while these rates of domestic credit expansion were significant, the total stock of domestic credit relative to GDP was only somewhere between 20–25 percent in 2008. Thus the lending boom in Russia was not as extreme as those that took place in parts of central and east Europe. Furthermore, while there was certainly evidence of a boom in property prices in some parts of Russia, especially in Moscow and some of the larger provincial cities, mortgage lending constituted only around 20 percent of total lending to households at the end of 2007. By international standards, this was modest. Indeed, domestic credit to households as a whole moved from a mere 1 percent of GDP in 2002 to only 9 percent in 2007. Unlike other emerging economies (and some advanced economies), the period of economic growth in Russia had not been caused by an unsustainable boom in lending to Russian households. If anything, the relatively underdeveloped banking system in Russia had impeded this avenue of growth. Of mild concern was the foreign currency-denominated nature of around 20 percent of mortgage lending. While this would be important in the event of any depreciation of the ruble, the extent of foreign currency-denominated

lending in Russia's overall household lending was comparatively meagre.

The direction and magnitude of financial flows in the corporate and financial sectors before 2008 was on the whole quite different. While the government sector accumulated surpluses and repaid debt, and while household sector borrowing was restricted by the underdeveloped financial system, large Russian companies and banks – many of which had close links to the state - increased their annual flows of borrowing considerably, with Russian firms taking to borrowing abroad in foreign currencies with alacrity. The positive terms of trade enjoyed by Russia prior to 2008 helped improve the perceptions among foreign lenders of the ability of Russian firms to repay debt. Furthermore, as investors' perception of Russian companies' creditworthiness improved, so private capital inflows increased, leading to a boom on Russia's stock market indices. The increased value of Russian corporate assets helped fuel additional speculation in Russian stocks as well as stimulating further borrowing by Russian corporations. Some of Russia's prized "strategic" corporations from within the natural resource sector pledged securities as collateral on their external borrowing. Overall corporate external borrowing reached $307bn in June 2008 (about 25 percent of GDP). Borrowing by the banking sector reinforced these tendencies; after increasing their external borrowing to just under $200bn in June 2008 (about 15 percent of GDP), Russian banks tended to lend either to the corporate sector or to speculate on the stock markets.

To sum up, Russian sectoral balance sheets appeared to compare favourably with most other emerging market economies on the eve of the crisis. Overall external debt was only around a third of GDP and was more than covered by hard currency reserves. The government sector in particular appeared in vigorous health, while the household sector had not increased borrowing beyond imprudent levels. However, high commodity prices and the perceived financial strength of the state generated a certain degree of hubris in the Russian corporate and banking sectors; while debt levels looked reasonable at the prevailing exchange rate that accompanied large natural resource revenues, these sectors were vulnerable to any exchange rate depreciation and/or reduction in export earnings that would accompany a terms of trade shock. These weaknesses were exposed as soon as Russian troops engaged Georgian forces on August 8, 2009.

The Crisis and Its Balance Sheet Effects

For Russia, private capital outflows and the depletion of currency reserves began in the spring of 2008, before the meltdown on international capital markets; the outbreak of fighting between Russian and Georgian forces in August and the altercation between the prime minister and Mechel, one of Russia's largest steel producers. It was, however, the precipitous drop in commodity prices that followed the collapse of confidence in world stock markets in September that triggered the most serious outflow of capital, resulting in a corresponding depreciation of the ruble from the Russian Central Bank's desired rate of around 25 rubles to the dollar in the summer of 2008, to over 36 rubles in March 2009. Russia's foreign currency reserves fell by around $200bn as the Russian government simultaneously sought to defend the ruble and support the budget. Perhaps most importantly, this depreciation increased the real external burden of Russian foreign currency-denominated debt at precisely the same time that real incomes dropped in the face of the terms of trade shock caused by the decline in commodity prices. Russia has also suffered one of the most severe recessions among the major economies: industrial production has plummeted; real incomes have dropped; unemployment has increased; corporate profits have been savaged; and non-state investment has collapsed. The consequence of the crisis for each of Russia's sectoral balance sheets is briefly outlined below.

The household sector entered the crisis in relatively decent shape. Flows of debt had not reached the levels observed in many other emerging market economies with total stocks of debt remaining modest. However, the failure of many smaller Russian banks, along with the impairment of the balance sheets of many of the larger ones, has resulted in the savage curtailment of lending to the household sector. Furthermore, increased unemployment and a decline in real incomes have increased the default rate on loans made to the household sector. These problems put pressure on the balance sheets of the other three sectors within the Russian economy in the form of diminished demand for Russian corporate goods, defaults on loan repayments, lower tax payments, and increased budget transfers.

The current crisis showed the corporate and financial sectors to be extremely vulnerable because of their dependence on external funding. The real value of external debt increased as the ruble depreciated. By the end of the second quarter, total external debt was estimated to be $475bn dollars, with corporate debt accounting for $294bn and bank debt for $142bn. Of this, the banking sector is due to repay $58bn by April 2011, with the corporate sector due to repay $148bn by the same date. In the context of the virtual "sudden stop" of capital flows to emerging economies since the onset

of the crisis, the prospects for the "rollover" of these debts is uncertain. Corporations' and banks' reduced revenues not only increases doubts over their capacity to repay their debts, but also reduces the amount that they might reinvest in the economy or make available for domestic lending, particularly as they seek to "deleverage". This might exacerbate the stress that is being placed on the household sector, which in turn might result in further reduced revenues and the persistence of loan defaults. The continued weakness of Russian stock markets is also of crucial importance to Russian banks and non-financial corporations; if asset prices remain depressed, the balance sheets of both sectors will remain impaired. Intervention by the state has saved the largest banks and corporations, but smaller banks and enterprises are not benefitting.

Finally, the government sector has experienced perhaps the sharpest reversal of fortunes at this point of the crisis. Because much of Russian corporate and financial sector debt was taken on by either: (a) entities with close links to the state; or (b) "strategic" entities that the state could not avoid helping, a large proportion of Russian external debt turned out to be de facto liabilities of the Russian government. Although estimates vary, the government has so far committed to providing over $200bn in short- and long-term capital to substitute for external finance. The Fund of National Prosperity has provided capital to the Russian banking sector, while the Reserve Fund has been used to prop up the budget as expenditure has increased dramatically at the same time as revenues have collapsed. Under existing budget projections, both Funds are likely to be much depleted by the end of 2010. External debt – much of which is a contingent, if not explicit, liability of the state – has, as a proportion of GDP, diminished only marginally even though Russia has made repayments at a faster rate than any other BIS reporting country since the start of the crisis. Perhaps more importantly, foreign currency reserves are no longer sufficient to cover all of Russia's external debt. While this should not be viewed too dramatically – the proportion of short-term debt (i.e. due to mature in the next year) is not worryingly high – it does demonstrate a distinct and significant reversal of fortunes for the Russian government in the space of a year.

Implications of Russia's Financial Vulnerabilities

The global economic crisis and the resultant decline in commodity prices, contraction in cross-border capital flows, and the severe recession that this has caused in Russia, have all contrived to cause a considerable deterioration in the balance sheets of each sector of the Russian economy. This has left Russia vulnerable to any further turbulence in the international economy and, even without any extra international distress, impaired sectoral balance sheets may inhibit post-crisis growth prospects. It is possible to make three main observations on the implications of Russia's impaired financial position.

First, commodity prices are, as usual, of crucial importance to the financial health of the Russian economy. Higher commodity prices improve Russia's terms of trade and increase government revenues, corporate and banking sector profits and household disposable income. This also helps inflate stock market valuations. However, because balance sheets have deteriorated in the last year, commodity prices will need to reach a high level and stay there if balance sheets are to be repaired to anything like pre-crisis levels. This would take some time.

Second, while the external debt situation appears to have stabilized, it is perhaps the impairment of domestic balance sheets vis-a-vis each other that is most worrying; the increase in inter-enterprise arrears, loan defaults and non-payments across the economy more generally raises the spectre of demonetization, something that would have catastrophic consequences for the banking system, the fiscal health of the state, and economic activity in general. Thus, while deleveraging is perhaps desirable to some degree, it should be gradual and not turn into a rout. In this respect, the diminishing financial capacity of the state is a source of concern; while it has so far been able to deploy a vast array of resources to combat the crisis, it will not be in a position to do so again in the immediate future should the need arise.

Third, the impairment of balance sheets should, even in the event of a stabilization of commodity prices to 2005 levels, place constraints on the prospects for future economic growth. The corporate and financial sectors borrowed imprudently between 2005–2008 and any deleveraging process, even if mild, will constrain investment and lending. Furthermore, much was made of MinEkon's plan for the diversification and modernization of the economy by 2020. This plan was predicated on the deployment of state financial resources that quite simply do not look likely to exist in the near future. Without this diversification, Russia will remain dependent on commodity revenues for the foreseeable future.

(For information about the author see next page)

About the Author
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Further Reading
Richard Connolly: Financial vulnerabilities in Emerging Europe: An overview, BOFIT Online Paper 3/2009, http://www.bof.fi/NR/rdonlyres/BA4C9028-D69D-45CB-ABF1-140ECB129E4C/0/bon0309.pdf

Analysis

Russia's Outward FDI Rise Amidst the Global Fall

By Peeter Vahtra, Turku

Abstract

Despite the global economic recession, Russia's outward foreign direct investment is increasing. Energy companies are seeking new resources and downstream assets. Companies are also seeking larger markets in the former Soviet Union. In some cases, the purchases have political rather than economic motivations. Although some investors, like Oleg Deripaska, have had to sell off some of their assets, many companies are still in expansion mode. Germany is one of the more popular target countries.

Ever Increasing Investment Flows

During the past year, the global economic boom has turned into economic gloom, bringing immediate and adverse consequences for multinational corporations. After nearly a decade of steady growth, global foreign direct investment (FDI) has entered a period of recession. Multinational corporations have put many new international investment projects on hold and have even sought to extricate themselves from existing projects and international subsidiaries in order to adjust to the changing business environment.

Amidst the general drop in global FDI, only a handful of countries stand out as sources for new investments. Most notably, Russia and China have posted growth in outward FDI (OFDI) over 2008 and early 2009, a notable exception to the current trend. Despite the faster growth in Chinese OFDI over 2008, Russia still outpaces the Asian economic giant both in OFDI stock and flows. Although the world's multinationals have seen the values of their international assets contracting in 2008, and the Russians are no exception, annual FDI outflows and the number of new transactions by Russian companies have increased despite the global economic downturn. The continuously increasing OFDI flows indicate a growing urge among Russia's multinational companies for further internationalization.

Since the beginning of its economic reforms, Russia has stood out among transition economies as a net capital-exporting country and the economy with the highest outward/inward FDI ratio. After a steady, yet relatively modest, average annual growth of some 10 percent throughout the 1990s, Russian OFDI flows took off in the 2000s, growing more than tenfold during 2000–2007. Despite a slowdown during 2008, Russia remained among the few economies in the world still posting growing figures in OFDI amidst the global economic crisis. Russia's outward direct investment flow grew to $53 billion in 2008, with the most recent statistics indicating a further rise during the first half of 2009. In addition to the officially registered OFDI, observers estimate extensive capital flight from Russia that by far exceeds the official OFDI figures. In fact, 2006 was the first year that Russia became a net capital importer, indicating a notably large amount of capital outflows by Russian commercial entities and residents.

Key Drivers of Russian OFDI

There are several stimulants driving Russia's outward investment flows. First, through OFDI, Russian companies seek to establish additional control over foreign natural resources in order to complement their domestic reserves. The Russian natural resource-based multinationals generally seek upstream investment targets that can be developed more readily and cost-effectively than untapped domestic resources, which are often geographically isolated and require vast investments