Analysis

The Russian Stock Market: Reflecting Society's Broader Problems

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Abstract

The Russian stock market has yet to overcome the problems that it inherited as a legacy from the mass privatization and loans-for-shares program that took place during the 1990s. After its founding in 1994, Russia's stock market grew quickly through 1998 and then continued to boom from 2000 to the 2008 crisis. However, the recent problems in the stock market contributed to the lack of liquidity in the financial sector. Reforms are needed to address problems with the regulatory agencies, extensive corporate conflict, unclear property rights, and the dearth of domestic investors. Ultimately the problems in the stock market reflect the low levels of trust in Russia society.

A Mirror on Society

The story behind the evolution of the Russian stock market tells us about much more than economic factors. It is, in fact, a mirror of the societal issues that Russia faces today. From the privatization of the 1990s to the global crisis that began in 2008, an examination of how the Russian stock market developed and how it differs from Western financial markets makes clear how a stock market is embedded in the broader social structure. As the market evolved, international influences on the market began to become more important than domestic ones.

Stock Market Formation 1992–1997

Russia built its stock markets from scratch in late 1994. But to understand the features that characterize it, one has to begin with the privatization process.

Mass privatization. Russia's privatization took place in a way that greatly distorted the newly created financial markets. To make privatization attractive to enterprises, the authorities put in place programs called Employee and Management Buy-Outs (EMBOs), which reserved a substantial allocation of corporate shares for management and workers. Consequently, on average, only 29 percent of the shares of a company were auctioned.

The government implemented mass privatization by issuing vouchers to the population. The process created a number of new legal categories of activities, which unfortunately left plenty of room for abuse. *Voucher investment funds* were designed to attract vouchers and cash from the population; *investment companies* bought and sold vouchers and securities for themselves and for their clients; *financial brokers* were allowed to do that on the stock exchange and *investment consultants* offered financial advice to companies willing to issue new stocks. By the end of 1993, officially there were about 600 investment funds, 300 investment companies, and 900 brokers and investment consultants. But official reports never matched reality: it is estimated that up to 2,000 unlicensed companies were active on financial markets during the mass privatization process, in which 80 million Russians invested between 50–70 trillion rubles ($5–7 billion).

The legal infrastructure was not sophisticated enough to prevent extensive fraud. The MMM scandal summarizes well this early period of the stock market formation. The crash of MMM, a giant pyramid scheme that swallowed the savings of thousands of investors in July 1994, was only the first of a series of newly created financial companies to collapse, and the institutional response in November 1994 was the creation of the Federal Commission on the Stock Market. In late summer 1995, the Russian Trading System (RTS) was launched, organized with the structure of a quote-driven market. The Moscow Interbank Currency Exchange (MICEX) began its activity in 1992 as a platform for carrying out currency transactions for banks and firms. But it was launched as a stock market in 1997 and has remained the principal exchange for dollar-ruble trading and corporate bonds.

Loans-for-shares. Trading in Russian securities began in late 1995 on a limited number of "blue-chip" companies working in the oil, gas, electricity, metals and telecommunication industries. Interestingly, these "blue-chips," which have the highest capitalization today, never were part of the mass privatization process. Instead, they were privatized in a second phase, through the "loans-for-shares" scheme. under which the government, in an effort to increase revenue, transferred control over these firms to private banks. The majority of the 16,000 medium and large firms that experienced mass privatization did not foster enough trading volume to allow for a liquid secondary market to develop. In 1996, new laws defined more clearly the broader legal infrastructure of the stock market and new licensing criteria came into force for the various players. The Federal Commission's tight budget forced it to endorse self-regulating organizations, which are still active today.

Stock Market Development, 1997–2010

The period from 1996 to the resignation of President Yeltsin in 1999 saw the most spectacular boom and bust cycle in financial market history. The main pattern of this period was a binary perception of Russia by international investors. Either the country would return to Soviet-style politics, or succeed in building a Western-style market system. And as foreign investors began to think that the transition was successful, they started investing *en masse*. The 1998 devaluation and government debt default proved, however, that the transition was going to hit a few bumps. That year the RTS fell by 93 percent from its pre-crisis peak in 1997. Even though this crisis migrated from Asia, investors overlooked Russia's specific country-risks. It took two years for international investors to regain confidence in the Russian market and the recovery was fast. From 2000 onwards, Russia's financial sector and stock market developed very quickly.

Integration. The Russian stock market became integrated domestically, which reduced opportunities for arbitrage and speculation, particularly the risky high-return investments that played on price differences across Russia's regions and had attracted myriad unlicensed financial companies at the early stages of privatization. Small domestic investors started to play a greater role and they tended to choose MICEX, an order-driven market, to minimize their transaction costs. The Russian stock market became integrated internationally as well, with domestic factors gradually having a smaller impact on stock market returns, while international ones gained weight.

Bond market. Until 1999, corporate bonds did not circulate in Russia. Only from that period onwards, did companies begin to use bonds actively to attract debt financing. The declining inflation rate ultimately pushed down yields, which made the market more attractive to issuers.

IPOs. The market for Initial Public Offerings (IPOs) began in 2004 and took off in 2005. Until then, the majority of big companies had turned to the London and New York stock exchanges, but new regulations eased the process of listing on the two Russian stock exchanges and limited the possibilities to list on foreign ones.

To financially justify an IPO, a company must have a capitalization of $100–$200 million. The costs of preparing the accounts for a company with annual proceeds of $100 million ranges between $100,000 and $300,000 and the cost of preparing IPO documents ranges between $50,000 and $80,000. A small cluster of companies therefore use IPOs for external financing.

The 2008–2009 Crisis

From the end of 2008 to March 2009 the stock market fell by more than 70 percent, but this time, in contrast to 1998, Russia had accumulated huge foreign currency reserves. As a major exporter of raw materials, primarily oil, gas and metals, Russia's equity market was hit hard by the fall in commodity prices. Although Russian banks were constrained by the liquidity crisis that emerged from the U.S. in late summer 2008, internal factors played a role. The outbreak of the crisis on the stock market can thus be seen as the result of a mix of investors' fear over state interference with the economy, lack of transparency in banking, and geopolitical tensions following the South Ossetia war in August 2008. Capital flight out of Russia from late summer 2008 onwards is an illustration of the sensitivity of the emerging stock markets to political events. The absence of a solid pool of domestic investors added more pressure.

The crisis spread from the stock market to the banking system through repurchase agreements, a financial instrument to finance the banks. The interbank money market relied on Russian stocks as collateral for repurchase operations. Obtaining loans during the crisis required far more securities than before and no financial institution was willing to lend to other institutions longer than overnight. The situation evolved from a confidence crisis into a real liquidity crisis.

The government reacted on September 17th by allocating 1.1 trillion rubles for 3 months to the three largest banks – VTB, Sberbank and Gazprombank. But government actions did not restore confidence and due to fear that the lack of liquidity could come back at any moment, only short-term money remained in the market. Such fears were justified: many second and third tier banks believed that more problems were still to come. At the same time, businesses needed to make tax and budgetary payments and knew that VTB, Sberbank and Gazprombank had no incentives to refinance their competitors. Indeed, these state owned banks are the government's financial arm and the financial steam of key industries runs through them. By the beginning of 2009, the Russian authorities finally admitted that the real economy would suffer. Funds were being allocated to the regions, but the main problem was that the money was not reaching the small and medium sized businesses it was intended for. Arteries were blocked and additional blood transfusions were simply not doing the trick.

A Stock Market Structure that Needs Reforms

In the wake of the crisis, it is clear that the stock market needs major reforms. Much of the Russian stock market exists in some sort of shade. There is a large volume of internal operations taking place inside the client pools of big companies. Precise numbers are hard to define since companies' internal transactions are never disclosed, but according to official statistics, this internal organized market could account for 70 percent of the total volume of trading in the stock market. Major brokerage firms frequently rely on offshore partners and the accounting methods for assets and settlements involving offshore companies are still not very transparent. The bulk of derivatives trading takes place in the underwater of the over-the-counter or offshore market and market participants are used to working with derivatives outside the Russian legal system, because the later is still not considered reliable and taxation of derivatives is unclear and contradictory. Overall the regulatory system is rather fragmented. Stock markets are regulated by one law, foreign exchange by another, commodities assets trading by a third. This "regulatory fragmentation" of the stock market reflects the import of "best practices," mainly from the U.S. However, the Russian regulators implemented the regulatory frameworks in isolation from each other, without a clear and coherent overarching framework.

Moreover, the complex of potential problems linked to corporate conflict and the redistribution of property, which renders the confirmation of ownership uncertain, has a greater effect when a crisis hits. The vulnerability of property rights also explains the low level of share circulation (around 10 percent of Russian blue-chips are in flotation). This concentration of shares is symptomatic of a need for control. Corporate conflicts could indeed result in a significant loss of shares, which means a loss of control, hence the incentives to minimize the level of free-floating shares. The real of threat of hostile takeover (Russian regulation is virtually non-existent on this matter) is a motor of progress from this point of view. Interestingly, in an imperfect institutional environment that renders ineffective the usual corporate governance mechanisms needed to discipline management and protect shareholders, ownership concentration can have a positive effect on corporate governance. Corporate governance, however costly, increases the value of shares and reduces the contestability of control and therefore the probability of takeover.

Another characteristic of the Russian stock market is the lack of domestic investors. Despite the outstanding number of companies providing brokerage services, there are still a small number of clients (about 0.8 percent of the economically-active population in the country). Indeed, by comparison, in India, for example, the number of private individuals investing in shares is 6 times higher. This absence of a pool of domestic investors is the result of the lack of an effective system of savings in the form of pensions and insurance. The absence of domestic investors renders the Russian stock market dependent on international investors.

The Stock Market Reflects Russia's Societal Problems

In order to see how the problems and characteristics stated above are not only economically relevant, but politically and socially as well, one has first to postulate that financial markets are more than simple "intermediaries" between savers and investors. They are arenas in which participants are able to engage in a series of impersonal transactions because trust is routinized. But the way mass privatization took place was linked to the view of markets as natural phenomena disconnected from social organization. It moved forward without the legal and enforcement infrastructure that would have been needed to prevent insider dealing and fraud inside the medium sized companies that were privatized first. The managers and employees did not gradually sell out in the same way that they do in the West in Russia because the difference in trust levels toward insiders or outsiders is more important in Russia than in Western societies. Corporate decisions that lack transparency and openness are not necessarily unethical from that perspective and it certainly explains why some companies do not bother entering the stock market and prefer borrowing money from banks. Listing their shares would require dealing with minority shareholders and disclosing more information.

The large volume of operations happening underwater and offshore is symptomatic of the hostile business environment that Russia inherited. Tax rules compelled managers to hide profits. By the same token, accounting rules were designed to meet the need of central planners and not investors and the Ministry of Finance updated them only in order to know how much to tax a company rather than to help investors understand the cash flow. Even if Russia is now implementing the International Financial Reporting Standard (IFRS), it poses conceptual challenges, for differences rooted in fundamental definitions persist.

Financial markets, perhaps more than other markets, need to rest on a "chain of trust" linking the various players from the end clients to the prime brokers. Yet the numerous scandals and frauds of financial companies during the initial period of stock market formation had disastrous effects on the levels of institutional trust. It is telling that the Federal Commission's first regulatory actions focused on the complete absence of domestic investment from the formal financial markets. The commission reported that the population viewed financial investments as lotteries and pyramid schemes and estimated that Russians kept $20 – $30 billion hidden at home instead of investing it into companies.

The numerous problems linked to corporate conflicts and the low proportion of shares in flotation in the stock market remind us that the question of "who owns what" – the critical legacy left by the privatization experience – has not gone away. The "loans-for-shares" program and its rigged auctions are still affecting the Russian economy and pushing back into the social arena political questions about the legitimacy of ownership for Russia's largest corporations.

Conclusion

Although the Russian stock market is evolving rapidly, many problems remain to be addressed. The trading volume on the derivatives section of RTS, FORTS, tripled in 2007. Structured products appeared recently on the Russian market and securitization is beginning as well. But until the recent amendment of the Russian tax code, which President Medvedev signed in December 2009, there was no definition of financial futures contracts. Until then, Russian law did not recognize that futures contracts were linked to risk management. The nature of central counterparty activities, whose key function is the efficient handling of risks prior to the settlement of a transaction, would require that the counterparty have the ability to deal on its own account. Yet the central counterparty is missing in Russia because the current law does not make it possible to cumulate dealer and clearing licenses. So, clearly, the financial market infrastructure needs to be updated.

But one cannot help wondering if it would not be wiser to strengthen the banking sector and its regulatory framework first. The efficiency of the banking sector is still very low and makes financial intermediation in Russia expensive. The development of creditors' rights for the banking system and efficient implementation of bankruptcy laws are considered to be more important than equity markets. It is believed to be the most effective way of fostering the development of small and medium sized enterprises, an important component of long-term growth. Proper accounting rules and practices, the protection of minority rights, and disclosure of corporate activities are all issues boiling down to corporate governance, which needs critical attention in Russia.

Agency theory, supposed to solve the principal-agent problem, provided a powerful argument to proponents of stock market development. Yet, it is based on Western views of business ethics and one could argue that it does not necessarily work for Russia.

About the author

Philippe Rudaz is a PhD student in Economics at the University of Fribourg, Switzerland. His dissertation focuses on the links between financial development and economic development in emerging economies. He worked two years in Russia for a Swiss consulting firm handling structured financial products.

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