

The Origins of the Russian Financial Crisis

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Notwithstanding the huge margin of strength of the Russian economy in the form of reserves of the government and the Central Bank, budget surplus and foreign trade, Russia turned out to be not less, but more vulnerable to the strike of the international crisis. It means that the crisis has brought to the fore explicit and implicit weaknesses. In order to figure out the causes of the crisis, it is necessary to consider its main mechanisms.

For a year since the beginning of the crisis Russian economy has barely felt it. First appearance of the crisis was due to the rapid fall of the stock market at the end of July-August 2008, which was followed by a severe liquidity shortage. Formally it was mainly caused by the capital outflow – in September it was estimated to be 25 billion dollars versus the average inflow of 14 billion monthly in April-July. This mechanism is a typical cause of the crises in the developing countries. As a result, there was a structural break in the dynamics of the accumulation of the currency reserves: they barely changed in August and fallen by 22 billion in September, as compared to the average growth of 17 billion monthly during the previous 10 months. Sudden fall in the reserves created liquidity problems in the economy. The root of the problem was the need not just to quantitatively increase the emission through different channels in order to compensate for the contraction of the money supply resulting from the selling of the currency by the Central Bank. During the recent years currency interventions of the CB usually significantly outpaced the increase in the money demand. Consequently, credit channel was mostly used for the sterilization of the emission surplus. Thus, it was necessary to radically change the regime of the credit channel usage, switching from attracting funds to banks deposits to providing them with necessary liquidity and compensating for the contraction in the money supply due to the selling of the currency.

To provide the economy with liquidity it was necessary to create completely new ways of money supply: crediting banks with temporarily spare budget funds, giving out subordinated credits to the main government banks, providing collateral-free credits by the Central Bank etc. However the problem was only partially solved: the period of money supply growth was replaced by its

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contraction.

One of the factors of the capital inflow slowdown was the fall of the stock market that resulted in the devaluation of assets that backed the borrowing. Between July and November Russian stock market index has dropped significantly lower (by 74%) than consolidated developing markets index (57%). The fact that stock market fall has accelerated with the beginning of the fall in the oil price, as was noted in the World Bank report, is important here. Subsequently these processes developed concurrently (correlation coefficient amounted to 97%!). It allows us to conjecture that in case of Russia the outflow of the capital from the developing markets was enforced by a number of additional factors: decline of the oil prices and worsening of the investment climate due to the “Mechel case” and the situation in Southern Osetia. It is also important to note that the fall of the stock prices and capital outflow began not after the oil prices reached some specific level, but when its upward trend was broken. The developing of the situation with the stock market demonstrates that the Russian economy was attractive for the investors only in conditions of appreciating oil, when the profitability of the mining industry was rising and the purchasing power of Russian citizens was increasing.

During the second stage the main factor was the collapse of the demand that resulted from the falling oil price and decreased credit. The depth of the fall in the industrial production suggests that the problems that surfaced are of qualitative nature. In fact the Russian model of growth has developed - the one that is working only in case of constantly rising commodity prices. The main element of this model was the rapid expansion of the domestic demand due to increase in oil prices. Increasing demand for tradable goods was mostly covered by imports but was also partially stimulating the growth of the domestic production, especially of the nontradables. The changing of the dynamics of the oil prices lead to the collapse of this model, demonstrating its inviability.

Furthermore, it is important to indicate a number of mistakes in the economic policy that increased the vulnerability of Russian economy to the development of the crisis. Primarily it is important to note the excessively permissive monetary policy of the last few years. Soft monetary policy was a result of conducting currency policy based on targeting the exchange rate and its predictability. Central Bank was attempting to hold back the appreciation of the rouble during the period of the rising oil price by conducting massive interventions on the currency market. From the middle of the 2006 the liberalization of the capital account was enacted. The consequence of this policy was the rapid increase in the growth of capital inflows and the settling of the interest rates

only slightly above the international levels. However, together with comparatively low inflation it meant supporting negative real interest rates. As a result, the economy went way past its potential level of output. At the same time import that was supporting the growing gap between the demand and the supply was financed partially with the improving terms of trade and partially with the capital inflow. Foreign indebtedness of banks and nonfinancial enterprises has increased by 3,8 times during 2005-2007.

Considerable part in the formation of the imbalances in the economy was played by the softening fiscal policy. In 2007 the real growth of the budget expenditures has outpaced the growth of GDP by 3-3.5 times. Expenditures as a percent of GDP have increased by 2.1 percentage point at the federal level and by 2.8 percent for the whole fiscal system.

In the end the economy was oversupplied with cheap money. The surplus of the money almost always weakens the economy, damaging it. In the USA cheap money was used to give out risky mortgage credits, laying a time bomb first for the American and then world economy. In Russia, as it usually happens with the weak financial system and poor investment climate, the surplus of money supply led to the consumer boom and the formation of the financial bubbles. At the same time the development was dampened by the inadequate access to the credit resources. However, the experience of the developing countries demonstrates that the surplus and the deficit of the money often coincide. Significant investment risks and weakness of the financial system result in the situation where cheap money (including lent money) is being used not for the development of the economy but for the consumption and real estate, artificially inflating its price.

Saving the part of the oil income using stabilization fund has partially limited the dangerous growth of the financial bubbles. However, the cautious use of the oil income was mostly undermined by the lifting of the restrictions on the capital operations in the mid 2006. On the one hand, rapid increase of capital inflow has pushed the investment activity, accelerating the production. On the other hand, this important liberalization measure was not supported by the further steps in the same direction – primarily, more flexible determination of the exchange rate. As a result, Bank of Russia had to smooth not only the fluctuations in terms of trade but also the increased volatility of the capital inflows using currency interventions. In the situation that ensued some elements of the economic policy have been directly contradicting other elements. The impact of the stabilization fund that was not letting the surplus of the petrodollars inside the economy was undermined by the capital inflows barriers for which were lifted. During the crisis, conversely, the

effect of the falling oil price was multiplied by the strengthening capital outflows.

Among the specific consequences of the economy overheating was primarily the rapid growth of the non-oil deficit of the current account. This indicator can be calculated using analogy with the non-oil budget deficit as current account balance saldo less the oil and gas exports. While in the 2005 non-oil deficit of the current account amounted to \$64 billion, in the 2007 it more than doubled reaching \$140 billion. It made Russian economy vulnerable to the fall in oil price.

Besides these specific problems, mistakes in macroeconomic policy have supported the formation of the unworkable model of the development. Distorted signals sent by the financial markets misinformed the economic agents. Such signals created the illusion of the sustainability of the extensive development: acquiring all the more assets, expanding the construction. Increasing the productivity of the companies was put aside for a long time – only the crisis made business return to it.

Inevitable move to the deficit of the current account in the time of the declining oil prices and the following increase of this deficit and rapid expansion of foreign borrowing by banks and companies would lead to the financial crisis even with stable foreign conditions.

Thus, the role of the American mortgage crisis is inconclusive. On the one hand, it has triggered the global destabilization. On the other hand, it helped Russia avoid the worst: if the growth of the “bubbles” and accumulation of the foreign debt of private sector have continued for a few more years, much more destructive crisis would have happened nonetheless.

Thus, we shall not only overcome the crisis, but build a new, viable model for the development of the economy, that would allow it to grow independently of foreign economic situation.

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