RUSSIA'S FINANCIAL MARKETS AND FINANCIAL INSTITUTIONS IN 2014

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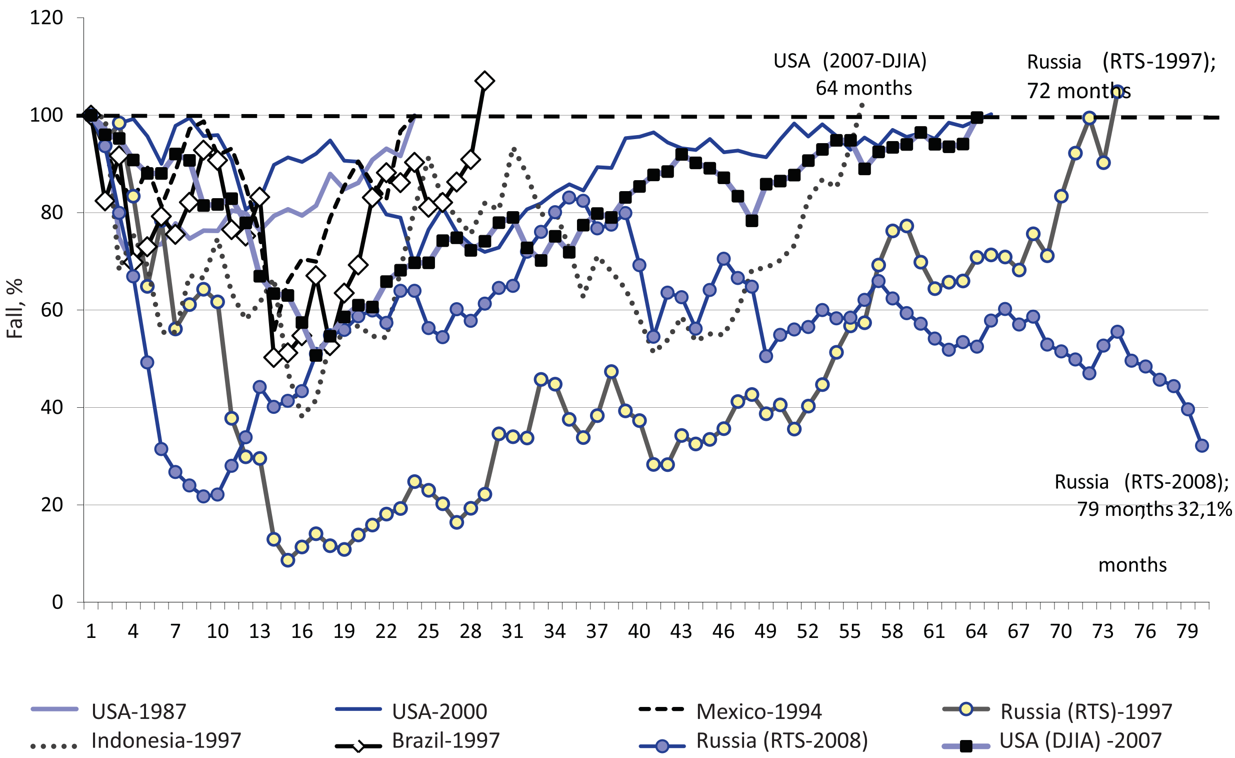
In 2014, the domestic money market saw the onset of a new wave of crisis, manifesting itself in capital outflow, a world's record plunge of the Russian stock indices, the ruble's devaluation, the surge in the key interest rate and interest rates in the interbank lending market. It is external shocks that were mostly responsible for that, i.e. slumping crude oil prices and the introduction of sanctions which closed down Russian companies and banks from external capital markets. The adverse external effects were reinforced by internal problems such as forced growth in the refinancing of the banking system amid announced free-floating exchange rate regime.

A new wave of financial crisis

In 2014, Russia encountered a new wave of the financial crisis which manifests itself in the devaluation of the national currency, capital flight, and plummeting stock indices. Technically, no recession has been reported, and sustainability of the banking system remained intact in general. The RTS Index movement has been following a W-shaped path since 2008. As of December 31, 2014, the Index stood at 32.1% of the value seen in May 2008 prior to the crisis, whereas it fell to 21.8% in January 2009.

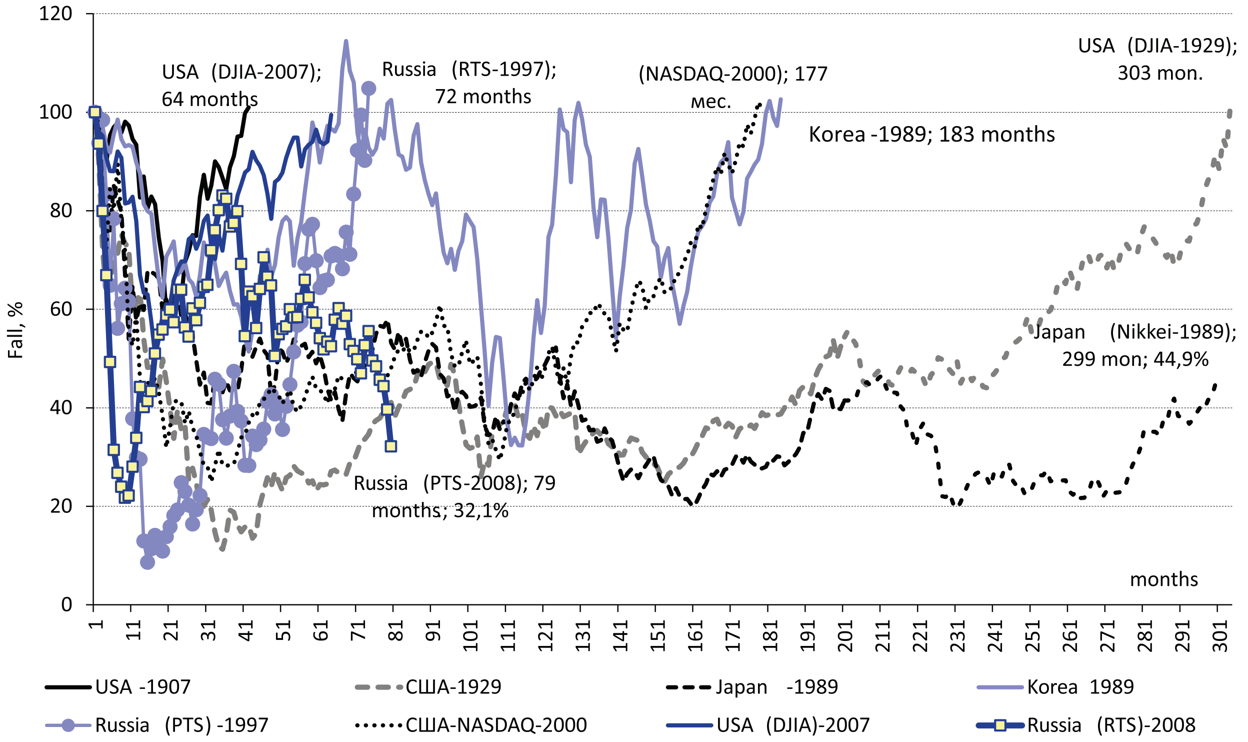
To date, the RTS Index hasn't yet recovered, lingering for a longer period than that seen in the time of crisis 1997–1998 (*Fig. 1*). After the crisis late in the 1990s, the RTS Index bounced back during 72 months. The Index hasn't hit its bottom yet after 79 months elapsed since May 2008. The fall of the RTS Index has been lingering for a record period of 6.6 years against the backdrop of the world's major short-lasting financial crises (in the United States in 1987, 2000 and 2007, in Mexico in 1994, in Indonesia and Brazil in 1997) with a recovery period of 5 to 6 years.

The current crisis in Russia has been lasting not so long compared with the world's major long-lasting financial crises (*Fig. 2*). There are two best known crises with a W-shaped path, namely shares of corporate stock in South Korea and NASDAQ in the United States, which lasted 183 and 177 months respectively. Furthermore,



Source: authors' computations based on the data provided by the Moscow Stock Exchange and the data available on www.finance.yahoo.com.

Fig. 1. The depth and length of world's short-lasting crises as of December 31, 2014 (peak = 100%)



Source: authors' computations based on the data provided by the Moscow Stock Exchange and the data available on www.finance.yahoo.com.

Fig. 2. The Depth and length of world's financial crises as of December 31, 2014 (peak = 100%)

it was not until 2014 that NASDAQ managed to fully recovered. It took Dow Jones Industrial Average (DJIA) 303 months to bounce back after the Great Depression in 1929. NIKKEI-225 is very likely to beat this record in May 2015, which, as of December 2014, cannot reach its peak of 1989 for a period of 299 months.

The crisis 2008 triggered sweeping changes worldwide, making the global saving glut factor[1], which used to lead to redistribution of foreign investment for the benefit of BRICS countries, spawn a reverse trend. For example, the United Nations Conference on Trade anticipates in the short run a reversal in the investment flows from developing countries and economies in transition towards developed countries[2].

However, Russia's stock indices in 2014 were the weakest compared with those in the BRICS countries (*Fig. 3*). After the crisis 2008, Johannesburg's JTOPI and India's BSE Sensex managed to reach the pre-crisis peaks for a period of 44 and 70 months respectively. It took Brazil's Bovespa 79 months to reach 68.9% of the pre-crisis highs Shanghai Stock Exchange Index (China) reached 49.3% during 89 months. Russia's RTS FX Index dropped by 32.1% of the pre-crises peak values within 79 months, the lowest value in the BRICS markets. The MICEX Ruble Index managed to stay at 72.5%, because the ruble weakened by 41.8% against the US dollar in 2014.

In 2014, the Russian stock market appeared to be absolute record-breaker by the depth of fall (*Fig. 4*). The RTS Index fell by 45.2% compared with the Athenian Stock Exchange Index (14.7%) and the Cypriot Stock Exchange Index (16.6%). The MICEX Index lost 7.1% during the same period.

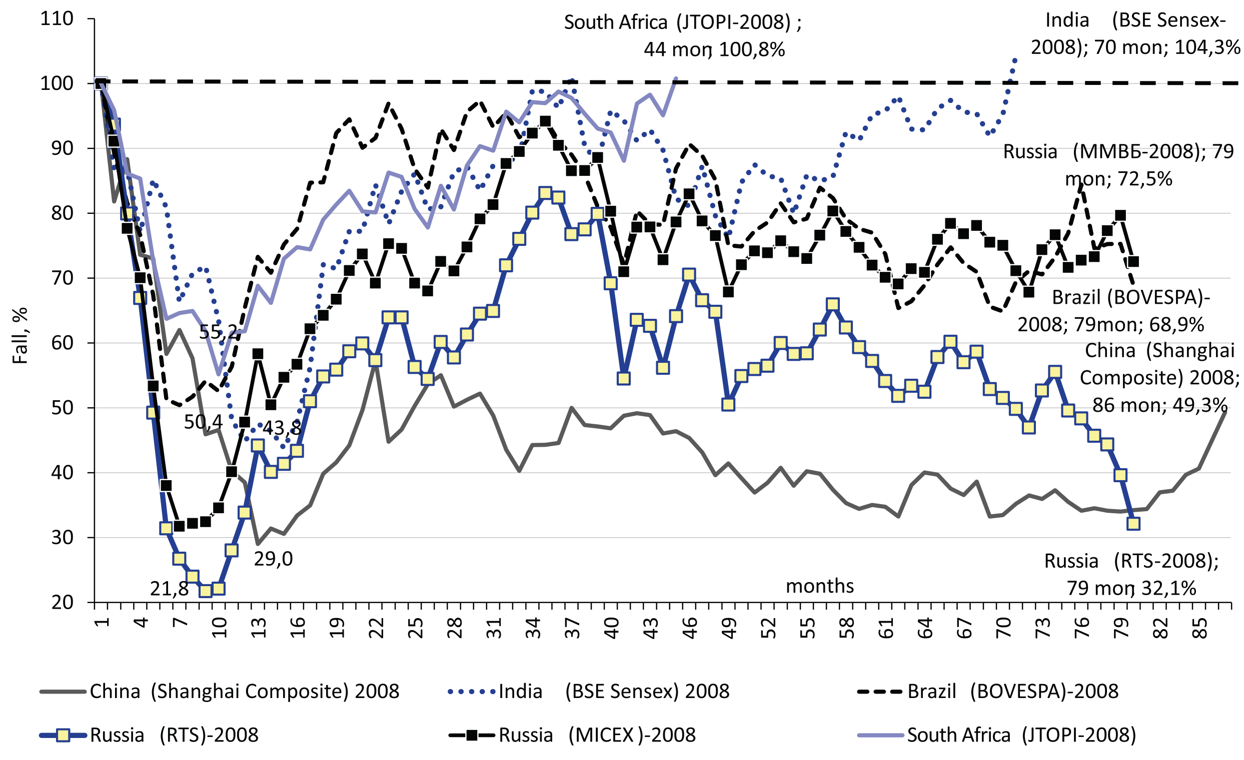
The exacerbation of crisis in the money market manifested itself in that the key interest rate has soared to 17% p.a. for the first time since the onset of the period the Bank of Russia's massive credit expansion in December 2014, thereby boosting interest rates beyond 20% in the interbank lending market. The lift of the key interest rate to 17.0% from 10.5%, effective since December 16, 2014, was a forced measure aimed at preventing the foreign exchange market from turmoil. In fact, however, this implied the introduction of indirect moratorium in the provision of bank loans to the real sector and retail customers.

The impact of economic factors on the financial market

The new financial crisis was governed by the key factors such as falling crude oil prices and the ruble's

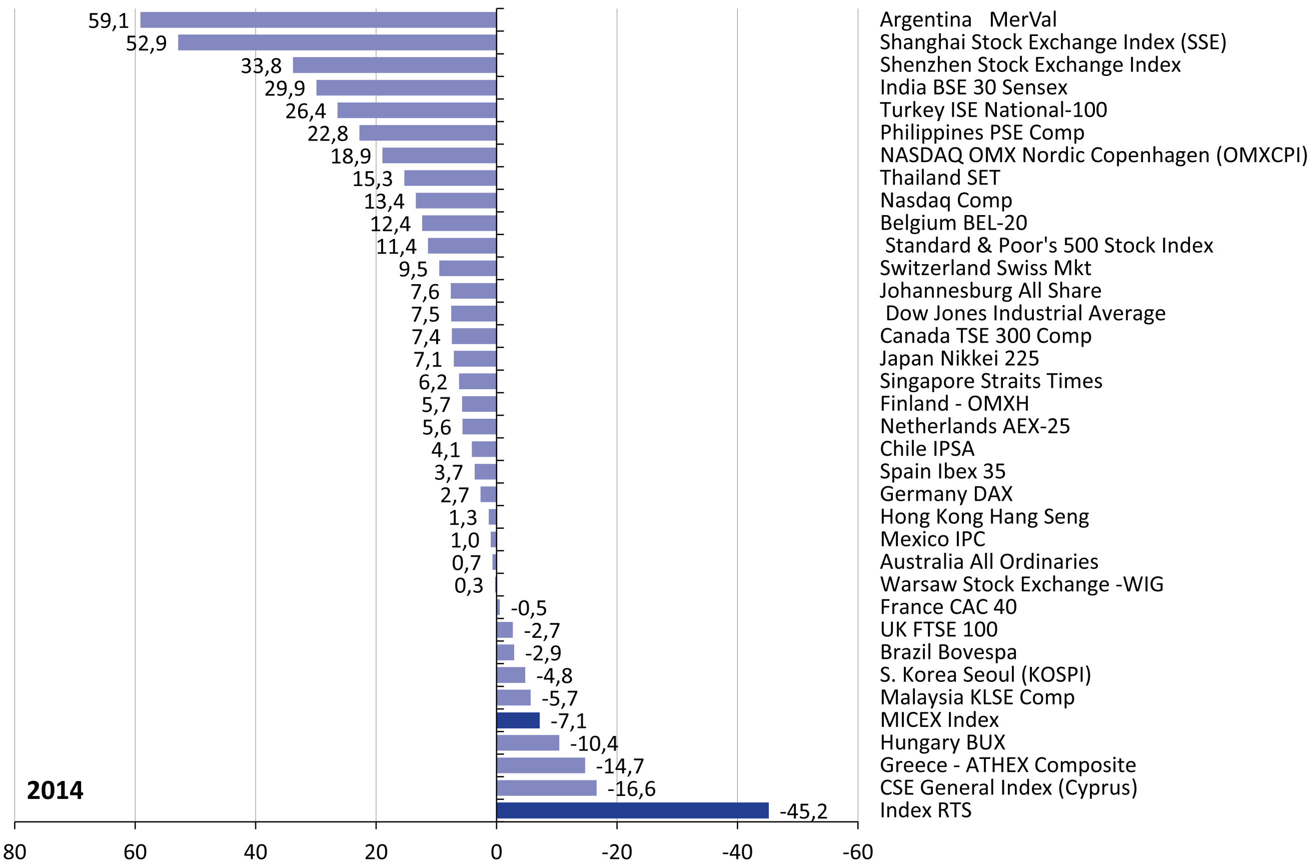
1 The Global Saving Glut and the U.S. Current Account Deficit. Remarks by Governor Ben S. Bernanke At the Homer Jones Lecture, St. Louis, Missouri. April 14, 2005: http://www.federalreserve.gov/boarddocs/speeches/2005/20050414/default.htm

2 World Investment Report 2014: Investing in the SDGs: An Action Plan UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD), 2014.



Source: the computations are based on the data provided by The Wall Street Journal and Thomson Reuters Eikon.

Fig. 3. The depth and length of the current financial crisis in the BRICS countries as of December 31, 2014 (peak = 100%)



Source: the computations are based on the data provided by The Wall Street Journal и Thomson Reuters Eikon.

Fig. 4. Stock indices rate of return in 2014, % p.a.

devaluation; sanctions which close down Russian companies and banks from external fundraising, as well as the unfavorable investment environment inside the country.

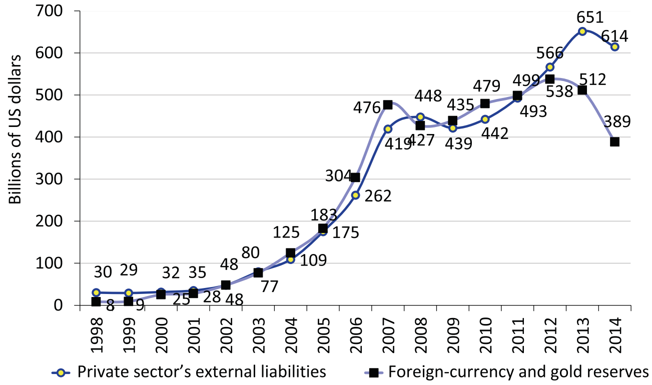
In December 2014, monthly average Brent crude oil price accounted for only 46.1% of the values seen in May 2008. During the crisis 1997–1998, it took crude oil prices 36 months to rebound to the pre-crisis value, whereas they haven't rebounded yet over 77 months since May 2008. Furthermore, the monthly average Brent crude oil price kept falling from $111,9 US a barrel in June 2014 down to $61,7 US in December, or by 44.9%. The RTS Index slid during the same period from 1366,08 points to 790.71, or by 41.1%.

In the period between June and December of 2014 the US dollar exchange rate raised to Rb 56,26 from Rb 33,63, or by 67.3%. Furthermore, the first few FX trading days in the Moscow Stock Exchange in 2015 showed that the ruble kept weakening. The ruble's devaluation in 2014 was triggered by falling crude oil prices, the growth in foreign exchange outflow while corporate external liabilities were repaid amid sanctions, as well as further growth in the refinancing of the banking system by the Bank of Russia following its FX interventions.

The sanctions didn't allow Russian companies and banks to refinance their external liabilities in the global markets, and they had to purchase more foreign exchange in the internal market to be able to repay their debt. In 2011–2013, the annual average growth in the private sector's external liabilities amounted to $69,6bn. The sanctions made the amount of the foregoing liabilities reduce from $651bn in 2013 to $614bn as of 10.01.2014, or by $36,7bn (*Fig. 5*). In other words, the sanctions are assumed to not allow Russian companies and banks to borrow about $110bn in the global market in 2014. At the same time, in 2014, the foreign-currency and gold reserves shrank to $389bn from $512bn, or by $123bn. This amount was utilized to support the ruble's exchange rate in the foreign exchange market and replenish, indirectly, the foreign exchange reserves of Russian organizations which are required for the repayment of their external debt. To compare, in the period of managed devaluation of the ruble, between August 2008 and February 2009, the foreign-currency and gold reserves shrank by $212bn, reaching a minimum of $384bn.

The issues relating to the internal model of economic growth

The Bank of Russia is to complete the transition to an inflation targeting and free-floating exchange rate regime in 2014. The economic community isn't unanimous as to whether this step is reasonable or not[1]. Without getting into the essence of pros and cons of the transition to a targeting policy, it's worth noting that this subject matter has a certain value for the society in the context of refinancing volume required for maintaining sustainability of the unstable banking system. The relationship is simple. The Bank of Russia's key interest rate (17% today) is the principal tool having a bearing on the market inflationary expectations. The Bank of Russia makes sure that interest rates in the interbank lending market, which reflect the short-term liquidity in banks, are stable and not incommensurate with the key interest rate. This can be done through the provision of Bank of Russia loans to banks in the amount required to achieve the set goal. In other words, given the set interest rate targets, the volume of refinancing depends basically on the banking system's demand. The Bank of Russia cannot conduct its inflation targeting policy without such a refinancing.



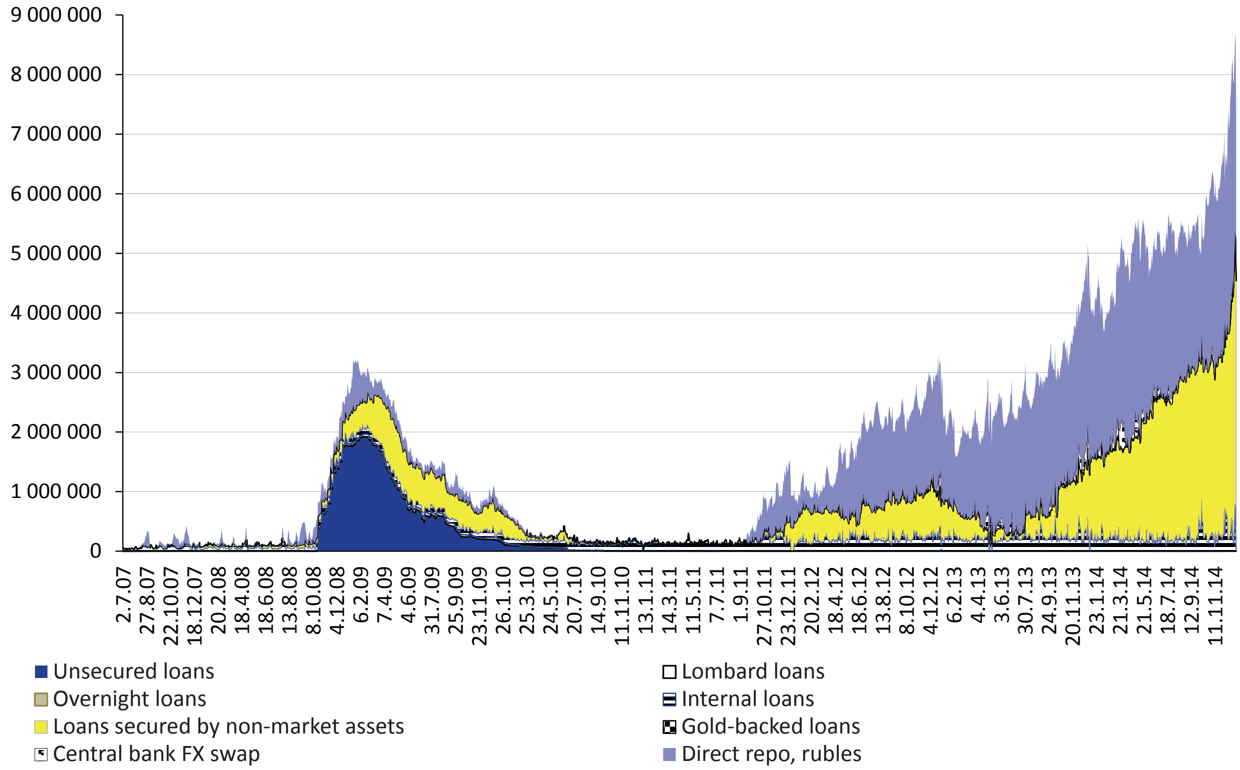
Note. 2014 data: foreign-currency and gold reserves as of 26.12.2014, private sector's external liabilities as of 1.10.2014

Source: estimated on the basis of the data provided by the Bank of Russia.

Fig. 5. Private sector's external liabilities and the foreign-currency and gold reserves in Russia, 1998–2014

The current volumes of refinancing are impressive (*Fig. 6*), which at various times was channeled via the provision of loans through direct repo and loans against non-market assets, as well as the provision of unsecured loans. In the height of the crisis 2008, banks owed a maximum of Rb 3,2 trillion to the central bank, and their liabilities reduced to Rb 100–200bn as the economy recovered from the crisis. However, bank's liabilities under the refinancing program started to grow again since October 2011. Late in 2012, the liabilities reached the maximum level seen during the preceding crisis. In December 2014, banks' liabilities to the central bank

1 For example, according to Bank of England experts, most countries have introduced inflation targeting when a degree of inflation was low (Hammond Jill. Inflation Targeting Practice. Central Banks Study Center, The Bank of England. Guidelines No. 29, 2012, p. 7). No such practice has to date been applied in Russia.



Source: the author's computations based on the data provided by the Bank of Russia.

Fig. 6. Credit institutions' liabilities on the loans from the Bank of Russia, inclusive of intraday loans, millions of rubles, July, 2,2007 to December 31, 2014

reached Rb 8,7 trillion, beating 2.7 times the "record" of 2008. Refinancing of banks through direct repo operations and the provision of loans against non-market assets plays a key role at this stage. The calculations also include the volume of intraday loans.

Technically, neither the executive branch of the government, nor the Guidelines for the Single State Monetary Policy annually considered by the State Duma set quantitative targets of refinancing. Refinancing was not regarded as the key subject matter in the Strategy of the Development of the Banking Sector of the Russian Federation until 2015 (hereinafter – the Strategy) adopted in the form of Statement No. 1472p-P13 by the Russian Government and No. 01-001/1280 of 04.05.2011 by the Bank of Russia. The need to develop instruments of refinancing was mentioned once in Section 18 of this policy document. The document is much more focused on the internal reserves of growth of the banking system, its transition to an intensive development model, boosting capitalization of the banking sector.

The setting of such refinancing volume targets falls within the competence of the Bank of Russia, as evidenced by its officials' statements such as "we are ready to provide refinancing in a volume as may be required …"[1]; "the Bank of Russia is ready, if necessary, to double the provision of liquidity as part of repo operations …"[2]; "…we can provide refinancing three times the current volume "[3].

The increase in refinancing since the beginning of 2012 was associated with the need to support the ruble liquidity in the banking system amid the increase in cash in circulation and the growth in the balance of government accounts, liquidity in the banking system because of limited sources of funding of banks. Furthermore, a refinancing mechanism was introduced after the crisis for the same purpose that was used prior to the crisis 2008, when the Bank of Russia provided extra liquidity by purchasing from banks the foreign exchange which they borrowed in global markets. In the mid-2009, long before the sanctions were imposed, the total foreign exchange assets of the banking system overran its liabilities to non-residents (*Fig. 7*).

The banking system obtained extra Rb 2,4 trillion through refinancing in 2014, which along with other sources helped make up for the absorption of ruble liquidity caused by Bank of Russia's foreign exchange

1 Shvetsov S, First Deputy Chairman, the Bank of Russia, November 2, 2011 http://www.finmarket.ru/news/2520879.

2 A. Ulyukayev, First Deputy Chairman, the Bank of Russia, November 17, 2011 – http://www.banki.ru/news/lenta/?id=3387737.

3 S. Moiseev, Deputy Director, Financial Stability Department, Bank of Russia, February 26, 2013 – http://www.1prime.ru/Financial_market/20130226/761430125-print.html

interventions worth Rb 3,4 trillion and the growth in cash in circulation, Rb 0,3 trillion. At the same time, amid the ruble's depreciation, which was caused first of all by such factors as falling crude oil prices and limited access for Russian companies and banks to external capital markets, certain conflicts emerged in the policy of the central bank which had to conduct inflation targeting policies while supporting the ruble exchange rate. Aiming at the two targets at a time, the Bank of Russia had to undertake foreign exchange interventions entailing the absorption of ruble liquidity in banks. By compensating for liquidity through refinancing at a rate less than the return rate on operations in the foreign exchange market, the Bank of Russia interfered to a certain extent with its own efforts in dealing with the ruble's depreciation through interventions in the foreign exchange market.

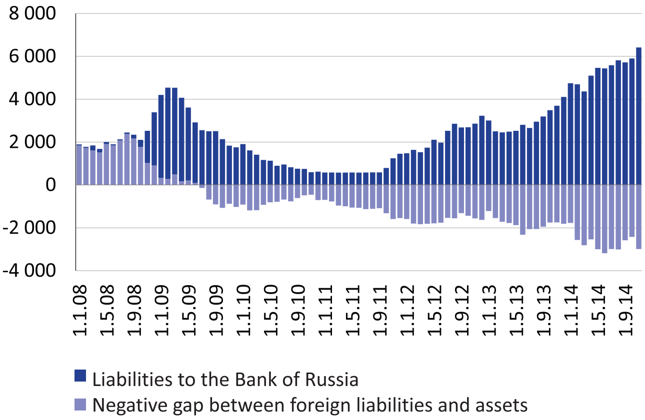
In the period between 2012 and 2014, refinancing was growing in volume at a much faster rate than credit portfolios of businesses and retail customers, as well as retail bank deposits *(Fig. 8)*.

Fig. 9 shows a 70% correlation in the second half of 2014 between the volume of banks' liabilities to the Bank of Russia on loans secured by non-market assets and the US dollar exchange rate expressed rubles, which testifies that the foregoing indicators are closely related. According to the data provided by the Bank of Russia, the Bank spent $39,9bn on its interventions in the foreign exchange market in the period between October and December of 2014. Furthermore, the volume of refinancing through loans secured by non-market assets and through direct repo transactions increased Rb 1,9 trillion during the same period, which equals to the same $39,9bn given the monthly average US dollar exchange rate in the same period.

* * *

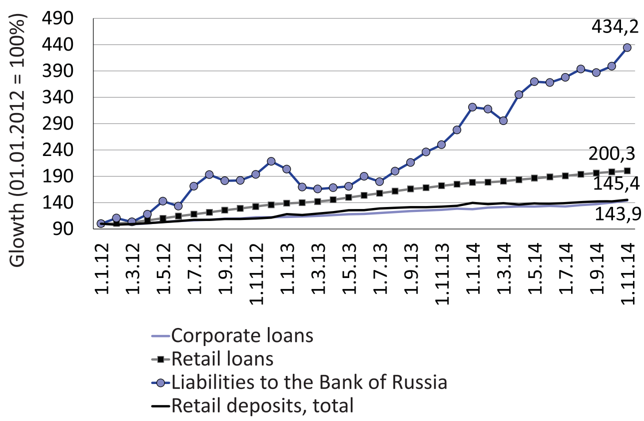
Thus, in 2014, the internal market saw the post-crisis economic standstill give way to a new wave of financial crisis manifesting itself in accelerated capital flight, a world's record slump of the Russian stock indices, the ruble's devaluation, the surge in the key interest rate and interest rates in the interbank lending market. It is external shocks that were mostly responsible for that, i.e. slumping crude oil prices and the introduction of sanctions which closed down Russian companies and banks from external capital markets. However, the foregoing adverse effects of external shocks were reinforced by internal problems associated with the forced duality of priorities in the monetary policy.

What measures can be taken to mitigate further growth in refinancing risks? The Bank of Russia has already started to take some of them, such as the transition to application of mechanisms of refinancing



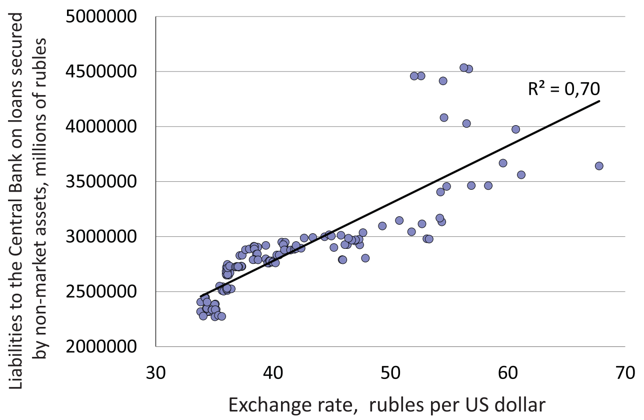
Source: the author's computations based on the data provided by the Bank of Russia.

Fig. 7. Credit institutions' liabilities to the Bank of Russia and a negative gap between foreign liabilities and banks' assets, billions of rubles, in 2008–2014



Source: the author's computations based on the data provided by the Bank of Russia.

Fig. 8. Growth in credit portfolios and increase in Bank of Russia's support to banks in the period between January 2012 and November of 2014



Source: the author's computations based on the data provided by the Bank of Russia.

Fig. 9. Correlation of the exchange rate and banks' liabilities on loans secured by non-market assets (01.07. – 31.12.2014, intraday data)

of the infrastructure bonds, securitized assets, credit pools for small businesses[1]. Hopefully, these mechanisms will make credit support flows to banks more target-oriented and make it less possible for them to employ these resources for currency speculations. Also, the Strategy should be actualized through better linking Bank of Russia's measures aimed at purging the banking system and strengthening the prudential supervision with the focus on more intensive development of the banking sector.

In the meantime, internal investment mobilization projects, which have no such a devastating impact on the stability of the national currency, should be developed to some extent as alternative to refinancing. The case in point is to promote growth in ruble-denominated bank deposits, the system of private pension savings, pooled investment and, of course, the national capital market.

1 Yudayeva K. The economy may unexpectedly reverse. Vedomisti, February 24, 2014.