What crisis is threatening Russia?

Despite that the microeconomic conditions are good in Russia, risks have significantly grown over the past months. First and foremost they are driven up by weakness of the banking system that will likely be in the epicenter of the forthcoming financial turmoil. The liquidity crisis we are facing has forced monetary authorities into extraordinary measures such as direct fund injections into major banks and dramatic reduction of the provisions.

Major domestic economic indicators remain strong despite that the global economy growth is slowing down, exchange rates drop and rally (the dollar climbed 11% against the ruble since mid July) and stock market is sinking (RTS fell 58% since mid May).

Economic growth stays at above 7% level which is quite good in the circumstances when the global economy grows at the 4.1% rate (according to the IMF July estimates). Inflation - approaching 15% per annum - remains a serious trouble. Yet, 10 to 20% growth in consumer prices is not an unusual thing for the economy. For a number of countries that are facing high inflation rates after a long break, a two-digit price surge turned out a real shock. Interest rates are not high (however they tend to grow stably), and the overnight rate (MosPrime) has reached 10-11% (in the wake of the bankruptcy of Lehman Brothers) - climbing from 7-8% in early 2008. External conditions are obviously unfavorable: Russia’s small- and mid-sized banks are facing some troubles with refinancing their debts and high levels of spreads. The balance of payments is robust with exports exceeding imports by $19.1 billion. In the first six months of 2008, the country saw a $35.7 billion private capital inflow (however, money outflow that started this summer will likely exceed the inflow in the third quarter). According to the Central Bank pre-estimates, $9 to 10 billion ‘left’ the Russian Federation. Gold and currency reserves fell 4% compared to the early August maximum ($597.5 billion), but they still exceed all adequacy norms and criteria.

Strange but true, all abovementioned positive trends may mean absolutely nothing on the onset of a crisis. Russia’s financial system is threatened by currency crisis risks. Different varieties of this scenario are described by the third-generation models of currency crises. The first-generation models (Krugman (1979), Flood and Garber (1984)) suggest that under the conditions of fixed currency exchange rates crises emerge due to a constant primary budget deficit. The deficit forces the government who cut down funding to resort to debt instruments to gain from seniorage. This measure inevitably leads to the fixed exchange rate system collapse. Russia is protected from such crises by the budget surplus and relative flexibility of foreign exchange regulations.

The second-generation model of crises (Obstfeld (1994, 1996)) is not dangerous to Russia, either. This type of crises is self-performing: if investors anticipate devaluation, upheavals will be inevitable despite positive macroeconomic statistics. The government will be out of the play in this case: a crisis might occur even if policies were quite expedient, as past successes do not guarantee future expediency of policies. At present, there is neither real threat of crisis, nor conditions for a speculative attack on the ruble. Traditionally, 'getting infected with a currency crisis' is seen as a reason to attack the national currency resulting from speculative attack on other currencies.

Yet, prospects are not that bright. Investors may give in to fears of the forthcoming budget deficit that will occur should the government be forced to bail out banks following investor invasion. The 2004 experience showed that bankruptcy or suspension of a single large bank might cause people to line in front of cash offices to get their savings back. In the Russian setting, bailouts might cost up to 3 to 4% of the GDP. With the current trend of surplus reduction aimed at plugging budgetary expenditure, this can cause a budget deficit. The 1997 Asian crisis unfolded according to this scenario: investors realized that the banking system was weak, and that understanding triggered off speculative attack on currency. For a fragile banking system this might become too much trouble. Back then, many Asian banks failed to survive that ordeal, and there is no certainty that the Russian banking system, saddled with dollar loans, is in a better situation than were the Korean or Thai banking sectors. The weaker is the financial system, the higher is the probability that such scenario will occur. The sinking stock market (or real estate market, however unreal it might seem) might trigger off this scenario. Yet another cause of the Russian economy vulnerability to such crises is lack of reforms in the banking system. Creating favorable conditions for Russian banks, protecting them from competition with foreign counterparts, inefficient use of prudential surveys and implicit warranties all lay responsibility for credit institutions volatility on the Russian monetary authorities.

Besides, after current and capital accounts of the balance of payments are split, long-lasting ruble depreciation may begin. This, alongside external debt nominated in foreign currency, will cause an economic recession in accordance with predictions of the third-generation crisis models.

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