

FROM DOUBLE SURPLUS TO DOUBLE DEFICIT IN THREE MONTHS

BY VLADIMIR KREINDEL, IFS SENIOR ANALYST, January 14, 2009

Russia's Central Bank presented an estimated balance of payment for 2008 and the data on net cross-border private capital flow. These illustrate a steep downturn in the Russian economy. In the third quarter of 2008, capital outflow reached \$130.5 billion, the highest from 1994. Based on the Central Bank's earlier estimates, the outflow could total \$50 billion dollars in December 2008. Judging by the cumulative indicator, the last three months' result nullifies all 'achievements' in raising foreign funds and causes the economy to bounce two years back (see Diagram 1).

This looks like a classical 'capital flows reversal' widely explored in books on financial crises, but it is not actually it. The Russian crisis cannot be described using a common 'hot money flow' scheme, as Russia almost did not see any hot money owing to its lean financial markets, especially the debt market. Portfolio investments have a minor implication on capital outflow; changing of funds into foreign currencies by residents of Russia had a greater impact and was interpreted statistically as capital outflow. This time, Russia did not need a 'George Soros' to devalue the ruble as it launched 'soft devaluation'. This is a direct consequence of the government's policy and, above all, the policy of the Central Bank that, hoping for the sizeable reserves, did not undertake momentary devaluation of the ruble with the new exchange rate protection.

The country's liabilities to non-residents fell \$44.7 billion within a quarter while in the same period in 2007 they grew \$59.9 billion. In 2008, banks saw a 7.9-fold decline in capital inflows, other sectors (companies and the population) – a 1.6-fold decline. At the same time, 'foreign currency' entry in the 'assets' section shows a substantial growth.

The 'net errors and blanks' column that reflects 'shady' capital outflows slightly increased compared to 2007; i.e. contrary to a widespread opinion, there is no purposeful 'moving' of funds abroad. At the same time, an estimated balance of payment proves that the need to early repay loans taken from western lenders makes enterprises and banks change their role radically – they turn into a channel through which funds flow out of the economy.

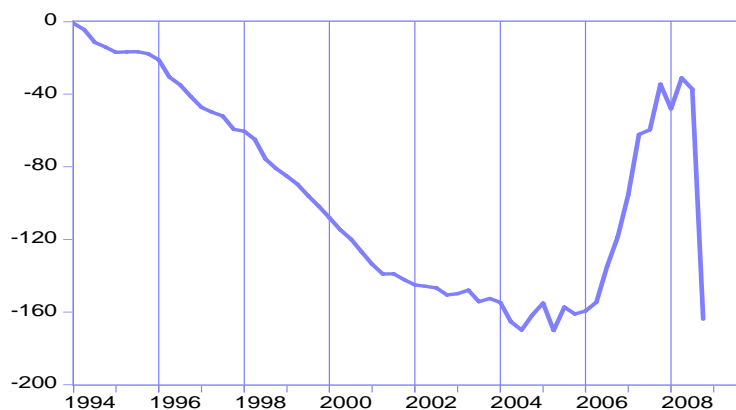
The current operation account remains positive, but in the third quarter, amid the petrol market turmoil, it grew only \$8.1 billion, that is two-thirds less than in the same period in 2007. In the past three months, inflows from Urals sales slid 28% compared to the third quarter of 2007. The ruble depreciation (the ruble fell 16%

against the bi-currency basket) and forecasts about a weak economic growth (or a recession according to some scenarios) will cause imports to decline. But the current operation account will continue to worsen - owing to the balance of trade, above all. It is unclear how income balance will progress: enterprises and banks will save on interest payments due to early loan repayments, but incomes from foreign investments will definitely decrease, all the more so because investments are in large part concentrated in the industries that are faced with a deep recession.

This data does not provide any reason for optimism and proves that the crisis-ridden Russian economy is unlikely to recover in the nearest months.

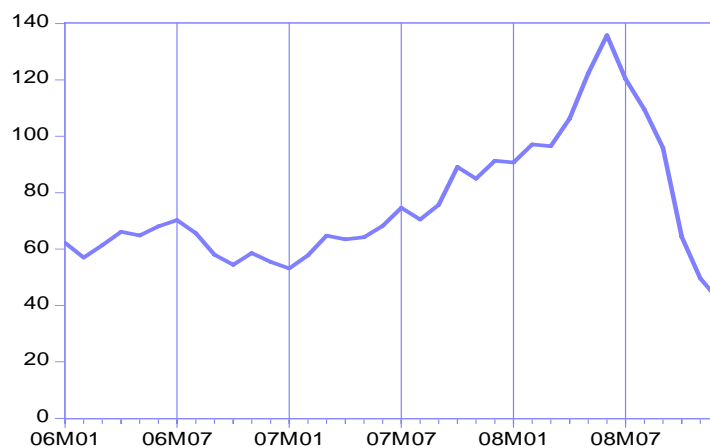
If the 2009 budget is adjusted so that expenses exceed incomes (which is practically inevitable), Russia will see double surplus replacing double deficit very soon. This will require drastic changes in Russia's financial and economic policies.

Diagram 1. Net capital outflow from Russia (seasonally adjusted data, accrued) in 1994-2008



Source: Central Bank of Russia

Diagram 2. Urals petrol price, dollars per barrel



Source: Bloomberg

