The Rocky Road to Modernity: 20 Years of the Russian Capital Market

By

Olga Kuznetsova

Andrei Kuznetsov

Yakov M. Mirkin

From a modest start almost 20 years ago, the Russian financial market has emerged as a major force in Eastern Europe and Central Asia. This article offers a retrospective account of the two decades of development of the financial sector in Russia, with an emphasis on the securities market; outlines the main stages in its development; and proposes an assessment of the capital market in comparison to other international markets. We conclude with an overview of the market's performance during the current financial crisis. © 2011 Wiley Periodicals, Inc.

Introduction

The modern Russian securities market had inconspicuous beginnings. Almost 20 years ago, pioneer traders were constrained to use rented flats with just a few creaky chairs in them as their trading floor. And yet this was a major breakthrough for a country in which any form of operation in private equity had been banned for 58 years. From this modest start, the Russian financial market has emerged as a major force in Eastern Europe and Central Asia. In a short historical period, it has acquired many modern features and, in terms of capacity and sophistication, is on a par with other leading "new" economies in Asia and Latin America, as well as playing a major role in the development of the market economy in Russia.

During its short history, the modern Russian securities market has been through successes and failures. On a positive side, the national economy is now served by a structured financial system that operates consistently throughout 11 time zones; is recognized worldwide and attracts great numbers of foreign investors; and is com-

Correspondence to: Andrei Kuznetsov, Lancashire Business School, University of Central Lancashire, Greenbank Building, Preston, PR1 2HE, United Kingdom, +44 1772 894695 (phone), akuznetsov@uclan.ac.uk.

Published online in Wiley Online Library (wileyonlinelibrary.com)
 • DOI: 10.1002/tie.20441

patible internationally in terms of employed technologies, architecture, size, and dynamics. At the same time, it is not as advanced and competitive as the best, while excessive volatility and risk betray its derivative origin. For such positions as "financial market sophistication" and easiness of "financing through local equity market," the World Economic Forum report (2009) places Russia in 92nd and 96th place, respectively, out of 133 countries.

This article offers a retrospective account of the two decades of development of the financial sector in Russia with an emphasis on the securities market, outlines the stages of its maturation, and eventually proposes an assessment of the capital market in comparison to other international markets. We conclude by providing an overview of its performance during the current financial crisis.

Learning Through Failures: The Early 1990s

The early 1990s were probably the most "revolutionary," not so much in terms of the progress achieved as the scale of changes and innovations introduced into the financial sphere. The early 1990s were the time of unorthodox ideas, daring personalities, quasi-market institutions, ostentatious corporate names, and dazzling financial instruments such as golden shares, golden policies, golden vouchers, and golden bonds. All these "golden eggs" were stirring the inflated aspirations of the totally unprepared population and equally inexperienced financiers. Some remember this period as a romantic era: in the morning, a hall could be a trading floor, and in the evening, it hosted discos. One of Moscow's principal stock exchanges of the time operated from an old Moscow communal flat, or more precisely, from a well-used sofa left behind by the previous occupants.

The start to all these developments was given by the initial economic liberalization that legitimized the creation of the joint stock companies and private firms in general. The mass-privatization program of the early 1990s provided a further impetus. The adult population of Russia was allocated free vouchers that could be exchanged for shares in the state-owned enterprises sanctioned for privatization. Voucher privatization was intended to create widespread ownership along the lines of the Anglo-Saxon model. In reality, the majority of Russians showed little interest in shares. This was due partly to poor information support and partly to the fact that during the immediate postprivatization period, shares did not bring any real benefits to most shareholders, as they had low liquidity and dividends were not paid. The usual asking price for a voucher was about US $10, which was hundreds of times below the voucher capitalization of US $2,000 based on the estimated value of privatized assets of US $300 billion (Kolovantin & Rybakov, 1996). One other feature of Russian privatization was its bias in the allocation of shares: originally the majority of equity (51%) was distributed among workers and managers of privatized enterprises. This soon resulted in the creation of insider dominance and the concentration of control in the hands of managers: their equity stake has increased from less than 10% in 1994 to over 30% at present. This has had serious implications for the stock market: its opportunity to become an important tool in the mechanism of corporate control has been undermined, as insiders have tended to view their shares more as control rights than as financial instruments (Fox & Heller, 1999).

The early growth of the financial market was explosive. By 1993–1994, there were more than 60 officially registered bond and stock exchanges and subdivisions attached to the commodity exchanges in Russia. Impressively, this represented 40% of the worldwide total. Yet, their turnover was meager, ranging on average from US $2,000–3,000 to $150,000–400,000 per month. These figures provide good pointers as to the weaknesses that later became the inherent characteristics of the sector for the next decades: too small, too impotent, too vulnerable, too risky, too murky, and too greedy.

The pandemic acquisition of vouchers following the corporatization and privatization of state enterprises, the mass arrival of quasi-equities soon to disappear without a trace, the spread of financial pyramids, and their rapid collapse had assigned to the Russian financial market the features of a corner shop and a street vendor with the culture of an Eastern bazaar. Self-quotations and financial surrogates were rampant. Low liquidity, a limited variety of issues, and a short survival span of both traders and markets were the trademark of the financial sector of the time. As a response to the high degree of uncertainty and in order to maximize short-term gains during these early days, participants had already started to experiment with derivative instruments. Considering the immaturity of the market players and a nearly absent regulatory framework, these activities made the whole financial system even more unstable, volatile, and susceptible to adversity. All in all, by October 1994 there were more than 2,700 investment institutions in Russia that included financial brokers, investment companies, and consultancies; more than 3,000 insurance firms had been registered; and over 660 investment funds had appeared on the wave of the privatization campaign (with the majority vanishing toward the end of the 1990s), as well as a small number of private pension funds (Mirkin, 1995). Very few of them have survived.

Despite all the drawbacks and failures, the early 1990s were the period during which some essential institutes and operational procedures were established that in turn formed the functional foundations of the modern securities market in Russia. One such institute was the Moscow Interbank Currency Exchange (MICEX), founded in 1992. Its ascendance to its current eminence started in 1993 when it became the sole official trading floor for the GKO (short-term government bond in the form of three-month treasury bills), the security that has played an important and controversial role in the development of the Russian financial market. MICEX managed to organize the issue and servicing of these bonds at a level that was on par with international standards. Soon short-term state bonds had become the main vehicle of the capital market, reaching nearly US $7 billion in value. The scale of operations in GKO provided a platform that enabled the professionalization of the securities market in the country. Three years later, in 1995, the Russian Trading System (RTS) was set up to become the largest interregional over-the-counter trade organizer for corporate stocks and bonds, futures, and options in the Russian securities market. The reported trade volumes of the RTS are usually a third of the MICEX volumes partly because the RTS brokers are not obliged to register all the trades. In practice, RTS is considered to be the most important stock trading base in Russia: it is the first regulated stock market in Russia and it trades in the full range of financial instruments from cash equities to commodity futures. The RTS Index has been widely accepted as the official benchmark and indicator of the dynamics of the trading system.

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It is essential to point out the role played by the state with respect to the development of the securities market. First, having introduced the GKO, it induced the creation of new financial instruments and generated a large-scale demand for financial services. Second, the state had made attempts to institutionalize the sector and by doing so it enhanced the stability and transparency of its operation. In imitation of the United Kingdom's Financial Services Authority and the US Securities and Exchange Commission (Pistor & Xu, 2005), the Federal Commission for the Securities Market (FCSM) was set up in November 1994 (re-established in 1996 to be transformed into the Federal Financial Markets Service in 2004) to oversee the registration of equity shares issued by Russian private enterprises and to coordinate the activities of the governmental agencies that had overlapping jurisdictions governing the securities market. The state-controlled Central Bank of the Russian Federation was encouraged to act in the market for state securities as a main player, regulator, organizer of primary placing and off-exchange auctions, and a counterpart in repurchasing deals. The state also encouraged, by applying such authoritarian measures as withholding operation licenses, the restructuring of the market by forcing out small players and tightening operative discipline. The state should also be credited with facilitating technological progress in the marketplace, as the issue of the state securities was accompanied by the introduction of a computer-based trading system, e-depositaries, and e-clearing. This active involvement of the state was in stark contrast to its self-withdrawal from the rest of the economy during this stage of postcommunist reforms, the policy that some experts blame for mass impoverishment, industrial collapse, the low level of trust and transparency in the Russian economy, and widespread corruption (Gregory & Stuart, 2001; Kuznetsov & Kuznetsova, 2003; Stiglitz, 2002).

The introduction of high-yield GKO in 1994 attracted numerous foreign investors. Their presence energized the securities market. The formal reintegration of Russia into international financial markets after more than 80 years of absence was reached in November 1996 when Russia launched its first Eurobond (Buchs, 2003). For the first time, international demand for the Russian stock inspired the creation of investment funds with Russian interest.

The early 1990s were important, therefore, as the period of the institutionalization of financial markets (Kuznetsov, Kapelyushnikov, & Dyomina, 2008). The very fact that the state took part in assisting with their development helped the speedy establishment of at least some of the market institutions. That this assistance was rendered because the state was desperate to mitigate the disastrous state of the national budget does not change the result: the capital market has emerged, in terms of functionality and efficiency, as probably one of the most advanced segments in the modern Russian economy. Yet, as the first half of the decade was drawing to a close, the Russian financial market in technical terms was little more than a "frontier" market:[1] it was generally highly unstable and chaotic, periodically experiencing contractions and falls but nonetheless showing the makings of a workable market instrument.

Late 1990s: From Boom to Crisis

The essential feature of this period was the unprecedented growth of the Russian market for securities between 1995 and 1998 (see Table 1). Rapid growth stimulated a notable increase in the variety of instruments and services; the number of issues had been constantly rising to reach the maximum of 300. Alongside this growth, the implicit operational risks were increasing as well. In the late 1990s, the price volatility ratio in Russia was one of the highest in the world: more than 50% throughout 1995–2000. This instability was the result of a combination of factors. One was low monetization.[2] In the mid-1990s, according to International Monetary Fund (IMF) methodology, monetization in Russia was only 16–20% of the gross domestic product (GDP) (and just 13.8% in 1997 [Buchs, 2003, p. 700]), compared with 80–100% typical of the developed world and 40–60% characteristic for the developing countries. This was accompanied by the expanding state debt, rampant inflation, and a fixed exchange rate that was limiting industrial exports but was stimulating the inflow of short-term speculative investments (Gustafson, 1999). Soon, the Russian financial market came to be highly dependent on the flows of "hot money" (short-term speculative funds that flow into a country to take advantage of favorable rates of return) and the interests of nonresidents. The latter were keen to extract maximum returns, exploiting the then policy of the Russian government to use a short-term debt as the main source of covering the budget deficit.

Quantitative growth of the security market was accompanied by qualitative changes, indicating that the market had been reaching a higher degree of maturity. It was during this period that the modern infrastructure of the financial markets set its roots.

The MICEX and the RTS, each with its own depositary and clearing mechanisms, had fully established themselves as the two leading securities markets in Russia,

TABLE 1 The Key Indices of the Russian Securities Market, 1995–1998

	1995	1997	1998
RTS Index	100 (1.09.1995)	572 (historical maximum—6.10.97)	58.9
Stock market capitalization (RTS), $ billions	2.7 (1.09.1995)	134.2 (6.10.97)	11.0
Stock market turnover (MICEX + RTS) $ billions	0.2 (September–December)	25.4	11,0
Government bonds ($ billions)	6.4	85.8	27.4
Corporate bonds ($ billions)	0.1	0.3	0.1
Outstanding drafts (balance estimate)	11.8 (1996)	17.4	6.4
Number of broker/dealer firms, end of month	3,176 (April 1995)	5,045 (April 1997)	1,628 (June 1999)
Number of financial organizations eligible to act as banks, end of year	2,295	1,697	1,572
Security exchanges and organized off-exchange markets responsible for 90% of trade turnover	2	3	3

Sources: Bank of Russia, Russian Ministry of Finance, Bank for International Settlements, Moscow Interbank Currency Exchange, Russian Trading System, authors' estimates.

defining the dynamics and risks of the sector. The organizational principles of the two markets were reflecting the existence of competing views within the regulatory bodies on how the national securities market should be run. FCSM favored the Anglo-Saxon model based on the separation of functions between investment institutions and commercial banks. The Bank of Russia, in turn, wanted to see all financial institutions actively participating in investment activities. The coexistence of two competitive models became a particular feature of the Russian capital market. Accordingly, the RTS had emerged as the trading organization of specialized nonbanking institutions while the MICEX was predominantly run by banks. The two organizations had created two independent infrastructures throughout the country. As a result, the objective of establishing a single national market structure and a set of universal standards has not been achieved.

Other most important developments of the late 1990s can be summarized as follows:

- The operation and the instruments of the market had become more streamlined following changes in the financial legislation.
- During this period, the market for corporate bonds took off, increasing the operational scope of the market.
- By April 1997, more than 5,000 investment institutions held operational licenses, a 1.8 times increase from 1994.
- An international segment of the market had been formed with the first issues of the Eurobonds on behalf of the federal and regional governments as well as some corporations.
- International investors firmly established themselves in the Russian financial market. By the mid-1990s, more than 90% of the turnover of the RTS and more than 30% of investment in GKO were financed by nonresidents.
- One other interesting development of this period was the emergence of a huge market of promissory notes as a response to the crisis of nonpayment and the demonetization of the economy. This new segment of the financial market was feeding the economy with surrogate money and made it more vulnerable. On a positive side, this market bore the beginnings of the modern market for short-term corporate securities.

All in all, the developments in the capital market were reflecting the progress (or lack of it) of the market reforms in Russia and their economic consequences, including budget deficit, high interest rate, double-digit inflation, artificial and fixed exchange rate, dependence of the exports of raw materials, and so on. During the second half of the 1990s, the Russian capital market acquired the features of an emerging market similar to the financial markets of some newly industrialized and developing countries in Latin America and Southeast Asia (Claessens, Djankov, & Klingebiel, 2000; Mirkin, 2002). Its emerging status was reflected in the following characteristics:

- a relatively limited range of instruments;
- low liquidity;
- low operational volumes;
- across-the-board dependence on international investors;
- high volatility (Table 2);
- high systemic risks;
- the speculative nature of most financial flows (according to estimates in 2000–2007, 40–50% of the growth of the financial sector could have been attributed to speculations);
- vulnerability to “hot money”;
- the oligopolistic structure of the market, where some five to ten financial instruments and a very narrow group of participants were responsible for 80–90% of the overall market turnover; and
- the regional mega-concentration of operations (60% of transactions occurred on trading floors in Moscow).

As an emerging market, the Russian securities market was showing profound dependence upon the short- and long-term fluctuations of the global economy and its financial component (Hayo & Kutan, 2005). This and the poor state of the national economy were making it highly

TABLE 2 Volatility of Stock Exchanges in Selected Countries %, 1995–2000

Selected Developed Countries	
Great Britain	17.74
Japan	17.76
Germany	22.48
United States	27.64
Selected Transition Countries	
Poland	14.73
Czech Republic	14.93
India	20.35
Brazil	23.36
Russia	54.06

Source: Mirkin (2003, p. 487).

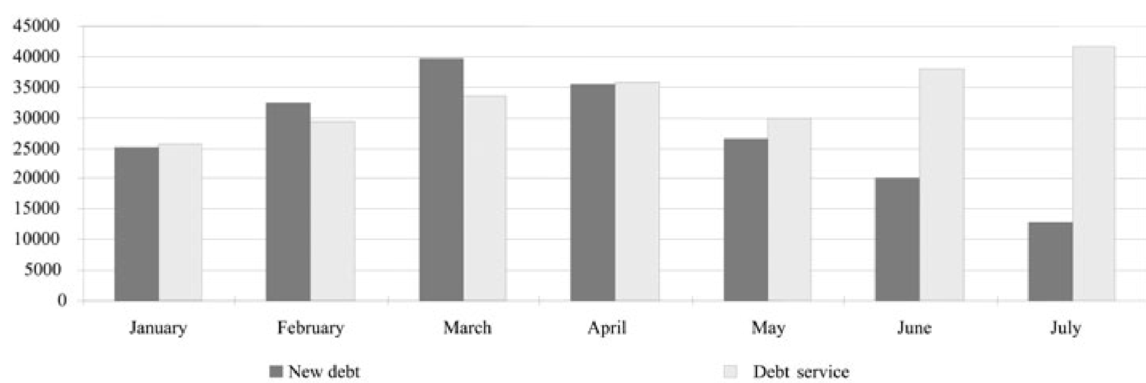
unstable and susceptible to manipulation and speculative attacks. The greatest turmoil followed the default of the Russian state on its short-term bonds (GKO) in August 1998. It was triggered by the Asian financial crisis (July 1997), which provoked a decline in world commodity prices. In Russia, tax revenues from the export of natural resources, the main income source of the state budget, had dwindled. The government tried to compensate by increasing the attractiveness of GKO: in July 1998, the nominal annual rate of return on GKO exceeded 120%. Yet, investors started to lose confidence, as it was obvious that the level of state debt was unsustainable, and as the cost of servicing the GKO was approaching 6.5% of GDP (Figure 1). Russia's monthly interest payments were well in excess of monthly tax revenues. Capital flight had begun. The government had no choice but to default on its short-term debt. The immediate consequences were dire, which was not surprising considering that government bonds were responsible for 85% of total turnover. The capital market was almost destroyed, as up to 50% of traders stopped operating and the state had revoked up to 90% of professional licenses. The corporate market was affected as well. The RTS Index, after growing 5.7 times from October 1995 to September 1997, fell 5.8 times from September 1997 to October 1998. The crisis spared nobody. Three leading industrial holdings—Sidanko Oil, Svyazinvest Telecommunications, and Norilsk Nickel—saw their market capitalization collapsing from the peak of about $31 billion in October 1997 to $3.8 billion a year later (Fox & Heller, 1999). In the end, however, the market has emerged from this calamity as a stronger entity. The "natural selection" diminished the number of players from 447 in October 1998 to 106 in December 2001, as only the largest and the strongest were able to stay in the market.

Entering the New Century (2000–2009): A Slicker and More Professional Market

Russia's recovery from the August 1998 financial crash was surprisingly quick. Because of the low monetization level of the economy, the Russian industrial sector was heavily relying on barter (up to 51% of all turnover in 1998 ["Survey Statistics," 2009, p. 24]) and other forms of nonmonetary transactions and therefore was not directly affected by the financial squeeze. Moreover, the depreciation of the ruble made the products of Russian enterprises more competitive on the domestic market, which in turn helped economic growth. The main reason for this speedy recovery, however, was the rapid growth of world oil prices during 1999–2000, allowing Russia to run a large trade surplus and increase investments into the economy.

Slimmed down by the 1997–1998 crisis, the Russian capital market started the new century well, showing growth as many capital markets abroad shrunk during 2002–mid-2003 (Table 3). In the wake of the 1998 default, investors had shifted their attention to the corporate market. Between 1998 and 2006, the RTS Index grew about 40 times, with the turnover increasing 55 times. One of the consequences of the financial crises of the late 1990s was that the bulk of operations in Russian American depositary receipts (ADRs)[3] had moved to stock exchanges in London, New York, and other foreign financial centers. However, as a sign of the recognition of the revival of the Russian markets, by 2006 the Russian exchanges had regained their position as leading traders of Russian ADRs. Despite these successes, Russia's financial market retained the dubious

FIGURE 1 GKO: New Debt and Debt Service, 1998, Rub Millions



Source: Drobyshevsky (1999, p. 28).

TABLE 3 The Key Indices of the Russian Securities Market, 1998–2007

	1998	1999	2003	2007
RTS Index (1.09.95 = 100)	58.9	175.2	567.3	2,291
Annual volume of trade in corporate stock (MICEX + RTS) ($ billions)	11.0	5.5	76.3	610.0
Annual volume of trade in corporate bonds (MICEX) ($ billions)	0.14	0.5	10.8	125.6
Annual volume of trade in government and Central Bank securities (MICEX) ($ billions)	70.0	4.5	12.5	421.4
Number of broker/dealer firms, members of MICEX (securities section), end of year	317	372	517	> 300
Number of broker/dealer firms, members of RTS, end of year	91	141	172	> 170
Number of financial organizations eligible to act as banks, end of year	1,572	1,349	1,329	1,136
Security exchanges and organized off-exchange markets responsible for 90% of trade turnover	2	2	2	2

Sources: Bank of Russia, Russian Ministry of Finance, Bank for International Settlements, Moscow Interbank Currency Exchange, Russian Trading System, authors' estimates.

honor of being one of the most unpredictable and volatile in the world.

Qualitatively, the market continued to change as well. Although the market retained its speculative tendencies, it had nevertheless assumed some new functions. Most importantly, it started to get involved in the financing of investments in the real economy on a systematic basis. Thus, first attempts were made to finance high-tech companies through a dedicated market subsector. The securities market also began to participate in business valuation and reorganization by assisting with ownership restructuring, mergers and acquisitions (M&As), foreign direct investment (FDI), credit rating, information transparency, and corporate governance standards.

Russia Vis-à-Vis Competitors

One of the principal outcomes of the development of the Russian financial sector during the last decade was that the capital market has grown to become the largest among Russia's main competitors—the countries from Central and Eastern Europe and Central Asia. Currently it generates 65–75% of the regional turnover of securities. Global investors routinely evaluate the competitiveness of the Russian market by comparing it with the other BRIC (Brazil, Russia, India, and China) countries.[4] In reality, Russia faces competition for influence over the post-Soviet space from other parties as well. One important contender is Turkey (see Table 4). As shown by the

TABLE 4 Russia Compared With BRIC Countries and Turkey: Dynamic Indicators of the Securities Markets

Country	2005	2006	2005	2006
	Volume of Annual Trade in Securities, $ Billions		**Securities Market Capitalization, End of Year, $ Billions**	
Brazil	165.3	276.1	474.6	710.2
Russia	145.5	582.8	330.1	968.0
India	473.7	638.1	553.1	818.9
China	392.7	1,159.0	286.2	917.5
Turkey	199.2	222.7	161.5	162.4
Russia's Share (%)	10.6	20.2	18.3	27.1
Country	**Volume of Annual Trade in Securities/GDP (%)**		**Securities Market Capitalization/GDP (%)**	
Brazil	55.0	55.4	44.6	40.4
Russia	18.7	25.9	53.8	66.5
India	19.0	59.2	43.2	98.3
China	60.8	73.0	71.0	93.7
Turkey	17.5	43.8	12.8	34.7

Sources: World Federation of Exchanges; IMF World Economic Outlook Database, October 2007.

TABLE 5 The Dynamics of Stock Market Indices (Change on Previous Year, %, End of Year), 2001–2009

	2001	2002	2003	2004	2005	2006	2007	2008	27.02.2009	2007/2001
RTS Index (Russia)	81	38	58	8	8	71	19	–72	–14	881
Dow Jones Industrial Average (US)	–7	–17	25	3	–1	16	6	–23	–20	132
FTSE 100 (UK)	–16	–24	1	8	17	11	4	–21	–14	124
DAX (Germany)	–20	–44	37	7	27	22	22	–25	–20	156
WIG (Poland)	–22	3	45	28	34	42	10	–51	–4	-
ISE National 100 (Turkey)	46	–25	80	34	59	–2	42	–52	-	403

Source: Dumov (2009, p. 9).

data, Russia gradually increases its share in terms of both the volume of trade and capitalization in respect to her main competitors.

The growth demonstrated by the Russian market in the last ten years is unparalleled (Tables 5 and 6). However, the inherent volatility of the market has remained extraordinary as well: the coefficient of volatility has increased from 30% in 2007 to 85% in 2009. These two features provide the underlying controversy of the Russian securities sector, which combines high potential for capitalization with exceptionally high risks. Alongside some other factors, this undermines its long-term competitiveness and delays it from acquiring the status of a full-fledged modern financial market. Crucially, this situation keeps Russian financial markets in a stand-by mode for a large-scale financial crisis because nonresidents, who in 2004–2007 were responsible for 60–70% of total turnover in the bond and stock market, but are hardly controllable, can easily trigger a chain reaction in the Russian financial market.

So, what are the main features that the Russian securities market has acquired in the 20 years since its inception? Our analysis gives the following answer:

- The market is highly volatile, with great proclivity for speculative activities.
- The market depends heavily upon the operations of nonresidents, be it individuals or institutions.
- The market is based on highly concentrated ownership (the free float of companies registered with the stock exchanges is only up to 10% [Abramov, Danilov, Kokarev, & Kuznetsov, 2006]).
- Its prominent feature is large-scale state participation and influence; the success of a business in the stock market depends on how closely a bank or a broker is "aligned" with the state and on the personal rapport between the owner of the financial institute and civil servants.
- The market is not attractive for small residential investors: less than 2% of the population hold shares or mortgages (Rutland, 2008).
- The market architecture is seriously distorted; many regions of the country are left without sufficient resources because they lack the necessary financial infrastructure; the absolute majority of brokerage firms and banks are very small: 40% of Russian banks have the statutory capital of less than $1 million and more than 60% of brokers—less than $0.5 million.
- The cornerstone of the Russian securities market is corporate debt rather than shares—a result of the ownership structure established following privatization; as in other emerging markets, the largest domestic companies are financed from abroad and are served predominantly by the Western investment banks.

There is one aspect of the business environment that cannot be overlooked when talking about the securities market in Russia. It is political risk, a permanent stress

TABLE 6 Volatility* of the Russian Stock Exchange, 2000–2006, % (+ Positive, – Negative)

2000		2002		2004		2006	
+	–	+	–	+	–	+	–
50.6	46.2	64.2	26.4	37.9	33.8	56.7	30.1

* The greatest deviation from the previous extreme of the RTS Index, %.

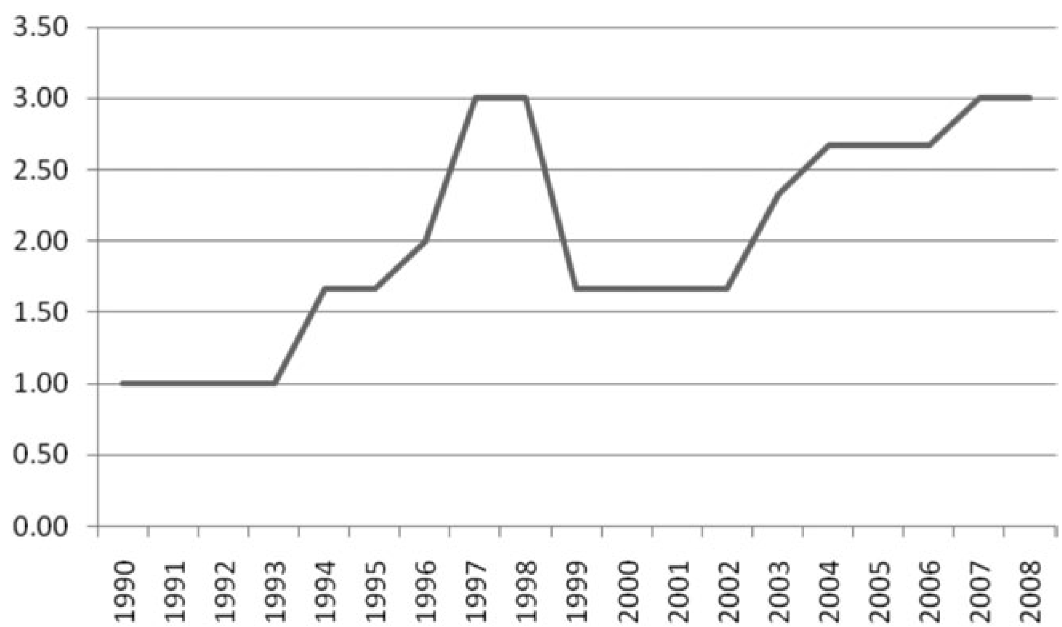
factor that can easily lead to the isolation of the Russian market in the long term and undermine its performance in the short term. The strong and expanding presence of the state in the economy and the financial markets is an undeniable cause of anxiety among all categories of nonresidential investors (see, for example, Adachi [2006] on the case of the factual renationalization of the oil company Yukos). Ultimately, this drags down the ratings of the Russian market, together with other factors, including increasing regulatory pressures, problems with ruble convertibility, price control, and other restrictive policies in general (Figure 2).

Coping With an International Crisis

Different countries experience the current global financial crisis differently. The Russian economy, a darling of international investors over the past eight years, had been until May 2008 one of the world's best-performing markets. By the end of the same year, the combined trading at the Russian exchanges had fallen by more than 70%, making Russia one of the world's worst performers over this period (Rosner, 2008).

While Russia was insulated from the impact of the US financial crisis in some respects, it was dangerously vulnerable in others. According to Rutland (2008), it had small domestic exposure but high international exposure and limited institutional depth to cope. The contraction in demand for oil and gas in the world market undermined Russia's economic growth, which fell from almost 10% in the fourth quarter of 2007 to just 1.1% during the same period in 2008. Western rating agencies reacted by downgrading Russia's sovereign debt to the lowest investment grade. Capital flight has ensued. The war in Georgia and several high-profile business disputes helped drive capital out of Russia.

FIGURE 2 EBRD Index of Reform of Nonbank Financial Institutions for the Russian Federation*



* On the EBRD measurement scale, 1 = little progress compared to the centrally planned economy; 2 = formation of securities exchanges, market makers, and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities; 3 = substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of nonbank financial institutions and associated regulatory framework; 4 = securities laws and regulations approaching International Organization of Securities Commissions (IOSCO) standards; substantial market liquidity and capitalization; well-functioning nonbank financial institutions and effective regulation; and 4+ = standards and performance norms of advanced industrial economies.
Source: EBRD economic statistics and forecasts, http://www.ebrd.com/country/sector/econo/stats/index.htm.

One well-publicized dispute involved the Russian-British oil company TNK-BP. The feature that raised particular concern among foreign investors was Russian financial oligarchs' reliance on support from the state when they resorted to strong-arm tactics toward their British partner in the fight for control over the company in early 2008: Western BP executives were denied visas to Russia, employees were accused of espionage, and the British director of TNK-BP was forced to leave Russia. The BP chairman lamented this as a return to the corporate raiding activities that were prevalent in Russia in the 1990s (Macalister, 2008). Another significant episode was the panic among investors after the Russian prime minister criticized the coal giant Mechel for inflated prices in July 2008. The market reacted nervously, fearing that this statement by the prime minister could be a prelude to an attack on large businesses similar to the one that destroyed the oil company Yukos in 2004.

Heavy capital flight in September 2008 caused a crisis in Russia's stock market. By early October, the market had collapsed, as businesses had to sell shares to raise collateral for margin calls required by international lending institutions. On October 6, within a few hours, the RTS Index had registered its greatest fall in history—19.1% when trade was suspended. In fact, the RTS had been weakening well before the US crisis hit. In the two months following May 18, 2008, the US stock market fell by 11.5% and the Russian market by 13.1%. Then in the next two months, the RTS crumpled by 51.8%, while the United States fell by only 8.5%. Bloomberg rated the RTS as the sixth-worst performing out of the 88 stock indices it tracked. Some experts suggested that the way out for Russia was going to be much harder than for many others (Rutland, 2008).

Clearly, the events in the Russian financial sector indicate that it has become an intrinsic part of the world system. However, this is not necessarily a sign of the close integration of the Russian capital market into the global market. While for the developed securities markets on both sides of the Atlantic the transmitting belt for the crisis was similarities in practices and linkages between institutions (Bosworth & Flaaen, 2009), for the developing world, the transmission has been largely through the extraordinary collapse of global trade. In addition, Russia faced a number of specific factors that shook the confidence of nonresidents in the Russian securities market. This was further undermined by the plunge of the price of oil and gas—the backbone of Russia's export-led growth—that followed the global economic slowdown. As US stocks plummeted, international investors cashed out their Russian holdings in a bid to generate cash and cover their obligations. Because of the low monetization of the economy, the withdrawal of just a few billion dollars was capable of producing very serious consequences for the investment market and the economy as a whole.

Although it is indisputable that the dominant presence of foreign investors was a factor that destabilized the Russian bond and stock market in the face of adverse developments abroad, it is equally clear that the Russian capital market has been hit particularly hard by the crisis mainly due to the inherent weaknesses of the Russian economy in general. Many of the flaws of the securities market, such as limited links with the real sector (only 300 of 50,000 public corporations in Russia are quoted in the stock exchange, according to Rubtsov [2006]), lack of diversification, and the excessive concentration of power, are a continuation of the problems of the national economy as a whole, with its shortage of modern investment opportunities, weak internal market, and volatile prices.

Huge foreign exchange reserves accumulated during the period of high oil prices allowed the government of Russia to implement an extensive stabilization program. In 2008, the total fiscal cost of anticrisis measures reached 1,089 billion rubles (2.6% of GDP), of which two-thirds were spent on support of the financial sector (World Bank, 2009). This support included a set of fiscal and monetary policies to ease the shortage of liquidity, recapitalize leading banks, and ensure repayment of external obligations by major banks and corporations. These efforts brought results. Financial panic was curtailed, there were no major bankruptcies, and the banking system stabilized. As a result, in the first quarter of 2009, capital outflows slowed to $38.8 billion from $130.5 billion in the fourth quarter of 2008 (US Department of State, 2009).

The Russian securities market in its present state is a typical large emerging market. It shows some impressive quantitative and qualitative gains but at the same time suffers from developmental "diseases" that act as barriers to robust and stable growth.[5] The economic cost to Russia of not having an efficient domestic market is enormous. For example, the opportunity cost of delaying initial public offerings (IPOs) is estimated at US $1 million per day for each US $10 billion in the queue, while the underwriting fees paid away since 2005 are on the order of US $700 million.[6] The costs associated with modernizing the capital markets in Russia to support its own IPO market are insignificant in comparison, and therefore this represents an extremely good investment opportunity.

Increasing the efficiency of the market will demand changes that go beyond simple regulatory measures. The key issues are assuring the growth of demand for financial assets by the residents of the country, building a strong domestic capability, further monetization of the economy, diversification, and demonopolization. The previous crises and emergencies were acts of "creative destruction"; every time, the market emerged stronger and fitter. Yet every resurrection bore the seeds of future calamity. The "boom and bust" nature of the Russian securities market remained mostly unchanged. Only time will tell whether the current crisis will finally cause changes that are deep enough to alter this predicament.

Dr. **Olga Kuznetsova** is a senior lecturer in international business at the Manchester Metropolitan University Business School in the United Kingdom. She is the author of numerous articles on postcommunist transition published in international journals. Currently she focuses on studying interactions between business and society and institutional aspects of business environment with an emphasis on Russia.

Dr. **Andrei Kuznetsov** is a professor of international corporate social responsibility in the Lancashire Business School at the University of Central Lancashire in the United Kingdom. His research interests include corporate governance, postcommunist transition, and global competition. He has written more than 80 publications, including journal articles as well as the books *Russian Corporations: The Strategies of Survival and Development* and *Foreign Investment in Contemporary Russia: Managing Capital Entry*. He is on the editorial board of the *Journal of East-West Business*.

Dr. **Yakov M. Mirkin** is the head of the International Capital Markets Department at the Institute of the World Economy and International Relations of the Russian Academy of Sciences. He is the author of numerous books and papers on the Russian financial market as well as an adviser to various government agencies on financial issues. He is a member of the board of MICEX, a leading Russian stock exchange, and the chairman of the board of directors of the "Eurofinansy" investment bank.

Notes

1. The term *frontier markets* describes the smallest, less developed, less liquid countries that make up emerging markets. The current examples of frontier markets include Bulgaria, Croatia, Kazakhstan, Nigeria, Sri Lanka, and Vietnam. The term first appeared in the International Financial Corporation's Emerging Markets Database (EMDB) in 1992.

2. Monetization is the proportion of broad money M2X, composed of narrow money M1 (currency in circulation plus demand deposits) plus time deposits in domestic currency plus deposits denominated by foreign currencies, to GDP. Monetization is related to the volume of transactions involving monetary instruments in the economy.

3. ADR is a negotiable security that represents the underlying securities of a non-U.S. company that trades in the U.S. financial markets.

4. This approach is based on the background similarities of these countries. Thus, the economy, sociopolitical problems, and the nature of financial risks have similar parameters in Russia and Brazil. Like China and India, Russia is a big transition economy, with a potential to have global impact.

5. Blueprint for the Capital Markets Infrastructure in the Russian Federation (2007). Available at: http://www.naufor.ru/default.asp.

6. Ibid.

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APPENDIX A Time Line

1991: Russia becomes "independent" as the Soviet Union collapses.
1992: January—"Shock Therapy," a program to change Russia to a free market economy as soon as possible, begins with the abolishment of price control. Alexandre Konanykhine, 25, a director of the Russian Exchange Bank, allegedly stole $8.1 million through falsified financial transactions and fled the country. June—Russia becomes a member of the International Monetary Fund. August—Mass privatization begins. December—The annual inflation rate reaches 2,506.0%.
1994: Russian troops invade the breakaway republic of Chechnya, followed by a protracted military conflict. The Russian international reputation and ratings of political stability drop.
1995: March—For the first time, the monthly inflation rate falls below 10%. August—"Loans for shares"—packages of shares in some of the most desirable state enterprises are auctioned as collateral for bank loans. As the loans are not returned in time, a handful of powerful banks acquire substantial control over major firms at giveaway prices.

APPENDIX A Time Line *(continued)*

1996: Russia admitted to the G-7 group of industrialized countries. December—The annual inflation rate equals 21.8%.
1998: June—The head of the State Statistics Committee is arrested for falsifying data to help corporations avoid taxes. July—The Russian stock market reaches its lowest level in 25 months. August—Alexander Smolensky, a Russian banking tycoon, closes a deal to sell $1.2 billion in Russian government bonds to Goldman Sachs International for about $500 million. The deal helps push jittery markets into a nosedive. The government of Russia allows the ruble's value to drop by up to 34%. It also defaults on $40 million in debt.
1999: December 31—Russian President Boris Yeltsin makes a shocking resignation speech on national television. Yeltsin is replaced by Putin as acting president.
2000: March—Putin elected president. May—President Putin unveils a new plan to revive the economy that includes a flat 13% income tax. December—The annual inflation rate is 19.7%.
2001: Goldman Sachs grouped Brazil, Russia, India, and China together as the four biggest emerging market economies under the acronym BRIC.
2003: October—Oil billionaire and Yukos boss Mikhail Khodorkovsky is arrested and held in custody over investigations into tax evasion and fraud.
2004: March—Putin wins his second term as president by a landslide. August—Russian authorities seize assets of the key production unit of Yukos to offset the latter's reported tax debts.
2005: June—The state obtains control of gas giant Gazprom by increasing its stake in the company to over 50%. September—Gazprom gains overwhelming control of the Sibneft oil company by buying out businessman Roman Abramovich for $13 billion.
2006: January—Russia briefly cuts the supply of gas for Ukrainian use in a row over prices. July—The ruble becomes convertible currency.
2007: December—President Putin's United Russia party wins a landslide victory in parliamentary elections.
2008: March—Dmitry Medvedev wins the presidential election. April—Putin becomes the prime minister. August—Tensions between Russia and Georgia escalate into a military conflict after Georgian troops mount an attack on separatist forces in South Ossetia. September/October—Share prices fall dramatically at the Moscow stock exchange as Russia is hit by the world financial crisis and a sudden drop in oil prices. October—The Russian parliament approves a $68 billion package of measures to help banks hit by the global credit crunch.
2009: January—Russia stops gas supplies to Ukraine over a row over unpaid bills and gas prices. Supplies to southeastern Europe are disrupted for several weeks as a result of the dispute. April—Russia ends "counterterrorism operation" against separatist rebels in Chechnya, one month after President Medvedev said life in the republic had "normalized to a large degree." May—Russia's uranium export company signs a groundbreaking $1 billion package of contracts to supply three US utilities with enriched fuel for nuclear power plants. June—Swedish retailer IKEA announces that it is suspending its investment in Russia because of the "unpredictable character of administrative procedures." July—President Medvedev and Barack Obama, on his first official visit to Moscow, reach an outline agreement to cut back their countries' stockpiles of nuclear weapons.

Source: http://www.russiaproject.org/part2/then_now/timeline.html; http://timelinesdb.com; http://news.bbc.co.uk/1/hi/world/europe/country_profiles/1113655.stm.