SUERF Workshop and Special OeNB East Jour Fixe

Current Trends in the Russian Financial System

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On January 23, 2009, the OeNB hosted a one-day workshop on "Current Trends in the Russian Financial System" that was jointly organized by SUERF – The European Money and Finance Forum and the OeNB. More than 100 Austrian and international participants followed the presentations of high-profile international speakers. The major contributions and results will be published in the SUERF Studies series (Study 2009/2) within the next months.

Introduction: CESEE Region, Including Russia, Seriously Affected by Global Financial Turmoil

The event was opened by OeNB Governor *Ewald Nowotny* and SUERF Vice President *Philipp Hartmann* (ECB). Governor Nowotny stressed the impact of developments in the CESEE region on the rest of Europe and addressed the challenges that the region currently faces in the context of the global financial crisis. He pointed out that the CESEE countries, including Russia, have to take the primary responsibility for their financial systems. At the same time, Governor Nowotny highlighted an initiative by several European (including two Austrian) banks, which pleads in favor of broad support of the region by the European Union. He added that it is indeed in the interest of the EU to monitor developments in the region and to look for ways to be helpful. Hartmann introduced SUERF and outlined the key issues to be discussed in the course of the workshop: What are the main structural features of the Russian banking system? Should the Russian banking system be opened up to more foreign investment? How strongly does the global crisis affect the Russian financial system? What are the country's macroeconomic and growth prospects? How can the contribution of the financial system to growth and prosperity be improved?

Keynote Session: Russian Finance: Drag or Booster for Future Growth?

In the introductory keynote session chaired by *Ernest Gnan*, Head of the OeNB's Economic Analysis Division, *Pekka Sutela*, Head of the Bank of Finland Institute for Economies in Transition (BOFIT), gave a speech on Russian finance and its implications for future economic growth. Sutela emphasized the dominance of the energy sector in the Russian economy and delineated the associated dual structure of the financial system where, on the one hand, the natural resource-dominated sector is integrated in the world financial market (and, thus, does not primarily rely on domestic funds) and, on the other hand, only a low share (about one-third) of domestic households have their own bank accounts. This duality makes for a comparatively small banking sector in Russia. Sutela assessed the ongoing devaluation of the Russian ruble as a major challenge for future (consumption-based) economic growth. He pointed to the 1998 experience as a possible benchmark for comparison: Devaluation at that time did not really result in economic diversification or an improvement of export market competitiveness. Therefore, according to Sutela, an imitation strategy analogous to China's would be the most promising strategy to improve Russia's competitiveness, but such a strategy conflicts with the current regime's post-superpower mentality. In the ensuing discussion, possible positive impacts of the devaluation of the Russian ruble and of the falling oil price for Russia's competitiveness (or inclination to reform) were put forward. However, Sutela contended that due to currently higher capacity utilization, the present devaluation is not likely to trigger the same supply response as the 1998 devaluation did. Moreover, the 1998 oil price decline did not give rise to structural diversification, so why should the energy price dive do so now?

Session 1: Banking Sector Development and Financial Deepening in Russia

The first session, chaired by *Otto Lucius*, CEO of the Austrian Society for Bank Research, addressed the structural issues of the Russian banking sector and provided facts for the process of financial deepening during the last two decades.

Stephan Barisitz, economist at the OeNB's Foreign Research Division, surveyed the development of Russian banking in recent years. He pointed out that the strong Russian banking expansion was supported by robust economic growth, which was itself underpinned by steadily rising oil prices. The credit boom, which had been fueled by accelerating, if volatile, capital inflows, ground to a halt in late 2008 under the impact of the severe international financial crisis. Given the continuing and deep decline of the oil price and unrelenting pressure on the Russian ruble, deposits were hit even harder and started to shrink in the fall of 2008. According to Barisitz, whether a crisis of confidence in the banking sector can be fended off or not will depend on when and at what cost to Russia's still ample financial resources confidence in the ruble can be reestablished and to what degree banks facing upcoming credit defaults will need assistance. Irrespective of the current crisis, Russia's level of FDI in the banking sector can be regarded as relatively low when compared to that in other CESEE countries, but not necessarily all that low when compared to levels observed in other large countries (e.g. Germany, France, Brazil or India), Barisitz added in the discussion.

In his speech on the role the banking system played in Russia's growth spurt until mid-2008, *Alexander Lehmann*, Senior Economist and Country Economist for Russia at the European Bank for Reconstruction and Development (EBRD), said that domestic banks' credit growth had a limited effect on the financing of investment. He also pointed out that the impact of the current credit crunch may constitute an opportunity for banking sector consolidation in Russia. While some of the country's presently 1,100 banks are viable, others will go through a process of mergers and recapitalization which will reduce the overall number of credit institutions. Lehmann added that it was essential to create a sufficient level of trust in order for the interbank market to regain a certain degree of functionality. He stressed that bank asset quality problems were only about to hit balance sheets. In the discussion, Lehmann pointed to expert estimates that a nonnegligible number of mostly very small banks were nonviable and might go under.

Cyril Pineau-Valencienne, CEO at CPV Conseil in Paris, spoke about Russian financial institutions, oil and gas sector funding and the related recycling of oil and gas revenues. He emphasized the substantial increase in capital needs for necessary investments in the oil and gas industry, which cannot be met solely by domestic financing, thereby underlining Sutela's argument of a dual financial system being in place in Russia. In this context, the special role of international banks and enterprises was highlighted in the discussion of how to finance the new North Stream and South Stream gas pipelines. Wrapping up the results of this session, Lucius said that Russia's macrofinancial situation was fairly gloomy, but that there was still room for optimism.

Session 2: The Role of Ownership for the Performance of Russian Banks

The second session, chaired by *Doris Ritzberger-Grünwald*, Head of the OeNB's Foreign Research Division, investigated the role of ownership in the performance of Russian banks. Both presenters in this session, *Zuzana Fungáčová*, economist at BOFIT, and *Koen Schoors*, Professor at Ghent University in Belgium, provided econometric results for data on quarterly balance sheets and profit and loss accounts of banks operating in Russia, compiled by the CBR and covering the period from 1999 to 2007.

Fungáčová analyzed the relationship between bank characteristics and banks' risk-taking and found that risk-taking levels in Russia are still below those observed in CEE. Moreover, bigger banks, regional banks and foreign-owned banks show a more pronounced risk-taking behavior than smaller banks, Moscow-based banks and domestically-owned banks, respectively. State-controlled banks are on average more stable than private banks and, given the current crisis, the role of large state-controlled banks is expected to strengthen. (Majority-state-owned credit institutions accounted for 41% of total banking sector assets at end-2007.) The discussion revealed that one rationale for foreign banks taking higher risks could be their better capitalization structure as well as their targeted focus on gaining additional market shares.

Schoors, by contrast, explored the relationship between Russian banks' cost efficiency and ownership structures and concluded that private banks are not more efficient than public banks and that foreign-owned banks are more efficient than domestic private banks. Schoors thus advocated giving preference to a stronger penetration of the Russian banking sector by foreign banks (pointing to beneficial effects caused by a higher degree of competition) rather than to bank privatization by selling to domestic investors.

Session 3: Impact of the Global Financial Crisis on Russia – Keynote & Panel

The third session, chaired by *Morten Balling*, SUERF and Aarhus School of Business, Denmark, took a more up-to-date perspective and discussed the impact of the ongoing global financial crisis on Russia.

In his keynote speech, *Zeljko Bogetič*, Lead Economist and Country Sector Coordinator for Russia at the World Bank, highlighted that Russia's economy had been able to decouple from the global financial distress only until mid-2008, when the decline of oil prices and the sudden stop of capital inflows – the twin engines of Russian growth – induced a sharp liquidity crisis and substantially worsened the macroeconomic outlook for 2009. In defending the stability of the Russian ruble's exchange rate first and then allowing a controlled depreciation, the CBR lost an important share of its foreign exchange reserves from early August 2008 to late January 2009. Assuming an average oil price of USD 50 per barrel for 2009, Bogetič expects that real GDP in Russia will not grow at all and might even shrink by 2% in 2009. At the same time, both the current account and government budget surplus are likely to turn into a deficit and capital outflows are expected to be strong. Bogetič highlighted the limited response to the monetary and fiscal policy measures taken so far and, as Russia apparently has room for extra government spending, advocated an additional fiscal stimulus of about 3% of GDP (coming from the Reserve Fund). In particular, he stressed the necessity to support the most vulnerable segments of society, as wage income is expected to decrease significantly in 2009.

In the accompanying panel discussion, *Peter Havlik*, Deputy Director and Senior Economist at The Vienna Institute for International Economic Studies (wiiw), contrasted Russia's previous achievements – such as the comparatively strong rise in incomes, the strong increase in foreign exchange reserves and FDI inflows; and the repayment of external debt – to the country's massive dependence on the energy sector and the economy's need for diversification. Somewhat at variance with Sutela's statements above, Havlik pointed to potential positive effects of the current devaluation of the Russian ruble that should raise Russia's competitiveness and to the lower oil price, which could open more room for economic diversification. In contrast to Bogetič, Havlik was slightly more optimistic about growth and budgetary outlooks. He expected real GDP to grow slightly by 0.5% in 2009 and referred to an oil price of USD 40 per barrel as being high enough to ensure a balanced budget.

Debora Revoltella, Head of CEE Strategic Analysis at UniCredit Group Bank Austria, attributed Russia's strong economic growth of previous years to domestic investment and consumer demand, supported by the rise in oil prices. Compared to other CESEE countries' domestic banking sectors, the Russian banking sector played a smaller role in driving economic growth. Revoltella identified credit quality as the next challenge for the Russian financial sector. As retail lending experienced a particularly high growth in the years prior to the crisis, the share of nonperforming loans in total loans is expected to increase in the coming years, possibly peaking in 2010 at around 14% for the top 30 Russian banks. In this connection, the persistent rise of loan-to-deposit ratios in recent years raises the risk of a future credit decline, Revoltella pointed out.

According to *Gintaras Shlizhyus*, CEE Senior Expert at Raiffeisen Zentalbank, Vienna, risk and spread premiums for Russia have overshot, given generally sound macroeconomic fundamentals. At the same time, Shlizhyus pointed to the decline in international reserves and the devaluation of the Russian ruble during the financial turmoil. His remark on the necessity of "letting the ruble go," of reducing foreign currency interventions and of adopting inflation targeting sparked a debate on changes that might be necessary in the Russian exchange rate policy.

Morten Balling finally closed the event by summarizing the main messages of the day. He emphasized the still dominant position of state-owned banks and the as yet limited presence of foreign strategic investors in the Russian banking sector and pointed to the low direct exposure of the population to stock market volatility, given that less than 2% of the population hold stocks. While recognizing that present challenges for Russia are serious, he recalled achievements of prudent fiscal policy such as the reduction of government debt and the building-up of large foreign exchange reserves that – together with twin surpluses, the Reserve Fund and the National Wealth Fund – serve as important buffers for current crisis management.