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Foreign investments, ruble exchange rate and restructuring of the Russian economy

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Author analyses the impact of foreign capital outflow on ruble exchange rate as an instance of vulnerability of the current national economy structure and suggests ways of improving economic policy of the Russian state.

Foreign investments in Russia: regularities and contradictions

From the start of economic reforms in Russia in the 1990s special stress was made on attracting foreign investments as the economy lacked «long money» and new technologies, usually associated with foreign direct investments (FDI). To create an attractive investment climate, Russian authorities consistently met demands of western partners, and eventually abolished currency control and trans-border capital movement restrictions.

But, even despite those obstacles in the early 1990s, the most motivated investors managed to acquire shares of the most attractive Russian base materials enterprises. It was when the large-scale privatization and parade of economic sovereignties of the Federation subjects created previously unimaginable access to the most valuable Russian assets, as viewed by the West. It was then that Russia received the most considerable percentage of FDI per year.

When all attractive assets found their new owners, it became clear that further transfer of ownership would be quite complicated, and foreign partners began to stress liberalization of market rules and greater transparency of large Russian companies to increase the chances of becoming their shareholders, no matter major or minor. The process was complex and slow, and foreign capital inflow began demonstrating new trends.

First – speculations on Russian currency and stock markets, which, just as many other rising economies' markets, were prone to high volatility and sensitivity to various information manipulations and other methods of forming short-term fluctuations.

Second – credit financing of the Russian business (for imports and for terms over 180 days). This trend found major support in the Russian government's policy of restricting internal money supply with the view of fighting inflation and accumulating reserve funds to confront sharp declines in Russian export goods' prices. The Bank of Russia (BR) had practically refused from being the lender of last resort – the role inherent to central banks of many developed countries – letting private business finance the economic growth alone.

Russian economy structure: seeking balance

Consequently, Russia ended up with a very peculiar economy structure, based on integrated extracting and exporting companies. But their integration did not follow suit of the developed economies with full production chains from extraction to final consumption and no unjustified intermediate price growth. The Russian model, on the contrary, provides primarily for integration with state authorities, based on understanding that raw material prices are volatile, and without support of the state, the largest Russian companies may suffer critical losses in times of market price declines.

This hypothesis was proved in the crisis of 2008-2009 when the Russian government supported core enterprises and banks by billions of rubles to prevent them from bankruptcy or collateral asset losses to foreign creditors. The state, after all, gave to the Russian business (its privileged part, to be precise) the financial resources, which previously, due to their deficit and high price on the internal market, Russian companies had to attract abroad. But the money was spent on payments to foreign creditors instead of production modernization and innovation within the country. In other words, a significant part of the reserves, accumulated during the period of high prices, returned to the West, with interest.

The conclusion seems to be obvious: national monetary policy should be changed. But, unfortunately, this is still not happening. And there is still no sign of adopting the successful experience of our major partner in the East – China, where the state kept its key role in economy, instead of total liberalization and wholesale privatization. The most tangible and, perhaps, the most offensive for partners from developed countries aspect of such approach is the «non-market» exchange rate of the Chinese yuan. The US believe that such policy creates great disparity in their trade with China in favor of the latter. In response to such criticism, a representative of China Foreign Ministry stated in one of interviews: «Maintaining the regulated floating exchange rate of yuan is the baseline policy of China. This mechanism reflects the long-term key interests of the country».[1]

[1] http://www.banki.ru/news/lenta/?id=2676577&r1=rss&r2=novoteka

A similar strict reply to criticism of Russia's actions was unimaginable up until recently. But the events in Ukraine and anti-Russia sanctions of the EU and US call upon the change of priorities. It is already taking place in the political sphere, but the key assumptions of Russian economic policy, dictating its vulnerability, remain unchanged. Despite the fact that, in its relatively short newest history, Russia has encountered clear demonstrations of such vulnerability, at least, three times.

In 1998, following the crisis in South-Eastern Asia and sharp decline in oil prices, the Russian economy entered a crisis that led to more than triple depreciation of ruble. In 2008, when the world was trying to cope with the global crisis, that originated in the US, the ruble plunged by more than 50%. In 2014, due to a number of reasons, anti-Russia sanctions and sharp oil price decline being the most obvious ones, the ruble lost almost half of its nominal value. All in all, in the last 15 years the Russian currency depreciated by nearly 10 times.

Trans-border capital movement and the Russian ruble exchange rate

The BR data demonstrate a record capital outflow in 2014 – USD 151,5 bln. It is 2,5 times more than in 2013 (USD 63 bln) and more than the record of 2008 (USD 133,6 bln). Outflow was especially high in Q4 2014 (USD 72,9 bln).[2] The bid for financing Russian business abroad led to USD 180 bln of outstanding foreign debt due in 2014. Even though, it was partially covered by export proceeds, net capital outflow from corporate and banking sectors hit USD 130 bln. USD 20 bln of that sum were covered by BR, which for the first time in its history – as a hint to acting as the lender of last resort – used currency REPO deals to help banks and companies pay their debts, which they were unable to refinance abroad due to sanctions.

Nevertheless, in December 2014 the situation began spinning: the regulator's late reaction to depreciation of ruble sparked the avalanche demand for currency from corporate sector and households, enhancing in turn the outflow of capital. Currency speculators made their contribution as well – in December 2014 correlation of the ruble/dollar pair fluctuations and the trading session volume, according to the author's calculations, rose to 0,7 (twice the regular average). As a result, capital outflow and depreciation of ruble, pushing each other, landed a massive blow not only to the Russian economy, but also to the foreign investors' trust, already ailing due to the sanctions.

Russian experts are now cautiously optimistic about the near future. Foreign debt due in 2015 is less than in 2014, and thus the capital outflow forecast is at USD 90-110 bln, which is still much more than the usual USD 60 bln in pre-crisis years.[3]

[2] http://cbr.ru/statistics/print.aspx?file=credit_statistics/bal_of_payments_new_14.htm

[3] http://ria.ru/economy/20150302/1050514119.html

Summing up, in the years of the new millennium, the diminishing state foreign debt has been replaced by the rapidly growing corporate foreign debt, thus creating another dimension of vulnerability of the Russian economy.

This can be demonstrated by the example of 2014. Despite the worsening economic situation, total foreign debt of Russia diminished for the first time in many years. The BR data show the total Russian foreign debt on January 1, 2015 at USD 600 bln (17,7% drop over a year). The state foreign debt plunged by 32,8% – to USD 41,5 bln, banking sector debt fell by 20,2% – to USD 171,1 bln. The major portion, just like in the previous years, remained in the corporate sector. It dropped by 13,8% – to USD 376,5 bln. Of which, foreign credit liabilities reduced from USD 268,4 bln to USD 229,9 bln.[4]

On the one hand, the data are optimistic: the total Russian foreign debt is down by USD 129,4 bln. But, on the other hand, the Russian state reserves fell by nearly the same amount – from USD 509,6 bln to USD 386,2 bln (by 24%). Thus, what happened in 2014 is very similar to 2008. Once again, the state paid to foreign creditors for Russian banks and corporations.

But that's not all. One should take into account that during 2014 the largest Russian companies, at the request of the Russian President, were selling their currency in the open market. For example, ROSNEFT sold about USD 93 bln.[5] Currency interventions of BR in 2014 amounted to USD 76,1 bln and 5,4 bln euro.[6] Thus, the real currency losses of the Russian economy in 2014 were significantly higher. And so were the proceeds of those who could benefit from depreciation of the Russian ruble.

It should be recognized that by failing to prevent another deep dive of ruble, Russia has once again impaired the attractiveness of long-term production projects on its territory. Why would foreigners invest in the long run and withstand all the drawbacks of business regulation in Russia, if every 7-10 years our country hands them an opportunity to earn the rate of return unimaginable in normal conditions. And in-between those occasions, foreign creditors can derive arbitrage and commission income, which, according to some estimates, amounts to USD 25-30 bln per year.[7] On top of it, Russian companies and banks borrow money from the financial pool of the West, to which our country regularly makes a significant contribution by allocating a considerable portion of its reserves in low income bonds of the developed countries, primarily, the US.

And all this is made possible thanks to the long-term bid of the Russian government on shrinking the internal money supply. It is hard to conceive why this paradox continues.

[4] http://cbr.ru/statistics/credit_statistics/debt_new.xlsx
[5] http://www.interfax.ru/business/422063
[6] http://www.interfax.ru/business/417256
[7] Россия и ЕС: особенности экономических отношений в современных условиях. БАНКОВСКОЕ ДЕЛО №2, 2015. С. 30.

Perhaps, the answer lies in the fact that every sharp depreciation of ruble, backed by massive capital outflow, is reimbursed not by Russian banks and corporations, nor even by the Russian state, but by its citizens. Naturally, nobody forces the people to catch the panic and offer excessive demand for foreign currency, thus pushing the ruble further down. But, on the other hand, in the newest Russian history the attempts of its citizens to protect their savings appear to be one of the most common forms of their participation in economic life of the country. And every time the panic subsides, representatives of Russian financial authorities invariably blame it on the «reckless» population.

Conclusions

1. For 25 years of reforms Russia has failed to attract the desirable amount of FDI. In 2014, as per BR data, direct foreign participation in the capital of Russian companies fell by almost 40%: from USD 0,41 trn to USD 0,25 trn.[8] As a comparison, at the beginning of 2014 FDI inflow stock in the Big China was equal to USD 2,5 trn, USA – USD 5 trn, EU – USD 8,5 trn.[9] It is equally important that Russia has received fewer of new technologies, associated with FDI and needed for modernization of national economy.

2. Apart from the base materials sector, FDI inflow stock in Russia is distributed mainly between retail trade and financial services. The number of modern industrial plants, especially «green field», built in Russia by foreign investors and producing competitive goods with considerable added value, does not correspond to the needs and scale of the Russian economy. Many of them are platforms for assembling consumer cars, production of which was halted due to sharp decline in demand. In general, current sector and regional distribution of FDI in Russia does not stimulate technology spillover, poor production interdependence between Russian and foreign-owned enterprises is evident.

3. Many years of the «sterilization of excessive rubles» have not led to tackling the inflation, because the policy does not eliminate the underlying causes of inflation in Russia. Experts believe that the latter stems from the abnormal structure of national economy biased towards natural monopolies and base materials export. On the contrary, this policy, by depriving Russian manufacturing industry of budget-friendly financing, aggravates the disproportions and further decelerates development of the Russian economy. The necessity to abandon the policy seems to be obvious, but it is also obvious that there is no clear vision of the mechanism that should replace it.

4. Skeptical attitude to financing economic growth by the state prevails in Russia. Along with the fear of galloping inflation, inherited from the 1990s, Russian economic authorities continue to believe that capital resources, provided by the state, are doomed to be spent inefficiently. The controversial example of Skolkovo innovation center, a focal point of many

[8] http://cbr.ru/statistics/credit_statistics/iip_rf_new_14.xlsx

[9] UNCTAD. World Investment Report 2014. http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf

hopes and considerable budget financing in recent years, serves to prove that for 25 years Russia has failed to find out how the state can invest in its own economy without the risk of public funds' misuse.

5. The solution exists. The recent quantitative easing policy in USA has revived the national economy without igniting inflation. Moreover, it stimulated inflow of foreign capital that began fleeing to USA from many regions of the world, including Europe. In response to that, the European Central Bank launched its own quantitative easing program, striving to avoid deflation in the Eurozone and to lower the excessive exchange rate of euro to dollar, impairing global competitiveness of the European economy.

6. The shift to internal financing is backed by anti-Russia sanctions, which limit the access of the largest Russian banks and corporations to their habitual foreign credit sources. It is obvious that the current economic model «cannot» transform the accumulated reserves into investments, otherwise it would have been done in the «fat years» of 1999-2008. At that time, the discussion on destination of the excessive oil export profits led to creation of reserve funds instead of investing the money into goal-oriented restructuring of national economy and minimizing its dependence on the base materials sector.

7. The change of economic model is dictated by the need for import substitution to make up the gaps opening in the internal market. Depreciation of ruble lowered consumer demand and affected the foreign partners who built retail networks and plants, assembling cars, producing building materials, household chemicals and food products. In the circumstances, state stimulation of demand for investment goods can motivate foreign investors.

8. State involvement in financing large infrastructure projects, including shared funding and guarantees, can signal good long-term prospects of this business for investors. Such projects should go well beyond trans-border pipelines and development of Arctic offshore fields, they must include construction of new and modernization of existing roads, development of electrical and gas infrastructure in populated areas, construction of modern houses and supplementary buildings. As long as the state does not invest in improving the quality of life of its citizens, foreigners will not be persuaded to do it instead of the state.

9. A good example to follow is the Chinese combination of extraordinary preferences to priority sectors and preservation of key regulating functions in the hands of state. The «non-market» yuan exchange rate and other «drawbacks» of investment climate did not keep China from becoming one of the largest FDI recipients in the world. Russia and China share not only the common non-capitalist past, but also the considerable amount of compatriot capital abroad. In this context, the capitals returning now to Russia under the amnesty law should not just relocate to Russian banks, the state should provide for their productive use.

10. The policy of smooth devaluation of ruble was launched in 2008. But its results stand in contrast with the achievement of US quantitative easing policy over the same period of time.

Of course, direct comparison of the two countries is not correct. Thanks to their geopolitical domination, USA were able to provoke a series of political events in the world that favorably influenced economic growth in the country during that period. And, of course, the quantitative easing did have negative impact on savings of American households, estimated at almost USD 0,5 trn.[10] But, as mentioned earlier, the smooth devaluation in Russia ended up by the plunge of ruble in December 2014, record capital outflow and depreciation of savings by 1,5 times. Taking into account the scale of Russian economy, this damage is more considerable, and is expected to increase in 2015 due to forecast GDP reduction by 3-5%, inflation growth by 12-17% and fixed capital formation cut by 14-19%.[11]

11. The way out should be sought in an efficient transformation mechanism of state reserves and household savings into productive investments. This will mean rejection of the current policy of ruble emission based on purchases of foreign currency. As per international experience, the ruble can be backed by security papers of large Russian companies, development institutions, construction and other priority sector enterprises. BR should play a greater role in stimulating economic growth as the lender of last resort and market regulator. In particular, instead of the inefficient currency interventions, large currency purchases by Russian companies (for foreign debt payments) can be closed at a set rate outside open trading sessions, to avoid additional pressure on the ruble.

12. Russia is said to have recently started regaining its role in the world politics thanks to a more independent and self-oriented approach to global agenda. A similar shift is imminent in economic policy. It is vital to realize that for the last 25 years our economy has been evolving within tight boundaries of the rules, traditionally used for developing countries in crisis. Only independent economic policy, free of the dogmata and restrictions of the recent years, can lead our country to success in the long run.

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[10] http://finance.yahoo.com/news/fed-policies-cost-savers-470-144516821.html
[11] http://top.rbc.ru/economics/05/03/2015/54f827049a79472d38a9407e