

# Russian Financial Markets: Lessons of the Economic Crisis



By Prof. I.V. Kostikov, Director of Sciences, Institute for Securities Market and Management (ISMM)

*To say that it was only crisis that opened everyone's eyes on imperfections of the Russian financial market would not be saying the complete truth. Most of the weaknesses of the financial sector have long been known. At the times of a relatively stable economic environment, however, the effect of these imperfections on macroeconomic mechanisms was not that devastating, so they did not give rise to specific concerns of financial authorities. It was the crisis that highlighted the imperfections and turned them into problems that have to be solved on a first-priority basis.*

To a large extent, the Russian financial sector is fairly autonomous; its links with the real sector of the economy are much looser than in other industrial economies. The financial market in Russia lacks procedures and mechanisms for financial assets turning into investments, and for cross-sectoral flow of capital. The financial market is generally regarded as a site for playing speculative games, with a limited pool of players and a narrow range of traded instruments.

Moreover, main players are foreign investors engaged in dealing Russian income-bearing and liquid securities. Insufficiency of the market depth and tightness of the national investment base have become obvious in the recession.

This, of course, is a problem of great concern, because the financial market fails to fulfil its functions to the full extent. When conducive market conditions prevail, however, companies of the real sector normally find alternative ways to satisfy their financial requirements without recourse to the financial market. This is why the Russian regulatory authorities, while recognising the above mentioned

failure, did not take decisive actions to solve the problem. The fact that speculative operations dominate the market cannot be taken for granted. Under crisis conditions, this fact has manifested itself in dual way. On the negative side, the crisis that first affected the financial market turned out to be very acute because of the market's insufficient depth; on the positive side, the troubles on the financial market had little direct effect on the real sector of the economy.

Poor protection of private property in Russia is a major fault that has become particularly apparent over the recent years. At the same time, while the effective legal base may be considered a satisfactory one, notwithstanding its being declarative to a certain extent, the existing law

enforcement practice and procedures for implementation of legal provisions should be improved resolutely. The problem also tends to

be aggravated by growing cartelization, price collusions and frequent cases of insider trading. Such developments distort market mechanism and violate interests and rights of financial services users. It is worth noting that a package of documents designed to improve the situation is already completed and supposed to be adopted in the short run.

The impact of the above developments on the financial sector is fairly evident. The domineering pursuit of money adversely affects the development of property and, therefore, of the material base for

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real product manufactures, and becomes a significant obstacle to the investment flows into the real sector of the economy. The crisis environment makes the problem ever more acute. Since no practical protection of private property is available, property owners are deeply concerned about preserving their liquid assets through extorting money in every plausible way to the detriment of preserving property in kind. Such behaviour both aggravates the crisis-related trends and put constraints on further economic development.

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Corporate management is normally associated with strategic planning, risk management, assessment of markets and estimation of long-term macroeconomic trends, as well as with other material aspects of long-term business development.

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Whereas a number of industrial enterprises, in one way or another, have succeeded in arranging corporate management, financial corporations have ignored the practice completely. Because of such short-sighted attitude, most of the players were caught by the crisis at their weak point when they were not ready to resist negative developments. This was evidenced by slapdash and inconsistent actions by many market players.

At the same time, the non-financial sector of economy lacks integrity and is functionally segmented. It is particularly true for the banking sector, which has loose connections with the real sector and financial

markets in terms of both cash flows and instrumentation. As a consequence, the banking system failed to fulfil its protective function through assuming credit risks. Situation is similar in many other countries as well, though in the Russian market it has showed up in a particularly pronounced manner due to the fact that personal savings could not find the way to the financial market and were mostly deposited in the banks. Therefore, the procedure for writing risks off banks' balance sheets on account of reserves does not work. The fact that this way personal savings have not been directly affected by the crisis may be seen as a certain consolation.

The current condition on the REPO market poses yet another problem of great concern in terms of liquidity maintenance and regulation. Till now, transactions in the said market were effected on the actual basis without a proper legal base. In other

words, the market reposes on mutual confidence, which could hardly be counted upon during a grave economic recession. In times of recession, when liquidity-related problems grow and the threat of potential bankruptcies by counterparties becomes a reality, markets collapse and in fact cease to exist. This how it was during the

1998 default; but, regretfully, no conclusion has since been drawn from that experience, and the same situation occurs again. In this regard, it is worth noting that a package of documents constituting a legal base for REPO market operation is now being developed and prepared for further adoption.

The above mentioned problems pertaining to unavailability of mechanisms for protection of proprietary rights and proper corporate management practices directly affect banking activities and, in particular, the credit-related ones. In such circumstances, it becomes more and more difficult to objectively assess risks of certain borrowers or collateral provided as a security. After all, when proprietary rights are not regulated properly, who would reasonably rely on any offered collateral?

This is also true for assessment, in particular, in a longer term, of a borrower with improper corporate management practices. Professional bankers call it uncertainty of credit risks that adversely affects credit cost and the amount of associated established reserves, and entails negative consequences for the economic development at large and integration of private and real sectors.

The economic crisis has not posed many new problems since most of them have been well-known and fairly evident for a long time already. However, the crisis has clearly demonstrated insistent necessity to find reasonable solutions to the said problems, in particular, when we consider the same from a post-crisis perspective.

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