Event Summary

High interest rates will hurt Russia more than any sanctions

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Amid the growing political tensions between Russia and the West, the world's top economists and politicians are unanimous that the Russian economy will get worse and worse under new waves of sanctions.

But none of them mention that Russia is just as likely to hurt itself with its own damaging monetary policy.

While the global economy has started to recover from the 2008 crisis, led by a moderate upturn in high-income countries, Russia has been facing a continued slowdown as a result of self-inflicted wounds.

In 2013, Russia's gross domestic product rose only 1.3 per cent versus an initial projection of 3.6 per cent. For the current year, the most optimistic assessment is 0.5 per cent. Most probably it will end up with negative GDP growth. In fact, the Russian economy has already contracted by half a per cent during the first quarter, prompting the International Monetary Fund to declare that the country is in recession, following two successive quarters of negative growth.

To compound this, capital flight from the country has increased exponentially – $60bn in the first quarter – with the IMF estimating outflows of around $100bn for the year.

Russia's central bank recently raised its key lending rate to 7.5 per cent in an attempt to reduce inflation. This was the second successive increase in as many months, from a base of 5.5 per cent in February. Although the aim was to bring inflation below 6 per cent, it has inadvertently multiplied the woes of many under-strain Russian companies.

In the past, a growth model based on large investment projects and soaring public sector wages – bankrolled by oil and gas – obscured both the absence of essential structural reforms and a lack of diversification in the Russian economy. More importantly, the distortion in economic activity, concentrated primarily on the extractive industries and the state sector, has been detrimental to manufacturing, consumer goods and agriculture, which have scarcely modernised since the turmoil of the 1990s. Electricity, gas and rail transport costs for companies have skyrocketed, also driving inflation.

If the Russian Federation wants to increase its global business competitiveness, it should allocate resources so as to modernise infrastructure, improve labour productivity, establish new production facilities and significantly upgrade existing ones. The tight monetary policy exercised by the finance ministry and the central bank has resulted in soaring borrowing costs for companies: larger entities typically draw funds from local financial institutions at an interest rate of 10 per cent a year, with smaller enterprises facing borrowing rates of up to 15 per cent. As if this was not bad enough, loan maturity periods tend to be short, with even sizeable corporations struggling to secure credit arrangements for longer than five to seven years. Acquiring credit through the main – and more solvent – state lenders (Sberbank, VTB, VEB) is often fraught with further inconvenience.

Compared with interest rates and loan terms offered to entrepreneurs in the West or in China, it becomes blindingly obvious that Russian companies are handicapped by a substantial competitive disadvantage.

The situation is aggravated by the deepening crisis in Ukraine, making it harder still for Russian businesses to secure financing abroad. This leaves Russian financial institutions as the only valid option for badly needed investment money; however the country's banking sector has recently been facing extensive liquidity pressure due to the accelerating capital flight.

The central bank is also reorganising the whole banking environment, on the one hand by imposing stricter prudential rules under the Basel III regime, and on the other by reducing the current 900 banking establishments. This has increased instability in the sector.

The situation becomes even worse in the regions, where few Russian banks control sufficient assets to finance large-scale business projects. The costs of running a branch network in such a vast country make it impractical for many institutions to open outlets outside the largest cities. The lack of reliable medium-size regional banks means companies have to look to Moscow for financing where borrowing rates and conditions remain at a level that merely allows Russian companies to survive, but not to thrive, against foreign competitors.

For the time being, Russian firms remain reliant on Western financial markets for their credit.

Overseas banks have extended a total of $242bn of loans to Russia, $121bn of which needs to be rolled over in the next 12 months. Vnesheconombank, Russia's state development bank, has just repaid a three-year loan of $2.45bn, alarmed at its prospects of securing fresh funding amid the threat of sanctions. Rosneft has been planning to obtain up to $5bn through oil major BP, syndicated from a consortium of European banks. Other Russian companies that have discussed raising debt with foreign lenders before the political tensions escalated include Metalloinvest, Novolipetsk Steel, Uralkali and Vimpelcom.

Any large-scale sanctions against the country would risk shutting out Russian corporations from financial markets and could squeeze the entire economy. As global creditors will become increasingly reluctant to prolong loans, or be debarred from doing so, the existing credit exposure of Russian firms should be substituted by internal sources, which in the present environment will prove challenging. The central bank maintains that without creating the conditions for macroeconomic stability, there can be no long-term development, claiming that lowering base interest rates would be counter-productive as it would boost inflation.

We should be under no illusion. The fiscal policy change that is needed will not happen quickly. Russia will only have a truly competitive economy and thriving businesses once it confronts its inner enemy. That can only happen through access to affordable borrowing through lower interest rates.

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