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Evaluating the Effectiveness of Government Intervention in the Stock Market: Evidence from Russia

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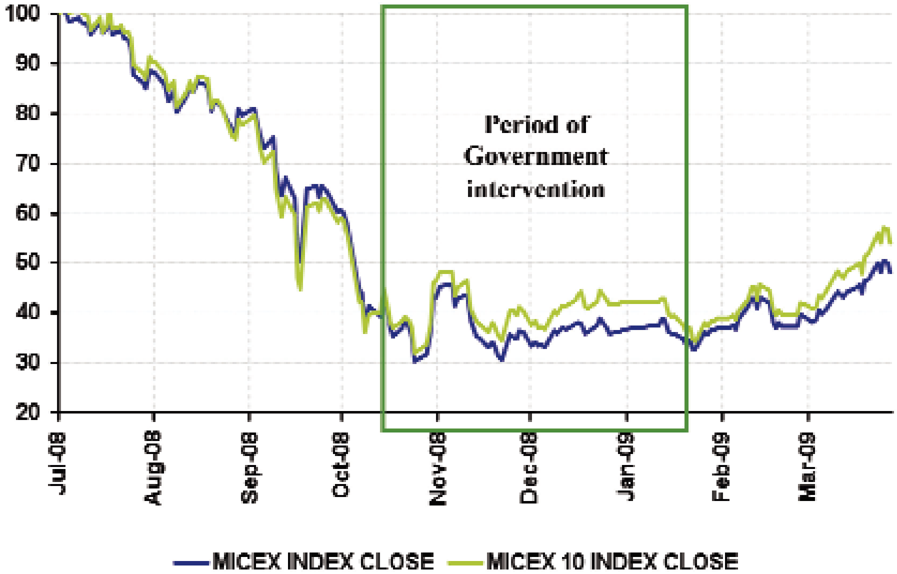
The effect of the measures taken by Vnesheconombank (VEB) to support Russia's stock market was quite limited. Government intervention led to slight increase in the prices on blue chips, which were the main target for support[1], during the intervention period. The effect of interventions became negligible in the post-intervention period (Chart 1). This inevitably rises the question about the overall effectiveness of the chosen support mechanism.

Chart 1.MICEX, MICEX Oil&Gas and MICEX 10 stock market indices dynamics[2]



To increase the effectiveness of implemented measures, it is reasonable to change the mechanism and procedure of support:

- To make VEB operations in the stock market more concentrated by volume and to possibly shorten the term of intervention;
- To declare the period of government investment in the stock market and the shares sale procedure after the end of this period;
- To publicly announce the criteria and principles of companies selection, link these principles with sustainability indicators of investee companies;
- To develop insurance instruments for individual investments in the stock market with the purpose to restore confidence and to develop national base for investment in the stock market.

Measures to support the stock market implemented by Russian government

Sharp decline in the Russian stock market indices created substantial risks for the country's financial system and the real sector companies:

- risk of claims for advance repayment of loans attracted by Russian companies (margin calls),
- risk of loss of national control over large companies in the real sector,
- risk of negative impact of falling stock market indices on the stability of the banking system.

To prevent possible negative effects of crisis on the stock market Russian government made a decision to support the market by investing in it a part of government budget funds. In 2008 the government allocated 175 billion rubles from the National Wealth Fund to VEB for investment in the Russian stock market.

VEB invests funds into Russian blue chips, which form Russia's main stock indices, and corporate bonds with credit rating higher than BB-. The mechanism of companies selection was not announced.

The Government intervention in the stock market started in the end of October 2008 and ended by the end of January 2009. According to market participants, daily VEB purchases averaged 5 million rubles (note: daily trading value in MICEX index constituents accounted for 20-25 million rubles during the intervention period). According to VEB Chairman V. Dmitriev, depending on the situation on some days VEB did not intervene and just contemplated.

[1]By Pyotr Kazakevich, Deputy Head of the Department for International Relations, Ministry of Finance
[2]MICEX 10 index consists of 10 most liquid shares circulating on MICEX stock exchange.

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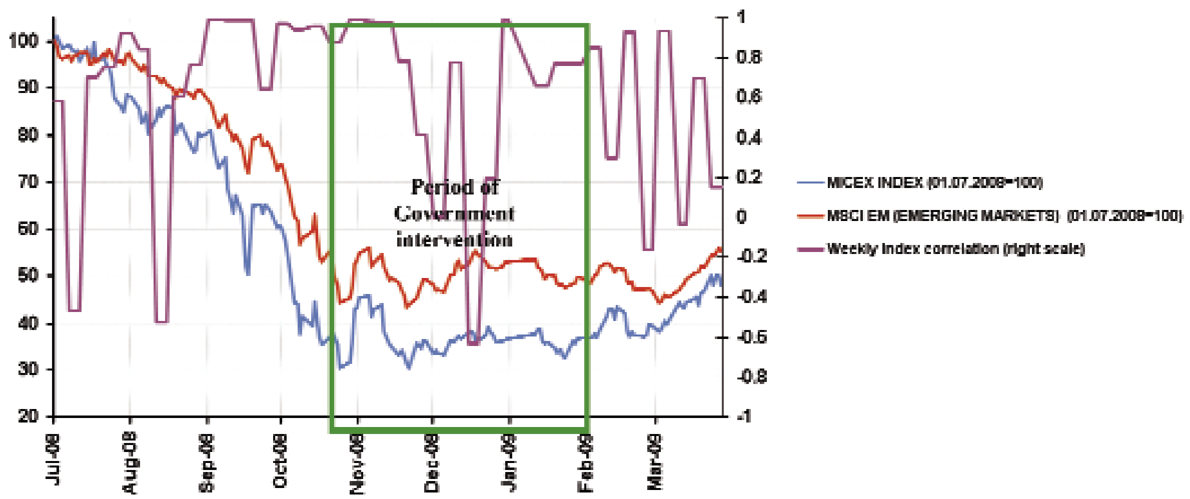
Risks and problems that resulted from the Government intervention in the stock market

First. The risk of absence of a substantial systemic effect because of deconcentration of resources

Experience of successful stock market support in Hong Kong in 1998 shows that effective support should be comparable with the daily trade volume (75% in Hong Kong) and focused on short time (2 weeks in Hong Kong).

On the contrary, Russian stock market support was implemented in small volumes during long period. Support volume averaged 20% of the daily trading value in MICEX index constituents.
Our analysis shows that VEB operations in the stock market did not result in any substantial positive effect. MICEX index was highly correlated with MSCI EM index during the pre-, post- and intervention period (Chart 2).

Chart 2 .MICEX stock market index and MSCI EM (emerging markets) index dynamics



Second. The risk of absence of a positive effect because of speculators' withdrawal from the market after VEB's entrance This risk increases in case of predictable time of VEB operations. According to market participants, in October 2008 VEB started purchases by the end of trade day thus increasing shares' closing prices. Speculators could probably capitalise on the expected VEB behavior. After shares increased in price because of VEB operations they may have withdrawn from the market.

Third. The risk of absence of a positive effect if market participants expect VEB to sell large holding of shares in indefinite future

Uncertainty about future VEB operations with large holding of shares rises in the absence of clear VEB investment procedure of funds. Market participants may be concerned about unexpected large sales by VEB in future. As a result, the market's systematic risk may increase which may lead to conservative investors' withdrawal from the market. This risk is not imminent, but may arise in the long run.

Fourth. The use of National Wealth Fund for stock market support increases risk of Russia's sovereign credit rating downgrade by international rating agencies.

Standard & Poor's Ratings Services revised Russia's sovereign credit rating outlook from stable to negative because Russian government adopted a more risky control strategy of the National Wealth Fund means. Later, the sovereign credit rating itself was lowered.

Fifth. VEB interventions may be interpreted by other investors as bailouts in the absence of clear criteria and principles of stock selection.

This may lead to withdrawal from these shares by private investors. This also reduced the effectiveness of government intervention.

How to improve the mechanism of Government support of the Russian stock market

First. The volume of VEB interventions in the stock market should be increased to ensure a significant systemic effect.
VEB should probably shift from daily purchases to infrequent large-scale interventions. Hong Kong's experience shows that only concentrated intervention significantly influences stock market evolution.

Second. The Government should develop mechanisms of exit from the purchased shares and make these public.
This mechanism may adopt a Hong Kong experience of combining shares into an exchange-traded fund and holding a subsequent public offering.
Disclosure of criteria and principles of liquidation of VEB stock holdings is necessary to eliminate private investors' concerns about large unexpected sales of purchased stock.

Trird. The Government should develop transparent criteria of stock selection for interventions to eliminate investors' concern in governmental bailouts of companies that are experiencing troubles.

Criteria should include the requirement for sustainability of business models employed by companies. Transparent criteria of stock selection will encourage private investors to «follow the leader».

Fourth. VEB should avoid entering the stock market according to a predetermined schedule. This will make it harder for speculators to benefit from government interventions.

Fifth. The Government should develop a mechanism to insure retail stock market investments for a modest premium. The Brazilian fund PIBB experience may be adopted.

Insurance will support restoration of individual investors' confidence in the stock market. This will strengthen the domestic base for the stock market investment.