

The Real Sector and the Banking System¹

V.I. Maevsky, RAS Institute of Economics, Moscow

The way the financial and economic crisis has evolved in Russia differs from similar processes in other countries. On the one hand, Russia has followed other developed nations decapitalizing the assets of organizations in the financial and real sectors, trimming solvent demand, slowing down economic growth rates, increasing unemployment levels, etc. But, on the other hand, the Central Bank has increased the refinancing rate to 13% whereas other developed countries have cut it to the lowest possible levels; interest rates like MIBOR have been on the rise, although similar rates in Western countries (LIBOR and EURIBOR) have been going down. The inflation rate in Russia is expected to hit 13%-14% in 2009 while it is likely to be zero in the euro zone and the United States. Finally, although the United States provoked the global crisis, it is the Russian ruble, not the United States dollar, that has been losing value.

I believe that one of the reasons why the Russian economy has been behaving in such an unusual way is that the balance between the banking system's credit potential and the real sector's credit needs in advanced economies is different from what it is in Russia. The advanced economies have "credit surpluses" whereas Russia has been beset with "credit deficits" in the last 17-18 years. In the 1990s this deficit affected both short and long money. Recently, there has been a deficit of long money.

Generally speaking, it is difficult to accurately quantify a "credit deficit" (surplus), unlike a budget deficit (surplus). Still, this should be done. Let us calculate v using the following formula:

$$v = \frac{CF}{CN} - 1,$$

where CF is the banking system's actual ratio defined as the banking system's assets over GDP; and CN is what we might call the national banking system's normalcy ratio.

If CN were a known value, then we might say that with $v = 0$, a country's banking system matches its real sector. If $v > 0$, the banking system has surplus assets versus the real sector, i.e. a "credit surplus." Finally, if $v < 0$, the banking system falls short of the real sector (a "credit deficit"). So, the thing is to define the value of CN .

Let us assume that "credit deficits" are typical of countries migrating from the command economy to the market and are not typical of countries with centuries of ongoing market evolution. In this case, the CN estimate

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should be derived from a multitude of actual *CF* ratios for countries with many centuries of market history where banks play a dominant role in the financial system.

If our assumption is correct, a *CN* can be taken as the minimum *CF* ratio typical of countries with many centuries of market history. In Russia, the banking system's assets/GDP ratio was 39% in 1998, compared with 200%-300% in most of the leading countries (Germany, Japan, the UK, Switzerland, and others) (M. Ershov, 2001). Accordingly, the 1998 *CN* was about 200%². That being so, v for the Russian economy in the same year of 1998 equaled about $-0.8 \left(\frac{39}{200} - 1 \right)$, which suggests that Russia's banking sector was substantially behind its real sector. The situation has improved in the last 10 years (1998-2007): the banking assets/GDP ratio in Russia increased from 39% to 61%, and assuming that the *CN* value did not change over the 10 years, v dropped to -0.7.

"Credit surplus" economies behave substantially differently from "credit deficit" economies. The former are looking for ways to extend lending, including long-term lending. Typically, they have quite low, and at times extremely low, interest rates and their economic growth is accompanied by low inflation rates. The real threat of cash bubbles appearing is offset by the just as real potential to make large-scale scientific, technological, economic and social advances (more than 70% of Americans live in comfortable homes – not least because of the notorious subprime rush that pushed the global economy into crisis). At the opposite pole, economies like Russia's have to operate amidst high interest rates. In turn, high interest rates can provoke inflation. These economies avoid cash bubbles. But, for one thing, growth based on a country's own banking system is either extremely limited or impossible. For another thing, there is more need for foreign borrowings.

What has happened in Russia since 2004 has been the growth of the government's and Central Bank's foreign currency reserves, on the one hand, and a surge of external borrowings, on the other. Most of the borrowers are exporter companies and system-forming banks. As a result, the country has received additional cash resources needed for major investment projects, and the economic growth rate and real incomes growth rate in 2004-07 were higher than expected.

In the fall of 2008 when the crisis reached the Russian economy, the external corporate debt soared to an astronomical sum of almost USD 500 billion. With the positive trade balance slashed, servicing this debt resulted in the collapse of the ruble (because imports became more expensive) and led to other Russia-specific crisis consequences.

Both scientists and practitioners recognize that a "credit deficit" market economy model is ineffectual. At the end of 2008, the Russian Government approved a

² There is another way to estimate *CN*. For example, in O. Solntsev's opinion, it can be set at 100%, a little lower than the banking assets/GDP ratio of second-tier industrialized nations such as Greece or South Korea. See M. Talskaya. *Poslezavtra//Expert*, # 47 (541), December 18, 2006.

"Concept for the Long-term Social and Economic Development of the Russian Federation until 2020." This calls for:

- increasing bank loans to the economy from 40% of GDP³ in 2007 to 70%-75% of GDP in 2015, and to 80%-85% of GDP in 2020; and,
- increasing the banking sector's contribution to funding fixed asset investments from 9.4% in 2007 to 20%-25% in 2020, including by way of operationalizing government development institutes and expanding the long-term component of bank loans.

If these objectives are achieved, Russia's v should grow approximately from -0.7 to -0.3. One can only welcome such growth. But the question is how feasible it is. Wouldn't the current financial and economic crisis stand in the way of such growth? Inasmuch as the Russian banks have followed their Western counterparts to securitize assets and the securities of many companies have lost their value, v may now turn back and drop to -0.8 or even lower. It is obvious that government support is critical.

The crisis, however, will come to an end sooner or later. The question is: what would drive the growth rates of the banking system's assets which should be more than double the GDP growth rates until 2020 (provided v can rise to -0.3)? And another question: how would the monetary authorities react to such growth? This would mean active loan issuance, which in turn is fraught with inflation growth.

In January 2009, Finance Minister A. Kudrin (A. Kudrin, 2009) contributed an article to the *Voprosy Ekonomiki* journal saying that Russia "has allowed a certain weakening of monetary and fiscal policies in the last few years. ... Low interest rates have sustained in the economy, effectively negative in real terms, which has resulted in an upsurge of lending. Naturally, the economy has become 'overheated.' On the one hand, this has increased inflationary pressure and on the other hand resulted in a rapid growth of external borrowings."

The above quote leaves no doubt that each step toward an increased value of v until 2020 will meet with resistance from the Ministry of Finance. Firstly, a surge in lending activity that is bound to follow the growth of v will be interpreted as a weakening of monetary policy. This interpretation is correct if we talk about the German economy which has for years been operating in a "credit surplus" environment and allowing a so-called overheating of the economy by lowering interest rates. The situation is fundamentally different in Russia. We have an ineffectual "credit deficit," not a "credit surplus." For this reason, reducing the deficit would not be a weakening (or a softening) of monetary policy as A. Kudrin believes, but a process to *normalize* the banking system and bring it to a development level that fits the needs of the real sector.

Secondly, it is perfectly obvious that with each increase of v happening, A. Kudrin will remind us of the risk of upsetting the balance and pushing inflation up. Here is another quote from his article: "When an *equilibrium rate* (italicized by V.M.) is achieved, additional cash injections in the economy could again result in

³ To avoid any confusion, it should be noted that this indicator differs from our *CF*. The latter is the banking system's *assets*/GDP ratio.

liquidity surpluses and additional inflation growth, with the task of creating "long" money again postponed by several years... That being so, the Central Bank's policy to increase interest rates in the economy is quite justified." The quote addresses a serious theoretical issue.

A. Kudrin implies a *short-term* equilibrium. The Russian economy, however, will have to pass a number of such states until 2020 starting from $v_{1997} = -0.7$ and ending with $v_{2020} = -0.3$. Each time there will be the same threat of inflation growth. It would be wiser therefore not to refer to this threat as an argument against normalizing the Russian banking system but to take measures to eliminate all other factors contributing to inflation growth. For example, it is possible to neutralize such factors as the growth of gas, electricity, railway and utility prices. The annual growth of these prices could be replaced with long-term loans from Vnesheconombank (Development Bank) issued at a rate 3%-5% above LIBOR.

Let's get back to the key issue: what would be the driver of the banking system's assets growing until 2020 at a rate more than double the GDP growth rate in order ultimately to overcome the "credit deficit," first of all the deficit of "long" money?

While recognizing the deficit of long-term resources, A. Kudrin considers that "institutional investors and actively lending commercial banks should ensure 'long' money supply in the economy and stabilize the cash market in the long term." This is a key point. Leaving aside the difficult problem of institutional investors (who currently play an insignificant role in forming "long" money), it means that the government and the Central Bank will not be assisting the commercial banks to overcome the deficit of "long" money.

In the meantime, such assistance is needed. Considering that the long-term growth of lending activity by commercial banks depends on changes in their equity, which is derived from banking profits and subordinated instruments, one can say that the Russian banking system stands little chance of bridging the "long" money deficit on its own. Indeed, equity gains from profits are limited by high tax burdens (up to 34% of the profit) and by the lack of "long" money in the domestic market needed for subordinated loans. Only the government can reduce the profit tax for the banks, e.g. by exempting the portion of the profit that is used to increase equity. Likewise, only the government in the person of the Development Bank can purchase some of the subordinated bonds from the commercial banks. The EBRD is doing a lot in this respect, so why the local Development Bank can't do the same? And the last thing: on January 16, 2009 the U.S. Treasury invested USD 20 billion in the Bank of America in exchange for its preferred stock with an 8% dividend rate (www.federalreserve.gov/newsevents/press/bcreg/20090116a.htm).

References

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