



Initiative for Policy Dialogue

IPD Tax Task Force

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Financial Crisis, Economic Recovery, and Banking Development in Russia, Ukraine and Other FSU Countries

Haizhou Huang, Dalia Marin, and Chenggang Xu
IMF Working Paper WP04/105: full text available from www.imf.org.

At least on the surface of it, several aspects about the Russian economy before and after the financial crisis in 1998 just don't make sense. For instance, companies started building up massive arrears *after* macroeconomic policies had stabilized the economy, and barter trade exploded in 1994—despite the fact that many new banks had opened their doors in the years following the collapse of the Soviet Union. But following the outbreak of crisis, which brought down many banks, arrears and barter started to decline. And contrary to the experience of most countries hit by crisis, Russia's economy began to grow almost immediately after the crisis.

In a recent IMF Working Paper, Haizhou Huang, Dalia Marin, and Chenggang Xu take an in-depth look at these anomalies. They suggest that Russia was caught in a banking trap and fiscal swamp before the crisis. Because of perverse incentives created by the Russian government, the banking sector had become almost completely divorced from the real sector. Instead of lending to companies in dire need of cash, Russia's new banks were busy cashing in on government treasury bonds, known as GKO's.

Setting the Stage

After the collapse of the Soviet Union in 1990, Russia traveled a bumpy road in its transition to a market economy. The real sector contracted sharply, with output in 1998 still at only about 50 percent of the level in 1989. In this kind of climate, companies accumulated large debt and built up arrears. As a result, noncash payments and barter rose from 8 percent of sales in 1994, when inflation was still under control, to more than 50 percent of sales in 1998.

In contrast to the struggling real economy, the financial sector was having a field day, with the number of banks swelling from less than 100 in 1988 to more than 2,500 in 1998. But despite this explosion in the number of banks, and despite the fact that many of them were

owned by large firms, the financial sector failed to lend money to companies in the real sector: the ratio of credit to the private sector declined from 12 percent of GDP in 1994 to 8 percent in 1997.

Instead, they invested in treasury bonds. By the end of 1997, commercial banks had invested almost three-quarters of their ruble deposits in federal government securities. Even those companies that owned banks chose to finance their investments through other means and even went as far as letting their banks absorb company credit so that it too could be invested in GKO's.

The Crisis

Given Russia's poor economic performance, the crisis in 1998 did not come as a surprise. What surprised many was the economy's rapid and strong recovery. Total arrears and barter started to decline almost immediately, with barter and noncash payments dropping by 20 percent in 1999. What's more, banks began to lend to the real sector almost immediately after the crisis. Ruble loans to the economy more than doubled in nominal terms between 1998 and 1999, rising from 123 billion rubles to 293 billion rubles. At the same time, lending interest rates declined sharply in nominal as well as real terms.

The Link Between the Government's Budget Deficit and the Noncash Economy

Huang and his coauthors developed a model that explains these developments. The model assumes the existence of a severe information asymmetry in the Russian economy that made banks unable to distinguish good credit risk from bad. As a consequence, they charged high interest rates on all loans to the private sector. This, in turn, induced even sound companies to turn to nonbank finance such as trade credits and barter trade, where information asymmetry was less of a concern—but costs were much higher. The fact that viable firms were able to raise liquidity through nonbank finance drove up the cost of bank lending even more, since banks now expected that only lower-quality firms would borrow. Within this new equilibrium, the banking sector developed a strong preference for investing in high-yield government securities.

The model suggests a link between the government's budget deficit and the noncash economy that has been overlooked so far. It is often argued that the increase in arrears and barter trade in Russia was driven by tax motives. According to the traditional argument, by allowing firms to hide some profits and thereby lower their taxable income, nonbank finance contributed to the difficulty of raising taxes and thus caused the government's budget deficit to explode. Huang and his coauthors point to another reason for the increase in arrears and barter trade: the government's budget deficit was crowding out bank lending to the real sector by creating an environment in which banks could invest more profitably in the treasury bond market. This forced the real sector to turn to nonbank finance.

This is the essence of a banking trap: the financial sector has separated from the real sector. This separation hinders banking sector development and economic growth, although on the surface there is financial exuberance, particularly in the government securities market.

The model also highlights the role of the financial sector after the crisis and explains why the 1998 crisis was beneficial in some ways for the Russian economy. When the Russian government defaulted on its bonds in August 1998, the government securities market collapsed. Although many banks with large holdings of government securities went bankrupt, the economy turned around, moving from negative to positive growth. The vanished market for government bonds induced the surviving banks to reallocate their assets as loans to the real sector at lower interest rates to attract borrowers. Lower interest rates, in turn, made it attractive for some better-quality firms to start borrowing from banks rather than continuing to use nonbank finance. This improved the average creditworthiness of the pool of borrowers, further lowering interest rates and inducing more firms to switch from barter trade to bank loans. The regressions carried out by Huang and his coauthors thus suggest that the financial crisis changed the behavior of the banking sector in a fundamental way. The strong economic recovery that followed the crisis was thus largely the result of Russia's escape from the banking trap.

A Cathartic Effect

The model suggests that a financial crisis, though often causing a credit crunch and a deep economic recession, may have benefits as well. If the economy is stuck in a banking trap in which the financial and real sectors have separated, a crisis may help it escape the trap and thus bring about a strong economic recovery. This, in turn, sets the stage for developing the financial sector.

These findings also have implications for what policy makers need to do after an initial economic recovery. Fiscal policy should be given high priority. The government should harden its budget constraint and avoid recreating an environment in which government bonds crowd out bank loans. If sustainable growth is to be achieved, banking reform must be undertaken. Reducing the information asymmetry between banks and their borrowers through policies aimed at improving corporate governance, accounting, transparency, and credit risk management is key. And as bank lending grows, developing mechanisms for enforcing contracts becomes increasingly important.