WHITHER BANKING REFORM?

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Liquidity and capitalization in Russia’s banking system have improved rapidly over the last few years. The broadest measure of financial sector depth, the ratio of broad money (cash and deposits) to GDP, now stands at a respectable 20 percent; more significantly, credit to the private sector has crossed the 20 percent threshold and is rising rapidly. While not close to the depth of financial intermediation in more mature economies (credit to the private sector in Germany, Japan or the US is about 120, 180 and 150 percent of GDP, respectively), this is far from a starting point at which the 1998 crisis had wiped out banking and financial intermediation in this country.

Until recently, market observers and government officials alike tended to look at the increased liquidity of Russia’s banks with great satisfaction, marveling how the system improved by aggregate measures. Most still view it that way. However, there is a small but rising chorus of dissenting voices (more audible in the private than in the public sector, it has to be said) warning of overheating, excess liquidity or threat of instability. Unfortunately, the critics have a point.

To see the potential problem, a few observations suffice. The first step leads to Russia’s foreign investment inflows. These increased from 9.5bn USD after the crisis (1999) to almost 20bn last year, or to the equivalent of almost six percent of GDP. Yet, the components of these inflows from abroad grew at different rates: The BP- TMK deal aside (not yet visible in the statistics), foreign direct investment – i.e. investment in concentrated ownership and liked by everyone because it is serious, stable and capable of transferring capital as well as technology – has declined since the crisis (from 2.2 percent of GDP in 1999 to 1.2 percent in 2002). And “other” inflows (commercial and trade credits) as well as bond investment (these days almost exclusively private corporate bonds) both ballooned. That is to say, financial investment inflows account for the substantial increase in overall inflows. In 2003, this trend accelerated.

At this stage, one could argue that foreign investors may not yet be willing to take concentrated ownership positions but they have at least started to finance business activities -- undoubtedly a step in the right direction.

It is revealing to see where the money actually comes from: In the group of top investors by country, Cyprus, the UK and Holland are regular members. However, money from the UK comes from the Channel islands and Dutch investors seem to have strong preferences for using the Netherlands Antilles, another offshore center. Clearly, this is Russian money coming home.

This conclusion squares well with the composition of inflows – bond investments are a convenient tool for repatriation (the same owner can issue a domestic bond and then invest in it via an offshore vehicle), and similar mechanisms exist to channel funds back home using commercial credit.

Data on capital “flight” confirm the conclusion. Since the crisis, net capital outflows have decreased steadily. This bane of the early transition years fell from almost 10 percent of GDP in 1999 to 3 percent in 2002. For the first time, gross investment inflows last year exceeded net capital outflows, and in the first quarter of 2003, Russia once again established a positive net foreign investment position. Good news all around, it seems: Russian money is coming home in sizeable chunks,
financing business here, and capital outflows (also mostly Russian, after all!) are diminishing drastically.

However, there is a glitch. Although hard to estimate, Russian capital parked abroad is 200 to 250 bn USD at a minimum. This is a conservative estimate, including neither the capital transferred out of the country before 1991 nor the sizeable returns which by now have been generated by the funds held abroad.

GDP in 2002 was about 340 bn USD. Clearly, the source responsible for investment inflows of currently about 5 percent of GDP has a lot more to offer in the future: With total funds held outside the country in an order of magnitude of 70, 80 or 100 percent of GDP, future inflows are likely to dwarf current ones. It is not inconceivable to expect inflows exceeding 10 or even 15 percent of GDP, if political and economic stability prevails and so long as the rest of the world has to offer little by way of investment opportunities.

It is worth bearing in mind that this source of liquidity is unrelated to oil revenues and, ironically, depends on Russia being successful in maintaining political and economic stability. Moreover, it is of course not the only source of future inflows. Russia as a natural resource exporter will continue to have a sizeable current account surplus (consistently in it double digits as a share of GDP since the crisis); the rest of the world looks likely to continue to suffer from large excess liquidity (with hot money looking for investment opportunities it can not find elsewhere); and meanwhile, back in Russia, people are just starting to re-discover the advantages and convenience of holding money in the bank and not under the mattress. There is, in other words, a potential avalanche of funds out there, ready to hit Russia’s financial sector.

And it is the shape of this financial sector, or rather the banking component of it, that poses the problem. Russia’s banking sector is not prepared to be hit by an avalanche of liquid funds. It has no capacity to absorb them or to facilitate an efficient allocation of these resources. Everyone knows what the banking sector looks like: Dominated by a few large units on one end, owned not only by the state but by the Central Bank, i.e., the agency supposed to supervise them, and scattered into a total of 1300 small units at the other end.

Many of these small units are not involved in banking proper, i.e. in taking deposits and making loans to independent entities. Instead, they act as the finance departments of large corporations, shuffling money from one division to another, or they serve to connect Russia’s large cash economy to the international payment system, or they serve more dubious purposes. The very fact that such a large number of licensed banks have survived indicates lack of competition and/ or lack of effective supervision. The large state banks, on the other end, are commonly understood to be engaged in connected lending, providing loans for below market rates, and without proper credit checks. If one where to draw up the balance sheet for the commercial banking sector as a whole, it would already be beset with a dubious loan portfolio and exposed to currency and maturity mismatches. The sector has been exposed to a relentlessly rising tide of liquidity, which now seems set to accelerate.

What usually happens in such circumstances is that banks try to cope with the influx of liquidity by building up assets, i.e. they increase lending and investment activities. Typically, this carries the danger of creating a bad loan portfolio -- a credit bubble -- and of bidding up asset prices, i.e. creating an asset price bubble. Such a situation is recognizable when faith in repayments replaces credit checks, and investment in fixed assets (housing, stocks etc.) ceases to be based on the expected future income streams generated by these assets, but is instead based on expected increases
in their capital value. Once this is under way, loans will be serviced and assets bought and sold at ever rising prices exactly as long as everyone believes the boom to continue. In the end these bubbles will burst, with minor events sometimes instrumental, and this will lead to asset price deflation and a credit crunch as credits can no longer be serviced.

Short of restricting capital flows, the only protection against such an unpleasant scenario is to generate a banking and financial sector which is strong, competent and hence fortified against the temptations of “easy money”. This is difficult in the best of circumstances. In Russia, not much has been done during the good years to accelerate banking reform.

Luckily, the Central Bank is now pushing this agenda, but valuable time has been lost over previous years of complacency, as the banking sector seemed to somehow rectify itself after the crisis. What needs to be done is known and straightforward – but it proves hard to implement the reform agenda. Preparation is slow for the introduction of international accounting standards, scheduled for 2004 at last; deposit insurance, essential for generating equal conditions for competition and also to improve quality standards in the system (at least for the group of banks that would benefit from its seal of approval) has just now once again been delayed by the Duma, testimony to the lobbying power of those opposed to change; and the introduction of effective supervision and licensing procedures by their very nature will take years to accomplish.

So has a boom and bust cycle started already and is it inevitable? One needs to be very careful in being clear that there is no crisis imminent in Russia. This is important. Even if the banking sector would be wiped out tomorrow, the consequences would not be overly dramatic, because it is so small. But its composition and the quality of its balance sheet is no cause for optimism. And as the tide of incoming liquidity is set to keep rising, its size will increase with it. Moreover, the environment for credit relations in Russia is of course still difficult. The lack of legal enforcement generally and access to collateral in particular, the absence of credit bureaus, rating agencies and credit history in the country create conditions under which credit is likely to grow and collapse rapidly. The often heard argument that the repayment morale in Russia is so high as to justify “easy” credit and lofty new products is in itself an indicator, an argument typically raised at times of an unsustainable boom.

Eurobond prices have escalated, house prices in Moscow, where there is a veritable construction boom, are soaring, and equity prices are set to follow suit. In Moscow, it is now possible to get uncollateralized consumer credit. These are early indicators that warn of overheating. Yet on the other hand, just a few kilometers outside, the trees are growing through the factory roofs. Roads crumble and there is huge demand for infrastructure and other finance, be it public or private. Even further out in the regions, surveys indicate that it still is a problem to find finance to open a small business.

One could argue that, ironically, Russia is now being punished for its success in creating the stability it once craved: years of it have led to a liquidity build-up too large to handle. It would be more accurate to say that Russia today is punished for a lack of stability in the past which let to those outflows in the first place. Like an echo from the past, these funds are coming back now, preventing the banking sector from developing in a more organic (and less threatening) way.

But the real irony is that, although the problems that now seem to build up are driven by private capital inflows and are in that respect similar to what was observed in Asia prior to the 1997 crisis, Russia is still different from that scenario in one essential respect -- even if it would manage to grow
its unreformed financial sector to Asian pre-crisis levels: In Russia, the problem is not credits used for investments in the 101st golf course that nobody wants. In Russia, there is a genuine and large need for (public and private) finance.

The sad truth is that the banking sector in its present shape is the bottleneck that prevents funds from flowing into the areas where they would have the highest use, geographically and by sector: while asset prices in Moscow have started to soar, people elsewhere can't get money to fix a shop, or build a road, or pay their teachers.

But in this tragedy lies the opportunity of the present situation: Having missed the chance to create an effective banking sector when times where good, there really is nowhere else to go but to speed up reforms now. Again luckily, the Central Bank has realized this and is certainly trying. If reforms are timely and decisive, the expected capital inflows can create new productive capacity instead of inflating the prices for existing assets. This would effectively deflate the present danger. But if the tide of liquidity continues to rise faster than banks’ capacity to learn how to intermediate the incoming resources to productive use, there will be a problem.

For a long time now, people have been asking “Why banking reform?”, while the economy ticked along nicely and banks’ situation did not really seem to matter. Now the race is obviously on. If reforms do not start in earnest, this race will have been lost before it even started.

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