

## *Banking Sector and the Russian Economy*

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**Troika Dialog**

**"Necessity Delivers Us From the Embarrassment of Choice"**

*Luc de Clapier de Vauvenargues , French moralist, 1715-1747*

### **Summary**

The period of «cheap» growth, as was in recent years is coming to an end: higher capacity utilization is already out of the question. The recent slowdown in economic growth indicates that the existing model for economic growth is coming to an end of its useful life. By increased non-interest spending the government attempted to stimulate domestic industries, however growth slowed last year, as increased domestic demand saw consumer preference shift toward more expensive goods, a sector in which Russian manufacturers are unable to compete with imports. Imports grew last year on the back of relatively stable real effective exchange rate.

In the past years the Russian banking sector was growing fast and have recovered from the 1998 crisis. This, however, largely occurred not due the improved banking services or active restructuring policy, but due to cheap resources, oil windfalls in the first order, that restored the capitalization of the banks. Nevertheless capitalization of the banking system, as well as monetization of the economy, is low, which is the major obstacle for the expansion of the banking business. With better institutions, the pace of economic growth could be faster, as capital flight is likely to drop. In this case, Russia could attract more FDI, which should also contribute to growing liquidity in the economy. In any event, an increase in monetization should be associated with a strong current account, accompanied by further reserve accumulation and domestic savings.

There are several problems associated with a low level of monetization. The high sensitivity of the market, banking sector and economy in general to capital flows is just one of them. The lower the level of monetization, the shorter the credit offered as well, which limits the investment potential of the economy. Another problem is associated with the fact that there is little room for maneuver in terms of fiscal policy, which needs to avoid deficits and domestic borrowing. This problem is more acute in the case of Russia, since the banking sector is weak and is in fact controlled by the state. Sberbank, the country's largest, still controls around 65% to 70% of the retail market. Vneshtorgbank, the second largest, is also state-controlled.

Sberbank is the dominant holder of government securities and is prepared to acquire them at a real interest rate close to zero, or even below it. Although this helps the government in running the

budget, it effectively means that the bill is being footed by Sberbank customers, i.e. private individuals. Average weighted deposit rates (including time and demand deposits) are therefore highly negative and Sberbank operates as a sort of “sterilization mechanism”, reducing the real value of money and monetization of the economy as a result.

Ruble began to appreciate in 2003. Appreciation of the ruble creates well-known problems - competitiveness of domestic manufacturing falls, profitability of the exporters also goes down. In principle it may negatively affect economic growth. On the other hand, however, strengthening of the on the ruble is a challenge: it stimulates more intense structural transformation, cost reduction. Strong ruble is harmful for the "old" economy, inherited from the Soviet period. At the same time stronger ruble may stimulate investment activity given the fact that the stronger the ruble, the more investment goods can be imported. It is quite likely that along with low interest rates investment activity will become a driving force for economic growth in the coming years. Thus Russia is on the brink of an intense structural transformation.

## **1. The economy is on the brink of an intense structural transformation**

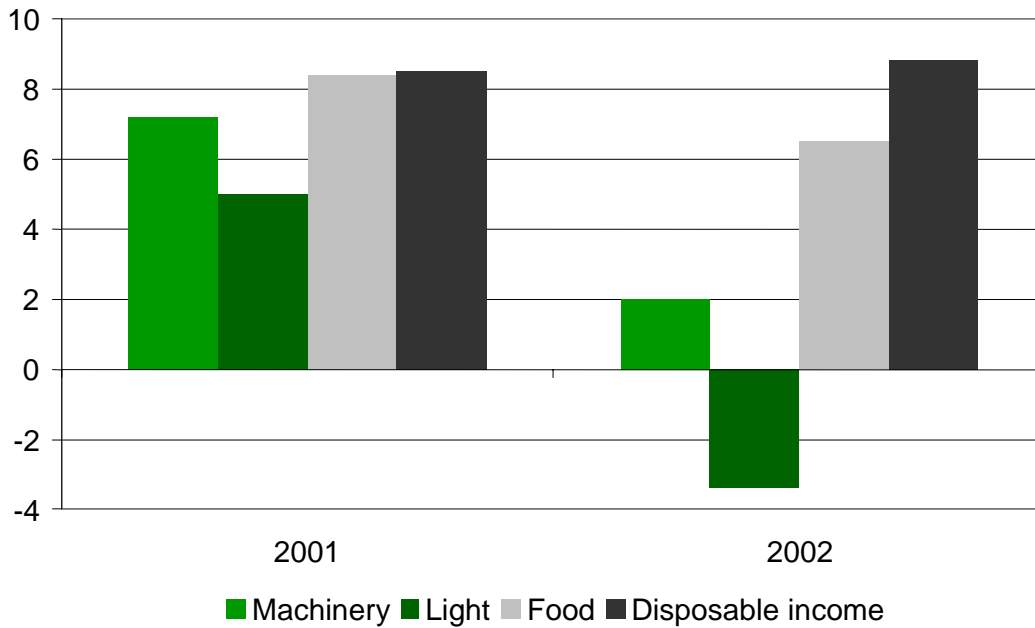
Russia's economic performance last year, with GDP up over 4.3%, compared favorably with slow growth in Europe and in the US. However, even this represented a slowdown in growth on previous years and on the back of high oil price, too<sup>1</sup>. It is important that high GDP growth rates in 1999-2002 (5.8% annual average) have been achieved on the back of high oil price, strong balance of payments, healthy fiscal performance, and increased capacity utilization. On the aggregate level banking sector and financial markets didn't play an important role with respect to Russia's post-crisis growth. Corporate profits and financing from the budgets have been the major sources of investment, which catalyzed overall economic activity.

However, the period of «cheap» growth, as was in recent years is coming to an end. Higher capacity utilization is already out of the question. Oil prices are likely to go down and stabilize at a much lower level. The recent slowdown in economic growth indicates that the existing model for economic growth is coming to an end of its useful life. The drop in manufacturing on the back of rapidly growing real disposable incomes in 2002 clearly proves that (chart 1).

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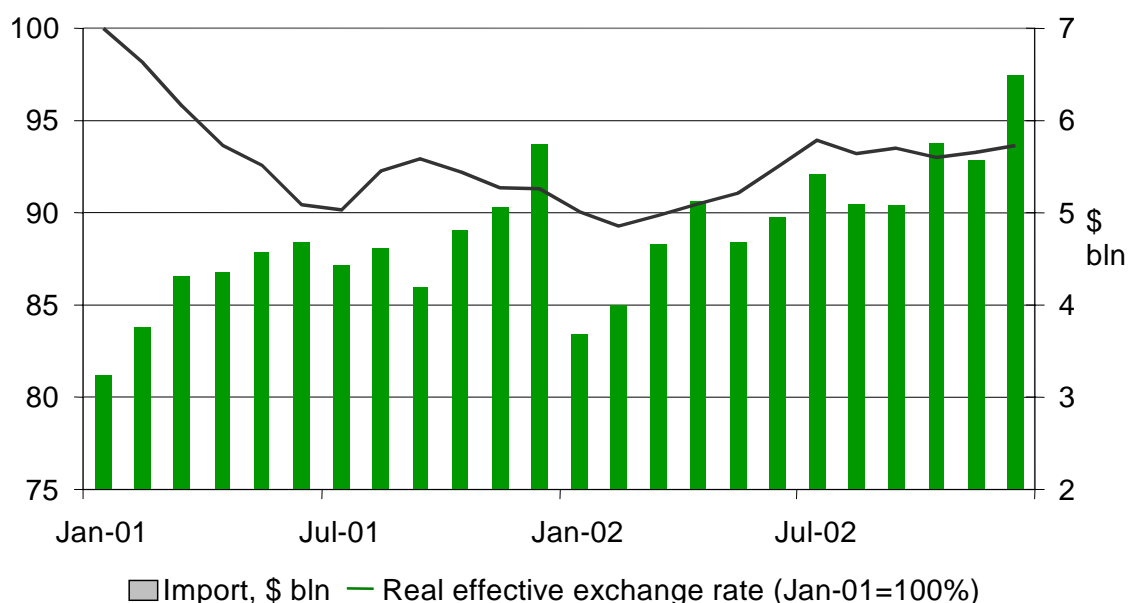
<sup>1</sup> The Russian economy grew 5.4% in 1999, 9.0% in 2000 and 5.0 in 2001

**Chart 1. Growth of output and disposable income (in %)**



It is well recognized that the structure of the national economy is skewed towards the fuel and energy sector, which accounts for 30% of industrial output, 32% of consolidated budget revenues and 54% of federal budget revenues. Exports of fuel and energy make up 54% of total exports. Russian manufacturing lacks competitiveness and thus the gap between rapidly growing incomes and domestic production was compensated for increased imports last year. It is important that this happened despite a relatively stable real effective exchange rate. In fact, this exchange rate actually decreased by 1.7% (chart 2) due to that fact that ruble slightly gained against the dollar in real terms, but depreciated a significantly against the euro.

**Chart 2. Imports increased on back of stable real effective exchange rate**



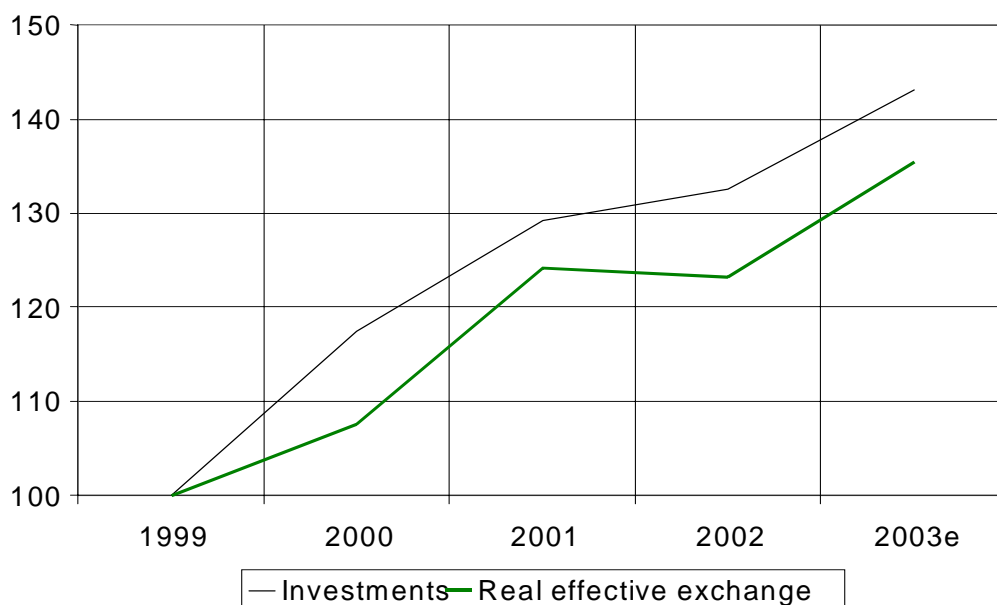
Growth slowed last year, as increased domestic demand saw consumer preference shift toward more expensive goods, a sector in which Russian manufacturers are unable to compete with imports. The food industry provides a clear example of how growing incomes have transformed consumer demand. In 1999-2000, when incomes were low, production of cheap foodstuffs (such as vegetable oil, bread, etc.) grew more rapidly. In 2001, as real incomes increased, production of those foodstuffs stopped growing and the focus shifted to more expensive high-protein foods. Last year and in the early 2003, growth in the Russian food industry slowed further from 8.2% in 1H02 to 3.4% in 4Q02 and 3.6% January-February 03. Since demand for food was almost entirely saturated, consumer demand shifted toward more expensive consumer durables and services.

So, the macroeconomic performance last year clearly indicated that the country can no longer rely on the advantages of easy growth and a repeat the same growth pattern which emerged after the 1998 crisis will be difficult for Russia if not impossible. Really, growth in the non-interest spending that took place in the past few years was able to stimulate domestic consumer demand to some extent. Now it may stimulate mostly imports.

Russia is on the brink of an intense structural transformation. Apart from obvious advantages high oil price and capital inflows create a number of macroeconomic problems for Russia: in the early 2003 ruble began to appreciate rapidly thus negatively affecting the competitiveness of the Russian economy. But this is only one side of the coin. On the other hand massive foreign exchange inflows and appreciation of the ruble creates extremely favorable environment for the restructuring of the economy.

In theory rapid appreciation of the ruble creates well-known problems - competitiveness of domestic manufacturing falls, profitability of the exporters also goes down. In principle it may negatively affect economic growth. On the other hand, however, strengthening of the on the ruble is a challenge: it stimulates more intense structural change, cost reduction in the first order. Strong ruble is harmful for the "old" economy, inherited from the Soviet period. At the same time stronger ruble may stimulate investment activity given the fact that the stronger the ruble, the more investment goods can be imported. As seen from the chart 3 investment activity was closely correlated with real exchange rate: the faster the ruble was appreciating the higher the growth rate of investments was recorded in the post-crisis period. As a result the Russian economy in the entire 1999-2002 period was growing on the back of real appreciation of the ruble.

**Chart 3. Real investments and effective exchange rate (1999=100%)**



## 2. Sustainable economic growth requires more active financial inter-mediation

Russia's GDP reached \$350 bln in 2002, up from \$310 bln in 2001. Due to real appreciation of the ruble<sup>2</sup>, the figure is growing faster in dollar terms (up nearly 13%) than in real terms (around 4%). As a result, actual GDP per capita should be \$2,440 this year, a third of the PPP-based figure of \$7,350. This PPP-based figure is half the level for South Korea and several times lower than in developed countries. If we assume that the Russian economy will deliver 5% average annual growth

<sup>2</sup> In spite of a relatively stable real exchange rate calculated as December 02 to December 01 numbers average annual appreciation of the ruble took place in 2002 due to the appreciation of the ruble in the fall of 2001.

between 2003 and 2010, then PPP-based GDP per capita will be \$11,000 by the end of the decade. This is on a par with the present value for Slovakia, but still below the Korean figure. If the ruble does not appreciate in real terms, then the actual GDP per capita at the market exchange rate will be just \$3,600, nearly 10 times below the present level for the world's richest countries.

However, delivering an annual 5% growth rate for such an extended period is no mean task, especially in an economy such as Russia's, where the extraction and export of natural resources remains the major source of foreign exchange revenues and in fact determines the state of the current account. Given the volatility of the energy market, it is hard to count on sustainable growth at all.

Future economic growth is associated with the growth of new businesses, which yet do not emerge and do not expand as intensive as it could be. To improve the existing growth mechanism and deliver sustainable growth Russia needs: a) remove the still existing «red tapes»; b) carry out financial sector reform (banks in the first order). In this case current account surplus will be compensated not for capital outflows (as it largely used to happen in the past), but for increased savings recorded in the capital account, thus contributing to growing capitalization of the banks and monetization of the economy. In fact sustainable economic growth requires more active financial inter-mediation, which should contribute to a transformation of the sectoral structure of the economy. Diversification of the economy is seen by the government as a one of the top priorities.

In the past years the Russian banking sector was growing fast and have recovered from the 1998 crisis. This, however, largely occurred not due the improved banking services or active restructuring policy<sup>3</sup>, but due to cheap resources, oil windfalls in the first order, that restored the capitalization of the banks. Nevertheless capitalization of the banking system, as well as monetization of the economy, is low, which is the major obstacle for the expansion of the banking business. Lack of transparency, which results from the Russian accounting standards, is another fundamental obstacle for development of the banking business. In addition to regular taxation Russian commercial banks are financially repressed by monetary authorities: reserve requirements is a tax base and inflation is a tax rate.

One of the first decrees of the Lenin's government was to nationalize banks, key elements of the market economy. Still state banks, that have certain privileges, dominate in Russia especially on the retail market and in foreign trade. The largest private banks are associated with vertically integrated conglomerates that strengthened after that 1998 crisis. Thus those banks operate mostly as treasures for those conglomerates.

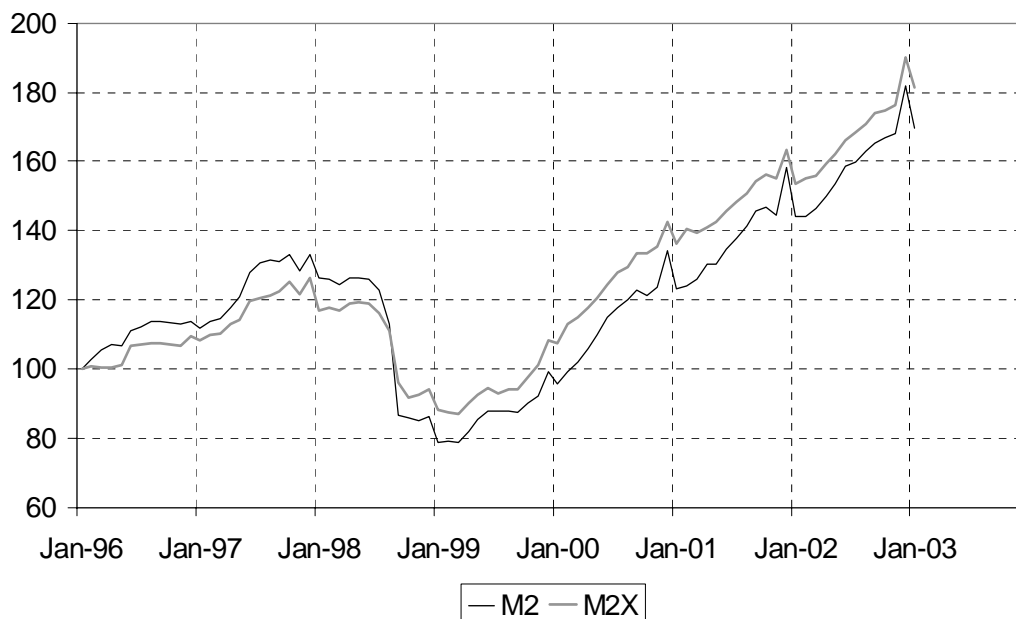
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<sup>3</sup> Although the Central Bank of Russia and the government drafter a law on deposit insurance it is still under consideration.

As said low monetization (M2 to GDP ratio) is an impediment to sustainable growth and a reason for the higher risk of inflation in the case of a soft fiscal policy. Low monetization of the economy requires much tougher fiscal discipline. If even a modest deficit (say, 3% of GDP) in a country with low monetization (say, 17% of GDP, as in Russia's case) is financed through printing money, then it will result in a high (in our case, 17.6%) increase in the money supply and consequent price increases.

Lack of liquidity in the economy also contributes to higher stock market volatility and hinders development of the banking business, since banks with a low capitalization can scarcely work as efficient intermediaries between savings and investment. By the end of 2002, Russia's ruble money supply (M2) was slightly over \$66 bln, while the broad money aggregate (M2X, which includes deposits in foreign currency) was just above \$80 bln (see chart 4). Russia's money supply therefore appears to be lower than Finland's, with its population of just 5 mln.

**Chart 4. Trend in M2X**

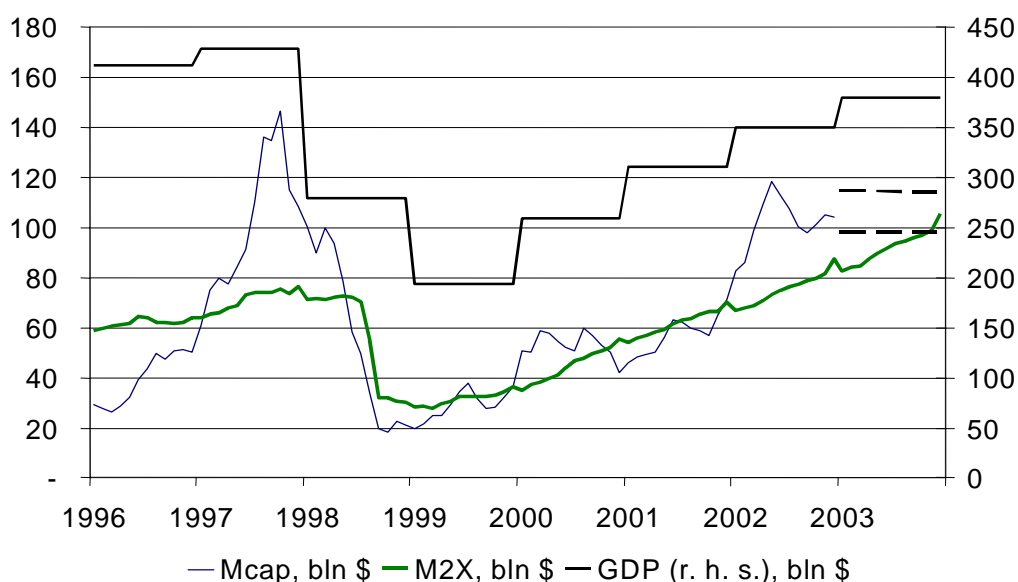


As this figure shows, Russia's real money supply has been growing steadily since the 1998 crisis, but is still low in dollar terms. The flow of a few billions dollars in or out of Russia could therefore generate substantial instability in the country's financial system. Capital markets are above all at risk: an inflow would inflated them quickly, while the lack of spare ruble liquidity would create a sudden vacuum in the case of a sudden outflow, risking their collapse. Since the Russian stock market is comparatively small by international standards (around 1% of that of the US), an inflow or

outflow of as little as \$250 mln can have a significant effect on volatility. Chart 5 shows how the market capitalization has fluctuated<sup>4</sup>.

The graph also shows how the Russian market was growing much faster than the real economy and monetization over 1995-97. As is well known, such growth was not sustainable and after the 1998 crisis both the money supply in real and dollar terms reverted to around the same levels as they were in 1995. Since 1999, the market had again been growing much faster than GDP and monetization of the economy and it was only a matter of time before this growth halted, which it did in 2H02. However, there is no fundamental reason to expect the gap between monetization of the economy and its market capitalization to widen substantially again in 2003 and beyond.

**Chart 5. Market capitalization and monetization of the economy**



Last year, monetization of the Russian economy reached its highest level since 1993 (see chart 6). The annual average broad money aggregate M2X to GDP ratio, increased from 16.1% in 1999 to 22% in 2002. However, as shown on the figure 7, despite the fact that growing liquidity has accompanied economic growth in recent years, it is still low by international standards, even compared with emerging market countries. In fact, there is a clear relationship between income per capita and the level of monetization.

Broad money has continued to outstrip inflation and the pace of economic growth this year. According to our estimates, the M2X to GDP ratio may reach 24% and this should provide for an increase in domestic credit levels. Calculations show that the ability of the economy to absorb money is limited by the quality of its market institutions and public regulations. Monetization cannot

<sup>4</sup> Similar fluctuations were seen for the RTS index

therefore be artificially accelerated. However, 2% annual increase in the M2X to GDP ratio will be sufficient to finance economic growth of around 4-5% and at this pace monetization should be close to 40% in ten years' time.

With better institutions, the pace of economic growth could be faster, as capital flight is likely to drop. In this case, Russia could attract more FDI, which should also contribute to growing liquidity in the economy. In any event, an increase in monetization should be associated with a strong current account, accompanied by further reserve accumulation and domestic savings. Appreciation of the ruble in real terms seems inevitable in such a scenario. As can also be seen from the graph below, liquidity in the economy grew in 1996 and 1997, but at that time was not backed up by corresponding reserve accumulation and therefore decreased after the crisis.

**Figure 6. Monetization of the Russian economy**

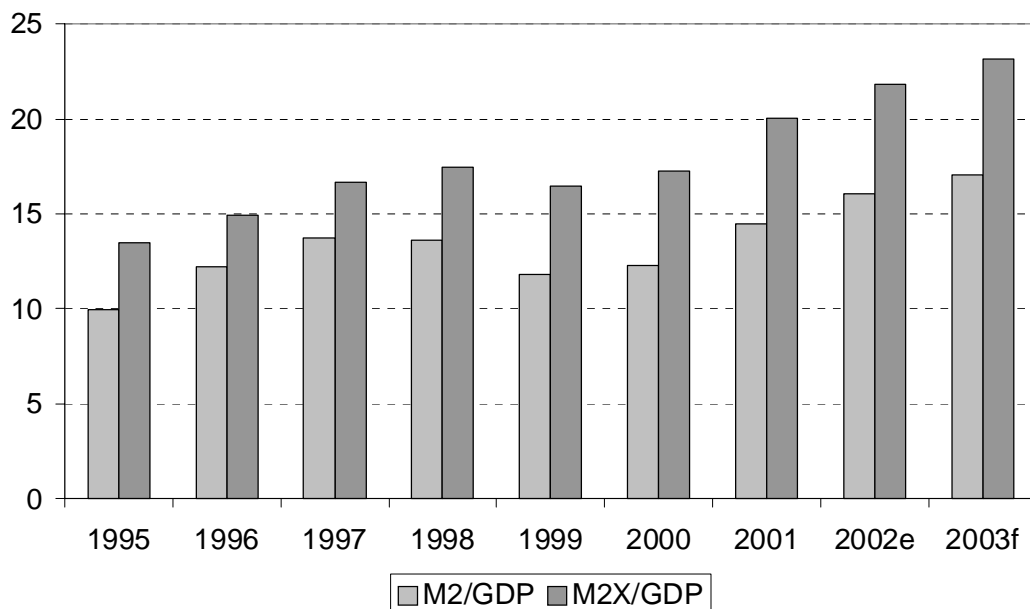
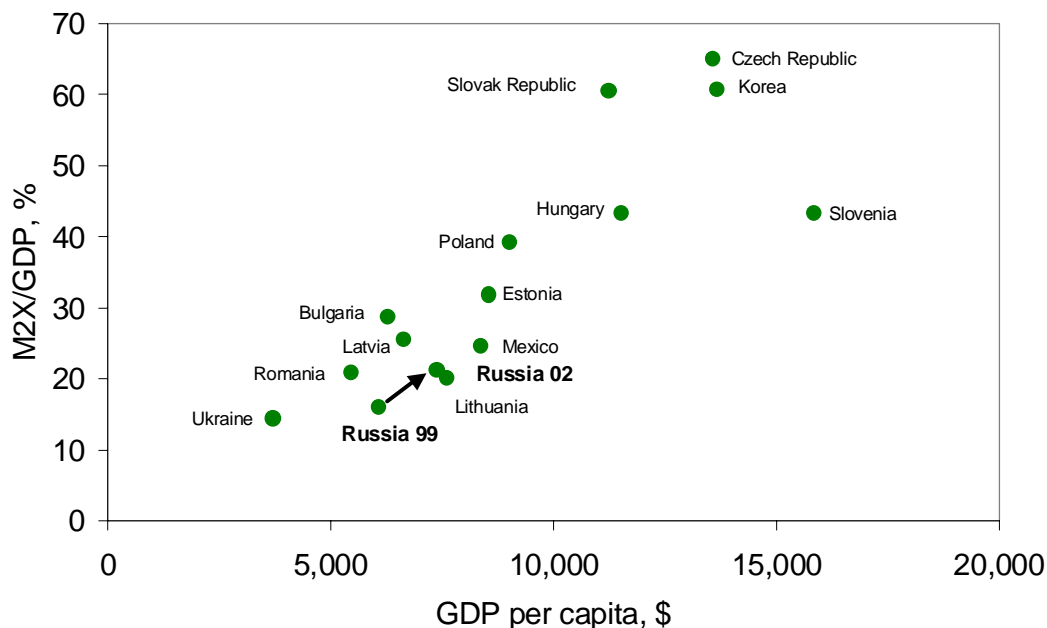


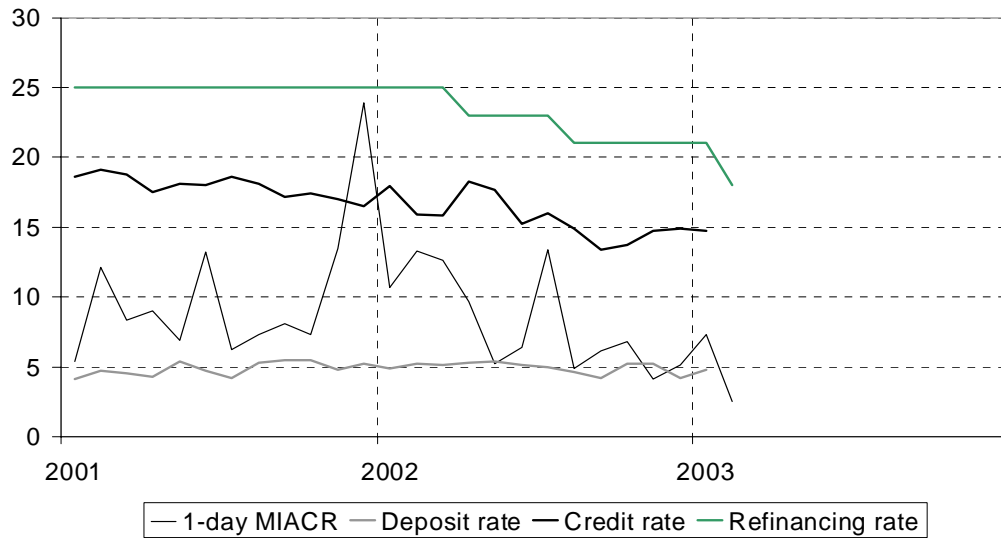
Chart 7. Monetization and economic development in selected countries (1999)



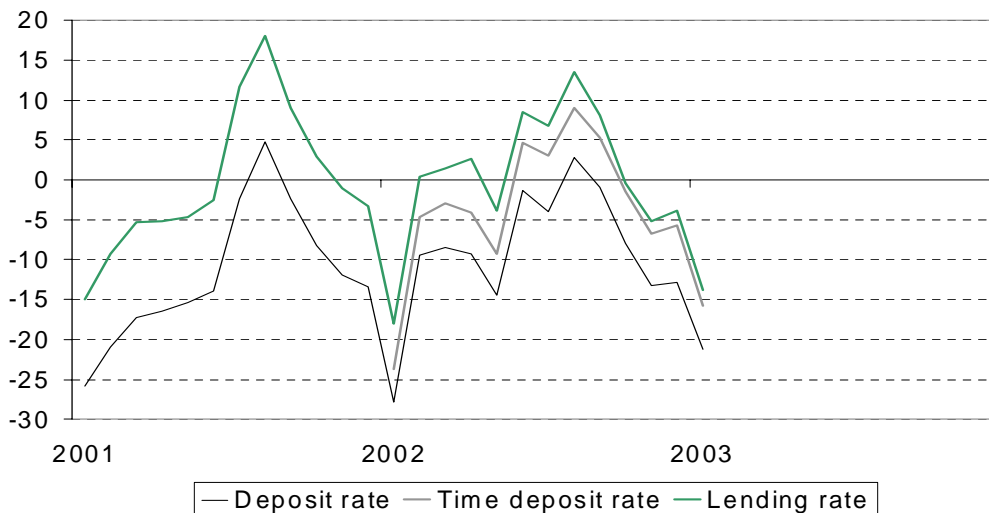
There are therefore several problems associated with a low level of monetization. The high sensitivity of the market, banking sector and economy in general to capital flows is just one of them. The lower the level of monetization, the shorter the credit offered as well, which limits the investment potential of the economy. Another problem is associated with the fact that there is little room for maneuver in terms of fiscal policy, which needs to avoid deficits and domestic borrowing. This problem is more acute in the case of Russia, since the banking sector is weak and is in fact controlled by the state. Sberbank, the country's largest, still controls around 65% of the retail market. Vneshtorgbank, the second largest, is also state-controlled.

Sberbank is the dominant holder of government securities and is prepared to acquire them at a real interest rate close to zero, or even below it. Although this helps the government in running the budget, it effectively means that the bill is being footed by Sberbank customers, i.e. private individuals. Average weighted deposit rates (including time and demand deposits) are therefore highly negative (charts 8,9) and Sberbank operates as a sort of "sterilization mechanism", reducing the real value of money and monetization of the economy as a result. This might not be a large problem since oil windfalls are too large to be processed by Russia's institutions and therefore contribute to higher economic growth. It will also not be a problem as long as the population is prepared to lose money on its bank savings. However, problems may be ahead in the longer term if the State Pension Fund becomes another large holder of government securities offered at real negative interest rates.

**Chart 8. Nominal interest rates**



**Chart 9. Real interest rates**



#### **4. Moving toward a more diversified and healthy economy?**

Due to low liquidity in the system none of the Russian banks (apart from Sberbank and Vneshtorgbank) is able to extend large credits to the corporate sector. Thus major Russian companies are forced to borrow internationally. As was seen Russian corporate sector last year borrowed about \$12bn on global market. Massive private external borrowing continued in the early 2003. Along with the high oil price (so that monthly trade surplus stays at the level of about \$5bn) this contributed to a rapid real appreciation of the ruble in the early 2003.

Smaller companies, which are unable to borrow on the global markets issue domestic corporate bonds, which allow them to attract capital from small creditors. Table 1 shows the structure of the

banking sector in Russia: although the table is based on the 1H02 data, little has changed since then. As seen from the table 50 banks control 75% of assets, while the rest over 1260 control only 25% of assets. Consolidation in the banking sector looks inevitable, while most likely it will be gradual until the government makes a decision regarding Sberbank: Sberbank will continue produce market distortions.

**Table 1. Sector structure, 1H02**

	All banks	Sber-bank	Foreign banks	Largest local banks	Medium banks	Small banks
Number of banks	1313	1	22	28	50	1212
Asset range, \$ bln		29	0.1-2.8	0.25-3.8	0.1-0.25	<0.1
Capital range, \$ mln		3500	30-200	80-700	30-80	<30
Share of assets	100%	26%	7%	42%	7%	18%
Share of capital	100%	13%	5%	45%	9%	28%
Share of retail savings	100%	72%	3%	13%	5%	8%

Preparation of a bill on insurance for retail deposits is an important step, which may accelerate banking sector reform. It is hard to say which type of deposit insurance mechanism may be introduced in Russia: strong opposition to this bill was seen from the Sberbank, although according to the bill Sberbank will retain its government guarantees for the transition period till 2007, which should assuage current fears of an outflow of resources. Quite apart from that, commercial banks do not have the infrastructure and experience to handle a large number of small depositors. Sberbank, on the other hand, will be able to make continued use of its state guarantees on all deposits, not just small ones, to corner the market of wealthy depositors during the transition period.

At the same time, the prospect of an insurance system will force the Central Bank to accelerate reform of bank monitoring, as initial due diligence will need to be performed on all banks, joining the system and to prevent them from any aggressive risk taking once they are in. However, these changes are unlikely to be made far in advance of the advent of the insurance scheme itself.

The government bill looks not perfect, given that there is no clear criteria, which may open the door for the banks to this opportunity. It could be more reasonable to offer joining the deposit insurance system as a privilege. Probably not all banks should be allowed to join deposit insurance and several requirements should be first met by those banks. First, they need to prepare reports in accordance

with international accounting standards. Second, they need to pass international audit. Those measures could really accelerate restructuring of the banking system. In addition Sberbank should be prohibited from extending credits to the enterprises: it should operate on the inter-bank market instead, crediting reliable banks that joined the deposit insurance scheme.

Such reform of the banking sector could accelerate restructuring and diversification of the economy. As mentioned in the first part of the paper recent trends show that the Russian economy is on the brink of an intense structural transformation. Meanwhile the most recent developments on money markets support this point of view. As seen from regular statistics, from mid February 2003 to mid March 2003 ruble appreciated against the dollar by about 1.3% in nominal terms and by 1.4% since the beginning of the year. Given that inflation in January-February exceeded 4% and in Q103 it is going to exceed 5% real appreciation of the ruble against the dollar was even stronger. In the early 2003 ruble also appreciated against the euro in real terms. So it looks inevitable for the Central bank to intervene actively on the foreign exchange market and accumulate international reserves actively. By mid March 03 international reserves grew by \$7bn, i.e. as fast as never before and at the same time ruble.

Investment activity picked up substantially in January and February 2003, which goes in line with chart 3. It appears as if at present a unique opportunity for a more active economic restructuring emerged in Russia. This happened as a result of combination of a number of factors. First of all, as was said, stronger ruble allows to import investment goods in larger amounts. One may point on the fact that ruble was also strong before the crisis and even stronger in 1996-1998, but investment activity was low at that time. Current situation differs from that of the 1996-1998 period because of much better investment climate, better institutions, lower tax burden, etc. So, at least some of the government efforts gave results. This is the second advantage of the present period.

It is also important that due to massive capital inflows and strong current account money is cheap in Russia and interest rates are low. Really, given that the government runs the budget with surplus the supply of the government bonds is low and interest rates on the bond market are negative. Deposit rates are also negative in real terms (chart 9).

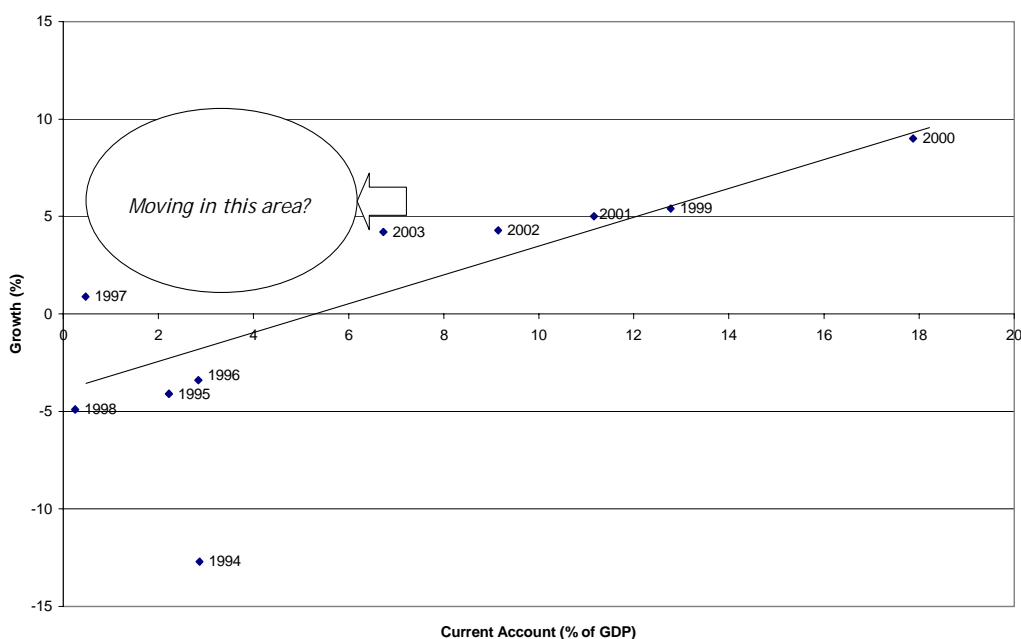
Appreciation of the ruble does not stimulate dollar savings as well. There is no reason to export capital given the stagnation on the global markets, and thus Russia experiences massive capital inflows. So it appears that nowadays there are much more incentives to invest in Russia's fixed capital than ever before. Apart from investing in equities, this may be seen as the only way to preserve money for most of domestic investors. This is the next major difference of the current situation compared to previous years. So, we believe that investment will become a main driving force for growth in 2003, and there will be no surprise if investments this year increase by one tenth or even more.

2003 may be seen as a breaking point not only with respect to overall growth of investment

(which already picked up in January 2003 by nearly 8 %), but also in a sense that investment activity may pick up in the non-energy sector as well since money remains cheap as never before. In addition the diversification of the economy is one of the government priorities declared in the recent medium term economic program. Thus there is a good combination of natural factors and the government policies that may diversify investments.

Chart 10 is another illustration of the fact that until now the Russian economy is really very much dependent on the world energy prices: i.e. the higher the price, the bigger is the current account and the higher the rate of growth is. 1997 is seen as an exemption given that this was the only pre-crisis year when Russia attracted foreign investments on a large scale, which contributed to positive growth rate, while 1994 is the last year of deep contraction that marked the end of the early transition period.

**Chart 10. Current account and economic growth**



On the back of expected diversification of the economy and appreciation of the ruble current account will continue shrinking. Thus the period of "cheap" money will be coming to an end. In turn it should switch on the refinancing mechanism so that commercial banks will start borrowing from the Central bank. Contribution of the banking sector to economic growth should inevitably start growing.