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Interrelation between the Monetary and Industrial Policies in the Russian Banking System

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Recently, there has been an active discussion: should the banking system led by the Bank of Russia only support the stability of the national currency and suppress inflation, or should it expand its tasks to include the bolstering of social and economic growth and employment?

Central banks of modern-day developed economies play the role of the *last instance creditor* and the primary source of financial resources. At the same time the central bank is also responsible for larger scale objectives: apart from purely financial tasks, i.e. control over inflation and foreign exchange rates, it also faces challenges that places it closer to the real economy: supporting economic growth and employment.

E.g. key objectives of the ***U.S. Federal Reserve System (Fed)*** include, *inter alia*: ensuring maximum employment; buttressing long-term growth of monetary aggregates subject to production upside potential; maintaining moderate long-term interest rates.

The ***Bank of Japan*** acts exclusively to implement tasks aimed at achieving government goals (with economic growth having always been a priority); shapes the national currency exchange rate; regulates money circulation and maintains the economic juncture in the country through its policy rate; maintains price stability; and supports stability of the financial system.

We would highlight the following among the key objectives of the ***European Central Bank (ECB)***: supporting price stability; ensuring a common economic policy in the euro area; facilitating efficient resource allocation; bolstering employment coordination; reinforcing industrial competition among Member States of the Economic and Currency Union, etc.

The Monetary Policy Committee of the ***Bank of England*** indicates that *supporting growth has always been a priority of the Committee*. Moreover, key objectives of the Bank of England are to maintain price stability and strengthen the financial system.

Maintaining economic growth rates is also the priority objective of the ***People's Bank of China***.

Perhaps, Russia has its own particularities, and its banking system may confine itself to the monetary and inflation functions as is the case today?

Let us discuss these matters in more details.

1. Can the banking system led by the Bank of Russia handle inflation?

We know that inflation mainly depends on the amount of money injected in the economy. Here, the Central Bank may in many respects regulate the scope and terms of lending. For instance, as of early 2012, the total amount of loans issued in the national economy was about RUB 28 trln, and in 2012 the bank loan portfolio grew by 19% in general. Apart from lending, the Central Bank regulates the amount of money creation. For example, in 2011, the monetary stock grew by almost RUB 4.5 trln (M2), while in 2012 M2 rose by 12%. The Central Bank also increases the

national currency in circulation by purchasing foreign currency to build up its foreign exchange and gold reserves. But the amount of rouble stock injected in the economy is not limited to the above.

Tremendous amounts are injected into the economy as the expenditure of the Russian consolidated public budget grows. In 2011, such expenditure grew by about RUB 2.4 over the year to about RUB 20 trln. As we know, the Bank of Russia is not involved in the public budgeting, and its influence in this area is minimal.

Apart from the amount of money in circulation, inflation materially depends on the amount of the goods turnover, which in its turn is contingent on the output and exports/imports that are not much influenced by the Bank of Russia, either, unlike the Government. Moreover, the amount of, say, imported goods that account for an important share of the goods turnover matching the money circulation often strongly varies from year to year. For instance, in 2010 and 2011, imports grew at an annual rate of 30-32%, which was equivalent to more than RUB 3 trln a year. In 2012, goods imports only grew by 3.6%, which was equivalent only to RUB 0.4 trln.

As we know, during the pre-crisis decade (1999-2008), the Government and the Central Bank were not able to suppress inflation. It was only in 2006 that they managed to overcome the 'plague' of two-digit inflation by reducing it to 9% a year. However, Russia was unable to maintain this level in 2008 when it was vital due to the outburst of the crisis. As a result, we entered the crisis with an annual consumer price index of 14.1%, an industrial producer price index of 21.7%, an agricultural producer price index of 26.7%, a consolidated construction material price index of 19.4%, and a freight rate index of 20.7%.

Inflation persisted in 2009, in the thick of the crisis, with the annual consumer price index growing by 11.7%. As a result, Russian economic growth rates slowed down, with elements of stagflation emerging, which aggravated the crisis and made it more difficult to overcome.

Why did it happen? What was the reason for such a strange performance? In our view, such high inflation was primarily due to the reduction in the consumer goods output and imports (in 2009, this figure decreased by more than 1.5 times), as the consolidated budget expenditure grew: by 23% in 2008 and by 15% in 2009. As a result, the amount of money in circulation considerably exceeded the demand.

Moreover, government-owned and oligarchic monopolies play a huge role in maintaining high inflation in Russia.

As we know, Russia usually starts the year by increasing utility prices that account for about 11% in the breakdown of household expenses. Approximately 15% in this breakdown goes to transport costs, with its rates also increased by transport organizations with approval by government authorities. During the crisis year of 2009, the most difficult for household, utility fees grew the most: housing fee rose by 14%; water supply fees, by 12%, heat, by 20%; gas, by 23%; and electricity, by 25%.

Setting the government as their benchmark, other government-owned monopolies also raise their prices. They include Russian Railways, AvtoVAZ, Aeroflot, and others. Furthermore, regional authorities and municipalities and their subordinates providing various services to households unilaterally raise their housing, electricity, heat, etc. fees on a systematic basis.

The substantial increase of consumer prices in 2009 may only be explained by activities of the government and monopolies. Since other factors that usually drive inflation were to drive temporary deflation as it happened in other countries, including in China.

In particular, in 2009, M2 that previously grew at 40 and more percent a year remained almost flat. Production costs decreased (industrial prices by 4% and agricultural by 3%). Demand for products tumbled down. All these factors were to lower inflation in Russia. But it remained at its highest annual level: 11.7%. What could the Bank of Russia do in such case? Alas, it could do next to nothing. Indeed, formally, the amount of foreign exchange and gold reserves allowed and still allows sterilizing all rouble stock (the ratio of foreign exchange and gold reserves to monetary stock is 1.9x). However, the reverse side of that would include an accelerated decline, more expensive loans, etc. Similarly, if necessary, the Central Bank may set the rouble exchange rate as high as it wants (since the more 'expensive' rouble is known to have a material anti-inflation effect). But such approaches also have a reverse side that prevents from fully implementing them as they would considerably complicate the position of Russian exporters, who are the government's key source of revenue.

Thus, we may conclude that in Russia the Bank of Russia may not have the exclusive right to combat inflation. The level of inflation depends on the government and anti-trust legislation to an equal and perhaps even to a greater extent.

Over the last 20 years, the Central Bank of the Russian Federation was unable to achieve a normal inflation of 1% or 2% or even an average inflation level of developing countries of 3% to 5% at any point in time.

Ukraine, Belarus and Russia are among the countries that have been failing to finally suppress inflation over many years. From 2000 to 2011, the consumer price index in Russia grew by 3.5 times against 1.2-1.3 times in developed economies. In Ukraine, prices grew by 3.1 times, and in Belarus, by 9.6 times. In Azerbaijan, Armenia, Kazakhstan, Kyrgyzstan, and Moldova prices grew by 1.7-2.46 times; in post socialist countries of Central and Eastern Europe (except Romania), by 1.4-1.83 times, and in China, by 1.3 times.

2. Has the banking system tools and instruments to speed up the social and economic development of the country?

The suppression of inflation, which is contingent to a significant extent on the Bank of Russia, positively affects the social and economic development of the country. Undoubtedly, cheaper money and lower prices strongly encourage further social and economic growth. At the same time, the level of inflation and stability of the national currency do not determine all drivers and factors of economic and social growth.

We primarily refer to the regulation of interest rates and the mechanism of refinancing. They enable the central bank to have an important influence over both the lending and financial markets, and the overall national economy (as is the case in major economies).

According to E. Nabiullina, the new head of the Bank of Russia (and we full support this view), 'a lower inflation does not automatically result in cheaper loans: we need to develop the system of refinancing of commercial banks to provide them with access to liquidity'.¹

Before the crisis of 2008-2009, the Bank of Russia did not lend to commercial banks on a systematic basis and actually had a limited role as last instance creditor. As such, its refinancing rate was of a rather declarative nature and did not play any major part in the national economy. During the crisis and post crisis, the Bank of Russia sharply intensified its activities. Now it has

¹ Ekspert. 2013. No. 15 (847). P. 8.

to make a new step by transforming its refinancing rate into a real policy rate at which commercial banks will be able to borrow from the Bank of Russia. As a result, the refinancing rate along with other instruments of the Bank of Russia will mainly determine the 'cost' of money, i.e. the level of interest rates for loans issued to corporate and retail borrowers.

Such approach would make impossible raising loan interest rates by 1.5 times during a crisis (from 10.03% in the pre-crisis 2007 to 15.31% in the crisis 2009),¹ which had heavily aggravated the situation of the real sector during the crisis. And all that happened on the bank of lowering loan interest rates in all other countries whose central banks had minimized their refinancing rates. For example, the loan interest rate in the U.K. was 5.52% in 2007, 4.63% in 2008, and 0.63% in 2009. In the U.S., interest rates declined from 8.05% in 2007 to 5.09 in 2008, and 3.25% in 2009.

The high interest rate is actually prohibitive for investment loans as such loans at such rates could only be taken for three years at the longest. Mortgages are the most vivid example: in Russia mortgages are tens of times less used (if we speak of the ratio of mortgage loans to GDP) than in developed countries. Since the Bank of Russia is not responsible for the social and economic development of the country, it actually insufficiently regulates the level of interest rates and does not assess economic losses of the country from excessively high rates in the post-crisis years when banks have used high post-crisis rates to achieve record high balanced financial results (profit less losses). According to data from the Association of Russian Banks, rates for >1-year rouble loans to non-financial organizations grew from 9.8% in 2010 to 10.7% in 2011 and 11.3% in 2012.

On the other hand, profitability of many real sector industries was close to zero. In 2011, the return rate of the pulp and paper industry was 5.8%; food industry, including beverages and tobacco, 5.3%; electricity generation and distribution, and gas and water supply, 5.1%; rubber and plastic production, 4.9%; electric appliances, 4.9%; machines and equipment, 4.8%; textile industry, 2.5%; wood articles and wood processing, 2.5%; etc. While the return rate of banks (in terms of capital) grew from 16.6% to 18.2% in the industry's worst year (according to the Association of Russian Banks).

No wonder that, in 2012, the industrial growth slowed down to 2.6% for the first time over 20 years, and is expected to be 2% in 2013 (with no growth at all in the first quarter). We believe that refinancing should be short-term, but also longer term (above one year as is the case in many countries).

To make the refinancing rate a really efficient pricing mechanism of the financial market, the money stock should be formed more by the 'internal' component rather than by foreign exchange proceedings (as is the case today). Financial resources should be generated in line with demand from the domestic market to enable access by non-exporting industries to necessary resources for modernization and structural changes. This implies that the money supply should primarily rely on internal mechanisms and instruments that better reflect the domestic demand for money.

Moreover, such approaches actually allow, first, creating monetary resources in line with the objectives of the organizational policy and, second, expanding the foothold for long money. As a result, both the economy and financial market will diversify the way we need, the market's liquidity will expand, and the investment potential of financial resources will grow. Given that even in more mature financial markets the basis for long money is built by national monetary

¹ Rossiyskiy statisticheskiy ezhegodnik. 2012. P. 767.

authorities (through the above approaches), such practice is quite worth being applied to Russia since it can ensure the necessary amount of long financial resources needed by the Russian economy.

In parallel, we need to work out comprehensive approaches to the problem of economy monetization aligning the policy of the Central Bank with the overall economic priorities, primarily the objectives of the budgetary and organizational policies. This should also be accompanied by measures that aim to bolster demand. Similar approaches have already been long used by developed countries. M. Boskin, former Chairman of the Council of Economic Advisers to the U.S. President (he occupied this position under George H. W. Bush) estimates that ‘while there has always been some level of industrial policy it has waxed and waned at a low level in previous administrations, the Obama administration has greatly expanded its size and scope.’¹ A so called *mondustrial policy* has emerged after the crisis, which implies the implementation of monetary approaches in conjunction with industrial priorities: its sectoral and corporate elements.²

The above approaches become particularly important due to the accession of Russia to the WTO resulting in tougher competition. Russian players should have opportunities comparable to those available to their competitors in terms of access to debt, its cost, amount and maturities.

Approaches to the modern industrial policy may not be confined to a certain portfolio of highly efficient projects (as, for example, the Russian Ministry of Economics tried to do in the mid-1990s). The system of priorities in the public industrial policy differs by definition from the priorities of commercial and investment banks whose key goal is to maximize profit. Challenges faced by the public industrial policy are of much more strategic nature. It must ensure a reasonable balance between highly efficient sectors and economic growth engines, on the one hand, and less efficient areas that enable advanced industries to take full advantage of their capabilities, on the other hand. Moreover, we believe that in applying the above approaches we should build ‘carrying structures’ that are needed for any economic system to operate properly.

*Only the implementation of a public industrial policy allows implementing long-term large-scale programmes that require important investments and that will pay back in ten or twenty years (such as space exploration or development of new sophisticated technologies). Both geo-economic and strategic aspects are important here from standpoint of ensuring the country’s economic security and safeguarding its economic sovereignty).*³

Evidently, the private sector should also be interested in such development. The scale and timelines for handling challenges arising today are oftentimes beyond the capabilities of even major companies. However, nobody doubts that robust infrastructure, strong research capabilities, and access to knowledge-intensive developments cement the positions of the country and national business in the country and abroad and help implementing competitive advantages based on advanced technologies and a knowledge-driven economy. Market forces in general are rather oriented towards applied and short-term objectives, while many pivotal economic sectors are left beyond the current interests of the business. For this reason, the country needs a system of direct and indirect public regulation measures that would funnel industrial development the right way and contribute to a stronger domestic and external economic position of the country.

¹ The Economist. 2010. Aug. 7 – 13. P. 55.

² www.investopedia.com

³ For more details see: *Ershov M.* Global Financial Crisis: What’s Next? M.: Ekonomika, 2011. P. 87 – 88.

Such system should rely on such criteria that will prioritize the right economic areas or industries. In particular, such areas might include economic growth indicators that capture the input by the industry in question, but also the multiplier effect where the growth of an industry leads to the growth in related sectors. Employment growth is also of much importance.

Apart from purely economic criteria, factors of social importance, framework, strategic and other parameters also play an essential part. We would specifically highlight the geographical aspect of industrial growth. A wide range of instruments representing various areas of economic policy are needed to make it more evenly spread. Other criteria are also possible.

We would draw specific attention to the role of cash flow regulation. In our view, it is vital that monetary authorities consistently use mechanisms available to them that are necessary to generate and funnel financial resources into areas prioritized by the current economic policy.

In particular, in 2012, in the *U.K.* the Bank of England launched, jointly with the Exchequer, a programme for financing banks' lending to non-financial industries (*funding for lending*), at below-market interest rates. Similarly, in recent years, to reduce external exposure and redirect banks' resources to the domestic market, *Switzerland* used relevant ratios that made domestic transactions more attractive for banks than international transactions, which facilitated the redirection of Swiss bank cash flows to the domestic lending market.

In general, during and after the crisis, a trend consisting in a higher appetite for investment in one's own economies has become more prominent globally. This phenomenon was named *home bias*. Similar measures were also applied in *Japan*. Up to the mid-1990s, the country used the 5-3-3-2 investment rule to regulate financial flows, which imposed the investment portfolio structure on market players, including pension funds and other major investors. The country conducts a vigorous cheap lending policy (in the late 1990s, policy rates were close to zero). Various economic ratios are applied to redirect resources of Japanese banks from abroad to the domestic market.

The *U.S.*, for instance, continues actively using the 'Community Reinvestment Act' (CRA) of 2009 that encourages investment at the local level and development of low-efficiency investment programmes. Although formally, the parameters promoted by the Act are but guidelines, market players try to stick to them closely, as otherwise this will be taken into account by the Fed when making relevant decisions.

Moreover, depending on their compliance with the above Act, they will be subject to other acts that provide for milder regulation (while trespassers of the Act are not subject to such allowances). As such, it would seem quite reasonable to use a wide range of measures (various ratios, tax and other instruments) also in *Russia* as they would help funnelling financial resources to priority areas. On the one hand, however, we need to consider milder requirements to banks to expand their capabilities to boost lending (e.g. by using lower ratios for weighing against relevant types of risks); on the other hand, such easing would need to be clearly defined to prevent undesirable destabilizing consequences. Similarly, companies that receive such funding must be interested in expanding their operations, which in its turn depends on the economic demand performance, overall economic situation, etc. In this connection, regulators should broadly use financial instruments available to them to cover as much areas as possible in handling this matter, subject to capabilities of manufacturers, consumers and banks.

The selection of priority investment targets should, in our view, capture the inter-sectoral aspect, and opportunities for encouraging demand in other sectors with the resulting multiplier effect for the overall economy. Other criteria might be used as well, including those that captures options

for faster and non-inflation resource development (to this end, the most efficient links of production chains need to be identified to ensure rapid payback of investments), capital generation, etc.

3. Reproduction of long money as the backbone of investment and sustainable development.

Almost all central banks of developed countries run policies that provide for the creation of long financial resources and in general for the expansion of long money in their economies (see examples in Fig. 1 and 2). We believe that the Bank of Russia should also pay closer attention to this area.

In particular, in 2011, the U.S. announced an approach that provides for more ‘long’ treasury instruments and fewer ‘short’ instruments in the Fed portfolio (Operation Twist), which has been repeatedly confirmed later on. The data show that about 90% of all U.S. dollars currently available over the world were initially injected in the economy as a result of funding of various government programmes. Then this money gets into the secondary market and multiplies into relevant monetary aggregates. Public budget priorities also play an important part in the creation of JPY monetary stock.

Another set of factors are also critical in this connection. First, papers bought by the central bank are typically held on the balance of the central bank until they mature. To put otherwise, the economy gets long and targeted investment resources. Moreover, once they mature, the central bank often issues new instruments and buys such newly issued securities. This makes the process of maintaining long resources in the economy almost endless. Furthermore, the involvement of the central bank in such mechanisms allows funding public budget objectives without cutting down the overall financial market liquidity (which would happen if companies and banks invested in such instruments, which would result in an outflow of resources to finance the public budget and constrain potential investments by the private sector).

The policy run by the Bank of Japan is as aggressive. According to its former Governor M. Hirakata, the Bank's will continue ‘its policy commitment on the duration of powerful monetary easing including the virtually zero interest rate policy’¹ and will increase its asset purchases, which will include not only Japanese treasury securities, but also risky private instruments (corporate bonds, etc), which is extremely unusual for a central bank.²

The new management of the Bank has been even more aggressive in applying the above approaches. For instance, the new Governor of the Bank of Japan H. Kuroda estimates that the coming two years will see the current level of JPY monetary stock double and the share of long-term instruments (up to 40 years) in the Bank’s portfolio increased.³ (Fig. 3)

To combat deflation, the Bank of Japan has announced that it is also planning to increase its balance sheet on a monthly basis by more than 1% of the country’s GDP, which represents twice as high growth rates as in the U.S.⁴

¹ Speech by *Shirakawa M.* The Bank of Japan’s efforts toward overcoming deflation // The Japan National Press Club. Tokyo, 2012. Feb. 17.

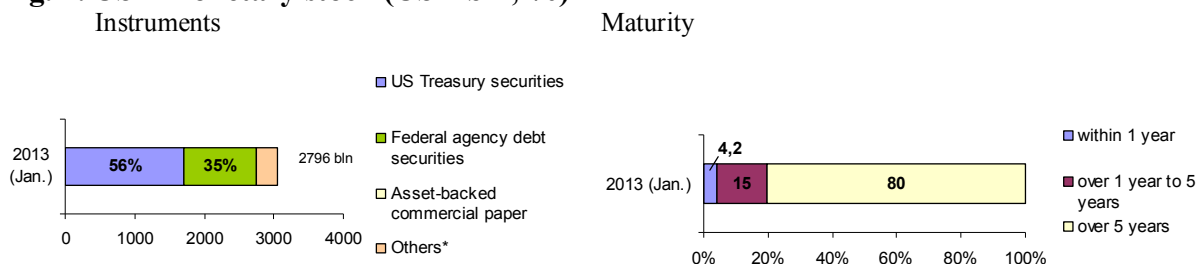
² Ibid.

³ At present treasury bonds (up to 65% of monetary stock).

⁴ Revolution in the air // The Economist. 2013. April 13–19. P. 10.

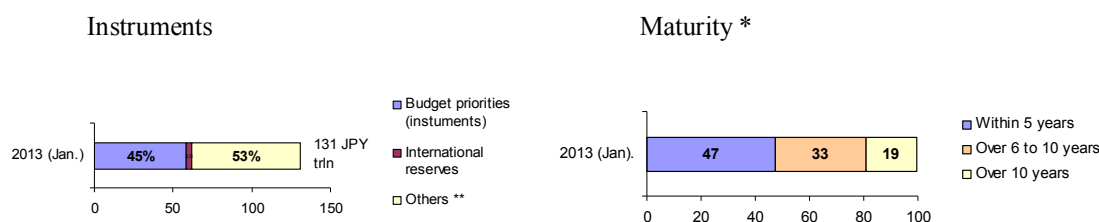
Although the overall inflation level in Russia is higher, the inflation lowering trend allows fully evaluating opportunities offered by similar targeted long money creation approaches practiced by the most mature financial systems of the world.

Fig. 1. USD monetary stock (USD bln, %)



Source: US Fed.

Fig. 2. JPY monetary stock (JPY trln, %)

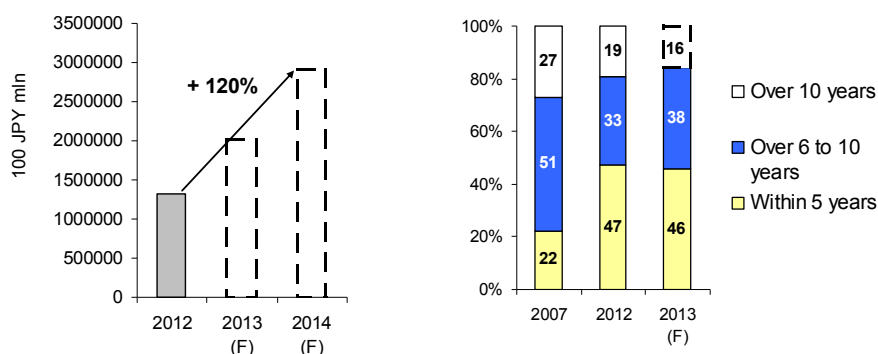


* Government bonds (account for 65% of the monetary base).

** Other include, *inter alia*, asset-backed financing (with such assets as bonds, commercial papers, etc.).

Source: Bank of Japan.

Fig. 3. JPY monetary stock: scope and timelines



The forecast is built on the Japanese treasury bond purchase programme of 4 April 2013.

Source: Bank of Japan

The discussion of this issue needs a thorough technical analysis. Moreover, we need to work out a set of measures to make resources cheaper. Both depositors and banks could be encouraged by lower tax rates applicable to interest accrued on longer deposits. Such measures could be combined with a lower provisioning requirement to long resources. This will allow offering higher yield on such deposits to make them more attractive. In case of concerns (that are sometimes voiced) that market players would still only recur to short deposits, mechanisms could be used that provide for lower provisioning and tax requirements only with respect to the amount of long maturity deposits. We need to use all potential regulatory measures to make rouble transactions more attractive as compared to foreign currencies in general and thereby

discourage any outflow of new liquidity resources to the foreign exchange market. Note that similar approaches are widely used by major economies, including by Japan, and currently by Switzerland.

A broad range of various instruments could be considered to this end. Among other things, it would be reasonable to lower the provisioning ratio for rouble liabilities as compared to foreign exchange liabilities (the Bank of Russia launched such practices a while ago). This will make rouble transactions more efficient. Additionally, as to ratios regulating the balance sheet structure (capital adequacy, etc.), foreign exchange transactions should be interpreted in asset and liability formulas as riskier transactions (formally they do carry exchange rate, political and other risks), and therefore be subject to stricter ratios. Consider the example of Japan that introduced tougher equity/assets requirements for foreign exchange resources to encourage JPY transactions of its banks as this measure made yen transactions more attractive for Japanese banks.

Maturities of debt provided by the central bank via its refinancing facilities would also need to be increased from 1 year (as it is now) to longer maturities. For example, the maturity currently applied by the ECB is three years. To expand the long lending opportunities and mitigate related risks, we would also need to continue improving the mechanisms for using bank requirements to long loans in the Lombard List. A proper regulatory framework for derivatives that allow using optimal forms and methods for covering such transactions (e.g. in the form of notes that allow fractioning the principal) would considerably increase creditors' capabilities in refinancing individual fractions of the loan in the market by selling such papers (notes) to get the necessary liquidity.

The Bank of Russia coordinates and directs the development of the entire national banking system and also oversees performance by banks of their functions. Anybody can easily see (and it would seem that the Bank of Russia should miss this important fact) that the share of investment loans in the total loan portfolio in Russia is a record low of 6%. While the share of bank loans in investment has been diminishing year on year: 11.8% in 2008; 10.3% in 2009; 9.0% in 2010; and 8.5% in 2011.

In advanced economies, the share of investment loans is 2-2.5 times as high. If we consider that the overall loan to GDP ratio in Western Europe is in its turn 2-2.5 times higher than in Russia, then investment lending to Russian companies will prove to be 4-6 times as low in the West. Given that the level of economic development in Russia is 1.5-2 times lower, Western investment loans per capita exceed relevant Russian figures by 6-10 times. And these *investments are investments in the future*. As no company can normally operate without such investment, it has to invest to a substantial extent its own money: profit and depreciation.

Note also that in Russia, unlike the U.S. and other developed countries, market long money funds (i.e. non-government retirement savings funds, insurance funds, unit trusts, etc.) are absent or extremely minor. The scale of each group of such funds in Russia does not exceed USD 20-30 bln as compared to hundreds of billions, and in the U.S. even trillions, of dollars. As such, banking assets and loans (measuring USD 1-1.5 trln) is actually the only domestic market source of liquidity, including investment money. While Western companies use 20%, or at most 30%, of their own money, Russian companies use up to 50%. Given the low returns in many industries, own money is clearly insufficient. This situation slows down the social and economic growth as we see.

In April 2013, the Ministry of Economic Development lowered its GDP growth estimates for 2013 to 2.4%, and industry growth to 2%. The Ministry also lowered its forecasts for 2014-2016,

particularly for the key economic sector: manufacturing. Over 5 years (from 2012 to 2016), industrial output would grow by less than 15%, i.e. less than 3% a year. The gross domestic product will grow faster, apparently driven by a higher share of services in GDP on the back of a lower real sector share.

Such low social and economic growth rates will prevent us from solving any vital problem in the nearest future:

- put an end to poverty;
- improve housing conditions;
- build highways and high-speed railways;
- increase life expectancy at least to the level of developing and other post-socialist countries;
- set a stage for accelerated development of science, education, information and biotechnologies.

All these objectives will fail for a simple reason: lack of financial resources that drive economic growth. As such, our priority task is to substantially accelerate social and economic growth by increasing the average annual growth rates from the current 3-3.5% to 5-6%, and all executive branch agencies, including the Central Bank, must focus on this task.

4. Surplus or deficit in the budget policy?

The large scale objectives faced by the economy, i.e. setting the stage for sustainable growth, improving its quality, diversifying away from commodities, solving long-term tasks (including regional development, mortgage) can be achieved if both the private and public sector considerably increase their expenses (and potentially deficit). Given that many of these objectives are of systemic and long-ranging nature, the government clearly must get involved in these processes. In its turn, such expenses are to be funded either by the financial sector and national regulators, or by international markets.

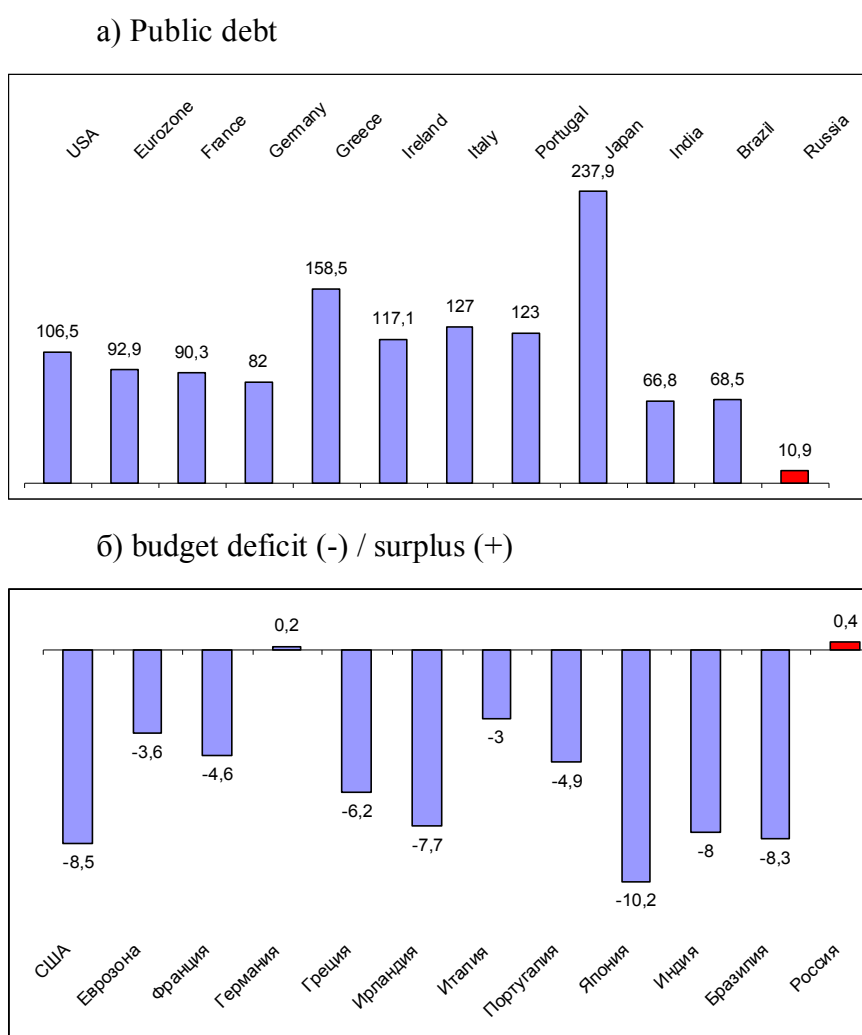
Meanwhile, a surplus-based budget policy actually implies that money is to be withdrawn from the economy while an expanding economy requires quite the contrary: additional funding.

The global experience of crisis management both in the 20th and early 21st century is quite representative. Major economies, primarily the U.S. and Japan, have once again demonstrated the successful practice of boosting the economy by using budgetary instruments (see Fig. 4). As such, *the use of economic growth support mechanisms relying on deficit funding mechanisms that ensure an inflow of additional financial resources requires the most careful attention.*

In general, the surplus budget cannot play any boosting role if such surplus is not reinvested into, but is actually withdrawn from, the economy (as in Russia, for instance), while other important problems are being solved (external debt repayment, etc.). Actually, unless income gained by the economy is partially reinvested, the basis for 'self-financing' economic growth is cut down, and economic growth becomes heavily dependent on external debt.¹

¹ If we consider this issue from the perspective of common economic logic (avoiding any specific theories), we will see similar cause and effect relations. Economic growth implies that the economy should get *additional* resources necessary to obtain the end result. Such resources should be advanced to the economy (i.e. provided before the result is produced). By analogy to the private sector, the company first invests in a project, and, once implemented, the project starts generating income, but not the other way round. In a purely hypothetical situation where all resources in the economy are used and efficiently operating, meaning that they cannot be redistributed to finance any new programmes (as this will mean that one is financed at the expense of another), then the production of additional goods or services driving GDP and economic growth will accordingly require more expenses, naturally before income is produced.

Fig. 4. Public debt and budget deficit in some countries (% of GDP), 2012

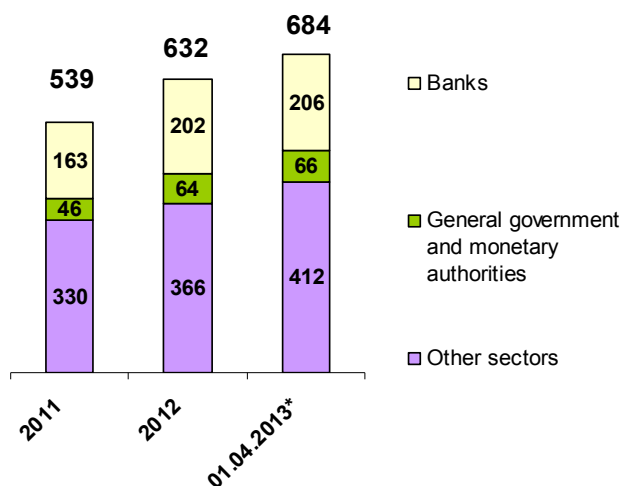


Source: IMF. 2013. April.

Moreover a number of strategic programmes are still financed given their importance for Western economies, even in spite of budget deficits recorded by them. Therefore, such important and promising development areas as small-size enterprises, mortgage, and other key areas subject to their potential and the role they can and must play in the economy should be supported and encouraged under any circumstances even if this implies a certain increase in the budget deficit as their contribution to economic growth and eventually to the economy and budget strengthening might be decisive.

The above approaches show a greater ‘degree of freedom’ than used by major global economies for themselves. In such situation, they do not face the dilemma that is thought to emerge in the Russian economy when the government actually forces companies and organizations, especially government-owned ones, to run into exorbitant external debt by borrowing at 3-4 times higher interest rates as compared to the income on national gold and foreign exchange reserves that lay unused for years, or make privatization a cure-all for all problems.

Fig. 5. External debt of the Russian Federation (USD bln)



*est.

Source: Bank of Russia.

On the other hand, high interest rates, particularly for investment loans, also make our companies and organizations build up their foreign debt by borrowing abroad at more acceptable interest rates.

Our article entitled ‘The Growing Corporate Debt to Foreign Investors: A Noose on the Neck of the National Economy’¹ deals with this issue specifically. The article gives the figure of the Russian external corporate debt as of 1 January 2013: USD 568 bln that increased by USD 75 bln or almost 15% over one year. The article also draws the attention of the Russian Government and the Bank of Russia to the amount of this excessive debt owed by our companies and banks. The result? Over the following three months the debt grew by another USD 50 bln, with corporate debt accounting for an overwhelming part of it (USD 46 bln). Foreign debt has grown the most: by USD 39 bln (16%) to USD 277 bln.²

5. The new role of banks in implementation of the planned real sector modernization.

To overcome the underdevelopment and accelerate the national social and economic growth, the country has to modernize its national economy: upgrade the outdated and worn out infrastructure of many industries, rebuild the economic structure by increasing the importance of high added value finished products, especially hi-tech and innovative sectors to dispel the *oil curse*, double homebuilding, launch large-scale construction of highways and high-speed railways, and develop the knowledge-based economic industries. This will require increasing the rate of investment by 1.5-1.7 times to 30-35%, which is equivalent to an increase of investment in capital stock from RUB 12.5 trln for 2012 to RUB 20 and more trillion roubles. The most efficient forms of investment could include self-financing investment loans, whose share in own investments will grow from 7% to 40 and perhaps more percent. As such, the role of the banking system and Russian commercial banks in investment will increase many times.

The Ministry of Finance and the Bank of Russia face a task of reproducing ‘long’ money, potentially using the experience of developed economies described above.

¹ Aganbegyan A. G. The Growing Corporate Debt ... // Dengi i kredit. 2013. No. 3.

² According to the Bank of Russia

Such large scale objectives that are currently faced by the Russian economy will require significant financing, which in its turn requires new approaches in the policy run by the Bank of Russia and in the overall investment policy of the country.

We would highlight that the same logic underlies international corporate financial planning when calculations of cash flows first imply a negative cash flow related to investment and then, as the project is implemented, income is generated to compensate for the initial deficit and transform into profit. As such, the practice of ‘deficit financing’ while encouraging economic growth actually has the same logic as in investment approaches applied by the private sector.

For more details see: *Ershov M.* The Economic Sovereignty of Russia in the Global Economy. M. Ekonomika, 2005. P. 227–228.