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Mikhail Ershov[1]
Senior Vice President of Rosbank, Doctor of Economics

Looking in the Wrong Place

Long-term money injected into the economy should mainly come from the Central Bank's issuance of such resources based on the purchase of the Ministry of Finance's long-term securities rather than from international markets.

The Development Strategy of the Banking Sector of the Russian Federation Until 2015 specifies the reasons hampering the development of domestic banks. These primarily include their insufficient involvement in the financing of economic processes, inability to compete adequately with international banks, constrained and long-term resource base.

The lack of long-term money is an acute problem, all the more so as the Russian economy faces systemic objectives of innovative development and modernization, which require large-scale and long-term investments.

Throughout the entire contemporary history of market reforms, there has been continued focus on the problem of long-term money. At different times, efforts have been made to shape more sustainable resource base for the financial system such as the introduction of lower reserve requirements for long-term money to make it more attractive. There has been a debate about possible options for using non-callable deposits, and discussions are still underway. The crisis opened an opportunity for obtaining longer-term resources through refinancing by the Central Bank (later it was cancelled).

Currently, attempts are being made to involve into the economy accumulated long-term pension and insurance resources; the resources of special institutions are being expanded (VEB, RBD). However, the task is still pending in a system- and economy-wide context and international markets remain the main source of long-term

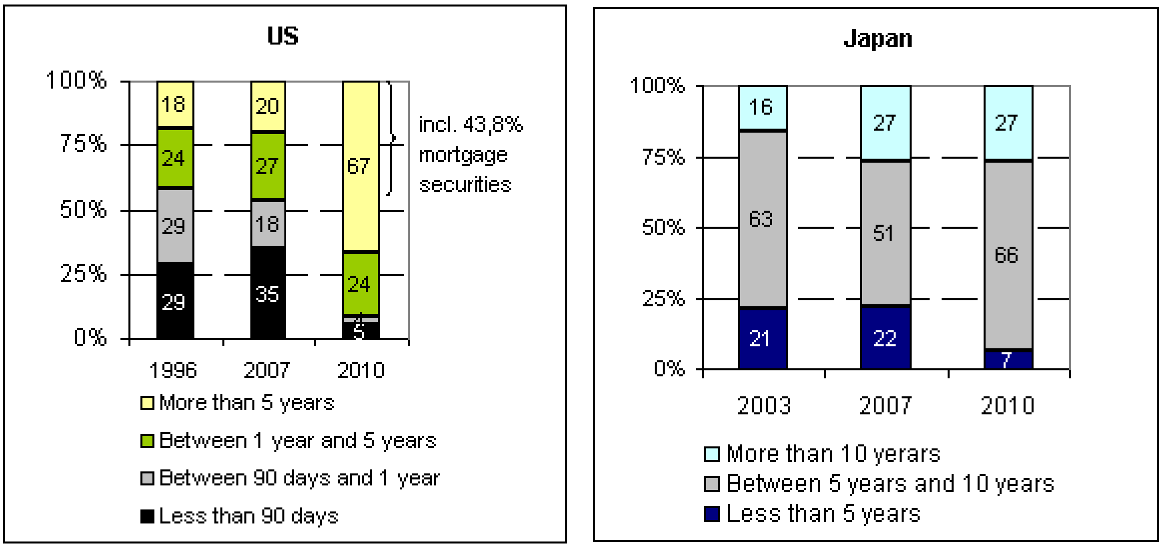
[1] The article reflects the personal opinion of the author.

money, as before (although during the crisis obtaining money even there was a challenge).

The Way They Do It

Instruments and sources of shaping long-term resources in developed economies are diverse. Yet the crucial role is played by their central banks as the principal emission centers which form the basis for long-term money. For example, the two most powerful global economies (the USA and Japan), when shaping money demand (monetary base), focus mainly on long-term government bonds issued for the purposes of budget deficit financing. Later, these papers are purchased by central banks and maintained on their balance sheets, resulting in the inflow of long-term special-purpose resources into the economy. This has been sustainable practice in recent decades (for detailed information, see www.ershovm.ru).

Figure 1. Breakdown of Monetary Base of the USA and Japan by Maturity



Source: M. Ershov. Global Financial Crisis. What's Next? M.: Ekonomika, 2011.

Given that budget instruments accounted for a total of 90% (or sometimes more) of the entire money creation (monetary base), long-term budget resources, as a result, account for at least 40% of the aggregate resources issued into the economy.

This practice allows bringing additional resources to the market in line with economic priorities.

Consequently, budget programs are primary recipients of resources. Afterwards, the resources are multiplied and go to the remaining sectors of economy, producing demand chain and encouraging growth in adjacent and other industries. Given that such issue is based on instruments with a maturity ranging between 10 and 20 years, their subsequent flow into the economy results in multi-layer long-term resource base. In combination with the involvement of insurance, pension and other money in the process, this lays a system-wide foundation for long-term investment processes.

When a central bank purchases (even indirectly) from its ministry of finance, for example, a ten-year security, virtually, this implies that the budget obtains a ten-year loan. Even after papers mature, a new issue is often performed and purchased again by the central bank. Typically, such operations are executed indirectly through various trust intermediaries operating in the secondary market. It is of paramount importance that the issuer of securities such as the Treasury receives for them the dollars issued by the US Fed and the US Fed receives securities in exchange for dollars, thus closing the exchange loop.

There is one more aspect. The purchase of budget instruments by the US Fed makes it possible to prevent funds from being crowded out of other economic sectors, thus not hampering their development. Crowding out occurs, on the contrary, when these papers are purchased by "ordinary" market participants.

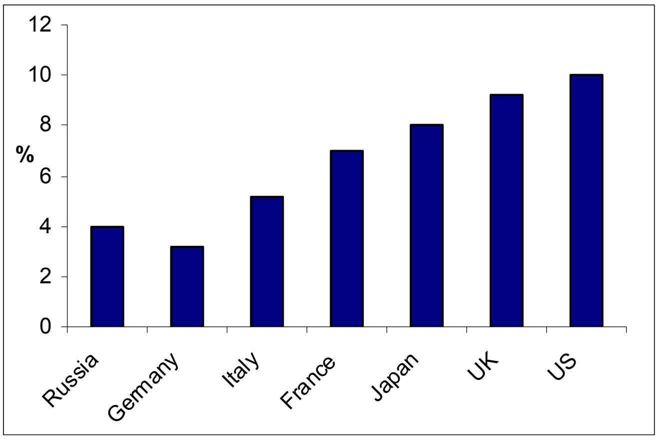
Interestingly, even when the economy faced budget surplus (as was the case in the late 1990s in the US), the amount of government securities recorded on the balance sheet of the US Fed, however, never decreased (although budget financing needs formally declined and the amount of government securities in the economy could have been reduced). The amount of government securities recorded on the balance sheet of the US Fed was maintained in order to avoid adverse implications of the already properly functioning resources' withdrawing from the economy. Their withdrawal would have implied interrupting the development of the economy working with this money.

During the acute phase of the crisis in developed countries, short-term instruments came to the forefront for a while in liquidity creation as a necessary source of emergency funds for the market. However, by mid-2009, long-term resources regained their dominant positions (currently, instruments maturing in more than one year account for over 70% of the entire portfolio). However, at present, the majority of such papers are mortgage-backed securities repurchased from the market as it was needed to support this market segment. In general, the share of long-term papers (adjusted for mortgage instruments) generally regained its common levels of the mid-1990s and the 2000s (see the figure below).

And again, as had already been the case with mature financial systems, monetary authorities laid basis of long-term money.

These are important mechanisms, all the more so as it is necessary to finance budget deficit, an issue faced by most developed countries. Let us note that many of them steadily breach the limits of 3% of GDP specified in the Stability and Growth Pact since deficit is a significant stimulus for economic growth. For example, in the US, the budget deficit accumulated between 2000 and 2010 was USD 4.4 trillion; the absolute growth of GDP, USD 4.7 trillion.

Figure 2. Most G7 Countries Considerably Outpace Russia in Budget Deficit Rate



Source: The Economist, Ministry for Economic Development of Russia

Creative deficit

The Russian economy needs to undergo serious restructuring which will bring it up-to-date with the new innovative challenges. It will require major long-term financing thus making approaches outlined above extremely important for further consideration (especially given the need to effectively finance budget deficit). This necessitates, first, the finding of reasonable balance in the sequence of financing economic priorities (mortgage lending, small businesses, etc) and, second, careful control over the ways they are implemented.

Obviously, possible necessary steps include significant revision of mechanisms for money demand creation and strengthening of the role of national monetary authorities in the process. Therefore, many years of experience in using such approaches in mature financial systems give serious reasons to look at them carefully.

Otherwise, the solution to the problem of creation long resources will be fragmentary (rather than systemic and covering the whole economy). In other words, we will witness “some successful examples” of domestic financing, but long-term funding for large-scale system-wide projects will essentially depend on the possibility of raising long-term money from abroad.

In this regard, effectively managing budget deficit and maintaining it at a relatively risk-free level (not more than 1.5-2% of GDP) can create more favorable conditions for long-term structural changes in the economy.