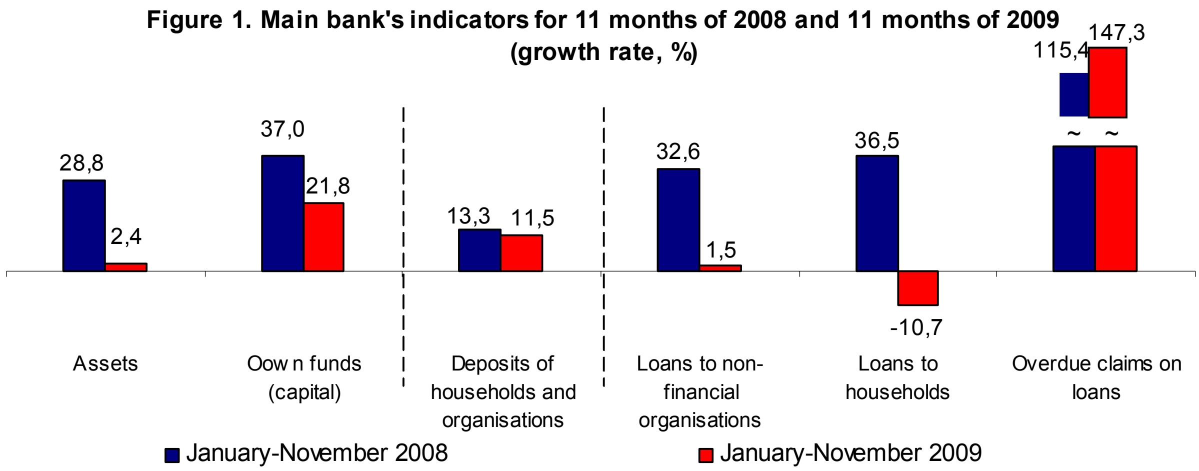
Published in Journal of the New Economic Association, №5, 2010, pp. 148-152.

M. ERSHOV,
Rosbank, Moscow

Financial Crisis: Some Aspects [1]

The ongoing economic downturn has visibly impacted the Russian banking system (Fig.1).

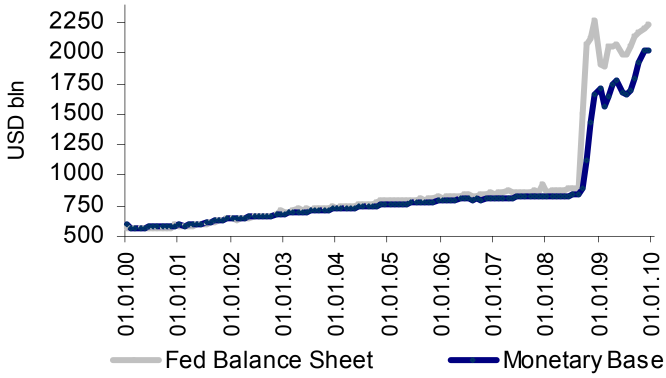


Source: CBR

It has also raised in earnest the issue of forming a sustainable resource base which is capable of making the system resilient even amid conditions of financial upheaval. At present, the proportion of Central Bank funds held as bank liabilities is shrinking dramatically (down from 12% as of the beginning of 2009 to 4.3% in November 2009); household deposits are returning to pre-crisis growth levels (18.5% in 11M09 compared with 7.1% in 11M08). At the same time, the pace of funds attracted from businesses has slowed down considerably. Furthermore, there are signs that financial resources are starting to flow in from abroad. This process fits squarely in line with expectations, given the large-scale injection of liquidity in developed countries, first and foremost, in the United States (Fig. 2).

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

Figure 2. US: Monetary base of the Dollar and Fed balance sheet (USD bln)



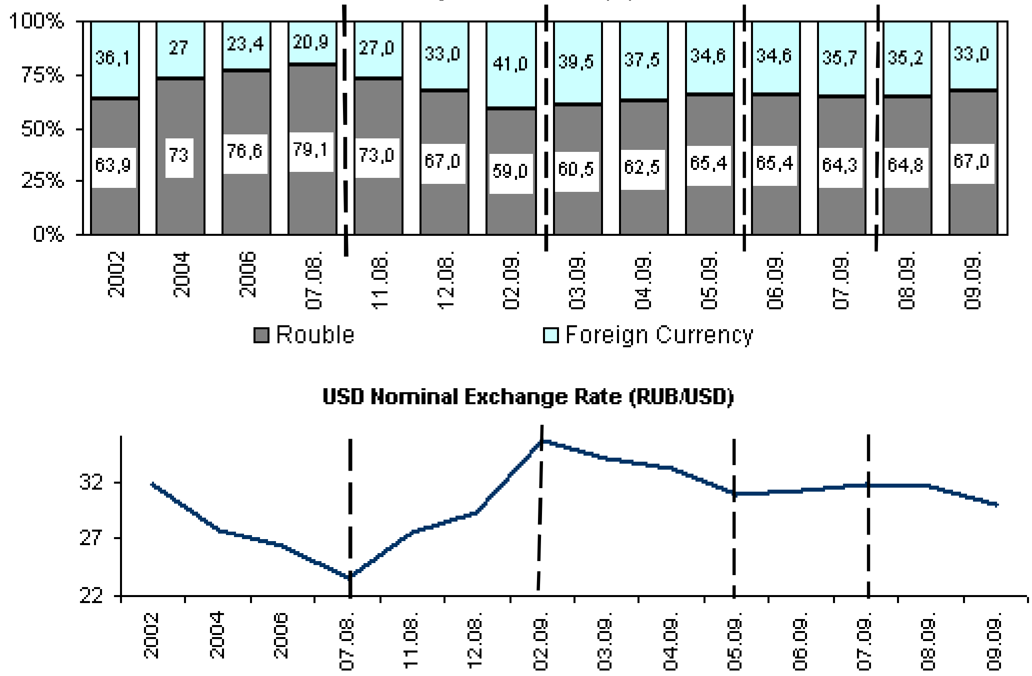
Source: US Fed

However, this same process runs the risk of raising an overhang of "hot" money, thus creating new bubbles, which poses even greater risks to the dollar itself.

Exchange rate trends

Paramount to the stabilization of the domestic financial situation is a balanced exchange rate policy, which should be designed to make the Russian ruble more attractive and to encourage its use in savings and investments. It should also be noted that the real devaluation of the ruble, which took place at the end of 2008 and early 2009, took a heavy toll on the currency structure of business and household deposits, substantially undermining the appeal of the country's currency and within a matter of months throwing the pattern several years back (Fig. 3).

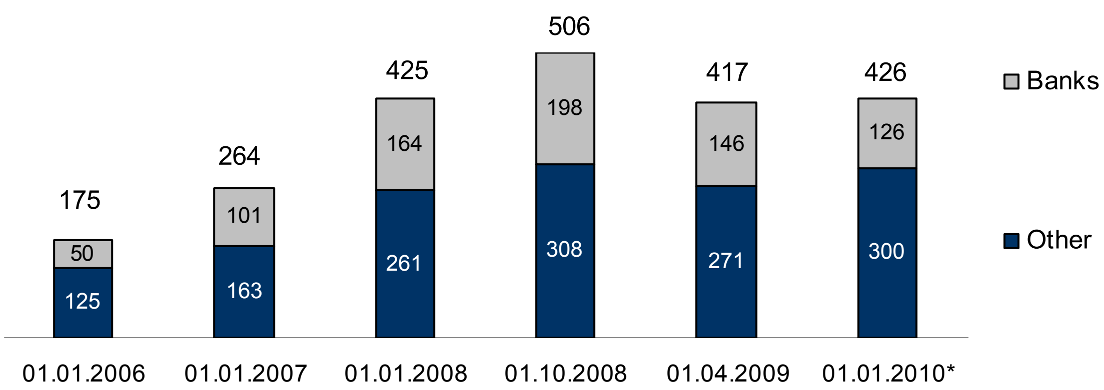
Figure 3. Currency Structure of Deposits of Households and Corporate Funds* (%)



* Corporate funds incl. money on deposits, settlement accounts and other accounts.
Source: CBR; calc. based on CBR data.

What draws attention is the correlation between currency trends and "currency preferences" (since as soon as the ruble appreciated deposits in the national currency shot up and vice versa). This is a major indicator when conducting a policy aimed at strengthening the ruble exchange rate at a time when global liquidity is on the rise (the latter implies the search of spheres of its placement and as a result a possible inflow of funds into the Russian economy), while Russian companies are again starting to raise funds from abroad (Fig. 4), which also helps bolster the strength of the ruble.

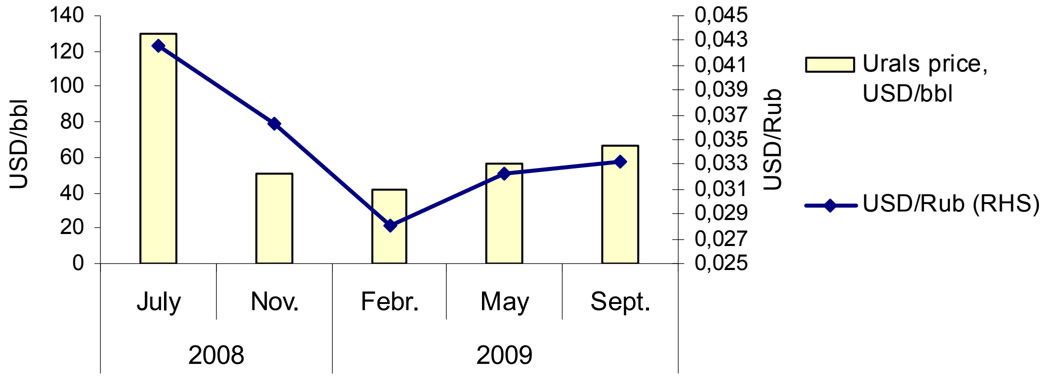
Figure 4. External debt of private sector (USD bln)



**Estimates of SBR*
Source: CBR

One benchmark trend which impacts the strength of the ruble is the price of oil. Its correlation with currency dynamics is quite high (Fig. 5).

Figure 5. Oil Price and Ruble Exchange Rate (USD/bbl, USD/Rub)



Source: Ministry for Finance, CBR

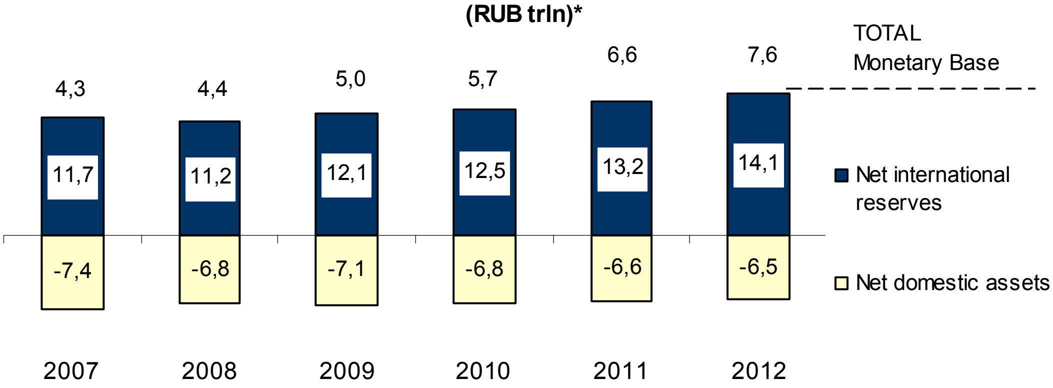
And in light of forecasts by international organizations according to which the price of crude could overshoot $100 per ton in H1 2010, this is also a factor underpinning strength in the ruble. The risk of reliance on external sources materialized in full during the crisis period, when companies had a hard time borrowing abroad, as a result of which they faced difficulties in gathering sufficient collateral (due to the depreciated value of collateral) and premature loan repayment. All of the above factors created serious problems for many companies, raising the threat of bankruptcy for some of them. For this reason, one of the pivotal anti-crisis challenges is to replace external financing with domestic sources, which should act as a major stabilizing factor. In this case, the ways and means for creating money supply play a major role in achieving this goal.

About monetary policy

Around the same time last year, when the effects of the economic meltdown were still being acutely felt and there were serious risks attached to external funding, the Bank of Russia carefully weighed its options amid the new conditions. In “Guidelines for the Single State Monetary Policy in 2009 and for 2010 and 2011”, adopted at the end of 2008, for the first time in many years the focus in forming money supply was on growing domestic sources (net domestic assets), while decreasing the external factor. The assumption was that this would make it possible to “use more effectively the interest rate instruments of monetary regulation and make the interest rate channel of the monetary policy transmission mechanism work” (Guidelines, 2008), and also “the scaling down of the Bank of Russia presence on the domestic forex market will help make the exchange rate policy more flexible and implement a gradual transition to the free floating exchange rate regime”.

However, the monetary policy for 2010 was worked out in line with the assumption that net international reserves, the main source for expanding the monetary base, are poised for growth. This essentially means that the Central Bank is distancing itself from the approaches it announced last year when the key concern was counteracting the crisis and the main sources of funds were domestic ones. Now the main sources for creating the monetary base (as was also the case in earlier years) will again be external sources (Fig. 6).

Figure 6. Sources of formation of the ruble monetary base (RUB trln)*



* 2009 - est. of CBR; 2010-2012 -projections of CBR according to the basic (second) variant of monetary program of 2009.

Source: according to Guidelines 2008, Guidelines 2009

Even under a scenario where the price of oil is $45/bbl (which looks most unlikely), the external factor would appear to play a decisive role.

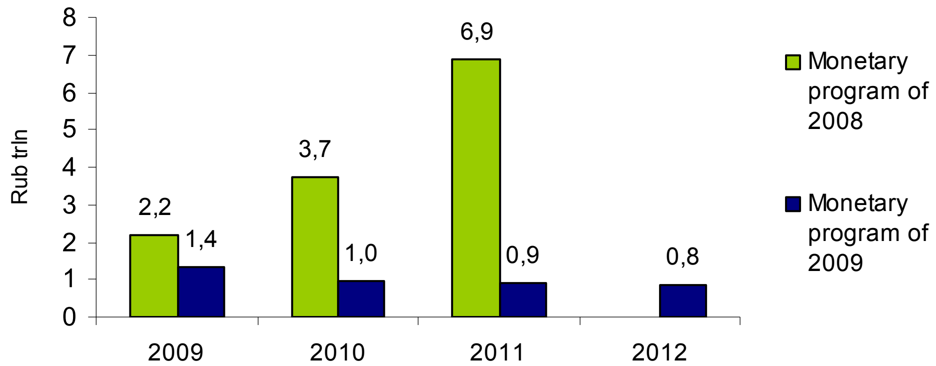
That said, it would be incorrect to assume that the objectives set forth in the document for 2008 have lost their relevance. The question now is what ways and means will be used to tackle the structural challenges facing the country's present-day economy. It bears repeating that the external monetization channel is fraught, first and foremost, with external risks in the process of raising resources (or the inability to raise them, as was the case at the height of the downturn).

Furthermore, the above-mentioned approaches will contribute to perpetuating the commodity export orientation of the Russian economy, whereas moving away from this model is a major systemic challenge. Needless to say, an exporter, by selling goods for hard-currency proceeds and generating additional rubles, is actually creating demand for the rest of the economy, which, in this way, begins increasingly to serve the interests of this very sector by expanding its positions in exports as well as in GDP, a trend we have witnessed over a period of many years. What's more, the spillover of financial resources into non-export sectors of the economy is in decline, as a result of which transmission mechanisms cannot effectively drive a cross-flow of resources, while interest rates are unable to properly reflect the value of resources for the economy.

The bigger question therefore remains of how to reconcile the challenge of scaling back interventions by the Bank of Russia in the domestic currency market (the expediency of which requires careful consideration amid such an imbalance in the currency market) with maintaining currency receipts as the core facet of money supply. This currency is purchased from the market by the Central Bank which issues rubles as a result. It is clear that international currency reserves offer a certain safety valve for the national economy, as aptly illustrated by recent crisis events. This, however, does not imply that the system should switch over to a "currency board" mechanism (if not literally, then in essence) at a time when all liquidity is formed only on the basis of currency inflow, while the Central Bank has actually turned away from its main function, that of being a primary source of monetary resources which are equally available to the export and non-export branches of the economy. Export proceeds and foreign loans will continue to flow into the economy. But their role in creating the monetary base should be balanced by domestic mechanisms for forming resources, in view of the internal needs of market participants, first and foremost in the non-export sectors of the economy. Unless these areas develop it will hardly be possible to achieve real diversification of the economy and shift away from the commodity-driven model of economic growth.

In the document (Guidelines, 2009) the role of banks in providing gross credit is significantly downsized (Fig. 7).

Figure 7. Gross credit to banks (Rub trln)



* according to the basic (third) variant of monetary program of 2008 and the basic (second) variant of monetary program of 2009.

Source: Guidelines 2008, Guidelines 2009

As a matter of fact, banks all over the world during the economic crisis have been reluctant to extend loans to economic participants. However, while the scope of funding through lending channels is expected to shrink, it is important that the role of internal factors does not narrow for the economy as a whole. The projected growth of net credit to an expanded government, budgetary and other mechanisms could act as balancing factors as part of such an approach.

The outlook

In the final analysis, the recovery of the banking sector will be largely dependent on overall progress in Russia's economic development. In the process, it will be important to achieve a sustainable resource base and efficient operations to ensure that financial resources find their way into the economy.

Should domestic channels prove to be insufficient, one should not rule out the eventuality that funds could once again be raised from foreign markets. Given the level of excess global liquidity, it would be logical to assume that a larger amount of monetary resources could flow in from abroad as short-term, and, to a lesser extent, mid- and long-term loans and investments, which will help strengthen the ruble, while assigning a more important role to the mechanisms for mitigating the risks of "hot" money.

Given the backlog of overdue debts at commercial banks (which creates an additional drag on capital and raises the likelihood of write-offs), the issue of supporting an appropriate level of capital requires serious attention, as a result of which bank capitalization difficulties will remain on the agenda which is even more important due to the fact that minimal capital reserve limits could be raised for lending institutions. Financing of the private sector is likely to recover, although growth might not be as strong as it was before the crisis.

And last but not least, it's important that there is some meaningful follow-up to the approaches which regulatory authorities and banks devised amid the downturn (on the part of regulators – rapid response to the lack of liquidity, expansion of lending provision mechanisms, etc. and on the part of lenders – achieving a more stable liabilities base, raising the quality of assets, cost-cutting, etc), once the economic environment stabilizes.

Sources:

Guidelines (2008): Guidelines for the Single State Monetary Policy in 2009 and for 2010 and 2011. http://www. cbr.ru/today/publications_reports, free access.

Guidelines (2009): Guidelines for the Single State Monetary Policy in 2010 and for 2011 and 2012. http://www. cbr.ru/today/publications_reports, free access.