Russia's Changing Financial System

The Monetary Situation in Early Summer 1995

IPC Working Paper No. 6

Dr. Adalbert Winkler

June 1995

Contents

I. The Monetary Situation in Russia

1. A new stabilisation effort

In Russia a new stabilisation effort is in progress. This is clearly reflected in all the monetary indicators (see Table 1): the monthly inflation rate has come down from 17.8% in January to (a provisional) 7.5% in May. Since the Central Bank of Russia kept its refinancing rate virtually unchanged at 200% - not until May did it cut the rate, and then only to 195%, a scarcely appreciable reduction - the monthly real interest rate, measured in terms of the CBR refinancing rate less the current rate of inflation, rose from -0.9% to 8.1%. The downward slide of the rouble, which began last September, bottomed out in April. Since then - to mid-May - the rouble has appreciated against the dollar for the first time since the Russia Small Business Fund was launched, not only in real terms but indeed also in nominal terms.

Table 1: **Monetary Indicators**, June 1994 - May 1995

	Monthly inflation rate	Monthly nominal interest rate (CBR)	Monthly real interest rate (CBR)	Dollar exchange rate US$ 1 = Rb ..... (end of period)	Rate of devaluation or appreciation (-): % change on previous month
Jun	6.00	15.00	8.30	1,985.00	3.60
Jul	5.30	12.90	7.20	2,060.00	3.78
Aug	4.60	11.90	7.00	2,197.00	6.65
Sep	7.70	10.80	2.90	2,633.00	19.85
Oct	15.10	12.50	-2.30	3,075.00	16.79
Nov	14.10	14.60	0.30	3,234.00	5.17
Dec	16.40	15.00	-1.20	3,550.00	9.77
Jan	17.80	16.70	-0.90	4,048.00	14.03
Feb	11.00	16.70	5.1	4,473.00	10.50
Mar	8.90	16.70	7.2	4,899.00	9.52
Apr	8.50	16.70	7.5	5,116.00	4.43
May	7.50*	16.25	8.1	5,043.00**	-1.42

* provisional
** as of 18 May

Basic Data: Brigitte Granville, Business World Weekly, Russian Economic Trends, Kommersant

The first signs that a return to stabilisation was under way came as early as October 1994 in the shape of the M2 growth rates. At that time, it was not yet possible to gauge the extent of the trend towards destabilisation that had followed the previous stabilisation effort. From the beginning of October to the end of March, the money supply grew by roughly 30%, compared with approx. 112% during the preceding six months (Table 2).

Table 2: **Monthly Growth of M2 (%), 1994 - 1995**

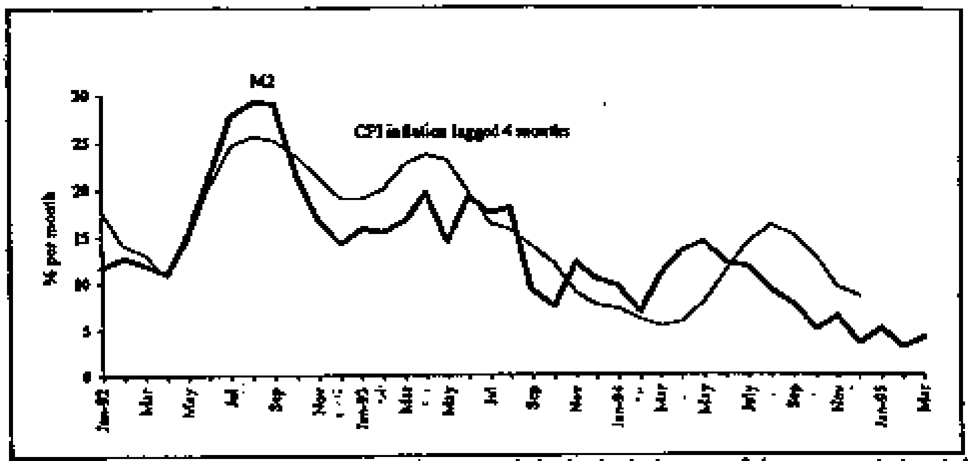
April	17
May	13
June	13
July	10
August	12
September	6
October	5
November	4
December	10
January*)	-4
February*)	9
March*)	4

*) provisional estimate

Source: Russian Economic Trends, May 1995

Thus, the surprising aspect of these developments has been not so much the fact that stabilisation has taken place, as expressed in the monthly growth rate of the consumer price indices, but more particularly the fact that it was not until the spring that the inflation rate showed any significant response. Previous regression analyses had shown that, until recently, inflation had been trailing money supply movements by a time-lag of four months.

Figure 1: **Monetary Growth and Subsequent Inflation** (3-month moving average)*)



* For all but the last month we give the three-month moving average calculated as the simple average of the current month, the preceding month and the following month. For the last month we give only the month in question.

Source: Russian Economic Trends, May 1995

Figure 1 shows clearly - allowing for a lag of four months between inflation and the money supply - the almost perfect correlation between these two variables, at least in terms of the direction of the trend, up until the early summer of 1994. Since then the time-lag has grown longer. However, as far as the winter of 1994/95 is concerned, it is not difficult to name the factors which may explain why inflation remained high despite the substantially reduced growth rate of the money supply:

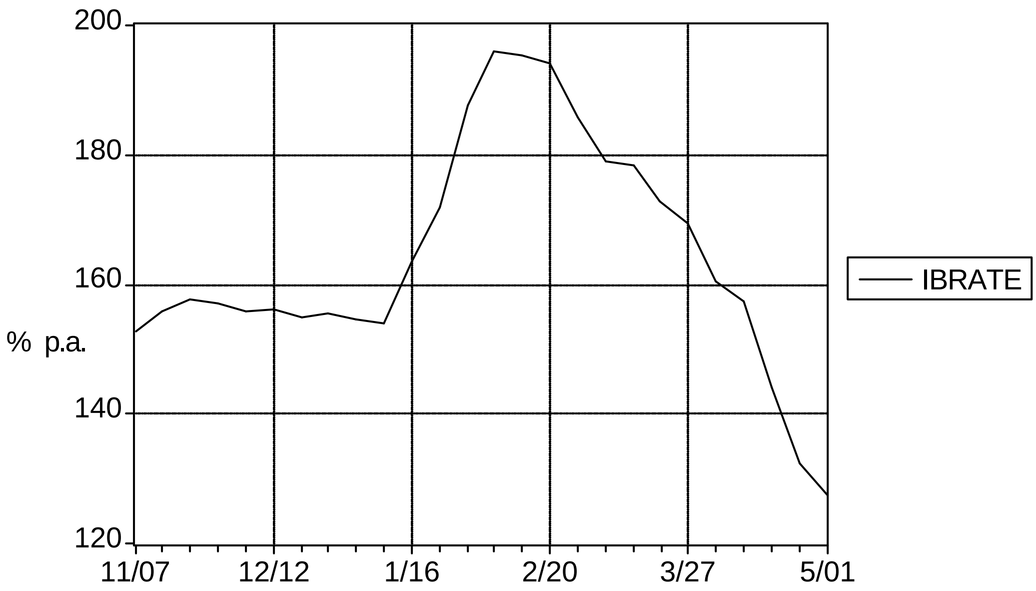
- the dollar shock of October 1994, which developed into a general state of uncertainty regarding financial stability in Russia,

- the political crisis precipitated by the war in Chechnya and its possible impact on the budget deficit in 1995,

- the payment of a thirteenth month's wage as a Christmas bonus in December, giving an additional seasonal boost to demand in the product markets.

Uncertainty over how the monetary situation would continue to develop was reflected in particular in the prices of financial assets and in the exchange rate of the dollar. The Russian government had to pay a risk premium on its treasury bills: at times the yield on these securities was considerably higher than the interest rate in the interbank market, whereas up until autumn 1994 government securities had consistently borne a lower interest rate than interbank credit.

Figure 2: Interbank Lending Rate on 1-3 Month Credits
October 1994 – May 1995



Source: CBR

Yet the interbank interest rates themselves did not reach their peak until the end of January, having initially shown only limited response to the resurgence of inflation in the autumn months (see Figure 2). This development was paralleled by movements on the foreign currency market: the rouble, having become noticeably more stable in November, came under pressure again, and remained so until the end of March.

Co-inciding with the IMF's decision to grant Russia a US$ 6.8 billion credit, there was a marked turnaround in the foreign exchange and financial markets. The rate of the rouble's depreciation slowed down, and in May - as has already been mentioned - the trend even turned slightly upward. Experts we interviewed in Moscow confirmed the published analyses which claim to have observed a flow of capital back into Russia that is playing a key role in stabilising the rouble. The appreciation of the rouble would have been even stronger had the Central Bank of Russia not intervened in favour of the dollar by selling roubles. As a result of these interventions, Russia's foreign currency reserves have apparently returned to the level at which they stood in January 1995, when the CBR sold dollars on a large scale in order to bolster its own currency. On the other hand, by concentrating on regulating the exchange rate, the CBR has allowed the central bank money supply to expand beyond the limits called for by the stabilisation programme which has been agreed with IMF.

From early April to mid-May, interbank interest rates were virtually in free fall (see Figure 2). Only towards the end of May did returns begin to pick up again slightly. The CBR refinancing rate has never been so far above the interbank interest rate than it is at present. It is therefore all the more important to point out that virtually no refinancing is actually taking place at the CBR's refinancing rate, but that in fact the interbank interest rate represents the rate of opportunity costs incurred by the banks in their lending activities. The role of the CBR refinancing rate has thus been reduced to that of a signal which the central bank uses to demonstrate its determination to adhere to its anti-inflationary policies.

2. How likely is stabilisation to succeed this time?

These special factors notwithstanding, the parallels between the present attempt to achieve stabilisation and last year's efforts are unmistakable. This is certainly true of the key monetary indicators (Table 3). Inevitably, then, one must ask whether there is evidence to suggest that this year's stabilisation effort is not doomed to end in destabilisation like the last one.

A first important clue to the prospects of stabilisation in the longer term is provided by the real economic fundamentals, i.e. the foundations on which stabilisation will have to be built. Table 4 shows that conditions in the real economy in 1995 are much more conducive to a thoroughgoing stabilisation than they were a year ago. The decline in industrial output has slowed down considerably. Indeed, provisional calculations for May show that industrial production is actually one percentage point up on the same month last year. This would mean that the industrial production index stands at 53.5, which in turn would mean that growth was also positive in a month-on-month comparison. Our contacts in Moscow cited construction and metallurgy, where growth rates are significantly higher than elsewhere, as the sectors that are leading the recovery of the real economy.

Table 3: **Monetary Indicators, 1994 - 1995**

	Monthly inflation rate 1994	Monthly inflation rate 1995	Monthly real interest rate (CBR) 1994	Monthly real interest rate (CBR) 1995	Rate of devaluation or appreciation (-): % change on previous month 1994	Rate of devaluation or appreciation (-): % change on previous month 1995
Jan.	17.9	17.8	-0.3	-0.9	23.66	14.03
Feb.	10.7	11.0	6.1	5.1	7.46	10.50
Mar.	7.4	8.9	9.4	7.2	5.79	9.52
Apr.	8.5	8.5	8.3	7.5	5.02	4.43
May	6.9	7.5	9.3	8.1	4.07	-1.42

Basic Data: Brigitte Granville, Business World Weekly, Russian Economic Trends, Kommersant

Thus, developments in the real economy give little cause to assume that industrial managers will be able to exert strong political pressure on the government and the central bank to abandon or water down their restrictive policies. The financial markets are also likely to lend more credence to the stabilisation policy now that it is not obviously at odds with real economic trends. This in turn further improves the chances that stabilisation will succeed.

A second clue is the behaviour of the budget deficit. Whereas in 1994 the consolidated budget showed that, in order to come close to the target, it would be necessary to run up a deficit in the region of 10% of GDP, this year's budget provides for a deficit of roughly 8% of GDP. People spoken to in Moscow pointed out that so far the budget has been implemented according to plan, and that in some instances the deficit has even remained below the target figure. Although in theory this positive development may contain an artificial element because certain planned expenditures are possibly not being made or are being deferred, the general view was that this possibility could be ruled out. In other words, the restrictive monetary policy is being accompanied by what is - by Russian standards - a restrictive fiscal policy.

Table 4: **Real Industrial Production** (% of one year ago)

	1994*	1995*	1994**	1995**
January	76.9	96.0	57.0	53.0
February	75.9	94.0	57.0	52.4
March	72.6	93.0	54.9	49.0
April	73.1		54.4	
May	72.0		52.5	

* = % of one year ago,
** = December 1991 = 100

Source: Russian Economic Trends, May 1995

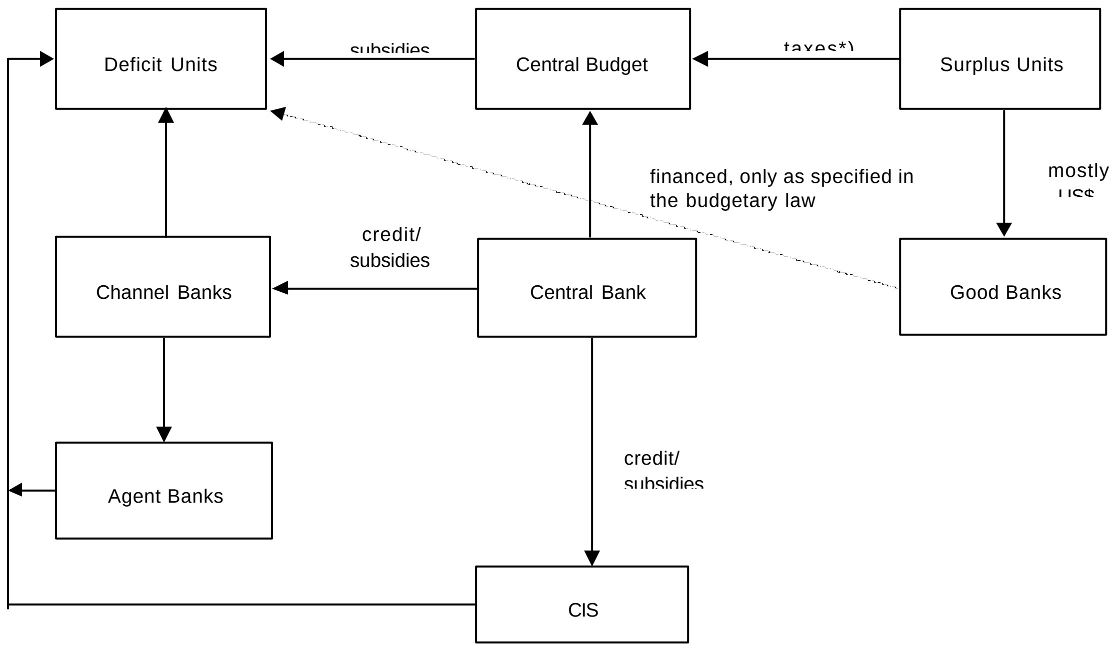
More important, however, than the two percentage-point reduction relative to GDP are the changes that are taking place in the way in which this reduced deficit is being financed. Whereas in 1994 almost 80% of the budget deficit was paid for using central bank loans at heavily subsidised interest rates (10% p.a.), this year the government plans to cover its deficit by borrowing from external sources, using the US$ 6.8 billion IMF stabilisation credit and selling treasury bills at market rates of interest. The almost total renunciation of central bank credits as a means of financing the budget deficit is the most fundamental change that has taken place within the Russian financial system in the past two years.

II. Russia's Changing Financial System

1. Looking back

The pilot study for the Russia Small Business Fund included the following schematic diagram of the Russian financial system.

Figure 3: **The Russian Financial System, 1993**



*) underdeveloped tax system

At the centre of this system stood the central bank, unable to exercise autonomous control over any of the sources of central bank money supply, namely credits to the CIS countries, credits to the commercial banks and credits to the government. Facing it was a commercial banking sector which was rapidly expanding in numerical terms, although a significant majority of its institutions were in fact small agency banks. Interest rates were negative in real terms, which meant that the bad loan problem - due in large part to deficiencies in the banks' analysis of borrowers' creditworthiness and debt capacity - remained hidden beneath the surface.

2. The Central Bank: Moves to control the central bank money supply

Much has changed in the meantime. The most important changes from the viewpoint of stabilisation policy have concerned the central bank, and can be traced by referring to the assets side of the central bank's balance sheet:

- The external component of the central bank money supply was determined by the need to finance the current account deficits of Russia's partners within the rouble zone. Roughly one quarter of the central bank money supply arose through the extension of credit to other CIS countries (see Table 5). When the rouble zone was abolished in summer 1993, the central bank gained control of this source of central bank money for the first time. Since then the volume of credits outstanding has remained virtually constant; as a consequence, the share of CIS credits as a percentage of total CBR credits fell from 23% in January 1993 to 7% in August 1994.

Table 5: **Central Bank of Russia - Credit Outstanding**

End of month	CBR credit to: Commercial banks	Other CIS states	Ministry of Finance	Enterprises	Total CBR credit*)
1993					
January	3,011	1,758	2,658	41	7,573
April	4,450	2,817	4,184	59	11,977
July	6,449	3,919	5,918	94	16,220
October	8,495	4,127	9,325	141	21,965
1994					
January	8,788	4,161	14,258	142	27,678
April	11,627	3,994	21,836	283	39,296
July	14,251	4,487	37,612		56,916
August	14,723	4,549	43,612		63,661
September	16,281		47,112		68,983
October	17,128		51,662		74,380
November	18,680		53,667		

* This is not equal to the sum of the first four columns. The reason for this is that CBR credit includes other credits not shown, such as credit to other (non-federal) forms of government, or to extra-budgetary funds.

Source: Russian Economic Trends

- Up until the end of 1993, the refinancing component - loans to the commercial banks - was also determined by factors beyond the central bank's control, namely by the financing demands of enterprises belonging to what the government designated as so-called "priority sectors", particularly agriculture, oil and energy. These heavily subsidised credits were passed on to the final borrowers by the so-called channel banks. At the start of 1994, at least the technical procedure for this kind of lending was changed. The required funds were now provided out of the government budget, which in turn borrowed from the central bank. This lent a wholly new complexion to the structure of central bank lending and thus to the assets side of the central bank's balance sheet: whereas up until October 1993 credits to commercial banks accounted for roughly the same share of total CBR credits (approx. 40%) as credits to the government, by October 1994 the share of the refinancing component had dropped to 23%, while the government component had risen to almost 70%.[1]

  Although these formal changes did not alter the economic substance and adverse impact of this type of lending, they did make financial processes more transparent insofar as the agent that was actually responsible for this credit extension, namely the government, which wished to use cheap loans as a means of subsidising certain sectors of the economy, now featured as such in the central bank's balance sheet.

- Since the change of government policy on how the budget deficit should be financed, which, as was mentioned above, took effect from the beginning of the current year, the central bank has been released to a significant extent from its role as a provider of low-interest finance to the government. The legal basis for this change is the new Central Bank Law, Article 22 of which states that:

  "The Bank of Russia may not grant unsecured credits to the Ministry of Finance to finance the budget deficit, and purchase government securities at their primary placement, with the exception of cases when this is specified by the federal law on the federal budget".

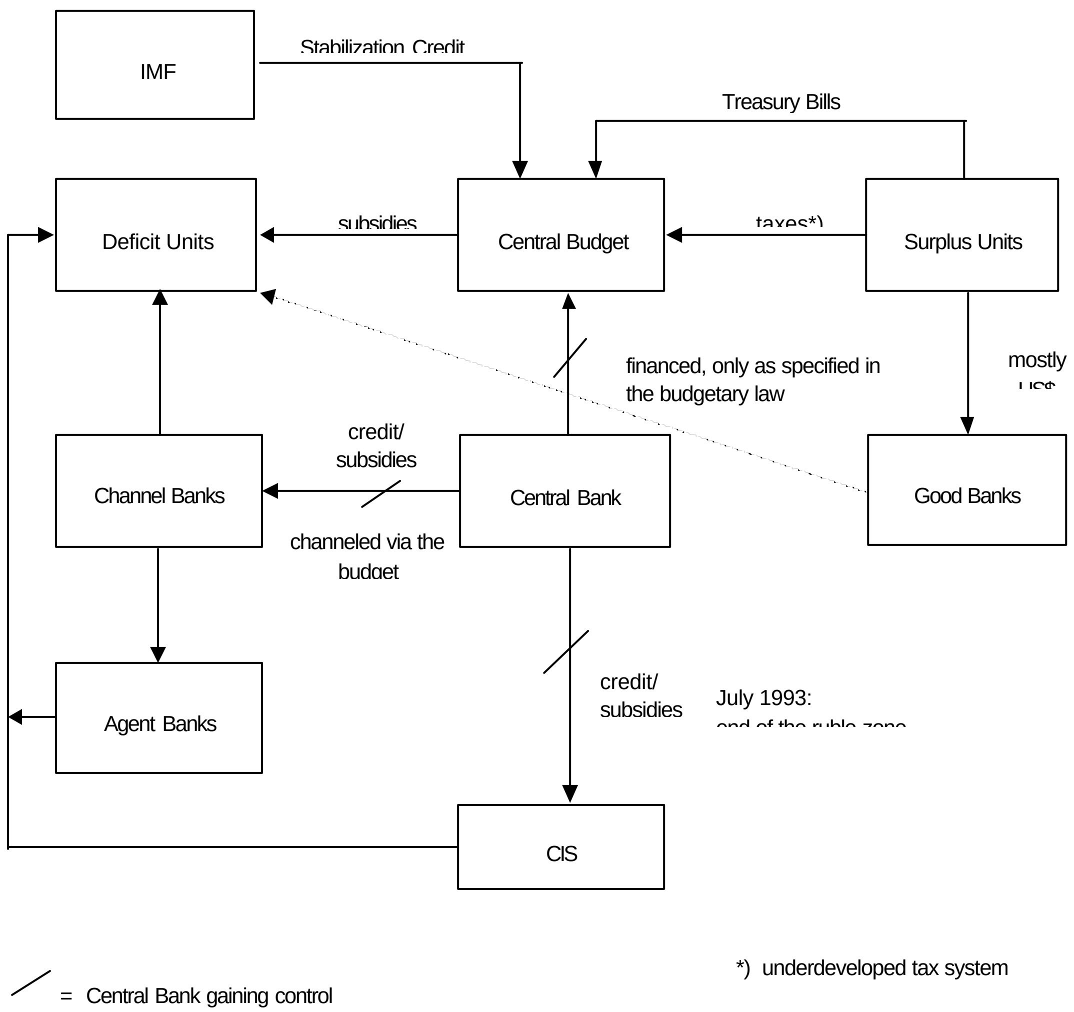
  In other words, the law does not prohibit the central bank from financing the budget deficit as such, but it allows it to do so only within the framework of a budgetary law which must be passed by parliament. The arbitrary granting of loans, for example by presidential

---

1 As before, however, still only a very small percentage of the credits that go to the commercial banks are distributed at credit auctions. This is not surprising when one considers that the interest rate in the interbank market itself makes it a cheap source of funds, and that, on aggregate, the commercial banks still hold excess reserves at the central bank amounting to 10% of all rouble deposits.

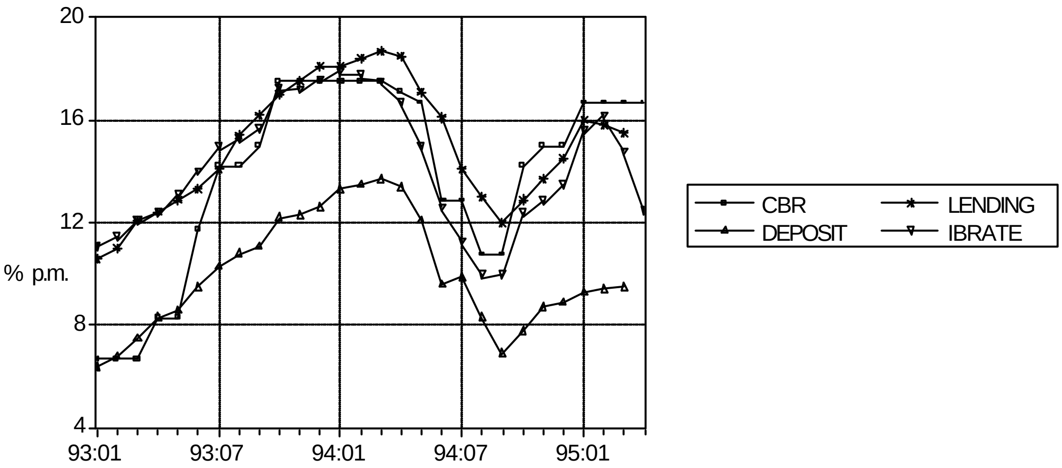
decree, is no longer possible. In the first four months of 1995, the central bank adhered to the stipulation that the funds it provides to the government must not exceed 1% of GDP. The ceiling imposed on central bank financing of the budget deficit has meant that other sources of finance have to be tapped. The funds are coming, in roughly equal measure, from the IMF and from surplus units within the Russian Federation which are acquiring treasury bills (see Figure 4).

Figure 4: **The Altered Role of the Central Bank Within the Russian Financial System**



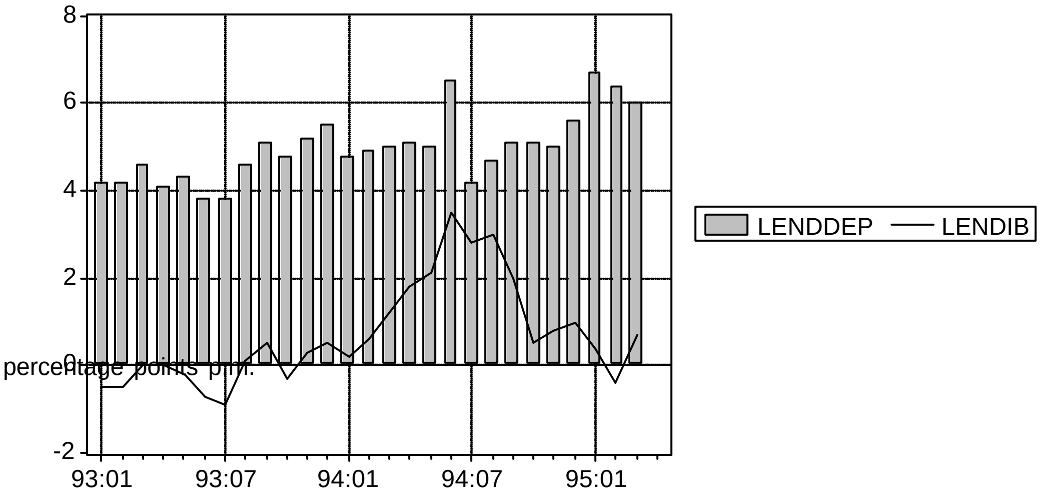
All in all, the CBR has been able to gain substantially greater control over the central bank money supply during the past two years. Aside from the budgetary law, there are now no longer any extra-economic factors which could undermine its ability to enforce a strict monetary policy and thus to set hard budget constraints.

Figure 5: Interest Rates in Russia



Source: Russian Economic Trends

Figure 6: Interest Rate Spreads
Lending Rate - Interbank Rate, Lending Rate - Deposit Rate



Basic Data: Russian Economic Trends

3. The commercial banks: Under pressure to adjust

The fact that the CBR refinancing rate has fallen short of the rate of inflation in only three months since the beginning of 1994 - the months immediately following the rouble shock - is an indication that the central bank is making use of its enlarged scope. The CBR also succeeded in making the interbank, deposit and lending rate fall in behind its interest rate policy (see Figure 5). The commercial banks took advantage of phases of falling interbank interest rates in particular to increase their spreads relative to the lending rate. The interest margin also widened relative to the rates of interest on deposits (see Figure 6).

Rising spreads are a sign that the banks are become increasingly aware of the bad loan problem. Table 6 shows that between January and November 1994 the volume of loans reported as being delinquent rose by 466%. Since the overall volume of credit grew by only 141% over the same period, the share of bad loans in the aggregate credit portfolio increased from 14.7% to over 30%.

Table 6: **Volume of Delinquent Loans Outstanding at Russian Commercial Banks** (Rb billions)

1.1.94	**1.4.94**	**1.7.94**	**1.10.94**	**1.11.94**
3,609.8	6,393.7	11,352.3	16,999.9	2,0436.9

Source: CBR

As the figures in Table 6 indicate, numerous commercial banks are in danger of getting into a precarious financial situation, and this is the explanation offered by some observers for the inability of the commercial banks to increase by any significant amount their share of deposit-taking from private households relative to the state-owned Sberbank over the past year. Whereas at the beginning of 1993, Sberbank accounted for almost 90% of all deposits by private households, by the start of 1994 this share had declined to just under 50%. From autumn 1994 onwards, in the wake of the turmoil that reigned in the financial and foreign currency markets, Sberbank succeeded in winning back some of its market share, evidently helped by the government-backed deposit insurance scheme which lent Sberbank the reputation of a "safe haven".

Despite this partial turnaround, there has been no change in the overall trend: financial intermediation in Russia is still on the decline in quantitative terms. Table 7 shows some of the indicators which are used to measure the degree of financial deepening within an economy. This trend is attributable to the accelerated pace of inflation during the last four months of 1994, which the banks could not keep up with: the growth rates of outstanding credit, the money supply and total assets were higher in the first half of the year than in the second half; for the growth rate of the price indices, i.e. the inflation rate, the reverse was true.

Table 7: **Selected Indicators of Financial Deepening***)

	1.1.94	1.7.94	1.1.95
Outstanding Credit at Commercial Banks	15.1	18.5	10.1
M2	23.0	28.0	17.0
Total Assets of Commercial Banks	68.0	71.6	51.0

*) in % of GDP

Basic Data: Russian Economic Trends

Since the beginning of 1994 the Central Bank of Russia has issued several regulations aimed either at improving the quality of the banking system or at bringing to light instances of poor quality. One such measure belonging to the first category was to increase the minimum capital standards for both newly founded and existing banks.[2] Table 8 shows that this new regulation only began to achieve its intended effect in 1995. In both relative and absolute terms, the Russian banking market grew faster in 1994 than in 1993. However, the growth rate slowed down considerably in the months January-April 1995, when there was a net increase of only 42 new banks in the market.

There has, on the other hand, been a slight increase in the equity capitalisation of the commercial banking system. The volume of equity capital held by Russian banks has grown not only in real terms but also in relation to both total assets and loans.

2 For details, see the first Monetary Report of July 1994.

Table 8: **Number of Banks in the Former Soviet Union/Russian Federation*)**

Year	Number
1988 1)	2
1989	57
1990 2)	121
1990	948
1991	1,306
1992	1,740
1993	2,019
1994	2,517
1995 3)	2,559

*) as of year-end, unless otherwise indicated

1) August
2) September
3) May

Source: DIW et al., Russian Economic Trends, CBR, Fuchita et al.

In 1994, for the first time since the reform process began, the central bank revoked the licences of existing banks: a total of 65 banks were affected by this measure. Also for the first time, banks were either restructured, or their shareholders voted to liquidate them: 45 such cases were recorded during the course of 1994.

From last December onwards, the Central Bank of Russia has been forcing the commercial banks to be aware of the risk to which they are exposed and thus the quality of their loan portfolio. Since then a directive has been in force that requires banks to set aside provisions to cover possible defaults. The extent of the provisioning is a function of the loan security provided and the occurrence and duration of arrears. There are five risk categories, each representing a different combination of these criteria and each requiring a specific level of provisioning (see Table 9 below): Fully secured loans with no payment irregularities have a provisioning rate of 2%, while the rate for unsecured loans or loans which have fallen permanently into arrears is 100%.

Table 9: **Classification of the Loan Portfolio into Risk Categories and Loan Loss Provision Rates**

	Collateralised	Insufficient collateralisation or repayment doubtful	No collateralisation or repayment more than doubtful
Payment on time	2%	2%	2%
up to 30 days overdue	2%	5%	30%
31 - 60 days overdue	5%	5%	75%
61 - 180 days overdue	75%	75%	100%
more than 180 days overdue	100%	100%	100%

Source: Own compilation based on a directive issued by the Central Bank of Russia

Since 1 May 1995, new minimum reserve requirements have been in operation. For deposits with a maturity of up to 30 days, the rate is 20%; for deposits with a maturity of between 30 and 90 days it is 14%; and for longer-term deposits, 10% of the volume must be deposited with the central bank at zero interest. Furthermore, the list of types of deposit which are subject to minimum reserve regulations has been expanded. Henceforth the commercial banks must keep 1.5% of their foreign currency deposits as a reserve at the central bank. The new regulations have noticeably soured relations between the central bank and the commercial banks, or rather their representatives in the Association of Russian Banks.[3]

---

3 Yet in view of the fact, that the commercial banks hold an aggregate total of almost 10% of their rouble deposits as voluntary excess reserves at the central bank, the economic impact of the new measures is probably quite small. To be sure, the banks no longer have as much scope to further expand their lending activities as they did before, yet it should also be remembered that they did not make use of this scope in the past either.

4. Conclusions

The changes which the Russian financial system has undergone during the past two years have increased the chances that the present stabilisation effort will be more successful than those in previous years. In particular, the Central Bank of Russia has been able to strengthen its position considerably. Assuming that fiscal policy lives up to the promises that have been made, and assuming that the sudden inflow of capital is not followed by another equally abrupt outflow of capital, a crucial factor in determining whether or not the stabilisation policies will succeed is the extent to which the commercial banking system is willing and able to adjust to the new situation.

Judging by the conversations we have had at meetings with bank representatives in the various regions of Russia over the past six months in connection with the roll-out of the Russia Small Business Fund, there are signs that the will to adjust is gaining in strength. The banks are increasingly open to the offer of institution-building assistance. A number of banks that are already partners of the Russia Small Business Fund have made very substantial efforts to improve their credit analysis, collateralisation policy, etc. This is surely due in part to the realisation that a strengthened loan portfolio is a precondition for survival in the changing environment of the Russian financial system.

Nonetheless, assuming that real interest rates will remain high over the coming months, a considerable number of commercial banks may soon find themselves in a precarious financial situation, or at least, the precariousness of their situation may soon become manifestly obvious. Provided that a new burst of inflation does not give the banks another breathing space, there may soon be an opportunity to observe whether the CBR is capable of exercising its new powers in an appropriate manner by acting to prevent instability from spreading to the whole financial system, and whether the adjustment process at the major banks has already gone far enough to enable them to serve as pillars of stability in phases of strict anti-inflationary policy.