Press Release

FINANCIAL CRISIS, ECONOMIC RECOVERY AND BANKING DEVELOPMENT IN RUSSIA

The Russian financial crisis of 1998 brought one major benefit to the national economy. It put an end to the heavy investment of banks in government bonds. The huge issuance of these bonds, thanks to the large budget deficit and the high yields offered, contributed to a banking development trap. This arose because the excessively high interest rates charged by commercial banks made firms prefer to raise liquidity through barter trade rather than borrow from banks. Banks found it more profitable to buy government bonds than lend to enterprises. And creditworthy firms found barter offered cheaper credit than did banks. The trap is generated by the information asymmetry between banks and firms and the relative ease with which firms could turn to barter. This startling conclusion appears in a paper to be presented at a lunchtime meeting in Brussels on Thursday, 25 January, sponsored by the Centre for Economic Policy Research. The author, Professor Dalia Marin, of the University of Munich, goes on to show how things changed after 1998. 'The financial crisis reversed this process and acted as a trigger to get out of the trap. This has led to a strong economic recovery, to a decline in barter trade and provided the basic conditions for banking development.'

Future economic development depends on whether the conditions for the development of the banking sector can be sustained. To achieve this, the highest priority has to be given to fiscal policy. The main lesson of the study is that budget constraints in Russia should be toughened in order to create an environment where banks prefer to lend to industry rather than buy government bonds. The conditions are there: in both Russia and Ukraine there is now a budget surplus.

For banks to grow, their rate of return has to be maintained at a high level. And this may mean less rather than more banking competition. 'If there is too much competition, it will be difficult to maintain the incentives for banks to lend to the private sector and to evaluate credit risk. If banking competition is too weak, banks will charge excessively high interest rates and thus force firms to return to barter trade.'

In conclusion the report highlights the benefits that a financial crisis can bring. In Russia it led the economy out of the banking trap and set the stage for healthy development. This provides a quicker solution than many other options suggested for dealing with such banking crises in developing and transition economies.