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R95 **Russian Economy in 2011. Trends and Outlooks.**
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The review provides a detailed analysis of main trends in Russia's economy in 2011. The paper contains 6 big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit spheres; financial sphere; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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Development of the Banking Sector in Russia in 2011

The Post-Crisis False Start

The financial sphere of Russia was the first sector of the national economy which was affected by the global economic crisis of 2008. Financial markets were hit first and then the banking sector experienced the liquidity problem to be followed by a full-scale economic crisis in Russia.

The two factors permitted to prevent the collapse of the banking sector: the government's financial aid and growth in households' savings. From the beginning of 2009, within the frameworks of anti-crisis measures the government allocated the largest resources to the banking sector. Households became a prominent participant (though an involuntary one) in rehabilitation of the banking system: during the crisis prevalence of the cautious behavior prompted people to save more money, rather than take loans from banks. In the 2009–2010 period, the growth in households' bank deposits amounted to Rb 4 trillion which figure exceeded the volume of all the consumer loans as of the end of 2009.

Early in 2011, all the factors pointed to the fact that the banking sector overcame the crisis, and it seemed the upward development began. The banking sector had at its disposal huge available resources for expansion of lending to the non-financial sector. The bank savings of the non-financial sector exceeded the volume of loans to industries and households by Rb 1.1 trillion, while the excessive banking liquidity amounted (according to our evaluations) to at least Rb 1 trillion. Thus, there were all the reasons to believe that in 2011 the Russian banking system would keep developing in a balanced way and overcome the structural problems which dated back to the pre-crisis period.

In reality, the situation was different: the balanced development failed, while rather intense growth took place in individual segments of the banking sphere and it was accompanied by dramatic structural imbalances. Lending to the non-banking sector of the economy increased considerably with fairly moderate growth in the depositary base. As a result, in the second half of 2011 the banking sector faced the liquidity crisis. More importantly, recovery of the acceptable level of liquidity will inevitably be accompanied by a decrease in the bank lending to the non-financial sector with the bad debt problem being, probably, aggravated. In reality, to achieve the mid-term curve of sustained development the complete restructuring of the banking sector may be required.

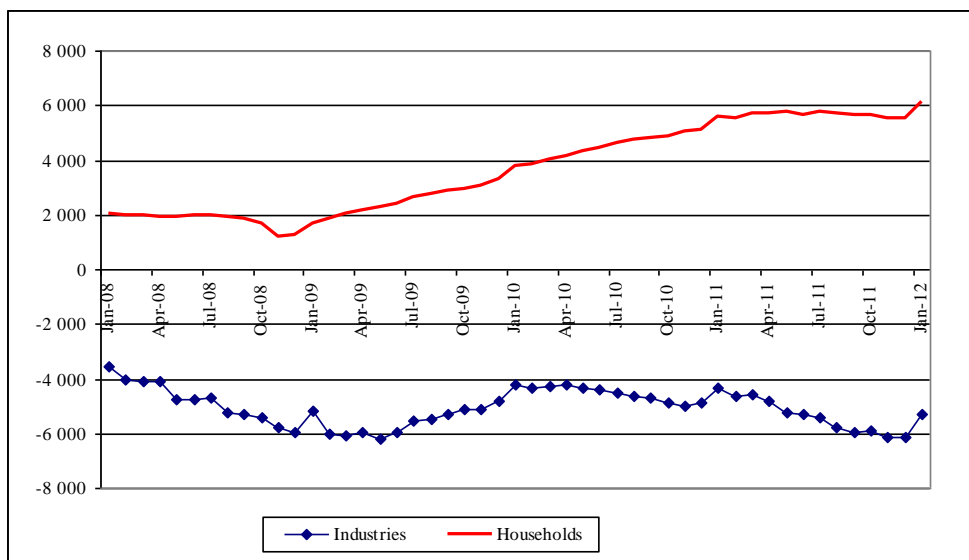
The Structure of Institutional Financial Flows in 2011

The structure of institutional financial flows which are redistributed by the banking sector provides the important information for evaluation of trends both in the financial and real sectors of the national economy. In 2011, the structure of flows actively shifted from the stable condition to the crisis one. If at the beginning of the last year the high level of excessive liquidity and lower growth rates of lending were typical of the banking sector by the end of the year the situation changed the other way round.

On the basis of the results of 2010, growth in loans to industries amounted to 9.8%, while that to households, to 14.4%. In 2011, more than twofold increase in the growth rates of lend-

ing took place (24.2% and 36.1%, respectively). A similar speed-up took place in a situation of sustained growth in the depositary base both in 2010 and 2011; the aggregate volume of funds of industries and households in accounts with banks rose by 23% (Fig. 48). That gap naturally “swallowed” the excessive savings which were accumulated in the 2008–2010 crisis period.

Fig. 48. The net credit of households and industries to the banking system of the Russian Federation, billion Rb.



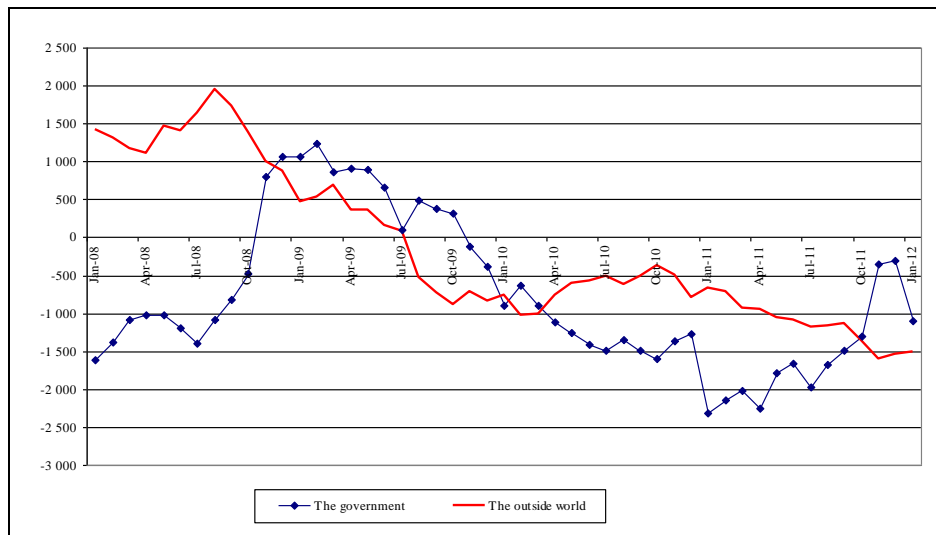
Source: The Central Bank of the Russian Federation and the IEP’s Structural Research Center calculations.

An important trend in 2011 was the outflow of capital from the banking sector: if in 2010 the net capital inflow was registered in the amount of \$ 15.9bn in 2011 the net capital outflow amounted to \$ 26.2bn. The growing gap between foreign assets and lending to the non-financial sector, on the one hand, and the disposable resource base, on the other hand, was financed at the expense of a decrease in the bank liquidity and attraction of government funds. During the year, the level of liquidity fell by over Rb 600bn (from 8.7% to 5.6% of assets). On the contrary, the deposits of the Ministry of Finance and the loans of the Bank of Russia increased by Rb 1.3 trillion (from 1.4% to 4.3% of the liabilities) (Fig. 49). It is to be noted that the balance value of the own funds of the banking sector increased within a year by the mere 13.7%, while the capital adequacy norm decreased from 18.1% to 14.7% in 2011.

Generally, in 2011 the following principal changes took place in the structure of institutional financial flows in Russia. To start with, the role of households as a net creditor of the banking system decreased: on the basis of the results of the year the amount of deposits placed by households with banks was only Rb 390bn more than the amount of loans which households received, while in the past two years the net credit to banks from households amounted to Rb 2.1 trillion and Rb 1.9 trillion, respectively. As regards the corporate sector, the situation is quite the opposite: the volume of the extended loans exceeded by over Rb 900bn the volume of the attracted funds and deposits. Finally, a net loan of Rb 740bn was granted to the outside world. As a result, in 2011 the net loan to the non-financial sector and the outside world in-

creased by Rb 1.3 trillion. The sources of such a substantial loan were the reduced bank liquidity and government resources.

Fig. 49. The net credit of the government and the outside world, billion Rb.



Note. Government loans – loans of the Ministry of Finance of the Russian Federation, including debt on federal bonds, and the Central Bank of the Russian Federation.

Source: the Central Bank of the Russian Federation and the IEP’s Structural Research Center calculations.

The Main Trends in the Banking Sector

Growth in Bank Assets

In 2011, the dynamics of bank assets somewhat accelerated as compared to 2010 (with adjustment to the revaluation of assets in foreign currency the growth amounted to 21.4% against 14.8% in 2010). Such growth rates are quite moderate as they exceed the GDP deflator and the domestic market deflator¹ by the mere 6% and 11%, respectively. It is to be noted that in 2011 the growth rates of the bank assets exceeded by the mere 3.4% the growth in the nominal GDP in 2011, and, accordingly, the ratio of the value of bank assets to the GDP increased insignificantly within a year from 74.8% to 76.5%. As it is shown below, even such growth rates of the banks’ asset operations were difficult to achieve. The main sources of the banking sector’s funds --account balances and customers’ deposits – failed to ensure growth rates which were equal to the nominal growth in the economy in general without further participation of government authorities.

In 2011, in the group of the largest banks, the highest growth rates of assets were observed with state banks² (without the Sberbank – 34%). Undoubtedly, a considerable contribution to

¹ Such a volume of goods and services consumed on the domestic market as is determined as the GDP, less the net export.

² For the purpose of the structural analysis of the banking sector, the following groups of banks were used: Sberbank, large state banks and banks of state companies (VTB, VTB24, GPB (Gasprombank), RSKhB (Russian Agricultural Bank), The Bank of Moscow and Transkredit), large foreign banks, large private Russian banks which are in the top 30 list and other (mid-sized and small banks).

the assets growth of the above group was made by the state's participation in the rescue of the Bank of Moscow. In September, the Deposit Insurance Agency (DIA) placed with the Bank of Moscow a long-term deposit in the amount of Rb 295bn which figure was equal at that time to about 35% of that bank's assets.

The lowest rates were registered with the group of large private banks (14%). It is to be noted that such results conform to the outputs of the polls of Russia's largest banks: 72% of the polled banks believe that in competition on the market of banking services the state banks¹ have the best advantages.

Own Funds

A factor behind the insufficiently dynamic development of the banking sector in 2011 was slow-down of growth in the banks' own funds. In 2011, the regulatory capital of the banking sector (calculated in accordance with the methods of the Bank of Russia) rose by 10.7%, which figure is twice as little as the growth rates of assets. As a result, capital adequacy fell from 18.1% as of January 1, 2011 to 14.7% as of January 1, 2012. That level is still far from the minimum admissible benchmark of 10%. However, it is important to take into account the following two factors. Firstly, even with such a seemingly significant average level of capital adequacy its index with individual banks, including large ones may be close to a critical value. For instance, the capital adequacy of the VTB bank – the second largest bank as regards the value of the assets – as of January 1, 2012 amounted to the mere 11.2%. Secondly, capital adequacy of the banking sector fell below 15% only twice before and each time capitalization of the banking sector was supported one way or another by participation of the state. It took place for the first time late in 2006 when capital adequacy of the banking sector fell to the minimum level of 14.4%. Later, bank capitalization grew considerably as a result of placement of equities of Sberbank and VTB. A similar decrease took place for the second time in autumn 2008 (a drop to the level of 14.5%) when the financial crisis was in full swing; after that banks received government support in the form of subordinated loans for which purpose resources of the National Welfare Fund were used.

In 2011, the main factor behind slowdown of growth in own funds was the fact that the banking sector became less attractive to investors and, as a consequence, no new contributions to banks' authorized capital were actually made. In 2011, the amount of the authorized capital and additional capital increased by the mere 4.6%, that is, the minimum rate in the past few years.

Raising of requirements to banks' minimum amount of own funds does not change the situation for the better, either. From January 1, 2012, banks need the capital of at least Rb 180m. Consolidation of small banks could become a factor behind growth in the own funds of the banking sector. However, the dynamics of the value of the authorized capital does not point to the fact that bank owners are seeking to secure their banks against a possible withdrawal of the license. As of January 1, 2012, the own funds of over 100 credit institutions were less than Rb 180m.

¹ A. VedeV, S. Grigoryan. Development of the Russian Banking System in the Current Decade. The Outputs of Polls of Large Russian Banks (http://www.vedi.ru/bank_sys/bank5411_banks%20poll.pdf).

Profit and the Rate of Return

Profitability of the banking sector remains low. The maximum level of profitability after the crisis was achieved in summer 2011 and then the rate of return started to go down. As regards ROA, the first half of 2011 corresponds to the year 2003 (2.6% on a year on year basis), while as regards ROE (21.0%), to the year 2004. In the pre-crisis period of the credit boom (2005–2006) the profitability of the banking sector was much higher (ROA 3%–3.5%, and ROE 25%–30%). In the second half of 2011, the efficiency of the banking sector as regards the return on assets and return on equity went down further and, as a result, the annual figures turned out to be even lower: ROA – 2.3% and ROE – 19.6%.

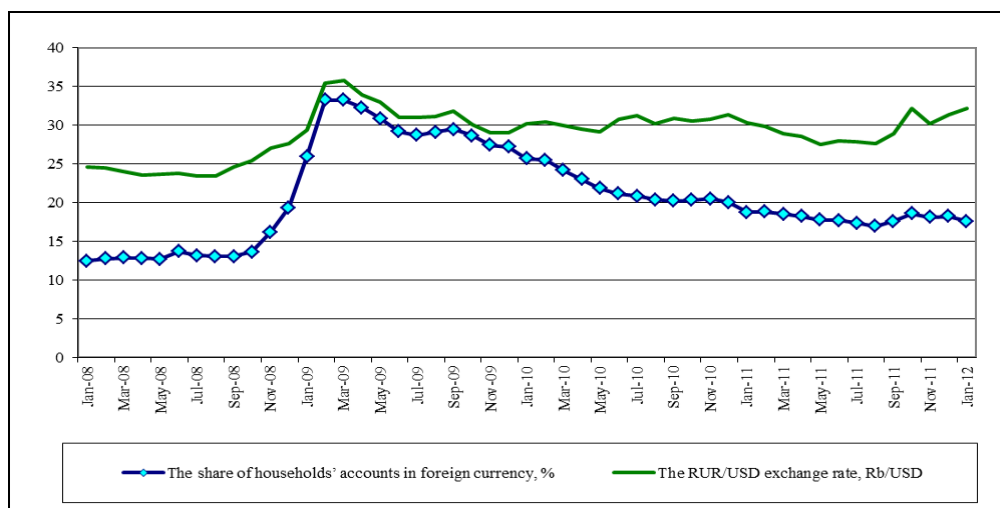
Raised Funds (Resources for the Banking Activities)

Households' Funds

In 2011, in the deposit market the major event was the slow-down of the savings activity of households. In the past year, the volume of funds in deposits grew¹ by Rb 1.9 trillion which figure is nearly 20% lower than in 2010 (Rb 2.4 trillion). The growth rates of households deposits in the banking system decreased by over 33.4%: 19.5% against 31.2%.

In 2011, the process of dedollarization of households' accounts and deposits slowed down (virtually stopped) (*Fig. 50*). If in 2010 the share of deposits in foreign currency in the total volume of households' deposits fell by 7% from 25.7% as of January 1, 2010 to 18.7% as of January 1, 2011 in 2011 it decreased by the mere 1.1% (to 17.6%). It is to be noted that in the second half of the year the share of accounts in foreign currency increased (from 16.9% as of August 1).

Fig. 50. The RUR/USD exchange rate and the share of households' deposits in foreign currency with banks



Source: The Central Bank of the Russian Federation and the IEP calculations

¹ With adjustment to the USD revaluation of deposits in foreign currency.

Slow-down of growth in bank deposits should not be regarded as evidence of a loss of households' confidence in banks. It rather shows that the norm of households' savings has generally decreased. An alternative instrument of savings can be cash national currency, but in 2011 the demand in cash funds slowed down as well. M0 monetary aggregate (that is, the cash funds outside the banking system) grew within a year by Rb 876bn which figure is 15% lower than a year before (Rb 1,025bn). It is to be noted that the ratio of nominal growth in cash funds in 2011 and 2010 is comparable to a similar bank deposits indicator. It is to be noted that in respect of sales turnover the volume of cash funds remains to be excessive. The value of cash funds is sufficient enough for a three-month consumption of goods and services.

The main factor behind slow-down of households' savings activities was stagnation of households' real disposable income. In 2011, households' real disposable income was only 0.8% higher than in 2010. Simultaneously, ultimate consumption of goods and services in real terms increased by 5.8% (IEP evaluation as regards the aggregate volume of retail trade, public catering and paid services). Stable growth in consumption was supported by simultaneous reduction in the norm of savings and growth in demand in consumer lending (see below).

Stagnation of the depositary base (in August-September 2011 the influx of households' deposits to banks was close to nil) made banks to raise interest rates on retail deposits. The average weighted rate on one-year deposits (except for demand deposits) rose from the minimum values (5% per annum) in July to 7% per annum in December. An indicator of "the maximum interest rate (on deposits in rubles) of ten credit institutions which attract the largest volume of deposits of individuals" – which indicator is monitored closely by the Bank of Russia – rose from the summer minimum of 7.85% per annum to 9.42% per annum in December.

However, proceeding from the macro conditions which justified the frontal decrease in the norm of households' savings it is believed that growth in interest rates on deposits will not have a serious impact on the dynamics of the market of deposits. Individual banks which were more aggressive in raising of deposit rates are likely to strengthen their market positions. But, generally, the growth rates of that type of bank liabilities will be quite moderate in future. In 2012, households' deposits are expected to grow by 15%–18%, including ruble deposits (18%–20% and deposits in foreign currency (7%–10%).

Corporate Customers' Funds

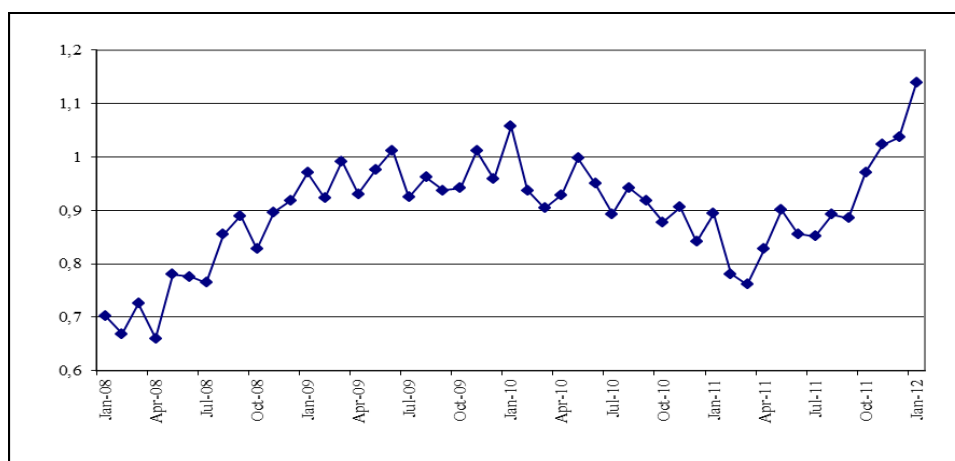
Funds in corporate customers' accounts are prone to serious fluctuations, on the one hand, due to both payment of taxes (a quarterly decrease) and a December surge in budget expenses and, on the other hand, due to the fact that fluctuations in the capital inflow and outflow have an impact on the amount of account balances of corporate customers. In the past few months, the weak dynamics of that type of bank liabilities can be mainly explained by the outflow of capital despite the favorable situation which prevailed on the market of Russia's main export commodities.

Generally, within a year, the funds of industries in bank accounts and deposits rose by 24.8%. However, December – the period of large-scale growth in budget expenses – accounted for nearly a half of that growth (Rb 1.05 trillion out of Rb 2.15 trillion). Within a year, account balances in rubles grew faster than those in foreign currency (28.9% against 3.7%); it is to be noted that virtually all the dedollarization fell into December when account balances in foreign currency decreased by 10%, while those in rubles grew by 16.2%.

The fact that most corporate funds are placed in term deposits, rather than current accounts which serve the economic turnover can be regarded as a negative factor in terms of economic activities. In the second half of 2011, the volume of term deposits of corporate customers exceeded again the amount of funds in settlement accounts. It is to be noted that about 45% of term deposits of industries and entities are placed for the term of over one year, that is, such funds have been withdrawn for a long period of time from companies' current operating plans.

The term deposits of corporate customers exceeded for the first time the amount of current settlement account balances in the mid-2009, that is, in the period of stagnation of the economic activities. At that time, such a ratio in the structure of bank accounts of the corporate sector evidently pointed to the low level of business activities and a lack of motivation to economic development. Companies preferred to receive the minimum return on funds placed in bank deposits, rather than take the risk of expansion of production. In 2010, the volume of industries' current account balances grew faster than the volume of deposits which actually remained stable in nominal terms. As of March 1, 2011, the ratio of the value of term deposits to that of current ones fell to 76%.

Fig. 51. Ratio of the volume of funds in term deposits of the corporate sector to the value of current account balances



Source: The Central Bank of the Russian Federation and the IEP calculations

However, later the banking sector returned to the policy of accumulation of savings in bank deposits. As a result, in 2011 the volume of the current and settlement account balances grew by 10.4%, while that of term deposits, by 40.7%, and the volume of term deposits, that is, funds which are not involved directly in serving of the turnover exceeded again the value of settlement accounts balances (*Fig. 51*).

Foreign Liabilities

In 2011, external financing did not have a decisive role in formation of the resource base of the banking sector. The inflow of foreign liabilities to the banking sector in 2011 (according to the methods of the balance of payments) amounted to the mere \$ 7.6bn which figure is 56.5% lower than in the previous year (\$ 17.7bn). It is to be noted that according to the balance statements in 2011 the value of foreign liabilities increased only by \$ 11.9bn. Accordingly,

banks' foreign liabilities ensured only 4% of the growth in the aggregate resources of the banking sector in 2011. It is to be noted that in the total volume of banks' debt on borrowed funds foreign liabilities amount to 11% as of January 1, 2012. Taking into account the current volatility of the global financial markets it is unlikely that in the short-term prospect banks will manage to return to active external financing.

Forced Growth in State Support in Autumn 2011 – Reaction to the Increased Outflow of Capital

A combination of a relative revival of activities on the credit market (see below) and stagnation of the banking sector's main sources of funds resulted in depletion of the reserve of liquidity which was accumulated during the crisis. Starting from summer 2011, banks started to take an active part in auctions of the Ministry of Finance on placement of temporarily available resources of the budget in bank deposits. In September, simultaneously with their debt to the Ministry of Finance remaining considerably high banks started to show demand in different instruments of liquidity provision by the Bank of Russia.

As a result, as of the end of August the total volume of funds of the monetary authorities placed with commercial banks amounted to Rb 950bn, while by the end of the year, to Rb 1.8 trillion. In 2011, the monetary authorities' total depositing of funds in formation of the resource base of the banking sector amounted to 19%.

Table 12

The structure of liabilities of the banking system of Russia (as of the end of the month), % of the total

	12.05	12.06	12.07	12.08	12.09	06.10	12.10	03.11	06.11	09.11	12.11
Liabilities, billion RB.	9696	13963	20125	28022	29430	30417	33805	34009	35237	38443	41628
Own funds	15.4	14.3	15.3	14.1	19.3	19.7	18.7	18.9	18.5	17.3	16.9
Loans of the Bank of Russia	0.2	0.1	0.2	12.0	4.8	1.7	1.0	0.9	0.9	1.3	2.9
Inter-bank operations	4.0	3.4	4.1	4.4	4.8	5.1	5.5	5.2	5.2	5.4	5.7
Foreign liabilities	13.7	17.1	18.1	16.4	12.1	11.5	11.8	11.2	10.9	11.4	11.1
Individuals' funds	28.9	27.6	26.2	21.5	25.9	28.3	29.6	30.0	30.4	29.0	29.1
Funds of industries and entities	24.4	24.4	25.8	23.6	25.9	25.4	25.7	25.1	24.3	24.4	26.0
Accounts and deposits of state and local authorities	2.0	2.2	1.5	1.0	1.0	1.8	1.5	2.3	3.5	4.9	2.3
Issued securities	7.6	7.2	5.8	4.1	4.1	4.2	4.0	4.1	4.0	3.8	3.7

Source: The Central Bank of the Russian Federation and the IEP's Center for Structural Research calculations.

Assets of the Banking Sector

Growth in Retail Lending as a Factor of Support of the Level of Households' Consumption

In 2011, dynamics of retail lending was determined to a great extent by the ratio of households' income and expenses. As was stated above, in 2011 households' real disposable income increased by the mere 0.8% as compared to the previous year, while expenses, by 5.8%. As a result, the share of consumer expenses in households' cash income rose from 68.8% in 2010 to 72.0% in 2011. Such a situation resulted, on one hand, in reduction of the share of the income allocated for savings in cash funds and with banks. On the other hand, support of the consump-

tion growth required additional resources which situation resulted in growth in households' demand in bank loans.

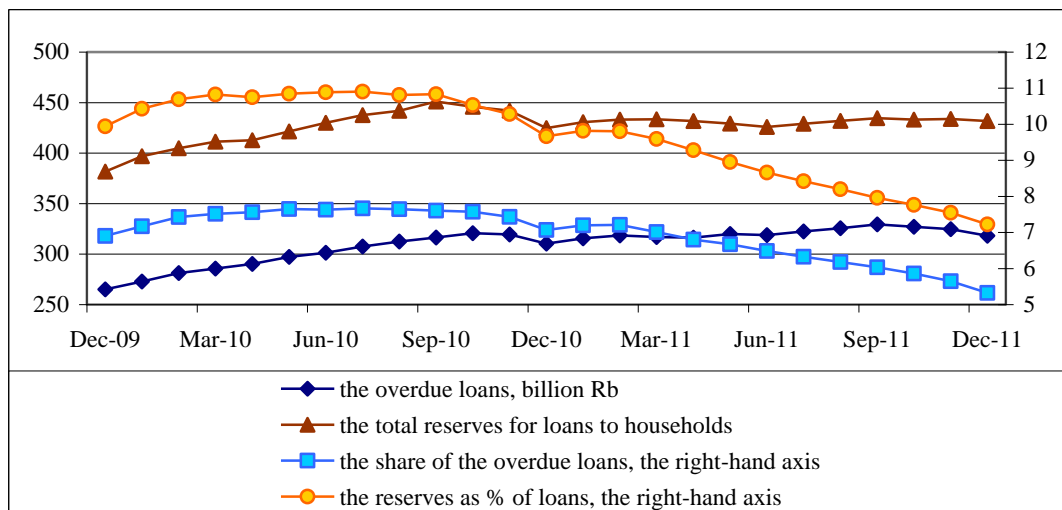
In 2011, the volume of loans was nearly 50% higher than in the same period of 2010 (Rb 5,420bn against Rb 3,649bn). In 2011, growth in extension of new loans¹ to individuals amounted in real terms to 37%. Such a situation resulted in the speed-up of the growth in the households' aggregate debt to banks. Within a year, its volume grew by 35.9% (against 14.4% a year before).

In the currency structure of retail lending, loans in rubles oust loans in foreign currency. As of January 1, 2012, the share of loans in foreign currency fell to 5.5%, which figure is the minimum level in the entire period of development of the Russian banking sector. The pre-crisis minimum level of lending in foreign currency (10.4%) was registered in summer 2008 in the period of the highest appreciation of the ruble exchange rate (the US dollar cost then less than Rb 24). After the revaluation which was caused by the ruble devaluation late in 2008 and early in 2009, that share rose somewhat (to 13.0% as of March 1, 2009). Simultaneously, the process of restructuring of the households' currency debt to banks began. It is to be noted that the demand in new loans in foreign currency does not exceed the value of the repaid debts from autumn 2008. Such a situation can be regarded as a favorable trend which points to the fact that most retail customers have adopted a more weighted approach to evaluation of currency risks related to lending in foreign currency, particularly, such exotic ones to the Russian market as the Swiss francs and the Japanese yens².

The speed-up growth in provision of retail loans usually conceals the accumulated problems related to the quality of the banking credit portfolio. In 2011, the share of the overdue loans to individuals fell from 7.1% to 5.3%, while the ratio of the formed reserves for retail loan losses to the aggregate retail credit portfolio, from 9.7% to 7.5%. It is to be noted that both the value of the overdue debt and the volume of the reserves remain at the stable level; such a situation points to the fact that the problem of bad loans accumulated during the crisis actually remains unresolved and is merely concealed by the renewed speed-up growth in the credit portfolio (*Fig. 52*).

¹ Deflated by the average index of consumer prices in that period.

² In 2007, in the midst of the credit boom the supply of long-term loans in such currencies to individuals (mostly mortgage loans) rose actively. However, as seen from the experience of the previous crisis the negative effect of the foreign exchange revaluation of loans in those currencies has considerably exceeded the expected profit from low interest rates.



Source: The Central Bank of the Russian Federation and the IEP calculations.

Fig. 52. Indices of the quality of loans to individuals

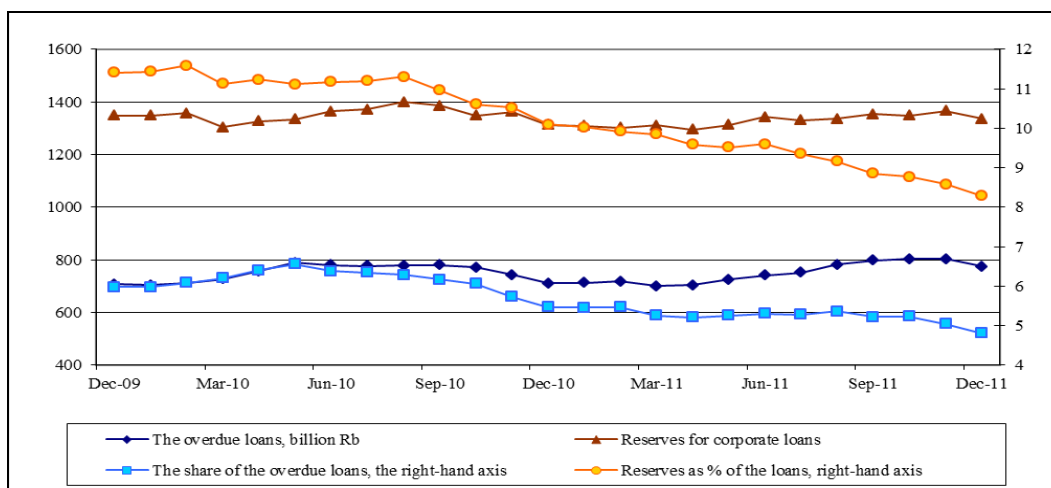
Lending to Corporate Customers

Along with active retail lending in 2011, banks increased lending to corporate borrowers as well. During the eleven months of 2011, the volume of new loans to industries and entities rose by 40% as compared to the similar period of 2010 and amounted to over Rb 25 trillion. The growth rates of the loan debt increased from 9.8% in 2010 to 24.2% in 2011. Rise in intensity of lending can be seen in the growth in the ratio of the volume of the extended loans to the total output. In 2011, that index amounted to 27% against 24% in 2010. It means that over a quarter of the economic turnover is carried out with use of credit funds. It is to be noted that in the pre-crisis year of 2008 that index amounted to 33%.

As in the retail segment of the credit market, the process of gradual dedollarization is observed in corporate lending. The share of debt in foreign currency of the corporate customers fell from the peak value of 29%–30% in spring 2009 to 19%–20% by the end of 2011. It is to be noted that the share of foreign currency in the newly extended loans decreased to 11% (in 2009 it amounted to 17%, while in 2010, to 13%).

Dynamics of the quality of the portfolio of corporate loans is similar to a great extent to the situation in the retail segment of the market. Relative indices show positive changes. The share of the overdue debt fell from 5.5% as of the beginning of the year to 4.8% by the end of the year, while the volume of the reserves, from 10.1% to 8.3% of the aggregate portfolio of corporate loans. It is to be noted that within the year the volume of the reserves did not actually change, while the volume of the overdue debt grew by 9%¹.

¹ In 2011, growth in the overdue debt in the banking sector in general was justified by the situation related to the Bank of Moscow. If in general the volume of the overdue debts in the banking sector grew by Rb 60bn within 12 months the volume of the overdue debt in the portfolio of the Bank of Moscow increased in the same period by Rb118bn. Thus, without taking into account the Bank of Moscow the share of the overdue debt in the corporate loans fell to 4.4%.

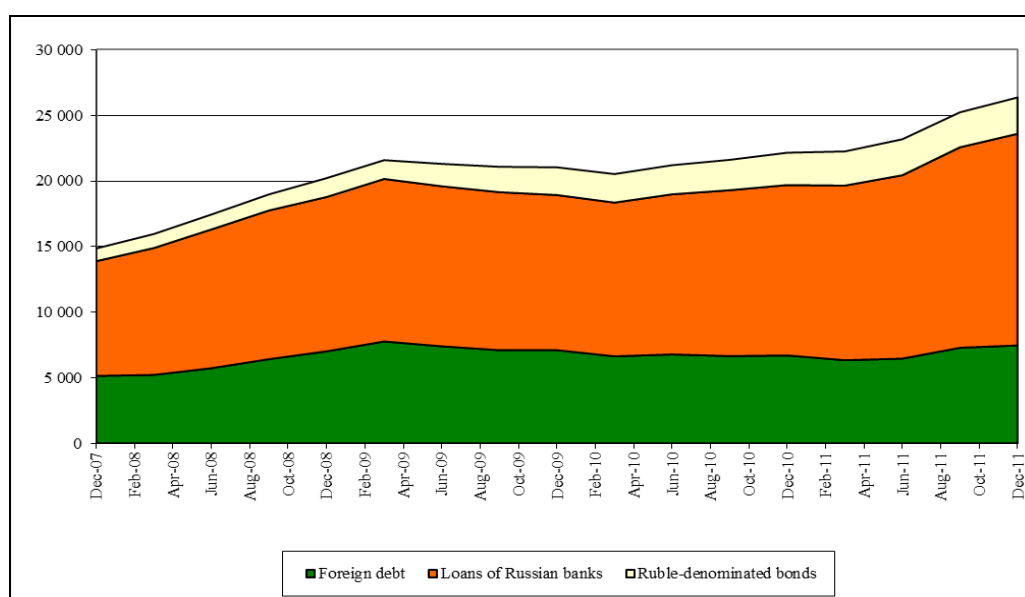


Source: The Central Bank of the Russian Federation and the IEP calculations.

Fig. 53. Indices of the quality of corporate loans

The borrowed funds of the corporate sector have the following three main sources *Fig. 54* : external borrowings from non-residents, bank loans in rubles and foreign currency and bonds placed in the domestic market. The external borrowings account nearly for the one-third of the aggregate borrowed resources of the corporate sector. It is to be noted that from the beginning of the crisis of 2008 the share of the external financing keeps gradually declining. Before the crisis, the volumes of non-banking corporations' outstanding debt obligations on the domestic market amounted to about 10% of the borrowings on the domestic market (excluding foreign debts) and 6%–7% of the aggregate liabilities of the corporate sector.

Fig. 54. Borrowed funds of the corporate sector, billion Rb



Source: The Central Bank of the Russian Federation and the IEP calculations

In 2009, in a situation where foreign markets were closed and bank lending was stagnant domestic bonds became the main channel for attraction of borrowed funds to the corporate sector. As a result, their share in the total volume of the corporate debt rose to 11% (16% on the domestic market). At present, the unit weight of the market borrowings in the total volume of attracted credit resources remains relatively stable. In the 2010–2011 period, the average growth rates of the volume of outstanding ruble-denominated bonds are almost similar to the growth rates of bank credit portfolios. Accordingly, their share in the domestic borrowings remains at the level of 14%–16%.

It is to be noted that the aggregate investments of banks in corporate debt obligations do not exceed 35%–40% of the market and amount to the mere 4%–5% of the total volume of banks' claims to industries and entities (loans and debt obligations). If in 2011 the growth rates of lending to corporate customers amount to about 22% banks' investments in corporate bonds increase at a slower rate (16%). The outputs of the polls of large Russian banks show that the existing ratio between investments in securities and lending is quite stable. According to the polls of large banks¹, over the two-thirds of the polled banks are not prepared to invest in bonds more than 10% of the aggregate portfolio of claims to corporate customers. Bonds do not become a real alternative to a bank loan either for borrowers or banks.

Liquidity

The banking sector entered the year 2011 with excessive liquidity. During the first quarter of 2011 (without taking into account the seasonal peak of January 1) the volume of excessive reserve assets of banks placed in deposits with the Bank of Russia and invested in its bonds amounted to Rb 1.1 trillion– Rb 1.3 trillion or 3.5%–4.0% of the banks' aggregate assets. Meant for lending to the real sector, that volume of resources could ensure growth of 30% in retail lending (which figure is comparable to the actual annual growth in 2011) or growth of 10% in corporate loans (nearly a half of the actual annual growth). With multiplicative factor taken into account, the aggregate volume of the reserve assets as of the end of the 1st quarter was sufficient enough to the banking sector to double the money supply (judged by the pre-crisis structure² of the money multiplier and the decreased share of cash funds in the money supply).

However, a potential credit boom did not materialize due to changes both in the structure of assets of the non-financial sector and preferences of the banks. Households started to switch over to a credit model of consumption which situation deprived banks of the main institutional creditor. Starting from July, households borrowed more funds than placed in deposits. In the first three quarters of 2011, the aggregate growth in loans to households (Rb 1,059bn with adjustment to revaluation of assets in foreign currency) turned out to be higher than the influx of households' deposits to banks (Rb 1,002bn with a similar adjustment).

However, it was banks' activities that contributed most to transformation of excessive liquidity into a liquidity squeeze, namely – a withdrawal of liquid assets abroad from the Russian

¹ A. VedeV, S. Grigoryan. Development of the Russian Banking System in the Current Decade. The outputs of Polls of large Russian Banks (http://www.vedi.ru/bank_sys/bank5411_banks%20poll.pdf)

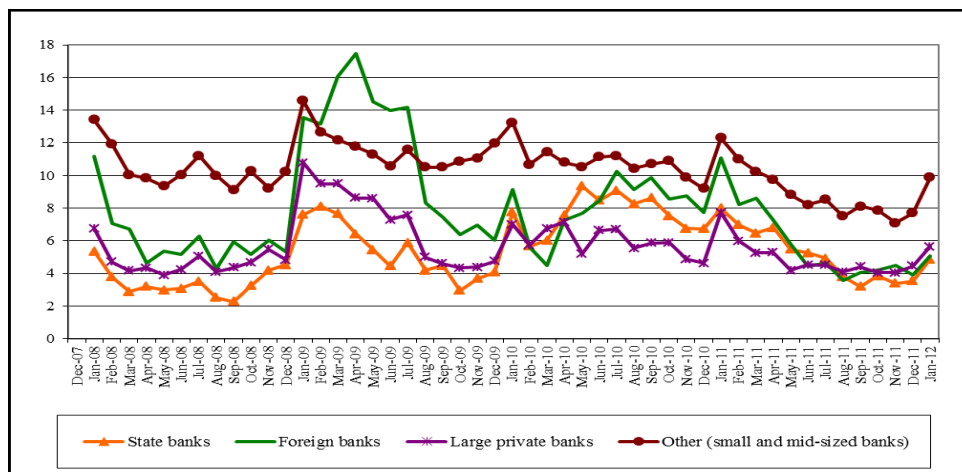
² In this context, the structure of money multiplier means the aggregate of actual relations between individual components of the monetary base: cash funds, banks' mandatory reserves, correspondent account balances with the Bank of Russia and respective components of the banks' resource base. For mandatory reserves – volumes of reserve liabilities, while for other reserve assets – the aggregate depositary base of the banking sector.

economy. So, in 2011 the net foreign assets of the banking sector rose by \$24bn or more than Rb 740bn (over 60% of the excessive liquidity at the beginning of the year). On the basis of the results of the year, an excess of foreign assets over foreign liabilities amounted to the record-high level of \$46bn, while foreign assets in foreign currency amounted to \$185bn.¹

The main channels of capital outflow were state banks and subsidiary banks of non-residents. Out of \$24bn of the net foreign assets growth, Sberbank and other state banks accounted for \$15bn, while another \$9.5bn was withdrawn by foreign banks. Thus, other private banks even ensured insignificant growth of about \$ bn in the net inflow of capital.

In 2011, the specifics of the shrinkage of the bank liquidity consisted in its overall nature. The ratio of liquid assets to the aggregate assets kept declining with all the groups of the banks (Fig. 55). However, state banks were still in a more advantageous situation. Only in that group of banks, a drop in liquidity did not amount to the pre-crisis minimum of 2.5%–3.0% having retained a small reserve for a further decline. As regards other groups of banks, liquidity amounted as a minimum to the pre-crisis level with a group of small banks and mid-sized banks being in the most disadvantageous situation. If in the 2007-2008 period liquidity of those banks did not fall below 9%–10% (due to low diversification of the business small banks need higher liquidity to maintain normal activities) in autumn 2011 that index amounted to the level of 7%–8%. Such a situation points to considerable liquidity shortages and rising risk level in that group of banks. Due to a lower business diversification, smaller banks need to maintain a higher volume of reserve (liquid) assets for comfort business activities. A further drop in liquidity makes such banks critically dependent on access to refinancing of the Bank of Russia and the inter-bank market.

Fig. 55. Dynamics of the share of liquid assets in different groups of banks



Source: The Central bank of the Russian Federation and the IEP calculations.

¹ Insignificant differences in data with Section 2.1.4 are justified by differences in calculating methods of the balance of payments and banks' balance sheet.

Table 13

**The structure of assets of the banking system of Russia
(as of the end of the month), % of the total**

	12.05	12.06	12.07	12.08	12.09	06.10	12.10	03.11	06.11	09.11	12.11
Assets, billion Rb.	9696	13963	20125	28022	29430	30417	33805	34009	35237	38443	41628
Cash funds and precious metals	2.7	2.6	2.5	3.0	2.7	2.1	2.7	2.2	2.2	2.3	2.9
Funds deposited with the Bank of Russia	7.3	7.5	6.9	7.5	6.9	7.8	7.1	5.9	4.5	3.5	4.2
Inter-bank operations	6.3	5.8	5.4	5.2	5.4	6.2	6.5	6.5	6.4	6.2	6.4
Foreign assets	9.1	9.9	9.8	13.8	14.1	12.7	13.4	13.6	13.8	14.6	14.3
Loans to households	12.1	14.7	16.1	15.5	13.1	13.0	13.0	13.3	14.0	14.2	14.4
Loans to the corporate sector	47.0	45.3	47.2	44.5	44.5	45.1	43.6	44.5	45.3	45.1	44.0
State	6.6	5.2	4.1	2.0	4.2	4.2	5.1	5.7	5.8	6.0	5.0
Property	2.4	2.4	2.2	1.9	2.7	2.7	2.6	2.6	2.5	2.4	2.3

Source: The Central Bank of the Russian Federation and the IEP's Center for Structural Research calculations.

Forecasts of Development of the Banking Sector

In 2012, development of the banking sector in Russia will be determined by a number of factors. On one side, the dynamics of the macro indices which reflect the condition of banks' main customers – industries and households – will have an effect on banks. On the other side, the situation will be determined by solution (or prevalence and aggravation) of acute structural problems inside the banking system.

According to the official forecasts (prepared by the Ministry of Economic Development of the Russian Federation), in 2012 a considerable decrease in the growth rates of the main macroeconomic indices is expected: real GDP (from 4.3% in 2011 to 3.7%), industrial production (from 4.7% to 3.6%), retail sales volume (from 7.2% to 5.5%). There is still a direct risk of investment activities being at a low level, but it is clear that growth in material assets will be the minimum (after soaring growth in 2011). The above factors will determine both the decrease in the growth rates of savings of the non-financial sector in the banking system and prevalence of the low demand in bank loans on the part of industries. In addition to the above, growth in households' real disposable income (from 0.5% to 4.5%) which corresponds to growth in the retail sales volume is expected; implicitly, such a situation may result in a decrease in the demand in consumer credit. In general, in 2012 the expected macroeconomic situation in no way contributes to the speed-up of development of the banking sector.

In the second half of 2011, structural problems in the banking sector became more acute – growth rates of the resource base kept consistently falling, while those of lending, increasing. As a result, the Russian banking system turned out to be “loaned up” while expansion of assets and maintaining of the minimum required level of liquidity were carried out by means of refinancing and deposits of the Ministry of Finance.

Generally, it appears that in a situation of moderately positive or moderately negative (depending on expectations) macroeconomic conditions development of the banking sector will be determined by structural problems which prevailed late in 2011. Such problems are characterized by a growing gap between the resource base of the banking system and volumes of loans which are financed by means of loans of the Central Bank and deposits of the Ministry of Finance of the Russian Federation. It is to be noted that the liquidity shortage is aggravated by

the segmentation of the banking system and its low capitalization. Generally, the situation may develop in accordance with the following three scenarios:

1. *Prevalence of the existing trends.* In such a case, the liquidity crisis is highly likely to occur in the banking sector as soon as February-March 2012. The crisis will be justified both by the short-term nature of deposits of the Ministry of Finance and problems related to refinancing of a large number of small and mid-sized banks. A relatively simple solution of the problem may consist in provision of another portion of state resources and modification of the system of refinancing (in order to ensure that an ever larger number of participants join it). Within the frameworks of that scenario with a simple solution of the problem, the situation will not radically change and the next large-scale aggravation of the liquidity crisis will take place early in autumn.
2. *Expansion of external financing.* The gap between the resources of the banking system and the volume of the extended loans can be covered by means of the external financing. A similar process was observed in the 2006–2008 period; it is to be noted that that process was accompanied not only by a drop in the volumes of refinancing to the zero level, but also by the growth in the gross (not net) capital outflow. In other words, as seen from the experience of the past decade growth in the inflow of external resources to the Russian banking sector encourages not only further growth in lending to the non-financial sector, but also growth in excessive liquidity and capital outflow which factor points to existence of both system difficulties and structural problems in the banking system. Realization of that scenario is far from being clear due to the fact that an unstable situation, primarily, in the banking sector of the developed economies is highly likely to remain.
3. *A drop in the growth rates* of lending to the non-financial sector. Such a scenario is of a crisis nature for a number of reasons. First of all, a drop in the growth rates of lending is possible not only due to toughening of requirements to the borrower, but also due to growth in interest rates. With loans becoming more expensive, economic activities will decline, prices will go up and the number of debt service payments will increase. Then, the bad debts problem will get worse due to both more expensive refinancing of old debts and the “effect of the base”. The latter means that indices of problem debts aggravate purely statistically when growth rates or absolute volumes of the extended loans fall.

In case of implementation of any scenario listed above, the banking system of Russia will face instability in 2012. Apart from the fact that bank lending will not be able to be a factor behind the economic growth, the very feasibility that it will meet the adequate demand in loans on the part of the non-financial sector appears highly doubtful. An important observation of the development of the banking system in 2011 consists in the fact that no proper conclusions have been drawn from the 2008–2009 crisis, and as soon as the first evidence of stabilization appeared structural problems got aggravated again. It is quite clear that restructuring of the banking sector is badly needed to ensure sustained development. However, such an operation is related to high costs and risks in a situation of unstable recovery growth.