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1998 Russia's Banking Crisis and Stabilization Phase

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Contents

The main aim of the book is to study the situation in the banking sector on the eve of and after the financial crisis of August 1998. The crisis of the Russian banking system that began dramatically after the payment system ground to a halt, depositors panicked and a number of big banks were unable to meet their commitments, was not as extended or serious as might have been anticipated. The weakness of the banking system in Russia—its low degree of involvement in crediting the production sector of the economy—was a factor that prevented the crisis from developing to a scale that would cause serious losses to national production.

The first chapter of the book deals with the state of the banking system just before August 1998, the main specifics of the Russian banking crisis and its quantitative parameters. In this work, we have concentrated only on those aspects that aroused discussion—the reasons for the crisis, the adaptation of banks to the new macroeconomic conditions, depending on their position on the market for banking services on the eve of the crisis, and approaches to assessing the scale of the crisis. Particular attention is focused on the non-performing assets of banks. The second chapter describes the banking system during the period of post-crisis stabilization, while the third considers interrelations between credit organizations and enterprises on the basis of surveys of banks and enterprises, carried out in mid-2000 by the Institute for Socio-Economic Analysis and Business Development, at the request of the Carnegie Moscow Center.

In Russia, the crisis was not preceded by economic growth, while the crisis itself not only did not intensify a recession, but proceeded against a backdrop of economic growth. In combination with favorable changes in the economic situation abroad, the growth of production became a factor helping the economy out of the banking system crisis. In addition, another factor of the banking crisis—the budget crisis—ended rather soon. Even so, there are sufficient grounds for describing the banking crisis that began in August 1998 as a system-wide one—in the autumn of 1998, the country's payment system was virtually paralyzed. We estimate the share of inactive assets, as of October 1, 1998, at about 20% of the assets of commercial banks. The contribution of state securities to the growth of non-performing assets was about a third.

As a rule, credit crises accompany banking crises, and this did, indeed, happen in Russia. The banks called in previously granted loans early, refused to grant new loans, imposed harsher security requirements, etc. These actions could not, however, exert a seriously negative impact on the non-financial sector, since bank loans played an extremely insignificant role in its operation. Under such conditions, the main party suffering from the crisis were the banks' creditors and, above all, private individuals and non-residents. The crisis revealed the lack of effective procedures for guaranteeing the rights of depositors and creditors and distributing losses incurred from the crisis among market participants. The natural reaction to this situation was a fall in trust in the banking system and an outflow of deposits.

As the study showed, however, far from all forms in which the crisis was manifested and its consequences were so easy to predict. It is no secret that the government is often blamed for the crisis, having stopped servicing its own internal debt. The percentage of licenses recalled during the year after the crisis was, however, higher among banks that did not have ruble state securities in their portfolios on the eve of the crisis, than among those that did.

Furthermore, the devaluation of the ruble dealt a particularly hard blow against banks that actively attracted loans from non-residents. According to this indicator, however, the lowest percentage of licenses recalled was among banks over 25 percent of whose liabilities consisted of foreign ones. At the same time, the level of profitability on the eve of the crisis was a major indicator of a bank's future fate.

Questions concerning the behavior of banks during the period of stabilization are considered in Chapter 2. The dynamics of a number of bank indicators indicate that crisis phenomena in the banking sector stopped growing from the spring of 1999 onwards and, already by the end of the year, marked positive changes had begun. Apart from the banks whose licenses were recalled, the problem of bad debts in the banking system had been resolved by the second quarter of 2000. According to the deferred debt payment indicator, the banking system had been restored by the third quarter of 2000. During this same period, the total assets of Russian banks in constant prices had returned to their pre-crisis level and the growth rate of the assets of regional banks had outstripped the same indicator among Moscow banks. The liquidity crisis of the banking system was overcome by the middle of 1999, primarily thanks to inflation. In 2000, banks again began to make profits from current operations. Moreover, the banks that survived the crisis demonstrate greater efficiency than in the pre-crisis period, receiving, on average, higher profits on assets by reducing outlays on interest payments and administrative costs. However, the cut in crediting the non-financial sector has not been overcome. The problems of capitalization have still not been resolved in terms of any of the indicators: neither the absolute magnitude of aggregate capital of the banking system nor the share of capital in assets have returned to their pre-crisis levels.

After the acute phase of the crisis, the banking system followed a well-trodden path. Inflation devalued the loans not returned to the banks, reducing their share in balance-sheets; an increase in the balance-sheets in the accounts of enterprises led to a growth in bank assets. The placing of funds in currency instruments made it possible, given the drop in the ruble exchange rate, to make an income in the usual way—from revaluation of currency assets. The ratio of assets to liabilities in currency changed from negative to positive. The need to earn money from crediting the production sector was again pushed into the background. Only the stabilization of the currency exchange rate in 2000 slowed down the drop in the share of loans to the non-finance sector in the banks' assets.

During the crisis, the banking sector received, by international standards, only modest support from the state—state expenditure on supporting the banking system during this period was relatively small accounting for about 2 percent of GDP. The spontaneous way in which the crisis was overcome had not only negative consequences. The positive aspects include the absence of any large-scale nationalization of the banking system, in spite of the energetic rhetoric supporting a concentration of state financial injections into this part of the banking sector. State intervention in the operation of the banking sector has evolved from a series of urgent measures designed to save it to a restructuring effort aimed at ensuring the more stable development of the banking system, improving the competitive environment within it and creating insurance mechanisms which would help if not averting banking crises in the future, then at least reduce their impact and scale.

The negative aspects include a failure to learn the lesson of the crisis, which laid bare the diseases of the banking sector. Society saw for itself that bankruptcy in the banking sphere is potentially dangerous for the state of the economy as a whole, owing to disruption of the country's payment system, and entails more substantial social consequences than in other sectors of the economy, since banks rely only to a small degree on their own capital, while operating with resources deposited by others, which are considerably larger. It is obligations to clients that create special problems when banks go bankrupt and require that the state pursues an active policy in the event of a banking crisis or threat of one. A crisis becomes a good reason for reviewing the existing system for regulating the banking system.

In Russia, where the government bears a considerable portion of the responsibility for the development of the crisis itself, the opportunities created by the crisis situation for taking measures to make the banking system more transparent for clients, to improve the normative base and provisions for financial accounting, to implement the principle of the responsibility of owners and management for the state of the bank and other elements of a banking restructuring, were largely allowed to slip past. As a result, the main manifestation of the crisis has not been overcome nor trust in the banking system restored. This means that, whatever the financial reports of the specific banks might show—a growth of assets, increasing efficiency or capitalization—it is still early to speak of the end of the crisis.

Chapter 3 is devoted to issues of the interrelationship between banks and their corporate clients during the post-crisis stabilization period. For this purpose, two thematic surveys were held, devoted to banking services for enterprises in the production sector. The respondents were four hundred enterprises and organizations in both industry and other branches of the economy—construction, transport, trade and the services sphere, located in the centers of seventeen constituent entities of the federation, as well as 36 banks from 13 regions. Mainly, these were the banks named by the enterprises as the financial institutions whose services they used.

It turned out that the overwhelming majority of enterprises were quite satisfied with the banks that serve them and are not inclined to change their business partner bank often. They are forced into this most frequently by the financial status of the bank, rather than the quality of the services it provides. Considering the fact that over 40 percent of the respondents held accounts in Sberbank, such answers may be regarded as an additional argument in favor of the need to raise the stability of the banking system.

At the time of the survey, less than a third of the respondent enterprises were using bank loans and more than half of them had never used bank loans. The percentage use of bank loans was particularly low in such sectors as the services sphere and construction. The most common reason given for not applying for bank loans was their high cost. The second most common was the unexpected answer that «the enterprise does not need a loan». This answer did not mean, however, that the enterprise did not need any outside sources of financing at all—less than half the respondents were in that position.

The alternative sources of funds for enterprises included the issue of bills of exchange, commodity loans, loans from other enterprises and funds of private individuals. The last of these instruments deserves particular attention. It gives grounds for assuming that some of the savings that are commonly called «under the mattress» savings, are in fact working in the economy, but either it is not profitable for them to come out of the shadows or trust in enterprises of the production sector is greater than that in banks.

The survey showed that no radical shifts are expected in segments of the production sector credited by banks. The banks note a rise in the demand for loans on the part of enterprises primarily in such areas as the acquisition of raw and other materials, expansion of production, and only in third place, modernization and renovation of production. The rate of expansion of crediting itself falls behind the processes taking place in the production sector, which prevents banks from increasing, to any marked degree, their share in the sources of funds for financing the circulating assets of enterprises, while their already modest (about 5 percent) share in financing capital investment even dropped during 2000. Thus, the serious rift between the banking and production sectors of the economy still remains.

To sum up, it is still early to speak of the banking system of Russia having emerged completely from the crisis. Steps to restructure the banking system, designed to overcome the consequences of the systems crisis and to construct a stable banking system, require more than just financial measures. They presuppose a comprehensive change in the legal base regulating relations between debtors and creditors and, possibly even more important at the moment, a desire on the part of the authorities to observe the established rules of the game.