A Long-Term Strategy for the Russian Financial Sector: Challenges of the Post-Crisis Period

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Financial tsunamis open up new windows of opportunities. The crisis of 2008 must trigger profound changes in the financial structure of the national economy, ensuring national security and promoting growth and innovation. It must also prove the effectiveness of State efforts to create a new center of influence on the monetary map of the world.

The State is the people acting on the basis of shared ideas. Confusion reigns in the minds preoccupied with financial matters. There is a contemptuous attitude to financial aspects and to accounting, which was typical in 1930-1980. Resentment toward speculation and super revenue never put back into production cycles. The unrealistic dreams to close down all exchanges and live a quiet life. Affection toward easy money. Too much admiration toward the financial skyscrapers and their inhabitants, currency exchange rate and cash flow managers. Faith in the self-regulating markets. Trust in only others' remedies and their replication, no matter whether it's good or bad for your health.

The second decade of no-anesthetics experiments with the Russian financial system is coming to an end. The 1991-92 inflation shock, the 1993-1994 financial pyramids, and the 1995-1997 financial stabilization, which left the country with no money. Over 600 check funds turning to dust. Creation of a speculative financial market model in 1995-1997 across all of the following segments: shares, state debt, currency, derivatives, banks, non-residents. As a result, a most acute crisis of 1997-98, which almost destroyed the market economy. In 2000-2007, a classic financial policy fraught with crisis consequences (which was repeated dozens of times in other countries). The 2004 liquidity crisis, and the first warning signs. And, in 2008, capitulation of the stock market and systemic risks emerging in the banks.

What's next? All those "black Mondays" have proved the need for a new financial market policy which the underlying principle of reasonable egoism, own (and shared) interests, balanced approach, growth, liberalism and openness along with protection against shocks, and direct investment. A different economic approach, which could certainly be applied by the government.

For starters, it's important to win public support of the simple truth. Money is the energy and water, or the blood of the economy. The payment infrastructure and good roads are similar in their significance. The exchange and nuclear power engineering are similar in their complexity, economic significance and inherent hazards. Financial markets are the instruments equally powerful with geopolitics, the army and foreign trade. The national project, Russia's Financial Site (similar to the German program of 1990), if launched, would have required state efforts as strong as those spent on education, science, and critical technology.

The volume of challenges determines the project's "national" status. Faster growth of demand in domestic finance vs. external finance demand. Promotion of the ruble as a freely convertible currency. Less dependence on the hot money of non-residents. Establishment of a model stimulating direct foreign investment in priority sectors. Reduction of the cost of money. Efforts to counter non-monetary inflation.

One of the project's goals is enhancement of social stability and diversification of ownership to the benefit of the middle class. Following that, creation of a favorable environment for mass-scale investment, establishment of new institutions for personal and collective investment, a breakthrough in providing access to information, and an unprecedented growth of listing systems.

Russia's financial market is one of the most risky markets in the world, therefore, it is inevitable to recapitalize and consolidate the infrastructure of the national financial system. Compensation funds must be set up and financial institutions must significantly improve risk monitoring.

Russia will have to create its own system of venture businesses and financial markets required to support innovation. It is pointless to copy the U.S. model, because there are too many differences between the two countries.

The regulatory agencies have failed to cope with crisis risk assessment challenges. Therefore, an urgent task is to expand their operating capacity and build up the legal framework of the market. It is also necessary to counter manipulation attempts and insider attitudes, ensure honest prices, and set up a system to assess systemic risks, or a financial system equivalent to the Ministry of emergency situations, and take under control over-the-counter market risks, the bill market, and derivatives.

On the external front, it is required to set up a CIS financial market development center, which will not only make it possible to borrow in London or New York, Singapore or Dubai, but allow them to borrow from us, as well. In addition to Moscow's New City, favorable financial zones must be set up in the coastal regions (using the extensive world experience). Kaliningrad and Sochi have good financial prospects.

The centerpiece of the Russian financial system must include a new financial and monetary policy stimulating growth, innovation, and domestic demand. The practice of 1995-2007 demonstrated a total failure of the inflation criterion in managing the complex financial system, which has a non-monetary origin.

The central issue is turning Russia's financial sector in a heavy monetary machine, which would be difficult to push off track. It is required to promote growth of monetization of the economy, and expand domestic demand. The Cash/GDP indicator for China is160%, for the developed markets – 80 to 120%, and for Russia - 38%. Loans in the Russian economy account for 36 per cent, and over 110 % in China (IMF 2007 data). For that reason, the commercial bank of China is the 9th largest bank in the world and Sberbank is in the 66th position (Banker 2007 data). Monetary saturation does not necessarily lead to inflation. In China, the rate of inflation is 2-3 times lower than in Russia.

Loans of the Bank of Russia to commercial banks can serve as the vehicle of monetization. Similar approaches work worldwide. In Russia, it is still the emerging practice in the operations of the Bank of Russia under the crisis situation, and it must be turned into standard operating practice, while in the past it was only used to make the “emergency rubles against hot dollars and external debt” steps, which in reality represented a restrictive policy regime of the “currency panel.”

Another challenge for Russia’s "financial site” is to destroy the “tragic triad,” consisting of the high price of money and high asset currency yield, fixed ruble rate and open capital accounting. As long as that triad exists, the economy will continue to be filled with hot money, and speculation and crisis risks will prevail. If it remains easy to bring the money in, get super revenues and withdraw, all efforts to set up an international financial center will be in vain.

Is it possible to dismantle that "triad"? The new policy must include efforts to gradually lower the ruble exchange rate in the currency basket and extend the currency exchange rate corridor. That will improve the trade balance and set up barriers to speculative capital and excessive external debt.

Will that lead to higher inflation? Hardly so, as the roots of inflation in Russia are non-monetary, but are represented by oligopoly, regulatory costs and risks compelling the businesses to operate on the basis of excessively high revenue targets, as well as the pricing policy of the State in the natural monopolies. In 1990, the growing prices were explained by the growing dollar exchange rate. In 2000, the main reason was the declining dollar rate and soaring import prices. That was an almost hopeless situation. If the ruble rate is gradually lowered under the slogan of consolidation of its strength (similar to the U.S.) and in parallel with the steps to counter inflation costs, the impact on prices will be minimal.

Some may ask, What about the international stability of the ruble, which is the subject of national pride and the basis for future reserve currency? At present, all that talk is just a dangerous myth and a threat to the economy. The dollar as the reserve currency has always displayed cyclic dynamics, while is has always stayed under control of the monetary authorities. In 2001-2007, its value dropped almost 50% to the Euro, but in 2008, the dollar it started to regain its positions.

Another additional component in the “triad” is the price of money, which is too high for a successful export economy. Before the crisis, cheap Western loans provided to Russia were promoting the unprecedented growth of external debt, USD/EUR conversion and emission of rubles covered under those loans.

There is a big difference between the 6- 7% loan interest rates in China, the Czech Republic or Poland and the 10-16% interest rates in Russia. The annual interest margin of the banks, which has reached 7- 10%, is probably too much to cover even the stronger Russian risks. The 15-16% business plan interest and in the structure of prices only speed up inflation.

The 2-3% interbank lending interest in 2005 – 2006 represents the base price of money in Russia. The reason why that level has been abandoned is in the lack of an effective Central Bank policy and the passive attitude of agencies with regard to non-monetary inflation.

There is a vital need for such a policy. It must be used to bring the loan interest down to 7- 9% for the citizens and in the third echelon of the economy, which is required to transform the ineffective refinancing rate from a mere rudiment into a realistic tool of money policy.

Capital accounting is yet another additional component of the triad. Increased monetization and reduced interest must restrict the flow of hot cash and foreign debt build up. But the most attractive part of that cash flow is direct foreign investments, which must not be lost. They bring along new ideas, technologies and modernization. In China, direct investments are 5 times greater than portfolio investments, and in Russia they are 1- 1.4 times greater.

Consequently, the entire system of incentives affecting capital accounting must be changed and re-oriented toward direct investment, primarily in the manufacturing and high-tech businesses. Which, naturally, brings us to the subject of taxation.

Our tax burden is heavier than in China by an order of magnitude. The “enlarged government income+non-budgetary funds/GDP” indicator in Russia exceeds 40%, while in China it totals 20% (2007). This is one of the reasons why only 24% of Russia’s GDP are used for asset accumulation; in China, 45% are used for that purpose (2006 World Bank data).

The structure and the rates of VAT, personal income tax, social and profit taxes (all those magic 13, 18, 26, 30 digits) are not as important as their common vector, which tends to drive Russia into the zone of low growth rates, and, specifically, to the use of outdated European economic models with 0.5 - 2% growth rates. In all fast-growing economies the tax burden is significantly lower. If the oil prices collapse, we will unavoidably face recession.

At the same time, taxation of nonresidents is even higher. Many internationally known tax benefits for non-residents used to channel their funds toward direct investment and in innovation are not applied in Russia. China is using dozens of benefits for promotion of high technologies. As a result, in China, the high tech share in the country’s export is 3 times larger than in Russia (30% and 9%, according to the 2006 World Bank data).

The other side of heavy taxation is the excessive state reserves. Tax revenue is used to form the budget surplus which then settles down as foreign currency reserves. In China, which also makes large savings, the foreign currency reserves are almost equal to their GDP used to build up capital, while in Russia these reserves are 1.4 times higher (2007). In August 2008, Russia’s currency reserves exceeded the Big Seven’s total reserves more than 3-fold, and accounted for 8 percent of the world’s total reserves, while Russia accounted for 2.4% of world GDP.

What can be expected? After the bottom of the crisis is reached in 2008 – 2009, the upswing phase in world economy over the next 15- 20 years will be inevitable (the “long cycles”). Over the first few years, there will be some inertia and loss, but the monocentric financial system based in New York and London will be restored. There will be lots of cash and investment, and many minor crises. The winners will be those who, relying on others’ experience, will generate new ideas, without too much copying and strictly following observing national interests.

For Russia, that indicates the need for a significant financial maneuver. The formula which can be described as “high taxation, high reserves, slow growth and dependency on the oil prices and non-resident assets” must be replaced with the following formula: “moderate taxes, focused tax benefits/monetization, low cost of assets, gradual decrease of the ruble exchange rate and extension of the currency corridor, direct foreign investment, optimal state reserves, fast growth, focus on innovation, and stronger financial potential.” Instead of the speculative third-world financial model, creation of an investment model for the financial sector, adequate in its maturity to the model of new industrial nations.

Otherwise, the accumulating systemic risks will bring about a third blow. The first was in 1997-98. The second occurred in 2007-2009. The third one may happen within the next 5-10 years.

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