FINANCIAL STABILITY OF BANKING SYSTEM IS A BASIS OF
ANTIRECESSIONARY ECONOMY DEVELOPMENT

Sergey L. ERMAKOV
Russian Academy of Entrepreneurship, Moskow
ermakovsl@mail.ru

Abstract
The problems of studying “the basic postulates of stability” of the banks and their system as a
whole are constantly being exposed to the analysis under various angle; they begun practically in the
‘90s of the XX-th century, that is almost simultaneously with the beginning of the formation of the
new bank system of Russia. However, the existence of various rating systems of an estimation of
stability, a choice of priorities, etc. do not allow us to develop the unequivocal approach to the given
problem. The stability of a bank system, being a complex characteristic, is in a close parity with the
stability and the stable development of economy as a whole. It is possible to consider as steady
development of economy the stable and high enough rates of economic growth, industrial production,
investment process (providing growth and its support in the long term).

The given article is devoted to the detailed analysis of questions of financial stability of banks
from the point of view of macroeconomics.

Keywords: bank system, credit institutions, financial stability.

JEL Classification: E44, E58, G21.

The assumption that economy can completely avoid crises at successful regulation is not
proved by practice. More likely, crises are the price which the economy is compelled to pay
for innovations.

Governmental authorities appear before very uneasy choice at realization of economic
policy. They can stimulate financial innovations, keeping the open markets. Herewith the
process of regulation will be simple, but there will be crises from time to time. It is necessary
for the state "to clear" the market and the regulation in that case should not only prevent, but
also treat economic illnesses.

At the realization of the alternative way the governments can aspire to safety and
stimulate formation of the financial systems, differing with super reliability, but thus not
allowing stimulating innovations and economic growth.
The heart of functioning of any market economy, its blood circulatory system is a complex of credit-bank institutions, which with serving their ability to live structures (infrastructural elements), represents the plethoric banking system of the country. If we are to go deeper into the theory of state’s construction, the banking system, as a rule, is considered a subsystem or a sector of a financial system which, together with the political system, makes the economic system of the state.

For effective and full-scale realize of the functions in conditions when banking system plays the role of economic growth maintenance and structural reorganization in a direction of increase of competitiveness, translation of economic growth into a stable basis, stimulation of internal industry and demand for made production, the credit institutions should be financial stability.

The interpretation of concepts of stability can be really various. The unified, established definition of this term has not been given yet. In a macroeconomic context, from the point of view of influence on an economic mechanism, it is important that banks under influence of the certain reasons can lose ability to realize their functions that is fraught with serious negative consequences not only for banking system, but also to economy as a whole. And such threat exists constantly (to a greater or lesser extent). Hence, the banking stability should be understood as ability of banks to realize their functions during rather long period.

Given treatment is close to the formulations accepted in a world practice. The European central bank defines stability of bank system as a situation at which the financial system is capable to realize well all the functions and which will not change the functioning of the financial system in the near future. It is clear, that it is a question of negative changes.

Being the major factor of economy development, stability of banking system becomes the extremely important characteristic for the economy which are being in transformation phase, demanding probably greater volume of long-term investments. For economy in general, and for a transitional economy in particular, system crisis (in some cases even bankruptcy the one largest systemic bank) means at times not just a loss of importance, but also an element of economic relations. Consequences are rather more serious and far-reaching - the replenishment mechanism is broken, i.e. continuity and sustainability of the manufacture process (bases of the expanded reproduction, i.e. forward development at least are undermined).

And if in a mature market economy the difficulties can be overcome quickly enough in a facilities reformed, in the rather small stock of "economic" durability, even insignificant infringement of balance (not speaking about such serious as crisis of bank system) can get destructive and irreversible consequences.
One of the most important problems at the present stage of Russia’s development is attraction of bank investments into the real sector of economy. Only thus it will be possible to bridle development of the crisis. It is obvious, that as the industrial sector depends on a real condition of channels of monetary flows movement, as the bank system cannot successfully work without normally functioning sphere of goods production. Being an indissoluble component of the economy, the banking system represents both the independent and, to a certain degree, the isolated sphere of the general economic complex. Hence, the economy and banking systems should be considered as an indissoluble unity at the analysis of the development of the investment activity.

One of the primary goals of Russian banking system’s reforming at the present stage is probably fastest overcoming of world crisis consequences and an output on the world standards level in the organization of the banking, corresponding, prevention and minimization of development of the crisis effects and their consequences for domestic economy. Thus the question of the stability of the banking system should be considered as defining for the future market economy.

From the point of view of the international practice, banking system is one of the most "natural" investors, because its function is redistribution of temporarily free capital between participants of market attitudes. Banking activity inevitably leads to accumulation of the capital, which banks should start in a turn again and to cover the expenses and to receive necessary profit for the further development.

Any investor always prefers to invest the capital for a long time and with possible in greater rate of return. The banking capital, being involved in investment process and directed on development of manufacture, proves as one of the major conditions of expansion of business and industrial (productive) activity.

The basic directions of modern investment activity of banks-investors:
- Investment in need of natural monopolies of federal value and the largest enterprises of the extracting and processing direction, used mainly for modernization of the fixed assets, reconstruction of the industrial equipment;
- Conversion of the defense industry and translation of a military-technical complex production into "civil" rails.

Unfortunately, including by virtue of the objective economic reasons, the credit institutions extremely reluctantly direct free financial resources to long-term crediting economy, preferring still short-term investments.

The major factors hindering from banking investment in manufacture are:
- Excessively high risk level of investments in real sector of economy owing to its instability;
• Significant blanks in the legislation adjusting questions of banks participation in investment process;
• Deficiency of the market effective investment projects;
• Insufficient for high-grade investment in significant economic projects volume of resource base;
• Really short-term character of the developed resource base of banks.

Traditional risks of banking activity raise in the Russian conditions owing to some economic and legal features. Among them it is possible to allocate:

- The general condition of the Russian economy, described financial instability of a significant part of the enterprises, frequent usage not monetary payment forms, non-professional management, etc.;
- Imperfection of the legal protection stipulated by the civil legislation, interests of bank as the creditor, inherent for operating system of mortgages registration, the bank rights to clients property. In these circumstances there is a significant concentration of credit risks at enough limited number of borrowers;
- Obvious discrepancy of short-term passives of the Russian banks to needs for investments owing to investment crediting bears threat of bank liquidity.

Repeatedly spent calculations of parity of involved and placed by banks testify that the most comprehensible and "counterbalanced", from the point of view of security necessary resources, are short-term investments. In process of increasing terms of investments, gap between volumes of investments and sources of their financing grows up to five times on the investments on above three years.

At present time short-term crediting are engaged by many commercial banks, but investment crediting and financing of investment projects are a field of activity of very limited banking group. By virtue of the specificity and as a result of presence of demanded volumes of the capital they have opportunities to decrease investment risks and diversification all possible risks in general. There are:

- The banks entering into financial and industrial holdings (FIH). Participation of banks in FIH, especially caused by the certain property attitudes, allows them to make urgent investments, to establish lower interest rates on credit. In this case interest of bank is blocked by interests FIH as a whole. Besides the bank entering in FIH, has an opportunity to supervise default risks and in time to solve questions of liquidity due to recourses stored it;
- The banks participating in projects of various international institutes (the European bank of reconstruction and development, World bank, the International investment bank, etc.) which percentage policy is regulated by corresponding agreements;
The corporate banks generated on a branch basis and serving appropriating sectors of manufactures. Participating in the state programs of support or progress of the branches and being, inherently, special-purpose branch banks, these banks dispose allocated on progress of appropriating branches by the budgetary funds, being of cheaper, than other resources;

- The banks, classifying as large, generated the reliable client base, carrying out industrial investments under condition of shares reception or other rights of participation in profits - in activity of the borrowers, providing the control over efficiency to use of the allocated recourses, as well as expansion of a zone of influence.

Other categories of banks which are not having sufficient resources for realization of large-scale investment activity, can give only short-term credits for formation of working assets. These banks, basically, are not interested in delivery of long-term credits as are compelled to consider not only the raised risks of long-term investments, but also the significant costs connected with realization of actual investment projects.

The motives stimulating banks on investment activity are:

- Possibility to establish the financial control over investments;
- Diversification of risk and increase of profitableness;
- Expansion of influence zone, types of the services, given to clients with objective of hardening of bank position in the various markets;
- Expansion of resource and client base by means of creating a network of affiliated financial institutions;
- An increase of monetary streams at the disposal of bank through channels of the affiliated and dependent organizations;
- Possibilities for evasion of a legislative interdiction on banking conducting of not profile operations (manufacture, commerce and insurance).

Orientation of commercial bank on similar motives (that often happens if the bank serves basically commercial interests of one or groups of the enterprises) is fraught for it with loss of profitableness, reduction of the capital and, as consequence, loss of a possibility to invest the financial resources in actual sector of economy.

In present conditions, considering the world crisis which has amazed economy of many countries of the world, the Russian banks need, undoubtedly, some external impulse to begin active investment crediting actual sector of economy. Such impulse can become, for example, creating of the developed market infrastructure serving credit-investment area of actual sector. For this purpose it is necessary to generate flexible and effectively working system of interrelations bank and the industrial firms, allowing to establish consistency as between the sizes of essential and had credit-investment resources, and their structure.
The problem consists also that the large banks, being the basic accumulators of monetary resources, as a rule are not in a condition to organize adequate credit-investment activity with significant number of the enterprises of the average and small investment business. In its turn, the last also difficulty can find partners among average and small banks. As consequence, it is arisen a problem of lawful and adequate usage of potential.

Practice of Russian banking having long-standing and effective attitudes with the enterprises of actual sector, confirms, that for adequate and long-term cooperation it is very important to be able to estimate properly efficiency of the investment project, paying ability of the borrower, a possibility to render services of financial management and to participate in business-plans preparation. It assists reduction of credit and investment risks with simultaneous assistance of the organization of investment projects management.

In our opinion, the restructured Russian banking system (its creating is begun from 2001 and will be prolonged up to 2020 at least, that is reflected in Development Strategy of banking sector of the Russian Federation and other program documents of the country) finally should meet the requirements of high reliability, controllability and an investment orientation, to guarantee an indispensable level of the offer of credit resources, insurances and preferences with a view of progress of banks’ investment business and maintenance of indispensable conditions of an investment climate.

Infringement of banking system stability disorganizes (or even completely stops) activity of financial intermediaries, and thereof also other participants of the market. The crisis negatively influences on social and economic progress of the country, and is capable to stop and even to undermine bases of economic growth on reasonably prolonged period of time as become the reason of the subsequent long-term stagnation. Developing economies, especially transitional ones, owing to unresolved fundamental macroeconomic problems and limitation in resources for the decision of a problem, are not in a condition rapidly and effectively to meet crisis and its consequences.

Banking crisis by the most destructive image affects all economy sectors. The real economy sector during rather prolonged period of time – “crisis + the regenerative post-crisis period” - remains without bank service as loses a possibility to render services to clients, to not able to carry out transactions and payments, not speaking about the credit. The disorganized work of banks causes by a life various "substitutes" of a bank product (for example, barter transactions) which partly solve the problem during the crisis period but which "removal" from a business practice during normalization of economic attitudes is an independent and uneasy problem.

The banking system also restores working capacity during reasonably prolonged period after crisis. For certain time it "is switched off" from reproductive processes. It occurs
because as a result of crisis the banking system loses certain, sometimes – quite considerable, quantities of the credit institutions. But also for banks to which managed to go through crisis, consequences do not pass completely - they lose a part of actives.

Even after restoration of working capacity of banking system the credit institutions are capable to serve actual sector of economy in the shorthand volumes in comparison with a pre-crisis level. And it means reduction of business activity of economic agents - clients of bank that constrains possibilities of banking system’s development (restoration).

After crisis the confidence to banking system (instead of to the country leaders, which fault, in some cases, significantly above, than banks) of clients, especially the population are fallen that undermines possibilities of formation of banks resource base with all following negative consequences. The same it was already repeatedly observed in the Russian practice.

The following aspect, characteristic for the countries with a transitive economy, experiencing a period of reforms, is extremely important. In developing economies, as a result of crisis and increase of economic complexities, the social and economic base for realization of reforms is undermined. All reforms require additional and scale resources. It is unnecessary to speak about this during crisis and post-crisis depression. The social base is essentially narrowed, the number of reforms supporters is sharply reduced, because positive results of transformations are once again postponed to uncertain time, while during crisis the population sustains quite actual material losses, and state possibilities on support of the population and the compensation of losses are very limited.

The problems of studying banks’ “basic postulates of stability” and their system as a whole are constantly exposed to analysis under various angles of visions; they begun practically in 90th of the last century, that is almost at the same time with the beginning of formation of the new Russian banking system. However availability of various rating systems of an assessment of stability, a choice of priorities, etc. do not allow to develop the unequivocal approach to the problem.

The stability of the banking system, being the complex characteristic, is in a close parity with stability and stable economic development as a whole. It is possible to consider as tolerant progress of economy stable and rather high paces of economic growth, industrial production, investment process (providing growth and its support in the long term). The stable, growing economy gives to banks favorable conditions for own development. In this case the question consists in that, how much adequately banks realize possibilities for own stable development. From the macroeconomic point of view, stability characterizes progress in development of system in whole.

The stability of banks (the banking system) consist not only and not so much in their capacity to resist to risks, to overcome adverse economic conditions, but also in their capacity
to support the working capacity, namely – to adapt for changing market conditions that is especially important from positions of participation of banks in the maintenance of the progress of the economy.

Carrying out such policy, the bank becomes an integral part of the economic mechanism, is organically entered into the economic processes, becomes demanded on the functions, but it does not get in a crisis situation. Thus, stability is an important if not a fundamental concept turned not to statics, but to movement, not to the past, but to the present and, that is especially important, to the future.

The popular belief in "cleaning" function of crisis will be coordinated with this position too. It is a question of stability not one bank, but banking system in whole. Some banks can appear for some reasons in a complex financial position and even to stop existence. However if financial complications mention banks not in the mass order, if are not mentioned large “systemic” banks, clearing of system of impractical banks or the banks working behind a side of the law, carrying out risky or not qualified a policy who leads to their leaving from the market of banks’ services, can promote strengthening of banking system, its improvement.

Banking crises can be considered as the system crises of the banking sector arising under influence of effect “domino” because of accumulation of problem actives in some limited number of banks and the termination of their solvency. Last circumstance leads to “bank panic”, mass and preschedule withdrawal of contributions and deposits, sharp reduction (and even to the termination) interbank crediting, to undermining of trust to banks, etc. On a background of such “credibility gap” bank payments are stopped, “payment communications” are broken, intercost accountings are fallen and there is an inevitable collapse of payment system and the financial markets of the country.

It is no doubts, that problems of banking crises and restructurings of banking systems recently have got a special acuteness. In this connection all over the world the big attention is given a problem of prevention of banking crises and the state support in rendering assistance to banks.

Banking crises cause the extremely serious macroeconomic consequences which entail decrease in real economic growth and as consequence of it, sharp falling of human wellbeing in the country. The inconsistency of some banks quite often is direct threat for real sector of economy as a whole, that leads to loss of trust both to separate banks, and to banking system of the country as a whole. Bankruptcies of banks can put much greater harm and damage to national economy, than bankruptcy of the enterprises as banks own instability necessarily destabilize functioning payment system of the state.
At the same time consideration and the analysis of threats which carry bank crises for a national economy, have served as stimulus for development and perfection of all complex of crisis management.

The major problems of crisis management are:
- A conclusion of the credit institution from a condition of crisis;
- Prevention of its bankruptcy;
- Minimization of losses of creditors and proprietors in case of liquidation of the credit institution.

Tools of crisis management should provide financial stability and reliability of separate banks and bank system of the country as a whole.

In conditions of the present economy the accents of bank management in crisis situations are displaced from a conclusion of bank from the final, sharpest and open stage of crisis when the bank already actually became insolvent and his internal resources settled, on management from a position of the prevention of occurrence of crisis situations in activity of bank. And the innovations concern both the maximum management and proprietors of banks, and the supervisory authorities who are carrying out supervision over the banks’ activity and a regulation of their ability to live.

References

1. Aristobulo de Juan, (1992), From good bankers to bad bankers. Inefficient bank supervision and deterioration of management as the main elements of banking crises, Washington: Institute of economic development of World Bank
4. Zelenskij, J. B., Birjukova, E. A., (2006), Mechanisms of increase of stability of bank system, Money and the credit, 7, and etc. similar publications