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EXECUTIVE SUMMARY

Until recently the evolution of two sectors - industrial and banking - has developed in diverging directions. Industry has suffered an unprecedented crisis, while the banking sector has enjoyed success that is just as unprecedented. In 1995 their situations converged again - industry is showing signs of stabilization, while the situation in the banking sector worsened. The two sectors have become more dependent on one another, trying to form a partnership to provide support and development.

The degree of interaction of manufacturing enterprises with commercial banks is still extremely low. A wide class of producers who operate primarily without credit is forming in Russian industry. Moreover, their economic indicators are significantly higher than those who rely on bank credit. In sum, bank funds are spent not on additional injections of credit to successful economic agents and the "multiplication" of their success (as in a normal market economy), but for the support of those who have not yet managed to adapt to the market system.

The mutual "estrangement" of the two sectors has been caused by objective reasons. This is, first of all, the divergence in their evaluations of the acceptable loan duration and interest rates. The conditions by which banks are able to offer credit are much stricter than the conditions under which manufacturing enterprises are able to use them to their advantage. And while such a gap between the demand and supply of credit remains, it does not follow to expect a noticeable increase in the flow of finances to industry.

At the same time, there are signs that demand and supply have begun to equilibrate. While the industry and banking sectors become accustomed to each other, it is important not to allow unjustified administrative intervention to disrupt this process. Similarly, measures that can establish high long-term inflationary expectations are undesirable, since it allows bankers to once again seek profitable investments outside the boundaries of the industrial sector.

Compiled by NCEEER staff.
The Scale and Dynamics of Enterprise Credit Supplied by Banks

Our observations indicate that approximately 25% of industrial enterprises for the last several years have no bank financing (here and below we mean enterprises that have not resorted to new credits for 4-6 months in a row). However, from 1994 to 1996 we observed that the share of "creditless" enterprises (i.e., enterprises which did not receive commercial credit) was growing. In other words, Russian industry has established a tendency in the last 2-3 years to isolate itself from the banking sector (see Table 1 below).

An analysis of bank debt leads to similar results. The nominal volume of enterprise debt to commercial banks has not grown since 1995. Once we adjust for price changes, then the real size of debt in the past 5 years has constantly fallen, and in real terms has in fact decreased several times.

Moreover, this tendency has not exhausted itself, since even those firms that rely on bank credit try to limit this practice as much as possible. For example, of the enterprises that had owed money to banks in 1996, half of them considered the size of their debt excessive, and only a third reported that they did not have enough debt (compared to what they considered normal).

Table 1. Percentage of Industrial Enterprises without Bank Financing, %

<table>
<thead>
<tr>
<th>Year, month</th>
<th>REB Industrial Sample total*</th>
<th>Consumer Goods</th>
<th>Investment Goods</th>
<th>Intermediate Goods</th>
</tr>
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<tbody>
<tr>
<td>1994</td>
<td>22</td>
<td>24</td>
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<td>1995</td>
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<td>1996</td>
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<td>January</td>
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<tr>
<td>December</td>
<td>42</td>
<td>39</td>
<td>39</td>
<td>45</td>
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<tr>
<td>Average for 1996</td>
<td></td>
<td>33</td>
<td>30</td>
<td>37</td>
</tr>
</tbody>
</table>

* Including enterprises not engaged in manufacturing

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This research was carried out at the request of the Ministry of Economics of the Russian Federation, with financial support of the "National Council for Soviet and East European Research," contract # 811-03. The analysis has been conducted with the help of a survey carried out by the Russian Economic Barometer (REB) using a representative sample of industrial enterprises and commercial banks.

Institute for World Economy and International Relations, Moscow,
Which enterprises do not use bank financing? What is the difference between enterprises using financing and those that avoid it?

One of the more noticeable differences is related to the number of employees. As a rule, "creditless" enterprises are smaller than their counterparts. On average, in the period from 1993 to 1996, there were 1057 employees in enterprises that use bank financing, and 526 in those which do not.

Comparisons of the ownership structure between the two groups of enterprises are inconclusive. In 1995 state owner enterprises emerged as the leaders; approximately 40% of them did not use bank financing. Purely private enterprises took second place at 30%, while enterprises with mixed structure were a little greater than 20%.

Enterprises of the two groups differ from one another according to their business success. This difference shows that members of the "creditless" group are on average more successful, while those producers in the credit using group show relatively worse results.

The amount of industrial capital was consistently higher for those who avoided bank credit. In 1993 the difference was ten percentage points higher, in 1994 eight percent, in 1995 four percent, and in the first month of 1996 it grew again to seven percentage points. A similarly stable relationship can be seen in the difference in the size of the work force.

Similar results apply for the analysis of indicators that describe the demand for the enterprises' goods: inventory and the portfolio of pending orders (as in the previous case, the normal monthly level starts at 100%). Here as well there is a distinct advantage for the "creditless" sector. Inventories in that sector are consistently lower, and the portfolio of pending orders is consistently greater than at enterprises that use bank credit.

Theoretically it is possible to suppose that more favorable outside conditions - in part, a stable demand for the enterprise's output - are one of the main reasons allowing for an enterprise's "creditless" existence. However, this hypothesis can only be confirmed for 1993 and 1994. After that, the difference between the two groups in this regard became smaller, although it has not completely disappeared.

The output of enterprises using credit always declined faster than that of their counterparts. On average, in five years the gap between these indicators was 8-10% a year.

The employment figures display a similar tendency (the personnel figures decreased faster for enterprises actively using bank credit), and in capital investments (their real volume decreased in both groups, but in the "creditless" group it decreased more slowly).

Finally, the most noticeable and symptomatic difference was the wage bill. The wage bill was lower for "creditless" enterprises only in four surveys out of 32 from 1993 to the beginning of 1996. In all other cases they maintained an advantage in the wage bill over their counterparts. During the indicated period their wages were 12% higher on average than wages at enterprises that used credit.
Financial Limitations of Production and Capital Investment

Thus, the tendency towards bank credit is tightly associated with the enterprise’s performance. The better the enterprise’s financial situation, the less likely it is to resort to a bank’s assistance. Now we ask the following question: to what extent does bank credit (or the refusal of it) help resolve financial problems?

Production. One of the problems which the majority of enterprises constantly come across is the lack of internal funding. Cooperation with banks, if it is sufficiently large-scale, can allow an enterprise to widen the narrow crediting possibilities for its ongoing production. But is credit enough to achieve this goal?

In the REB surveys enterprises’ lack of financial means is the most commonly cited factor limiting output. From 1992 through 1996 the percentage of respondents citing this factor never fell below 55%. Lack of demand held second place, receiving on average 10-20% less citations from the respondents.

It turns out that those enterprises that use bank credit cite the lack of financial means most often during the observed period (the average response was 65-69%). As for the “creditless” enterprises, at first their responses were twice as low (30%) and only by 1996 did they rise to a comparable size (67%).

These results can be interpreted in the following way. On the one hand, a sharp lack of money forces enterprises to turn to bank financing. But, on the other hand, the presence of credit did not lead to a radical easing of the financial restrictions, but rather allowed a gradual equaling of the situation in the two sectors. The conditions of the loans and their potential size are such that enterprise managers do not consider loans a realistic means for resolving the given question – and in reality it does not.

Capital investment. The lack of financial means was the main limiting factor for capital investment as well. Those enterprises who feel the financial limitations for capital investment most sharply are the ones that most often turn to bank financing. The only difference here is that the use of credit here (as opposed to its use in production) did not ease in any noticeable way the financial limitations and did not bring about any equalization of the situation for the enterprises in the two groups.

Bank Credit and the Enterprise’s Financial Status

The financial situation is in some ways a general characteristic of enterprises, a synthetic indicator of their past and future business prospects. Therefore it is not surprising that financial indicators also confirm the present study.

Thus, in 1996, compared to the group using credit, the share of successful enterprises (i.e., with a grade of “good” or “normal” for their financial status) of the “creditless” group was three times higher and the share of loss making and potentially bankrupt enterprises, respectively, was 1.5 and 1.25 times lower.

It is interesting that those manufacturers who use credit consider its role as harmful. For them, growth in bank debt is almost always associated with a worsening in the financial situation of their enterprises, while lowering the debt is an improvement.
In 1996 only four percent of those enterprises planning on increasing their bank debt expected an improvement in their financial situation, as opposed to 45% of those who planned to decrease it. 73% of enterprises planning to increase their bank debt forecasted a worsening of their financial situation, while at the same time, among those enterprises who expected to lower their debt, such pessimists were only 11% of the sample.

These results testify to the low quality of credit. Figuratively speaking, credit was until recently not a life-preserver for enterprises who had fallen on hard times, but a kind of preserver that made it harder to swim, and which they would rather be saved from, rather than saved with.

Credit Conditions and Commercial Interest Rates

For manufacturers, the quality of bank credit is connected with the level of interest rates. In fact, in the course of the last two years it was observed that growing nominal interest rates corresponded to a lower share of enterprise directors indicating a worsening in credit conditions, and vice versa.

It is interesting that similar outcomes are not observed when real interest rate indicators are used. For example, the basic growth of real interest rates from -3% in November 1994 to +3% in the start of 1996 seemingly should seriously downgrade the evaluation of credit conditions. But this did not occur. Enterprise directors seemingly "don't see" changes in the real interest rate when they evaluate short term tendencies on the credit market.

The second most important parameter – length of loan – is changing in an unpleasant (for manufacturing) direction. While from 1993 to the first half of 1994 the majority of loans were 3.6 months in length, by the start of 1996 they were only 2.2 months long.

In sum, one can establish that the small volume of credit in Russian industry and the presence of a large "creditless" sector is the direct result of the low quality of credit which commercial banks are willing to offer to the industrial sector, the high interest rates, and the restrictively short time periods of the loans.

The Role of Loans to Industrial Enterprises in Banking Portfolios

Despite the sharp decline in the volume of bank debt and the appearance of a large sector that ignores bank credit, loans to industrial enterprises make up a significant part of total bank operations. By the start of 1996, 80% of the bank-respondents of REB characterized credits to industrial enterprises as one of their two most important assets. According to the data, only credits to wholesale traders could compete with industry in importance. But their rating steadily declined from 90% in 1992 to 40% by the start of 1996. At the same time the rating for industry (ignoring its variability) stayed constant in general.

At the same time, until recently loans to industrial enterprises were unprofitable more often than not, in the bankers' opinion. For this indicator, only loans to individual citizens were considered less preferable. Credits to banks and wholesale traders were the most preferable (and recently excessively so).
The main reason credits to industrial enterprises up until now have not been valued as much as they could is their large probability of default. This phenomenon has long ago characterized the majority of the Russian banking sector, reaching to a larger or smaller degree into every aspect of the banking system. Starting from December of 1993 the presence of enterprise-borrowers with debts past due for more than 3 months were reported by every two out of three banks responding to the REB survey.

These figures that describe the factors that limit the distribution of bank credit demonstrate the importance of the above-mentioned problem, large probability of default. In the past two years it is precisely the borrowers' insolvency which is the main obstacle to credit expansion for 80-95% of the banks in the REB sample. The rating of any other factor in this period was never greater than 50%.

The unreliability and unprofitability of credit partnerships with enterprises has already long ago lead to a halt in the growth of the circle of enterprise-borrowers. Thus, while in the first half of 1993 62% of the banks were expanding their number of enterprise-clients, in the next period, only 50%, and in 1996 this indicator fell for the first time to 40%.

With this in mind, the long-term worsening in the financial situation of the banking sector can be viewed in a positive light. Until recently the financial situation of banks on average were much better than enterprises, including enterprises which did not use bank credit. Thus, in 1996 the share of financially successful banks was close to 80% (in 1993, almost 100%). The corresponding indicator for all manufacturing was 15%, and for the creditless sector, 25%.

Such a situation is difficult to call normal. And it is difficult to expect that the relatively successful banking sector would want to and is able to cooperate with the impoverished manufacturing sector on favorable (for manufacturing) terms. However, to the extent that the situation in the banking sector worsens, however paradoxical this sounds, the situation for enterprises will improve. Even more so, if such an improvement is accompanied by even the smallest revival in manufacturing.

This is not a straightforward relationship. A worsening in the financial situation influences primarily the banks themselves, forcing them to restructure their business into more healthy, market-oriented foundations. And only the result of such restructuring could serve to widen the interconnectedness of the two sectors. The fact that such a sequence of events is possible indirectly confirms the results of our research. For example, banks whose economic motivation reflects a more market related character (maximization of profit) interact with industry much more successfully than banks that do not.

**Conclusions**

The degree of interaction of manufacturing enterprises with commercial banks is still extremely low. A wide class of producers who operate primarily without credit is forming in Russian industry. Moreover, their economic indicators are significantly higher than those who rely on bank credit. In sum, bank funds are spent not on additional injections of credit to successful economic agents and the "multiplication" of their success (as in a normal market economy), but for the support of those who have not yet managed to adapt to the market system.
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