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Current proposals for "targeted refinancing" – Back to the past?

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Current proposals for "targeted refinancing" – Back to the past?

Executive Summary

An intense discussion among policymakers and research circles is currently underway in Ukraine on how economic growth can be stimulated by monetary policy. A number of proposals argue in favor of an active stimulation of the economy via "targeted refinancing" of selected commercial banks by the National Bank of Ukraine (NBU). On the back of this refinancing, the selected banks would provide funding to priority industries and projects. In such a model of directed lending, it is ultimately the government that decides which sectors, projects and companies get access to finance at preferential conditions.

For a number of reasons, we do not support these proposals; their implementation would be risky and dangerous and won't achieve the favorable environment needed to finance sustainable investment and growth.

A very simple argument is that similar schemes have already been tried before in Ukraine, without any lasting positive results. They also run against international evidence, where a shift from direct instruments (that constitute costly distortions to financial markets) towards indirect instruments is observable in both developed and emerging economies. Modern central banks use indirect instruments like open market operations where they buy or sell financial instruments to change the amount of liquid assets on interbank markets and thereby change the interbank interest rates. Taking such a step would in our view lead back straight to the past, where the previous "oligarchic" banking system would be replaced by a state directed banking system, with very similar characteristics: Deposits are directed towards insiders who keep newcomers and competitors out of their respective markets, reducing the Ukrainian economy's growth potential. Bank lending becomes a political issue; policymakers will be urged by lobbyists to influence the direction of lending towards specific sectors and very likely, also firms. In all likelihood, it will be the best connected and established companies and entrepreneurs that will thereby influence the decisions regarding the direction of lending. Finally, "targeted refinancing" will create problems in the cooperation with international financial institutions like the IMF, which is currently of paramount importance for the future of Ukraine's economy.

Instead, we recommend relying on indirect instruments, where the NBU decides the monetary policy stance, but it is ultimately the decision of banks to channel savings into investments. These institutions are superior in performing that task because of their advanced risk assessment skills and methods. This is actually the path the NBU embarked upon with its comprehensive banking system reforms. After some painful adjustment period, we see first positive results. Inflation, the policy rate and corporate lending rates are declining; corporate lending in local currency is picking up, and banks are confident that this trend will continue into the future. These are clear signs that the reforms start to work and the banking sector is increasingly supporting the economic development of Ukraine. Consequently, we think the current direction of monetary policy should be continued, instead of looking for quick "solutions".

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1. Introduction

Ukraine's economy has successfully stabilized after the significant decline during 2014/15 and finally returned to growth in 2016. This new phase in economic development has initiated an active discussion in Ukraine among policy makers and the research community on how future economic growth can be further stimulated by economic policy.

One part of the discussion deals with how specifically monetary policy can contribute to a quick economic recovery after stabilisation; some observers are in favor of an active stimulation of the economy via "targeted financing" of selected commercial banks by the National Bank of Ukraine (NBU). These banks would in turn lend the (preferential) ressources obtained that way to state-selected, predetermined priority investment projects ("directed lending").

The question on how monetary policy can best support Ukraine's ongoing recovery is indeed of crucial importance. This paper wants to contribute to this discussion and provide some respective recommendations.

The paper is structured as follows: In the next chapter, we review a number of proposals that are currently in the public discussion in Ukraine. Since this is not a completely new instrument to Ukraine, we also show some past experience. In chapter 3, we assess these proposals both against theoretical considerations and international evidence, but also against the concrete context in Ukraine. The last chapter concludes with our vision on how monetary policy should contribute to Ukraine's sustainable economic development using indirect instruments.

2. Proposals for directed lending in Ukraine

2.1 The current discussion

Several experts and politicians in Ukraine returned during 2015-2017 to the discussion of "targeted refinancing" of commercial banks by the NBU. The basic idea of directed lending is that the NBU would provide refinancing on preferential terms i.e. longer maturities and/or lower interest rates to banks that in turn provide loans in accordance with predetermined priorities. These may include long-term funding for investment projects or loans to companies in certain industries or sectors, or SMEs. According to proponents of this proposal, this would contribute positively to economic growth. These proposals are mostly discussed in public discussions in media, but also in more formal documents.

In July 2015, the Institute for economic and social research (ISER) presented a study "Policy of economic pragmatism"[1] that proposed a comprehensive development strategy for Ukraine. In the chapter on financial markets, "financial dirigisme" policies were proposed that would encourage banks to provide funding to priority industries and projects. These included the "provision of support to long-term bank liquidity while supporting investment projects, ensuring a strict control over the funds received by the banks for refinancing". An increase in NBU refinancing that would lift the ratio of money supply to GDP by at least 10 percentage points was also proposed. The study argued that this would encourage investments in fixed capital and thus stimulate economic growth.

In May 2016, the Banking Committee of the Verkhovna Rada supported the draft of the "2016-2020 Banking system development strategy"[2]. This was intended as an alternative to the "Comprehensive

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[1] A revised version was published in March 2016 and can be found at http://iser.org.ua/uploads/pdf/NEP_big_ENG_NEW_2_print.pdf

[2] http://kneu.edu.ua/userfiles/Credit_Economics_Department/afedra+bankspravi/ proekt_strategi.pdf

Programme of Ukrainian Financial Sector Development Until 2020" approved earlier by the NBU[3]. This document suggested changes in the conduct of monetary policy by the NBU and includes the creation of a "funding for lending" scheme. According to the authors, this scheme would encourage bank lending to the real sector of the economy with a focus on high-tech companies and SMEs. Banks with higher volumes of loans to the real sector (and in particular priority sectors) would receive more refinancing under the scheme at a lower interest rate. As a justification, the document cited experience of the UK, the ECB and the Central Bank of Korea where refinancing was issued on preferential terms in return for an expansion of lending in general, or to SMEs. Later on, the Banking Committee supported a number of draft laws that claim to implement the Strategy, but these didn't include any provisions related to NBU refinancing.

2.2 Past experience

There were several attempts to implement targeted refinancing in Ukraine in the past. Between February 2002 and March 2004, the NBU issued long-term (up to 3 years) refinancing[4] to banks holding existing loans for investment project of companies in priority industries. In total, the NBU issued UAH 1.1 bn in long-term refinancing[5]. This is a significant amount, as compared with total long-term bank loans of UAH 30.5 bn in the end of 2003. The refinancing programme was eliminated as part of the reforms under the 2004 IMF stand-by programme.

In 2006-2007, the NBU started to provide long-term loans secured by deposits at the NBU. This was supposed to allow banks to comply with regulatory rules when providing long-term loans to companies by converting short-term deposits in foreign currency into long-term refinancing. This facility was little demanded by banks, with only UAH 0.1 bn in loans.

In 2008-2009, there were several ideas for the NBU to provide refinancing to banks for a number of purposes, including support of agricultural producers, the Euro-2012 football championship and construction companies. Some of the legislative initiatives were vetoed by the President. Still, legislation was passed, requiring all banks receiving NBU refinancing to extend their loans to agricultural producers, while the NBU was required to accept loans to agricultural producers as collateral on preferential terms[6]. Also, UAH 1 bn in refinancing was provided to a single bank on an ad-hoc basis to support lending to agricultural producers.

In February 2010, the NBU approved a new long-term refinancing facility where banks could refinance up to 5/8 of a loan to large industrial and agricultural producers (as defined by a list of "strategic" companies approved by the government) for up to 5 years[7]. The IMF almost immediately asked for this facility to be cancelled as part of negotiations for a new stand-by facility. It was duly cancelled in July 2010, but the NBU issued about UAH 1 bn in refinancing loans under the programme over the few months it was in force.

Overall, attempts for targeted refinancing in the past were relatively small-scale and therefore didn't have detectable macro-level effects on the financial and the real sector. Furthermore, they were occasionally vetoed by international financial institutions like the IMF during cooperation periods (or negotiations about possible cooperation).

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[3] https://bank.gov.ua/doccatalog/document?id=43401314

[4] http://zakon3.rada.gov.ua/laws/show/z0150-03

[5] Here and later refinancing figures are based on NBU annual reports

[6] http://zakon2.rada.gov.ua/laws/show/922-vi

[7] http://zakon2.rada.gov.ua/laws/show/z0146-10

3. Assessment of current proposals for directed lending

3.1 Direct versus indirect instruments: Theoretical background and international evidence

Directed lending towards certain firms or sectors through participating commercial banks at the behest of the government (or the central bank) is a so-called **direct instrument** of monetary policy. Other direct instruments are credit ceilings, or interest rate controls. The name is derived from the direct relationship between an instrument used by a central bank and the pursued policy goal. In case of directed lending, the goal is an increase in bank lending which is immediately achieved. In case of interest rate controls, the goal is to allow firms access to cheap financing instruments that are provided by a central bank's directives through commercial banks.

At first sight, direct instruments are appealing to policymakers and the general public because they pretend to be easy fixes to improve an outdated capital stock, or that they allow to easily kick-start economic growth. However, developed countries abolished those instruments decades ago and many developing countries and emerging markets followed suit in the past decades. Instead, modern central banks use **indirect instruments** like open market operations whereby central banks buy or sell financial instruments to change the amount of liquid assets on interbank markets and thereby change interest rates charged on those interbank markets among banks. Those interbank rates, in turn, as they affect the costs of refinancing banks' lending business, affect those institutions' incentive to set their own interest rates charged for loans and interest rates paid to depositors. Open market operations thus have an indirect effect on commercial banks' lending and interest rate decisions. But why were direct instruments replaced by indirect instruments?

The main reason for the abolishment of **direct instruments** is that they **constitute a costly distortion to financial markets**. In a market-based economic system, the purpose of a banking system is to channel private households' savings to investors: Banks collect deposits from households and firms and lend to firms and other households who are in need of funding for investment purposes. Banks are superior in performing that task compared to individual households and even the government because of their advanced risk assessment skills and methods.

This provides them with ample knowledge about the specific needs of investors and allows them to assess the profitability of lending projects. A government official, instead, will not have the same expertise and inside knowledge that is a pre-condition for a reasonable allocation of credit across the economy. This superior knowledge will thus result in an overall superior investment performance of the economy compared to lending practices enacted on behalf of government[8].

Moreover, when governments or state institutions like the central bank determine the direction of the flow of savings towards firms, **bank lending becomes a political issue** and an object of political lobbying. Policymakers will be urged by lobbyists to influence the direction of lending towards specific sectors and very likely, also firms. In all likelihood, it will be the best connected and established companies and entrepreneurs that will thereby influence the decisions regarding the direction of lending. **New companies** and those unrelated to the established political and economic system, **which are crucial for economic progress** and the continuous modernization on an economy, will find it **more difficult to get access to credit** if bank lending becomes a politicized issue. This will be a particularly serious concern in a country plagued by a high level of corruption and cronyism.

In contrast, market-determined bank lending will be fairer as long as banks operate in a competitive environment. If access to funding is a matter of competition among banks for households' deposits,

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[8] See Hayek (1948): On the efficient use of knowledge in society https://en.wikipedia.org/wiki/The_Use_of_Knowledge_in_Society

this tends to increase the cost of re-financing their lending business. Banks are then in need of productive lending opportunities and eager to screen investment projects for their profitability. This, in turn, will incur competition among banks to finance the best projects available in an economy. Companies with viable business plans will then face a favorable environment to finance their growth, and the economy as a whole benefits.

3.2 Back to the past?

Even if the banking system just described may be an ideal that deviates from real world systems in most economies, it nonetheless serves as a useful benchmark that provides guidance for regulatory and supervisory reform. Over the past three years, the NBU has been pursuing comprehensive policies to restructure the Ukrainian banking system. Many banks were liquidated and in the process bank lending to the economy contracted severely, certainly reinforcing the recession. However, the motivation to pursue this radical policy is the very absence of a banking system operating in the way described in the previous section. Many banks were not operating under a competitive environment but rather directed lending towards companies related to the banks' owners. It is unlikely that these businesses were the most profitable ones of the Ukrainian economy, at least the disappointing performance of the Ukrainian economy before the crisis does not support this hypothesis. Furthermore, such related lending practices constitute an unjustifiable risk for depositors and tax payers, as banks' lending portfolios will not be well diversified implying a high risk of bankruptcy. The NBU's goal has been and still is to end such lending practices. The new system being built is hoped to better fulfill the promise of a banking sector that supports the Ukrainian economy.

If this previous "oligarchic" banking system is replaced by a state directed banking system, it might well end up having the same characteristics: Deposits are directed towards insiders who keep newcomers and competitors out of their respective markets, reducing the Ukrainian economy's growth potential. Furthermore, the significant (fiscal) costs incurred by the current restructuring efforts would be wasted.

Beyond these general considerations, there are very practical limits to directed lending practices in Ukraine. In particular the **goals** of **full convertibility of the Hryvnia**, a **flexible exchange rate** and **free capital flows into and out of the Ukrainian financial system** are incompatible with direct monetary policy instruments. The reason is that directed lending practices will result in low returns for depositors when the projects receiving financing are not the most profitable ones. This will drive deposits out of the banking system, possibly abroad, and drain the system of resources to support a growing economy and causing a depreciation of the currency. The NBU would then be forced to re-introduce (or tighten) capital controls, and financial repression is unlikely to be overcome in such an environment.

4. Our vision: Monetary policy based on indirect instruments

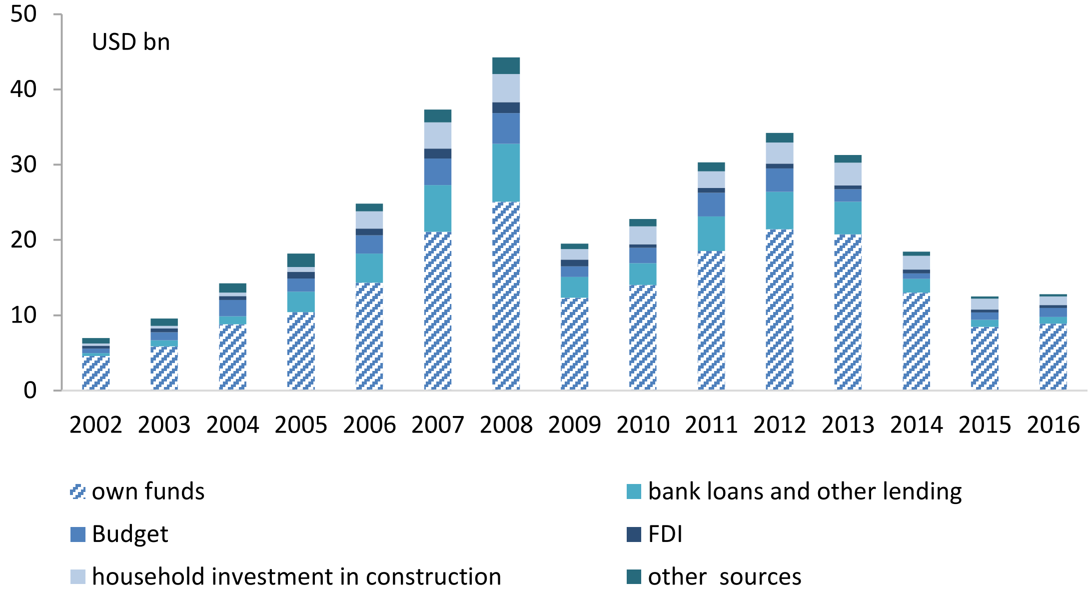
In the previous chapter we argued against the introduction of directed lending practices in Ukraine[9]. A valid question is then how monetary policy can best support the ongoing recovery of the Ukrainian economy. In this chapter, we provide our vision on how the NBU can contribute to a sustainable economic performance in its conduct of monetary policy, using indirect instruments instead.

[9] One should also follow the experience of Belarus closely, where directed lending practices are still wide-spread (about 40% of the total loan stock), but where significant efforts are currently undertaken to curtail the flow of such loans for micro- and macroeconomic reasons.

Among the components of aggregate demand that are influenced by monetary policy, capital investments play a key role. If we look at the financing sources of these investments (Figure 1), we notice that the majority of realised investment projects are financed by retained earnings, i.e. internally. Bank finance plays currently only a minor role as an external source, as do other components (FDI, budget, etc.).

Figure 1

Capital investment by source of financing (USD bn)



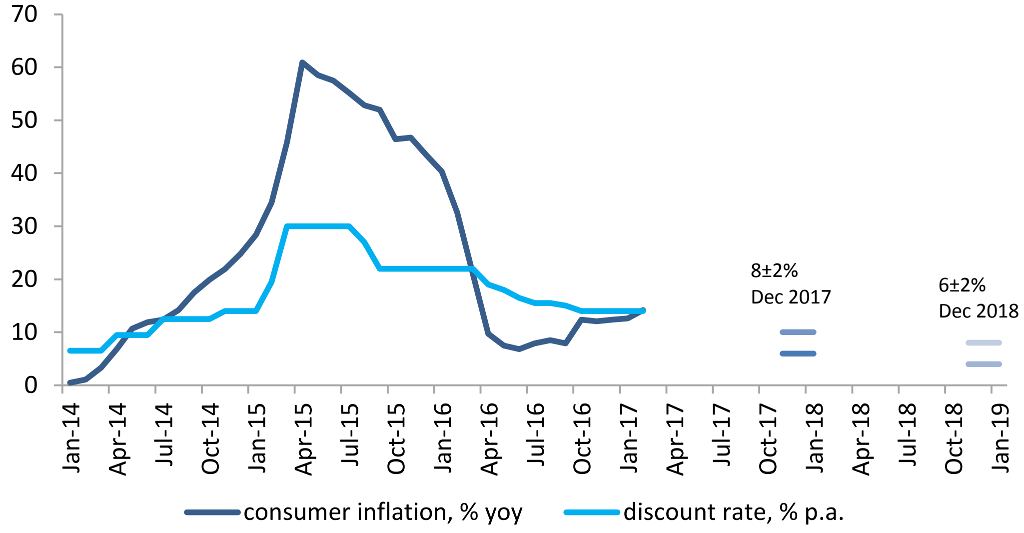
Source: Own calculations based on Ukrstat and NBU data

Going forward, bank finance should definitely contribute to a recovery in investments, but it is unlikely that they turn into a major financing factor at least in the short- to medium-term. Even during the “boom years” of 2007-2008, when the financial sector expanded (too) rapidly, its contribution to investment finance amounted to only 17%.

The inflation targeting regime of the NBU, if pursued successfully, guarantees low levels of inflation and a stable (not fixed) exchange rate and thus an environment which supports investment and economic growth. The following Figure 2 shows the development of inflation and the NBU key policy rate over the last two years, as well as the official inflation forecasts for end of 2017 (8±2%) and 2018 (6±2%). One can see that inflation is on a downward trend (despite some slight increases over 2H 2016), and is forecast to be in single digit territory by the end of this year. This has created room for decreases in the policy rate, which stands currently at 14%. While a number of risks (e.g. also related to the recent doubling of the minimum wage) currently call for a pause in lowering the rate further, the general inflation outlook will probably create room for a further easing in the months ahead.

Figure 2

Inflation target and NBU policy rate



Source: Ukrstat, NBU

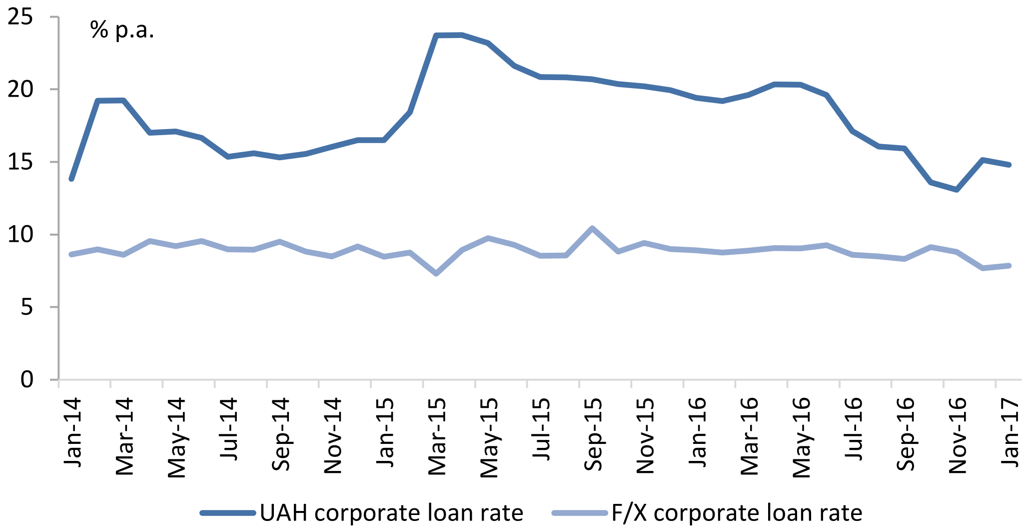
How do policy rate changes translate into loan rates changes? Apart from lower NBU refinancing costs, the nationalisation of Privatbank (which had to offer above-average deposit rates due to its risk profile) allowed state banks, which control now more than 50% of the market in terms of assets, to cut deposit rates. As the refinancing of banks gets cheaper, the loan rates should follow suit.

In the following Figure 3, we show the dynamics of the corporate loan rate (both in UAH and in foreign currency). It is obvious that the gradual easing of monetary policy (as witnessed by the decline of the policy rate) since mid-2015 also decreased the loan rates in local currency, which dropped by 9 percentage points to currently 14.8% (the real rate (ex-post) stands at around 0%). This process of decreasing nominal rates will in all likelihood continue, taking the inflation forecast into account.[10]

[10] One should also notice that the current level of corporate loan interest rates is below the 10-year average of 16.6% (in UAH) and 9.5% (in FX).

Figure 3

Corporate loan interest rates

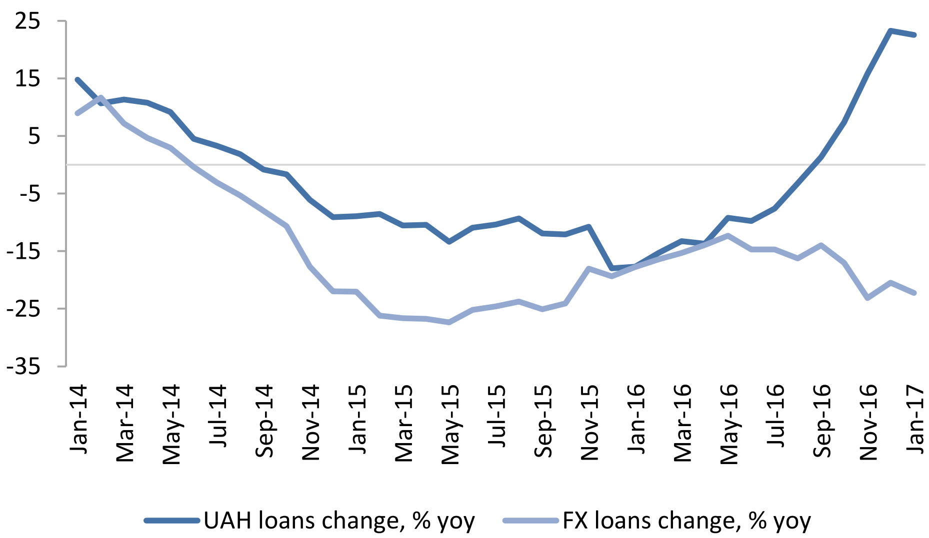


Source: NBU

As the cost for bank loans have declined, how have lending volumes responded so far? The following Figure 4 shows a clear rebound in lending dynamics in local currency. While this trend can be also be explained by the ongoing restructuring of non-performing FX loans into local currency loans, there is nevertheless a clear upward trend observable.

Figure 4

Corporate loan dynamics (% yoy)

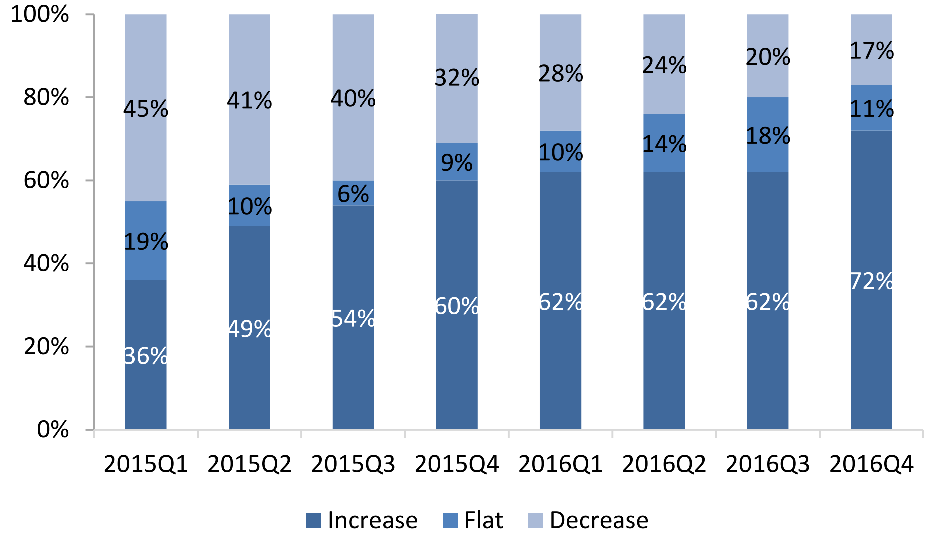


Source: Own calculations based on NBU data

These positive lending trends are further strengthened by survey data regarding the expectations of new corporate lending by loan officers in commercial banks. Figure 5 shows that a clear majority of banks (72%) expects a future increase in lending, while only 17% expect a decline in lending (11% see lending as unchanged).

Figure 5

Expectations on corporate lending



Source: NBU Bank Lending Survey

To sum up, if the NBU concentrates on lowering inflation in its inflation targeting framework and provides refinancing using indirect instruments for a marked-based lending system, this will in all likelihood strengthen and improve the access to finance by Ukrainian corporations.

However, that does not mean that the sole responsibility for a sustainable pick-up in investment lending rests only on the NBU. Fundamental changes in the judicial and legal framework with a view of protecting creditor's rights are needed, and probably at least as important as a stable macroeconomic environment with low policy rates. This is in particular a task for the Parliament, which needs to adopt a corresponding legal and regulatory framework[11]

Conclusion: There are clear signs that bank lending to Ukrainian corporations for the purpose of investment finance is recovering, and that this recovery is gaining traction. In that sense, the painful banking sector reforms undertaken are beginning to pay off. We recommend following the chosen market-based path further, and not to embark on a new approach with significant risks to medium and long term growth.

[11] See our policy paper PP/01/2016 „Mopping up Ukraine's Banking Sector: Short-term Pain, Long-term Gain" for a detailed discussion.

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