Who Gains and Who Loses from Russian Credit Expansion? (1994)*

with A. Richter

When credit is created, it appears to help those who get it. But this conclusion does not follow, for an increase in credit also causes inflation. This reduces the value of the existing stock of money (or working capital). Thus the process of credit creation also imposes costs. At the same time that it replenishes the working capital of enterprises, it generates further inflation – which erodes that working capital. From the point of view of the economy as a whole, the process is thus largely self-defeating.

To understand the process in full, there are six main steps in the argument, which we develop extensively in this article.

1. Growth in total credit causes an equal growth in total money (M2), other things being equal.

2. This growth in money causes inflation. When money growth is constant, inflation equals money growth four months earlier. But when money growth rises, prices rise faster than money, because firms and households react to higher inflation by spending money faster (‘velocity increases’). Thus in Russia the inflation rate closely mirrored the growth rate of money four months earlier, but there was also an upward drift in the inflation rate due to higher ‘velocity’.

3. Inflation erodes the real value of money, creating a shortage of real working capital for enterprises and robbing households of their real savings. (A fall in real wealth means that monetary wealth has a lower purchasing power in terms of goods.) Enterprises react to this by seeking still more credit in order to restore their liquidity, while households (who receive little or no credit) can only restore their liquidity by saving more.

4. Thus inflation imposes an inflation tax on enterprises and households equal to their monetary wealth times the inflation rate (adjusted for any

interest received on deposits). Thus,

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\text{Inflation tax} = \text{Currency} \times \text{Inflation rate} + \text{Deposits} \times (\text{Inflation rate} - \text{Interest rate})
\]

This inflation tax causes a direct reduction in real liquidity.

(5) But, for enterprises, this negative effect has to be weighed against the benefit of new credits. For the direct effect on liquidity from the process of credit creation is

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\text{Change in liquidity} = \text{New credit} - \text{Inflation tax}
\]

For enterprises the new credit may well exceed the inflation tax. But for households the opportunity to borrow is negligible. In this way the process of credit creation helps enterprises at the expense of households. It is vital that this reality be understood by all who make decisions about credit emission.

From April 1992 to September 1993 households paid on average an inflation tax equal to 13.3 per cent of GDP each month. This is equal to nearly 30 per cent of all household income.

By contrast, enterprises have paid an inflation tax equal to 12.6 per cent of GDP each month – roughly the same amount as households pay. But to set against this they have received new credits worth 26 per cent of GDP. The process of credit creation has thus gone far beyond what was needed to restore liquidity. No wonder enterprises clamour for more credits, heedless of their direct effect on the well-being of households.

(6) Enterprises may argue that more liquidity is necessary in order to sustain production. But the main forces which can lead to higher output are higher investment and higher productivity. The international evidence shows clearly that these are reduced by high inflation.

We can now examine these arguments step by step.

1 CREDIT GROWTH CAUSES MONEY GROWTH

Money grows mainly due to an increase in credit. This can be seen by looking at the consolidated balance sheet of the banking sector (the Central Bank, the Sberbank and the commercial banks). When their accounts are consolidated, commercial banks' reserves and CBR credit to commercial banks get netted out (see Appendix 1, p. 443). Hence the assets of the banking sector are the outstanding credits (see Table 24.1). The liabilities of the banking sector are money (currency and bank deposits) – with net worth making up the difference.

Thus, if credits expand, money expands by the same amount, other things equal. Table 24.2 shows the history of credit growth and money growth in Russia. The bulk of the increase in credit has been credit to enterprises.