Directed Lending: Is It An Efficient Tool to Modernize the Economy?

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Over the last couple of years, the growth rate of potential Belarus' GDP declined. The government intends to revive economic growth through a policy of 'modernization', in practice pinned down to a drastic increase in the volume of capital investment, including by the means of directed lending. As the pre-crisis macroeconomic imbalances are at least partially cured, the government seems to be eager to apply a familiar policy tool. However, the empirical analysis of the effects of directed lending on total factor productivity and economic growth casts serious doubts on the efficiency of this policy tool.

Over the last couple of years, the growth rate of potential Belarus' GDP declined. This conclusion is robust as suggested by the application of competing methodologies to asses potential GDP. For instance, the statistical filters, including the HP-filter, the Kalman filter, and the production function approach, produce different levels of potential growth, but generate similar growth rate dynamics, particularly the downward trend. From this perspective, the tendency for high and sustainable GDP growth in Belarus is increasingly compromised.

Economic authorities seem to be aware of that fact. For instance, the Ministry of Economy stresses the need to create a new, 'highly productive' sector in the national economy as the new engine of growth. An ambitious plan involves expanding the size of this sector to contribute to about half of the GDP growth rate, aimed at 12 per cent per annum by 2015. The creation of this 'highly productive sector' falls into recent policy initiative, called 'modernization'. Under this banner, the government plans to renovate the capital stocks (primarily machinery, equipment, and transport vehicles) of a large number of state-owned enterprises. In a nutshell, this strategy may be seen as a way to facilitate technical progress embodied in capital.

What is necessary, according to the government, is to make a spurt in capital investments, often on a case-by-case basis. The government has a pool of enterprises to be modernized. The majority of them are unable to modernize themselves – i.e. radically increase capital investments – due to the lack of internal funds and poor access to external finance. Accordingly, directed lending is considered to be a useful policy instrument of modernization. In 2013, the Development Bank plans to considerably increase its credit portfolio (by about USD 0.5 billion) by financing projects at subsidized interest rates under the 'modernization' program. Recently, the government compiled a list of 67 agricultural enterprises liable to have an access to cheap loans for modernization purposes from the Development Bank. In addition, state-owned banks will continue the provision of policy loans that can be considered as directed ones.

With directed loans, we mean those loans that are typically granted to selected borrowers at interest rates lower than the market interest rates. In Belarus, directed lending has been an important policy tool over the last decade. Selective credit programs have been applied to prevent underinvestment and to stimulate output growth.

According to the estimations of Fitch Ratings (2010), almost a half of the outstanding loans in the Belarusian economy by the end of 2009, were directed ones. The IMF provided a slightly smaller, but still substantial figure of 46.2 percent (IMF, 2010). According to our own calculations, by 2011, the volume of directed loans amounted to about 40 percent of the total volume of outstanding loans. These loans have been made abundant in agriculture and housing construction sectors and, to a lesser extent, in manufacturing. This massive presence of selective credit in the national economy can be seen as a large factor contributing to the currency crisis of March 2011.

Accordingly, after the crisis, and following the necessity to ‘clear up’ the assets of the national banking system, the share of directed lending was reduced. We estimate that in 2012, the ratio of directed loans in total loans dropped to roughly 30 percent. However, the recent rhetoric of the development of ‘highly productive’ sectors and modernization is indicative of the intention to find new life for this old cloth. Directed lending is expected to revitalize enfeebling growth. In 2012, real GDP growth amounted to 1.5 percent against the background of the initial government plan of 8.5 percent.

Under selective credit programs, banks have been partially deprived of their autonomy to make decisions over the provision of credit. Thus, banks’ intermediation role has been circumscribed by the authorities. In theory, directed loans may spur capital accumulation as beneficiaries of these loans have access to cheap loans and thus invest and – arguably – produce more. In Belarus, there has also been an additional incentive, i.e. the necessity to substitute depreciating and outdated capital stock, inherited from the Soviet past. At the same time, political interference into the process of credit provision suggests that loans may be allocated to lower-yielding projects, and thus dampen growth rates of factor productivity and GDP (Fry, 1995). In addition, non-favored companies – typically from the private sector – face higher interest rates as their state-owned counterparts receive substantial discounts for their use of capital.

So far, these soft budget constraints in the financial system have allowed favored companies to receive loans up to three times cheaper, if judged by the level of real effective interest rates. Although private companies tend to be more efficient than state-owned enterprises in terms of factor returns and profitability, higher interest rates may reduce the volume of outstanding market loans. Furthermore, increases in the volume of cheap residential loans, which do not contribute directly to enhancement of productive capacity of the economy, may dampen the returns on investment further.

Governments have traditionally relied on selective credit programs by stressing positive externalities and spillovers for the economy as a whole (DeLong and Summers, 1991). Commercial banks care about private returns, while governments seek to maximize social returns by financing firms, which are capable of generating positive externalities. Unfettered operations of credit allocation mechanisms minimize allocation inefficiency and induce banks to minimize the costs of financial intermediation, thereby making credit more accessible.

How do these competing forces meet in Belarus and what are the effects of their joint working? In answering those questions, we have conducted an empirical analysis of the effects of directed lending on total factor productivity dynamics. The latter is considered to be a good proxy to observe the impact of selective credit programs on the efficiency of actor use.

The results of our econometric analysis show that over the period concerned, 2000–2012, the expansion of directed lending in Belarus has negatively affected total factor productivity dynamics and, subsequently, negatively contributed to the rates of GDP growth. A positive impact on growth, stemming from additional capital accumulation might nevertheless occur, but with a substantial lag. This likely positive impact is associated with the ability of banks to increase the volume of market loans alongside with the rising volume of directed loans. The option has been made possible only due to massive liquidity injections by the government and mainly the National Bank of Belarus. However, such injections are problematic to maintain over the medium to the long run as they have severe inflationary repercussions for the economy.

The effects of individual components of directed lending are mainly the same. In particular, loans for residential construction, provided to households in need, negatively affect total factor productivity. Moreover, it is through housing loans the adverse effects of directed lending upon factor productivity are mainly realized. The interest rate spread – between preferential interest rate and market interest rate – amplifies these negative relationships. Lower preferential rates result in larger losses in total factor productivity. Loans to agricultural firms have similar impact, although it has to be emphasized that the overall impact on total factor productivity approaches zero (not negative, as in the case of housing loans).

We also find that for Belarus, an increase in the total volume of directed loans leads to an increase in the volume of market loans. Both the National Bank and, to a lesser extent, the government, strive to minimize risks in the national banking system, which provide loans with smaller returns and/or non-performing policy loans. Similar challenges have been observed in China, where the Central Bank has been forced to recapitalize domestic banks to support economic growth after the global financial crisis of 2008. In 2007–2008, Chinese growth of 8–10 percent was driven by new lending averaging 30–40 percent of GDP, of which up to a quarter of the loans might have been non-performing, amounting to losses of 6–10 percent of GDP (Das, 2012).

In Belarus, the recapitalization policy, apart from its inflationary consequences, has other important effects. In particular, it prevents a dangerous trade-off between directed loans and market loans to resurface, whereby the former crowds out the latter as banks are unable to expand their portfolios due to the liquidity constraints.

Therefore, unless the expansion of directed loans would be checked, adverse effects of selective credit programs on productivity and growth would not evaporate, with negative consequences for the whole economy. Regarding policy recommendations, we claim that there is a need to fundamentally revise directed lending policies or to even minimize it to the extremes by allowing standard market mechanism for credit allocation to prevail in the national economy. Furthermore, we argue that directed lending, even after some cosmetic changes in the system design made in 2012, is not an efficient tool for economic growth promotion.

Tentative results of growth accounting made at the level of selected important industries suggest that the downward growth dynamics is associated with weak total factor productivity growth, i.e. disembodied technical progress. Improvement of total factor productivity seems to have the biggest potential for revival of economic growth. Therefore, the use of directed lending, as a policy instrument that hampers total factor productivity dynamics, may undermine prospects for long-term economic growth in Belarus.

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