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On the Prerequisites for a Well-functioning Retail Credit Market

Coming from Finland, I cannot lecture about financial development from high moral ground. Finland has had more than its share of problems in this area, and made some mistakes as well. But as a result, we also have a lot of experience, and I would like to share with you some thoughts about financial development which stem from this experience of the last twenty years.

Today, Finnish banks are in a good shape. They are well-capitalized, highly profitable, and make excellent services available to all kinds of customers. The situation has not always been as healthy, however. Twenty years ago, after decades of financial regulation, the Finnish banks and credit markets were very different from what they are today. The banks were very fragile and their business practices were not up to high professional standards as we require today. Worst of all, it took the painful and very expensive banking crisis of 1991-1993 to change the situation for the better.

Let me begin by recalling some of the problematic characteristics of the Finnish banking markets in the latter half of the 1980's.

Banks and industrial companies were closely linked with each other by ties of cross-ownership and governance. Largest banks owned large portfolios of industrial shares and exercised often dominant control in industry. Conversely, top managers of industry also often sat in the governing bodies of Finnish banks. Also banks' lending policies were influenced by the close links between banking and industry. Banks made large loans to companies in their own sphere of interest, and, consequently, very large risk concentrations existed. This made the banking sector very fragile against risk, and did not support the best governance practices in their management.

Another problem area was that the market for loans to households was not well developed. After the decades of tightly regulated credit markets, there was a lot of pent-up demand for loans, especially in the housing sector. In the late 1980's, the banks started to sell loans much more aggressively than

before to our then relatively unsophisticated and financially inexperienced household sector. Very many people took much bigger risks than they should have taken. That was dangerous in itself. The problem was made more serious by the development of the housing market: as a result of the lending boom of the 1980's, housing prices rose to extraordinary heights and subsequently collapsed.

The third problem at the time was that we had relatively high interest rates and high inflation. It was not just that the level of inflation and the level of interest rates were high. High interest rates also meant volatile interest rates, and high inflation meant large uncertainty of the value of money. As a result, the financial environment was not conducive to careful economic planning, but instead was conducive to speculation. Firms and households were led to think that "inflation would pay their loans", irrespective of economic realities. But this kind of economics turned out to be built on sand when interest rates had to be increased to control mounting inflationary pressures. The high interest rates and the eventual downturn in the economy ultimately exposed the fragility of the Finnish financial system and the crisis ensued.

Based on the Finnish experience, and also the experience of some other countries, one could draw a list of basic conditions which seem to be essential for the healthy development of a stable and efficient banking system, which also can serve the society at large in a constructive and reliable way.

1. Price and interest rate stability

Banking is about economic calculations. In the course of their financial dealings, banks and customers must evaluate assets, forecast returns, and estimate risks of different kinds of investments. These calculations must be done in terms of money. They involve not only today's prices and interest rates, but also those of the future. Uncertainty of inflation and volatility of interest rates is harmful for the functioning of the loan market.

For the unwary customers, volatility of inflation and interest rates can cause serious problems by undermining the calculations on which borrowing was based. Even worse, since interest rate and inflation volatility concerns all customers, banks can get hurt unless they have prepared for this and managed their risks in a proper way.

For the more sophisticated customers, interest rate and inflation uncertainty act as deterrents to borrowing, because such customers will try to avoid the risks which borrowing involves in an uncertain financial environment. Especially the long-term loan market is harmed by financial and monetary instability.

This is really the area where monetary policy can play a role in supporting sound financial development. The primary task of monetary policy is to create a stable financial environment, “an atmosphere of stability”, where inflation expectations are low and stable and where these expectations are not disappointed. Moreover, a stable financial environment in which monetary policy enjoys good credibility, is characterized by relatively stable interest rates. If the credibility of monetary policy is good, the central bank can control inflation mostly by its information policy and it does not need to resort to drastic interest rate movements.

2. Reasonable level of interest rates

The development of a well functioning loan market requires, quite simply, that the prevailing interest rates are not too high. I do not mean just the lending rates applied by banks, but also the money market rates controlled by the central bank. If the general level of interest rates is too high – I am not going to quote any number, but anything in too digits seems difficult to me – the conditions are certainly not favourable of healthy borrowing and lending.

Now, I want to emphasize, my advice is not that monetary interest rates should be lowered if necessary for the sake of developing the loan market. Interest rates are an instrument of monetary policy and monetary policy has its own tasks and responsibilities. It must safeguard the value of money, and that determines what kind of interest rate policy can be followed. The point is, instead, that if economic conditions do not allow a lower rate of interest, for example because of inflationary pressure, then general economic conditions simply do not make rapid development of a healthy loan market possible.

A corollary of this is that the development of the loan market depends on the general economic conditions and economic stability in each country. This development can only take place when economic policy has succeeded in creating conditions where interest rates can be sustained at a "normal" level. This means that inflationary pressure must be under control, that the credibility of monetary policy is good, etc. Loan markets cannot be developed in isolation from the rest of the economy.

3. A healthy competitive situation

One of the problems which is frequently encountered in newly developing credit markets is that lenders compete for market shares in an unhealthy way. In the Finnish case, the combination of free wholesale money market and the undeveloped loan market led, in the 1980's, to an extremely hard competition for market shares. Banks saw a large potential demand for loans, both from households and firms, and tried to obtain quickly as large market shares as possible.

In the banking market, strategic competition for market share is very dangerous because it has been seen to lead to a sort of blindness to riks and credit quality. It is thought that after a good market share been won, profits will come later. By contrast, a healthy competitive situation is one where banks think of their lending in terms of the value of each loan, on its own merits, and do not play strategic games against each other. No loan should be made for the sake of winning market share, if the loan is not good business on its own terms.

What causes unhealthy competition in the loan market and how can it be avoided? One cause of unhealthy competition in the credit market can be bad pricing of other banking products, such as deposits, payment cards and investment funds. If there is no effective competition in these other products, banks may think that they can use aggressive lending to get customers, and then cash in by selling them other banking products which are priced to be highly profitable. But that is a bad idea, and leads to a wrong focus in the lending decisions.

4. Adequate Consumer Information and Financial Awareness

Last, but certainly not least, one must emphasize the consumer side of the credit market. Financial transactions, like loans and financial investments are relatively complicated affairs and require some degree of sophistication at the customer side of the market. One example of the problems, which may ensue from inadequate consumer awareness and consumer information, is the problem of widespread use of overpriced consumer credit. This has been observed in many countries, especially the United States. Also in Finland, "quick" loans and credit cards programs are now being marketed which are ridiculously expensive, and so much so that one suspects that the target group can only consist of people who are either uninformed or not really creditworthy.

If consumers are not able to well judge their own financial situation and negotiate with banks from an informed position, they will tend to make short-sighted decisions and take on too much risk. This will result in over borrowing by people who are in financial difficulty to begin with, and lead to several kinds of problems. There will be social problems, with people having difficulty with their debt, there will be credit losses for the lenders, and there will be a general loss of respect and trust in the banking business in the society at large.

Ideally, the business ethics of banks and other lenders (such as credit card companies) should prevent lenders form taking advantage of unsophisticated and uninformed customers. We must be realists, however. Unfortunately there seems always to be some lenders who do not care what kind of problems some of their customers end up with. So, it is very important to invest in financial education of the population. Government agencies such as the consumer agency, banking supervisors, and the central bank have a natural role to play here. But I think that in addition to public authorities, also banks themselves and especially their national banking associations should recognize their responsibility in improving the level of financial awareness among the general public.

These conditions for stable development are not exhaustive, but I think that they do go a long way towards supporting the development of a healthy market of personal and household loans. Ensuring these conditions is not a trivial task, but at least my interpretation of the Finnish experience is that trying to disregard them can prove to be unwise.

Now, are there any lessons for Russia to be learned from the Finnish experience from which I have quoted? How do the stability conditions which I listed apply to the Russian economy? One must naturally be very cautious in replying to these questions. Each country has its own particular circumstances and is unique in some respects. Also, history does not repeat itself in any simple, mechanical way. But still, it is not unreasonable to guess that, as we observe how the Russian financial sector matures in the next years, we will note some phenomena which will look familiar.

Russia has enjoyed remarkable economic growth in the last years. This is obviously a great opportunity for the Russian society in many respects, and not least for the financial sector. If this opportunity is seized, and the underpinnings of sound financial development are patiently created and strengthened, the Russian banks should now be able to make great progress. But as we Finns have learned, mistakes are also possible. The mistakes can only be avoided if there is a lot of patience and a lot of respect of professionalism, in the banks, and in economic policy as well.

Reflecting my job as a central banker, I would like to close by emphasizing the crucial role of monetary policy. It is important that the primary task of the central bank, to pursue price stability, is well understood and also respected widely in the financial community and in the society at large. Without this understanding and respect, it is difficult for the central bank to achieve price stability in practice, and price stablity is essential for a well functioning banking sector. A healthy banking system cannot exist without a foundation of stability and trust. And the stability of money itself is the most important part of this foundation.

Thank you very much.