

The model also highlights the role of the financial sector after the crisis and explains why the 1998 crisis was beneficial in some ways for the Russian economy. When the Russian government defaulted on its bonds in August 1998, the government securities market collapsed. Although many banks with large holdings of government securities went bankrupt, the economy turned around, moving from negative to positive growth. The nonexistence of a market for government bonds induced the surviving banks to reallocate their assets to loans in the real sector—offered at lower interest rates to attract borrowers. Lower interest rates, in turn, made it attractive for some better-quality firms to start borrowing from banks rather than continuing to use nonbank finance. This improved the average creditworthiness of the pool of borrowers, further lowering interest rates and inducing more firms to switch from barter trade to bank loans. The regressions carried out by Huang and his coauthors suggest that the financial crisis changed the behavior of the banking sector in a fundamental way. The strong economic recovery that followed the crisis was thus largely the result of Russia's escape from the banking trap.

### A cathartic effect

The model suggests that a financial crisis, though often causing a credit crunch and a deep economic

recession, may have benefits. If the economy is stuck in a banking trap, a crisis may help it escape the trap and, thus, bring about a strong economic recovery. This, in turn, sets the stage for developing the financial sector.

These findings also have implications for what policymakers need to do after an initial economic recovery. If sustainable growth is to be achieved, banking reform must be undertaken. Reducing the information asymmetry between banks and their borrowers through policies aimed at improving corporate governance, accounting, transparency, and credit risk management is key. And as bank lending grows, developing mechanisms for enforcing contracts becomes increasingly important. Fiscal policy should also be given high priority. The government should tighten its budget and avoid recreating an environment in which government bonds crowd out bank loans. ■

Copies of IMF Working Paper No. 04/105, "Financial Crisis, Economic Recovery, and Banking Development in Russia, Ukraine and Other FSU Countries," by Haizhou Huang, Dalia Marin, and Chenggang Xu, are available for \$15.00 each from IMF Publication Services. See page 335 for ordering information. The full text of the paper is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

**This banking trap—where the financial sector has separated from the real sector—hinders banking sector development and economic growth, although on the surface there is financial exuberance, particularly in the government securities market.**

## Available on the web ([www.imf.org](http://www.imf.org))

### Press Releases

- 04/235: IMF Managing Director Rodrigo de Rato's Statement at the Conclusion of His Visit to Mexico, November 9
- 04/236: IMF Mission Statement at the Conclusion of the 2004 Article IV Consultation Discussions with El Salvador, November 10
- 04/237: Statement by the IMF Resident Representative in Chad, November 12
- 04/238: IMF Completes Fifth Review Under Sierra Leone's PRGF Arrangement and Approves \$21.1 Million Disbursement, November 12
- 04/239: IMF Managing Director Rodrigo de Rato to Visit Russia, Germany, Poland, and Spain, November 15
- 04/240: IMF Executive Board Approves \$4.4 Million in Emergency Assistance for Grenada, November 16

### Public Information Notices

- 04/121: IMF Concludes 2004 Article IV Consultation with France, November 3
- 04/122: IMF Concludes 2004 Article IV Consultation with Ireland, November 4
- 04/123: IMF Concludes 2004 Article IV Consultation with Tunisia, November 8

- 04/124: IMF Concludes 2004 Article IV Consultation with Australia, November 8
- 04/125: IMF Concludes 2004 Article IV Consultation with Papua New Guinea, November 10
- 04/126: IMF Concludes 2004 Article IV Consultation with the Republic of Estonia, November 11
- 04/127: IMF Concludes 2004 Article IV Consultation with Benin, November 12
- 04/128: IMF Concludes 2003 Article IV Consultation with St. Lucia, November 15
- 04/129: IMF Concludes Article IV Consultation with Rwanda, November 16

### Speeches

- "Agricultural Trade Reform: The Role of Economic Analysis," Anne O. Krueger, IMF First Deputy Managing Director, Department of Foreign Affairs—Australian Bureau of Agricultural Research Conference, Canberra, Australia, November 4
- "Spreading Prosperity and Resisting Economic Divergence: The Significance of Richard Snape's Academic Legacy," Anne O. Krueger, IMF First Deputy Managing Director, Richard Snape Memorial Lecture, Melbourne, November 8

PRGF = Poverty Reduction and Growth Facility