Russia’s Financial Markets and the Banking Sector in Transition

Edited by Jouko Rautava
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Abstract

Financial markets are crucial for the development of the Russian economy as they influence two major factors underpinning economic growth, ie the accumulation and efficient use of capital. Until now, high inflation has been seen as a major threat to the development of Russia’s financial markets and economy for there is hardly any institution, sector or activity that has not been afflicted by high inflation. Yet, in the face of high inflation and many other problems, Russia’s financial markets and the banking sector have rapidly evolved into some of the most dynamic influences in the Russian economy.

Nevertheless, Russian financial markets are still exceptionally fragile. Their problems are compounded by extremely rapid growth, lack of experience, inadequate legislation, poor implementation of laws, an unclear regulatory framework and an unstable economic environment. In particular, there is a clear and present need for structural reform in the banking sector. Government actions will largely determine how this ongoing restructuring process will proceed and the related impact of such reform on other sectors of the economy.

Keywords: banking, economic reform, financial markets, inflation, Russia

Tiivistelmä

Rahoitustekijöillä on keskeinen merkitys Venäjän talouden kehityksessä, sillä ne vaikuttavat taloudelliseen kasvuun sekä investointipääoman määrän että sen tehokkaan käytön kautta. Venäjän talouden suurin ongelma on toistaiseksi ollut korkea inflaatio. Venäjällä tuskin yksikään instituutio, sektori tai toiminta on säätänyt inflaation vaikutuksilta. Epäsuotuisista ololista huolimatta rahoitusmarkkinat ja pankkijärjestelmät ovat olleet eräitä nopeimmin kehittyviä aloja Venäjällä.

Venäjän rahoitusmarkkinat ovat kuitenkin hyvin hauraita, koska rahoitusmarkkinat ovat kasvaneet nopeasti, ei ole riittävää kokemusta, laainsäädäntöä ja sääntelyjärjestelmät ovat puutteelliset ja toiminta-ympäristö on epävakaa. Erityisesti pankkijärjestelmään tarvitaan rakenneellisia uudistuksia. Hallituksen toimenpiteistä pitkälti riippuu, miten jo käynnissä oleva uudelleenjärjestely kaikkine vaikutuksineen muihin aloihin ja koko talouteen etenee tulevaisuudessa.

Asiasanat: inflaatio, pankkitoiminta, rahoitusmarkkinat, talousuudistus, Venäjä
Preface

At the beginning of 1992, Russia launched its economic reform process, the aim of which was to change the former centrally managed economy into a market economy. As in the other eastern European countries, the core elements of the transformation process are the liberalization of prices, trade and business as well as macroeconomic stabilization, structural changes and privatization. All these fundamental changes are aimed at improving economic efficiency and promoting economic growth. Due to developmental disparities in the different production sectors and regions, and inadequate statistical data, it is, however, difficult to give a comprehensive assessment of the state of and developments in the Russian economy. Still, we can perhaps safely say that during the first four years of economic reforms in Russia there have been important changes and progress in many sectors.

The financial markets and the banking sector have been among the most dynamic aspects of the Russian economy. They are also very important for the Russian economy as whole because reforms in these areas are believed to be crucial for economic growth. Furthermore, one can get a deeper view of the more general problems of today's Russia by scrutinizing developments in the financial markets.

The articles included in this publication describe, analyse and discuss some of the most important developments and policy questions related to the Russian financial markets during the early years of transition. As the subject of this book is a wide and relatively new field of research, I hope the book will stimulate discussion and further research in this area. The book is a continuation of the research work and publications on transition economies being undertaken in the Unit for Eastern European Economies at the Bank of Finland. Besides Inkeri Hirvensalo, Juhani Laurila and Jouko Rautava from the Bank of Finland, Glenn Hoggarth (Bank of England), Ilkka Salonen (International Moscow Bank) and Lev Gelman and Alexandra Morozova (Ernst & Young Vneshconsult Group and CEMI, Moscow) have made important contributions to the book. Tiina Saajasto has done the technical editing work and the graphs. Naturally, the opinions expressed in this volume are those of the authors and do not necessarily reflect the views of the Bank of Finland or the institutions of the visiting authors.

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Contents

Abstract ................................................................. 5
Preface ................................................................. 7

Introduction
    by Jouko Rautava ............................................. 11

Financial Factors and Economic Development – Russian Dilemmas
    by Jouko Rautava ............................................. 25

Monetary Policy in Russia
    by Glenn Hoggarth .......................................... 53

Russian Banking Legislation and Supervision
    by Juhani Laurila ........................................... 83

Russian Commercial Banks: a Banker’s View
    by Ilkka Salonen ............................................ 119

Capital Markets in Russia: Putting the Cart Before the Horse?
    by Lev M. Gelman and Alexandra G. Morozova ........ 145

Payment Arrears and Russian Reforms
    by Inkeri Hirvensalo ....................................... 167
Introduction

by Jouko Rautava

Contents

1 A brief history of Russian reforms ................. 13
2 Financial markets and Russian reforms .............. 16
3 Financial market crisis and Russian transition ........ 23
1 A brief history of Russian reforms

After more than 60 years of Communist rule and a highly centralised economic management system, the Soviet Union started the so-called Perestroika process in 1985 to fight against declining growth rates and the widening gap between the Soviet economy and the developed industrial countries. The initial purpose of Perestroika was to increase the efficiency of the Soviet economic system by giving firms more autonomy and by trying to make use of the signals and incentives coming from markets in its policy making. Clearly, the purpose was not to change the core economic and political structure of the Soviet Union.

However, in the late 1980s it became clear that it would not be possible to improve the functioning of the Soviet economy by half-measures that do not address the core questions related to economic behaviour. Indeed, the partial modification of the system led to a situation where the old system gradually degenerated, while the development of new structures was limited by the commitment to maintain the old basic structures, and by intensified confrontation between various interest groups. As a result, by the beginning of 1990 the general situation in the Soviet Union was chaotic. Many new agents had appeared in the markets who tried to make use of their new-found freedom and choices while also capitalising on the old structures (e.g. regulated prices) and the weakness of the state. Meanwhile the politicians and other authorities were no longer able to manage the process, particularly the crumbling state economy, and budget deficits were increasing rapidly. Consequently, because financial markets were yet undeveloped, the government had to finance its deficits by printing more roubles and borrowing from abroad.

In the last years of Perestroika, the Soviet economy was characterised by various problems such as declining production, a short supply of goods, long queues, wide-scale price regulation, budget deficits, problems in servicing international debts, and accelerating inflation. Simultaneously, the Soviet republics started to demand more independence and thus distanced themselves from the central administration. Total economic and political chaos reigned, culminating in the coup of August 1991, which resulted in the final disintegration of the Soviet Union in December 1991.

An important step in the process which finally led to the dissolution of the Soviet Union was a decision made by the Russian Federation in
late 1991 to take its own path and embark on a series of far-reaching economic reforms. The Russian reforms differed from to the idea of Perestroika in that they aimed from the very beginning to make far-reaching changes at all levels. The ultimate purpose of this process was to transform the Russian economy into a market economy.

At the beginning of 1992, Russia launched a new economic programme through a policy of extensive price liberalisation. Compared with the more successful East European or Baltic transition economies, however, the environment for economic reforms was much more difficult in Russia. First, complications arose owing to the sheer size of Russia, with its population of 150 million, its huge land area comprising 11 time zones, and its significant regional and cultural differences. Second, after 70 years of Communist rule there was no tradition of a market economy and its institutions. Third, due to the long and disappointing process of Perestroika, even at the beginning of the reforms, people were very sceptical. Moreover, Perestroika gave various interest groups time to organize themselves and increase their power, which has also complicated the subsequent reform process. Fourth, the old political structures and an unclear division of work between the major state institutions, namely the president, the government, parliament and the Central Bank, gave rise to considerable problems in economic management. Related to all of these factors, in the first years of reforms there was no strong general commitment to or support for reform. This proved to be detrimental to the progress of reforms in 1992–93.

Since 1994 there has been a sounder institutional basis for reform policies, because of the new constitution and parliamentary elections in December 1993. Despite serious mismanagement in economic policy, there has been development in various sectors of the economy; although progress has not been as fast as it could have been if the government policies had been more reform-oriented. With the passage of time and the accumulation of experience, politicians and authorities are also learning to deal with the new environment. However, even by the end of 1994, while one-third of the elite decision makers believed that Russia is moving in the right direction, about the same number of decision makers hold the opposite view (see the survey by the RFE/RL, Transition, No.14, 11 August 1995). Thus, since Russia missed the opportunity to use the pro-reform climate within the general public in the first years of transition to push through strong stabilisation policies and structural reforms, and since there is still considerable resistance against reform policies, one cannot expect a radical speeding up of the reform process in Russia. The situation has normalised in the sense that economic policy will become more dependant on the decisions of various state institutions
and on legislation. This means that reform policies must now be executed through normal channels that will take longer and most likely will lead to gradual development rather than radical reforms.
2 Financial markets and Russian reforms

Developments on the financial market aptly illustrate the links between different policy sectors and the very complex nature of the whole reform process in Russia. In the mid 1980s, while financial markets in the industrial countries continued to grow and develop rapidly thanks to liberalisation of the global financial market and the introduction of ever more sophisticated financial market instruments, the former Soviet Union embarked on reforms from a more tenuous position: for decades, money and financial markets had only played an extremely minor role in economic management and development. Although this changed to some extent during the 1985–91 Perestroika period, Russia started its reforms in 1992 with very weak financial market institutions and almost no experience of the appropriate policies needed to manage financial markets and, therefore, of general economic development.

The articles in this volume describe and analyse some of the most important questions related to different financial market sectors and policies in Russia. Since the basic idea of the whole reform process underway in Russia is to promote the well-being of the nation through economic growth, this volume leads off with an article by Jouko Rautava, in which he discusses the role of financial factors in economic development. The importance of financial factors derives from the fact that they influence both of the major factors underpinning economic growth, i.e. the accumulation and efficient use of physical capital. In other words, financial factors contribute to economic growth through savings and investments. In Russia, as a result of the decline in production, the discussion too often seems to concentrate on questions concerning the promotion of investment, rather than the mobilisation of domestic and foreign saving that is necessary to finance investment in a non-inflationary way. It is an intrinsic feature of Russian financial markets that only a very small fraction of total saving is intermediated through the banking sector, which is partly related to interest rate policies in Russia. For the time being, financial savings have not been an attractive alternative because real interest rates on bank deposits have been deeply negative. Instead of financial savings, other forms of savings like hoarding of goods and flight of capital have taken place. In terms of economic growth, these savings are not very efficient. Because higher interest rates can either encourage saving by making future consumption
more attractive in relation to current consumption (substitution effect), or
discourage saving because higher interest rates would provide a desired
future income with a lower level of savings (income effect), the net
impact of higher interest rates on the total volume of savings is unclear.
However, there is clear evidence that positive real interest rates promote
financial forms of savings that can be intermediated through the financial
system into productive investments. Thus, interest rate policies
promoting positive real interest rates can significantly contribute to
savings and investments and, therefore, to Russia’s economic growth.

Besides interest rate policy, another important issue, particularly in
Russia, is the role of the State in the financial markets. In the case of
Russia, this question has several dimensions. First, there is a need to curb
public sector deficits that have very strongly contributed to high inflation
and the overall instability of the financial markets. Moreover, public
financing needs tends to crowd out new private sector investments.
Second, as a result of the deep recession, there has been lively discussion
on what kind of investment activities the government should promote and
how to promote them. Third, how should the government intervene in
markets in order to guarantee that agents behave prudently. Naturally,
there are many important areas such as education and the rebuilding of
infrastructure where the government’s role is crucial. However, there is
considerable evidence that the Russian State is rather weak in its ability to
set up and carry out any highly sophisticated policies based on direct
government intervention. Consequently, there are reasons to believe that
Russia should focus on policies and regulations that are relatively easy to
carry out, and rely on market incentives rather than bureaucracy and
heavy direct regulations. Unfortunately, old Soviet practices are deeply
ingrained in Russian society and policy makers still seem to rely heavily
on ad hoc measures and direct regulation, rather than a strong legislative
system and market control.

For the time being, high inflation has been the major concern of
Russian financial markets and economic development. It is difficult to
find any institution, sector or activity that has not been hit by high
inflation. There is no doubt that any effort to improve the functioning of
financial markets is dependent on how the government and the Central
Bank manage to curb inflation and keep it at a reasonable level.

Russian inflation and monetary policy are analysed in the article by
Glenn Hoggarth. In general, the current view of almost all central banks
is that the key objective of monetary policy is to maintain the external or
internal stability of the currency. However, maintaining internal currency
stability, i.e. controlling inflation, is not an easy task even in developed
market economies. The central banks cannot directly control the inflation
rate and, consequently, they have to choose indirect methods of controlling inflation. In liberalised economies, policy makers often use a two-step approach: they first use monetary instruments (e.g. an interest rate) to change intermediate targets (e.g. money supply), and then try to predict how these changes will affect inflation, which is the final goal of monetary policy. All structural changes, including financial market liberalisation, seriously affect this transmission process and, consequently, complicate the conduct of monetary policy.

It has not always been clear in Russia that the major concern of the central bank should be currency stability, but in recent years this idea has won more support; the new central bank law from May 1995 explicitly confirms this goal. Potentially, the most important instruments in the Russian monetary policy framework have been the credit supplied by the Central Bank of Russia (CBR) and its short term lending rate. By regulating the supply of credit and interest rates, the CBR has controlled the growth of money supply (rouble M2) and the exchange rate and, ultimately, the inflation rate through these intermediate channels. There is clear empirical evidence for this monetary transmission mechanism in Russia, and particularly the excess credits supplied by the CBR have in recent years very strongly contributed to high inflation in Russia.

However, there have also been some important changes in the monetary policy transmission mechanism that may reflect the growing role of market forces in Russia, recent changes in the CBR's behaviour and the process of moving from a high to low inflation environment. Thus, since mid-1993 the CBR has introduced a number of market-based means for monetary control. In addition the role of interest rates has become more important in the transmission of monetary policy. Trends in monetary growth also appear to have had a weaker and more protracted impact on inflation over the last two years now that a lower inflation environment has been established. As well, the CBR's directed credit supply has fallen markedly, thereby contributing to a fall in the inflation rate. Another significant change in monetary policy in mid-1995 was the introduction of an explicit exchange rate target for the latter part of 1995. All these factors will have their impact on both the monetary policy transmission process and the framework within which the CBR must conduct its policy.

Besides monetary policy, the authorities also have a central role in creating institutions and rules and regulations so that participants in the financial markets will behave prudently. Developments in Russian banking legislation and its supervision are dealt with in an article by Juhani Laurila. There was some progress during Perestroika following the creation of a two-tier banking system and the creation in the CBR of
a special department for banking supervision, regulation and auditing. Further, the first laws concerning the CBR and commercial banking in Russia were already approved by 1990. However, in practice, the situation in this field was at a rudimentary stage when Russia embarked on its reform policies at the beginning of 1992.

Problems concerning banking legislation and supervision also illustrate quite well the more general problems related to Russian transition. On the one hand, because of the very weak State and, consequently, extremely liberal policies, financial markets have developed very rapidly. For example, the number of banks mushroomed from only five at the beginning of 1988 to around 1700 in 1992 and 2500 in mid-1995. It is easy to understand the kind of pressure this exerts on banking supervision and regulation. On the other hand, the State authorities still seem to rely on the old style of administration and bureaucratic practices, rather than on more market-oriented procedures, to control developments. This is true even though there is no longer a basis and capability for such behaviour. Moreover, as the basic legislation concerning financial markets has been lacking and the division of work between the authorities has been unclear, financial market regulation has relied on outdated laws, decrees issued by the president and government, and circulars from the CBR. As banks, clients and other authorities have not been sure about the legality of operations, the situation has discouraged the development of the banking industry and the whole economy, and also encouraged activities that can be extremely risky and harmful for the rest of the society. As in other sectors of the economy, the only problem in the financial markets is not the state of legislation itself, but how the laws are applied. In this connection, bankruptcy procedure is a particularly interesting question.

Despite many problems related to the unstable economic environment, the banking industry has proved to be one of the most vital and progressive sectors of the Russian economy. In this volume, Ilkka Salonen gives an insider’s view into the banking business in Russia. Economic disintegration in Russia and throughout the Commonwealth of Independent States partly resulted from and was intensified by the severe problems related to the payment system. The costs arising from failures in the payment system have been extremely high, however, as the players have been unable to exploit the advantages of existing markets, which were large and relatively homogeneous. Thus, the payment system applied by commercial banks and the CBR is the key to Russia’s economic reintegration. There have already been significant improvements in this field. For example, in the early 1990s it took several
weeks to send money just within Russia, while today it takes about one week.

For the time being, the foreign exchange market has been perhaps the most vital and progressive sector of the Russian economy. Together with the inflation rate, the rouble/dollar rate has also been a good indicator of the state of economic policy in Russia. The major players in currency markets have been commercial banks, but the impact of activities in these markets has been felt by everyone. This was well illustrated by the events leading up to 'Black Tuesday' on October 11, 1994, when the collapse of the rouble in the exchange markets led to an immediate jump in the prices of imported goods, thereby, adversely affecting the everyday life of Russian people. High inflation and exchange rate volatility has enabled banks to make excess profits through their currency operations. Nevertheless, if inflation continues to decline and if the exchange rate of the rouble stays more stable due to continuation of the currency band system, the banks will face a more demanding operational environment; many of those whose survival has depended on high inflation and currency operations will be forced out of business.

A hot topic related to commercial banks is their possible role in corporate governance in Russia. It is widely thought that due to their financial and management resources, banks can play a very important role in developing Russian industry. The fact that banks are also very eager to take on this challenge is evidenced by the government's latest plan in autumn 1995 to tender state shares to investors (mainly believed to be Russian banks) in about 100 companies in exchange for credits (worth USD 660 million) to the government. Under this scheme the investors will hold the State's shares as collateral for the credits, which will be repaid by selling the shares. Beyond repayment of the principal, the investors will get 30 per cent of capital gain on their shares. Thus, although the purpose of this scheme is not to increase the power of the banks in the corporate sector, Russian banks are expected to be the biggest investors and may have strong incentives to influence companies in order to increase the price of their shares. The first credit auction related to this arrangement was held in November 1995.

In addition to helping finance the budget deficit, the shares-for-credit scheme is optimistically anticipated to speed up privatisation and encourage the development of securities markets, which are analysed by Lev Gelman and Alexandra Morozova. For the time being, the Russian securities markets have been dominated by government paper. Securities markets have become ever more important as a non-inflationary way to finance the federal budget deficit. The market for government securities is also the best organised and most developed sector of Russian financial
markets. In this sense government paper has promoted the general development of securities markets in Russia. There is a serious danger, however, that excess financing needs and issuance of government securities will hamper the future development of financial markets by crowding out privatised and new private enterprises. There is a huge potential for bond and equity markets and, to ensure their continued development, it is important to keep the government's financing needs in control.

As in other financial markets, the problems encountered in securities markets have related to legislation, enforcement of laws, poor division of responsibilities between regulatory authorities, lack of relevant information and volatile prices. Other special difficulties have included clearing and settlement systems, shareholder registries and custodian services. The volatile nature of these new markets and the general lack of experience in dealing with them was illustrated by the famous MMM scandal in the summer of 1994, which seriously undermined the faith of investors in the securities markets.

Nevertheless, given that the inflation rate will be relatively low and stable, there are good prospects for the Russian securities markets. The continued privatisation and liberalisation of financial markets is essential to promote this development. Naturally, the opening of securities markets can place significant pressure on the current ownership structure and the system of corporate governance. Consequently, the ways in which securities markets are steered will make an important contribution to the structure and functioning of the Russian economy in the future.

Various types of payment arrears have been an inherent feature of the transition process. These are discussed in this volume by Inkeri Hirvensalo. The question of payment arrears is an interesting problem because it demonstrates how both macro-level policy making and micro-level enterprise behaviour adjust to the demands of the new business environment. The basic problem is, on the one hand, how will the enterprises that have been used to 'soft' budget constraints behave when budget constraints become more binding: will they continue to deliver goods and services to their clients even if there are clear signs that they will not receive payment in return? On the other hand, how the situation develops in the future will greatly depend on how the government responds to demands to bail out troubled enterprises. At the beginning of the reforms in 1992, the Russian government gave in to pressure to grant new loans to problem enterprises. Consequently, these firms were not forced to revise their practices, and payment arrears thus continued to disturb policy making and hinder inevitable structural changes until now. Incidentally, the way in which the question of payment arrears has been
addressed in Russia illustrates the observation made earlier concerning the power of different interest groups in Russian politics.

The payment arrears problem also offers an interesting insight into the inflation process. On the one hand, payment arrears are partly a result of high inflation, because in a high inflation environment the delay of payments can be highly profitable. On the other hand, 'soft' loans given to enterprises to solve the payment problem contributes to a higher government budget deficit and, therefore, to faster inflation. Moreover, because viable firms also have incentives to run up payment arrears and make use of 'soft' loans, government bail-out procedures are likely to give rise to various kinds of economic abuses.

Nonetheless, accumulation of experience and, particularly, more sound fiscal and monetary policies seem to make agents in the markets behave more prudently. Today, enterprises must more clearly carry customer-related risks by themselves. Thus, one can also expect that the relative importance of the problems related to payment arrears will gradually decline.
3 Financial market crisis and Russian transition

Due to the very rapid growth of financial markets, lack of experience, inadequate legislation and regulation of markets, and the unstable economic environment, the Russian financial markets are very fragile. There are already many examples of how these factors can cause various kinds of financial crisis. The MMM scandal in the summer of 1994 reveals the risks inherent in poor regulation and legislation of financial markets as well as the lack of experience of the participants in Russian financial markets. For its part, 'Black Tuesday' in October 1994 aptly illustrates how the problems in fiscal policy can spill over into other sectors and lead to broad financial crisis. Another example is the 'Bloody Thursday' in August 1995, when the money markets were hit by a liquidity crisis because of the increased uncertainty in the interbank markets after some banks failed to fulfill their payment obligations. Moreover, already in 1994 some 500 banks declared losses, and the CBR has cancelled a rapidly growing number of commercial bank licences. Thus, it is only a matter of definition whether or not the Russian financial market is already on the verge of a crisis.

On the context of future developments, at least two potential sources of crisis are worth mentioning. First, due to the directed credit programmes and ownership structure of the banks, many banks have accumulated a large non-performing loan portfolio. According to some estimates, this extra burden is said to be around 25–30 per cent of the whole loan portfolio of Russia's commercial banks. Second, in recent years the banks have made large profits through opportunities created by high inflation and currency volatility. If the fiscal and monetary policy is tightened, however, many banks will face serious difficulties. The enterprises with bad loans will have even more difficulties in making their payments than before, either because they will no longer receive directed loans from the government or because their subsidies are reduced. Moreover, as an austerity policy is likely to produce a lower inflation rate, there will be more limited scope for making profits through money and currency operations. Thus, these two factors together are likely to speed up the necessary restructuring of the current fragmented and fragile banking sector.

How the banking sector restructuring will proceed and how it might spill over into other sectors of the economy depends largely on
government actions. As we have seen in other transitional economies, crisis in the banking sector does not have to lead to an overall economic crisis, as has happened in many industrial countries. There are several reasons for this. First, the weight of the banking sector, and therefore the scale of a banking crisis for the Russian economy, is still likely to be much smaller than in industrial economies. Second, due to the fragmented nature of the markets, the spillover of crisis in Russia is also less likely than in highly integrated western countries. Third, currently only the deposits in State-owned Sberbank are guaranteed by the government. Thus, the direct fiscal consequences of the bank failures may not be as serious as in industrial economies, where the deposit insurance system is typically more extensive. If the State decides to bail out the troubled banks, however, the social costs of a banking crisis could potentially become rather high: it would mean that the government has to give up its tight fiscal and monetary policy and, hence, inflation would accelerate again.

In general, it is difficult to see how Russia can avoid a major restructuring of its banking sector. To put this in a more positive way, there are many reasons why Russia should restructure its financial market and banking sector as soon as possible to build a more solid basis for its future growth. These issues are discussed and analysed in more detail in the articles that follow.
## Contents

1. Introduction .................................................. 27
2. High inflation – a major setback for the rouble ............ 29
3. Several factors undermine financial savings in Russia ..... 32
4. Some important issues related to investments in Russia .... 38
5. The limits of the Russian government ....................... 44
6. Conclusions .................................................... 49

References ......................................................... 51
1 Introduction

There are at least two important motives for studying the role of financial factors in the Russian economic reform process. The first is related to the nature of the stated target of the reforms. In Russia, it is commonly agreed that the target of the systemic transformation process that has been underway since the beginning of 1992 is to transform the Russian economy into a market economy. The target itself is naturally rather vague since there are almost as many types of market economies as there are countries. Due to the reliance of market economies on prices and monetary exchange, there is, however, at least one crucial element all market economies have in common, namely money. The second motive is related to the first in the sense that a market system can be seen as an efficient instrument for achieving economic growth, the ultimate goal of the reforms. It is a well-known fact that economic growth is a result of the accumulation of physical capital and its more efficient use. The crucial role of financial factors in economic development derives from the fact that they influence economic growth through both channels. Consequently, because the ultimate goal is to establish a market economy and economic growth, money and financial markets are, almost by definition, at the core of the transition process going on in Russia.

There is, however, no well-founded theory of economic transformation, or any commonly accepted theory on the role of financial factors in economic development which would offer a neat frame of reference for dealing with these questions. In fact, opinion is divided among economists on many important issues. There are, however, some commonly accepted 'golden rules' on which kind of factors and conditions are positively linked to growth. For example, stability of financial markets and financial institutions is believed to contribute positively to economic growth. On the other hand, there are points on which even theory becomes vague. Moreover, as conditions vary from one country to another, it is extremely difficult to make an empirical distinction between the relative role of different factors in financial markets and their contribution to economic growth. Issues such as the role of government in economic development typically fall into this second, more controversial, category.

This article evaluates some basic problems related to financial markets and economic development in Russia. The focus is purely on some important questions connected with economic policy making and debate in today's Russia rather than on more general questions related to issues such as growth theory. The discussion is partly based on the
experiences of the developing countries. After the introduction, the paper provides a commentary on the role of money in a market economy and the need for financial stabilization in Russia. The following two sections deal with questions related to saving and the investment environment, which are particularly important in a Russian context. Emphasis is given to fiscal and interest rate policies. As Russia is the main focus of this paper, particular attention has been paid to questions linked to the role of the government in financial markets, which are discussed in greater detail in section five. The article concludes with some remarks on the so-called financial repression paradigm.

Naturally, there are many other factors which influence economic growth besides those mentioned in this article. Hence, it is commonly believed that factors such as monetary policy and price stability, financial market regulation and supervision, institutional structures, payment systems and questions related to corporate governance all have an impact on economic development. These questions are discussed in the other articles in this volume.
2 High inflation – a major setback for the rouble

Historically, money and financial markets did not play major role in economic policy or decision making in the former Soviet Union. Prices did not reflect the scarcity of production factors, and resources were allocated centrally according to the negotiating power of different groups. Consequently, financial markets and the related complex information systems were underdeveloped. Naturally, experience and understanding of how the market economy works was also lacking. Thus, from the very beginning of Russia’s transition into a market economy, it was quite clear that far-reaching changes were needed in the financial sector. As all the functions of financial markets are related to money, it is useful to begin by considering the role of money in a market economy.

Money is traditionally expected to carry out three basic functions. First, as a means of exchange in a market economy, money makes it easier and much more efficient for trade to be conducted between economic agents than would be the case under a barter system. Exchange based on money is more effective because less resources and time are needed to find appropriate trading partners or to transmit the means of payment. In addition, a market economy based on money offers more opportunities for business than a barter system. Second, as a numeraire, money serves as a convenient instrument for pricing. As market economies rely on a well functioning price system, it is important for them to have a common yardstick for prices so that price information can be easily conveyed and understood. As a numeraire, money also makes accounting and planning much easier. Third, money is also a repository of value, thus being the precondition for it to serve as a means of payment, because there is usually a time lag between the exchange of goods or services and the submission of payment. This third function is also related to saving and capital accumulation, and therefore to investment and economic development.

In general, all the functions served by money are related to the information needs of markets. It is clear, then, that monetary stability is essential in order for money to fulfil its basic functions, i.e. ensuring that information in the markets is interpreted efficiently. Consequently, the battle against inflation is considered one of the most important aspects of transition policies.
Figure 1. Average monthly inflation (CPI) in selected transition countries after price liberalisation, 1990–1995

1 Czech Republic  
2 Poland  
3 Estonia  
4 Russia

Compared to the transition process in the relatively more successful Central European and Baltic economies (see Figure 1), perhaps the most striking difference between these countries and Russia is in their stabilization policy. Macroeconomic mismanagement has been more severe in Russia than elsewhere and, consequently, budget deficits have been substantial and inflation has been high. In 1994, three years after the initial price liberalization, consumer prices shot up by over 200 per cent, and in 1995 the annual inflation rate will still exceed 130 per cent. This is clearly a less encouraging result than, for example, the outcome of stabilization policies in Poland or Estonia, to say nothing of the Czech Republic. Without further analysis of the specific reasons behind inflation in Russia,¹ high inflation has not only decreased the rouble's purchasing power, but has also undermined its functions as money. Consequently, the rouble has been deserted in favour of other forms of saving like hoarding of cash dollars, dollar deposits and flight of capital. Payments

¹ There is a vast array of literature on Russian inflation and its underlying causes. See, for example, Hoggart's article in this volume, Easterly and Vieira da Cunha (1994), Layard and Richter (1994), Titkov and Wörgötter (1994), Rautava (1994).
and agreements have likewise widely been based on currencies other than the rouble.

High inflation and the consequent lack of confidence in the rouble has clearly been the major factor underlying Russia's general economic disorder and, therefore, in postponing a realization of the fruits of transition. However, as Russia has steadily built up experience through a natural learning process, an anti-inflationary stabilization policy has won an increasing number of supporters among the Russian authorities and politicians. Despite severe slippages from the agreed economic programme during 1994, which led to accelerating inflation at the end of 1994 and beginning of 1995, in terms of stabilizing inflation, the situation in 1995 looks better than it ever has since the beginning of Russian transition in 1992. This is not to say, however, that there is a sound basis for the future development and growth of the Russian financial markets.

The importance of instilling confidence in the rouble derives from the fact that the stability of and confidence in the domestic currency is directly linked to financial savings and, consequently, to investment. Let us now embark on a more detailed study of these links.
3 Several factors undermine financial savings in Russia

Russia, like all other transition economies, has enormous investment needs, but investment is kept in check by the short supply of available savings. As a result, reform policies that stimulate both public and private savings and the import of foreign capital are particularly important.

In the public sector, this calls for measures to balance the budget deficit. Aside from contributing to high inflation and a general lack of confidence in the economy and its management, public sector deficits tend to crowd out important private sector investments. In the short run, cutting down expenditure is the key to balancing the State budget because, due to the general economic decline and problems related to changes in the tax system and tax collection, the Russian authorities have not managed to increase budget revenues. Although there are important expenditures which the Russian government cannot avoid, clearly in recent years the structure of budget expenditures has not been conducive to economic growth. For example, the generous backing provided to agriculture and big State firms through subsidized credits has not promoted structural change. In fact, it is suspected that a large part of these credits has been used in an extremely inefficient and harmful manner. There is evidence that State enterprises have used cheap loans to speculate on currency markets rather than using these funds to restructure their production. In the medium and long term, due to new expenditures on social security and infrastructure, more emphasis must be given to the revenue side, too, to prevent the public sector from sinking further into the red.

Another important aspect of public sector deficit is its impact on the overall indebtedness of the country through the current account. The current account can be viewed as a combination of the balance between private savings and investment and the balance between government receipts and expenditures. Thus, if there is no change in the level of private sector saving and investment, the government deficit will automatically upset the current account and hence increase the country's indebtedness.
In private or household-sector savings, the focus has been on interest rate policy and its role in determining the saving rate of any given country. There has been special interest in the question of how real interest rates affect savings. Theoretically, the impact of the real interest rate is unclear. On the one hand, higher interest rates could encourage savings by making future consumption more advantageous than current consumption. On the other hand, increased interest rates could reduce savings because a higher interest rate provides a desired future income at a lower level of savings. Thus, the mutually offsetting effects of higher interest rates have an ambiguous net impact on total saving. Furthermore, empirical studies fail to confirm any strong or unambiguous correlation between higher interest rates and total savings. (See discussion on savings and real interest rates in Amsden 1993, Arrieta 1989, Dornbusch and Reynoso 1989, Polak 1989, World Bank 1989).

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2 The effect of income level on the saving rate is not relevant to the purpose of this study. As a further example of the impact of other factors on savings, the effects of social security variables seem to support the view that any net savings in the social security system add to the savings flow coming from households. Moreover, reforms in social insurance systems can have a major impact on financial market expansion. (Polak 1989, p. 88; Uthoff 1993).
Although interest rates may have only a weak or negligible effect on total private savings, they certainly influence the form in which people save. Higher real interest rates favour financial rather than nonfinancial forms of saving which tend to encourage more rational use of savings (Polak 1989, p. 87; World Bank 1989, p.27).

Figure 3. **Real interest rates on bank deposits in Russia 1992–95, per cent per month**

![Graph showing real interest rates on bank deposits in Russia 1992–95.]

1. Commercial banks' deposit rate
2. Sberbank 3-month deposit rate

Source: Russian Federation, Towards Medium-Term Viability, World Bank 1995

As is typical of high inflation countries, Russia’s real interest rates have, for the greater past, been negative (Figure 3). Because rouble savings have lost their real value, they have not been an attractive alternative to other forms of savings (e.g. durable goods and flight of capital). For the time being, due to insufficient data and the general instability of the economy, it is perhaps difficult to show any strong, direct relation between interest rates and rouble savings in Russia. Nevertheless, available data on currency in circulation, demand deposits and time deposits (the sum of which equals money aggregate M2) reveal that the ratio of financial assets (defined as M2) to GDP is much smaller in Russia than in other countries relevant for discussion here (Figure 4). As the capital markets are underdeveloped, the low ratio of M2 to GDP shows that only a small fraction of financing is intermediated through the

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3 Almost 60 per cent of savings are deposited in Sberbank.
official financial system and, consequently, Russia’s financial markets lack the 'depth'.

Russia's current national saving rate, i.e. savings in relation to GDP, is around 0.25, which is rather a good result compared with some other transition economies. A low rate of financial depth shows, however, that the other forms of saving (e.g. cash dollars, hoarding of goods, inventories and real estate, flight of capital) are not likely to be very efficient in terms of economic growth. The relevance of financial depth to economic growth will be discussed later in the context of investments.

Perhaps too much attention has been devoted to the availability of financing at the expense of questions concerning its more efficient use. This tendency to emphasis factors related to supply of capital, and especially foreign capital, rather than factors improving the use of available capital, was common to the development theory of the 1950s and 1960s (Polak 1989, p. 23). Since the Second World War, only few developing countries have managed to attract a significant amount of foreign investment, and foreign capital typically lags behind rather than leads industrial development (Amsden 1993, pp. 75–76). Although based on the experiences of the developing countries and the early phases of industrial development, this last observation also seems to have more general relevance. It is unreasonable to expect a heavy inflow of foreign capital if the situation in the country fails to attract domestic investors. Policies aimed at attracting foreign investors through special treatment (tax exemptions, free economic zones etc.) are likely to be rather inefficient. Moreover, special treatment for foreign capital also
encourages domestic investors to circulate their savings through foreign partners (perhaps owned by the domestic enterprise itself) in order to avoid taxes and gain short-term benefits. Consequently, there is a danger that the special treatment of foreign investments decreases public sector revenues and increases incentives to short-term rent seeking at the cost of long-term investment.

The same one-sided view of the role of external financial factors in economic development can often be found in the literature and policy debate on the development problems of transition economies. One obvious reason for this is that it allows the focus to be shifted to the external factors causing economic distress instead of essential but uncomfortable domestic measures. Particularly if we take into account the size of the Russian economy, the role of foreign capital in development has perhaps gained too much attention.

During the early years of transition, Russia has managed to accrue only a minor sum in foreign savings. In 1994, foreign direct investment in Russia amounted to around just USD 1 billion. The cumulative sum of net foreign direct investment in Russia in 1990–94 is around USD 4 billion, which is only about one third of the sum the Czech Republic, Hungary and Poland have managed to attract (ECE 1995, Table 3.7.5). However, there is a clear indication that foreign investors would be interested in investing in Russia if the conditions for investment were more favourable, i.e. when the overall economic situation stabilizes and questions related to ownership rights and legislation are resolved. The willingness of foreign investors is demonstrated by their potential commitments to invest in Russia. According to available data on long-term investment plans, Western firms plan to invest in Russia a sum corresponding to around USD 37 billion. This is around one third of all the potential investment commitments in eastern Europe and the former Soviet Union (ECE’s study, Financial Times, March 28, 1995).

Besides the unstable economic environment and problems related to ownership legislation and the legal system in general, the fact that Russia has had considerable difficulties in servicing its foreign debt has impaired its ability to attract potential foreign investors. Russia’s total commitments to foreign creditors amount to around USD 120 billion, which is just under 160 per cent of its total exports. Although the rate itself is rather high, it is clearly lower than in Poland and Hungary. Indeed, there is reason to believe that the problems related to debt servicing in Russia are merely an indication of problems in the field of economic management rather than Russia’s economic potential for servicing its debts.
Table 1. **External debt indicators for selected transition economies in 1994**

<table>
<thead>
<tr>
<th></th>
<th>Current account/ GNP, %</th>
<th>Gross debt, USD billion</th>
<th>Gross debt/ exports⁴, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>0</td>
<td>120</td>
<td>160</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>2</td>
<td>9</td>
<td>52</td>
</tr>
<tr>
<td>Hungary</td>
<td>−11</td>
<td>29</td>
<td>212</td>
</tr>
<tr>
<td>Poland</td>
<td>−1</td>
<td>42</td>
<td>214</td>
</tr>
</tbody>
</table>

Source: ECE 1995, Table 3.7.13 and Central Bank of Russia

It is generally accepted that underdeveloped countries should use foreign finance to launch their economic growth. There is even literature on the optimal use of such financing. Russia, too, clearly needs foreign finance to stabilize its economy and reconstruct and modernize its production base. Taking into account its current problems with economic management and debt servicing, however, Russia must first address its most basic problems (public sector deficit, management, taxation, legislation, etc.) and agree on current debts with the London and Paris Clubs. Only after that can they hope to utilize foreign savings more extensively to step up economic development in Russia.

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⁴ Exports include both goods and services. According to Russian balance-of-payments statistics, exports of goods and services totalled USD 75 billion in 1994. The figure also includes exports to the other CIS countries.
4 Some important issues related to investments in Russia

Historically, the productivity of investment has been at least as important for growth as the supply of capital or labour. Empirical studies indicate that typically less than half the growth in output derives from increases in capital and labour. The rest is the outcome of the improved productivity of both labour and capital resulting from better qualified labour (health, education, motivation), technical progress and the more efficient use of capital (World Bank 1989, pp. 29–30).

Public sector investments form a crucial part of any strategy to increase the general productivity of new capital formation in any country. Because of the importance of public sector investment, it is useful to survey some general trends in the developing countries.

In periods of rising government expenditure there has been a tendency, particularly in developing countries, to discriminate against other expenditures in favour of investment. This has partly been a result of an overemphasis on capital formation as a determinant of growth in standard growth theory. Thus, governments have been inclined to support, for example, the import of investment goods through overvalued exchange rates and low import duties. On the other hand, during recessions, for reasons of employment, current expenditures have got a more favourable treatment. However, because both investment and current expenditures can be equally important for the production of government services and economic growth, the authorities should judge them on their merits and abandon the preconceived notions such as expenditures classified as 'capital' are more important than expenditures not classified as such. (Polak 1989, pp. 91–92).

A tendency to discriminate in favour of investment expenditures was common in the former Soviet Union. This was reflected, for example, in the strong position of heavy industries and the enormous subsidies paid on the import of investment goods. Due to the transformation of the system and the deep economic recession in Russia, all government expenditures are now under pressure. Public sector investments have collapsed, but the situation in other sectors has also been very serious, which is illustrated, for example, by wage arrears problems. In the context of the ongoing debate on industrial policy in Russia, however, the division of government spending into capital and current expenditures poses another important set of questions. Bearing in mind the power of industrial lobbyists and the Soviet Union’s history of supporting
investment through low credits and favourable terms of import, there is a
danger that in the future capital expenditures will be given more
favourable treatment than current expenditures. Public sector policies
giving too much emphasis to capital formation could thus potentially risk
economic growth by endangering, for example, the quality of human
resources and R&D.

For the time being, however, the main concern in Russia is the
overall balance of the budget, since under the present circumstances any
expenditure increases could endanger the government's fiscal balance and
hence undermine confidence in financial markets. This could easily offset
the potentially positive impact of public sector measures on economic
growth by decreasing private sector saving or willingness to invest in the
Russian economy. At least in the current situation, any high profile
industrial policies involving large scale State investments would probably
be very risky because there is no clear basis to assess what kind of
strategy the country should follow. The State is also too weak to carry out
any sophisticated policies or to protect its own interests sufficiently, to
say nothing of problems related to financing these investments.

As stated above, although the impact of real interest rates on total
private sector saving is unclear, positive real interest rates support
financial forms of saving over other saving (e.g. durable goods, flight of
capital). Thus, there is a link between positive interest rates and
investments since positive interest rates promote forms of saving which
can be channelled into investments through financial intermediaries.
Thanks to their experience and information systems, i.e. know-how,
financial intermediaries are, on the whole, better than households at
selecting viable investment projects. Consequently, financial 'deepening'
resulting from an interest rate policy maintaining positive interest rates is
believed to promote growth, especially by improving the productivity of
investments. Interest rates also influence the productivity of investment
more directly. If nominal interest rates are lower than expected inflation,
investments tend to take rather unproductive forms (e.g. build up of real
estate and inventories), which are regarded as a good hedge against
inflation.\footnote{The favourable impact of positive interest rates on investment and economic growth has
been strongly emphasized by the International Monetary Fund and the World Bank (see the
IMF 1987 or the World Bank 1989). Positive real interest rates are therefore an important
focus in economic programmes supported by international financial organizations.}

There is empirical evidence to support the above arguments on
interest rates, financial 'deepening' and economic growth. According to a
study of 33 developing countries conducted by the World Bank, causation
runs from higher interest rates through financial 'deepening' to economic
growth (World Bank 1989, pp. 31–33). Thus, although the relationship between the investment ratio (investment/GDP) and growth of GDP is weak in general, investments in countries with positive interest rates are more productive than average. These findings should, however, be viewed with a measure of scepticism, because it is difficult to take into account other factors such as the general macroeconomic situation or the foreign trade system, both of which also contribute to economic growth.  

Figure 4 revealed that financial markets in Russia are still very tenuous. We may assume that, due to high inflation, negative interest rates and the high risks associated with banks, savers themselves invest a large share of their savings in a rather inefficient manner. Moreover, due to high inflation and difficulties in securing long-term finance in recent years, the volume of rouble debts sustained by the government and by private enterprises is, as yet, likely to be rather modest. Consequently, domestic indebtedness is not yet a serious threat or a reason to keep interest rates unduly low. Taking a positive view, then, there is a great potential for growth in Russian financial markets simply waiting for to be tapped.

Naturally, the quality of financial institutions and the financial intermediation system as a whole is essential for transforming financial savings into sound investments and economic growth. One important aspect of the quality of the whole financial system is its level of integration. In this sense, there are serious problems in Russian financial markets, because they are very fragmented. Fragmented capital markets have generally been found to be a major cause of inefficiency in the financial intermediation systems of developing countries (Polak 1989, p. 57). In Russia this problem has at least two dimensions. First, there is clear evidence that Russian financial markets are geographically fragmented, as transfer of funds from one region to another is difficult for local reasons (see article by Salonen in this volume). Furthermore, as Figure 5 shows, variance in interest rates in different regions reflects the regional fragmentation of financial markets. Second, the fact that many banks have been founded by industrial conglomerates presents a danger that funds will not be channelled into the most efficient investments as the owners may try to influence the credit decisions of these banks. As a

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7 At the end of 1994, the outstanding domestic debt of the public sector was less than 100 trillion roubles, or around 15 per cent of GDP.
result, we may assume that for some time to come, Russian financial markets will not be capable of efficiently channelling regional or enterprise level surpluses into areas where they could be put to the most profitable use.

Figure 5.  

**Regional fragmentation of Russian financial markets**  
- bank deposit rates in regions of Russia in April 1995  \(^8\)

1 = juridical persons  
2 = private persons

A  Northwest region  
B  Volga region  
C  Southern region  
D  Ural region  
E  Western Siberia  
F  Eastern Siberia  
G  Far East

Source: Tekuscie tendencii v denezhno-kreditnoi sfere, No. 8, 1995, Central Bank of Russia

Naturally, besides the above-mentioned factors, general financial stability is imperative for enhanced investment efficiency. High inflation is a deterrent to investment, as it shortens the planning horizon and makes relative prices more volatile. Regulated prices can also decrease the efficiency of investment if the prices do not reflect underlying

\(^8\) Average annual rates for 1–3 month deposits in commercial banks.
deficiencies in the economy. Furthermore, regulated prices can harm investment plans, because returns become vulnerable to changes in pricing policy. From this point of view, if we look beyond the financial markets, the liberalization of energy prices could alleviate uncertainty in Russian markets and support a climate conducive to investment. Incidentally, some progress have been made in this field during 1995, as energy prices have been raised closer to the world market price level.

Confusion prevails in Russia’s investment situation, and therefore its growth prospects are difficult to evaluate. According to official statistics, in 1994 the volume of investment declined 26 per cent to one third of the level recorded at the beginning of the 1990s. Another worrying problem is the low volume of direct investment from Western countries. On the other hand, overly simple interpretation of statistics (which are not entirely reliable as it is) can lead to an unduly pessimistic view of the situation. As mentioned before, during the Soviet era, the volume of investment was seen as a major engine of growth and, consequently, the price of investment goods and their financing were heavily subsidized. Naturally, this led to overinvestment, at least in the sense that the service sector was extremely underdeveloped, and productivity declined. According to some studies, the industrial sector in Soviet-type economies was one quarter to one third larger than in market economies at comparable levels of development (Winiecki 1995).

Due to market reforms, tougher budget constraints and the increased relative prices of investment goods, there is reason to believe that the productivity of current investment is much higher than during the Soviet era. Moreover, as shown in Table 2, despite the steep decline in officially recorded investments, the investment ratio (investment/GDP) in Russia is not exceptionally low, assuming that official statistics are genuinely indicative of current trends. It is particularly important to note that the share of inventory investments in GDP has declined sharply. This can be regarded as a positive development because inventories are in terms of economic growth a highly ineffective form of investment.

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9 Data on 51 developing countries, the average annual growth rates for which were 3–7 per cent during the period from 1965 to 1987, show that their average gross investment/GDP was 23 per cent. See World Bank 1989, p. 27, Table 2.1.
Table 2.  

<table>
<thead>
<tr>
<th></th>
<th>1992</th>
<th>1993</th>
<th>1994</th>
<th>1995&lt;sup&gt;10&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total investments</td>
<td>32</td>
<td>28</td>
<td>27</td>
<td>25</td>
</tr>
<tr>
<td>– fixed investments</td>
<td>20</td>
<td>22</td>
<td>24</td>
<td>21</td>
</tr>
<tr>
<td>– inventory investments</td>
<td>12</td>
<td>6</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: Goskomstat

Due to statistical problems, it is difficult to piece together a reliable picture of investment in Russia. Certainly, there are enormous problems in this area, but the whole picture is not necessarily as bleak as is commonly thought. Whatever the truth might be, the government will at any rate continue to play an essential role in future developments. For this reason, the government’s role in Russian financial markets warrants closer study.

<sup>10</sup> These figures are for the first half of 1995. There is strong seasonality in investment figures. The share of total investment in GDP in the first half of 1994 was 27 per cent.
5 The limits of the Russian government

Besides the narrow meaning of interventions in everyday monetary and exchange rate policy, there have been at least four broader motives for governments to intervene in financial markets. First, like other economic agents, governments use financial markets to finance expenditures exceeding their revenues. Second, governments use their power in financial markets to influence overall macroeconomic trends and, third, the volume and composition of investment. Finally, because a possible run on the bank and other special risks inherent to financial markets could potentially endanger the stability and functioning of the whole economy, governments intervene in the financial markets to guarantee that market agents behave prudently. Development of legislation and financial market regulation are therefore considered to be very important functions of the State.

As to the first motive, due to the special role of the State as an issuer of money, and in addition to related seigniorage revenues, the government can obtain funds directly from the Central Bank in the form of loans. Financing a public sector deficit by Central Bank loans is, however, extremely risky. If the increase in the money supply caused by this form of government lending is not neutralized by the Central Bank, it has to print more money to meet the government’s financing needs, which is likely to result in accelerated price inflation. Excess government borrowing from the Central Bank has been a severe problem in Russia. The Russian authorities have been forced to rely on direct Central Bank financing because the State has been running enormous deficits and there has been no other source to finance the budget deficit due to underdeveloped financial markets and lack of external financing. As pointed out earlier, this has fuelled inflation and severely disturbed the whole economy.

According to new legislation enacted in May 1995, the Central Bank of Russia is no longer allowed to grant direct credit to the government (see article by Laurila in this volume). However, the problem of the government’s excess involvement in loan markets persists, as the emerging Russian capital markets are dominated by government securities (see article by Gelman and Morozova in this volume). As a result government securities will potentially crowd out private enterprises in capital markets. Therefore, although government securities are important for the development of Russian securities markets, there is a
danger that excess issuance of government securities can potentially impede the further development of markets by crowding out banks and enterprises as borrowers in Russian capital markets. The best way to alleviate the situation in a sustainable manner is to improve the State's financial situation by cutting expenditures and increasing tax revenues.

As far as motive two is concerned, how effectively the authorities can manipulate economic activity by means of monetary and fiscal policy remains a source of ongoing dispute, even in developed countries. Problems arise, for example, from the difficulty of assessing the true state of the economy, to say nothing of making reliable forecasts, and from uncertainty related to market expectations and timing in monetary and fiscal policy. The current situation in Russia is even more complicated because its economy is in the grips of structural transition, rather than a normal business cycle recession, and all the key parameters of its economic policy are changing. Russia's own experience of recent years also demonstrates the limits of the authorities' capacity to promote economic activity. Even in the short run, it is impossible to halt a decline in production by keeping interest rates unduly low, or by extending excess credits. On the contrary, the 'short-termism' of the government's financial policies has undermined future growth prospects by accelerating inflation, delaying needed structural changes and increasing uncertainty in the markets. One might consequently argue that there is little scope for economic 'fine tuning' in Russia. Instead, all efforts should be focused on stabilizing financial markets to create a sound basis for a future growth.

The third motive, namely that of influencing the volume and composition of investment, is particularly interesting since it links together the debates on financial and industrial policies. The example of the Republic of Korea illustrates the main arguments because Korea and the financial and industrial policies of Korea have often been held up as a potential model for Russia. The annual growth rate of the Korean economy since 1965 has averaged around 9 per cent. At the same time, almost every aspect of finance, including access to the banking sector, the determination of interest rates and the allocation of credit, have been heavily regulated by the government. The fact that this heavy government intervention in financial markets has coincided with rapid economic growth has led to the assumption that the Korean model could be good for Russia as well. However, this argumentation often fails to recognize that the Korean example does not necessarily indicate that government intervention is the key to rapid economic growth. Indeed, one might preferentially argue that economic growth could have been even faster under a more liberal financial regime. Moreover, although a policy of heavy government intervention has perhaps proved successful in the
East Asian countries, interventionist policies in Latin America have been much less successful, in many cases verging on disastrous (Jaramillo-Vallejo 1994).

It would thus seem that heavy government intervention in financial markets is not a key per se to rapid economic growth. Moreover, we might look at things the other way around and ask whether there is something special about Korea whereby heavy government intervention has no adverse impact on economic growth. A closer look at the Korean example reveals that, besides factors such as cultural differences there is indeed an enormous difference between Korea and today's Russia. This applies particularly to economic management. In Korea, as elsewhere in rapidly growing East Asian countries, the authorities have managed to impose strict and monitorable performance standards in exchange for subsidized loans. Thus, Korea has avoided many inefficiency problems related to their repressive financial system, because exports have been the main criteria for bank loans. Accordingly, most of the loanable funds have been allocated to export firms which, due to international competition, are likely to be more efficient than those firms operating only in domestic markets (Park 1994). To succeed, however, this policy has required a high degree of State autonomy. In Korea, this autonomy has been reinforced by the relative weakness of industrial and agrarian interest groups. (Amsden 1993, pp. 78–80).

As already pointed out in reference to public sector investments, the situation in Russia is fundamentally different. There the State is too weak to set up and push through any sophisticated industrial policies. This weakness derives from an incompetent State bureaucracy, strong regional powers and very strong industrial and agrarian, as well as some financial, interest groups. There is also no consensus as to what kind of industrial policy should be followed. Moreover, in the face of all these shortcomings, if Russia were still to follow the Korean example, what kind of performance criterion would apply in exchange for subsidized loans? One can only speculate as to whether export performance would be seen by the Russians as too restrictive a criterion and, hence, whether there would be a real danger of the whole idea of the performance criterion collapsing. In summary, then, there seems to be no cause to believe that the Korean model would work in Russia too.

Moreover, financial systems in which the government is extensively involved have also proven to be very vulnerable to corruption, and in Russia this problem seems to be imminent. Because of the Soviet legacy – a poor legal system and a confused tangle of red tape and regulations – Russia is said to have one of the most corrupt bureaucracies in the world. For example, authorities have been reported to collect 13 per cent of
loans directed to commercial banks and State-owned enterprises as bribes (Cohen 1994). Although the reliability of information on actual cases might be dubious, it is difficult to deny that the problem itself is very acute.

There is doubt as to whether the government is capable of influencing economic development through demand management and industrial policies. Consequently, what is to be regarded as the right level of budget deficit is another contentious issue. Indeed, the role of the government is one of the most controversial issues concerning economic policy in transition economies.\(^{11}\)

Although consensus on the first three motives for the government intervention is hardly to be expected, regarding the fourth motive there is widespread agreement that the State should strengthen legislation and improve supervision of financial markets. Here, too, there are two main ways of going about it. First, reliance on intensive use of government controls and regulations and, second, making use of markets rather than regulations to urge financial institutions and agents to behave prudently. There are, however, reasons to believe that leaning on direct regulations and government intervention in financial market policies is not the best way to guarantee the operation of financial markets in Russia. This assessment is based on various factors. Besides questions related to the capacity of the State and the threat of corruption, it should be noted that, in practice, controls on Russian financial markets have been fairly lax, and they partly already operate under a very liberal regime (e.g. interest rate policy, existence of the unofficial sector). The agents have thus already learnt how the market works and how to avoid regulations. This, together with the fact that financial markets outside Russia have already largely been liberalised, could make it extremely difficult, if not impossible, to reverse the more liberal trend. As a result, there is cause to believe that financial market supervision and prudential policies in Russia should harness market incentives rather than bureaucratic power in order to urge financial institutions and agents in the financial markets to act prudently. Moreover, one should focus on measures and regulations that can be enforced with ease and precision (see Laurila in this volume on development of banking legislation and banking supervision in Russia).

Deposit insurance in particular has thus far failed to motivate the Russian government to intensify efforts to monitor and regulate banks, because the State-owned Sberbank is the only commercial bank whose

\[^{11}\] International financial organizations are usually seen as representing a rather liberal approach, where the role of markets, rather than the government, is emphasized in economic development. For a critical assessment of this approach, see Amsden, Kochanowicz and Taylor 1994.
deposits are guaranteed by the government. However, current and
anticipated bank closures and the consequent threat of bank runs and
major financial crises will intensify discussion on the role of the State as a
guarantor of deposits in other banks, too. On the other hand, at least
during the initial stages of transition, potential financial crises are not
likely to be as disastrous as they would be if there were an extensive
deposit insurance system. This is because in the present system financial
crises are not as likely to generate fiscal crisis and, therefore, spill over
into other sectors and cause general economic distress. This is
demonstrated by the experiences of other transition economies. Thus, the
development of a deposit insurance system based on State guarantees is
perhaps not the most urgent matter the authorities should focus on in
Russia. Bearing in mind how difficult it is for the government not to
intervene when something disastrous happens,\(^\text{12}\) and considering how
difficult the fiscal situation is, there is clearly a need to clarify what kind
of commitments the government currently has, and perhaps to reduce
them, for example, through privatisation, rather than taking on more
responsibilities.

\[^{12}\text{A relevant example is the debate concerning the State's responsibility to compensate for losses on savings, which resulted from price liberalization and subsequent high inflation at the beginning of 1992. In May 1995, the Duma passed a law according to which the State has to pay savers compensation. How this law is to be applied in practice is still unclear.}\]
6 Conclusions

If the government intervenes heavily in the financial market, the economy is said to be financially repressed. The typical features of such repressed financial markets are negative real interest rates on bank deposits, a system of directed and subsidized credits, high reserve requirements on bank deposits and high taxes on the financial sector. A repressed financial system, together with persistent high inflation, reduces incentives to hold domestic monetary assets. Consequently, a smaller proportion of savings would be intermediated through the banking system. The subsequent fragmentation of the financial market would be likely to cause various unfavourable consequences for the quality and quantity of investments (see McKinnon 1991, pp. 11–12): (i) As the level of financial savings falls, potential borrowers have to rely increasingly on self finance; (ii) If the yield on bank deposits is negative, repressed financial markets also beleaguer self finance because, instead of accumulating liquid assets, economic agents have to consider forms of saving which offer a better hedge against inflation; (iii) The availability and terms of bank lending becomes more dependent on factors which do not necessarily contribute to more efficient use of savings; (iv) A repressed banking sector potentially holds back the development of capital markets through hazards related to illiquid firms or high inflation; (v) Repressed financial markets could risk the availability and efficient use of foreign savings. These arguments and findings form the core of the so-called financial repression paradigm.

The financial repression paradigm hinges on two important and interrelated factors, namely strong government involvement in financial markets, i.e. heavily regulated financial markets, and the concomitant high inflation. According to the financial repression paradigm, both factors contribute negatively to economic growth. Although the role of government in financial markets and the prudence of financial liberalisation is still an unresolved issue, the role of high inflation is quite clear. Both theoretical and empirical findings strongly support the theory that high inflation is detrimental to economic growth (see, for example, Akyüz 1993, Dornbusch and Reynoso 1989, Fischer 1993, Barro 1995).

As argued in this paper, Russia is no exception to the rule when it comes to the effects of high inflation. In Russia, it is difficult to name any institution, operation or trend that is unaffected by high inflation. Thus, it should be eminently clear that curbing inflation is Russia’s number one economic priority.
The financial repression paradigm also helps to identify problems related to the role of the government and the regulation of financial markets, although the beneficial effects of financial market liberalisation are still under debate. Indeed, Russian financial markets in many respects meet the criteria of a repressed financial system, and there are all-too-obvious examples of the aforementioned negative implications related to market fragmentation and the lack of financial 'deepening'.

Moreover, to overcome problems in financial markets, there are sound reasons why the Russian government should use policies and regulations which are relatively easy to carry out, and rely on market incentives rather than measures which are based on bureaucracy and heavy direct regulation. There are two main reasons for this. First, the State itself is very weak and, therefore, it is extremely doubtful that it could effectively carry out any sophisticated policy packages. Many of the factors which contributed to the failures of government intervention in other countries are also endemic in Russia. For example, the quality of economic data is poor, the State bureaucracy lacks experience, corruption is widespread and, perhaps most importantly, the industrial and agrarian lobbyist are very powerful. A second important factor which should be taken into account in reference to the Russian financial markets is the baseline operating environment. In fact, the situation in Russia is rather vague, as markets and institutions have mushroomed and a substantial share of the markets already operates under a rather liberal regime. Moreover, the agents have already learnt how the markets function and how to bypass regulations. Thus, although there is an urgent need to improve the legal and regulatory environment in Russia, it would be extremely difficult, costly and inefficient to return to a system based on direct controls and heavy regulation. The recent history of financial market policies and developments in Russia is the best proof of this.
References


Monetary Policy in Russia

by Glenn Hoggarth

Contents

1 Introduction ....................................................... 55
2 The monetary transmission in Russia ....................... 57
3 Policy instruments ............................................. 61
4 Intermediate monetary targets ............................... 66
   4.1 Quantity theory of money ................................ 66
   4.2 Trends in the velocity of money ....................... 67
       4.2.1 Structural change of the banking system ...... 68
       4.2.2 Macroeconomic stabilisation .................. 69
   4.3 Time lags from money growth to inflation .......... 75
5 Conclusions ..................................................... 77

References ......................................................... 79

Appendix .......................................................... 81

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1 Centre for Central Banking Studies, Bank of England. Although I would like to thank my colleagues for helpful comments, the views expressed in this paper are my own and not necessarily those of the Bank of England.
1 Introduction

The current view of almost all central banks is that the key purpose of monetary policy is to maintain either the internal or external stability of the currency. In the domestic economy this means to reduce and then keep inflation at low (in principle zero) rates. Although governments sometimes think there is a choice between either low inflation and low output or high inflation and high output, this appears to be at best a choice for the very short run. The evidence across many countries suggests that over long periods, higher inflation is associated with lower not higher economic growth.\(^2\) Also, since the breakup of Comecon, transitional economies with the largest increases in prices have tended to be those which have witnessed the largest, rather than smallest, reductions in output.\(^3\)

But central banks cannot directly control the inflation rate. In fact it is difficult for them to trace the effect of changes in monetary policy on inflation through the economy. So often they adopt an intermediate monetary target to guide policy decision making. Under a regulated banking system, intermediate money targets can be reached directly by imposing credit ceilings on the banking system.

Financial liberalisation requires the government and central bank to hand over some control for the path of interest rates, the exchange rate, broad money and credit to the private sector. This makes the central bank's job in conducting monetary policy more difficult.

It is ironic that, in the short run at least, it is easier to control broad money, credit and the banks' interest rates under a command system than a market based one. However, such controls not only reduce the competitiveness of the banking system but over time financial activity will occur in the unregulated grey sector, implying that control over total

\(^2\) Fischer (1993) shows empirically for a sample of 80 countries over the 1960–1990 period that lower inflation is associated with higher economic growth. Barro (1995) also shows for a sample of about 120 countries that there is a significant association between low inflation and high economic growth. The evidence is clearest at inflation rates over 10%–20% per annum.

\(^3\) For example, see Chart 22 in the IMF World Economic Outlook, October 1994. In principle, this negative association between output and prices could imply that the causation runs from lower output to higher prices rather than from looser monetary policy and higher prices to lower output. For this to have been the dominating effect would require that transitional countries have faced markedly different adverse structural impacts on their output. It is not immediately obvious why this should have been the case.
financial activity will be more apparent than real. Liberalisation also offers large potential gains to the economy from a more competitive banking system, the mobilisation of savings and more productive investment.

In a liberalised economy, policy makers often adopt a two-step approach to controlling inflation. First, they change their policy instruments to influence general monetary conditions, such as the growth of M2 and total credit. Secondly, they predict how monetary conditions – the intermediate target – affect price inflation – the final goal of monetary policy. Both of these two stages are complicated by the process of liberalisation. Control of money and credit growth through policy instruments is not precise while the relationship between broad money and credit growth and inflation may be unstable. These issues are discussed below in relation to Russia’s recent experience.
The monetary transmission in Russia

The schematic diagram below shows the monetary policy framework facing the Central Bank of Russia (CBR). The instruments of policy – the growth of credit supplied by the CBR and its price (short term lending rate) – affect the inflation rate through a number of possible channels. Potentially, at least, broad measures of the money supply and the exchange rate may be useful intermediate indicators of the inflation process. Higher CBR credit growth and lower CBR interest rates should increase the growth of credit and money and reduce lending rates of the whole banking system. These in turn should increase expenditures in the economy (eg wages) and thus inflation. Higher credit growth and lower interest rates may also result in a faster depreciation of the rouble. This increases import price inflation, in terms of roubles, which would feed through to a general increase in cost and price inflation.

The lines in Figure 1 represent the significant links that I have estimated in Russia between instruments, intermediate targets and the final policy goals, based on recent data (albeit with a limited number of observations). The bold lines in the figure show where a relationship is strong (accompanied by the length of the monthly lag) while a dotted line shows a weaker relationship. The direction of effect (+ or –) is also shown. The starting point (1992M5) is after the period of very high inflation following price liberalisation in January 1992. The period has been split into two parts – broadly in the middle (1993M10) – after which date monthly inflation was consistently below 20 per cent.4

In the earlier period (1992M5–93M10), an increase in the growth of CBR credit is found to lead to, in a statistical sense, both higher broad money growth and inflation. Part of the monetary channel appears to have worked through the exchange rate since there is a strong link during this period between changes in rouble depreciation and inflation 3 months later. Short term interest rates, on the other hand, do not appear to play a significant role in the transmission of monetary policy.

4The statistical method used is described in the appendix. A 'strong' relationship is measured by a goodness of fit (R-bar squared) greater than 0.4. A 'weaker' relationship means an R-bar squared between 0.2 and 0.4. Due to the length and quality of the data one should treat all the estimation results in this paper tentative. The test statistics are reported in the appendix.
In contrast, in the latter period (1993M11–94M12) there are strong negative links running both from changes in the growth in CBR credit to short term nominal interest rates and from changes in short term nominal interest rates to inflation.\(^5\) This may reflect the growing importance of financial prices – interest rates – in the transmission of Russian monetary policy as the market plays a larger role. The one month lead between credit growth and interest rates is suggestive that from about the middle of 1993, when the IMF stand-by facility started, a deliberate policy tightening was enacted through a reduction in the quantity of the supply of credit which, for given demand, resulted in higher interest rates.

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\(^5\) The link would be expected to be from real interest rates – nominal interest rates minus expected inflation over the period of the loan – and future inflation. Using both actual monthly inflation and the average inflation rate over the previous three months as measures of inflation expectations, I did not find strong links here. This may be attributable to the difficulties in measuring expected inflation.
This increase in interest rates appears to have resulted in lower inflation after a 5 month lag. It also appears to have reduced real output, at least on the official measures. As shown in Figure 2, the increase in interest rates in the second half of 1993 appears to have been followed after a few months lag by both lower output growth and inflation. Similarly the reduction in interest rates in mid–1994 is followed towards the end of 1994 by less negative output growth and higher inflation.

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6 The output measures are the 12 month growth of real GDP and industrial production. Output growth is measured on an annual basis to avoid the problem caused by monthly seasonal movements. It probably does not capture accurately the growth in private sector output.

7 The respective R-bar squares over the 1993M11 – 94M12 period are as follows: CBR rate lagged 3 months and industrial output growth –0.80, CBR lagged 3 months and real GDP growth –0.36, industrial output growth lagged 1 and 2 months and inflation 0.86, real GDP growth lagged 1 and 2 months and inflation 0.63, and CBR rate lagged 5 months and inflation –0.78.
The positive relationship between interest rates and broad money may reflect the difficulty in reducing broad money growth in an economy undergoing financial liberalisation. Since financial liberalisation allows the banks to increase their customer deposit rates along with other interest rates, it reduces the sensitivity of M2 holdings to the general level of interest rates. As shown in Figure 3, bank deposit interest rates in Russia followed the upward movement in lending rates from mid-1993, thus making deposits, which account for about two-thirds of total rouble M2, more attractive to hold.

The role of policy instruments and intermediate money targets in Russia are discussed, in turn, in more detail below.
3 Policy instruments

In Russia, the CBR has sought increasingly since mid-1993 to provide the quantity and price of its own credit which is consistent with the final economic goals of policy, particularly low inflation, and gradually to introduce monetary instruments which complement, as much as possible, financial market competition.

As shown in Figure 3, in order to reduce inflation, short term interest rates were increased to positive real rates in 1994 from large negative rates in 1992. Increasingly too CBR loans have been provided at market interest rates applied uniformly to all borrowers. Since April 1994 the CBR refinance rate has been kept above the interbank reference rate, and the scale of directed credits has been reduced sharply, with subsidies now provided via the budget rather than the CBR. Credit auctions were also introduced in Russia in February 1994, initially on a regional basis, and from July 1994 on a centralised basis. At the auction, commercial banks compete with each other for the limited available quantity of credit at interest rates of their own offerings.8 Auctions occur on a monthly basis providing credit for up to 3 months. These auctions accounted for 17 per cent of all new CBR credit in the first half of 1994.

From the beginning of this year the CBR has been committed not to provide any new directed credits. Similar to many other countries, the CBR is also proposing to introduce rediscount and Lombard facilities, which will place respectively a floor and ceiling on CBR lending rates. The rediscount rate will be available for private sector bills of suitable quality, for a maximum of 3 months. Lombard credit is planned to be available as a lender of last resort facility providing loans up to a 1 month period for banks facing short term liquidity shortages. These funds will be charged at a penal rate.

All the CBR rates – rediscount, refinance and lombard – will be set at or above the interbank market rate for comparable securities and above the banks' customer deposit rates. The purpose is to encourage households and enterprises to borrow and lend to each other using banks as intermediaries and to encourage banks to use the central bank as the lender of last resort rather than the lender of first resort. Investment in the economy will then be financed by higher savings from individuals (and foreigners), intermediated through the banking system, rather than through central bank money creation.

---

8 The CBR uses the refinance rate as the lower limit on lending rates it is prepared to accept at the credit auction.
Whereas the CBR has made a number of changes to provide liquidity indirectly, and on a market basis, it has at present only a limited number of instruments to remove liquidity should it judge that there is an excess amount in the banking system. This has become an important issue during 1995 following a sharp capital inflow induced increase in banks' correspondent accounts. In the past, reserve requirements has been an important monetary instrument at the CBR's disposal. Commercial banks have to hold a fixed percentage of their liabilities as non-interest bearing deposits at the CBR. These requirements are based on the previous month's liabilities and are then frozen at the CBR over the following month. This percentage varies depending on the type of deposit. The current reserve requirements are 20 per cent on rouble deposits of less than 30 days maturity, 14 per cent on rouble deposits of 30–90 days maturity, 10 per cent on rouble deposits over 90 days maturity and 1 1/2 per cent on foreign exchange deposits.

(Non-remunerated) reserve requirements are a tax on the banking system and are also difficult to change quickly and frequently. Because of this, most western countries, and now increasingly many countries in the former command economies of eastern Europe, use transactions in marketable securities as their main instrument to reduce banks' liquidity. In the primary market, this is done through the issue of new bills. In Russia, for example, banks purchase bills at the Treasury bill (GKO) auction through running down their excess deposits (correspondent accounts) at the CBR, therefore reducing the banks' ability to lend money to enterprises and households. More usually, once a sufficiently deep market has developed, bill operations occur in the secondary market through the central bank making outright sales (or purchases, at market interest rates, if it wants to provide liquidity) of existing stock on its own balance sheet or temporary sales with the commitment to repurchase the bills at a future date (reverse repos).

In Russia, primary auctions of Treasury bills were first introduced in May 1993. Presently, bills are sold at weekly auctions in varying maturities from 3–12 months. Treasury bill are mainly regarded as a vehicle to finance the government's budget deficit rather than an

---

9 Of course, it could reduce the size of the credit auction which would gradually over time reduce the stock of outstanding credit as credit is repaid to the CBR.

10 This will reduce liquidity in the economy so long as the government leaves the proceeds from selling GKO bills as deposits at the CBR rather than using the money to finance still higher government expenditures.

11 The secondary market offers central banks more flexibility in the size and timings of their monetary operations.
instrument to be used to flatten out short term variations of liquidity in the banking system. However, these auctions – which became materially significant from the last quarter of 1994 – have helped to reduce the money supply indirectly, since the more the government's deficit is financed through Treasury bill sales, the less it is financed through the central bank printing money and lending to the government.

Nonetheless, at the end of 1994, the stock of Treasury bills held outside of the CBR still only accounted for around 15 per cent of the monetary base and 10 per cent of rouble M2. Consequently, more than three-quarters of the burgeoning enlarged government budget deficit in 1994 was financed from the central bank. Although total new CBR credits have fallen sharply in relation to GDP since 1992, this cutback has been confined to other CIS republics, to whom new credits were discontinued in July 1993, and to the commercial banks (see Table 1). In contrast, and reflecting the growing budget deficit, new CBR credit to government grew as a share of GDP in the first nine months of 1994 and accounted for more than four-fifths of total new CBR credits.

Table 1.  

<table>
<thead>
<tr>
<th></th>
<th>1992</th>
<th>1993</th>
<th>1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial banks</td>
<td>39</td>
<td>35</td>
<td>20</td>
</tr>
<tr>
<td>Government ¹</td>
<td>37</td>
<td>51</td>
<td>79</td>
</tr>
<tr>
<td>CIS Republics</td>
<td>24</td>
<td>14</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td><strong>Memo: Total % of GDP</strong></td>
<td>36</td>
<td>11</td>
<td>12</td>
</tr>
</tbody>
</table>

¹ Ministry of Finance, non-federal government and extra-budgetary funds.


The ability of the CBR to reduce the money supply through selling Treasury bills from its own balance sheet (ie through secondary market operations) is less potent still. At the end of 1994, the stock of marketable government securities held by the CBR equalled 3 per cent of the monetary base and less than 2 per cent of rouble M2.

¹² The monetary base is defined here as the issuance of cash roubles plus required reserves deposited at the CBR and excess reserves at the CBR (correspondent accounts).
During 1995 Treasury bills are anticipated to become more important as a monetary instrument. Under the March 1995 IMF stand-by arrangement, the plan for 1995 is to eliminate altogether direct financing of the federal budget deficit from the CBR and reduce financing of the enlarged budget deficit to 40 per cent of the deficit (2.7% of GDP). The share of the enlarged budget deficit financed by Treasury bill sales is anticipated to be more than two-thirds in 1995, compared with 25 per cent in 1994 and zero in 1993. Also, the CBR plans to begin repo operations in Treasury bills by the end of 1995.

Increasingly, over time, as the Treasury bill market expands, bill operations are likely to become the centrepiece of monetary operations in Russia. In the meantime, one additional instrument which the CBR plans to use to withdraw liquidity is deposit auctions. These work in exactly the opposite way to credit auctions (without the credit risk for the central bank). Here the CBR asks banks to bid the amount and interest rate at which they wished to deposit money at the CBR. The CBR stacks up the offers, starting at the lowest interest rate, until it has reached its target for liquidity withdrawal.\(^\text{13}\)

All these instruments mean that, in the first instance, the CBR acts to affect the monetary base (B) – the CBR's own liabilities – and short term interest rates. These in turn affect the quantity and interest rates of the banks' lending and deposits and therefore the spending behaviour of enterprises and households. In principle, if the ratios of the banks' reserves at the CBR to their own deposits liabilities (R/D) and currency issued to their deposits (C/D) are constant then any increase in the monetary base will be reflected in fixed multiple expansion of broad money (M) – the so-called money multiplier (m) will be constant.\(^\text{14}\) In such a situation the central bank's job is quite straightforward. As long as it knows the effect of changes in policy instruments on its own balance sheet, it will know with precision the effect on the banking system as whole. For example, an increase in the obligatory reserve ratio (R/D) would have a predictable contractionary effect on broad money. In practice, the money multiplier is often not stable or predictable and is affected by the process of financial liberalisation (see later).

\(^{13}\) Both the Bank of France and the National Bank of Denmark, for example, have used central bank deposits as an instrument to affect banks' liquidity.

\(^{14}\) If broad money $M=C+D$ and the monetary base $B=C+R$ then the money multiplier

\[
m = \frac{M}{B} = \frac{C+D}{C+R} = \frac{(C/D) + 1}{(C/D) + (R/D)}.
\]
The discussion above suggests that the usefulness of intermediate broad money targets in guiding future inflation in Russia need to be examined independently of the monetary base.
4 Intermediate monetary targets

4.1 Quantity theory of money

The quantity theory of money provides, seemingly, a straightforward framework in which to use intermediate broad monetary targets. By identity, this shows that the stock of the money supply (M), multiplied by the speed it moves around the economy (velocity, V), equals output measured in current prices (PY).

\[ MV / PY \]

If real output (Y) can be assumed to be determined by the supply side of the economy – the amount and productivity of the labour force, capital equipment, land and technology – and velocity (V) is stable, then the theory implies that changes in the money supply will be fully reflected in changes in prices (P). In a dynamic context, this means that changes in monetary growth will be fully reflected in changes in the inflation rate (money is neutral in its affect on real output).

Using this framework, the intermediate monetary target can be made operational by the following steps (i) set a desired final target for future inflation (ii) estimate the underlying growth of real output and (iii) predict the future trend in velocity growth. This will yield an intermediate target for money supply growth consistent with the final target for inflation. This type of framework is used by the Bundesbank when it sets its intermediate broad money targets to guide future inflation. In Russia too, as indicated in Figure 1, there appears at first sight to have been a strong relationship between rouble M2 growth and future inflation in recent years (although, as discussed later, this relationship appears to have changed recently).

However, there are a number of practical difficulties with the quantity theory framework. In particular it is difficult to measure M and Y (and therefore V). It is also difficult to predict velocity, even if it can be measured.

It is unclear from theory which is the appropriate measure of the money supply. Theory suggests it should be the measure most closely related to transactions money. But is this M1, M2, inclusive or exclusive of foreign currency and inter-enterprise arrears? In economies where there is little confidence in the domestic currency, foreign currency is used as a means of payment, to some extent, as a substitute for the
domestic currency. But some foreign currency is held as a financial hedge against inflation rather than to pay for transactions. In such 'dollarised' economies it can be argued that, in principle at least, foreign currency notes used for transactions should be included in the money supply aggregate. Prior to legislation banning foreign currency as a means of payment in January 1994, anecdotal evidence suggests that US dollars were used extensively for transactions in Russia. But in practice there are no accurate figures, certainly not on a time series basis, on dollar circulation in Russia. In a number of transitional economies the effect of monetary policy changes may also have been moderated by changes in interenterprise arrears. The effects on inflation of a reduction in the growth of banking system money and credit may be muted by an increase in interenterprise debt or by a lengthening in debt contracts. Gavrilenkov (1994) attributes a large part of the rise in rouble M2 velocity in Russia in 1992 to a sharp increase in enterprise arrears which maintained nominal expenditures. This would suggest perhaps that interenterprise arrears – if they can be accurately measured – should be added to conventional measured of the money supply.

Second, trend, or potential, real GDP is difficult to measure, particularly over short periods, and particularly, as in the case of Russia, when the economy is undergoing a dramatic structural adjustment.\textsuperscript{15}

The velocity of circulation too can be erratic, particularly over short periods and again is likely to be affected by financial liberalisation. The time lag between changes in monetary growth and its effect on inflation may also change over time.

These problems mean that over the time horizon of most concern to policy makers, say 2 years, and in an environment of marked structural changes to the real and financial economy, monetary policy may affect real output and the velocity of circulation – even if it can be measured – may be unpredictable. This is the situation presently facing Russia. Under these circumstances the relationship between intermediate money targets and inflation may not be reliable.

4.2 Trends in the velocity of money

Experience in other countries suggests that after a big initial rise following price liberalisation, the velocity of broad measures of money is likely to fall during transition, but not necessarily in an easily predictable

\textsuperscript{15} Even actual output is difficult to measure in present circumstances in Russia because of the problem in collecting data on the growing private sector.
way. There are two main, but interrelated, reasons for this (a) structural change of the banking system and (b) macroeconomic stabilisation.

4.2.1 Structural change of the banking system

Liberalisation of quantity restrictions usually results in more lending and deposits for those banks which were previously controlled. Financial activity which previously occurred in the informal banking sector switches back to the formal or measured sector. This portfolio shift alone does not affect total (formal plus informal) financial sector lending and deposits or prices and economic activity in the economy. It does, however, increase measured formal sector lending (domestic credit) and borrowing (M2) relative to prices and activity. Over time, it is also likely that financial liberalisation will increase total financial sector activity. An increase in competition between banks may result in more competitive (higher) bank deposit rates. This would encourage higher savings in M2 and probably in the economy as a whole.

These factors have resulted in a decline in broad money velocity in many countries in both the developed and developing world which have liberalised their financial markets (see Figure 4).

Figure 4. Velocity of broad money\(^1\) (1980=100) by selected countries facing financial liberalisation

![Graph](image)

<table>
<thead>
<tr>
<th>1</th>
<th>China</th>
<th>4</th>
<th>Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>United Kingdom</td>
<td>5</td>
<td>United States</td>
</tr>
<tr>
<td>3</td>
<td>Australia</td>
<td></td>
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</tr>
</tbody>
</table>

1) M2 for United States, Canada and China; M3 for Australia; M4 for United Kingdom
4.2.2 Macroeconomic stabilisation

In addition to structural change, the previous command economies of eastern Europe and the former Soviet Union are undergoing macroeconomic stabilisation programmes. Following very rapid inflation rates, many of the transitional countries have tightened monetary (and fiscal) policies to reduce and then stabilise inflation. For those countries which have been successful, this has increased the financial attractiveness of savings and generally increased confidence in domestic currency assets (see Figure 5).

Figure 5. Broad money velocity in Poland, Czech Republic, Hungary, Slovenia and Russia in 1991 – 94

 Enterprises and households are more willing to hold domestic broad money at lower and more stable rates of inflation because money is expected to maintain its value better compared with other inflation-protected assets such as consumer goods and foreign currency. In Russia, just as the high rates of inflation during 1992–93 reduced holdings of rouble M2 relative to prices and GDP, the reduction of inflation and move to positive real interest rates in the first half of 1994 and again in the first half of 1995, increased the demand for broad money relative to nominal GDP and velocity fell (see Figures 2 and 5).
In an environment of lower inflationary expectations, a larger share of the stock of real broad money will likely be willingly held for savings purposes rather than held temporarily ready to spend. Other than in the very long run, this means less of the money supply will affect future prices.\textsuperscript{16} If the monetary authorities do not allow for this eventuality, there is a danger that their policy actions, based on intermediate monetary targets may destabilise rather than stabilise the macroeconomy.\textsuperscript{17} In periods of rising inflation, monetary growth may understate the inflationary overhang and policy actions based on money targets may be too loose. In contrast, as low inflation is established, money growth may overstate the future inflationary threat. If no allowance is made for this shift increase in the demand for money policy may be excessively tight.

This shift in the money growth-inflation relationship appears to be evident from recent Russian experience. I say 'appears' because the estimated results discussed below are based on a very limited data set, implying that the results should be treated with a fair degree of caution. Bearing this caveat in mind, Figure 6 below shows the monthly rate of inflation in Russia between early 1992 and the end of 1994 compared with a prediction based on an equation comprising of past monthly rouble M2 growth and the rate of inflation in the previous month.\textsuperscript{18} Such a relationship can explain around three-quarters of the movement of inflation over this period. To the extent the observed relationship between past money growth and present inflation is causal, it may reflect, as pointed out by Fischer, the affect of higher money growth on rouble depreciation and the affect of higher bank credit growth on state sector wages.\textsuperscript{19} For this three year period taken as a whole, past monetary growth is significant at lags of 3 and 4 months.\textsuperscript{20} There is no evidence of money growth affecting inflation in less than 3 months and little evidence of an impact beyond 4 months.

Alternative measures of the money supply provide qualitatively similar results. With, cash I found that the most significant lags occur at 6

\textsuperscript{16} Savings made today will eventually be spent in the very long run.

\textsuperscript{17} See Dornbusch and Simonsen (1988) in the references.

\textsuperscript{18} As shown in Table 2, the affects of changes in monetary growth on inflation are smaller when the lagged dependent variable is excluded. However, with this exclusion the relationship shows signs of misspecification. This may suggest that it takes time for the total impact of monetary changes on inflation to pass through.

\textsuperscript{19} See Fischer (1994) in the references.

months, and particularly 3 months, and the fit of inflation is slightly worse than when using broad money. Koen and Marrese found no difference to their qualitative result, that money growth preceded inflation by about one quarter, by adding their own estimate of inter-enterprise arrears to rouble M2.

As shown by the gap between actual and fitted values in Figure 6, however, there is some evidence that the equation based on past rouble M2 overpredicts actual inflation in the first eight months of 1994. A possible reason for this overprediction becomes clearer when the sample is broken into two sub-periods. Table 2 and Figure 7 show the preferred equations in the two periods 1992M5–93M10 and 1993M11–94M12. The results suggest, albeit based on a limited number of data observations, that the relationship between past money growth and inflation changes between the two periods. The equation estimated over the earlier sample period suggests that a 1% point increase in monthly rouble M2 growth adds 0.85% points to future monthly inflation. This relationship (fitted1) tracks actual inflation well over this period. But as shown in Figure 7, the (dynamic) forecast from this relationship – the line 'predicted' in the figure – overstates inflation, and thus understates real monetary growth, during the disinflationary period in the first three quarters of 1994. Monetary policy based on such a relationship would, therefore, overstate future inflationary concerns.

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21 Koen and Marrese, found a similar result using a number of different measures of the money supply.
Figure 6.

**Inflation actual and fitted**
(based on past rouble M2 growth)

1  Actual
2  Fitted

1) Fitted = 0.37+0.17 M2 growth_{t-3}+0.15 M2 growth_{t-4}+0.65 inflation_{t-1}

Figure 7.

**Inflation actual and fitted**
(based on past rouble M2 growth)

1  Actual
2  Fitted 1
3  Fitted 2
4  Predicted (from fitted 1)

1) Fitted 1 = 2.7+0.16 M2 growth_{t-3}+0.31 M2 growth_{t-4} +0.44 inflation_{t-1}
2) Fitted 2 = 1.5+0.23 M2 growth_{t-6}+0.57 inflation_{t-1}
Figure 8.  

**Inflation actual and fitted**  
(based on past rouble M2 growth)

![Graph showing inflation actual and fitted over time]

1 Actual  
2 Fitted 2 (see Figure 7)  
3 Predicted (from fitted 2)

Table 2.  

<table>
<thead>
<tr>
<th>Sample period</th>
<th>Average monthly inflation rate(%)</th>
<th>% point impact on inflation rate of a 1% increase in past monetary growth</th>
<th>Significant lag length (months)</th>
<th>Equation’s fit (R-Bar-Squared)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992M05–94M12</td>
<td>17 1/2</td>
<td>0.94 (0.64)</td>
<td>3, 4</td>
<td>0.71 (0.36)</td>
</tr>
<tr>
<td>1992M05–93M10</td>
<td>20</td>
<td>0.85 (0.55)</td>
<td>3, 4</td>
<td>0.61 (0.43)</td>
</tr>
<tr>
<td>1993M11–94M12</td>
<td>10 1/2</td>
<td>0.55 (0.31)</td>
<td>6</td>
<td>0.69 (0.31)</td>
</tr>
</tbody>
</table>

Results for equation excluding lagged inflation shown in parentheses.  
See appendix for full description of the equations.

Table 2 suggests that during the period of falling inflation, changes in monetary growth have a smaller quantifiable impact on future inflation – a 1% point increase in M2 growth is estimated to add only 1/2% point to future inflation over this period. The time lag from M2 growth to inflation is also estimated to have increased from 3–4 months to 6 months (see later). This relationship – fitted 2 in the figure – more closely tracks
actual inflation in Russia during 1994.\textsuperscript{22} As shown in Figure 8, fitted 2 accurately predicts the return of monthly inflation to single digit rates during the first half of 1995.

This smaller quantifiable affect (and longer time lags) from money growth to inflation in 1994, reflects an increase in real money holdings. It is probably due to an increased willingness to hold bank deposits in Russia as inflation was reduced, at least for a while, to single digit monthly rates.\textsuperscript{23} Similarly, part of the rapid increase in monetary growth during 1995 may reflect an increase in demand of Russian residents to hold roubles rather than foreign currency and therefore may not be inflationary.

On the other hand, the monetary base – cash issued plus banks' deposits at the central bank – is likely to be less affected, in real terms, by macroeconomic stabilisation. Unlike deposits, cash serves a function as a direct means of making payments. Therefore, higher prices of goods and services imply that more cash will be required to make payment. After the initial price liberalisation phase, there is less scope for economising on cash than on deposits. In Russia, real cash holdings fell by much less than rouble M2 during the high inflation period of 1992–93 but increased less rapidly than broad money from spring 1994. In consequence, the cash-broad money multiplier rose gradually during 1994 having fallen markedly in 1992–93.

However, over the longer term, financial liberalisation may result in a fall in the monetary base relative to current price GDP, and thus lead to an increase in velocity. First, more competitive interest rates and a greater array of available financial assets should result in a switch by households and enterprises from (non-interest bearing) cash holdings to interest-bearing bank deposits and for the banks to switch from non-interest bearing excess reserves to Treasury bills (GKO\textregistered{s}). The banks' excess deposits held at the central bank, for precautionary reasons, are also likely to fall as the payments system becomes more efficient and banks centralise their liquidity management at Head Office. Also competition between banks will result in their offering their customers more

\textsuperscript{22} In the long run, once the inflation rate and velocity growth stabilise a 1% increase in monetary growth should be associated with a 1% increase in inflation.

\textsuperscript{23} In principle, an increase in real money holdings (M/P) could be due to a rise in real output (Y) rather than resulting from a decline in velocity (V). But, on the basis of the official data at least, the reverse happened in the first half of 1994, with industrial production dropping further (see Figure 2).
convenient means of making payment such as cheques, credit and debit cards, thus reducing cash holdings in relation to nominal GDP.\textsuperscript{24}

4.3 Time lags from money growth to inflation

It is stylised 'fact' that the earlier a country is in the transition process, the shorter is the time lag between changes in money growth and inflation. In Russia the lag is 6 months or less whereas in Poland, for both narrow and broad money, it is according to my estimates about one year. In western economies, the lag from monetary policy changes to inflation are longer still. For example, in the UK the lag is estimated at between 2–3 years.\textsuperscript{25}

Ceteris paribus, the time lag would be expected to be shorter in more developed market economies where supply, demand and relative prices are more flexible. The shorter estimated lags probably reflect the higher rates of inflation witnessed in transitional countries rather than a direct implication of transition. In periods of fast monetary growth and high inflation the costs of not adjusting prices, including the exchange rate, are larger and more visible. Therefore, changes in money growth quickly result in changes in inflation. Not only may a falling inflation rate (temporarily) reduce the extent to which money growth affects future inflation but establishing a lower inflationary environment may permanently lengthen the time lag.\textsuperscript{26}

This idea is supported by the recent Russian data. As shown in Table 2, the lag from M2 growth to inflation appears, on the basis of the limited available data, to have increased from three-four months in the 1992–93 period to six months in the lower inflationary environment of 1994. This would suggest that the proximate cause of the inflation pick-up in Russia in 1994 Q4 was faster broad money growth six months earlier in 1994 Q2. Conversely, the slowdown in broad money growth from the middle of 1994 to January 1995 was responsible for the decline of inflation in the first half of this year. Unless there has been a marked further shift increase in the demand for rouble M2, which would weaken further the

\textsuperscript{24} See, for example, Hoggarth, G. and Pill, H. (1992) for the affects of these innovations on the monetary base in the UK.

\textsuperscript{25} Gerlach, S. and Smets, F. (1994) find in recent VAR simulations that monetary policy effects are broadly similar across G7 economies. The smaller reported effects on output and prices in France and Italy are attributed to the absence of an exchange rate response.

\textsuperscript{26} In the technical jargon, the short run Phillips Curve may be flatter at low rates of inflation than at high rates.
link from changes in monetary growth to inflation, the sharp rise in rouble M2 growth in 1995 Q2 suggests there will be some pick-up of inflation at the end of 1995.

Partly because of these unanticipated changes in the velocity of money, particularly through the affects of continuous financial liberalisation and innovations, together with the desire for greater policy transparency, a number of developed countries have abandoned intermediate money targets in favour of final targets for future inflation.27 Final inflation targets have tended to be set in terms of ranges rather than fixed points. Partly, this flexibility has been built in to accommodate output shocks to the economy which also affect prices (eg changes in oil prices). Also it is to acknowledge the limits of our understanding of the determinants and time lags in the inflation process in market-oriented economies.28

27 Inflation targets are now set in Australia, Canada, Finland, Israel, New Zealand, Spain, Sweden and the United Kingdom.

28 See Haldane (1995) for a survey of this recent shift in some countries away from intermediate to final monetary policy targeting.
5 Conclusions

Most central banks around the world believe the key aim of monetary policy is to reduce inflation and then keep it low. Financial liberalisation has important implications for how central banks best pursue this policy. In a market-oriented financial system, unlike in a planned economy, the central bank cannot control banking system credit and interest rates by decree. Instead monetary instruments are required which complement the workings of a competitive financial system. Since mid-1993 the CBR has introduced a number of market-based techniques of monetary control. Directed credits have fallen markedly and are anticipated to end in 1995.

In a liberalised system, changes in policy instruments affect, in the first instance, the quantity and price of credit and money on the central bank's own balance sheet. Then this transmits through the whole banking system and the wider economy to affect the behaviour of enterprises and households and thus inflation. In a more market-oriented environment interest rates play a greater role in the transmission of monetary policy. This appears to have occurred in Russia during 1994.

Over the past 20 years, many central banks have used intermediate broad money growth targets, at one time or another, to guide monetary policy. In Russia, there is evidence too in recent years that rouble M2 has been a useful guide to future inflation. Continual liberalisation and financial innovations have, however, resulted in money supply targets becoming less reliable in a number of countries. Similarly, there is some evidence, albeit based on a limited number of observations, that this happened in Russia in the move to a lower inflationary environment in 1994, with the relationship from changes in broad money growth to future inflation appearing to have both lengthened and weakened.

A number of countries have reacted to the difficulty in predicting the velocity of money by abandoning monetary targets altogether in favour of targets for the exchange rate or price inflation. Faced by large capital inflows during the first half of 1995, in Russia too the CBR has intervened to contain rouble appreciation. Since a central bank cannot at the same time fix the exchange rate and the growth in the money supply, the attempt to stabilise the rouble has resulted in reserve money growth rising well above its indicative target. The CBR's explicit aim in the second half of 1995 is to keep the nominal exchange rate within 6.5% of USD/rouble 4,600 (ie a range of 4,300 – 4,900). Such a large exchange rate target range, however, should leave some room for the use of an independent monetary policy. To the extent that intermediate money targets are used in Russia to guide monetary policy, they should be

77
interpreted cautiously and reassessed continuously. Given the uncertainty in predicting velocity, intermediate money (or credit) target ranges would probably be more credible than specific target points.\textsuperscript{29} More generally, money targets should not be used in isolation – although important, they are only one potential indicator of inflation conditions. Rather, all the possible causes of inflation should be examined and, in particular, the various mechanisms by which changes in the CBR's policy instruments affect future inflation, including in an increasingly market-oriented environment, the behaviour of interest rates and the exchange rate.

\textsuperscript{29} See Dornbusch and Simonsen (1988) in the references. Of course the range should not be so wide that it could not possibly be missed.
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80
Appendix

The relationships summarised in Figure 1 were estimated using single equation ordinary least squares. The variables in the boxes were regressed on numerous lags of each explanatory variable and a one month lag of the dependent variable (to capture inertia). The parsimonious form was derived by sequentially dropping statistically insignificant lags. The estimations were then repeated by excluding the lagged dependent variable.

So for example:

(1) \( \text{Inflation}_t = \text{constant} + a1* \text{M2}_{t-i} + \text{inflation}_{t-1} \)
    
and

(2) \( \text{Inflation}_t = \text{constant} + b1* \text{M2}_{t-i} \)

Because of a severe degrees of freedom problem the lags (i) were restricted to six. The results of specification (1) of inflation regressed on rouble M2 are shown below and graphed in Figures 6 and 7.

The results reported in figure 1 exclude the lagged dependent variable, although including this variable does not qualitatively change the results.
### Dependent Variable – Monthly Inflation (%)

<table>
<thead>
<tr>
<th>Explanatory Variables</th>
<th>92M05 – 94M12</th>
<th>92M05 – 93M10</th>
<th>93M11 – 94M12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>0.37 (1.87)</td>
<td>2.69 (3.55)</td>
<td>1.49 (1.77)</td>
</tr>
<tr>
<td>M2 (−3)</td>
<td>0.17 (0.08)</td>
<td>0.16 (0.08)</td>
<td></td>
</tr>
<tr>
<td>M2 (−4)</td>
<td>0.16 (0.08)</td>
<td>0.31 (0.10)</td>
<td></td>
</tr>
<tr>
<td>M2 (−6)</td>
<td></td>
<td></td>
<td>0.23 (0.08)</td>
</tr>
<tr>
<td>Inflation (−1)</td>
<td>0.65 (0.11)</td>
<td>0.44 (0.16)</td>
<td>0.57 (0.15)</td>
</tr>
<tr>
<td>SEE</td>
<td>3.69</td>
<td>3.43</td>
<td>2.51</td>
</tr>
<tr>
<td>R-Bar-Squared</td>
<td>0.71</td>
<td>0.61</td>
<td>0.69</td>
</tr>
<tr>
<td>DW statistic</td>
<td>1.85</td>
<td>1.92</td>
<td>1.00</td>
</tr>
<tr>
<td>Durbin H-statistic</td>
<td>0.55</td>
<td>0.24</td>
<td>2.29</td>
</tr>
<tr>
<td>LM (12)</td>
<td>7.6</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Standard errors in parentheses.
M2= % monthly growth in rouble M2.
Russian Banking Legislation and Supervision

by Juhani Laurila

Contents

1 Introduction .................................................. 85

2 Russian banking legislation .................................. 86
2.1 Updating the banking legislation in 1990 ............... 86
2.2 The New CBR Legislation makes
   Central Bank more independent .......................... 90
2.3 Supplementary financial legislation ...................... 92
2.4 Treatment of foreign banks in Russia .................... 95

3 Russian banking supervision and inspection .............. 96
3.1 Legislation on banking supervision and inspection ..... 96
3.2 Licensing .................................................. 97
3.3 Objectives and approaches ................................ 101
3.4 Assessment of the reliability of banks .................. 104
3.5 Asset management .......................................... 106
3.6 Accounting and audit ..................................... 109

4 Conclusions .................................................... 112

Literature ......................................................... 115

Statistical sources ............................................... 116

Chronology of most important acts of
the Russian banking legislation in the 1990s .............. 117

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1 Part of information in this article is based on interviews of representatives of the branch office of the Central Bank of Russia, commercial banks and auditing companies in St Petersburg in January–March 1995.
1 Introduction

Since the Second World War, Western European countries have had 50 years to set up their banking and financial systems, together with the necessary democratic and market institutions; Russia has had only 5–10 years or so. Consequently, the first market-oriented banking legislation in Russia was bound to be somewhat general in nature and its guidance and regulations subject to further modification in accordance with changing needs and experience. Once adequate experience has been accumulated and a political consensus achieved, more detailed and up-to-date legislation can be implemented.

The development of Russia's financial legislation has centred on the banking system, and the Central Bank in particular. The first phase comprised the transformation from a single to a two-tiered banking system overseen by a Central Bank more independent than before. Once the legislative framework was established for the Central Bank, the legislation on the commercial banks and other areas of the financial markets could be developed.

In this article we review developments in Russian banking legislation, focusing mainly on the 1990s and the period since the dissolution of the Soviet Union. This second phase has involved reinforcing the independence of the Central Bank by increasing its powers in order to allow it to accomplish its task of promoting the stability of the rouble. Simultaneously, the reform process has begun to tackle the even more difficult task of consolidating the commercial banks and putting them on sound financial footing.

The present problems relate to the re-capitalization or liquidation of insolvent banks and to the creation of a credible and modern banking system. The search for a solution to these problems has emphasized the role of banking supervision and inspection in Russia and the means by which this can be improved. The principal features of Russian banking supervision and inspection are described in the third chapter of this article.
2 Russian banking legislation

2.1 Updating the banking legislation in 1990

The legislative changes required to establish a two-tiered banking system had initiated already in autumn 1986 when the central banking function became the responsibility of the State Bank of the Soviet Union (Gosbank) and the financing of clients the responsibility of the five specialized sectoral banks. In 1987 Gosbank changed its name to the Central Bank of the Soviet Union (CB of the USSR). It assumed the responsibility of implementing monetary policy, maintaining stable currency, supervising of the commercial banks and facilitating of inter-bank settlements.

The next major change, influencing the status of the CB of the USSR and creating the Russian banking system came in the form decree on the banking system for the Russian Federation issued on 13 July 1990. The following was enacted under this decree:

1) the Russian office of the CB of the USSR had to become the State bank of the Russian Federation, answering directly to the Supreme Council of the Russian Federation;

2) the offices of the CB of the USSR and the special banks were declared the property of the Russian Federation and were to be transformed into joint stock companies or cooperatives from the 1 January 1991; and

3) the highest state organs of the Russian Federation were obliged to present to the Russian Parliament with draft for renewed legislation on the Central Bank of Russia (CBR) as well as with draft for banks and banking operations in Russia.

This decree effectively drew the rug from under the feet of the CB of the USSR. It became simply an umbrella organization for the central banks of the CIS. The State bank still had to face the banking war brought about by the unwillingness of the Soviet republics to submit to the State bank the right to issue currency and to stay with the rouble zone. The CB of the USSR failed to provide the central banks of the republics with a credit plan. In November 1991 the CBR took over the responsibilities of the CB of the USSR, which continued to exist until the collapse of the Soviet
Union in December 1991, when it was first amalgamated with the CBR and later on officially discontinued. This led to the emergence of independent banking structures in Russia and the other republics of the CIS. The Russian banking laws then served to steer the development of a modern banking system in Russia.

In October 1991 the Bank of Foreign Economic Affairs (VEB) took upon itself the responsibility of servicing the debts of the Soviet Union. Following the formal dissolution of the Soviet Union, the VEB was moved from Gosbank’s jurisdiction to the CBR and continued operating as a commercial bank. In 1992 it was split into two banks the first one continuing as a commercial bank and the other one operating as an agent in charge of Soviet foreign debt and receivables. In July 1992 Russia assumed the foreign debt of the Soviet Union and the VEB acted as agent in its settlement.

The legislation which laid the foundation for the present Russian banking system consisted of the Law on the Central Bank of the RSFSR, henceforth 'the Old CBR Legislation', approved and implemented in 1990, and the Law on Banks and Banking Activity in the RSFSR, henceforth the 'Commercial Banking Legislation' and Statutes of the CBR, henceforth the 'Regulation on CBR', approved in 1990, implemented in 1991 and amended in 1991 and 1992. The Regulation on CBR specified further the stipulations of the Old CBR Legislation and made an effort to improve their operational capability.

The Old CBR Legislation was a fairly concise document. It entrusted a number of tasks and functions to the CBR: granting licences to banks, control and inspection of banks, regulation of the money supply, refinancing of banks, function as a reserve bank, monetary and foreign exchange policy, defence of the internal and external value of the rouble, etc.

The CBR was made accountable to the Supreme Soviet of the RSFSR. It was entitled to issue the account money and cash but was prohibited from printing money in order to cover the federal budget deficit. It "had the right" to finance federal budget deficits by granting credits with a maximum maturity of six months.

The principal merit of the Old CBR Legislation was that it acknowledged and reinforced the two-tiered banking system, with the Central Bank at the first level and all commercial banks and credit institutions at the second. For the first time it streamlined the position of the CBR with respect to the government and commercial banks in a Western-style two-tiered banking system: the CBR was to be independent from the government and to function as the banks' bank and lender of the last resort. Independence from the government related only to its right as a legal juridical entity to independently manage its own assets and liabilities,
although this did not preclude financing the federal government's budget deficit whenever the latter considered it necessary.

Historically, it was possible for the money to be routed to the Soviet-Russian economy at the will of the government in three different ways:

1) granting loans to the Soviet republics,

2) giving directed credits via commercial banks to Russian industry and agriculture, or

3) via the Ministry of Finance, covering the federal budget deficit.

The first of these was discontinued with the collapse of the Soviet Union in 1991. In 1995, the New CBR Legislation cut the remaining two routes (Edwards 1995, p. 70).

The Old CBR Legislation 'gave the right' to the CBR to finance the federal government's budget deficits up to the limit set by the Supreme Council; it implied a practical obligation to do so. This obligation has hindered the CBR from maintaining the internal and external stability of the rouble. As a consequence, until recently most commercial bank credit represented directed credits from the government to industries, agriculture and, to some extent, to the banking sector itself. Easy access to financing directly from the CBR and indirectly through owner companies, together with its position as a distributor of financing has made commercial banking one of the most profitable businesses in Russia today. The high rate of profitability is reflected, for example, in the high salaries of bank employees and directors in comparison with salaries earned in other economic sectors in Russia.

The last occasion on which the CBR made financing available to the Ministry of Finance and channelled directed credits through the Promstroibank and the Rosselkhozbank was the first quarter of 1995. Meanwhile, however, in 1994, the Russian government moved to 'non-inflationary' financing by issuing bonds and treasury bills.

As for relations with the commercial banks, the Old CBR Legislation gave the CBR considerable flexibility to introduce further legislation and to determine the norms and framework within which Russian banking is expected to operate (Tosunyan 1995, 227). Due to its powers to instruct banks, the CBR in fact plays a far more central role in shaping the banking and financial sector than would appear from its formal position in legislation (Talvitie–Kesanto 1995, p. 263). This practice of management through instructions turned the formal hierarchy set out in Russian legislation upside down: the CBR instructions became more important
than parliamentary laws or presidential, government or local government decrees.

Generally speaking, the extensive powers of a central bank in managing the banking community are beneficial provided that they increase the stability of the financial community and hence of the entire economy. In fact, a powerful role for the central bank often goes hand in hand with stable trends in inflation and interest rates. Unfortunately, in the Russian case, the regime based on a large number of instructions issued by the CBR and governmental or presidential decrees, has created a situation where neither the commercial banks nor their clients can be sure about the legality of their operations. Ambiguous and occasionally controversial rules have encouraged the tendency to take advantage of inadequacies in the legislation and have slowed down day-to-day banking operations due to time wasted in trying to verify their legality in each individual case.

The CBR would not interfere with commercial banking beyond the requirements of monetary policy and banking supervision and control. This independence was confirmed in the Commercial Banking Legislation, the stipulations of which were mirrored in the Old CBR Legislation. The merit of the Commercial Banking Legislation is that it clearly defines a new banking structure in Russia. It also clearly sets out the permissible banking operations and deals, the preconditions of licensing and recalling licenses, the commercial banks' obligations and rights vis-à-vis the CBR, and the relations between the commercial banks and their clients. The Commercial Banking Legislation also contains stipulations on banking secrets. This relates to bank-client relations but does not prohibit banks from disclosing more general information about their activities.

The Commercial Banking Legislation defines the concept of a commercial bank, enumerates its tasks and explains the procedures for opening and closing a bank. It also presents, in general terms, liquidity and solvency criteria that were later substantiated by the CBR instructions (explained below in chapter 2.3 in the context of banking inspection). The banks are free to set their own commissions and interest rates on borrowing and lending, provided, however, that they are within the limits of the monetary and credit policy of the CBR. Cartels are forbidden. All banks can accept deposits, although they have to be insured and otherwise protected in accordance with instructions issued by the CBR.

The CBR owns the majority of shares in Sberbank, while the government of the Russian Federation fully insures the deposits with this bank. As recently confirmed, this arrangement can only be changed through legislation. The Commercial Banking Legislation also states that all information on a bank's accounts and its clients' accounts and related operations are, with certain exceptions, secret.
These questions will be further elaborated in chapter 2 from the viewpoint of practical problems and development needs within the context of Russian banking supervision and inspection.

2.2 The New CBR Legislation makes Central Bank more independent

The Russian parliament approved the new Federal Law of the CBR on 12 April 1995, henceforth the 'New CBR Legislation'. It came into force on 4 May 1995. Unlike the preceding legislation, this clearly expressed the objectives of the Central Bank: to defend the stability of the rouble and the Russian banking system. It therefore confirms the task already allotted to it in the Russian constitution.

According to the New CBR Legislation, the CBR is an economically independent juridical person. Its capital and assets are owned by the Russian Federation. The Russian State is not, however, responsible for the debts of the CBR. Neither is the CBR responsible for the government's debt. The CBR alone finances its expenditure and is not responsible for the liabilities of the commercial banks.

The New CBR Legislation also stipulates the following responsibilities:

- the CBR reports to the State Duma, henceforth the 'Duma';
- the Duma nominates the management of the CBR based on the proposal of the president;
- the CBR is responsible for monetary and foreign exchange policy;
- the CBR supervises the banking and payment system;
- the CBR will develop governmental financing operations;
- the CBR is not entitled to directly finance the federal budget.

Particularly important is the stipulation that the Central Bank has no right to grant credits to the government to cover budgetary deficits. The most radical revision of the preceding central bank legislation concerns the CBR's scope for conducting independent monetary and credit policies. The importance of this feature in reducing excessive money supply and avoiding the associated destabilization of the economy cannot be overstated.

In operational terms the New CBR Legislation places the CBR under the Russian parliament, although it is still under the control of the Duma,
the lower house of the Russian parliament. By December each year the CBR is obliged to submit general consolidated guidelines on monetary and credit policy to the parliament, after they have first been presented to the president and the government. The guidelines must be based on the growth forecast for the Russian economy and include basic directions, parameters and instruments of the monetary and credit policy.

During the preparation of the New CBR Legislation, the Duma made a number of changes aimed at increasing its ability to intervene and influence the monetary policy decisions of the CBR. However, its proposal that all CBR decisions on monetary policy should be submitted to the Duma did not receive approval.

In the New CBR Legislation it is unambiguously stated that the CBR reports to the Duma. The Duma nominates the chairperson of the CBR for a period of four years. These guidelines are subject to decisions made by the Duma. The nomination is based on the proposal of the President of the Russian Federation and the members of the board. The chairman of the CBR board reports to the Duma twice a year on the bank’s activities of the CBR. The Duma can request the presence of representatives of the CBR. The CBR’s annual report and auditors’ report have to be confirmed by the Duma.

In order to coordinate policies between the CBR and the Ministry of Finance, the former Credit Commission has been replaced by a Commission for Financial and Credit policy. This new commission is chaired alternately by the deputy prime minister responsible for economic policy and by the governor of the Central Bank. The Ministry of Finance has only a representative on the Commission.

According to the constitution of the Russian Federation, the principal task of the CBR is to defend the stability of the rouble. In accomplishing this task the CBR operates independently from other governmental bodies. The CBR defends the stability of the rouble by means of its monetary and credit policy. In cooperation with the Russian government, it prepares and implements the annual plan for "a single state monetary and credit policy" which aims at defending and maintaining the stable value of the rouble.

The New CBR Legislation clearly represents a modernization and Westernization of the central bank legislation. This is seen most clearly in the enumeration of the functions of the CBR set out in para 4 and in the definition of the instruments of monetary and credit policy set out in paragraph 35. According to the latter, the selection of instruments available to the CBR includes interest rate policy, reserve requirements, open market operations, refinancing of banks, foreign exchange control and regulation of money aggregates, and quantitative regulations. Besides
being more detailed and transparent than the Old CBR Legislation of 1990 and the Regulation on CBR of 1991, there is a clear difference in terms of definition of the status, functions and approach laid down for the CBR.

All in all, the New CBR Legislation leaves the idea of an independent central bank, as defined in the Russian constitution, somewhat ambiguous and, in any case, subject to the way it will be observed in practice. Experience shows that the personalities of the leaders and the power relations between the institutions concerned are of greater significance in day-to-day operations than the formal legislative framework. In the case of weak State Duma and a strong government, the CBR may be expected to act more like a governmental bank. On the other hand, even if an independent central bank were subordinated to a strong parliament, the former would still be expected to cooperate and compromise with governmental policies.

2.3 Supplementary financial legislation

Within the framework of the Old CBR Legislation and the Commercial Banking Legislation the banking and financial markets have been governed by means of a considerable large number of presidential or governmental decrees (ukaz prezidenta / postanovlenie pravitelstva), hundreds of Central Bank circulars, instructions and orders.

The use of reserve requirements, foreign exchange controls, refinancing of banks, etc. has served the monetary policy objectives and thereby improved the stability of the Russian financial system. The reserve requirement policies have played a central role, serving both the monetary policy objectives, by regulating the amount of money in circulation, and the stability objectives controlled through banking supervision, by forcing the commercial banks to deposit a given amount of their borrowing with the CBR.

Given the present transitory state of Russian financial markets, drafting a consistent legal framework based on international banking law and practice would be more important for the credibility of the Russian banking than the flood of central bank interventions, restrictions and adjustments aimed at guiding the course of Russian banking and financial markets. Typically the interventions seem to have encouraged bureaucratic regulation rather than the promotion of modern, reliable and prompt banking services. For instance, the requirement allowing enterprises to open only one rouble and one foreign exchange account was aimed at facilitating the tax and foreign exchange controls. Subsequently,
at the insistence of the banks who were loosing their customers, these instructions were withdrawn.

Indeed, the numerous and often contradictory instructions appear to cause embarrassment and confusion instead of creating confidence in the Russian banking and financial system.

The tasks of the CBR in foreign exchange regulation were defined in the Law of Foreign Exchange Regulation and Control. The right of the CBR to authorize commercial banks to execute foreign exchange operations is based on this legislation, which came into force in July 1992 (‘Law on Foreign Exchange Regulation and Control’ of 19 October 1992; Kommersant 29/1992; see Chronology of most important acts of the Russian banking legislation in the 1990s). The regulation made it possible for foreigners to open rouble accounts after August 1993. From the beginning of 1994 foreign currencies could no longer be used as a means of domestic payment. Simultaneously, the CBR established cooperation between the customs authorities and the commercial banks to control compliance with the regulations on the surrender of export proceeds.

In October 1993 the CBR announced a new foreign exchange control system in which banks receive information about export declarations from the customs authorities. According to the surrendering rules, 50 per cent of export proceeds or foreign exchange otherwise received has to be converted into roubles within two weeks of its receipt. The commercial banks report monthly to the CBR on the accounts and balances of their accounts of customers. In the case of non-surrender of export proceeds within the specified time period, banks have to alert the customs authorities (Hirvensalo 1994, p. 36).

The brief references to the Russian monetary system in the Commercial Banking Legislation (section II) were supplemented in 1992 by the Law on the Russian Monetary System (Zakon Rossiiskoi Federatsii o denezhnoi sisteme Rossiiskoi Federatsii, Rossiiskaya Gazeta, 21 October 1992). It defined the legal foundation for the Russian monetary system (emission, accounts, regulation and controls). These stipulations were later summarized in section VI of the New CBR Legislation.

The CBR maintains a number of clearing centres so as to expedite payment transfers. Some commercial banks have also been authorized to establish and maintain those centres. However, it can still take weeks to transfer money within Russia. Moreover, documents may be lost and the entire system is vulnerable to fraud. A comprehensive overhaul of the payments system has been made, however, which has resulted in considerable improvements in payment transfers within Moscow. One way to further improve the system has been to standardize the payment docu-
ments by introducing serial numbers to improve the system's deficient security. The legislators of the Old CBR Legislation seem to have been more concerned about the regulatory issues than the prompt and secure transfers of payments.

Bankruptcy procedures are still in need of improvement, and there is no clear legislation defining the rules and procedure to be followed in the acquisition and merger of banks. In addition, the deposit protection schemes and the rules for excluding the possibility of misusing insurance funds need to be better defined.

A fairly high degree of profitability has enabled banks to expand their operations into related areas of banking business, such as trading in shares, factoring, leasing and insurance, although in many Western market economies these lines of business turned out to be risky. In Russia, foreign exchange markets and interbank markets were created first, followed by security and commodity markets, and supplemented more recently by narrow markets for derivatives (forward markets for foreign exchange and options). The growth has been disorderly without any coordinated registration of securities etc. Government securities have recently filled the markets and crowded out the shares of local enterprises. Associated legislation is still lagging behind and the securities market is still guided by means of presidential decrees while waiting the approval of new security market legislation. The issues currently slowing down the passage of the legislation are:

1) whether holder securities should be covered by this law, as insisted by the CBR and the Ministry of Finance and opposed by the State Property Commission and the Federal Commission on Securities (FCS);

2) whether the powers of the FCS should be extended to licensing, and

3) whether the FCS should be subordinated not only to the government but also to the parliament.

In December 1990 the CBR took over from Gosbank the task of quoting the external values of the rouble. In July 1992 the rouble was allowed to float. Its quotations were based on the foreign exchange auctions and trading in the Moscow International Currency Exchange (MICEX).

Credits guaranteed by the government are not available in Russia. The CBR credit auctions are open only to a few banks which satisfy strict criteria. Interbank credits can be used only up to 25 per cent of the funds in the reserve fund, and the maximum credit period is seven banking days.
2.4 Treatment of foreign banks in Russia

The Old CBR Legislation gave the CBR the right to authorize representative offices of foreign (non-resident) banks in Russia. According to the New CBR Legislation the CBR can authorize the establishment of foreign-owned banks or foreign participation in existing banks as well as the establishment of representative offices.

One of the stumbling blocks on the road to more liberal and open banking was the treatment of non-resident banks. On 8 April 1993 the CBR issued a decree entitled 'On Conditions for Opening Banks with Foreign Ownership in Russia'. It limited total foreign ownership to 12 per cent of the total banking capital in Russia, required the founding capital to be no less than ECU 5 million and restricted the number of branch offices of any foreign bank to one as well as restricted activities with small clients (Ekonomicheskaya Gazeta 15 April 1993). These conditions were said to have arisen as a compromise with conservatives in the Russian parliament who wanted a total ban on foreign banking operations in Russia. Most active amongst those lobbying for conservative protectionist attitudes were the Russian Bankers' Association and the League of Russian Banks (Kommersant 12–18 April 1993, Financial Times, 16 April 1993).

On the eve of parliamentary elections, 17 November 1993, a presidential decree 'On Operations of Foreign and Jointly with Foreigners Owned Banks in Russia' was issued barring the ten licensed, though not yet operative, foreign banks from dealing with Russian residents, effectively limiting their dealings to off-shore operations until 1996. Three foreign banks already operative at that time were allowed to continue their operations. However, this legislation was in conflict with the agreements on the protection of direct investments that Russia had already concluded with countries of the European Union. Following implementation of the Partnership and Cooperation Agreement with the European Union in 1994, Russia relaxed its restrictions on banks from EU countries. Once the agreements on the protection of direct investments with the United States was concluded, restrictions affecting the two US banks already licensed in Russia were removed in April 1995.
3 Russian banking supervision and inspection

3.1 Legislation on banking supervision and inspection

The Old CBR Legislation and the Regulation on the CBR gave the CBR certain rights to instruct, supervise and inspect the commercial banks with regard to minimum capital requirements, solidity, liquidity, reserves, limitations on client risks, currency exposures and foreign exchange risks, share ownership in relation to client deposits and deposit insurance. The development of the banking supervision and inspection has so far taken place mainly under the umbrella of the old legislation.

The current objectives and tasks of banking supervision and inspection are enumerated in the New CBR Legislation. According to this legislation the main objectives are maintenance of the stability of the Russian banking system and protection of the interests of depositors and creditors. To carry out its duties the CBR has access to information on the banks' operations, bookkeeping and other necessary information, and maintains a banking register, authorizes and cancels banking licences, decides on qualifications necessary for management and book keeping, and has the right to intervene in sales or purchases of shares comprising more than 20 per cent of the banks' share capital. Provisions on the participation of non-residents in the Russian banking system are set forth in federal law. Banking supervision and inspection are also based on a number of letters and announcements of the CBR.

Like the rest of Russia's commercial banking, the supervision and inspection function has emerged only recently. Owing to a lack of time and experience, Russia has had greater difficulty establishing adequate supervision and control than in other parts of the world (Prokofyeva – Ivanova 1994, p. 33).

The supervision and inspection of Russian banks are the responsibility of the CBR. To tighten up control of the commercial banks, two departments were established under the CBR early in 1993. The Banking Supervision Department (departament bankovskogo nadzora), with more

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than 70 employees, was put in charge of regulation, monitoring and research of the banking sector. It comprises three divisions: the Division for Licensing Banks, Lending Institutions and Bank Auditing; the Banking Supervision Regulation Division; and the Division for the Economic Analysis of Banking.

To ensure the stability of commercial banking the CBR has also established a new inspectorate to control the reliability of the commercial banks' accounting and financial reporting, the legality of operations and their compliance with the licence issued by the CBR. The directorate has been given powers to recall licences or demand the resignation of management (Prokofyeva – Ivanova 1994, 34).

Currently this Department of Inspection of the Commercial Banks (glavnoe upravlenie inspektirovania) has more than 1100 banking inspectors conducting regular on-site inspections of bank operations. The inspectorate is clearly understaffed, considering the large number of units to be inspected – almost 2571 commercial banks, with more than 5723 branch offices, 38567 savings bank offices (as of end-July 1995), thousands of foreign exchange booths etc., from one end of the country to the other. Their task is further burdened by the fact that Russian accounting law does not oblige commercial banks to produce consolidated balance sheets covering the balances of their branch offices.

### 3.2 Licensing

In order to rapidly create a private banking sector, the threshold for establishing a bank was deliberately set very low. Only a few thousand dollar capital was required to start with. This resulted in the very rapid registration of a great many new banks of varying quality. The growth in the number of banks and branches (excluding Sberbank branches) over the last few years has been as follows (Belyanova and Vestnik Banka Rossii):

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of banks</th>
<th>Number of branches</th>
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<tbody>
<tr>
<td>1992</td>
<td>1713</td>
<td>3135</td>
</tr>
<tr>
<td>1993</td>
<td>2019</td>
<td>4539</td>
</tr>
<tr>
<td>1994</td>
<td>2517</td>
<td>5440</td>
</tr>
<tr>
<td>1995</td>
<td>2571</td>
<td>5723</td>
</tr>
</tbody>
</table>

1 On 1 August 1995.
The general guidelines on bank licensing conditions are enumerated in the CBR announcement 'Methodological instructions on commercial bank operations in Russia' issued on 26 February 1991 and later brought up to date and supplemented in 1994 and 1995. In addition to these instructions, the CBR provided the Russian commercial banks with a great many detailed circulars containing instructions on the minimum amount of founding capital, dealings in foreign currencies, relations with foreign partners, conditions and procedures applied in case of liquidations of a commercial bank, etc.

The licensing system includes the following licences:

1) **general licence**, giving the right to perform all foreign exchange operations and universal banking,

2) **extended foreign exchange licence**, giving the right to maintain correspondent relations with up to six banks abroad,

3) **restricted foreign exchange licence** giving right to perform foreign currency transactions only within Russian territory, and

4) **rouble licence** withholding the right to effect foreign exchange transactions.

These licences are given to new banks and to existing banks wishing to extend their activities. By the end of July 1995 the CBR had granted general licences to 263 banks and extended foreign exchange licences to 789 banks. In addition around 105 licences had been issued for trading in gold and precious metals.

More specifically, the general licence comprises the following banking operations: opening foreign exchange accounts for customers, financing foreign trade and effecting transfers of related payments, noncommercial operations, purchase and sale of foreign exchange and financing. Permission to open correspondent accounts with foreign banks is issued separately from the general licence.

To be eligible for a licence a new banking entrepreneur must have a solid economic base, is verified by auditors, and the directors must have at least two years' experience in banking with a good reputation and an academic degree in economics or law. These requirements are designed to discourage the inexperienced and poorly qualified. Only the banks with a general licence meet Western banking standards.
Due to the relatively lax monetary policy, restructuring of the banking sector had to be postponed in 1993. At that time, there were already more than 2000 banks in Russia that had emerged by virtue of the extremely low founding capital requirements. The majority of the newcomers were relatively small banks. The 100 or so 'more serious' banks accounted at that time for 3/4 of banking activities.

To remedy the situation, the first step, in July 1993 was to introduce the minimum capital requirement of 100 million roubles. This was raised to ECU 1 million or 2.2 million roubles from the beginning of March 1994. The minimum capital requirement is linked with the type of licence. Banks with a full range of banking operations are expected to raise their authorized capital from the present ECU 1 million to ECU 5 million by 1 January 1999, whereas, at the opposite end of the spectrum, the credit cooperative banks, which only borrow from and lend to their participants, are currently required to support their activities with a minimum authorized capital of 100 million roubles. In addition, as mentioned above, a newly established commercial bank must have been in operation more than a year, observed all norms and rules and unfailingly honoured its dealings with the CBR.

Besides raising the threshold for the establishment of new banks, the CBR has started to recall the licences of substandard banks. The pace at which licences have been revoked has recently accelerated. For instance, by the end of 1994 the CBR had cancelled 85 licences, but in 1995 83 licences had already been cancelled by the end of July (Table 2). By that time the CBR had, altogether, frozen the negative balances on the correspondent accounts of 168 Russian commercial banks which had failed to provide their accounts with adequate cover or had otherwise violated Russian banking laws. In addition, 286 banks ceased operation voluntarily mostly by merging with another bank.

Measures to exert stricter control over the financially weaker banks were taken in September 1994, when the CBR assumed the right to nominate its own representative to the bank's management for a maximum period of three months. Because of the increased activity of the CBR in this area it implies that the net growth in the number of banks in Russia is likely to slow down in the future. For example 150 new banks were established and 96 ceased operation (i.e. net increase of 54) during the first seven months of 1995 (cf. Tables 1 and 2).

A CBR circular dated February 1995 substantially tightened the licensing conditions for new commercial banks (Gryaznevich 1995). The objective was to prevent 'unhealthy' banking organizations penetrating the system and increasing the systemic risk created by interbank financing.
Table 2.  
Number of banks ceasing operation  

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<tbody>
<tr>
<td>By decision of shareholders</td>
<td>19</td>
<td>92</td>
<td>117</td>
<td>45</td>
<td>13</td>
</tr>
<tr>
<td>– of which mergers</td>
<td>(17)</td>
<td>(90)</td>
<td>(115)</td>
<td>(40)</td>
<td>(10)</td>
</tr>
<tr>
<td>Ceased, violation of law</td>
<td>1</td>
<td>0</td>
<td>19</td>
<td>65</td>
<td>83</td>
</tr>
<tr>
<td>Postponement of operations$^1$</td>
<td>0</td>
<td>5</td>
<td>6</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

$^1$ Postponement of operations with more than one year elapsed since issuing date of licence constitutes a ground for cancellation (see Commercial Banking Legislation, para. 18 c).

Source: Vestnik Banka Rossii No. 33, p. 2.

Whether the commercial banks comply with the conditions set out in their licences is monitored by the bank inspectorate maintained by the CBR. For the time being the inspection of the commercial banks is inadequate. Some banks are still operating without any licence and beyond the scope of all banking inspection and control. This is possible because free commercial banking is still quite new in Russia and the potential clientele, in particular small depositors, are inexperienced, often gullible and ultimately perhaps not motivated enough to report fraudulent banking practices once their money has been lost. Furthermore, tax evasion is widespread and debts are not serviced. Several collocutors in the banks claimed that a majority of the Russian banks have not been able to avoid at least some dealings with organized crime. The only exceptions are the banks wholly under foreign ownership, at least to the extent to which they confine themselves to dealing only with foreign clients.

Occasionally licensing policies and also prudential controls may be reinforced with policy measures, alleged or factual, which run counter to proper principles of banking supervision. For example, the CBR branch in St. Petersburg allegedly discriminates against Moscow banks by setting stricter criteria for them in licensing and controls compared to local banks. Another example is the fact that the reserve requirements for industrial bank loans are lower than for other lending in order to encourage the financing of industrial investments.
3.3 Objectives and approaches

The objective of banking inspection in Russia is to assess the economic circumstances and the soundness of the bank. The inspection verifies that bookkeeping is correctly carried out, debts serviced, and obligatory transfers to reserves made. The performance of a commercial bank is assessed against nine criteria based on data derived from the bank's balance sheet.

Besides the above-mentioned minimum capital requirement the nine criteria are as follows (Instructions of the CBR, 30 April 1991):

- the ratio of a bank’s capital to risk-weighted total assets
- the ratio of a bank’s capital to high risk assets
- the ratio of a bank’s capital to liabilities
- the ratio between credits and funds on term-deposit, deposit, current and other accounts
- the ratio of liquid assets to total assets
- the ratio of liquid assets to demand liabilities
- the ratio of amortization of long-term loans to liabilities created by deposits, credits and long-term debt service
- risk against individual debtors classified according to CBR instructions

The analysis of Moscow commercial banks for a 10-month period in 1994 shows a good average for liquidity and other parameters (Makarevich 1995). In St. Petersburg, too, the largest commercial banks holding a general licence seem to have well fulfilled these criteria in 1994. The Russian banks have been, in general, relatively profitable and the financial status of the banking sector healthy in terms of the above criteria. Those who claim that this is due to the banks’ ability to take advantage of the deficiencies in the country’s financial system and the weaknesses in its economy (i.e. a high rate of inflation and the deterioration of the external value of the rouble) are probably right. Consequently, the anticipated wave of bankruptcies has been staved off or mitigated, due to the absence of an efficiently functioning market mechanism in the financial and currency markets. As soon as the rate of inflation is reduced and the market mechanism really begins to allocate financial resources more efficiently and improve trade in convertible currencies, the sources of easy profits will be closed.

For the time being, bankruptcy does not provide a viable means of keeping the Russian banking sector healthy. Enacted in 1992, the 'Law of the Russian Federation on the Insolvency (Bankruptcy) of Enterprises'
came into force on 1 March 1993 and has subsequently been reinforced with additional provisions. Indeed, it takes more than just a bare bankruptcy law to create an operational bankruptcy regime. Without a well functioning commercial environment, sound accounting practices, well respected and competent courts and trained bankruptcy lawyers with high professional standards, there is little hope of creating a workable bankruptcy system (Homan 1995, p. 54).

The challenges faced by the banking inspection authorities vary regionally due to the uneven geographical distribution of Russia's banks. More than one third of the 2517 banks in Russia at the beginning of 1995 were located in Moscow. The Moscow banks are also the largest. In terms of assets, the 40 largest Russian banks include only seven banks from outside Moscow, only one of which, Promstroi bank, is in St. Petersburg (Ekonomika i zhizn 1995, p. 5). According to some estimates, the Moscow banks operate 75 per cent of Russia's total banking capital.

Table 3.

<table>
<thead>
<tr>
<th>Number of banks and branches on 1 January 1995</th>
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</thead>
<tbody>
<tr>
<td>Joyd, Moscow, St. Petersburg, Lenigrad region</td>
</tr>
<tr>
<td>No. of banks</td>
</tr>
<tr>
<td>No. of their branches</td>
</tr>
<tr>
<td>No. of branches of banks from other regions</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

1 Includes 46 branches from other CIS republics, 39 of which are in Moscow and the others elsewhere in Russia (Vestnik Banka Rossii No 3, 24 January 1995, p. 8).

Problems related to inspection and supervision are at their most acute in Moscow. According to several reports from St. Petersburg, the banks there operate in more orderly manner than those in Moscow. Moscow suffers from shortage of trained staff. The number of banks in Moscow was so great, 1391, at end-1994, that the CBR was unable to control them efficiently. In St. Petersburg, where there are 165 banks and branches, the local branch of the CBR has 70 inspectors, i.e. only one inspector for 2–3 local banks. Every inspector is expected to concentrate on his own banks and learn to know them properly. The CBR receives the balances of the commercial banks once a month, and all correspondent accounts are monitored on a daily basis. The CBR branch also monitors the quality of
management and auditing at the banks. Should any unclarities arise, the central bank inspector goes to the spot and has to be admitted free access to all the banks' records.

Spokesmen for banks in St. Petersburg characterize the supervision as extremely tight, particularly as the commercial banks have to send reports to the St. Petersburg branch of the CBR daily, weekly, quarterly and annually. For the time being, few commercial banks are able to transfer this information to the CBR branch office by computer. Most banks simply mail these records. There has been speculation as to whether the Central Bank, faced with this flood of information, is really able to study the reports in sufficient detail and absorb all the information it receives.

Another problem for licensing and inspection is exchange booths. Exchange booths are believed to be a channel for money laundering, which is why they should be kept under close surveillance. In Moscow alone there were 9000 unlicensed exchange booths at end-1994, in addition to 2100 registered ones. A substantial volume of 'dirty money' flows through these booths. According to the CBR branch office in St. Petersburg, all booths there are licensed and under a more efficient control.

In practice, bank inspection has been indirectly supported through the introduction of relatively strict tax controls which bring discipline to payment procedures and at least marginally increase transparency. The banks are obliged to inform the tax authorities of each new bank account. Since summer 1993, all large payments exceeding USD 500 (about two million roubles in March 1995) had to be made through commercial bank accounts in order to facilitate tax and customs controls. In October 1994 the CBR issued new payment instructions, requiring companies to keep in their bank accounts all cash reserves in excess of their current needs for wage and social security payments (Hirvensalo 1994, pp. 35–36).

Strict controls and the continuous influx of new decrees and instructions seem to have a mutually compounding effect. On the one hand, it makes law-abiding banks excessively cautious, which slows down the transfer of payments through bank accounts, as time is wasted checking and verifying the legality of each individual transaction and transfer. On the other hand, a widespread shadow economy has arisen due to heavy and often arbitrary taxation, high customs duties and bank commissions and bureaucratic and erratic procedures of tax and customs authorities and banks. Despite strict sanctions imposing a threat of suspension and extremely heavy fines, the risk of being caught is still too low to outweigh the benefits to be attained by evasion of taxes, customs duties and bank commissions.
The integrity of the local auditing firms is put to the test under these circumstances. Usually the auditor is not even informed of possible 'shady' transactions. If he suspects any irregularities, but the enterprise is reluctant to disclose this information, auditor risks losing the client if he presses the matter.

3.4 Assessment of the reliability of banks

Knowing which banks are reliable and which are to be avoided is the main problem for potential clients choosing a commercial bank. The available balance sheet information does not fully describe the structure of the banks' portfolios. Some Western rating firms have recently started to rate banks in Eastern and Central Europe. One reason for this increased concern is that Western countries are increasingly becoming more aware about Russian banks seeking to establish their business abroad. Russian banking supervision and inspection still lag far behind Western standards. It is feared that this will limit the scope for cooperation in banking supervision and inspection, thus opening the door to unsound banking practices, money laundering in particular (Festa 1995, p. 3, see also The Banker April 1995, p. 33). Lately, the United States and United Kingdom have been reluctant to license Russian banks (Financial Times 13 October 1995).

In order to promote sound banking practices in Russia, the CBR has occasionally released rankings based on the performance and status of Russian banks. The rankings listed by the CBR primarily reflect compliance with the CBR's instructions (eg Finansovye Izvestiya 23 April 1993), whereas listings such as the '100 largest banks in Russia' (eg the 'Top 100 Russians' The Banker, July 1995, p. 41), ranks them by value of assets. Lists frequently published in the Russian press are often based on other criteria. This reflects the fact that the size of the balance sheet of a Russian commercial bank does not necessarily have bearing on its reliability or ability to serve clients.

State-owned banks and banks in which the government has a majority stake are generally considered reliable. As for the private banks, the reliability and quality of the bank depends on the principles of the directors, i.e. on its strategy. When customers decide whether or not a bank is reliable, they generally base their decision not on analyses, but on information from three sources: newspapers, hearsay and on feedback from customers.

To improve the banks' reliability, the CBR has introduced a system of prudential controls in cooperation with the IMF. Its recommendations
issued in 1991 take into account the Basle convention of 1988. The main criterion for these prudential controls is solidity. The CBR is progressively striving for the full eight per cent Basle ratio of capital to risk-weighted assets and plans to attain this market by 1999. The ratio currently stands at four per cent. For the purpose of regular reporting, the CBR has prepared a manual for commercial banks, including a set of standardized reporting forms (On Opening Financial Accounts between Commercial Banks, 1993). Moreover, the World Bank and the European Bank for Reconstruction and Development are working on a project aimed at reshaping Russia's existing banks into a core group of some 30–40 banks capable of meeting international banking standards.

The commercial banks have to rate their credits in five risk categories: standard credits, non-standard, questionable, dangerous and unreliable ("beznaedzhiye sudy"). The reserve requirement measured as a percentage of their balance is as follows: standard credits two per cent, non-standard 2–30 per cent (depending on the collateral), questionable 5–75 per cent, dangerous 30–100 per cent and, finally, unreliable credits 100 per cent, i.e. they must be fully covered by an equal sum in deposits (CBR letter 130/94, p. 5). The reserves are tax deductible which acts as an incentive for banks to exercise caution.

Russia's commercial banks have proved unable to comply with these norms (Makarevich 1995, p. 4). The claims from the large State enterprises were so heavy, that the profits of the commercial banks would not have sufficed to meet these requirements. The commercial banks were therefore allowed to set up a reserve fund that is to be written off within five years.

The commercial banks are not required to report these reserves to the CBR, but they are monitored in conjunction with routine bank inspections. The results of these inspections show that most banks have succeeded in making up only two per cent of these required reserves.

Commercial banks are at liberty to exercise their own judgement in rating their credits in the above-mentioned risk categories. Thus, compliance particularly with the liquidity requirement has been poor. The Russian banks easily tend to depend on a small fraction of the financial market or a certain group of depositors. They accumulate only short-term deposits in current accounts and end up taking out long-term loans. If the borrower is one of the bank's owners, as often is the case, a low interest rate or flexible debt servicing schedules are often granted. Some banks claim, however, that they refuse to grant loans to any owner who is obviously unable to service his debt. In any case, preferential lending to owners does not support the profitability of these banks.
The ultimate objective of banking supervision and inspection is to protect the funds of depositors and investors in the bank. However, there were no regulations limiting clients' risks prior to 1990, when this clause was added to the old CBR legislation. In 1991 the CBR issued a directive obliging commercial bank to accumulate funds to insure deposits (CBR directive on deposit insurance of 1 July 1991). This legislation was supplemented in 1994. Since the beginning of 1995, the CBR has made special an effort to improve the security of deposits. To this end the commercial banks were required to bring their own capital up to the level of deposits made by households. As mentioned earlier, new banks can start accepting deposits no earlier than twelve months after they set up business.

In January 1995 the CBR instructed commercial banks to reduce their uncovered foreign exchange positions by 30 per cent. The CBR also introduced a reserve requirement for the foreign exchange accounts according to which two per cent of the balances on these accounts must be converted into roubles and deposited with the CBR. To protect these deposits, the CBR requires that a share must be deposited with the Central Bank: 22 per cent of deposits maturing in less than 30 days, 15 per cent of those maturing in 30–90 days and 10 per cent of those exceeding 90 days must be deposited with the CBR. The CBR then raised the minimum reserve requirement to tighten the money supply in February, and in April it slightly lowered the reserve requirements to 20, 14 and 10 per cent of the above-mentioned deposits, respectively.

More than 50 per cent of the savings of physical persons are deposited in the State-owned Sberbank, and thus guaranteed by the State. Sberbank’s depositors are mostly pensioners and ordinary citizens, whereas the depositors in the commercial banks are mostly the new rich and well-to-do citizens. Savings in commercial banks are not insured but they earn higher interest. As a rule of the thumb, the riskier the bank, the higher the interest it offers.

3.5 Asset management

Choosing their approach to asset management, the Russian banks face methodological problems that cannot necessarily be remedied through western approaches which, as a rule, can be based on a reliable accounting and internal audit. Some problem areas have come up in recent debate in Russia. Various methods of asset management are being discussed and developed. There is lack of uniformity in the observance and interpretation of cash reserve requirements. The outcome depends on what items
the commercial bank chooses to include in its primary reserves which constitute a principal source of liquidity. These primary reserves are not explicitly stated in the balance sheet but are included under 'cash and credits to other banks' (including funds in accounts with the CBR, funds in correspondent accounts with other banks, cash in vaults, cheques, debt collection documents, etc.) and funds to back the deposits. The ratio of liquid assets or cash to all assets should be at least 15 per cent.

Nor are secondary reserves shown in the balance sheet. These assets consist of first-class shares and claims which are readily convertible into cash, their function being to support the primary reserves. Any assets exceeding these primary and secondary reserves can be used for lending. Lending is the most important item because it is a source of income, but it is also the most risky share of the assets.

Liquidity is given focal attention in fund management. No general premise can be established, however, for the liquidity requirements of different kinds of assets. In practice, the liquidity requirement tends to be evaluated on the basis of intuition, experience, advice, etc.

To avoid this, many banks resort to allotting liquid funds over a number of different kind of assets. Liquid reserves are primarily allotted for settlement of the outstanding liabilities, then for deposits and short term claims, and last of all, for base capital. This method splits the banks into a number of independent 'mini-banks' or small liquidity and profit centres. Again the weakness of this approach is the very independency of these profit and liquidity centres. The Russian economic environment is so unstable that the bank may not be able to react rapidly to, say, a bankrun set off by a rumour. The upside is that there is a lower liquidity requirement and profitability increases because the funds are used more efficiently.

A thorough analysis would necessitate that sources and use of assets be clearly separated from each other. For instance, proceeds from buying and selling foreign exchange seldom compensate the costs of borrowing the necessary rouble cover in the interbank markets. Banks often try to avoid this problem by also asking for deposits when lending to clients /owners. Often the owners of the bank are offered exceptionally advantageous terms and hence turn out to be often the borrowers and depositors. This has turned many Russian banks into 'zero-banks' (banks owned by their own clients) effectively precluding banks from operating on a commercial basis.

Mathematical methods and models provide a sound basis for asset management because they allow the use of assets and liabilities to be optimized with a view to several targets simultaneously: liquidity, profitability, solvency, etc. The problem is only that this works best in a stable
economic environment with all banks following the same, commonly accepted rules. This is not the case in Russia. Nor are the Russian banks able, for the time being, to use such methods or interpret the results of optimization programmes.

Russian banks lack the capability to take into account maturity structures and risks on the assets side, and liabilities on the other. Smaller banks in particular try to satisfy the needs of their clients by tapping the interbank market. As noted above, the cost of this very short-term borrowing usually exceeds the proceeds from lending. More cautious banks resort to the interbank market only when the deposits in the clients' accounts are increasing. However, even this creates a volatile situation which can result in crisis at the first major default of a client. Whenever the costs of borrowed capital exceed the profit on the invested capital, the net cost of borrowed capital increases steeply. It will take a major crisis before it is finally understood that the volume borrowed assets must be no greater (or smaller, for that matter) than is necessary to bring revenues to the bank.

Given the Russian banking sector's present operating environment, the intuitive and practical approach to asset management is obvious: banks concentrate on maximizing their profits from short-term lending. They focus their efforts on maximizing interest proceeds, and the liquidity of collateral. Banks are hesitant about long-term lending due to the persistently high rate of inflation and various other obstacles: lack of experience in enforcement of this or existing bankruptcy law, the absence of a market mechanism to assess the value of collateral, etc.

The existence of old structures in banking characterized by cross-ownership, heavy dependency on State enterprises and having federal or local administration as the principal clients, leads to obvious problems in assessing any bank's profitability, liquidity, solidity and various kinds of risk. 'Zero-banks' represent a fairly common situation in which the shareholders, lenders and borrowers are the same legal or natural persons. More than one third of the largest banks in Russia are 'zero-banks'. As pointed out above, this unavoidably leads to misallocation of savings in loss-making enterprises.

Unfortunately, in real life, it is not only a matter of choosing an analytical approach, but also of sound bookkeeping and data management. This applies particularly to the old banks currently wrestling with problems related to bad debts. In fact, they are unsure of the precise amount of their bad debts, because some of those debts have been transferred to the subsidiaries of factoring companies to conceal them so as to make the balance sheets look better. Many of them have now realised
how bad the situation really is and taken measures to have them re-
claimed or get them written off.

The CBR is now drafting improvements to existing prudential regu-
lations. However, the process of implementing these improved regulations
will be a time-consuming process calling for substantial development and

3.6 Accounting and audit

The authorities in charge of banking supervision and inspection can
hardly operate without adequate access to accurate and reliable bookkeep-
ing which is verified by internal and external auditors. The owners and
management of the commercial banks cannot be properly informed about
the profitability, liquidity and solvency of their banks without reliable
accounting verified by audit. Bankruptcy laws can hardly be enforced
without adequate accounting standards. For these reasons, increasing
attention is paid to banking supervision, inspection, and upgrading of
accounting and audit. Together with stricter licensing rules and capital
and reserve requirements, this yields promise about a healthier banking
sector in the future.

The present legal form and framework of accounts have its roots in
the bookkeeping of the former Soviet Union. This bookkeeping system
served only the controlling needs of the central government and therefore
comprised a large number of individual accounts. This framework has
since then been reformed twice, in 1991 and last in 1995. Nevertheless,
the underlying weaknesses in the structure of the system of accounts still
linger on:

1) accounting practices allow too much flexibility,

2) the system records only the cash flows and not the actual proceeds
   and expenditures created during each accounting period,

3) accounts are kept in roubles and provisions are not made, for in-
   stance, in lending, to accommodate the effect of inflation on claims
   or other items, and

4) the standard criteria for evaluation of assets are ambiguous. Evi-
   dently, most of the real estate assets are undervalued.
There is no accounting law as yet. Such a law is currently under preparation. Once one is familiar with the Russian statutory chart of accounts, it is relatively easy to devise a chart of accounts to meet both Russian and Western standards. Still, in order to use these rouble-denominated accounts as a basis for valuing enterprises, they have to be adjusted to accommodate inflation, undervalued property, depreciation, etc.

In the past auditing was not conducted independently. There were banks and firms which had their own auditing companies. The new legislation prohibits this. According to a Presidential Decree (No. 2263 dated 22 December 1993) all auditing firms must apply for a license from a committee under the CBR. The purpose is to impose discipline and to eliminate unhealthy auditing practices. Currently, according to the interviewed auditors, more than 15–25 per cent of the turnover of enterprises is never seen in the balance sheet.

Under the pressure of increasing competition, the Russian banks are extending their network of branches across the country. This also causes problems for audit firms. The Russian banks have no consolidated accounts covering all their branches in different parts of the country. The changes in the branches’ accounts are only reflected as mirror images in the mother company's accounts. Thus the branch offices have to be individually audited, which again creates greater demand for licensed auditing staff. Obviously, the rapid growth of banking networks poses tougher challenges for auditors.

All Russian accountants have been required to pass a special examination by the 1 July 1995 in one of four license categories: 1) general; 2) insurance; 3) investment companies; and 4) banking. Candidates must have three years’ practical experience before they become eligible to sit for the examination. The licences are granted by three special State commissions, all in Moscow. These examinations will replace the voluntary courses arranged by the Chamber of Chartered Accountants.

Russian banks have no internal audit in the western sense (starting with the bank's general strategy, identifying, carefully screening and monitoring the bank’s risk concentrations ). They usually have their own screening procedures, whereby a bank clerk usually double checks his colleague's work to avoid errors in calculation or in account entries. This internal audit is dependent of the bank's ordinary hierarchy as it is in the West. Commercial banks increasingly resort to consultation with external auditors. International pressure will probably pave roads for Western practices in the future.

The CBR has adapted, with support of the World Bank and IMF, the accounting standards of Broadly Adapted Financial Statements, which represents a first step towards the introduction of international accounting
standards. The implementation of these standards will require a committed effort from banks in terms of adaptation and training.

The largest commercial banks usually also have their accounts audited by international auditing firms not only as a matter of prestige, but also to have their accounting system brought up to date. The six largest international auditing firms have already established a presence in Moscow and St. Petersburg.\(^3\)

As mentioned earlier, the World Bank and EBRD have launched the 'Financial Intermediary Development Project'. This project includes technical support to computerization, standardization and training of personnel. The Russian banks involved in this project have each chosen a Western 'godparent bank' to develop their respective operations. The EU's TACIS (Technical Assistance for Economic Reform in the 11 members of the Commonwealth of Independent States and Georgia) and the USAID have been active in assisting the Russian banks by translating their accounts into US accounting principles and establishing of overseas offices.

Although this Western assistance is generally welcomed and appreciated, criticism has also been voiced. The technical assistance is sometimes considered too theoretical and not entirely relevant to the local requirements. Complaints have been voiced about representatives of Western organisations who cling to 'imperialistic' attitudes: instead of adjusting their methods and approaches to local needs, they insist on forcing local operators into a Western mould. Some major Western auditing firms have acknowledged this and believe that the problem could be overcome at least partly by hiring local people, teaching them Western bookkeeping and auditing procedures and letting them apply these skills at grassroots level.

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\(^3\) Some have already extended heir operations across the country, such as Deloitte & Touche CIS, which also has offices in Vladivostok and smaller business counselling agencies in seven other cities (Reuters 26 April 1995).
4 Conclusions

By western standards, the supervision and inspection of the Russian commercial banks are inadequate. Some commercial banks even operate without a licence and hence outside the official system of banking inspection and controls. Tax evasion is widespread and not all debts are honoured. Accounting practices are not up to international standards, and transparency is lacking. According to the Russian authorities, many commercial banks cooperate with criminals or are involved in illegal activity.

On the other hand, not all the blame should be put on the CBR and Russian banking laws. The absence of traditions, experience and know how in banking necessitate continuous corrective measures and interventions from the CBR. The Russian legal system seems to lack a concept of fiduciary duty obliging agents or trustees to act not in their own interests but in the interests of those whom they serve. Considering the deficiencies in law enforcement, it is bound to take some time before these practices become rooted in Russia. Nevertheless, problems are still liable to emerge all the same even in well developed banking communities, as recent crises in Western banking well demonstrate.

The evolution of banking and banking legislation in Russia, either as an outcome of a conscious strategy or the result of transitional trends in the economic environment, has ranged from extreme liberalism to increasing regulation and control. Despite the fact that Gosbank introduced banking supervision and audit as early as 1989, the threshold in terms of minimum capital requirement for establishing a commercial bank was extremely low. In the early 1990s, newly established banks were fairly free to try out various modes of operation. Having recently dismantled the controls of a centrally planned economy, it was generally felt, that it was time to allow full freedom in business and banking by lifting regulations and inspection.

The Old CBR Legislation and the Commercial Banking Legislation, both passed in 1990, were fairly adequate at the time they were passed, no matter how outdated and obscure they may seem today. These laws broadly streamlined the guidelines that banks were expected to follow. Given that the transitional development of banking and the Russian economy was yet in its early stages, it would have been neither possible nor expedient at that time to issue detailed norms for banking, supervision and controls.

We should bear in mind about the rapid pace of transitional developments since these old laws were issued. The Soviet Union dissolved,
giving the Russian Federation sovereignty with the result that the CBR took over Gosbank's role as central bank in November 1991. Politically decisive events took place in October 1993: a new constitution was adapted and parliamentary elections were held.

The rapidly growing and virtually unregulated commercial banking sector could make rapid and substantial profits by taking advantage of cheap central bank credits, high inflation and wide currency fluctuations. The CBR tried to cope with the rapidly changing situation by issuing a wide array of instructions. Due to an element of improvisation in dealing with new and unexpected developments, this form of 'management by circulars' led to redundancy in instructions and norms. This naturally created insecurity and confusion in the banking community.

Unfortunately, the new freedoms also led to unsound and fraudulent practices, bringing crime and corruption into the banking sector. This 'wild west' atmosphere inevitably prompted a demand for stricter controls. These demands were met starting from 1993–1994 when the CBR phased out its commercial operations and increasingly took over the responsibility for banking supervision and monetary policy. The experience thus accumulated was codified in the New CBR Legislation in 1995.

Whether the Russian banking sector will ever develop into a liberal Western type banking system reliant on market incentives remains to be seen. The market economy now has its chance. At present, the market economy in Russia is not functioning properly enough to guarantee the efficiency of the banking system. The legislation on banks and their supervision is inadequate and inefficiently applied. There is a chronic time shortage because there is too much to be done in too little time. There are bankers who boast of being involved in the derivatives business but admit that their bank is unable to transfer a payment promptly within Russia. The lack of time is an inescapable problem.

There is an obvious need to establish proper legal norms for banking, bank supervision and inspection. Still, much will depend on how the laws are applied. In this sense, the Russian tradition of showing 'bureaucratic muscle' instead of cooperating with those being supervised and inspected may pose problems in the future. There are, moreover, various other factors that may slow down Russia's progress towards becoming a market economy. The old structures still prevail, eg the banks are still owned by their client-organizations. The fear of foreign or non-local competition also fosters protectionist attitudes. The outcry for public measures to prevent organized crime, fraud, taxes evasion, etc. also supports the traditional tendency to resort to administrative intervention.

In the light of the above observations, increased administrative intervention based on supervision and controls seem to be the most likely
path for the development of banking in Russia. Cooperation between the controller and the controlled – for instance, within the framework of the banking associations – should be welcomed to the extent that it will promote self-imposed controls and pursuit of higher moral and ethical standards in the banking sector. Increased cooperation would then reduce overdependence on banking laws, decrees and instructions supported by heavy bureaucracy and, instead, foster self-discipline and compliance with the existing legislation.

The behaviour and norms governing the banking sector necessarily reflect the undercurrents of Russian society. To the extent, that the principles of free market economy are seen to serve the best interests of the Russian economy, there should be no doubt that the banking sector and the legislation governing it should be further adapted to meet the needs of bank owners and their clientele.
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Russian Commercial Banks: 
a Banker's View

by Ilkka Salonen

Contents

1 Introduction ................................................. 121
2 A brief survey of the Russian banking system .......... 123
3 The present structure ........................................ 127
   3.1 Domestic network ...................................... 127
   3.2 Foreign network of the Russian banks ................. 129
   3.3 Foreign banks in Russia ................................ 130
4 The payment system ......................................... 132
5 The currency market ......................................... 135
6 Credit ......................................................... 137
7 The banking crisis ........................................... 140
8 Are holding-structures the answer? ....................... 142
9 Concluding remarks .......................................... 144
1 Introduction

A financial system enabling payments to be made in an efficient and credible way, on the one hand, and fulfilling the financing needs of the economic agents (be they households or enterprises), on the other hand, is an essential element of any society striving for the well-being of its members. From this perspective it is clear that when the structure of the society changes, the banking system must also undergo a fundamental restructuring.

For Russia, the birth of a banking system basing its behaviour on commercial laws has been an integral part of the astonishing change the country has undergone during the past decade. In one of his theatrical spectacles, the famous playwright Bertolt Brecht states that it is a far smaller crime to rob a bank than establish one. If this is true, a large number of serious crimes have been committed in Russia in the last five or six years: the country has seen the start-up of more than 2 500 new banks in this short period.

The need to analyse the banking system in a country like Russia is enormous, both for the internal and the external institutions cooperating with the newly created banks. With most of the banks having a very brief history which has taken shape in a newly emerging market, a qualitative analysis inevitably involves a lot of value judgements. Unlike an analysis based on the balance sheet and profit/loss account, this analysis must rely on a history too short for clarifying any stable tendencies.

This article is exactly what is promised in the headline: a banker's view. Had another banker pursued this, the view would most probably be different. Moreover had this very same banker written his view six months ago, or even six months from now, the view would also most likely be somewhat different.

The aim of this text is not to try to analyse what is wrong and what is right. It humbly attempts to provide the reader with a snapshot of how the system can look like from the inside.

One specific topic which remains totally outside the discussion is the Russian banks' links with crime and criminal structures. This very important topic should be discussed in a separate article and not by a banker, but by a policeman.

The next chapter deals briefly with the history of the Russian banking system. Again the aim is to stay as close to everyday banking as possible. Further, this article provides a brief description of the structure of today's banking system in Russia. Later, we speak about the technologies related
to certain key operations (payments, forex, credits). The instabilities of the present system are discussed in the last two sections\textsuperscript{1}.

\footnote{The sources drawn on for this story are mostly discussions with colleagues and friends. Some articles from daily newspapers have also been used. I apologize for any unacknowledged sources used in this text. The opinions expressed are those of the writer and do not necessarily represent the institution for which he is working.}
2  A brief survey of the Russian banking system

As in other countries, the banking system in the centrally planned Soviet Union was a reflection of the economic system as a whole. There was a very limited number of banks, which was possible because of the existence of monopolies in other spheres of the economy: the Central Bank (State Bank or Gosbank), the Savings Institution (sberetagelina kassa), an institution for the financing of major projects (Stroibank) and the Foreign Trade Bank of the Soviet Union (Vneshtorgbank). It goes without saying that no competition prevailed (except for power) between these institutions, and each of them had clearly defined functions.

The Savings Institution absorbed from a liquid market the savings of private persons and transferred this money to the State budget. The liquidity of this market was guaranteed by the fact that an ordinary Soviet citizen had practically no assets available to be invested in legally (apart from jewellery and some durable consumer goods like cars) which could have been resold in exchange for ready cash.

Stroibank focused on the domestic financing of major construction or industrial projects and drew all its funding from the budget. Stroibank's role was actually more of an extended arm of the State planning committee (Gosplan) than that of a real financial institution. Its main task was to ensure that the money was used for the purposes decided upon by the respective bodies. On the other hand, the amount of non-performing loans was not at issue since liabilities derived from the same source as the assets.

Vneshtorgbank was the country's financial institution visible to the outer world. It had the exclusive right to deal in foreign currencies. In other words, it utilized the good name of the Soviet Union on the international syndication market to obtain funds for the country, and it was also one of the really big players in placing funds on the international money market.

Notably, Vneshtorgbank's balance sheet was virtually the only route by which a foreign currency-denominated item could legally enter the

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2 Actually, there were two other pre-Perestroika-era banks authorized to operate in the foreign exchange sector: the International Investment Bank (IIB) and the International Bank for Economic Cooperation (IBEC). These two banks were jointly owned by the COMECON countries. Their biggest borrower was the Soviet Union, but a widely held opinion among the Western bankers was that their scope for independent action was very limited.
Soviet Union (apart from cash in the pocket of a tourist), hence it effectively formed a buffer between the rouble and hard currencies. The exporter never saw the dollars, but received the amount of roubles the currency coefficient allowed them to have. Vneshtorgbank's clientele was effectively limited to fewer than a hundred so-called Foreign Trade Organisations (FTO). With this arrangement the foreign-related financial transactions of the entire country were handled by a very small number of bankers.

Last, but by no means least on the list, is the Central Bank, which of course was the institution issuing the country's legal tender. The Central Bank was also obliged to extend short-term financing to industrial companies and all the financing needed by the agricultural sector.

In a country intent on meeting quantitative targets and where money had meaning only as an accounting unit and a means of transaction, this kind of banking system functioned in a satisfactory way. Since the prices of goods were set artificially, the exchange rates did not reflect the 'real' purchasing power of the rouble. As long as currency control, in the broadest sense of the word, was working, the black market was kept under control.

The reforms started in 1985 by the General Secretary of the CPSU, Mikhail S. Gorbachev had very little immediate impact on the banking system. After a year or so, however, articles started to appear in the economic press in which then the Chairman of Gosbank Mr. Viktor Dementsev lectured to the companies that a credit has a limited life span and the idea should be that the borrower pays back his obligations.

This new tone appeared at the same time as companies were expected to transfer to the system of self-financing (hozraschot). In practice, this meant that they could no longer rely on paying back the credit from the State's budget, but had to create the income stream for servicing their debt themselves. It was clear, however, that without the possibility of bankruptcy a key part of self-financing was missing.

When the decision making for individual enterprises was brought closer to the companies themselves, the need for a less monolithic banking system became apparent. At the beginning of 1988, a system of specialized banks was introduced in the Soviet Union:

- The Savings Bank, relying on the same principles as the Savings Institution, was required to service private persons, including the supply of credit,
- Agprombank, formed by the department within Gosbank which took care of agriculture, specialises in agricultural customers,
- Promstroibank, the successor of Stroibank, was concerned with heavy industry and construction,
- Zhilsotsbank granted services to light industry, the service sector and municipalities and
- Vneshekonombank or the Bank for Foreign Economic Affairs of the USSR, the renamed Vneshtorgbank, which held the currency monopoly and served as the Government's agent in foreign currency-denominated transactions.

It goes without saying that Gosbank did not vanish, but freed itself from commercial operations and took upon itself the traditional role of a central bank. A Council of banks was also created comprising the presidents of each specialized bank and chaired with unchallenged authority by the Chairman of the State Bank. The ultimate purpose of this Council remained somewhat obscure.

The stated aim was to move into a two-tier banking system. Some restrictions remained: the banks were given their customers from above and only Vneshekonombank could grant foreign currency-related services. Speculation as to when and in what form the specialized banks would get their currency licences ran high. Since there was no consensus among the banks, it was impossible to issue new banking laws. It was clear, however, that it was only a question of time before the monopoly was broken once the FTOs' monopoly was abolished and Vneshekonombank's clientele grew to some tens of thousands. It was obvious that the old structures could no longer meet the demands of the new system.

At the same time, a reform which was to be of immense importance to the development of the Russia's market economy was introduced: it became possible to establish commercial and cooperative banks. The first ones started their operations in the summer of 1988. In 1989, Vneshekonombank's currency monopoly was broken and the number of banks authorised to operate in the currency sector grew slowly but steadily. Despite this and the fact that the number of banks had grown to more than 1000, banking laws were not passed by the Supreme Soviet until 1990.

When the Soviet Union fell apart at the end of 1991, so did the banking system. Many specialized banks were split into smaller units and the newcomer, Zhilsotsbank, went out of business altogether. New institutions were born out of the old structures and regional branches were transformed into independent banks.

Along with the (r)evolution of society, the banks' role and character changed. Many of the old ones were transformed into Limited Liability Companies and some became publicly listed as soon as this was possible.
These rapid changes gave a strong impetus to some of the newly established banks, and they grew from regional institutions into banks of nationwide importance. Though in recent years this process has slowed down substantially, it is still possible for a bank to rise out of nothing and make the top ten list in less than two years; this can be taken as a sign that the structural evolution of the system is yet incomplete.
3 The present structure

As in other countries, Russia's Central Bank plays a crucial role when a new bank is to be opened. One of the key parameters for the Bank of Russia seems to be the bank's capital. The aim is to bring Russia in line with European standards by the end of this century, which would entail a minimum sum of capital equivalent to ECU 5 million. At present, however, this goal seems rather remote: only less than 10 per cent of the banks have capital exceeding 5 billion roubles (less than USD 1 million). According to the Head of the Association of the Russian Banks, Mr. Sergey Yegorov (Delovye Lyudi, April 1995 No. 55), to attain this goal, the banking system would require capital injection amounting to 30 trillion roubles (approximately USD 7 billion). One can only wonder where such sums of money can be found.

The policy of the Central Bank is to urge the banks to increase their equity by raising the minimum requirements step-by-step. A bank wishing to conduct international operations should, according to the rules prevailing at present, have capital of no less than 6 billion roubles (ECU 1 million) and a bank operating solely on the domestic market can still do so with as little as 1.5 billion roubles (ECU 0.25 million). It is worth noting that these minimum amounts are indexed to the rouble/ECU rate.

A Russian bank can obtain basically one of three types of licence:

- a general licence, which enables the bank to execute all operations included in the law on banks (252 banks have this kind of licence)
- a limited currency licence, with which the bank can execute operations in hard currencies, but with certain limitations in its cross-border operations (774) and
- a domestic licence only for the rest of the banks.

3.1 Domestic network

At the moment Russia has around 2 500 registered banks with a combined total of 44 159 individual branches. To get the whole picture, we have to look at the structure a bit closer. Out of the figure presented

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3 The figures presented in this chapter are from the Central Bank's publication 'Vestnik Banka Rossii', issue March 14, 1995.
above, as many as 38,567 branches are in the Savings banks chain. If we
then deduct the 1,202 branches belonging to Agroprombank – which
inherited this network from Gosbank in 1988 – the combined figure for
all other banks is no greater than 4,390. The obvious conclusion to be
drawn from this is that there are many banks with only headquarters or
one branch.

Some of the new banks have in their relatively brief existence
developed a fairly extensive network. For some banks it seems to be an
end in itself to establish a presence everywhere. As a Vice President of
one of the banks put it: 'When we run out of cities with a million
inhabitants, we move over to ones with 700,000 people and when these
are exhausted we go on to the next level.' In almost any market, there is
one valuable lesson to be learnt from the history of banking: that it is
extremely difficult to grow rapidly and maintain stability. Fast growth is
easily paid for a few years after the assets have been added to the balance
sheet. At this stage, it is too early to assess whether the Russian banks
have succeeded in avoiding the mistakes many of their fast growing
predecessors made on other markets.

It is almost exclusively the Moscow-based banks which are expand-
ing their network over the vast area of Russia. Although banks from other
regions have outlets in Moscow and St. Petersburg, due to lack of capital
or other reasons, they seldom choose to expand any further than this. On
the other hand, the regional banks usually maintain an extremely strong
position on their 'home field' and have the full support of the local autho-
rities.

Muscovite expansion is often far from welcomed by the regional
banks who are afraid that the more capital-rich banks will come and take
the best customers and leave the local banks to deal with the financially
weaker companies. There is also fear of the outside banks coming and
channelling the financial resources of one region as credits into
investments in other regions. It is hard to prove this argument right or
wrong since there is a lack of relevant statistics. Logically, one would
think that the investment needs and subsequent demand for credits is so
substantial in any area of today's Russia that a bank with serious inten-
tions of working in a region would have difficulties 'exporting' capital
without endangering the local funding base.
3.2 Foreign network of the Russian banks

The Russian banking system inherited a number of foreign outlets from the time of the Soviet Union, the best known of which are Donaubank in Vienna, East West United in Luxembourg, Eurobank in Paris, Moscow Narodny Bank in London and Ost-West Handelsbanken in Frankfurt. Most of these are still either majority owned by the Central Bank or under its fairly strict control. Some of the units were inherited by the Vneshtorgbank of Russian Federation from the Vneshekonombank (e.g. the branch in Cyprus and the Zurich bank were inherited from Vneshekonombank).

Some of the new banks have also been actively establishing units abroad. The most popular place is Cyprus because of its status as a tax haven. Typically, a branch or a fully owned subsidiary is opened and the idea is to evade the high Russian tax rates and profit from the relative low rates of Cyprus. The fact that the island hosts a plethora of off-shore companies of Russian origin could also offer potential for local business.

The new banks are also expanding to other places. London and New York are obvious choices for opening a representative office, while some also have a presence in Frankfurt and Helsinki. One bank recently announced its intention of entering the Chinese and Vietnamese markets. At the same time, there has been news that western authorities are trying to limit the activities of Russian banks operating in the west. In the United Kingdom, for example, several dozen Russian banks, understood to have sought authorisation for branches or subsidiaries in London, have been advised by British authorities not to make a formal application. Instead, they have been encouraged to set up representative offices. The situation in the United States is similar. The reason for this caution is said to be that the authorities in the West are concerned about the instability of the Russian banking system and the ability of Russian banks to maintain Western banking standards (Financial Times, October 13, 1995).

So far it is hard to rate the success of Russian banks that have launched operations abroad. As difficult as it may be to be profitable in the fiercely competitive conditions of international financial centres, this process is an important step for the new Russian banking community on the road to integration into the international banking system. This can also be seen as a tendency throughout the Russian economy as a whole to step up its cooperation with the outside world.
3.3 Foreign banks in Russia

One of the hottest topics of discussion has been the participation of foreign banks in the Russian banking system. As recently as 1993, most of the big Russian banks were lobbying quite strongly against letting in foreign banks. As in many other countries, the local Russian banks accused the big international banks of coming in and establishing a too-dominant role in the nation's financial system.

This discussion led to the president's decree, issued in autumn 1993, which stated that the share of foreign banks in the equity of the banking system should not exceed 12 per cent. Also according to this decree, foreign banks starting their operations after November 1993 can operate only on a so-called off-shore basis (i.e. being authorised to grant services only in foreign currencies and to non-residents or banks with a currency licence). The adoption of the latter rule is, however, not so straightforward, as Russia has concluded agreements with the EU, whereby banks from EU member countries are entitled to offer full-range banking services in the Russian market.

In autumn 1995, subsidiaries of about a dozen foreign banks were active in Russia, along with one branch, operating only on an off-shore basis. All of the foreign, full-fledged banking units were located either in Moscow or St. Petersburg. The actual tendency is for a concentration of banks in Moscow with some of the foreign banks maintaining scaled-down operations in St. Petersburg. Taking a longer view, the picture will almost certainly become more diversified in the future. A non-Russian bank with a competitive edge in the Far East would under normal circumstances open its unit in some of the cities of Far East. So far, however, Russia's financial system is so heavily concentrated in Moscow that this logic does not yet operate.

Another notable tendency has been that foreign, non-banking investors have acquired a stake in some Russian banks. They are still not dominant in the banks, but they could be a potential source of technology transfer if the investor has serious intentions.

Recently, with the Russian banks becoming more sophisticated and starting to tap the international market by setting up operations abroad, the issue of foreign banks has acquired new dimensions. For example, the general practice of reciprocity cools down the ambitions of the local banks, which want to penetrate the international markets, and yet build barriers preventing the entry (cf. the agreement with the EU) of foreign banks in Russia.
The above-mentioned president's decree of 1993 expires at the end of 1996. It remains to be seen how the rules of the game will change; one could assume that some kind of restrictions will be kept in place. Whether these impose direct limits on foreign ownership in the banks with full licences, or whether they place a limit on the share of foreign-owned banks in the banking system as a whole is very much dependent on the then prevailing political situation.
4 The payment system

Regarding payments, in the case of Russia one has to make a clear distinction between payments crossing the border and payments made within the country. Technically, the larger banks are well equipped to make international payments which meet international standards; the number of banks which are members of SWIFT is constantly growing and is expected to exceed 200 during 1995. In practice, this means that if a Russian importer has a sufficient balance on its account, the foreign exporter can receive payment as rapidly as from almost any other country, provided that the terms of contract have been met.

As is well known, a substantial amount of money has fled Russia for various reasons during the last few years. In order to bring this outflow under control, the Central Bank is establishing a comprehensive system of foreign exchange regulation. Control over the repatriation of export earnings has been in place for more than a year, and preparations for implementing a system for controlling import payments have been in progress for same time, with completion expected during 1995 (cf. Kommersant Daily No. 77, April 27, 1995).

For the commercial banks the regulation system is of immense importance, as the Central Bank is currently executing control through the so-called authorized banks. In controlling export earnings this means the Russian exporter has to register a certificate of the deal (passport sdelki) at an authorized bank which, in turn, is obliged to ensure the money is paid to the exporter's account (held at the same bank) within the stipulated time period. If this does not happen, the bank in question has to inform the tax authorities, who then act accordingly. If the bank fails to fulfill its obligations, the sanctions imposed on it are directly related to the value of the contract and can thus be very severe.

As the saying goes, there is no better consultant than the dollar. This seems to be true for Russian currency regulation, too: according to the Central Bank, the amount of export earnings illegally held abroad has dropped from 70 per cent of the value of total exports in 1992 to 12 per cent in 1994, which amounted to USD 2 billion (Kommersant No.77, April 27, 1995).

The domestic payment system is, however, more complicated. At present the rules are fairly clear: two Russian (i.e. resident Russians in the currency regulation sense of the word) legal entities have to settle their commercial deals in the legal tender of the country, the rouble. Furthermore, they have to do so using bank transfers – no cash payments are
allowed. Any deviation from this requires the permission of the Central Bank.

Foreign companies doing business with Russian companies in the early 1990s well remember how it took weeks for a payment to reach the beneficiary within Russia. Correspondingly, a Russian importer, even with the option of buying foreign currency against an import contract, could not obtain the money without a major delay. In circumstances of hyperinflation this was, of course, detrimental and in many ways paved the way for capital outflow. Since then the situation has improved substantially: for instance in Moscow a payment can be made within a day, and money can be transferred a lot faster from one end of the country to the other than was possible a couple of years ago.

A payment can be channelled in two main ways: either through the payment centres of the Central Bank or as transfers to and from direct correspondent accounts between two banks. There are few independent clearing houses, and so the volume of operations channelled through them consequently remains, for the time being, relatively small.

For quite some time, the Central Bank’s payment centre system was the only channel for transferring money from one region to another within the former Soviet Union. Direct account relations in roubles between two Russian banks was not possible until 1992. Since then, some banks have developed an impressive set of correspondent relations within Russia and are transferring money within this framework. However, payment centres of this kind are based on bilateral relations, and, at least for the time being, no real clearing operations are made.

The Central Bank has a payment centre (Raschotno Kassowyi Tsentr) in every Region and big city. Each of the banks operating in this region/city has a current account in the centre. Payments are made through debiting and crediting the correspondent accounts of the banks in respective centres. Figure 1 shows an example of a transfer chain. It is notable that whenever a bank transfers money from one region to another and the final beneficiary is a customer of another bank the money passes through two different payment centres at the Central Bank. The maximum time for executing a payment order in one centre is officially set at two banking days. In practice, however, a week can easily be lost in transferring money from Moscow to, for instance, Vladivostok, but, as noted above, this compares well to the earlier practices.

One of the problems with the existing system is that the computer technology of the different regional payment centres is not consistent, which makes it slower to create a functioning clearing system than with a more homogenous hard ware structure. This has led to a process whereby
some banks have created independent clearing houses which are licensed by the Central Bank.

At the moment it is difficult to foresee the shape of the 'final' payment system in Russia. In spite of this, it is clear that, as in other countries, the Central Bank holds the key. It is therefore tempting to take the view that the payment centres will remain part of system.

Figure 1. **Settlements by rouble payment orders in the Russian Federation**
Example of advance payment for goods, services rendered, etc.
5 The currency market

One date will always remain significant whenever the economic history of Russia is written (or re-written): the day the country instituted a unified rate of exchange. Amongst its many effects it made cross-border prices comparable for everyone. Indeed, the RUR/USD rate quickly became part of the average Russian's everyday life. In Moscow, at least, people are extremely sensitive to any dramatic change in the country's fortunes and promptly revise their position according to their expectations.

Until 1994 the bulk of foreign exchange operations were handled through the Moscow Interbank Currency Exchange (MICEX) or other corresponding units in St. Petersburg, Yekaterinburg, Vladivostok, Rostov na Don, Nizhni Novgorod, Novosibirsk and Samara. This also meant that a substantial part of foreign exchange deals were commercial in nature. Trends in trading volumes in the MICEX in 1995 are illustrated in Figure 2.

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It was no surprise that when the rules were liberalised the banks began increasingly to conclude deals outside the currency exchanges. In all the foreign exchange markets the bulk of turnover is created by interbank transactions. In Moscow this development was boosted by a special tax introduced by the municipal authorities. In 1995 the bulk of operations have already been carried out on the interbank market, though the number of regular participants in the market is still limited.

In spite of these developments, the MICEX still plays a significant role. The rate quoted in the each day's session is still an important benchmark which also has a great symbolic value, as was shown on 'Black Tuesday' in October 1994. The Central Bank closely follows developments at the MICEX and reacts through interventions if the rate is moving in an undesirable direction. The presence of the Central Bank is clearly also felt from time to time on the interbank market.

So far, the instruments in the RUR/USD market are not too sophisticated. The bulk of operations are spot deals. Some forward deals are also made, but only for very short periods. A well-functioning forward market requires a well-functioning (cash) money market in the domestic currency; this is still under development in Russia. The Central Bank could give a strong boost to a rouble money market by establishing a refinance system with a term structure for interest rates and clearly established rules.

Though the creation of a domestic interbank market is the logical outcome of this course of events, it seems that in the unstable circumstances typical of an emerging market the MICEX will have a role to play for at least the foreseeable future. The MICEX could also develop into a market for derivatives and stocks, as it has the infrastructure in place and clear rules already established.
6 Credit

Like any other company the banks need raw materials for their operations. For commercial banks, in particular, constant and sufficiently stable supplies of raw material are of vital importance to credit operations. In an emerging market like Russia, lending is often constrained by the short supply of funding.

In today's Russia the possibilities of establishing fixed-term deposits are virtually nonexistent among most companies, and even among those for whom it is possible there is practically no willingness to do it. The uncertainties are so great that companies calculate the opportunity cost of tying up their liquidity to be extremely high.

Looking at Russia from the outside, the commercial and other risks are deemed to be so high that there are only a few organisations willing to lend across the border to Russian banks and, even in these cases, they are understandably very strict on their terms and want to study each individual project very thoroughly.

Bearing these points in mind, it is no wonder that the prices of dollar funds on the Russian market are well above the Euromarket. The Russian financial newspapers frequently have advertisements from banks quoting one-month dollar at 15–20% p.a. in an attempt to obtain funds from the general public and/or corporations. On the interbank market even the very few top names pay more than 10 per cent for the same period.

When a margin is added to the figures quoted above, which in Russia is understandably much wider than those quoted in the international markets, the cost of a borrowed dollar can rise up to 30% p.a.

In terms of the rouble, it is more convenient to look at interest rates based on a per month basis rather than per annum. The tendency of the Central Bank has recently been to keep rouble rates above inflation; with the present rate of inflation, this means interest rates are still three digit numbers. Margins are also higher than those associated with the dollar.

In the early stages of market reform high returns (especially pre-tax returns) were so common that the cost of borrowing was relatively unimportant. With the present underlying economic tendencies (inflation slowing down, rouble stabilizing, the strongly stated wish of the

---

5 In the mid 1994, in Moscow it was not unusual for someone to promise a 60 per cent return in currencies. This was usually possible only for companies importing foodstuffs or consumer goods and to sell the goods in a short period on internal markets in roubles and then convert the proceeds into dollars, thus accepting a huge open foreign exchange position.
government to keep the budget deficit under control) it is difficult to find a single project so profitable that it can pay off its loans and still leave a satisfactory return for the investor.

So far, most banks have kept the maturities of their lending well below one year. Recently, however, there has been a tendency for some banks to introduce longer maturities as well (cf. Kommersant Weekly No. 7, February 28, 1995). The number of companies eligible for investment loans is still small, but the fact that there are banks with half their loan portfolio in maturities exceeding one year shows that confidence is growing and a badly needed investment credit market is emerging.

Looking to the future, it seems clear that maintaining investments at a sufficiently high level will be a crucial precondition for accomplishing a sustainable stabilisation of the economy. However, so far there does not seem to be any clear policy from the government for supporting manufacturers and improving their competitiveness vis-a-vis foreign competitors. Investment sums are huge; the cost of individual projects can rise to hundreds of millions of dollars. Indeed it is hard to believe that such sums can be realized without government support - and perhaps even the support of governments in Russia's trading partner countries.

From the macro-economic viewpoint the crucial question is how this can be done without the current account deficit becoming intolerable. As long as the question of the indebtedness inherited from the previous Soviet Union remains it presents a kind of natural constraint, as most agents in the market are unwilling to accept the risk in a country which has not restructured its unpaid debt. At the time of writing, the so-called London Club is scheduled to meet in order to resolve the issue together with representatives of the Russian government. If this succeeds, the constraints will probably be eased somewhat (subject, of course, to political stability), though it will certainly take some time to regain the confidence of investors when seeking to borrow for the medium or long term.6

It is clear that without the support of institutions like the IFC and the EBRD the medium-term loan market in Russia would develop only slowly if at all, given the prevailing conditions. Recently there have been encouraging signs from the international banks regarding a growing readiness to accept Russian short-term risk. So far, the deals have been relatively straightforward pre-export financing arrangements, in which the financing bank accepts the performance risk of the Russian enterprise

6 In the mid November 1995, Russia reaced an agreement with the London Club of Creditors to reschedule its commercial bank loans. Under the deal, Russia will reschedule about USD 25.5 billion in principal over 25 years and USD 7 billion of interest over 20 years, both with a seven year grace period (editor's note).
in question. Usually the companies having access to such financing have to produce tradable commodities. If these kinds of deals are successful the next step might include consideration of longer maturities and official approval for certain Russian banks. It must, however, be stressed that a functioning syndication market is not yet possible and that much depends on political developments in Russia.
7 The banking crisis

The word 'crisis' has often been brought up in connection with analyses of the Russian banking system. The reason is the same as in many other countries where the system has had to face unstable conditions: more and more customers are unable to meet their obligations with the banks. One feature peculiar to an economy undergoing fundamental transformation is present in Russia too: the banks have inherited a major share of the poor quality assets left over from the old system. This extra burden is carried especially by the larger banks created from former specialized banks.

According to the Association of Russian Banks around 500 banks were writing their profit and loss statements in red ink in 1994. Consequently a growing number of banks are experiencing difficulty in fulfilling the needs of their customers and are having to re-negotiate the maturities of their interbank deposits.

Although the reasons behind this worsening situation have to be analysed in more detail, on the surface there seem to be two basic reasons: the tightening up of budgetary policy (which reduces money in circulation and creates difficulties for companies which were used to 'soft' budget constraints) and the slowing down of inflation, which leads to higher real interest rates and allows fewer 'mistakes' to be masked by high inflation. These two factors are interrelated. Another contributory factor referred to in the press is the tougher policy of the Central Bank towards banks with overdue payments in its settlement centres (Kommer- sant Daily, April 25, 1995 No. 75).

The situation has so far remained calm, since most of the banks in trouble were relatively small and so their insolvency did not have a major impact on the system. However, if a major bank were to be in difficulty the general reaction would be rather different, as there is no insurance for deposits held in private banks.

The increasing uncertainty was show in the abrupt rise in the amounts traded on the MICEX in the last days of April (see Figure 2). A likely explanation is that the confidence felt by the banks in dealing directly with each other has fallen sharply and they have instead returned to dealing through MICEX where the risk is small as the MICEX requires strong guarantees or cash cover. Naturally, the liquidity crisis in the banking sector in August 1995 demonstrated even more clearly the current problems of confidence between the banks.

The overall indebtedness in the country has almost reached 200 trillion roubles (around USD 40 billion). The share of non-current loans in the loan portfolio of the commercial banks is said to be, on average,
25–30 per cent (Finansovye Izvestija No.13, February 23, 1995). Even though margins, especially in rouble-denominated loans, tend to be high, the refinancing of these non-performing loans must be a major burden to many banks (and interest payments are in arrears in many cases), especially with the prospect of inflation coming down and real rates growing.

In some countries the central bank has encouraged banks to create so-called generic reserves for bad loans by, for example, accepting the accumulation of these kind of reserves up to certain percentage share of the loan stock before taxes. In Russia there is currently intense discussion between the banks, on the one hand, and the tax authorities and Ministry of Finance, on the other, as the latter want to retroactively impose taxes on the provisions made by the banks in 1994.

It is difficult to evaluate the extent of reserves for bad loans in the banking system as a whole, but with the banks growing fast – which means heavy investments and simultaneously paying handsome dividends (some banks paid up to 1 000 per cent from 1994 profits) – it would be no surprise if the size of reserves did not meet the volume of noncurrent assets in many banks.

In the well-known cases of pyramid-like funds in which ordinary people lost substantial amounts of money, the Central Bank could not be blamed as there was no clear division of responsibilities between the authorities (the Ministry of Finance and the Central Bank) and no up-to-date legislation. Today this would, however, no longer be a case, as a recently passed law relating to the Central Bank clearly states that one of its functions is to ensure the development and strengthening of the banking system. It is also clearly stated in the law that the Central Bank is the lender of last resort for the banks.

It is hard to envisage the banking system of any country vanishing completely. This is true of Russia as well. On the other hand, it is equally hard to avoid coming to the conclusion that the Russian banking system is still facing a major structural change through mergers and even bankruptcies.
Are holding-structures the answer?

Many Russian banks began as institutions with the sole purpose of servicing the needs of one or a very limited number of shareholders. These banks were soon nicknamed 'pocket banks' (karmannye banki). With the emergence of more independent and financially strong banks the establishing of financial holdings in which a bank forms the nucleus of the structure has started to gain momentum.

Though initially the reason behind the creation of holdings might have been simply to enable a bank to become active in non banking operations (e.g. real estate), these kind of holdings have clearly become an important means of concentrating economic power.

In the Russian context, there are two types of holding structures: the so-called Financial Industrial Groups (FIG) and pure banking holdings. The latter are simply formations of groups of banks, some of which are created as a bank expands regionally through acquiring a majority of shares in several regional banks.

The FIGs, on the other hand, are more complicated structures. An important motivation behind the establishment of these groupings is a decree issued by President Jeltsin in 1993 which gives tax exemptions to intragroup operations. About a dozen FIGs have been formally registered, although informal FIGs are widespread. These range from a 'closed club' with a limited number of members to groups with over 500 participants, where ties are fairly loose.

The purpose of some of these groups seems to be to create a powerful union of financial institutions and industrial companies. In most of these cases the bankers appear to be the driving force. Some of the banks may go as far as openly informing a borrower that it would be preferable not to repay a loan but instead transfer the shares deposited as collateral to the ownership of the bank.

At this point a comparison could be made between the American way of restricting the role of banks to that of lenders and the German system where banks can fairly freely own shares in non-banking companies. It is tempting to argue – again in the absence of any more thorough analysis – that Russia did not have any choice here, as the banks have been, and to great extent still are, the only available institutional investors with meaningful resources.

What will be the end result of this process? The creation of a bank-controlled economy where the market is divided amongst a limited number of financial institutions defending their own interests? This might well be a temporary result. On the other hand, it is hard to believe that a
single bank or even a group of banks could exclusively manage the financial needs of the big conglomerates (i.e. the metallurgical or oil industry) which badly need financial resources for realizing huge investments in production equipment. The sheer size of the country will most probably lead to the emergence of a more multi-faceted structure with functioning capital markets and pure investment banks playing an important role in managing the financial needs of enterprises.
9 Concluding remarks

Anyone working on the Russian market will frequently be asked how many banks are likely to survive in Russia and to name them. (With rapidly developing information technology this could also be a valid question on Western markets, too!) It is doubtful whether anyone would be prepared to reveal such a list, should it exist. Nevertheless, it is expected that the number of banks will drop from the present level. On the other hand, the number of actual banking premises may rise, as the number of branch offices is constantly growing.

It is unlikely that the development of markets can be stopped. With the new instruments, whichever parties are in government will notice that they are also dependent on local investors in financing the budget. According to the latest information, this market will also be opened up to international investors.

If we try to create plausible scenarios for the future in Russia it is hard to imagine any where the banks would not have an important role to play.
Capital Markets in Russia: Putting the Cart Before the Horse?¹

by Lev M. Gelman and Alexandra G. Morozova

Contents

1 Introduction ................................................. 147
2 Market sectors ............................................. 149
   2.1 Government and municipal securities ............... 149
   2.2 Equity market trends .................................. 155
   2.3 Debt instruments and new private sector securities . 162
3 Marketmakers and market infrastructure ............... 163
4 Conclusions ................................................. 165

¹ This paper represent only the views of the authors.
1 Introduction

No-one would argue that the capital market in Russia has not experienced major growth over the last five years. Economic crisis and the absence of financial stability did not allow the market to achieve the necessary depth and volume, but even during the stagnation, market infrastructure was created virtually from scratch. As soon as the first signs of financial stabilization are seen, the available infrastructure should facilitate business growth.

Market forces have helped to establish several competing trading systems for stocks. In 1994 traders, brokers and corporate investors were able to locate and acquire some of the industrial stars of the Russian economy. Attitudes tend to change with time, however, influenced by the specific features of the Russian equity market, currently oriented toward the interests of foreign investors. This change in attitudes is reflected in the list of most-traded industries. Many of the market traders simply imitate each other: if one broker begins to buy shares in an energy producing company because he has an order from a foreign investor, other dealers will start to do the same. Such switching occurs in any market, but because the Russian market is tenuous, the price volatility is greater. If stock issued by the banks was popular in the market in 1993 and 1994, in 1995 the most attractive stocks are in telecommunications, oil and gas, metallurgy (ferrous and non-ferrous), food processing and other mainly export-related industries.

Legislators need to pass new laws to clarify the roles and responsibilities of market participants. The basis for the legal environment was laid down in 1990 in the Law on Joint Stock Companies. In accordance with the former Soviet tradition, the right to regulate the stock market in Russia before 1995 was vested in three different agencies: to Ministry of Finance, the State Property Committee and the Central Bank, which did not coordinate their regulating activities very well. Moreover, taking into consideration the existence of funds ready to be invested, the issuing of government securities could not be coordinated with the sale of government-held shares in the process of privatization. All this led to unnecessary competition for capital between different state agencies. The years of 1993 and 1994 were a period of

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2 A recent (1995) survey conducted by the State Property Committee revealed that there are more than USD 9 billion held by Russian banks, insurance companies and households ready to be invested in different sectors of the Russian capital markets (Commercsant Weekly No. 23, 1995).
some uncertainty from the perspective of market regulation. The
government and the Central Bank had several legal conflicts which
prevented further developments in legislation. The Law on Joint Stock
Companies is now outdated and prevents further market development. Its
prospective replacement has just passed the first reading in the Duma and
is not likely to be implemented before 1996. However, a law or decree is
in itself not sufficient; a law enforcement mechanism or agency is also
necessary. Such an agency, the Federal Commission on Securities and
Stock Markets, was created at the end of 1994.
2 Market sectors

The capital market in Russia represents a conglomerate of sectors which differ in terms of organization, procedures, level of technical sophistication, liquidity and traditions.

The market can be broadly represented by the following sectors: (i) government securities; (ii) municipal securities; (iii) stocks and bonds of privatized corporations; (iv) bank securities; (v) securities of private corporations.

2.1 Government and municipal securities

The market for government securities is the most organized and technically developed. Short-term, zero-coupon government notes with a three, six and twelve-month maturity, known as GKOAs, have been traded daily on the Moscow International Currency Exchange (MICEX) since 18 May 1993 by authorized dealers whose number grew from 27 in 1993 to 51 in 1994. In 1994, the total value of government T-bills issued was equal to 20 500 billion rubles (3.2% of GDP), compared to 230 billion rubles (0.1% of GDP) in 1993 (Rossiyskaya Gazeta, 17 February 1995).

The Central Bank and the Ministry of Finance have been attempting to place increasingly large amounts of GKOAs on the market. In 1994, yields grew and the supply increased. The government’s 1995 budget depends heavily on the GKO market as the primary source of non-inflationary financing. The 1995 budget deficit forecast to be 73 100 billion roubles, of which 12 600 billion is to be covered through issuing GKOAs. To do so, the total value of GKOAs issued has to be approximately 6 per cent of GDP. However, some analysts believe that the demand for GKOAs will be insufficient to match the expected supply. An extensive survey has estimated the total potential investment by all economic agents in government (including municipal) securities to be 22 600 billion roubles with a 1–3 per cent monthly inflation rate, 22 000 billion roubles with a 4–10 per cent inflation rate and 17 000 billion roubles with 11 or more per cent (Commercsant Weekly, No. 23, 1995). Table 1 illustrates the distribution of potential demand for government securities among the different types of the economic agents under a scenario of 4–10 per cent monthly inflation.
Table 1. Distribution of estimated potential demand for GKO$s among different types of economic agent under 4–10 per cent monthly inflation

<table>
<thead>
<tr>
<th>Type of economic agent</th>
<th>Potential demand, billion roubles</th>
<th>Demand, % of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td>11 200</td>
<td>51</td>
</tr>
<tr>
<td>Foreign Companies</td>
<td>1 700</td>
<td>8</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>1 400</td>
<td>6</td>
</tr>
<tr>
<td>Brokers</td>
<td>2 500</td>
<td>11</td>
</tr>
<tr>
<td>Non-residents</td>
<td>20</td>
<td>0</td>
</tr>
<tr>
<td>Investment/Pension Funds</td>
<td>1 200</td>
<td>5</td>
</tr>
<tr>
<td>Commercial Companies</td>
<td>800</td>
<td>4</td>
</tr>
<tr>
<td>Households</td>
<td>3 000</td>
<td>14</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>21 820</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Calculated by authors from Commer$ant Weekly, No. 23, 1995

It is no surprise that the commercial banks are interested in buying the lion’s share of the potential supply. The government securities promise to pay a substantial interest with a low risk profile. Figure 1 shows the effective yield curves for the GKO for the period January–June 1995 with different maturities. The effective yield take account of certain tax exemptions on income from GKO$s, in order to make yields comparable with other financial instruments available. The nominal yield can be calculated by multiplying effective yield by one minus the tax rate, where the tax rate is equal to 35 per cent. Even with the successful attempts of the Ministry of Finance to reduce the yield on the GKO that matures within 180 days from 330 per cent in January 1995 to 81 per cent in June, the rate of return guaranteed by the government defers investors from financing any industrial projects. Moreover, because of stabilization in hard currency exchange rates, the annual return on the dollar investment in the government securities made at the beginning of the year could be as much as 200 per cent by mid-year. Banks would therefore be much more willing to finance the government instead of private industry.

The government has never delayed or suspended payments on its securities. Despite the growing volume of outstanding GKO$s and the speculation over the problem of finding a balance between economically

3 The dollar to rouble exchange rate in August, 1995 was the same as in February, 1995. Therefore if someone were to buy rubles for 100 USD on February 1, 1995 to invest in GKO$s for a 6–month period at an annual rate of 200% (291 times 0.65), in August 1, 1995 he would be entitled to USD 100 as interest payment.
feasible refinancing and a pure pyramid scheme, there is no evidence of concern from investors over whether the government will meet its obligations. There is a belief that the government and the Central Bank, whose role as guarantor and paying agent for GKO transaction settlements on the primary market is crucial, will manage to find a suitable solution.

Another point worth mentioning is the interest revealed by the households sector. Despite difficulties in accessing the market, especially from regions worst affected by a lack of financial trading facilities, households are prepared to make safe investments. Their willingness to invest in government securities is a very promising sign, especially when compared with the traditional propensity of Russians to keep money 'under the mattress'.

Brokers are also interested in buying GKOs, one of the reasons being that they can draw loans collateralized by GKOs purchased with funds in margin accounts.

Demand by non-residents is discouraged by the 10 percent limit on non-residents' and foreign companies' participation in this sector. This restriction is expected to be lifted in 1996.

The GKO sector competes for funds with the interbank loan market. Both sectors represent the most liquid markets with similar levels of technical sophistication. Several trading floors organized by the commercial banks provide easy access for banking traders to the market. The comparative structure of the yields on interbank loans is provided in Figure 2. As an example of the interaction of these markets, the liquidity crisis in late August 1995 ('Bloody Thursday', as it was named by the banking community) led to the increase in yields on GKO because funds from interbank loans were transferred to the GKO market. Measures undertaken by the Central Bank and the government helped to stabilize the situation, although the average rates did not immediately return to the pre-crisis level. The close affinity between these two sectors was also observed on 'Black Tuesday' in October 1995.

The structure of the domestic debt is clearly biased toward short-term maturities. The average duration of GKOs outstanding is about 2.5 months (Commersant Weekly, No. 23, 1995), whereas only 25 per cent of the total domestic debt in developed countries, and less than 10 per cent in Germany and Japan, consists of short-term borrowing. The shorter the average duration, the greater the instability. A domestic debt of 33000 billion roubles, all in short-term notes, would represent a threat to any

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4 The Central Bank was forced to buy GKOs from the banks for the amount of 1 trillion roubles (= USD 250 million).
Figure 1. **Effective yield with different maturities of GKOs**

![Graph](image)

1 January  
2 February  
3 March  
4 May  
5 April  
6 June

Figure 2. **Term structure of the Moscow interbank offered rate (declared %)**

![Graph](image)

1 January  
2 February  
3 March  
4 April  
5 May  
6 June
sector of the capital market. The regulation of duration of the domestic debt is also an instrument to regulate the term structure of interest rates, among the key parameters in monetary policy.

In an attempt to increase the average duration of domestic debt, the Ministry of Finance issued a new instrument in June 1995. This paper, a federal borrowing bond (OFZ), carries a floating rate. The first bond issue, which are to mature in 378 days, raised about 570 billion roubles (57 per cent of the total value of the first issue), compared with 2 000 billion roubles raised through the GKO issue. The annual yield to maturity calculated at auction price was in line with yields on the GKO at 64 per cent, or about 4.2 per cent per month. As with the GKOs, the Central Bank serves as the principal agent, and in this role guarantees coupon payments and redemption of the bonds.

Approximately USD 7.8 billion in five tranches of dollar-denominated 'Taiga' Bonds were issued by the State in 1993 in exchange for frozen deposits in the bankrupt State-owned Vnesheconombank. These bonds are traded at a discount by several market makers and offer sizable long-term dollar returns. The major risks are of a political nature. Thus far, the government has honoured all of its obligations. Yields on these securities correspond fairly closely to those for external Russian State debt (Paris and London Club). These bearer securities are considered domestic securities by the Russian Government, and they are not CEDEL/Euroclear eligible.

The Ministry of Finance is issuing rouble-denominated notes known as KOs to securitize government indebtedness to enterprises financed from the budget. At the end of the first quarter of 1995, the total value of KOs issued in 218 tranches was equal to 12 000 billion roubles. The notes are intended to ease Russia's inter-enterprise non-payment crisis and can be viewed basically as a supplementary form of legal tender. The notes are relatively liquid and offer a 40 per cent coupon rate. The return could be higher if the notes are bought at a discount. The KOs are scheduled to be replaced by treasury notes during the first quarter of 1996.

Municipal securities are becoming more popular among regional leaders and the market for them is growing as we can see from the trends for the years 1992–1995 presented in the Table 2.
Table 2. **Trends in municipal securities issuance**

<table>
<thead>
<tr>
<th></th>
<th>1992</th>
<th>93</th>
<th>94</th>
<th>95†</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of issues registered</td>
<td>5</td>
<td>8</td>
<td>28</td>
<td>25</td>
</tr>
<tr>
<td>Of these:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>placed and redeemed</td>
<td>4</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>placed but not redeemed</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>at maturity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>placement failed</td>
<td>1</td>
<td>2</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>placement not completed</td>
<td>0</td>
<td>0</td>
<td>16</td>
<td>19</td>
</tr>
<tr>
<td>Par value of securities (billion roubles)</td>
<td>5.60</td>
<td>9.85</td>
<td>2555</td>
<td>4819</td>
</tr>
<tr>
<td>Value of funds raised (billion roubles)</td>
<td>0.05</td>
<td>5.83</td>
<td>80</td>
<td>808</td>
</tr>
</tbody>
</table>

Source: Expert, No. 2, 8 August 1995

Initially, in 1992, each issue was quite small (not more than 1–2 billion roubles) because of the inadequate skills of local bond issuers, the deficient infrastructure of the regional market, and insufficient market depth for large issues. Issues have tended to be more successful where the regional government has a strong position or holds stakes in natural resources. Where investors were worried about the ability of local governments to collect enough taxes or to sell property to meet their obligations, the issues were not successful.

The volume for municipal securities is expected to equal that of federal securities in the very near future if the current growth rates hold. Generally speaking, the federal government does not encourage issuance and circulation of these papers because they are thought of as competitors to papers issued by the federal government itself. However, bonds issued by the members of the federation enjoy the status of state securities and subject to certain federal tax exemptions. Some securities are also exempt from local taxes. Municipal bonds could also be redeemed by non-monetary items, such as real estate or stocks, which could in some cases be more attractive to investors than expected yield. For this reason, one potential drawback for this sector of the capital market is the absence of a secondary market for all but four issues. But turnover even for these four issues is not very high (less than 40 billion roubles per month). They are considered a riskier investment because the federal government, unlike local governments, could redeem T-bills by printing money. Investment in municipal securities is also associated with political risk, and there is no clear legislative procedure for cases of default.

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† As at 30 May 1995
2.2 Equity market trends

The next level of capital markets, and second in turnover, is represented by the equity market for shares of privatized companies. Development of this sector has been linked with the privatization process. Shares in over 16,000 former state enterprises were sold through the voucher auctions. Trading is conducted mostly over-the-counter. The wide range of the companies represented on the market brought demand for such services as depository, registrar and custody. Average market capitalization ranges from 18 to 25 billion dollars, or about 10 per cent of GDP. A list of the 20 biggest companies by capitalization is provided in the Table 3.

Table 3. Biggest Russian companies by market capitalization, as of 25 November 1994

<table>
<thead>
<tr>
<th>Company</th>
<th>Market price per share, $</th>
<th>Capitalization, $ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Petroleum Company LUKOIL</td>
<td>39</td>
<td>3708</td>
</tr>
<tr>
<td>Gazprom</td>
<td>0.1</td>
<td>2841</td>
</tr>
<tr>
<td>Unified Energy System of Russia</td>
<td>16</td>
<td>2240</td>
</tr>
<tr>
<td>Norilsk Nikel</td>
<td>13</td>
<td>1638</td>
</tr>
<tr>
<td>Ugansneftegaz</td>
<td>22</td>
<td>1174</td>
</tr>
<tr>
<td>Surgutneftegaz</td>
<td>0.2</td>
<td>915</td>
</tr>
<tr>
<td>Rostelecom</td>
<td>4</td>
<td>822</td>
</tr>
<tr>
<td>Noybrskneftegaz</td>
<td>8</td>
<td>628</td>
</tr>
<tr>
<td>Megionneftegaz</td>
<td>5</td>
<td>595</td>
</tr>
<tr>
<td>Kogalymneftegaz</td>
<td>40</td>
<td>579</td>
</tr>
<tr>
<td>Purneftegaz</td>
<td>5</td>
<td>501</td>
</tr>
<tr>
<td>CONDPetroleum</td>
<td>9</td>
<td>453</td>
</tr>
<tr>
<td>Sakhalinmormneftegaz</td>
<td>5</td>
<td>406</td>
</tr>
<tr>
<td>Tomskneft</td>
<td>8</td>
<td>338</td>
</tr>
<tr>
<td>Mosenergo</td>
<td>0.1</td>
<td>333</td>
</tr>
<tr>
<td>Niznevatovskneftegaz</td>
<td>17</td>
<td>310</td>
</tr>
<tr>
<td>Komiteft</td>
<td>8</td>
<td>272</td>
</tr>
<tr>
<td>St.Peterburg Telecom</td>
<td>16</td>
<td>240</td>
</tr>
<tr>
<td>KamAZ</td>
<td>4</td>
<td>240</td>
</tr>
<tr>
<td>Langepasneftegaz</td>
<td>8</td>
<td>228</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>18461</strong></td>
</tr>
</tbody>
</table>

Source: Komersant Daily, February 15, 1995

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6 The equity market for shares in newly established companies (such as MMM) represents another sector, described further on.
The list of Russia’s biggest companies, as we can see from the table, is dominated by oil, gas and energy producers. A nickel mining company, a car producer and two telecommunications companies represent other industries.

The size of the Russian economy, compared with market capitalization, suggests that most stocks are undervalued. The classic example is the price of shares in Russian oil companies, which are sold at an average of 0.15 dollars per barrel of oil in reserves, compared to 3.58 dollars for Western European Companies and 7.06 for American companies. The gap between the market value, set by cash or voucher auctions, and the book value of a company could be as much as hundreds of per cent, as represented in Table 4.

Table 4. **Gap between market and book value in selected Russian companies**

<table>
<thead>
<tr>
<th>Company</th>
<th>Book value per share, $</th>
<th>Market price, $</th>
<th>Ratio</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>as of date of cash or voucher auction</td>
<td>as of 25/11/94</td>
<td>(2)/(3)</td>
</tr>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
</tr>
<tr>
<td>Gazprom</td>
<td>2.36</td>
<td>0.0134</td>
<td>0.15</td>
<td>175.1</td>
</tr>
<tr>
<td>Norilsk Nickel</td>
<td>161</td>
<td>5.19</td>
<td>13</td>
<td>31.8</td>
</tr>
<tr>
<td>Achinsk Aluminum Smelt</td>
<td>166</td>
<td>13</td>
<td>16</td>
<td>12.8</td>
</tr>
<tr>
<td>Niznevarotskneftegaz</td>
<td>160</td>
<td>13</td>
<td>17</td>
<td>12.3</td>
</tr>
<tr>
<td>Ulyanovsk Auto Plant</td>
<td>154</td>
<td>20</td>
<td>11</td>
<td>7.7</td>
</tr>
<tr>
<td>Sayank Aluminum Smelt</td>
<td>28.3</td>
<td>3.89</td>
<td>21.5</td>
<td>7.3</td>
</tr>
<tr>
<td>Vnukovo Airlines</td>
<td>74</td>
<td>26</td>
<td>35</td>
<td>2.8</td>
</tr>
<tr>
<td>Apatit</td>
<td>15.25</td>
<td>8.65</td>
<td>6.2</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Source: Kommersant Daily, January 17, 1995

However, if investors make their decisions based only on a factor such as undervaluation, they do so at their peril. The investment required to turn around an average company, especially in marketing and financial management areas, may cancel out all potential benefits.

Undervaluation of stock companies was the main reason for the bullish equity market in 1994, which attracted, by some estimates about USD 3 billion in Western portfolio investments. This capital inflow dwindled by the end of the year as a result of political events in Russia.
and claims to renationalise the industry on the grounds of unfair privatization. Furthermore, growing inflation caused households to convert their savings (up to 60 per cent) into dollars. These were the main reasons for the bearish market at the beginning of 1995. The general trends are presented in Figure 3, which shows the dynamics of the Moscow Times Index. Moscow Times Index has been compiled since early September 1994 from the over-the-counter prices of 50 different Russian stocks that meet certain key criteria. The companies on the list represent a broad industrial and financial base, i.e. the metallurgy, aviation, shipping, automotive, oil, gas, energy, telecom, banking and retail trade sectors of the economy.

Figure 3. The development of Russian equity markets 1994–95
Moscow Times Index

The decline in prices for shares in the biggest privatized companies induced investors to shift their attention to medium-sized enterprises in primary industries, like ferrous metallurgy, forestry, and cement production. In anticipation of the general shareholders’ meeting, usually held in April or May, the holders of major stakes try to further increase their interest; therefore, the market for stocks usually experiences an increase in activity in March. Another factor that influenced demand and supply on the equity market was the additional inflow of funds from the financial markets: the decline in interest rates reduced the profitability of

7 These political forces spelled out their demands through Mr. Polevanov, then Chairman of the State Property Committee.
the interbank and governments securities market. Trading in April of 1995 was characterized by a decline in oil sector activities. Because the individual oil companies are still shifting from one oil holding to another in the course of industrial restructuring, investors are awaiting the end of this process before they make any major decisions. Market prospects began to improve in May. Further decline in yields on other sectors of the capital market caused additional inflow of funds, supplemented by an increase in foreign portfolio investment channelled mainly into infrastructure related companies (energy, construction materials, forestry). During that period, about 70 per cent of purchases were made by brokers to satisfy foreign investors’ orders. Russian investors are (i) generally more cautious and (ii) less sophisticated about market trends and pricing behaviour. They usually invest up to USD 400 000 in portfolios consisting of Russian first-class ’blue chips’, which they hold for 6–8 months. The bullish mood prevailed in the early summer of 1995 as a result of Russian banks that had previously not been very active on the equity market plunged in. However, prices for shares started to decline again in July. The dynamics of the market is presented in the Table 5.

Table 5. **Trading volume of biggest privatized stocks in 1995 in 1000 shares**

<table>
<thead>
<tr>
<th>Company</th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>Jul</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unified Energy System</td>
<td>1257</td>
<td>1606</td>
<td>4481</td>
<td>2243</td>
<td>1553</td>
<td>5316</td>
<td>3571</td>
</tr>
<tr>
<td>Krasnoyarsky Aluminum Plant</td>
<td>4075</td>
<td>5621</td>
<td>903</td>
<td>1664</td>
<td>632</td>
<td>526</td>
<td>385</td>
</tr>
<tr>
<td>Lenengo</td>
<td>23</td>
<td>30</td>
<td>878</td>
<td>67</td>
<td>168</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>LUKOIL</td>
<td>69</td>
<td>93</td>
<td>563</td>
<td>560</td>
<td>318</td>
<td>2800</td>
<td>8700</td>
</tr>
<tr>
<td>Magnitogorsky Metallurgical</td>
<td>766</td>
<td>4739</td>
<td>104</td>
<td>198</td>
<td>809</td>
<td>937</td>
<td></td>
</tr>
<tr>
<td>Megionneftegaz</td>
<td>5507</td>
<td>4180</td>
<td>2050</td>
<td>4200</td>
<td>6240</td>
<td></td>
<td></td>
</tr>
<tr>
<td>InterCity International Phone</td>
<td>2611</td>
<td>5662</td>
<td>124</td>
<td>58</td>
<td>146</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mechsel</td>
<td>65</td>
<td>507</td>
<td>426</td>
<td>726</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>St-Peterburg Marine Port</td>
<td>26</td>
<td>17</td>
<td>12</td>
<td>3</td>
<td>24</td>
<td>30</td>
<td>12</td>
</tr>
<tr>
<td>Moscow Oil Refinery</td>
<td>6</td>
<td>247</td>
<td>44</td>
<td>396</td>
<td>569</td>
<td>420</td>
<td></td>
</tr>
<tr>
<td>Niznevarovskneftegaz</td>
<td>619</td>
<td>504</td>
<td>214</td>
<td>514</td>
<td>702</td>
<td>201</td>
<td>282</td>
</tr>
<tr>
<td>St-Peterburg Phone Network</td>
<td>325</td>
<td>60</td>
<td>774</td>
<td>19</td>
<td>224</td>
<td>112</td>
<td>237</td>
</tr>
<tr>
<td>Rostelecom</td>
<td>2017</td>
<td>4874</td>
<td>3403</td>
<td>3849</td>
<td>3002</td>
<td>4851</td>
<td>5828</td>
</tr>
<tr>
<td>Total</td>
<td>2993</td>
<td>5438</td>
<td>4650</td>
<td>13370</td>
<td>9920</td>
<td>6189</td>
<td>7505</td>
</tr>
<tr>
<td>Growth rate (%)</td>
<td>82</td>
<td>−15</td>
<td>188</td>
<td>−26</td>
<td>−38</td>
<td>21</td>
<td></td>
</tr>
</tbody>
</table>

Source: Commerzent Daily, August 18, 1995

Demand for shares of the privatized companies will grow, at least during the period of financial stabilization and declining returns on financial markets. Economic agents are buying shares mostly in anticipation of capital gains. The structure of potential demand for different sectors is presented in Table 6.
Table 6. **Industry-oriented potential demand structure for shares in privatized companies**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Banks</th>
<th>Foreign investors</th>
<th>Insurance companies</th>
<th>Funds</th>
<th>Firms</th>
<th>Households</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil companies</td>
<td>18.3</td>
<td>30.0</td>
<td>16.1</td>
<td>17.5</td>
<td>8.0</td>
<td>21.3</td>
</tr>
<tr>
<td>VIOC&lt;sup&gt;8&lt;/sup&gt;</td>
<td>3.0</td>
<td>6.0</td>
<td>6.6</td>
<td>4.2</td>
<td>6.0</td>
<td>5.4</td>
</tr>
<tr>
<td>Energy</td>
<td>10.8</td>
<td>19.0</td>
<td>8.5</td>
<td>21.0</td>
<td>5.0</td>
<td>15.5</td>
</tr>
<tr>
<td>Machinebuilding</td>
<td>6.1</td>
<td>1.0</td>
<td>3.5</td>
<td>3.5</td>
<td>2.0</td>
<td>6.4</td>
</tr>
<tr>
<td>Chemical</td>
<td>6.1</td>
<td>3.0</td>
<td>3.3</td>
<td>6.5</td>
<td>9.0</td>
<td>2.6</td>
</tr>
<tr>
<td>Metallurgy</td>
<td>6.0</td>
<td>5.0</td>
<td>1.0</td>
<td>10.8</td>
<td>1.0</td>
<td>3.9</td>
</tr>
<tr>
<td>Forestry</td>
<td>12.4</td>
<td>2.0</td>
<td>1.7</td>
<td>11.1</td>
<td>7.0</td>
<td>2.5</td>
</tr>
<tr>
<td>Marine</td>
<td>0.8</td>
<td>2.0</td>
<td>1.4</td>
<td>3.3</td>
<td>6.0</td>
<td>2.2</td>
</tr>
<tr>
<td>Inland transport</td>
<td>2.6</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>14.0</td>
<td>0.4</td>
</tr>
<tr>
<td>Avia carriers</td>
<td>1.4</td>
<td>1.0</td>
<td>0.7</td>
<td>5.2</td>
<td>7.0</td>
<td>4.3</td>
</tr>
<tr>
<td>Communications</td>
<td>8.6</td>
<td>13.0</td>
<td>20.2</td>
<td>1.9</td>
<td>3.0</td>
<td>8.7</td>
</tr>
<tr>
<td>Textile</td>
<td>0.3</td>
<td>4.0</td>
<td>0.0</td>
<td>2.9</td>
<td>1.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Food</td>
<td>1.3</td>
<td>5.0</td>
<td>1.3</td>
<td>5.9</td>
<td>5.0</td>
<td>5.7</td>
</tr>
<tr>
<td>Savings Bank</td>
<td>2.2</td>
<td>0.0</td>
<td>2.2</td>
<td>0.9</td>
<td>0.0</td>
<td>6.1</td>
</tr>
<tr>
<td>Banking</td>
<td>9.3</td>
<td>2.0</td>
<td>8.6</td>
<td>1.4</td>
<td>1.0</td>
<td>5.7</td>
</tr>
<tr>
<td>Other</td>
<td>10.8</td>
<td>7.0</td>
<td>24.3</td>
<td>3.8</td>
<td>25.0</td>
<td>8.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Commersant Weekly, No. 23,1995 and authors’ calculations

As we see from Table 6, most investors are interested in oil companies as major sources of Russian export revenues, in energy production as a stable, low-cycle industry, and in communication as a rapidly growing sector that attracts substantial foreign investment. Yet another interesting example is inland transport in which firms only are willing to invest. The prime reason for this is that by acquiring stakes in the transport sector these companies are trying to cut down transport costs.

Raising finance through new equity issuance has not been very popular among privatized companies. One of the reasons has been managers’ fear that they might lose control over their enterprise. Another reasons has been the specific legislation under which, up to September 1994, the authorized capital of a company<sup>9</sup> had to revalued before its second stock issue could be registered. This requirement is sometimes used by certain companies to weaken the equity position of outside investors hostile to current managers.

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<sup>8</sup> Vertically integrated oil conglomerates

<sup>9</sup> The revaluation had been required because initial authorized capital was equal to book value of the company’s assets at January 1, 1992 prices. After price liberalization assets were revalued several times to reflect changes in the price levels. In the accounting framework, the additional value was reflected as additional capital.
Issuers differ in their approach to the equity market. The leaders recognize its importance. They have established communication with the players in the market place. Other regularly traded stocks are characterized by an irregular, uncoordinated information flow. Some companies provide no information and, most important, have not yet committed themselves to the stock market. Their shares are very difficult or impossible to trade.

The government hopes that companies will be able to raise finance via cash auctions instead of investment tenders. The reason for this shift in the privatization strategy is a general dissatisfaction with the compliance record of investment-tender winners. Foreign investors are similarly dissatisfied with the investment-tender process, because the tender structure involved too many interested parties with either no incentive to see the project succeed or an incentive to ensure it failed (The Moscow Times, June 6, 1995). Another approach was undertaken by the consortium of banks, which suggested lending about 9 trillion roubles to the State, to be collateralized by government stakes in industrial companies. It is clear that through this transaction the banks hope to later sell the collateral at a higher price. Again, while this transaction could be very beneficial to the budget in the short-term, and the chances that the stock will be sold more efficiently are higher, by signing the agreement the government itself does little to promote investment through the existing financial market infrastructure.

The Russian stock market is dominated by insider trading. Quotations do not represent the true evaluation of a particular stock by market-makers and investors. It is known within the industry that the seller can arrange for a broker to set a higher bid for a block, and then tell the buyer that the price was high; while the buyer could arrange for a broker to set a lower bid for a block, and then tell the seller that the price was low.

The market price represents the 'intrinsic' value of a company and the value of information on this company. The intrinsic value of the company represents the net present value of cash flow to shareholders from the company, and its ability to conduct business and to grow. Informational value determines the perception of the market in respect of the company. The ratio between these two values determines market behaviour. The Russian stock market represents a purely informational market, as the dividends paid to shareholders are so small and consumed by inflation that no one could predict price on this basis. This type of a marketplace could be named a 'swing market'.

In such cases, the market tends to overreact, and any generally negative information leads to a sharp decline in prices. On February 10,
1995 the market closed at an all-time low Moscow Times Index, caused by investors’ disappointment with the failure of the government to agree with the International Monetary Fund on a USD 6.4 billion loan and the banks’ stoppage of hard-currency transfers to the accounts of Russian brokerages (The Moscow Times, February 11, 1995). The latter move was caused by a controversial Central Bank letter requiring foreign investors to obtain a licence to purchase Russian assets for hard currency.

As we noted before, price movements are dictated by fads. Investors with short-term objectives buy the same shares, then sell them when that specific class of shares is no longer ‘in’. For example, December 1994 was the month for oil extraction and processing plants. January 1994 speculators stopped buying oil company stocks, opting for banks' shares instead.

Market forces have really helped shape a fairly sophisticated banking system, even if the Russian banks do not provide the same scope of services as their western counterparts. Moreover, most Russian owners of small banks do not take banking ‘seriously’ and consider banks mainly as a treasury unit. The banking system is undergoing the first wave of restructuring, with the smaller banks merging or being taken over by more wealthy banks. This process is reflected in the distinction between banking securities available through the market and the securities of any other institution or corporation. Banks have been the only institutions that have rewarded their owners by paying dividends. The reasons for their high liquidity are quite clear. During the last three years the biggest banks have been able to meet dividends payments and to reward their shareholders because of a highly inflationary environment and lax monetary policy. For banks, especially those formed as joint stock companies, equity placement is the crucial path to raise capital because the ability of the bank to attract additional funds is linked to the size of the bank's capital. The collapse of financial companies, which had attracted huge funds from the public during 1994, has allowed more stable and conservative banking institutions to attract depositors. They claim that the stable investment into state papers will help depositors to earn income at low risk. Banks try to please small investors by creating special funds to invest in government securities.
2.3 Debt instruments and new private sector securities

The market for companies' debt instruments (bonds and notes) is not developed enough to satisfy even the market watchdog – The Federal Commission for Securities and Capital Market. Generally speaking, company managers prefer to raise capital through bank credits using other assets as a collateral. This is reminiscent of the German model of corporate governance, where banks and industrial companies are in close contact through their boards of directors.

The public placement of debt instruments is limited to several issues of commodity (product) backed instruments. In one case, the borrower, a car producer, promises to repay its obligations to the lender with a car to be assembled in the redemption year.

The ability of the companies to raise debt finance via public or private placements is also limited by a leverage requirement set forth in the Civil Code, stipulating that the value of bonds outstanding should not at any time exceed 50 per cent of the company's capital. This clause is considered to be a temporary safeguard for investors.

The government opposes the provision of guarantees\(^{10}\) to private issuers of debt securities, considering these securities, as well as municipal bonds, to be competitors of Government T-bills – today the main vehicle for financing the budget deficit. In some rare cases, however, the firms have managed to obtain privileges in that capital gains related to their securities are not to be taxed\(^{11}\).

The wildest sector consists of papers issued by newly-established private joint stock companies. The pyramid scheme adopted by various companies seriously undermined the faith of small private investors in the equity market. The major suppliers of funds to this sector, they prefer nowadays to keep their savings in dollars, or in a bank account (savings represent about 20 per cent of personal disposable income). Even the most transparent companies that presented a full range of information suffer from a low volume of trading.

\(^{10}\) The Government provided guarantees previously only for foreign loans

\(^{11}\) For example, the joint stock company 'High Speed Railways' was granted this privilege for its bonds. Commersant-Daily, January 10, 1995

162
3 Marketmakers and market infrastructure

The market is an intermediary between investors and issuers of securities. It performs three functions: (i) trading, (ii) depository, (iii) clearing.

The Ministry of Finance has certified some 13 000 individual specialists operating in the field of securities trading. Also, about 1 400 institutions were granted a licence to conduct investment business. 66 stock exchanges and stock departments are operating under special Ministry of Finance permission. Specialized voucher investments funds experienced substantial growth in 1993, stagnated in the first half of 1994, and their number is now declining due to mergers and acquisitions (Rossiyskaya Gazeta, February 17, 1995). The largest funds attracted foreign investors. The year of 1994 was the year of private pension funds, of which there are now 800. Pension funds might become major institutional players once financial stabilization is achieved.

Brokerage houses provide different type of services to their clients. There are perhaps about ten brokerage houses and banks with an international and domestic client base. They possess research capabilities, deal in large volumes and trade in most stocks. Another 30 brokers or so operate with domestic clients only, deal intensively on the Moscow market, specialize in one issuer or regional networks, and offer a limited range of stock. A further 200 brokers, represented by banks, voucher investment funds, local commercial structures or financial companies, have a limited local client base and do not conduct research, but capitalize on contacts with local administration and issuers.

All sectors of the financial market interact via their infrastructure. As we said before, the market for government issued securities is technically the most highly developed and organized. Traders and the managers of the trading system, however, are looking to expand into the active equity market.

The current structure could be characterized as follows: first, clearing and settlement systems are at an early stage of development. Second, stock ownership is evidenced only by listings in shareholder registries frequently maintained not by an independent share registry, but by the issuer, despite the fact that such an arrangement is directly prohibited by law. Third, transfer of ownership requires on-site re-registration at a specific registry. The fee for re-registration could take the form of flat fee ranging from 25 cents to 12 dollars, or a pro rata fee calculated as a certain percentage of the transaction value. The fee in that case could be
as much as 4 per cent of the transaction value. Fourth, the lack of acceptable custodian services excludes most institutional investors. Finally, there are several major players preparing to enter Russian capital markets to provide experience and much needed trust.

As we saw, the capital market in Russia is very fragmented, which is reflected in the fragmented nature of legislation. It is clear today that the absence of a legal basis for trust activities and fiduciary (asset management) and custodial services thwarts the development of such market sectors. There are several different draft bills circulating in Parliament, but the members of the Duma do not appear to consider such laws a high priority.
4 Conclusions

The recent crisis, or loss of liquidity as the official phrases goes, in the interbank loan sector proves that the development of financial markets can lead to financial distress. Banks that lost the money on the interbank loan market had borrowed it from the general public. Even if the true reasons of the failure were at a slightly different level, general weakness and multiple distortions within the financial sector as a whole were revealed.

Some critics associated the crisis with the failure of the system to adjust to a low-inflationary environment. The reason, however, is so-called short-termism. Under this approach, even adjustment itself is not possible. The refusal to adjust is not the fault of shortsighted bankers, but rather distrust of the stability of the government's monetary and fiscal policy.

Adverse selection and moral hazard problems in the financial markets of transitional economies are well-known phenomena. The lack of information available to domestic and foreign investors, and the absence of successfully completed projects, lead to demands for a higher rate of return. The sponsors of investment projects have to compete for increasingly expensive money, and to that end present projects with higher potential profits which, inevitably, entail higher risks. A high-inflation environment does nothing to encourage financing of long-term investment projects. Only short-term trading succeed in raising external funds. The banking sector does not channel funds into the industrial sector, but into the financial sector.

Returning to the title of this article, one can say that, for the time being, it has not been very important if the cart (capital markets) has been put before the horse (the real economy), because the horse has only recently started moving in the right direction. Naturally, in the future it will be more important to have the horse in the right place, as further progress in capital markets will depend on how well the real economy recovers.
Payment Arrears and Russian Reforms

by Inkeri Hirvensalo

Contents

1 Introduction ................................................. 169

2 Payment arrears and tougher budget constraints .............. 171
   2.1 Definitions and records of payment arrears .............. 171
   2.2 Tougher budget constraints and
       behaviour of enterprises .............................. 174

3 Trends in payment arrears in Russian enterprises ............. 177
   3.1 'Line 2' in 1992 and subsequent trends
       in payment arrears .................................... 177
   3.2 The discrepancy between debts and receivables .......... 181
   3.3 Wage arrears ........................................ 184
   3.4 Indebtedness and inflation ............................ 186

4 Russian banks and payment arrears ............................. 188

5 Reasons behind the indebtedness problem ........................ 192

6 Attempts at solving the arrears problem ........................ 195

7 Concluding remarks ......................................... 197

References ...................................................... 199

Statistical sources ............................................. 201
1 Introduction

The growth of payment arrears is a problem well known throughout the Eastern European transition economies. This article analyses trends in payment arrears within the Russian economy in 1992–94 and attempts to find out why they have so far not stabilized in Russia even though they have done so elsewhere in Eastern Europe.

There are at least five different kinds of payment arrears in Russia: first, there are interenterprise arrears, which consist of unpaid trade credits extended by Russian enterprises to each other; secondly, there are payment arrears between enterprises and the state, which consist of overdue receivables of enterprises from governmental organizations, on the one hand, and tax arrears, on the other; thirdly, there are payment arrears on credits extended between banks; fourthly, there are payment arrears between banks and enterprises, which consist of overdue payments on loans extended to enterprises; and finally, there are arrears on wage payments by enterprises to their employees. The arrears problem has been most acute in payments between enterprises.

Interenterprise arrears have accumulated throughout Eastern Europe since the introduction of economic reforms. They grew especially rapidly in Romania, The Czech Republic and Poland during the initial stages of transition in 1989–91. In those three countries they have since stabilized at a level which corresponds to trade debt of enterprises in many market economies. However, in Russia the problem has persisted longer than in other transition economies. Although the arrears stabilized for a while after a multilateral clearing settlement was undertaken by the Central Bank in 1992, they began to grow again in 1993.

Since 1993 the problem seems to have taken a new turn. Whereas in 1992 the growth in Russian payment arrears was mainly for technical reasons, since 1993 it has persisted because enterprises expect to continue receiving financial aid from the government.

It is claimed that the problem represents a continuation of the managerial behaviour acquired within the former planned economies. Such behaviour developed as a response to the 'soft' budget constraints which were a salient feature of the planned economies. Since the introduction of economic reforms the budget constraints have become tougher. However, enterprise managers have continued to believe that their best survival strategies consist of financing their operations by lobbying for governmental support rather than by introducing real changes in the way they operate. The soft credits extended by the government in 1992–94 have strengthened this belief.
One dimension of the payment arrears problem is the role of the Russian banks as a source of financing for Russian enterprises. This role has diminished in relative terms as enterprises have increasingly resorted to trade credits received from each other instead of using bank credits. During the first half of 1992, Russian payment arrears grew rapidly and doubled the volume of bank credits before the Central Bank intervened with new credits to settle the problem. Between July 1993 and December 1994 overdue interenterprise debts have again outgrown the credits extended by the banking sector.

Growing interenterprise debts have, in turn, made it more difficult for the banks to judge the creditworthiness of their customers. Consequently, the banks have grown more reluctant to extend credits to enterprises. Instead of lending to enterprises, they have increased investments in government bonds and interbank money markets. As the credit risks have started to materialize, an increasing number of both banks and enterprises are operating under the threat of bankruptcy.

The present article is structured as follows: Section 2 concentrates on the problems of defining payment arrears and describes the behavioural changes of Russian enterprises under conditions of tougher budget constraints; Section 3 describes statistical trends in payment arrears; Section 4 compares trends in payment arrears with the volume of credits extended to enterprises; Section 5 analyses possible causes of arrears; Section 6 presents the various approaches that have been used in Russia to solve the problem; and Section 7 provides some concluding remarks.
2 Payment arrears and
tougher budget constraints

2.1 Definitions and records of payment arrears

In order to analyse the change in payment behaviour we need to know how payments were made before the arrears started to grow. In the former planned economies payments between state enterprises were effected by means of payment orders given to the state-owned banks. After delivering goods to a customer enterprise the supplier would send a payment order directly to the bank, which then debited the customer's account and credited the supplier's account by the required sum in roubles. In the rare event that the customer's account did not cover the required amount, the payment was placed in the so-called 'Line 2' (kartoteka) to wait for a sufficient amount of roubles to be deposited in the account (Fan and Schaffer 1994, p. 173; Hirvensalo 1993, p. 37).

The payment orders did not specify the due date, because the financing requirements of both the seller and the buyer were covered by the state. Consequently, state-owned enterprises could be sure of being paid sooner or later, and interest charges, if any, were very low.

All payments between enterprises were effected as bank transfers in 'account roubles'; direct cash payments between enterprises were not allowed, nor where the companies allowed to extend credit to each other. When carrying out the payment orders the banks did not specify value dates for the transfers, either. The transfers were processed according to established working practices at the banks. Such practices made it impossible to define exactly how soon the enterprises should have received payment for their deliveries. In practice, it was likely to take a couple of weeks for the payment to be processed within a state-owned bank. The required time probably increased considerably in 1988 when the banking system was decentralized and hundreds of new banks began their operations. In particular, payments between distant cities were notoriously slow after the restructuring of the banking sector (Hirvensalo 1993, p. 33).

Interenterprise payment arrears began to attract attention in Poland, Czechoslovakia and Romania in 1989, when the transition from planned to market economy began in those countries. In Russia this did not happen before 1992. By that time Russian enterprises had accumulated substantial arrears. These had been placed by the banks in 'Line 2',

171
signifying that the balances on the enterprise accounts were insufficient to cover all payments. The payment orders were placed in 'Line 2' in chronological order, as the due dates were not defined. The new commercial banks were required to record all overdue payments of state enterprises. These payments were placed in 'Line 2' in July 1992, and this was followed by a multilateral settlement of the overdue payments. Thereafter the 'Line 2' payments of state-owned banks were closed and the banks no longer recorded the overdue payments of Russian enterprises. As a part of the economic reforms enterprises were given the freedom to decide themselves which payments they should pay and when they should be paid (Fan and Schaffer 1994, p. 173; Hirvensalo 1993, p. 37).

According to the 'Line 2' practice, payment arrears were recorded from the day the payment order arrived at the bank, if there was not sufficient cover on the account of the enterprise. This meant that arrears were also accumulating during the time the banking system would have taken to process the payment, had there been sufficient cover in the account. In addition, the chronological nature of the 'Line 2' payments of an enterprise meant that even small payment orders could not be paid if they had been placed in line after the first unpaid order. Consequently, the payment arrears recorded as 'Line 2' most probably overestimated the real problem in 1992.

If the Russian payment arrears recorded as 'Line 2' are compared to typical payment terms in Western European countries, they would cover both the average trade credit period of two months and the customary arrears period of 40–50 days, depending on the payment practice prevailing in the country in question (Fan and Schaffer 1994, pp. 157–159). Taking this into account, the Russian recorded payment arrears in 1992 can, for the most part, be considered the result of a shift in the terms of payment towards Western European practices.

Since July 1992, payment arrears recorded in Russia have been based on the reports of enterprises to the state statistical office, Goskomstat. Companies themselves also determine what part of their receivables or payables are reported overdue. Due to the changed recording method it is not possible to make a direct comparison between the development of arrears before and after the netting operation.

Moreover, there is no widely established payment practice whereby payment arrears can be specified. After 'Line 2' was closed, enterprises

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1 Goskomstat statistics are based on questionnaires sent to all registered enterprises, but no information is available on the response rate to these questionnaires. It can be assumed, however, that the information is less complete than the previous statistics based on the registration of arrears by the banks, because of the growing shadow economy in the country.
were required to adopt the practice of prepayment, but not all enterprises have done so, which is evident from the growth of payment arrears since 1992. While bills of exchange have been introduced, especially in the public sector, their use has generally been considered too costly.

Therefore, when enterprises report their payment arrears, they may interpret the situation differently depending on their particular circumstances, unless they happen to have used bills of exchange specifying due dates. Practices may also differ between various industries. Moreover, there is no clear practice regarding the application of interest charges on arrears. It is likely to depend on the quality of the relationship between the companies. The most important clients will probably receive trade credits for which no interest is charged. In Russia’s highly inflationary conditions this is a much greater issue than in Western European countries.

The collection of arrears is also problematic, because the necessary changes in legislation and related legal procedures are not being processed quickly enough. In addition, receivables are normally not collateralized because there was previously no need for it. Even when enterprises recognize the need for securing their receivables it is very difficult because the registration of property rights is unclear or nonexistent. The sale of collateralized property is not possible either, due to the same ambiguities in legislation and registration.

Information published in the Russian press is often contradictory and many different definitions of indebtedness are used. Instead of referring only to the overdue share of the debts, the total indebtedness of Russian enterprises is often used as the yardstick in measuring the seriousness of the problem. Furthermore, the reported overdue interenterprise debt often includes arrears in taxes and bank credits.

Even when describing only the overdue share of interenterprise arrears, the figures differ depending on how receivables and payables and gross or net debts are defined. The gross debt of the enterprises is naturally greater than the net debt after deduction of receivables. Likewise, gross receivables exceed net receivables (from which the payables have been deducted).

In summary, the concept of payment arrears in Russia is quite ambiguous and difficult to define in specific terms. It is not yet possible to make direct international comparisons of recorded arrears in market economies, as payment and collection practices still differ considerably between Russia and Western Europe.
2.2 Tougher budget constraints and behaviour of enterprises

According to Janos Kornai's well-known conceptual analysis, budget constraints were generally 'soft' under the socialist system. There was the possibility of negotiating administrative pricing, subsidies, credit conditions and taxes by using the lobbying powers and party connections of the company's managers (Kornai 1980, pp. 299–322, and 1992, pp. 140–145). As the former socialist economies move towards becoming market economies, budget constraints have started to become tougher.

The initial reaction of most Russian managers to the liberalization of pricing at the beginning of 1992 was simply to raise prices as high as necessary to cover the increasing costs. However, they soon faced a fall in demand and subsequently in sales revenues, which was a sign that sales prices had been raised in the new market conditions as much as they could be (Russian Economic Barometer, Vol. II, No 3, 1993, p. 4.)

During 1993 most subsidies paid to Russian enterprises were discontinued\(^2\). The government also introduced new and higher taxes and only the powerful energy sector companies have been able to negotiate significant exemptions for themselves. As a result, tax evasion is one of the most urgent problems for the Russian authorities, who have not been able to collect nearly as much in tax revenues as planned in the budgets. Taxes collected in 1994 amounted to only about 60 per cent of the budgeted tax revenue. Most Russian enterprises now have limited scope for negotiating their tax rates. Tax evasion can be considered a reaction to the tougher tax regime.

Bank credits have also become more difficult to obtain than before the economic reforms were introduced. Within the planned economy, financing of enterprises by bank credits was already part of the economic plan. In cases, where an enterprise could not service its debts according to plan, renegotiation of the credit conditions was relatively easy. This changed after the introduction of economic reforms. According to a survey published in 1994, Russian managers considered that the most significant restricting factor in production between December 1991 and June 1993 was no longer the shortage of raw materials but a shortage of financial resources (Russian Economic Barometer Vol II, No 3, 1993, p. 47).

Some companies have been able to secure themselves the possibility of acquiring soft credits by setting up banks of their own, which has been

\(^2\) Some notable exceptions are made for the coal industry.
possible since 1989. Others have been able to receive centrally allocated credits from the government (Fan and Schaffer 1994, pp. 177–182). However, the tightening monetary situation has made it more difficult for the banks to expand such practices. It is estimated that among the Russia’s 2,500 commercial banks there are several hundred which are in severe financial difficulty. In addition, the Russian government is committed to stop granting direct credits over and above those already budgeted for agriculture and northern areas in 1995.

Soft budget constraints allowed companies operating in the socialist system the chance of survival if, for one reason or another, profitability targets were not met or were not likely to be met. In transition economies companies have retained inherited modes of behaviour, trying to negotiate softer constraints, although the opportunities for negotiation have become more scarce.

As pointed out by Kornai, the willingness of companies to resort to soft constraints was a function of the degree of independence desired by the managers within the planned economy. In order to secure softer constraints, companies had to negotiate with authorities or banks and accept the loss of independence this entailed. Companies with a strong preference for independence thus accepted tougher budget constraints than those for whom independence was less important.

In Russia the toughest budget constraints have been imposed on new private and privatized companies, which have had the strongest desire for independence and have wanted to cut the paternalistic ties with governmental organizations and authorities. The new and privatized companies have experienced the greatest difficulties in obtaining bank credits or supplier credits from other companies (Ickes and Ryterman 1992, p. 335 and Russian Economic Barometer, No. 4, 1993, pp. 19–22). On the other hand, the new, profitable business operating in trade and the service sector have been better able to finance their activities and small investments directly out of profits.

For most companies, however, the use of soft supplier credits has provided a cushion or an invisible pool of reserves in much the same way as soft budget constraints under the centrally planned system. In general terms, where budget constraints have become tougher, the ways learned under the planned economy manifest themselves in problems of tax evasion and payment arrears. The sector in which the tougher budget constraints have been easiest to avoid legally has proved to be interenterprise relationships. Giving and receiving trade-related credits has become the most widely-used avenue where budget constraints have yielded and provided companies a way of adapting without making other, more difficult changes in their operations, such as cutting production or
laying off employees. Wage arrears have provided another similar source of adaptation.
3 Trends in payment arrears in Russian enterprises

3.1 'Line 2' in 1992 and subsequent trends in payment arrears

Significant payment arrears started to accumulate in Russian companies at the beginning of 1992 after most of the price controls had been lifted. They rose from 40 to 3,000 billion roubles in only six months, amounting to about 20 per cent of GDP by June 1992. In July 1992 the Central Bank of Russia ordered the commercial banks to register in 'Line 2' all payment arrears of Russian state enterprises in order to carry out a multilateral netting of the arrears. The netting process was concluded in October and, as a result, the arrears were reduced to 450–480 billion roubles. The remaining credit balances were used to service the debts of enterprises with the commercial banks, and the remaining debit balances were settled by funds provided by the Central Bank to the indebted enterprises.3

After 1 July 1993 the 'Line 2' system was discontinued and inter-enterprise arrears were no longer recorded in the banking system. Therefore, it is not possible to examine trends in arrears on the same basis as before the netting operation.

According to Goskomstat statistics, interenterprise arrears (defined as overdue receivables owned by one industrial enterprise to another) stabilized at a level of 1.8 trillion (1.8*10^{12}) roubles between July 1992 and May 1993, when they started to grow again in nominal terms. Whereas in July 1992 the arrears amounted to about two thirds of total trade credits extended to customers and to 158 per cent of the monthly GDP, by March 1993 their share of total receivables had fallen to one third and of monthly GDP to only 34 per cent. However, after March 1993 they started to grow again in relative terms as well, amounting to 57 per cent of total enterprise indebtedness and 90 per cent of monthly GDP by November 1994 (see Figure 1). At the end of 1994 the overdue arrears amounted to approximately 14 per cent of yearly GDP.

In December 1994 the total indebtedness of Russian enterprises in the industrial, agricultural, transportation and construction sectors amounted to 205 trillion roubles (see Table 1). Of this sum, 90 trillion roubles,

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3 A detailed account is provided in Bigman and Pereira Leite, 1993; see also Rostowski, 1994.
Figure 1.

Total and overdue receivables of Russian industrial enterprises in 1992–95
Left scale: Total and overdue receivables in trillions of roubles
Right scale: Overdue receivables as % of monthly GDP

Table 1.

Indebtedness and payment arrears of Russian companies in December 1994

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Overdue</th>
<th>Overdue debts as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total indebtedness</td>
<td>205</td>
<td>90</td>
<td>14</td>
</tr>
<tr>
<td>Overdue debts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>to suppliers</td>
<td>55</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>to the state budget</td>
<td>18</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Overdue payments to banks</td>
<td>5</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Overdue receivables,</td>
<td>78</td>
<td>12</td>
<td></td>
</tr>
<tr>
<td>of which</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>receivables from buyers</td>
<td>68</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>Wage arrears</td>
<td>5</td>
<td>1</td>
<td></td>
</tr>
</tbody>
</table>

Source: 1994 Statistical Yearbook of Goskomstat (Sotsialno ekonomitsheskoe polozhenie Rossii 1994 g.)
or 44 per cent of the total, was overdue, 55 trillion consisting of overdue accounts payable to suppliers, 18 trillion of tax arrears and 5 trillion of overdue bank credits.

In addition to the trade debt with suppliers and receivables from customers, Russian enterprises have accumulated considerable arrears in wage payments to their employees. In December 1994 these amounted to about 5 trillion roubles, close to one per cent of the yearly GDP and more than the total monthly wages within the economy.

The number of enterprises with overdue trade debts was about 48 000 in December 1994. Among the debtor companies there were 20 000 agricultural enterprises, 10 000 construction companies and 14 000 industrial enterprises. From the total of 20 000 industrial enterprises in the country, about 70 per cent had debts which are overdue. About two thirds of these had been overdue for more than three months. The distribution of overdue debts among various sectors in the economy is shown in Table 2.

Industrial enterprises accounted for the largest debts; their share of total overdue debts was 74 per cent. The transportation and construction sectors also had significant debts, but these were divided among a larger number of companies. The same applies in the case of agricultural companies.

Within the industrial field the energy and machine-building sectors were the most indebted. The energy sector alone accounted for one third of the arrears, and together with the machine-building sector for about one half of the total overdue debts and two thirds of the debts within industry.

The biggest single creditor and debtor within the energy sector is the Russian Power Grid Company, Gazprom. In December 1994 the company had receivables amounting to 16.5 trillion roubles (BBC, SWB, Former USSR, 9 December 1994), 8 per cent of the total recorded receivables and close to 20 per cent of the overdue receivables.

With its export earnings the energy sector in Russia is better able than other sectors to compensate for financing difficulties brought about by interenterprise arrears. Export prices of energy are adjusted to world market prices, which are still much higher than the domestic price level. Consequently, it is relatively easy for the companies to compensate for lost domestic revenues by high export earnings. The energy sector has also been in a very powerful position in relation to its suppliers and has been able to make use of this to delay payments to its suppliers and to cash in receivables from its customers in order to benefit from the high inflation rate.
Table 2. Overdue enterprise debts to suppliers and the state budget of industrial, agricultural, transportation and construction enterprises in December 1994

<table>
<thead>
<tr>
<th></th>
<th>Total due debts</th>
<th>(%)</th>
<th>Debts to state budget</th>
<th>(%)</th>
<th>Debts to suppliers</th>
<th>(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>84 877</td>
<td>100.0</td>
<td>17 924</td>
<td>100.0</td>
<td>54 877</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Composition of total:

- Agriculture: 3 715 (4.4%), 496 (2.8%), 2 484 (4.5%)%
- Transportation: 10 408 (12.3%), 2 141 (11.9%), 7 346 (13.4%)%
- Construction: 8 185 (9.6%), 2 256 (12.6%), 4 683 (8.5%)%
- Industry: 62 569 (73.7%), 13 031 (72.7%), 40 364 (73.6%)%

Composition of industry figures:

- Electricity generation: 9 115 (10.7%), 992 (5.5%), 7 444 (13.6%)%
- Fuel: 21 643 (25.4%), 7 070 (39.4%), 11 842 (21.6%)%
- Oil extraction: 10 982 (12.9%), 4 854 (27.1%), 4 520 (8.2%)%
- Oil refining: 3 564 (4.2%), 252 (1.4%), 3 156 (5.8%)%
- Gas: 3 640 (4.3%), 1 054 (5.9%), 2 408 (4.4%)%
- Coal: 3 246 (3.8%), 903 (5.0%), 1 664 (3.0%)%
- Ferrous: 5 224 (6.2%), 601 (3.4%), 3 648 (6.6%)%
- Non-ferrous: 3 407 (4.0%), 407 (2.3%), 2 013 (3.7%)%
- Chemical and petrochemical: 4 817 (5.7%), 176 (1.0%), 4 087 (7.4%)%
- Machine-building and metalworking: 11 075 (13.0%), 2 463 (13.7%), 6 292 (11.5%)%
- Wood, pulp and paper: 2 148 (2.5%), 525 (2.9%), 1 216 (2.2%)%
- Glass: 112 (0.1%), 10 (0.0%), 81 (0.1%)%
- Light industry: 940 (1.1%), 202 (1.1%), 595 (1.1%)%
- Food: 1 914 (2.3%), 348 (1.9%), 1 317 (2.4)%

The Russian Ministry of Finance and local tax authorities are significant creditors in the fuel industry. Within that industry, oil extraction alone accounts for 27 per cent of the debts to the state budget.

The situation regarding overdue receivables in the various sectors of the economy strongly resembles that of overdue payments. The largest volume of receivables is recorded by the industrial sector, about two thirds of the total. Within industry, the energy sector is also the largest creditor.
3.2 The discrepancy between debts and receivables

In a closed economy debts and receivables should, by definition, be equal, provided that the statistics cover all contracting parties. However, in the case of Russia the state sector has not been fully recorded, which causes a certain bias in the statistics. A further bias is due to the receivables which the Russian energy suppliers have accumulated from buyers in the other CIS States, which do not report their debts to Goskomstat. Furthermore, the theoretical balance between debts and receivables can only be reached if the debtors and creditors have the same understanding of the due dates and the amounts due.

According to the statistics published by Goskomstat, overdue debts to suppliers amounted to 13 trillion roubles (about 20% of overdue receivables) more than the total overdue receivables from buyers at the end of 1994.

The net position of the Russian state as a debtor to enterprises, especially in the military sector, and as a creditor of overdue tax payments is not fully revealed by the statistics. However, the receivables of the military and agricultural sectors from the state form a considerable part of the debt problem. It has been estimated that state debts in these sectors alone amounted to 22–25 trillion roubles at the end of 1994 (Segodnija, 31 December 1994). In 1993 the Central Bank estimated that about 35 per cent of the total indebtedness of the economy had accumulated in the ministries and state offices (Tekushie tendentsii b denezhno-kreditnoi sfere No: 7, Oktjabr 1993).

The receivables of energy suppliers from the other CIS States amounted to 2.8 billion dollars or approximately 9 trillion roubles at the end of 1994 (Ekonomika i Zhizhn, No. 17, April 1994). Two thirds of these receivables had accrued in Ukraine and almost one fifth in Belarus (Russian Economic Trends 3/94). If we assume that the estimates concerning the debts of state organizations and the other CIS States describe gross indebtedness and about one half of them are overdue, then discrepancy between overdue debts and receivables is largely explained.

The recorded difference between the overdue payables and receivables of Russian enterprises is continuing to grow. According to Table 3, the net position of the enterprises in summer 1994 changed from that of net creditor to net debtor. Altogether the overdue net debts of enterprises amounted to almost one fourth of total receivables and to 22 per cent of monthly GDP in May 1995. A year earlier their relative size had been only half that.
### Table 3.

**Difference between overdue receivables and debts of industrial, agricultural, construction and transportation enterprises**

**January 1994 – May 1995**

**trillions of roubles**

<table>
<thead>
<tr>
<th></th>
<th>Overdue receivables</th>
<th>Overdue debts</th>
<th>Net receivables</th>
<th>Net receivables as % of total receivables</th>
<th>Net receivables as % of monthly GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>total receivables</td>
<td>monthly GDP</td>
</tr>
<tr>
<td>1994</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>January</td>
<td>18.1</td>
<td>16.4</td>
<td>1.7</td>
<td>9.4</td>
<td>6.9</td>
</tr>
<tr>
<td>February</td>
<td>21.4</td>
<td>19.9</td>
<td>1.5</td>
<td>7.0</td>
<td>5.2</td>
</tr>
<tr>
<td>March</td>
<td>25.8</td>
<td>25.0</td>
<td>0.8</td>
<td>3.1</td>
<td>2.5</td>
</tr>
<tr>
<td>April</td>
<td>30.8</td>
<td>30.5</td>
<td>0.3</td>
<td>1.0</td>
<td>0.8</td>
</tr>
<tr>
<td>May</td>
<td>35.6</td>
<td>36.9</td>
<td>-1.3</td>
<td>-3.7</td>
<td>-3.5</td>
</tr>
<tr>
<td>June</td>
<td>39.7</td>
<td>41.6</td>
<td>-1.9</td>
<td>-4.8</td>
<td>-4.5</td>
</tr>
<tr>
<td>July</td>
<td>44.7</td>
<td>48.1</td>
<td>-3.4</td>
<td>-7.6</td>
<td>-4.7</td>
</tr>
<tr>
<td>August</td>
<td>49.3</td>
<td>51.9</td>
<td>-2.6</td>
<td>-5.3</td>
<td>-4.8</td>
</tr>
<tr>
<td>September</td>
<td>54.2</td>
<td>58.5</td>
<td>-4.3</td>
<td>-7.9</td>
<td>-7.7</td>
</tr>
<tr>
<td>October</td>
<td>65.7</td>
<td>71.8</td>
<td>-6.1</td>
<td>-9.3</td>
<td>-7.9</td>
</tr>
<tr>
<td>November</td>
<td>73.6</td>
<td>81.5</td>
<td>-7.9</td>
<td>-10.7</td>
<td>-9.6</td>
</tr>
<tr>
<td>December</td>
<td>77.9</td>
<td>84.9</td>
<td>-7.0</td>
<td>-9.0</td>
<td>-8.3</td>
</tr>
<tr>
<td>1995</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>January</td>
<td>80.4</td>
<td>90.4</td>
<td>-10.0</td>
<td>-12.4</td>
<td>-13.7</td>
</tr>
<tr>
<td>February</td>
<td>84.2</td>
<td>99.0</td>
<td>-14.8</td>
<td>-17.6</td>
<td>-17.8</td>
</tr>
<tr>
<td>March</td>
<td>89.9</td>
<td>79.7</td>
<td>10.2</td>
<td>11.3</td>
<td>10.6</td>
</tr>
<tr>
<td>April</td>
<td>95.9</td>
<td>115.9</td>
<td>-20.0</td>
<td>-20.9</td>
<td>-18.9</td>
</tr>
<tr>
<td>May</td>
<td>106.2</td>
<td>132.1</td>
<td>-25.9</td>
<td>-24.1</td>
<td>-21.9</td>
</tr>
</tbody>
</table>


This trend could be linked to the forms of behaviour learned under the regime of soft budget constraints. It could be argued that enterprises benefit from undervaluing their receivables and overvaluing debts in the expectation that the state will come and bail out the indebted companies.

Additionally, it could be argued that in the highly inflationary conditions of the Russian economy enterprises do have a considerable interest in cashing in their receivables as soon as possible, while delaying payment of debts in the expectation that the inflation tax will then be paid by their creditors. How well individual enterprises manage to pursue such a strategy depends on how influential they are. Large enterprises are generally more influential than small ones. This situation may also explain why the powerful energy sector enterprises are the most indebted within the Russian economy.
Because payments are still notoriously slow, especially between distant parts of the country, there is also a discrepancy in the statistics relating to the sum of payments being transferred at any time. The amount of this 'float' is also important for the banks, who have been accused of intentionally slowing down transfers so as to take advantage of this non-interest-bearing financial resource provided by the transfers.

There is also a link between the payable-receivable relationship and the liquidity of an enterprise. In a study of interenterprise arrears in Hungary it was found that payables rise faster and receivables more slowly the poorer the liquidity of the enterprise (Abel and Siklos 1993, p. 10). As Table 4 shows, the liquidity of Russian enterprises has also deteriorated rapidly while the gap between payables and receivables has become widened.

It is clear from Table 4 that the liquidity of Russian enterprises in relation to their debts to suppliers has continuously and significantly deteriorated during 1994. Less than one fifth of the debts were covered by the cash reserves of enterprises at the beginning of 1995 in comparison to about 50 per cent one year earlier.

Even though a significant number of Russian enterprises are considered hopelessly unprofitable and unable to service their debts, bankruptcy proceedings are not being initiated very often. According to the Russian Federal Bankruptcy Agency, 1 240 Russian companies had been declared bankrupt by January 1995. These enterprises have debts amounting to only 11 billion roubles, just 0.1 per cent of the total recorded overdue indebtedness of Russian enterprises (Segodnija, 21 April 1995; Delovoi Mir, 18 January 1995).

The reduced liquidity of enterprises has, in turn, increased interest in barter transactions, which offer buyers a way to finance their purchases and sellers a way to avoid production cuts. According to a survey carried out in 1994, the share of barter transactions in total sales of industrial companies increased considerably in 1993 and reached 16 per cent at the beginning of 1994. Moreover, the growing volume of barter transactions was clearly related to the accumulation of payment arrears. The most indebted industries were among the most frequent users of barter transactions.  

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4 Russian Economic Barometer, Vol III, No 3, 1994, pp. 3–13; Krupnov J.S. (1995) p. 8, estimated the share of barter transactions at approximately 90% of industrial production in the middle of 1994. The statistics covering barter transactions can generally be considered relatively unreliable because there is no uniform definition of barter transactions; keeping official records, for example for tax reasons, can also be easily avoided.
### Table 4. 
**Liquidity and overdue indebtedness of Russian enterprises in 1994–95**

<table>
<thead>
<tr>
<th>Year</th>
<th>Month</th>
<th>Money balances of enterprises as % of overdue debts to suppliers</th>
<th>comprised of:</th>
<th>Industry</th>
<th>Construction</th>
<th>Agriculture</th>
<th>Transportation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>January</td>
<td>52.3</td>
<td>50.7</td>
<td>41.7</td>
<td>43.6</td>
<td>96.2</td>
<td></td>
</tr>
<tr>
<td></td>
<td>April</td>
<td>33.3</td>
<td>31.9</td>
<td>19.6</td>
<td>19.4</td>
<td>90.5</td>
<td></td>
</tr>
<tr>
<td></td>
<td>July</td>
<td>25.1</td>
<td>23.3</td>
<td>18.9</td>
<td>20.1</td>
<td>59.3</td>
<td></td>
</tr>
<tr>
<td></td>
<td>October</td>
<td>20.6</td>
<td>20.7</td>
<td>18.1</td>
<td>17.1</td>
<td>23.1</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>January</td>
<td>18.7</td>
<td>18.7</td>
<td>21.1</td>
<td>11.9</td>
<td>19.9</td>
<td></td>
</tr>
<tr>
<td></td>
<td>February</td>
<td>19.3</td>
<td>19.3</td>
<td>17.4</td>
<td>12.5</td>
<td>22.0</td>
<td></td>
</tr>
<tr>
<td></td>
<td>March</td>
<td>24.6</td>
<td>25.7</td>
<td>23.5</td>
<td>12.1</td>
<td>24.5</td>
<td></td>
</tr>
<tr>
<td></td>
<td>April</td>
<td>23.5</td>
<td>25.1</td>
<td>21.3</td>
<td>12.0</td>
<td>21.1</td>
<td></td>
</tr>
<tr>
<td></td>
<td>May</td>
<td>23.8</td>
<td>25.9</td>
<td>23.5</td>
<td>12.5</td>
<td>19.5</td>
<td></td>
</tr>
<tr>
<td></td>
<td>June</td>
<td>21.6</td>
<td>22.5</td>
<td>28.5</td>
<td>12.6</td>
<td>19.2</td>
<td></td>
</tr>
</tbody>
</table>


The largest net debts in relation to total receivables are recorded in the agricultural sector and the paper and wood-processing industries. Other significant net debtors include the fuel industry, especially coal, and the non-ferrous metal and machine-building industries. Whereas the overall position of industry is that of net debtor, the reverse is true in the sectors of electricity generation, ferrous metallurgy and construction.

### 3.3 Wage arrears

In addition to interenterprise debts, debts to the state and local budgets and overdue bank credits, unpaid wages to employees also form a significant arrears problem in the Russian economy. In December 1994 such arrears amounted to 4.7 trillion roubles, about 5 per cent of all payment arrears recorded in the economy. Altogether 34 000 enterprises were recorded as having wage arrears in December, of which 21 000 were in agriculture, 7 000 in industry and 6 000 in construction. Agriculture accounts for a relatively high share of wage arrears, about one quarter, although its share of all overdue debts was only 4 per cent.
This reflects the general nature of agricultural work, which is highly labour-intensive.

Within industry the energy sector and machine-building sectors are particularly deeply in debt to their employees. The military and coal industries have high wage arrears due to the fact that there are significant delays in budgetary payments to these companies (Kommersant, 21 April 1995). Wage arrears were growing at a more rapid rate than other debts during 1994 (see Table 5).

**Table 5. Wage arrears among the industrial, construction and agricultural sectors in Russia in December 1994**

<table>
<thead>
<tr>
<th>Number of enterprises</th>
<th>Arrears (billion roubles)</th>
<th>Arrears (as % of monthly wages)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>54 200</td>
<td>4 474</td>
</tr>
<tr>
<td>Industry</td>
<td>7 100</td>
<td>2 507</td>
</tr>
<tr>
<td>Construction</td>
<td>6 300</td>
<td>868</td>
</tr>
<tr>
<td>Agriculture</td>
<td>20 800</td>
<td>1 372</td>
</tr>
</tbody>
</table>

Source: 1994 Statistical Yearbook of Goskomstat (Sotsialno ekonomitsheskoe polozenie Rossii 1994 g.)

The problem of wage arrears is also explained by other factors which are not purely related to the poor liquidity of the enterprises concerned. It has been beneficial for enterprises to keep the personnel on their payrolls under minimum salary contracts and to give them unpaid leave without laying them off. In this way the enterprises have been able to pay others higher salaries without paying fines for those wages which exceed the legal maximum of eight times the minimum wage level (Segodnija, 21 April 1995). In practice, employees have no legal means of securing salary payments.

Accumulated wage arrears have led to angry protests only among the employees of the coal industry. Miners threatened to strike on many occasions during 1994 unless the arrears were paid. However, at the beginning of 1995 such threats were silenced by the far more serious threat of closing down many of the unprofitable mines. In other industries wage arrears have so far caused very little public protest, which can be explained by the same fear of unemployment as in the coal industry (Morvant 1994).
If wage arrears are taken into account, the real wages of the Russian workforce have decreased even more than is indicated by the wage statistics. This fact draws attention to a particular feature of the Russian transition, whereby employees have been much more willing to accept a decrease in real wages, rather than open unemployment (Layard and Richter 1995).

3.4 Indebtedness and inflation

During most of 1994 overdue payables grew more rapidly than receivables due. In addition, the rate of growth in both cases was higher than that of inflation (see Figure 2).

Figure 2. Payment arrears and inflation in Russia in 1994 – 1995

1 Increase of debts over the previous month
2 Increase of receivables over the previous month
3 Increase of prices of industrial goods over the previous month

Source: Statistitsheskoje Obozrenie

In the highly inflationary conditions of the Russian market enterprises have probably tried to benefit from inflation by slowing down the payment of debts and trying to cash in their receivables more rapidly. It is likely that the large enterprises, who are better represented in the statistics than the smaller ones, are also in a better position to exert
pressure on their customers (Suslov and Buzulutskov 1994, p. 98). As pointed out above, this could also be a partial explanation for the large discrepancy in the statistics between the debts and receivables of enterprises.

It can also be argued that trade credits extended by one enterprise to another have been inflationary in allowing them to price their products higher than they would have done in circumstances where they would have had to acquire the necessary working capital from other sources (Bershtam and Sitnikov 1995, p. 51). This, in turn, has contributed to a general lack of working capital and a fall in production. On the other hand, with the help of trade credits such companies have been able to continue production where they would otherwise have had to close down. The influence of trade credits in supporting the old production structures has probably been stronger than their influence in decreasing production through higher prices.
4 Russian banks and payment arrears

Whereas interenterprise arrears are in a rising trend the role of the Russian banks as a source of finance has diminished. Enterprises have increasingly resorted to borrowing from each other instead of taking bank loans. During the first half of 1992 Russian payment arrears grew rapidly and doubled the volume of bank credits until the Central Bank intervened with new credits to offset the problem. Table 6 shows the growth of credits given by banks to the nonfinancial sector in relation to the overdue payables in the Russian economy since July 1993. Between July 1993 and December 1994, overdue interenterprise debts have again outgrown the credits extended by the banking sector.

Table 6. Bank credits and interenterprise debts

<table>
<thead>
<tr>
<th></th>
<th>Bank credits</th>
<th>Overdue payables</th>
<th>Overdue payables as % share of credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>July</td>
<td>15 900</td>
<td>3 400*</td>
<td>21</td>
</tr>
<tr>
<td>October</td>
<td>23 600</td>
<td>6 400*</td>
<td>27</td>
</tr>
<tr>
<td>December</td>
<td>30 900</td>
<td>9 200*</td>
<td>30</td>
</tr>
<tr>
<td>1994</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>January</td>
<td>30 000</td>
<td>16 400</td>
<td>55</td>
</tr>
<tr>
<td>April</td>
<td>38 900</td>
<td>30 500</td>
<td>78</td>
</tr>
<tr>
<td>July</td>
<td>52 900</td>
<td>48 100</td>
<td>91</td>
</tr>
<tr>
<td>October</td>
<td>69 900</td>
<td>71 800</td>
<td>103</td>
</tr>
<tr>
<td>November</td>
<td>77 700</td>
<td></td>
<td></td>
</tr>
<tr>
<td>December</td>
<td></td>
<td>84 900</td>
<td></td>
</tr>
</tbody>
</table>

* Payables and overdue payables of industrial enterprises only


There are a number of reasons behind the growth shown in the table. The two most obvious explanations are trends in interest rates, on the one hand, and the creditworthiness of enterprises, on the other. First, the
credits extended by banks have become more expensive not only in nominal terms but also in real terms, whereas the trade credits extended between enterprises do not necessarily carry any interest at all. Secondly, as the financial situation of Russian enterprises has deteriorated, the banks have become more reluctant to extend credits to them. While bank credits represented 19 per cent of yearly GDP at the end of 1993, the share had fallen to about 12 per cent by the end of 1994.

The banks face a situation where they can no longer acquire additional creditworthy customers by attracting them from the other banks, since companies which have received credits from more than one bank have been found to be in a worse financial situation than those that had been customers of just one bank (Russian Economic Barometer, Vol III, No 1, 1994, pp.11–13). Enterprises probably start looking for other sources of financing only after they have been turned down by their traditional bank. The competing banks, in turn, have difficulties in assessing their creditworthiness due to the extended and received trade credits which are not fully revealed by the financial statements.

Even when extending so-called centrally allocated credits to their customers the state-owned banks have had to carry the credit risk of the enterprises themselves. Accordingly, it was found that over 40 per cent of directed credits were not repaid by the enterprise-borrowers in time (Russian Economic Barometer Vol III, No. 3, 1994, p. 35). Moreover, as revealed by an earlier survey, those enterprises which had received centralized credits were in a better financial situation than those which had not (Russian Economic Trends, Vol II, No. 4).

For reasons elaborated above, the interest of the banks in channelling centralized credits has greatly diminished, although the largest of the former state-owned banks had little choice but to accept the task of channelling such credits. However, the Russian government has promised to tighten the conditions of centrally allocated credits in 1995.

Additional reasons for low interest on bank credits can be found in the interest shown by enterprises in circumventing the banking system in general. By avoiding the use of banks, enterprises have a better prospect of avoiding taxation and the 50 per cent currency repatriation requirements, and even the alleged connections of the banks with the various mafia groups operating in the country (Grossman 1995, p. 2).

It can generally be assumed that is has been easier for enterprises to negotiate credits from each other than from the banks. Statistics also confirm the softness of interenterprise debts in comparison to bank

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5 The directed credits to agriculture are an exception to this rule, however. In 1995, the banks which had granted such credits to their clients could exchange these credits, which were all overdue, for government bonds.
credits. The overdue bank credits reported by the Central Bank amount to approximately 21 per cent of the credit portfolio of the banks (Bulleten bankovskoi statistiki No. 12, 1994, p. 33). On the other hand, the share of the overdue interenterprise debt in comparison to their total debt is approximately 50 per cent. It can be assumed that the banks record their credits more strictly due to banking supervision, which is not extended to enterprises.

It is possible to draw this conclusion even though there are large differences between the statistics on overdue bank credits. According to Goskomstat statistics collected from enterprises, the share of overdue bank credits in December 1994 was 15 per cent of the total amount of credits received from the banks. The discrepancy between the amount of overdue payments on bank credits recorded by Goskomstat (about 5 trillion roubles) and the Central Bank (about 20 trillion roubles) in December 1994 is, however, striking.6

The Central Bank's statistics most likely reflects the true situation of the banks more closely than the Goskomstat statistics which are based on information from enterprises. However, the question should also be asked whether even the Central Bank statistics give a realistic picture of the extent of bad debt within the economy.

Only from the beginning of January 1994 have the Russian banks been obliged to classify their credits extended to Russian enterprises in five different categories according to the probability of having these credits fully serviced. The banks have been able to use their own judgement in making this classification, without any strict guidelines from the Central Bank. As a result of this classification the banks were required to build up loan loss reserves to hedge against the expected bankruptcies among their clientele.7

As the Central Bank monitored the accumulation of these reserves, it found that most banks considered the risks related to their credit portfolio to be very low, requiring only the minimum amount of reserve accumulation by the bank. Such a classification by the banks clearly

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6 There is also a large difference between the total credit portfolio of the banks recorded by Goskomstat (30 to 35 trillion roubles) and by the banks (70 trillion roubles), which has also caused concern in the Central Bank (see Reuter, 24 April 1995).

7 Information received from the Central Bank of Russia.
contradicts the fact that a significant proportion of Russian enterprises are unprofitable. The banks' view is probably motivated by the difficulties in accumulating the required loan loss reserves.

Following the above discussion it is clear that the Russian banking sector is also facing serious difficulties as a result of the arrears and bad debt problems. The lessons learnt from the problem of interenterprise arrears should, however, prevent the Russian authorities from creating the same kind of expectations among the banks regarding state financial assistance as were created among enterprises after 1992.

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8 The financial accounting of bad loans is also complicated by the new regulations under which hopeless credits extended by the banks may be written off only after a court decision and within not less than five years after the decision has been made (Kommersant-Daily, 13 January 1994). However, the loan loss reserves can, after a long battle with the tax authorities, be deducted from the profits before taxes and not after taxes, which was the view held by the tax authorities (source: Central Bank of Russia).
5 Reasons behind the indebtedness problem

Analytical reports on early trends in the Russian interenterprise problem during 1992–93 highlight certain technical problems within the Russian banking sector as being the main underlying causes of these debts. Such problems included technical delays in transferring payments within Russia and especially between the CIS States, and a shortage of cash roubles and of credit issued to cover the liquidity needs caused by rapidly rising prices. The last point, referred to especially by Russian economists, can also be interpreted as a criticism of the tight monetary policy of the Central Bank (Bigman and Pereira Leite 1993, Odess, Delovoi Mir, 3 November 1994, Delovoi Mir, 31 March 1995). It can also be claimed that the magnitude of the arrears problem in 1992–93 was overestimated, as it was mainly adaptation to payment terms prevailing in market economies (Gros 1995, pp. 25–28).

Another line of reasoning concentrates on the behavioural aspects behind the persistent arrears problem. Some point to the collapse in financial discipline among Russian enterprises, some refer to the tougher budget constraints, creditor passivity or the collusive behaviour of enterprises, while others argue that the low credibility of the monetary policy has been the main reason behind the problems (see Bigman and Pereira Leite 1993; Ickes and Ryterman 1992, p. 348; Suslov and Buzulutskov 1994, p. 100; Begg and Portes, p. 7; Perotti 1994; Rostowski 1994; Fan and Schaffer 1994). It is quite easy to agree that the problem is not simply a technical one that can be solved by making payment transfer systems more effective. Moreover, it also seems that it is not a question of a collapse in financial discipline but rather a continuation of the atmosphere of lobbying and negotiation to which Russian managers had become accustomed during the centrally-planned administration. Their main motivation has been to continue production and not to lay off employees.

Since the Central Bank yielded to pressures to ease monetary policy in 1992, also later on the authorities were expected to provide 'soft' crediting when enterprises again faced financial difficulty. This is why the low credibility of the monetary policy can be seen as a significant factor.

In April 1994 the government again channelled 13 trillion roubles into the economy to help the northern and far eastern regions and especially the agricultural sector (Reuter, 20 October 1994). Following this, it has been claimed that the subsequent inflationary jump in the
money supply was a key factor behind the crash of the rouble on 'Black Tuesday', 11 October 1994.

In April 1995 the Duma passed a law which transferred a total of 25 trillion roubles of centralized and overdue credits that had been extended by the banks to the agricultural sector into internal government debt by issuing interest-bearing government bonds to the creditor banks. The Central Bank opposed this law openly, claiming that it would again revitalize expectations among Russian indebted enterprises of receiving cheap centralized credits (Kommersant Daily, 13 April 1995). Even though the government is committed to a tight monetary policy and has explicitly declared that the agricultural financing was an exception to the rule and will not be repeated, the logic of collusive behaviour might raise the pressures again to assist another politically significant sector in financial difficulties.

In May 1994 the Russian government commissioned a committee to investigate the reasons behind the growing interenterprise arrears. The committee prepared a detailed report of its findings and at the end of 1994 the Russian press published a series of articles based on the report, analysing the causes of the interenterprise debts\(^9\). According to their findings there were also other reasons behind the remounting debts. Among the indebted enterprises they found many which had illegally withheld their foreign currency earnings from the Central Bank and kept their currencies in foreign banks, while at the same time accumulating rouble debts with their suppliers and even employees. This had apparently happened in the expectation that sooner or later the authorities would bail out the indebted enterprises. As a result they would not have to use the accumulated foreign currencies to pay the domestic debts. In some cases the indebted companies 'found' additional financing only when they were threatened with bankruptcy proceedings.

Through such a mechanism there is also an obvious link between trends in the interenterprise debt problem and the flight of capital estimated at USD 10–15 billion in 1994 (Ekonomika i Zhizhn 42/94; IFR EBRD Report 1994). Many other ways were also found of not reporting earnings to the tax and other authorities. Such immoral practices are most probably the result of a low respect for the authorities and the law in general in the transitionary Russia.

Such practices are also a sign of the inefficient control over management by the owners of the enterprises. The managers have been able to use their position to freely pursue purely personal financial goals without having to face any controls. This is made possible by the fact

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that the state, as a major, if no longer a majority owner, is a passive
owner and does not intervene in the management of enterprises. The
other owners are insufficiently informed and have no organized control
mechanisms. So far, not even the above-mentioned committee report
seems to have led to any concrete changes in the control of companies.

It is argued, in addition, that the most significant reason behind the
arrears problem is the government itself, which has also accumulated
significant arrears and, by doing so, has set a very bad example to the
other actors within the economy. It has been estimated that the go-
vernmental arrears have a cumulative multiplier effect of 3–6 times the
original amount (Segodnija, 31 December 1994; Finansovye Izvestija,
16 March 1995). This is due to the fact that the government mostly buys
finished products, and if they are not paid, financial difficulties are
created for all the enterprises which have delivered raw materials or
components to those producing the products. In addition, the government
has also been accused of not honouring the promises it has made to some
of these enterprises for providing working capital (Rossijskaja Gazeta,

In these questions the Russian government is under attack from both
sides. On the one hand, it is committed to a tight monetary policy and, on
the other hand, the tight monetary policy is backfiring in the short run by
creating tax arrears which, in turn, make it impossible for the govern-
ment to honour its commitments without softening its monetary policy.
6 Attempts at solving the arrears problem

Russia has tried out several different approaches to addressing the arrears problem. Since 1992 enterprises have been required to use prepayments in order to avoid accumulating additional arrears. This requirement has not been respected, as can clearly be seen from the mounting debt figures. Furthermore, there were no sanctions for disobeying this rule, and continuing production with the help of trade credits extended to customers was obviously considered preferable to cutting production.

The multilateral clearing operation and the additional financing provided by the Central Bank of Russia in 1992, seemed to settle the problem temporarily but, as we have argued before, it created expectations of continued financial assistance from the government in the future. Furthermore, the multilateral clearing equalised the value of all interenterprise liabilities regardless of the viability and financial standing of the enterprises concerned (Rostowski 1994, p. 17). In this way multilateral clearing exacerbated the moral hazard problems within the economy by giving the signal that there is no need for enterprises to change their strategies.

In August 1994 a Commission was created to examine ways of improving the payment system. It planned to resolve the arrears problem by firstly developing the legal basis for payments and, secondly, by improving the possibility of solving the arrears problems at a regional and local level and at the level of the enterprises involved (Rossijskie Vedomosti, 23 September 1994). Accordingly, various regional arrangements have been made to diminish the problem.

A technical solution, the use of promissory notes, was also introduced in 1994 (Delovoi Mir, 20–26 December 1993, Novoe Vremja No. 4/1995). The Russian government has been the major issuer of such notes, but banks have also started to issue promissory notes to cover their overdue payments (Kommersant Daily, 17 August 1994). However, issuers other than governmental organizations face the problem of creditworthiness and transparency in the financial markets. The enterprise has to be large, well known and considered creditworthy to be able to use this instrument.

The government has also tended to crowd out other issuers, especially the local authorities, from the emerging financial markets. In addition to the problem of being crowded out, companies face problems in securing the promissory notes. In practice, notes issued by the companies could only be secured with their own working capital. It is, however, not
clear how the holders of the promissory notes would be reimbursed in the case of nonpayment, because the working capital is often earmarked to paying current outlays, not loans. In practice, the strict rules of financial accounting and the use of bank accounts should be changed to allow for greater flexibility.

In 1995 further administrative measures were taken by introducing a presidential decree sanctioning both the use of trade credits for more than three months and delays in wage payments (Kommersant Daily, 20 January 1995). A measure was also introduced to enhance the financial control of oil companies over their branches, which have extended trade credits to their customers (Reuters, 27 February 1995).

It is impossible to evaluate how effective such restrictive measures are in operation when the authorities have limited possibilities of controlling them. Their impact will depend, to a great extent, on how credible and consistent Russia’s tight monetary policy proves to be.

An obvious solution to the persistent arrears problem would be to close down the most unprofitable enterprises, especially in the coal mining industry. However, both closing down factories and introducing bankruptcy proceedings have proved to be very slow processes in Russia.

There are also differing views on the character of the arrears problem, which are reflected in the different ways of tackling it. Most Russians consider that the mounting arrears have created a financial crisis which needs to be solved by special measures. Many Western specialists, including the IMF, consider that the problem is transitory and will disappear by itself as the economic reform process continues (Kommersant Daily, 15 June 1995). Therefore no special measures are needed if Russia’s economic policies can be geared towards curbing the money supply and inflation.
7 Concluding remarks

The problem of payment arrears has persisted in Russia for longer than in other East European transition economies, where the arrears have stabilized at roughly the same level as in Western Europe. In Russia the corresponding stabilization took place in 1992 when a multilateral clearing operation was carried out to settle the problem. However, since 1993 the arrears have grown again, in relative terms too, but the problem has taken a new turn. Whereas in 1992 the reasons for the arrears were mainly technical, the reasons behind the more recent arrears are related to fact that enterprises expect to continue receiving financial assistance from the government.

In addition, enterprise managers believe that by creating enough lobbying power the financial authorities can be persuaded to bail out enterprises in financial difficulties. Such expectations are not only a result of the transitory conditions, but also a prolongation of the behaviour acquired under the earlier 'soft' budget constraints and the legacy of the planned economy. Such behaviour is not unheard of in market economies, either.

Multilateral clearing used as the first solution to the arrears problem created additional moral hazard problems as no differentiation was made between the debts of enterprises in terms of their viability. It is likely that this has contributed to, for example, tax evasion, capital flight and the shadow economy, which have developed at the same time as the arrears problem.

A number of advisors to the Russian government, most notably the IMF, have recommended not to take any special measures in order to solve the arrears problem, as this will lead enterprises to rely on their own judgement and own sources of information on the creditworthiness of their clients. Those sources are probably the best available, anyway. Many Russians, however, consider that the problem has reached the magnitude of a financial crisis, and various measures have been taken in trying to solve it.

Russian approaches to solving the problem include both market-based solutions and administrative controls. The use of promissory notes represents a market-based solution and has been confronted with difficulties in credit risk assessment when used by issuers other than the government. However, for the public sector and large enterprises, which are close enough to potential investors to provide them with a well-founded analysis of the risks involved, it provides a useful instrument.

The more recent attempts at resolving the arrears problem have included various restrictions, controls and sanctions, rather than market
solutions. So far such administrative measures have not proved very successful in Russia. It is likely that any real change in conduct among Russian enterprises will depend on the lobbying powers of banks, on the one hand, and industrial enterprises, on the other. Increasing threats of bankruptcy among both groups are likely to cause mounting pressure on the government to loosen its monetary policy, which is a highly political issue.

The crucial question in this process is how rapidly and extensively the aims of economic reform in restructuring the economy can be adopted among enterprises. A second crucial question is the credibility of tight monetary policy as a tool to combat inflation. At least part of the behaviour of enterprises described above will become meaningless in conditions of low inflation. Finally, a significant role will also be played by the development of managerial control mechanisms, which should eliminate the most morally questionable practices among enterprises.
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199


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