CHAPTER-V

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This study is a modest attempt to illustrate the significance of banking system in the functioning of Russian economic system. The Russian banking system has developed from the centralized system of the Soviet period into a two-tier system including a Central Bank and commercial banks. At the end of the 1980s the Soviet Union had barely emerged from the Monobank system of the communist era, when effectively one single banking institution Gosbank handled the full range of banking services required in the command-administrative system.

Until 1987 the Soviet banking system was organized as a ‘Monobank’ with the state bank (Gosbank) as the agent of the government. Reform of the system started with the 1998 Law on cooperatives which permitted the creation of co-operative banks to service those newly created co-operative (that is private) enterprises that did not wish to rely wholly on the state apparatus.

At the beginning of 1988 there were just four state owned commercial banks, the so-called spetsbanks: Vneshekonombank handled foreign trade and payments, while the three domestically oriented institutions were supposed to focus respectively on agriculture (Agroprombank), industry (Promstroibank), and housing
(Zhilsotsbank). Over the next two years about 150 new banks were created. Then in 1990 many regional offices of the State Bank become independent, bringing a further 800 separate banks into existence on the basis of the former state network, especially for the former Agrorombank. Many of these newly spawned institutions were short lived. By 1993 most of them had been absorbed as branches of independent private institutions created from 1992 onwards and unconnected with the former state banks.

The new banks were a spontaneous by-product of the privatization of non-bank entities. Industrial companies, agricultural marketing bodies and other business organisations wanted to keep control of their revenue and cash flows both to facilitate misappropriation and to protect against misappropriation by others — by setting up their own pocket banks to handle them. Acquisition of the former state owned banks that had emerged from fragmentation of the three domestically focused spetsbanks was facilitated by the swift depreciation of the state owned banks capital in the force of inflation.

The Russian Central Bank assumed the functions of Gosbank in November 1991, and Gosbank was eliminated when the Soviet Union dissolved one month later. In its first year of existence, the Russian Central Bank functioned under the guidelines of the 1977
Soviet Constitution and Russian laws passed in 1990, which made the bank essentially an arm of the Russian parliament.

In the subsequent decade the banking sector followed a turbulent and unpredictable path, remote from broad infrastructural position, characteristic of banking in stable market economies. In line with its Soviet ancestry, however, it continued to play an important part in relation to public sector budgets both in channeling government expenditure and in assisting tax collection.

The Russian Central Bank has the greatest impact on Russia's economy through its role in monetary policy. It controls the money supply by lending funds to commercial banks and by establishing their service requirements. For several years after its establishment, the Russian commercial banks issued direct credits to enterprises and to the agricultural sector at subsidized rates. Such credits were directed via commercial banks to politically influential sectors, agriculture, the industrial and energy enterprises of the northern regions, the energy sector in general, and other large state cum enterprises. In the early years the Russian commercial banks also financed state budget deficits by issuing credits to cover government expenditures. The availability of such credits played a central role in the high inflation that the Russian economy endured between 1991 and 1994.
By 1995 there were well over 2,000 commercial banks in existence across the country, about one third of them with major offices in Moscow. The Russian parliament approved the new Federal Law of the CBR on 12 April 1995. Unlike the preceding legislation the new Federal law very clearly defined the Central Bank’s objectives, to defend the stability of the rouble and the Russian banking system in conformity with the task allotted to it in the Russian constitution. According to the 1995 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 commercial banks.

The 1995 CBR legislation stipulated that the Central Bank has no right to grant credits to the government to cover budgetary deficits. This represented a significant reversal of earlier legislation that more or less obligated the CBR to finance the government deficit. Hence, it opened the door for conducting independent monetary and credit policies.

In 1995, the CBR legislation placed the CBR under the control of the Duma. The 1995 CBR legislation represented a modernization
of Russian banking legislation. The CBR’s monetary instruments now included rate policy reserve requirements, open market operations, refinancing of banks, foreign exchange control and regulation of money aggregates and quantitative regulations. After 1995 the CBR began to control the money supply much like the Central Bank in the industrialized market economics.

In 1996–97, there was considerable liberalization, policy makers being concerned about the rising cost of debt service, having discovered that the Russian banking and financial system were not rendered stable. Russian banks were drawn into making large-scale forward sales of dollars to foreigners in disregard of any major exchange risk.

The international financial conditions took a turn for the worse on the onset of the Asian crisis in Autumn 1997. The withdrawal of foreign funds from Russia over the succeeding six months mainly affected the equity market.

The Central Bank reported that in the nine months from 1 August 1998 to 1 May 1999 aggregate capital of the commercial banking sector shrank by 50 percent in nominal terms (from 102 billion new roubles to 46 billion) and thus by 80 percent in real terms. The real value of the sectors balance sheet reportedly fell by a
smaller amount about 25 percent mainly because of the presence of foreign currency assets, including cash balances. The status of foreign currency claims other than cash, however, was questionable, especially where the debtor was an enterprise with little or no export revenue. From February 1999 onwards the Central Bank insisted on a minimum 40 percent provision rate for the banks foreign currency loans.

While the Russian banking debate of 1998 had its parallel at various times in other transition economics, it nevertheless represented tremendous failure for policy makers who had for several years been attempting to put the banking system upon a sounder footing. The policy makers in question included both Russian domestic authorities, chiefly the Central Bank, and international institutions, advising them, notably the World Bank and the European Bank for Reconstruction and Development (EBRD). The 1998 crash showed their policies to have been at best quantitatively insufficient, at worst irrelevant because they addressed the wrong targets.

The problems facing the banking sector have had an impact on the Russian economy. First and foremost Russia has not been able to attract necessary investment in the economy.
Secondly, there are also reports both in Russia and in the West about the increase in money laundering from Russia. Russian government is reported to be unable to create a special agency to combat the problem of money laundering. Apart from this, there are not only shortcomings in banking laws, they are often applied arbitrarily as has been the case with the ‘Bank Bankruptcy Law’. The Russian banking sector suffers from the malady of wide gaps between policy statements and their implementation.

To overcome the problems facing the banking sector and to enable it to meet the demands of a modern market economy, Russia needs genuine banking reforms. In this regard, the most significant and urgent reform measure is the one relating to the ill-suited accounting system, which was inherited from the Soviet era. The Russian authorities have realised the importance of this measure and hence decided to introduce the ‘International Accounting System’ (IAS) in the banking sector as there is a growing realization of its need in the context of increasing economic ties with the western financial institutions and improving the prospects of Russia’s membership of the World Trade Organization (WTO).

The proposal of introducing IAS has been supported by the Central Bank of Russia since it will give a more accurate idea both to the government and to the CBR as to where a Russian Bank stands.
financially. Pursuing this policy select Pilot-Banks are to train bank staff to follow IAS standards. Even as the CBR hopes implement this new accounting system in the next five years, this task is quite formidable as Russia has over 1,300 banks with over 40,000 staff.

To effectively implement various policy decisions and laws concerning the banking sector, it is necessary to increase the role of regulatory authorities. This is particularly the case with regard to applying bankruptcy and liquidation procedures and introducing share-holder accountability.

For the overall improvement of the economy and of the financial sector in particular, there is a need for generating an atmosphere of healthy competition among banks. There is an urgent need for greater co-ordination among various agencies such as the CBR, the DUMA and the Ministry of Finance while taking policy decisions affecting the banking sector. Moreover, it is necessary to strictly implement policy decisions and laws, which needs greater political will. The banking sector should also be relieved of its heavy tax burden by introducing a uniform rate of taxes for all sectors of economy.