CHAPTER-III

RUSSIAN BANKING SYSTEM
IN THE POST DISINTEGRATION ERA
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On 25 December 1991, the Soviet Union ceased to exist. The event shook the world. For one thing, the Soviet Union was the largest country of the world, stretching from Europe to Asia. It had played a pivotal role in international politics for seventy-four years. It had emerged, besides, as a formidable military Power, matching the United States. Above all, it had sought to blaze a trail by its endeavour to translate an ideal into a reality. It presented a distinctive model of socio-economic development other than capitalism. The disintegration of the Soviet Union was not, therefore, just the break-up a huge State system or an empire: it was an ideal turning into a myth. A dream becoming a nightmare.¹

On all counts, it was an unprecedented event in history; for it was precipitated, not by war or rebellion or by force or threat of use of force, not even by a mass upsurge or popular mandate. Nor was it an

accident of history, bringing into sharp focus the follies and frailties of humankind.²

Admittedly, the country had been in a state of crisis since the beginning of the 1980s.³ And the crisis intensified as the decade progressed. However, it was not so acute as to bring off sudden disintegration. Like any other country, the Soviet Union could certainly have lived with the crisis and made one attempt after another to resolve it. Such attempts might have become a permanent feature, turning the Soviet State into a soft one without bringing about its actual disintegration. Indeed such a scenario had been part of the historical experience of Soviet society right since the day it came into existence. In other words, the situation was not as hopeless as the one in which the Tsarist empire had found itself in November 1917.

No wonder, therefore, that by and large the world received the news of disintegration of the Soviet Union with disbelief. Interestingly enough, even President Mikhail Gorbachev could not hide his surprise at this unexpected turn of events. He stated:

“For me, as the country’s President, the main criterion for assessing the documents is the degree to which it conforms with the security interests of citizens, the task involved in the overcoming the present crisis, the preservation of statehood and the continuation of

² Ibid.
³ Ibid., p.378.
democratic transformations. The agreement has positive points. The Ukrainian leadership, which of late had not been active in the treaty process, took part in it.

The agreement explicitly proclaims the end of the existence of the USSR. Without question, each republic has the right to leave the union but the destiny of a multinational state Cannot be determined by the will of the leaders of three republics. The matter can be only be resolved by constitutional methods with the participation of all sovereign states and with due regard for the will of their peoples.

The statements on ending the force of all union legal norms which, can only intensity the chaos and anarchy in society is also unlawful and dangerous. The waste with which the document has appeared also gives rise to bewilderment. It was not discussed either by the population or by the supreme soviets of the republics on behalf of which it is signed. The more so as this occurred at the moment when the parliaments of the republics were discussing the draft treaty on a union of Sovereign states elaborated by the USSR state council.

In the current situation it is my deep conviction that it is essential for all the supreme soviets of the republic and that of the USSR to discuss both the draft treaty on a Union of sovereign states and the agreement conclude in Minsk. As the agreement purpose a different from of statehood which has in the competence of the USSR, Congress of Peoples Deputies, it is essential to convince such a congress moreover, I would not preclude holding a nation-wide referendum plebiscite on this issue."

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In his farewell address to the nation, televised on 25 December 1991, Gorbachev sought to explain the demise of the Soviet Union. He identified the dismal economic performance of the system as the primary reason. He stated: “Fate had it that when I found myself at the head of the state it was already clear that at all was not well in the country. There was plenty of everything, yet we lived much worse than the developed countries and kept falling behind them more and more.” He then gives his reasons: “The society was feeling suffocated in the vice of the command-bureaucratic system doomed to serve ideology and bear the terrible burden of the arms race.” The three ills of the society which he identified were thus the command bureaucratic system, its subservience to ideology, and the terrible burden of the arms race. Gorbachev then adverted to his launching his programme of glasnost and perestroika: “It [the Soviet Union] had reached the limit of its possibilities. All attempts at partial reform, and there had been many, had suffered-one after another. The country was losing perspective. We could not go on living like that. Everything had to be changed radically.” Speaking of the perestroika years he claimed that “work of historic significance had been accomplished”, but added: “The process of renovating the country and radical changes in the world community turned out to be far more complicated than could be expected.” Finally, he declared; “The totalitarian system which

For the text of his farewell address, see Times of India (New Delhi), 27 December 1991.
deprived the country of an opportunity to become successful and prosperous long ago has been eliminated. A breakthrough has been achieved on the way to democratic change.” He also claimed the terminal end of the Socialist economic system and the beginning of a market economy: “Economic freedom of the producer has been legalised and entrepreneurship shareholding, privatisation are gaining momentum.”

First of all the very *modus operandi* of implementing the much-needed and overwhelmingly popular programmes of *glasnost* and *perestroika* was wrong; so much so that it led to a gradual disintegration of all established institutions. No new institutions were evolved to take their place in a programmatic manner. The vacuum thus created turned democracy upside down. A case in point is the sudden shift of power from the Party to new representative institutions without the necessary preparations being made to sustain them. Consequently, the new Parliament soon became a debating club, and the Government was confined to the Kremlin. Second, although the programmes of *glasnost* and *perestroika* were the need of the hour and the CPSU, the only organized mass political movement in the country, was unanimously committed to implement it, it is obvious that the leader of the party, Gorbachev, and his close associates like Shevardnadze were

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6 Imam, n.l, p.380
7 Ibid., p.397.
not entirely confident of its eventual success. Not that Gorbachev and his close associates had planned and elaborate deception, but their very lack of conviction in the resilience of the system, articulated consistently through the difficulties created on the road to perestroika and to reform, created hesitancy and doubt and facilitated politicking for power from top to bottom. Increasingly they found themselves confronted with new problems almost every day.

The Gorbachev leadership fostered high expectations among the Soviet people. One thought at first that the Soviet Socialist system might eventually manage to cope with the numerous consumer demands and to create a viable market economy of a distinctly non-capitalists type. However, the *perestroika* years multiplied the economic difficulties, which led gradually to a total breakdown of the traditional Soviet economic system, thereby creating a vacuum. The non-performance of the economy thus emerges as a major factor in the dissolution of the Soviet Union and its Socialist system.\(^8\)

The rise of Yeltsin and his determined programmatic drive to break the Soviet system were a totally new phenomenon for the party and the Gorbachev leadership. Not that the system was inherently incapable of coping with a determined opposition in a democratic way for, after all, the years of *glasnost* and *perestroika* had created and

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\(^8\) Ibid., p.398.
altogether different political culture, however incipient or underdeveloped. And yet Gorbachev failed to harness the new, freshly unleashed energies if the Soviet people; so much so that he lost his domestic constituency before long. By mid-1991 the intelligentsia totally went over to the Yeltsin camp. Even the Party bureaucrats, increasingly feeling insecure, quietly started making overtures to the Yeltsin movement. As a matter of fact, after Yeltsin was directly elected Russia’s President there was a kind of scramble among the Party bureaucrats, from top to bottom, to salvage their positions in the new set up in the Russian Federation. This was a tradition set by Yeltsin himself when he left the party in March 1989 and formally resigned in July 1990 while Gorbachev on his part indulged in overt politicking to keep his presidency. Like rats from sinking ship, they moved away from the party en masse

Fifth, there was the leadership crisis. The indecisiveness of Gorbachev was amazing. He seemed to be incapable of taking hard decisions and acting resolutely till the end.

As I have pointed out already, he identified three specific, problem-ridden areas: the command-bureaucratic system, adherence to the ideology of Socialism, and the terrible burden of the arms race. It can be easily seen that the crisis arose essentially from two fundamental
issues—the economic performance of the Soviet system and the

democratic norms and practices of Soviet society.9

The economic performance of the Soviet system was traditionally
its Achilles’ heel. The rate of growth slowed down particularly at the
end of the 1970s. In accordance with the soviet figures, the average
annual growth rate of national income during the decade 1961-70 was
7.1 percent; it declined to 4.9 percent during 1971-80 and to 3.5 percent
during 1981-85, so that the annual growth rate was 5.5 percent for 1961-
85. According to Western estimates the GNP of the Soviet Union
showed an annual growth rate of just 3.4 per cent during 1961-85”10
This means that the economy was moving, however slowly; it was
certainly not at a standstill. How stagnant were the living standards
during the Brezhnev era (1964-82), not to speak of the earlier,
Khrushchev years, i.e, the years following the death of J. V. Stalin
(1953)? A leading proponent of the official position on the “stagnant
Brezhnev years”, Fedor Burlatsky, conceded in an article published in
Literaturnaia Gazeta (Moscow) early in 1990:

“Does this mean that the country made no
progress and had come to a standstill? Of
curse not. The people kept on working away.

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10 Gorthrude E. Schroeder, Nationalities and the Soviet Economy, in L.Hajda and M. Bissinger, eds,
Industrial output grew, albeit slowly.... The nation continued to develop extensively.\footnote{Feder Burlatsky, \textit{Brezhnev and the End of the thaw}, in Leonid Brezhnev, \textit{The Period of Stagnation} (Moscow: Novosti, 1990), pp. 42-43.}

The \textit{perestroika} years, however, sent the economy nosediving. Following frequent changes in policy and personnel and ill-conceived hasty amendments to the basic laws, production suffered. Distribution was disrupted. People were called upon to put up with hyperinflation accompanied by severe shortages.\footnote{Andres Aslund, “Gorbachev, Perestroika and Economic crisis”, \textit{Problems of communism} (Washington, DC), January – April 1991, pp. 18-41, quoted in Imam, n.l, p. 381.} The last two years of the Gorbachev era were particularly shattering. According to official statistics, the national income fell by 1.3 per cent in the first three-quarters of 1991.\footnote{As quoted in Anatoli strelyn, \textit{The last Romantic} in Nitika Khruschev: \textit{Life and Destiny}, (Moscow, Novosti, 1989), p. 34.}

Broadly speaking, there were three major problem-ridden areas in the economy – at the level of policymaking, at the level of management, and at the level of meeting the rising consumer demands. At the level of policymaking, allocation of resources between the military-industrial complexes and the civil industries was totally unbalanced, with the military taking the lion’s share. At the level of management, there was overcentralization marked by the growing stranglehold of the vested interests and by widespread corruption, profiteering and cover up – thanks to the notorious tolkachi system. The
tolkachi system arose as the proto market system was inefficient, what with the “war of laws” and the black market, Gorbachev’s drastic action in dismantling the traditional centralized command system had created a vacuum, which was yet to be filled for the simple reason that, as in the past, political reform had followed economic reform. Legitimacy could have been achieved, and confidence in economic relations promoted with a reverse timetable. Besides, the growing pressure of consumerism was something that the system was just not able to cope with although Khrushchev had reminded the people in the early 1960s that it was impossible to have a situation in which everybody had

“The correct ideology while going about without trousers”.

The Socialist economy of the Soviet Union was unfamiliar with the intricacies of the ever rising consumerism. To top it all there were two patterns of development which were characteristically soviet-the numerous consumer demands the came particularly from the vocal and volatile people of the big urban centres who lusted affluence a la the West, and the rampant corruption in all spheres of economic activity, with the bureaucrats and the Party functionaries greedily grabbing as much as they could and by fair means or foul under the tolkachi system. The system had catered so far to certain simple consumer demands of “ideology with trousers”; it had not broken the monopoly of the west

\[14\] Ibid.

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over affluence. For instance, the shops/stores could barely manage to sell three or four brands of shoes. They were unable to meet the varying needs, real or artificial of the consumers as in the west. As for corruption, the shops/stores were nearly empty during 1989-91, but the flats and dachas of the bureaucrats and the party functionaries were well stocked.

Taking an overview, the system was resilient enough to cope with problems at the levels of policymaking and management. During the Gorbachev years, political reform, however belated, was just about beginning to make its impact in those two areas. Moreover, the country had abundant material resources and plenty of trained technical personnel capable of putting the economy back on the rails. One certainly felt in 1991, that there was a difficult period of transition ahead with conditions of scarcity but there was no panic, as the economic performance of the system had not reached a dead end. Also, the steep decline of the economy in the various republics, particularly in Russia could have been checked in no time, with the over haul of the old soviet economic system.

It was however, the inability of the system to cope with the market mechanism and the growing consumer demands that caused disillusionment and anger all round. Corruption also contributed to the

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15 Imam, n.l, p.391.
difficulties. A major negative development during the Gorbachev era was in fact the menace of corruption, which was unchecked and which had already infected the bureaucracy from top to bottom, both in the government and in the party in a big way. All this provided the necessary ammunition to the Yeltsin camp for discrediting Gorbachev and his perestroika.

**DISINTEGRATION – CAUSES**

The Gorbachev government seeking to reform the economy by decentralizing it, broke up the USSR State Bank into five specialized banks (for agriculture, foreign trade, industry, housing and household savings). 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. In the subsequent decade the banking sector followed a turbulent and unpredictable path, remote from the broad infrastructural position characteristic of banking in stable market economies. In line with its Soviet ancestry however it continued to play an important part

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in relation to public sector budgets both in channelling government expenditure and in assisting tax collection.

In 198, the Central Banking function became the responsibility of the State Bank of the Soviet Union (Gosbank) and financing clients became the responsibility of five specialised sectoral banks. Until 1987 the Soviet Banking system was organised as a ‘Monobank’ with the State Bank (Gosbank). In 1987 Gosbank Changed its name to the Central Bank of the Soviet Union (CB of the USSR). A decree of July 13, 1990 changed the name from Russian office of the Central Bank of the USSR to the State Bank of the Russian federation, answering directly to the Supreme Council of the Russia Federation. The offices of the CB of the USSR and the special banks were declared the property of the Russian Federation, to be transformed into joint stock companies or co-operatives.

In November 1991, the Central Bank of Russia (CBR) formally took over the responsibilities of the CB (Central Bank) of the USSR, which had continued to exist until the collapse of the Soviet Union in December 1991.

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19 Ibid. p.317.
Once the process of reform started it did not stop there. The following year, the banking system divided and divided again, and hundreds of banks appeared overnight. By the end of 1991, when the Soviet Union broke up there were already over 1,600 private banks in Russia\textsuperscript{20} and the number grew steadily over the following years. The state retained control of Central banking functions, gathered into a newly renamed Russian Central Bank modeled along the lines of European Central Banks and of the main savings banks system, Sberbank. Most of the rest passed quickly into private hands.

At first, the emerging banks performed mainly two kinds of functions, which might be called ‘defensive’ and ‘opportunistic’. The defensive functions were responses to the break-up of the Soviet system of payments and transfers. Traditionally a Soviet enterprise was automatically paid for its output as soon as it left the factory gate by a simple transfer of funds from the account of the buyer to that of producer. As this system shattered in 1990-91 enterprises needed to find new sources of funds to maintain liquidity. One of the main defensive functions of the new private banks was to funnel state credits to cash starved enterprises.

But the private banks also enabled their founders to get around the remaining restrictions of the Soviet system and to mobilize short-term capital to take advantage of the new opportunities opening up mainly in foreign trade. The banks bankrolled commodity trading and import-export operations or participated directly as players; they helped their clients convert their state controlled assets into cash they conducted illegal foreign currency exchange; they transformed profits abroad through illegal correspondent accounts. It was only gradually that they began taking deposits and making loans.

Thus the period 1987-91 could be called the era of ‘pre-banking’. It was then followed by the ‘golden era’ of 1991-95 when the Russian banks multiplied manifold the capital they had accumulated in the previous phase. This was the time in which the banking giants grew and the financial base for the ‘oligarchies’ was built.

SPONTANEOUS PRIVATISATION AND THE FORMATION OF COMMERCIAL BANKS

Until 1987, the Soviet Banking system was organised as a ‘monobank’ with the State Bank (Gosbank) the agent of the government. Reform of the system started with the 1988 Law on Co-operatives, 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.\textsuperscript{21}

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 became independent, bringing a further 800 separate banks into existence on the basis of the former state network, especially of the former Agroprombank. 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 privatisation of non-bank entities. Industrial companies, agricultural marketing bodies, and other business organizations 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 the fragmentation of the three domestically focused spetbanks was facilitated by the swift depreciation of the state—owned bank’s capital in the face of inflation.

By 1995 there were well over 2,000 Commercial Banks in existence across the country, about one-third of them based or with major offices in Moscow. Most of them were small, with average assets at the beginning of 1995 of a mere $36 million equivalent. Moscow-based banks accounted for most of the decade for around 70 per cent of Commercial Bank assets, with half of this total in the five largest banks.

For most of the period since 1990 the Commercial Bank’s main sources of deposits had been enterprises and the government sector. Households played a prominent role only for a brief spell from late 1993 to early 1995. It was at that time that Sberbank’s share of total household deposits experienced its short—lived fall to below 50 percent. This reflected, however, not a shift of existing deposits out of Sberbank but rather a rapid growth of the aggregate deposit total from a low base. During 1994 aggregate bank time and savings deposits in

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22 Ibid., p.215.
23 Ibid.
roubles rose from 5 trillion to 25 trillion, an approximate doubling at constant prices. Demand deposits rose from 12 trillion to 33 trillion.

Collection of household deposits was not at that time subject to Central Bank licensing or regulation, and the bank's main competitors for funds were a variety of unregulated 'savings businesses' which used colourful advertising, wild interest rates, and implausible sounding instruments (from certificates of deposit to 'agreements for joint investment in real property') to lure customers. While rouble interest rates of 200 percent or more might look plausible in a climate of high inflation, rates of up to 30 percent per annum in US dollars, such as were commonly advertised in 1993-4 even on the Moscow metro, pointed clearly to fraudulent operations, especially pyramiding or 'Ponzi finance'. The most notorious instance was the MMM investment fund, whose organizer Sergei Mavrodi subsequently gained release from prison by getting himself briefly elected to the Duma. By early 1995 non-bank savings companies had largely disappeared, either bankrupted or in a few cases converted into (marginally more respectable) banks. Estimates of the number of depositors who lost money ranged from 20 million to 50 million.²⁴

²⁴ Based on the last of television time the ten biggest TV advertisers included four financial companies all of which failed during 1995. Thereafter financial advertising by banks and investment funds was essentially confined to 'image-building', Quoted in Iman, n.1, p.381.
This colourful episode notwithstanding, interest-bearing deposits never accounted for more that one-quarter of Commercial Banks’ liabilities, a far lower figure than is typical in western market economies. The central reason is that nearly all the deposits of the enterprise sector and of government bodies remained non-interest bearing. In the case of the enterprise sector, this partly reflected the symbiosis between ‘pocket’ banks and their associated businesses. But the more important explanation is the mass of varying state regulation, which restricted companies freedom of action both in managing bank accounts and in switching between bank deposits and cash.

Such regulation reflects a continuation of the Soviet system of using banks as the means of exercising financial control over enterprises by the rouble. The system rests on twin foundations. On the one hand, all settlements between enterprises, and between enterprises and public authorities, are required to be made through bank transfers. Cash may be drawn only to pay wages and pensions. On the other hand, the opening and maintenance of bank accounts by enterprises is subject to a complicated registration process involving (among others) the fiscal authorities. The latter, moreover, may draw money from a firm’s account on their own initiative—a kind of state enforced direct debit mechanism—in order to settle tax or other public obligations such as statutory contributions to off-budget funds for health or employment insurance.
In the early 1990s the operation of the system was motivated mainly by the struggle for monetary stabilization.\textsuperscript{25} Cash shortages – rather than tight money – were employed as an anti-inflation instrument acting for the most part on wage payments. A special aspect in 1992-3 was the attempt to limit money creation within the still unified rouble zone (broadly the former Soviet Union) by Central Banks other than that of the Russian Federation. While these other central banks other than that of the Russian Central Bank maintained its monopoly on cash (banknotes). From 1994 onwards, however, the focus shifted increasingly to the fiscal side, bank –account regulations playing a central role in efforts to increase revenue and diminish tax evasion.

The relationship between the banks’ liabilities and their role as agents of government changed over time, and was linked with parallel developments on the assets side of their balance sheets. In the early 1990s, and to a reduced extent in 1993-4, the banks were of great importance as channels for the delivery of directed (namely, government-subsidized) credits to enterprises at hugely negative real interest rates. According to World Bank estimates such credits amounted in 1992 to nearly 19 percent of GDP.\textsuperscript{26} The greater part of the funds involved were furnished to the banks through refinance by the

\textsuperscript{25} Gramville, n.21, p. 216.

\textsuperscript{26} Subsidized credits were a major element in a huge were of subsidies totalling on some estimates more than 50 percent of GDP.
Central Bank. From 1995 onwards, however, subsidized credits with Central Bank refinance were a minor element—and the quantitative significance of banks in the economy declined correspondingly.

The mainstay of Commercial Bank’s profits in 1993-4 was their holdings of foreign currency balances in correspondent banks abroad, amounting to 40 percent or more of their assets. With the great bulk of their liabilities in roubles and bearing zero nominal interest despite inflation running at 200 percent per year, the mere retention of hard-currency balances was sufficient to ensure a disproportionate return on capital as the rouble depreciated month by month. The market in inter-bank deposits served to bring about a certain diffusion of profits to banks lacking direct access to foreign exchange.

THE FIRST SHOCK—1992

In January 1992, Russia liberalized most wholesome and retail prices. The government continued to control the prices of only a handful of key commodities (bread, milk, residential rents and utilities: electricity, natural gas and retail gasoline). This liberalization failed to take into account the political and economic changes which had occurred between the attempted coup d’etat in August 1991 and the end of the year. The USSR had disintegrated politically; however, the

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27 Monetary authority credit to Commercial Banks in 1992 totalled 15 percent of GDP and carried a negative real interest rate averaging more than 12 percent per month.
economies of the newly independent states remained linked through the legacies of seventy years of Soviet planning and business practices. The mood of the Russian reformers was exceedingly optimistic about the transition to capitalism, since they were certain that massive western aid would accompany the process. 28

The post Soviet republic’s governments did not discuss co-ordination of policies to deal with the beginning of the transition to a market economy. The necessity of collaboration in the design of a coherent package of monetary tariff and taxation policies was not considered. The policy arrangement of disintegrated USSR republics can be seen in Table-3.1.

**TABLE 3.1**
**Policy Regimes before and after 1992**

<table>
<thead>
<tr>
<th>Before collapse of the USSR</th>
<th>After collapse of the USSR till 1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single currency</td>
<td>Single currency</td>
</tr>
<tr>
<td>Single monetary policy</td>
<td>15 monetary policies</td>
</tr>
<tr>
<td>Single Central Bank</td>
<td>15 independent Central Banks</td>
</tr>
<tr>
<td>Single legislation and tariff regulation</td>
<td>15 independent legislative and tariff regulatory regimes</td>
</tr>
<tr>
<td>Single customs area</td>
<td>15 independent customs areas</td>
</tr>
<tr>
<td>Single customs borders</td>
<td>NO customs borders within the FSU</td>
</tr>
</tbody>
</table>

Source: Quoted in Charles and Vasilii, n.28, p. 452.

The results of such an uncoordinated policy could be nothing but disaster. Moreover, it coincided with hyperinflation and declines in gross domestic products. Inflation in 1992 varied from 951.2 percent in Latvia\textsuperscript{29} to 1,528.7 percent in Russia.\textsuperscript{30} GDP declines varied in 1992 from -14.1 percent in Estonia to -52.3 percent in Armenia.\textsuperscript{31}

The Russian budget immediately came under pressure. This was met only because of the hyperinflation and the need to increase expenditures to maintain some real purchasing power of those dependent on the state (salaries, pensions, enterprise budgets, various other social expenditures) but also the rapid evaporation of state tax revenues. As the collapse in economic activity become widespread the Russian government and its Central Bank were pressured to take action. Russian enterprises demanded funds for operations, and after July 1992 governments and enterprises in the non-Russian republics demanded funding to finance their trade deficits with Russia. The Russian government and Central Bank acted providing centralized loans to Russian enterprises via command banks in Russia and technical loans

\textsuperscript{29} Ibid.
for non-Russian enterprises through the local (republican) authorities. Apparently little of the financing reached the enterprises, rather these funds were used to purchase dollars in the relatively liberalized Russian foreign exchange market leading to a strong depreciation of the rouble.

Hyperinflation, and the temporary freeze on deposit withdrawals in state-owned banks, eliminated the real values of bank balances held by citizens. This contributed to the popular perception that the only way to guard one's real purchasing power was to save in non-rouble, non-bank deposit form—i.e., in dollars kept 'in one's sock,' as Russians say. The Commercial Bank sector in Russia had little incentive to attract individual depositors, become this method of attracting funds appeared costly compared with the zero interest centralised and 'technical' loans from the Russian government. Commercial Banks found the best use of funds to be short-term financing of the import-export trade and acting on their own account in the foreign exchange market. Banks which lent to enterprises for operations and production found themselves holding bad debts.


Initial moves to lower the growth rates of money and the price level had begun in 1994.\textsuperscript{32} Two main lines of attack were pursued to

\textsuperscript{32} Granville, n.21, p.220.
restrain the growth of bank balance sheets. One was a further reduction in directed credits to enterprises. The other was a shift in financing the federal budget deficit from Central Bank credit ('money printing') to issuance of interest-bearing government debt. Rouble treasury bills (GKOs)-zero coupon instruments with three-month or six-month currency-had been introduced in 1993. In addition, issues of domestic bonds denominated in foreign currency (so called Min Fins or Taiga bonds) were expanded. Somewhat longer term rouble bonds (OFZs) with a quarterly coupon linked to GKO yields, followed later, from mid-1995 onwards. Incidentally, the issuing procedures for GKOs in particular were another profit source for authorized institutions. The primary issuing agents for the government consisted initially of 19 Commercial Banks and six brokerage houses.

The change in Russia's financial climate led to a reversal of Commercial Bank's asset/liability preferences. The instinct was now to look to domestic (rouble) assets rather than to foreign-exchange holdings as the basic source of profits. The most flamboyant manifestation of this, initiated only a few months after the August upheaval, was the loans-for-shares scheme referred to above. In the guise of meeting urgent short-term financing needs of the government,

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13 There were also small amounts of other rouble instruments, mainly governments saving bonds (GKSZ) and treasury obligations of the Ministry of Finance.
14 Graville, n.21, p. 221.
and with the unstated interim purpose of forming an election war chest to ensure Boris Yeltsin's re-election as President in 1996, a handful of politically influential Moscow banks (the two most prominent being Uneximbank and Menatep) acquired control in 1995-7 of major export enterprises in the oil sector and elsewhere. This created a handful of conspicuous FIGs, an arrangement periodically promoted by the authorities as a means of bringing about industrial restructuring.

The enterprises became a crucial source of wealth for the controlling banks, who appropriated by one route or another not merely profit but total revenue streams of the enterprises in question, leaving them indebted to employees, suppliers, and the authorities, and sometimes with balance sheets stripped of their principal assets. The strategy was not riskless for the exploiting banks. Tax debts could lead to an enterprise being dismembered or seized as bankrupt on the initiative of regional fiscal authorities, who tended to act in consort with some rival corporate entities anxious to gain control of the exploited company. There were both successful and unsuccessful instances of such attempts at seizure. In short, there emerged a grotesquely distorted form of competitive struggle for corporate control, involving among other things blatant abuse of bankruptcy laws and of judicial processes.
These activities although important enough to be harmful for the economy's development, were none the less confined to a small number of major players and were not a model that others could readily follow. Commercial Banks at large continued to register more orthodox-looking claims on the general run of domestic companies. Two points must be emphasized, however. First, relative to GDP the aggregate value of these claims remained low by comparison both with other transition and market economies with Russia itself in the early 1990s when directed credits were still extensive (Table 3.2 & 3.3).

### TABLE 3.2

The evolution of Russian banking, end of the year, unless otherwise stated

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Number of operating credit organisations a</td>
<td>1,713</td>
<td>2,019</td>
<td>2,517</td>
<td>2,295</td>
<td>2,030</td>
</tr>
<tr>
<td>Licences Withdrawn (number, cumulative)</td>
<td></td>
<td>13</td>
<td>78</td>
<td>303</td>
<td>592</td>
</tr>
<tr>
<td>Charter capital requirement for new banks (thousand US$)</td>
<td>214.4</td>
<td>70.6</td>
<td>1,244.7</td>
<td>1,291.5</td>
<td>3,648.9</td>
</tr>
<tr>
<td>Real monthly refinance rate of CBR b</td>
<td>-12.2</td>
<td>-6.9</td>
<td>4.4</td>
<td>7.6</td>
<td>6.5</td>
</tr>
</tbody>
</table>

*Percentage share of GDP*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit from monetary authorities to Commercial Banks</td>
<td>15</td>
<td>5.1</td>
<td>2.4</td>
<td>1.1</td>
<td>0.6</td>
</tr>
<tr>
<td>Bank credit to the non-financial sector</td>
<td>33.6</td>
<td>20.4</td>
<td>19.6</td>
<td>12</td>
<td>10</td>
</tr>
<tr>
<td>Interbank credit received</td>
<td></td>
<td>3.2</td>
<td>4.9</td>
<td>3.9</td>
<td>3.1</td>
</tr>
<tr>
<td>Gross assets of the banking sector</td>
<td>88</td>
<td>54</td>
<td>56</td>
<td>36</td>
<td>36</td>
</tr>
<tr>
<td>Households deposits</td>
<td>1.9</td>
<td>2.4</td>
<td>4.2</td>
<td>4.3</td>
<td>5.3</td>
</tr>
<tr>
<td>Households deposits outside of Sberbank</td>
<td>0.3</td>
<td>0.9</td>
<td>1.7</td>
<td>1.5</td>
<td>1.4</td>
</tr>
</tbody>
</table>

Notes: 
\(^{a}\) 1.360 at end 1991. 
\(^{b}\) Yearly average of real monthly rates. For 1992 February-December (so also exclude the January price jump). 


### TABLE-3.3

**Commercial bank credit in selected central and eastern European countries: Credit to the non-financial sector as a percentage of GDP**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Russian Federation</td>
<td>20.4</td>
<td>19.6</td>
<td>12</td>
<td>10.4</td>
</tr>
<tr>
<td>Poland</td>
<td>21.3</td>
<td>19.8</td>
<td>19.7</td>
<td>22.1</td>
</tr>
<tr>
<td>Hungry</td>
<td>28.4</td>
<td>26.5</td>
<td>23</td>
<td>22.9</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>73.1</td>
<td>72.9</td>
<td>63.8</td>
<td>61.1</td>
</tr>
<tr>
<td>Slovakia</td>
<td>71.5</td>
<td>60.4</td>
<td>59.2</td>
<td>62.4</td>
</tr>
<tr>
<td>Romania</td>
<td>24.4</td>
<td>19</td>
<td>22.7</td>
<td>24.6</td>
</tr>
<tr>
<td>Slovenia</td>
<td>22.2</td>
<td>22.9</td>
<td>27.5</td>
<td>28.7</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>67.8</td>
<td>51</td>
<td>41.3</td>
<td>69.5</td>
</tr>
</tbody>
</table>

Sources: CBR: National Banks of Poland, Hungry, Czech Republic, Bulgaria, Slovenia, Statistical Office of the Slovak Republic; Romania National Commission for Statistics; IMF. Published in OECD (1997). Quoted in same as that of Table 3.2.
Secondly, the nature and soundness of the banks’ claims was generally far from transparent. Company attitudes to bank and other debt still reflected the Soviet-era mentality of ‘soft’ budget constraints. Interest and amortization schedules were often not taken seriously, especially where a company was also living on arrears to other creditors—though to be sure such arrears were for the most part a much cheaper credit channel than Commercial Bank loans. Banks for their part lacked reliable means of enforcing credit terms. The bankruptcy laws were an uncertain weapon, and if invoked on any scale might well bring down the bank itself instead of, or before, its miscreant clients. At the same time, accounting standards particularly as regards, provision for bad debts, were far less stringent than in western countries. It was easy, when compounding unpaid debt service back on the originating loan to pretend that the situation was healthy and the loan still earning good profits for the bank. Probable defaults tended to be acknowledged only on scale small enough to be outweighed by supposed continuing interest earnings on other items. Thus a banks loan portfolio might remain ‘profitable’ up to the moment of insolvency.

15 Ibid., p.223.
16 A technical point of interest is that under Russian accounting rules provisions were treded as a liability rather than as diminution of a sets thus by western standard inflating the balance sheet at the very least.
Optimistic accounting practices are arguably more justified when commercial credits are guaranteed by the state. Such guarantees were extensively employed by both federal and local (oblast and municipal) governments as a means of financing deficits. In other words, instead of payment from public authorities suppliers might receive state-guaranteed bank credit. This was attractive to the authorities in as much as budgetary appearances were improved in the short term, without depriving government creditors of fund. On the other hand it was bad for payments discipline, since the enterprise receiving the credit had a positive incentive not to service it unless the authorities happened to have some independent sanction over the enterprise, such as a threatened loss of orders or prosecution for tax offences. For this region, banks granting credits of this type typically deducted ‘up front’ any interest and fees due to them and not covered by the guarantee.

A key credit instrument for the banks, both on their own account and for incorporating state guarantees. Where so-called veksels, or commercial bills. It should be emphasized that this instrument constitutes only one segment, albeit an important one, of a much wider network of financial relations in Russia. The network has been characterized by extensive improvisation, and its linked in turn to the fluctuating pattern of arrears and barter that has been a feature of the

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37 The Russian word veksel is a straight forward transliteration of the German, indicating the origin of Russian Financial institutions in Tsarist times.
country's post-Communist economy. The issue *veksele* was given legal sanction by a decree of the RSFSR parliaments in mid-1991 before the break-up of the Soviet Union but their proliferation dates from a presidential decree of October 1993 which sought to ease the problem of inter-enterprise arrears by encouraging their securitization and secondary trading. Since then they have been issued not only by (large) enterprises but also by banks and by public authorities, especially at regional and municipal level.

The Central Bank reported that during 1996 some 18 trillion roubles' worth of *veksele* credits with federal government guarantees were issued by twenty-six correspondingly authorized banks. This formed a significant proportion of the above-mentioned 20-55 trillion estimated range of aggregate Federal guarantees in that year.

In the early part of 1997 Commercial Bank *veksele* outstanding totalled some 30 trillion roubles, but the total outstanding from all sources was perhaps ten times this amount, which would be the same order of magnitude as the broadly defined rouble money supply.

The most conspicuous source of Commercial Bank earnings between the two crisis landmarks of 1995 and 1998 was the holding of GKO's and other related government paper.\(^{38}\) This was true even though

\(^{38}\) Graville, n.21, p.227.
statistically speaking the GKO market was dominated by Sberbank, which typically held over 40 percent of the outstanding stock, accounting for significantly more than half its assets. Since around two-thirds of Sberbank’s liabilities consisted of household deposits (its overwhelming preponderance in this area was noted earlier), one may reasonably say that during this period Sberbank acted simply as a conduit for channelling housing liquid assets into government debt.\textsuperscript{39}

By contrast with Sberbank, Commercial Banks—especially the larger ones in Moscow—relied for their build-up of GKO holdings on the profitability of GKOs themselves and on various forms of foreign borrowing (credits from foreign correspondents, euro-market issues, and so forth).

International financial conditions took a turn for the worse with the onset of the Asian crisis\textsuperscript{40} in autumn 1997. The withdrawal of foreign funds from Russia over the succeeding six months mainly

\textsuperscript{39} Ibid.
\textsuperscript{40} The Asian financial crisis started when the previously basket-pegged Thai currency was free floated on the fateful Thursday, 2 July 1997. The Thai Central Bank was defending a weakening currency for a while. But mid 1997, when the Thai cabinet dithered over taking bold decisions to tackle its banking problem, a wrong signal was sent to the much more open financial markets. Confidence was shattered and the currency declined.

Major economic set back from the crisis created large-scale economic disorders in five of the 13 economies (Korea, Thailand, Indonesia, Malaysia, Philippines). The other countries though spread (China, Hong Kong, Taiwan and Singapore) the worse effects, also felt significant declines in growth at a later time, albeit not of the order experienced by the worst hit five. In early 1999, the crisis even threatened to engulf the world. The crisis incubated in July 1997 in Thailand, spread to other countries in the form of rampant speculative attacks on currencies (Exchange rate instability).

affected the equity market. But foreign borrowing terms for Russian, banks also hardened, and there was a serious indirect effect via the fall in world oil prices, which pushed Russia’s current balance of payments into deficit and, more important, caused a sharp drop in federal tax receipts because of the profit squeeze in the oil export sector.

The tax position could have been ameliorated, and the 1998 federal debt default at least postponed through timely devaluation of the currency, which would have raised export-sector profits in rouble although not in dollar terms. But this would not have avoided the collapse of the banking system, given its exposure to devaluation because of hefty borrowing and forward –market commitments in foreign currency. The banks therefore lobbied first of all against devaluation. Their arguments were strengthened by political fears that a large, devaluation could not be prevented from re-starting the earlier spiral of rapid inflation. The immediate impact, however, of maintaining the exchange rate was to aggravate the deterioration in the public finances and government debt market, without diminishing the ultimate likelihood of devaluation. Nobody in government seems to have thought of attempting to boost confidence in the government’s debt servicing capacity by enforcing a drastic administrative cut in GKO yields as a quid pro quo to the banks for maintaining the exchange rate.
When in mid-August devaluation was felt to be no longer postponable, its magnitude proved difficult to control and was eventually much larger than the government had hoped. This in itself was enough to render most of the large Commercial Banks insolvent because of their foreign-exchange liabilities. But in addition, the GKO market collapsed and the federal government defaulted on (initially) all of its debts. At that point government paper appeared to have constituted about 20 percent of Commercial Bank assets. Financial market turmoil's had, however begun in late July, with banks switching from domestic to foreign currency assets. The Central Bank had endeavoured to stem the tide and sustain confidence in both the rouble and the banking system through selective market support, including long-term credits to two large banks. The only noticeable result was a bigger loss of foreign exchange reserves-though doubtless a few banks succeeded in mitigating the scale of their subsequent insolvency. At a late stage about one-third of house-hold deposits with Commercial Banks-60 billion new roubles or 60 trillion pre-1998 roubles were withdrawn.

Subsequently 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 sector’s 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 bank’s foreign currency loans.

AFTERMATH

While Russia’s banking debacle of 1998 had its parallel at various times in other transition economies, it nevertheless represented a tremendous failure for policymakers who had for several years been attempting to put the banking system upon a sounder footing. The policymakers 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 (EBPRD). The 1998 crash showed their policies to have been at best quantitatively insufficient, at worst irrelevant because they addressed the wrong targets.

In 1994 the Central Bank of Russia (CBR) initiated a policy of successive increases in minimum charter capital requirements for new banks: at first from $100-200 thousand to $1 million then in 1996 to $2.5 million and in January 1997 to $3.5 million, with further increase in 1999. These figures applied to banks seeking general licences for universal banking including foreign-exchange operations. Somewhat lower requirements applied in relation to licensing for domestic (rouble) operations only. All the figures, however, where tiny. Their declared rationale was to encourage consolidation of the smallest banks and thereby to reduce the total number of banking institutions. The urgency of this was debatable. Small banks have not been an important source of Russia’s banking weakness.

Prudential regulation took a more serious turn in the wake of the 1995 inter-bank market crisis. In 1996 the CBR set up a special regulatory division for the monitoring of large banks that could pose a systemic risk.

Russian banks in the current phase of their and the Russian economy’s development could not be expected to have much patience or understanding for such a system. Prudential regulation is a sophisticated matter, a dynamic blend of consensus—based guidelines

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and legal compulsion, in which banks recognize that it is in their
general interest to submit to restrictions on their commercial behaviour
while also manoeuvring to minimize the impact of such restrictions on
their own competitive position. Russian banks were (and are) not yet
into such subtleties. The permissive nature of Russian accounting
practices made it relatively easy to disguise infringement of prudential
ratios. Major Moscow banks that were part of FIGs could routinely
manipulate their accounts—whether just for reporting purposes or for
more substantive reasons—by shifting assets and liabilities of different
types between themselves and their affiliates. They could also exercise
political influence to deter officials from over-zealous investigations.
At times of acute speculative fever rules on such matters as open
foreign-exchange positions were simple ignored: better to prosper with
excuses than go bankrupt with a halo.43

As it happens, none of the top Russian banks was transparently
under capitalized in the period preceding the 1998 crash. Table-3.4
gives figures for mid-1997 on those Russian banks, twelve in number
which at that date were in the list of the world’s thousand largest banks
ranked by tier-one capital. (The latter is a multiple Russian bank’s
charter capital). The biggest strictly commercial institutions among the
Russian was Uneximbank, number 346 in the world ranking. The item

43 Granville, n.21, p.230.
in the table which catches the eye is Tokobank on account of its lack of reported profits; it was subsequently identified as bankrupt well before the general crash, and in due course had its licence revoked. All this suggests that what Russian Commercial Banking stands most in need of is not external regulations but internal reshaping of objectives and behaviour. The point has been amply recognised by knowledgeable western observers.

**TABLE-3.4**

**Russia's largest banks**

**(End-1997)**

<table>
<thead>
<tr>
<th>World Rank</th>
<th>Name of bank</th>
<th>Capital ($ Million)</th>
<th>Assets ($ Million)</th>
<th>Annual Profits ($ Million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>134</td>
<td>Sberbank</td>
<td>2,752</td>
<td>29,764</td>
<td>759</td>
</tr>
<tr>
<td>279</td>
<td>Vneshtorgbank</td>
<td>1,023</td>
<td>3,126</td>
<td>97</td>
</tr>
<tr>
<td>346</td>
<td>Uneximbank</td>
<td>826</td>
<td>3,779</td>
<td>72</td>
</tr>
<tr>
<td>536</td>
<td>SBS-Agro</td>
<td>466</td>
<td>5,201</td>
<td>56</td>
</tr>
<tr>
<td>670</td>
<td>MFK</td>
<td>320</td>
<td>1,299</td>
<td>115</td>
</tr>
<tr>
<td>683</td>
<td>Rossiiskiy Kredit</td>
<td>314</td>
<td>2,135</td>
<td>60</td>
</tr>
<tr>
<td>697</td>
<td>Menatep</td>
<td>305</td>
<td>3,433</td>
<td>41</td>
</tr>
<tr>
<td>720</td>
<td>Tokobank</td>
<td>287</td>
<td>1,219</td>
<td>2</td>
</tr>
<tr>
<td>761</td>
<td>Inkombank</td>
<td>261</td>
<td>5,102</td>
<td>115</td>
</tr>
<tr>
<td>852</td>
<td>Imperial</td>
<td>210</td>
<td>1,110</td>
<td>65</td>
</tr>
<tr>
<td>919</td>
<td>Mosbusinessbank</td>
<td>183</td>
<td>1,509</td>
<td>62</td>
</tr>
<tr>
<td>993</td>
<td>Promstroibank</td>
<td>155</td>
<td>1,196</td>
<td>26</td>
</tr>
</tbody>
</table>

*Source: The Banker, July 1998. Quoted in same as that of Table 3.3.*
In 1995 the World Bank, together with the EBRD and the European Union’s Tacis programme, set up a Financial Institutions Development Project (FIDP) with the purpose of assisting Russian banks to adopt western standards. In the following years the FIDP worked through the Federal Government’s Foundation for Enterprise Restructuring (FRP) with several dozen Russian banks, in some cases organizing ‘twinning’ arrangements with western counterparts.44

A lesson of the 1998 crash was that the FIDP efforts had as yet borne insufficient fruit, whether because they were on too limited a scale or because of insufficient time (or both). But the aftermath of the crash also showed how critically necessary were the reforms promoted by the FIDP, and how they were obstructed both by corrupt bank managements and by infighting among policymaking institutions, with corruption doubtless at work there as well. What was wanted, had it been feasible, was an immediate and comprehensive strategy towards the Commercial Banking sector as a whole. The bulk of the sector was insolvent, and not just a few individual banks. Moreover, for what the figures were worth, large banks reported deepening losses on current businesses.45 As a practical matter, however, policy measures were piecemeal, selective, inconsistent, and slow to emerge. More than a

44 Ibid., p.232.
45 The thirty largest banks turned loss making in August 1998; a year later their reported net losses were running at 20% of capital.
year after the crash there had been no firm action to be establish the banking system on a proper footing. As is explained below, plausible looking legislation was at last in place and conflicts among policy-making institutions had been diminished. But former bank owners and management remained in control, their surviving assets disguised or transferred beyond the reach of outside creditors.

On the more far-reaching issue of bank restructuring, there was controversy and paralysis. The Russian government and CBR, in a document published in November 1998, outlined a policy with both selective and general aspects. A limited list of banks deserving of rehabilitation was to be identified. At the same time a new body, the Agency for the Restructuring of Credit Organizations (ARKO), was to have general but unspecified responsibility for restructuring the system. Problem banks not singled out for rehabilitation were to be swiftly merged or liquidated.

The dual approach in part reflected the promptings of international bodies (World Bank, EBRD) who were keen to apply unspent assistance monies to the tasks of bank restructuring and training ARKO staff. But it also suited the different Russian authorities, who could smell opportunities for enhanced political influence and favouring their friends. In fact, at the moment when the policy document was published, the FIDP in collaboration with the CBR, and
assisted by western auditors, was already conducting a review of eighteen banks. Most of them had been involved with the FIDP’s earlier programme. About half had been nominated for the review exercise by the CBR. The findings of the review were not published, and are not known to have led to any specific policy actions.

ARKO was mooted for half a year, and finally established in March 1999 as a joint stock company with a charter capital of 10 billion roubles (about US$ 400 million). The figure was much too small to constitute serious financial muscle in relation to bank restructuring—compare the capitalization figures in Table 3.4. This suited both the Duma and the CBR, who wanted to retain their own leverage in the area and not be sidelined by ARKO or others. The international agencies for their part were reluctant to fund ARKO so long as it remained dependent on the CBR for personnel and information. The CBR was under a cloud for two reasons. The more scandalous one was that its management and senior staff had come to be suspected of large scale financial misappropriation. The charge stemmed first and foremost though by no means exclusively from the existence and activities of FIMA Co., a Jersy Company to which in the years 1993-8. The CBR had delegated the placements of up to US$ 50 billion of its foreign exchange reserves. The presumption was that commissions paid to

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FIMA Co. ended up in the pockets of (unnamed) CBR officials. The circumstance was brought to light by prosecutor general Skuratov on the eve of his resignation in February 1999.  

Months earlier, however, the CBR had already begun to attract criticism on account of its capricious and untransparent policy towards the banking industry following the August events. It propounded no general principles or objectives; undertook only occasional and indecisive actions towards individual banks; and adopted a permissive attitude to home made restructuring by major institutions, even when this was clearly suspect and designed to prevent creditors from asserting claims against incumbent managers and owners.

In October 1998 the CBR sought to make a scapegoat of Inkombank and its head, Vladimir Vinogradov, by revoking its licence, while a court initiated bankruptcy proceedings and imposed a temporary administration. Many months later the courts overturned the CBR’s action. An even more chequered history is that of SBS-Agro. The CBR initially favoured it with a soft line of credit. Subsequently its licence was revoked, but later reinstated by court decision. Its future remained in doubt at the end of 1999.

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17 Granville, n.21, p.234.  
18 Ibid., p.234.
As regards home-made restructuring, shortly after the August collapse three of the big names—Oneksimbank (Potanin), Menatep (Khodorkovsky), and Mostbank (Gusinsky)—announced a forthcoming merger to create a new giant, Rosbank.\textsuperscript{49} The motive was presumably one of mutual support in a crisis, especially with a view to extracting concessions from the authorities. In the event the merger was not carried through, but Rosbank remained in being as the successor of Uneximbank, exploiting its owner’s political connections (becoming, for instance, in February 1999 one of a handful of banks entrusted with the distribution of soft credits to agriculture) but leaving their unpayable liabilities behind. Menatep for its part moved its principal assets into its St Petersburg subsidiary, whose ownership was then transferred to the Rosprom holding company (Menatep’s FIG partner). Again the original Menatep was left with nothing but liabilities, while the public face of the bank was re-labelled ‘Menatep StPetersburg’. In other, more straightforward, instances Unikombank was observed into Gutabank (part of the business empire associated with Moscow mayor Yuri Lushkov): the troubled Mosbusinessbank moved assets into the Bank of Moscow: and Impexbank merged with Rossiisskiy Kredit. Thus when the CBR in 1999 withdrew the banking licences of Uneximbank.

\textsuperscript{49} Ibid.
Menatep, Unikombank, and Mosbusinessbank, this appeared as a mere cynical gesture, with no implications for future business standards.\footnote{Ibid., p.235.}

While bank restructuring thus proceeded at a snail’s pace, to which the population was indifferent, Russia’s economic performance showed a distinct turn for the better. Industrial production increased, particularly among small and medium-sized enterprises; likewise federal tax receipts. This was partly due to higher world oil prices and partly to rouble devaluation, the latter maintained in real terms by the effective containment of inflation through fiscal and monetary restraint. In this respect, the impotent condition of the banking system was a help. In all other respects the bank’s irrelevance for the time being to Russia’s economic fortunes was conspicuous.

This, however, is a temporary phase. Sooner or later Russia will need somehow to acquire a banking system appropriate to a modern market economy. The history of the past decade means that creation of confidence in Russian banks will be a long and difficult task—even on the assumption (which is not self-evident) that Russian bankers themselves regard it as an important objective.

Progress could be speeded up, if and only if major foreign banks were brought in, since the population would see them as trustworthy in
the same way as dollar bills. Foreign banks would need to operate in their own name as branches or wholly owned affiliates of the parent, and not as subordinate or hidden partners of Russian institutions. Opportunities to move this forward arise from the unresolved issue of foreign bank creditors of Russian banks in the aftermath of the 1998 crash. Equity debt swaps and similar modes of acquisitions offer foreign institutions the prospect (probably the only prospect) of recovering their claims.

CONCLUSION

The disintegration of Soviet Union shook the world. It played a pivotal role in international politics for seventy-four years. It had emerged, as a formidable military power matching the United States. Above all, it had sought to blaze a trail by its endeavour to translate an ideal into a reality.

In January 1992, Russia liberalized most wholesome and retail prices, but liberalization failed to take into account the political and economic changes which had occurred between the attempted coup d'état in August 1991 and the end of the year. The Gorbachev government seeking to reform the economy by decentralizing it, broke up the USSR state Bank into five specialized banks (for agriculture, foreign trade, industry, housing and household savings).
The emerging banks performed defensive and opportunistic functions. The private banks enabled their founders to get around the remaining restrictions of the Soviet system and to mobilise short-term capital to take advantage of the new opportunities opening up, mainly in foreign trade. The banks bankrolled commodity trading and import-export operations directly as players; they helped their clients convert their state controlled assets into cash; they conducted illegal foreign currency exchange; they transformed profits abroad through illegal correspondent accounts. It was only gradually that they began taking deposits and making loans. Thus, the period 1987-91 could be called the era of 'pre-banking'. It was then followed by the 'golden era' of 1991-95 when the Russian banks multiplied manifold the capital they had accumulated in the previous phase. This was the time in which the banking giants grew and in the financial base for the 'oligarchies' was built.

The Russian banking debacle of 1998 had its parallel at various times in other transition economies, it nevertheless represented a tremendous failure for policymakers who had for several years been attempting to put the banking system upon a sounder footing. The policy makes 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. The 1998 crash showed their polices to have been at best quantitatively insufficient at worst irrelevant because they addressed wrong targets.