INTRODUCTION

Since the breakup of the Soviet empire in 1991, Russia has attempted but failed to develop a real market economy. The Russian economy has experienced a massive (40 percent) contraction in national income and consumption. Opportunities for sustained growth have been derailed by repeated failures of economic policy. The ostensible major economic reforms that were carried out—privatization, removal of price controls, foreign trade liberalization, reducing inflation—did not generate the widely expected prosperity.[1]

The Coming Russian Boom,[2] the title of a book written in 1996, reflects a widely held view that economic growth in Russia

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2. Richard Layard and John Parker, *The Coming Russian Boom* (New York: Free Press, 1996).

is inevitable. That inevitability is found in the country's highly educated population, the high savings rate of its people, and, most important, its vast natural resources, especially oil, gas, and strategic metals. In addition, Russia appears to have made perceptible progress in attaining macroeconomic stability by bringing inflation under control.

So why has the *boom* not yet come? The explanation lies, in large measure, in Russia's failure to develop a financial system independent of the government, specifically, a real commercial banking system, which is an essential component of a market economy. To redress that problem, we set forth a proposal for reforming Russia's financial markets that strives to establish a real banking system.

The central theme of this book is simply put. Compared with Western market economies, banks in the Russian Federation (hereafter Russia) do not engage in normal banking practices of accepting deposits and making loans, do not facilitate normal investment, and therefore do not contribute to growth. *Russian banks are not really banks at all.* They have the look and feel of banks but are better described as nonbank banks or pseudobanks—we prefer the term *ersatz*, or *inferior imitation, banks*. Their owners and managers may use the name *banks*, but these institutions are not banks. Rather, they have served since 1991 as financial arms of the government and the Central Bank of Russia, distributing and reallocating resources to favored individuals, companies, groups, and industries. They play a role in economic development but one unique to Russia and similar countries, in that the banks themselves are the principal instruments of ownership, management, and subsidies and are the chief beneficiaries of the transition. This strategy has not yet brought visible economic improvement to the rank and file of the Russian people.

Why do we attach such importance to banks? Apart from their normal role of allocating resources by accepting deposits from the public and making loans to enterprises, banks also establish clear boundaries between the "public" and the "private." A defining characteristic of socialism is the unity, commonality, or indivisibility of the public and private. Under socialism, all resources were owned or controlled by the state and all production was financed by the state. A starting point of transition economies is to create private ownership and separate the financing of production from the government. The establishment of real commercial banks, independent of the government, becomes the vehicle to break up the financial chain of socialism. Banks create the sovereignty of private individuals in the economy by lifting households to the role of reigning lenders, thereby replacing the government, which is relegated to a more limited role of issuing money and performing other legitimate public endeavors.

The book has four chapters. Chapter 1 provides some background material on Russian economic conditions. Chapter 2 covers 1991–1995, what we term the era of nonmonetary and ersatz banking systems. Chapter 3 encompasses 1996–1997, which saw the slow emergence of a monetary regime but during which real commercial banks failed to develop. Chapter 4 looks at 1998 and beyond, offers some ideas about how to convert Russia's ersatz banks into true banks, and assesses the prospects for Russia's financial system if the current system remains in place.