CHAPTER THREE

The Emergence of a Resource-Based Monetary System, Hamstrung by the Persistence of Ersatz Banks: 1996–1997

The Russian government's budget was the defining hallmark of International Monetary Fund (IMF) concern. The Ministry of Finance, the CBR, and the Russian government became bound by terms set by the IMF, the Paris Club of creditor nations, and the foreign aid programs of Germany, France, and the United States. The receipt of each month's tranche of a three-year IMF loan of $10 billion, along with direct foreign loans, required meeting performance criteria on budget deficits, inflation, the level of net international reserves, ceilings on net domestic assets, and limits on central bank lending to the federal and regional governments. From time to time, the IMF withheld its monthly transfer when Russia failed to meet its stipulated targets.

Whether the CBR would have developed some semblance of a real monetary system without prodding from the IMF is not clear. The CBR had previously tried and failed to get control of the money supply, the ruble, and inflation. In any event, Russia's dire need for international financial assistance put an end to the indiscriminate issue of central bank credit and currency.

EXPERIMENTING WITH THE CREATION OF A MONETARY SYSTEM

The IMF established performance criteria with the Russian government that stipulated targets for net international reserves (NIR) and net domestic assets (NDA), which together define the monetary base. Restricting the growth of the monetary base helped bring inflation, as measured by the consumer price index, down to 11 percent (almost single-digit levels using the GDP price deflator measure) by the end of 1997. The CBR began to close small insolvent commercial banks and temporarily took over larger banks as needed. In short, Russia got on track to test a real monetary system through which it could conduct normal monetary policy operations.

Serendipity: Prelude to a Monetary System

Beginning in mid-1994, the Russian government, together with the CBR, considered using the exchange rate as a nominal anchor to achieve financial stabilization, a policy that seemed to have worked with considerable success in the Czech Republic, Slovakia, and Poland in the 1990s and Israel in the mid-1980s, to give but four examples. For Russia, this would amount to fixing the nominal exchange rate of the ruble to a strong foreign currency, such as the dollar, to discipline the CBR's conduct of monetary policy. Fixing the exchange rate, or creating a narrow band around which the ruble would be permitted to fluctuate, would, it was thought, help dampen inflationary expectations among holders of rubles, thereby reducing the velocity of money and inflation, even as prior monetary expansion temporarily continued to inflate the price level. As inflation continued in the face of a fixed nominal exchange rate, the real exchange rate would begin to appreciate, which would further increase ruble demand

and further reduce inflation. If, at the same time, the CBR significantly slowed the increase in the money supply, inflation could be brought down quickly and a stable monetary regime could emerge.

However, to achieve and maintain a stable monetary regime, defined as the attainment of relatively stable prices, budget deficits cannot be financed by printing money. Any budget deficit, preferably as low as possible, would have to be financed exclusively by debt. There could be no central bank refinancing of commercial banks except the emergency provision of liquidity, no open market operations with government bonds as an instrument of monetary expansion, and certainly no monetization of quasi-fiscal deficits such as interenterprise arrears or rollover of enterprise defaults on bank loans.

To be effective, the new monetary regime would also require a sound, independent banking system capable of raising funds from the household sector to supply credit to the productive sector. This regime would also require a low current-account deficit or a current-account surplus to sustain the exchange-rate peg and some initial foreign exchange reserves to start the system.

Thus the Russian government entertained the idea of the fixed exchange-rate corridor in conjunction with moving from central bank credit to debt financing the budget deficit. But the government knew that its banks were insolvent and could not mobilize household deposits and that the Russian people held their deposits in foreign currency in their mattresses. Moreover, the fledgling market for government debt could not handle even a slowly growing amount of government bonds. Thus in September 1994 the government confronted a severe liquidity crisis. It was forced to rely on *foreign* debt financing of its still large budget deficit and various other debts in the economy (including the ever-growing enterprise arrears). Effectively, the Russian government said to Western governments and the IMF that, if they did not like

Russian inflation, they would have to supply dollars to reduce the need to print rubles to patch Russia's fiscal and quasi-fiscal holes and, at the same time, provide foreign exchange reserves to support the new exchange-rate regime.

The Russian government presented this blueprint to the IMF October 3–5, 1994, with a request for $16 billion. However audacious, this proposition was not without foundation: Many times since 1992 Western governments and the IMF pledged to Russia various astronomical sums of foreign aid and, specifically, a multibillion-dollar stabilization fund. So the Russians called the Western bluff and ambushed the IMF in Madrid.

The plan lacked both fiscal and monetary credibility. The budget deficit was forecast at 8 percent of GDP (and was actually 11 percent of GDP), excluding quasi-fiscal deficits. As a result, the IMF put the request on hold pending further negotiations. On October 11, 1994, there was a run on the dollar in Moscow, and the ruble lost 27 percent of its nominal value, although it soon recovered. The collapse in the ruble was a shock with political repercussions and a policy watershed.

The central bank raised interest rates to 170 percent in October 1994, 180 percent in November 1994, and 200 percent in January 1995. These high rates reduced credit to enterprises and increased placement of government bonds at annualized yields hovering between 80 and 100 percent. The most important measure, however, was the resumption of forced loans, abolished after the death of Joseph Stalin in 1953. The government issued special short-term bonds, or promissory notes (called KOs), which was a forced subscription on enterprises and banks, and imputed them in lieu of outlays to budget recipients. That drastic reduction of money outlays and the growth of fiscal arrears cut the budget deficit to 4 percent in early 1995. The parliament adopted the budget in March 1995 with an estimated 5.5 percent deficit, which was to be fully financed by bond issues without central

bank credit. The growth of money supply decelerated (but still remained at about 8 percent a month).

At the same time, the CBR commenced a series of rapid devaluations, while Russia's current-account surplus expanded. Foreign exchange reserves doubled, from $4 billion to $8 billion during the first half of 1995. In the spring of 1995, the exchange rate stabilized and even began to appreciate. Meanwhile, the IMF reconsidered its previous rejection and signed a $6.7 billion one-year package. In July 1995, the government and the central bank fixed the exchange rate in a narrow band. A new monetary system thus came into being one year after the idea first circulated inside government circles.

This heroic effort would not have been durable or sustainable beyond a year, a year and a half at best, save for an unforeseen and completely unrelated parallel development on the banking and privatization fronts. In another corner of Moscow, oblivious to and unknown to the IMF and the Russian government, a small group of Western investment bankers of Russian descent, spun off from the Russian office of CS First Boston, and their Russian partners, from an obscure but rapidly growing Uneximbank (the private United Export Import Bank),[1] developed a brilliant scheme to fill the government's desperate need to finance the deficit.

Here is how the scheme was designed to work. The government would consolidate its considerable but dispersed demand deposits in a small number of trusted, loyal banks. These banks would issue low-interest loans from these funds (the government's own deposits) to the government in exchange for an option to purchase stock in valuable, state-owned, natural resource enterprises. Since these options to buy are not initially the actual sales

1. Uneximbank was created from the frozen and transferred assets of the collapsed, state-owned Soviet Bank for Foreign Trade.

of real assets but only stock options held in trust by the banks in the event the government failed to repay the loans, this transfer could be conducted at very low equity prices. These low prices would make the existing government demand deposits sufficient for conducting the financial transfer operations on the books. The government could list these low-interest paper loans as additional budget revenues (adding the loans to its deposits, even though it was a single source of funds), thereby appearing to reduce its budget deficit and thus qualifying for the receipt of real loans from the IMF. The actual amount of domestically raised government funds would not change, but its paper deposits would multiply by those financial shenanigans—self-borrowing and self-lending through the banks. It is hard to blame the banks for taking real resources off the government's hands at bargain basement prices as they helped the government get real foreign currency from the IMF!

Meanwhile, the trusted, loyal banks obtained new financial resources as the option to purchase shares in oil, metals, and other natural resource enterprises endowed them with real assets and a steady flow of income from either dividends or resale of these assets. As long as the government retained the option to return the loans to the banks and recall the enterprise shares, this meant giving the banks a direct money subsidy instead of a subsidy in the form of real assets, which was not feasible given IMF constraints on credit creation and the continued budget deficit.

This scheme, euphemistically called *options auctions* or *collateral auctions* in Russia and *loans for shares* in the Western press, went into effect in late August 1995, just after the exchange-rate band was set and right in the middle of the ensuing banking-liquidity crisis. The truth was that the banking system was insolvent and that the government was running a larger-than-reported budget deficit and an even larger quasi-fiscal deficit. The government could not possibly have financed these def-

icits and sustained the banking system without continuous monetization and inflationary finance. Debt financing was not really feasible except through central bank repurchase of government bonds. The banks also did not have funds to purchase enterprise shares on the real market at the market price, which is why the option sales, or loans for shares, hiddenly financed by the government itself, raised five times more revenue in 1995 and early 1996, despite their low prices, than all other actual privatization.

But the significance of this development, which went beyond the fiscal bookkeeping and bank recapitalization, revealed itself when the equity and bond markets broadly opened to foreigners in 1996–1997 and the resale of shares and bonds became the principal source of money creation instead of the repurchase of bonds by the CBR. The rise in share values helped sustain the new monetary regime after 1996.

The above transfer-lending process operated until September 1996. Thereafter the government, predictably, did not repay the "loans" and allowed the banks, which held the shares in "trust," to purchase them at prices only nominally above the loans. At the same time, the government also started to sell to the banks, through closed auctions, large portfolios of shares in the remaining natural resource state-owned enterprises, instead of offering shares to the public directly on the stock market. By that time, the ruble was convertible into foreign currency on the capital account, albeit with some restrictions. The government bond market was partially open to foreigners, who were permitted to purchase up to 30 percent of ruble-denominated debt. The Russian equity markets were fully open to all potential purchasers.

The banks began to resell their assets in equity on the stock market to foreign investors and used the proceeds to purchase government bonds. The government also sold debt to foreigners and entered the dollar-denominated foreign bond market, issuing eurobonds. Those efforts enabled the government to finance its

debt, recapitalize the banks and allowed the banks to purchase high-yield government debt that sustained their own operational liquidity—using foreign capital inflows as the source of new funds. Access to foreign funds throughout 1997 sustained an otherwise unsustainable monetary regime.

Even though the banking system remained afloat through real resource recapitalization and resale to foreigners, the monetary regime became unsustainable because high bond yields during 1995–1996 required rolling over a steadily growing debt (see below for details). Both the total debt and the costs of debt service continuously increased. These higher costs could be sustained only through the repurchase of bonds by the CBR and monetizing the debt. The semifixed (crawling peg) exchange-rate anchor of the emerging monetary system could not have withstood this monetization without large capital inflows. The ruble would have undergone a sharp devaluation, high inflation would have set in, and any kind of stable monetary framework would have gone up in printed paper.

What saved the day for the monetary system were the foreign investors who bought stocks at market prices, giving the banks and other enterprises substantial capital gains, which became the means of recapitalizing the banks from late 1996 into 1997. The government was relieved of the need to provide high-yield bonds to the banks as the vehicle for recapitalization because it was able to secure foreign sources of funding for more than a third of its debt. Short-term interest rates fell, CBR repurchases of bonds declined, and the growth in the money supply became compatible with the growth in real foreign resources (whether a return of Russian capital flight or genuine foreign capital).

Focus on Ruble Stability

The central plank of Russian monetary policy during 1996–1997 was the relative stability of the ruble in the quest to reduce infla-

tion, a process difficult to achieve overnight. During the transition phase to lower inflation, the CBR pursued a low nominal depreciation of the ruble against the dollar to offset higher domestic Russian inflation. When necessary, the CBR entered the currency markets, buying foreign currency to avoid ruble appreciation as in 1997, which witnessed an increase in the inflow of foreign capital and some repatriation of flight capital. As a result, net international reserves rose from $0.6 billion in January 1997 to $11 billion in July but fell to about $9 billion in November and to $4.2 billion in January 1998.[2]

The CBR's purchasing of dollars with rubles in 1997 was a marked change from previous years, when the issue of rubles resulted in rapid currency depreciation, inflation, and a fall in reserves. This time, the issue of rubles was driven by the demand for Russian currency and ruble-denominated assets. The Russian stock market was the world's best-performing equity market in percentage gains in both 1996 and 1997. The government officially de-dollarized the economy, requiring that all legal payments be made in rubles. The growing strength of the ruble led the government to announce in mid-1997 its intention, beginning January 1, 1998, to lop three zeros off the ruble, redenominating the currency at a rate of one new ruble to one thousand old rubles. To avoid the panic that took place during previous currency measures, the government announced that both old and new

2. Net international reserves are defined as gross international reserves minus short-term international liabilities of the monetary authorities (all liabilities shorter than one year of the CBR and the Ministry of Finance). By definition, short-term foreign liabilities include the outstanding value of IMF loans, even though their duration may exceed one year. The difference between gross and net international reserves consists largely of IMF lending. Thus real net international reserves are actually higher than listed net international reserves because a portion of Russia's short-term foreign liabilities is not really short term. Net reserves peaked at about $9 billion in the fall of 1997, which was a historic high and which reflected the removal of forward cover offered by the CBR through the former S-Account structures through which foreign investors bought and sold dollar-based Russian securities.

rubles would circulate as legal tender during all of 1998 and that old rubles could be exchanged for new rubles through 2002.

The "Asian contagion" that afflicted Thailand, Indonesia, Malaysia, the Philippines, and Korea beginning in midsummer 1997 spread to Russia's currency and financial markets in early December 1997. The CBR spent more than $5 billion in foreign reserves of its $23 billion gross cache in an attempt to defend the ruble, while trying to keep its refinance rate at what was then a relatively low 18 percent (down from 48 percent in January to 42 percent in February, 36 percent in April, and 24 percent in June). As reserves dwindled, and with some persuasive advice from one of the inventors of the loans-for-shares scheme, Boris Jordan, chief executive officer of Renaissance Capital, the CBR realized that it was more important to defend the hard-won gains in ruble stability than to maintain low interest rates and protect low debt service costs. The CBR recognized that the risk to the banking system, heavily burdened with dollar liabilities, was too great to permit those liabilities to rise sharply in ruble terms. At one point, the entire commercial banking system teetered on the brink of financial implosion. Equally important, the government debt market was at risk of a massive sell-off of bonds, as investors stood ready to dump bonds to hedge against ruble devaluation if yields did not increase to compensate for the risk of devaluation. The CBR withdrew from the money market and let interest rates rise above 30 percent, which kept the ruble within its predetermined annual exchange-rate band against the dollar. It also adjusted the band to plus or minus 15 percent on either side of the rate.

The creation of a commercial banking system has been the most tortuous and least successful part of the Russian reform process. The government and the CBR have attempted to sustain the banking system by numerous methods of endowing banks with capital, with the ultimate goal of financing real enterprises

with credit. In the face of IMF restrictions on the CBR's issuing credit, the CBR was finding it increasingly difficult to inject new capital resources into the banks, which would be a monstrous problem were the entire system to crash under the weight of its dollar liabilities. The decision to let banks maintain some degree of solvency in their balance sheets, in the form of higher interest rates on government debt, simultaneously protecting the ruble, won out over devaluation. The price would be another postponement of the long-awaited beginning of growth, as higher interest rates would reduce real investment and drain additional resources into refinancing government debt.

The Growth of Domestic Debt

Limits on CBR credits during the past few years have forced the government to rely on debt financing in the form of short-term Treasury bills (GKOs) and longer-term federal loan bonds (OFZs). By mid-1997, the outstanding stock of GKOs and OFZs reached R311.4 trillion ($52 billion), or 12.1 percent of annualized June GDP, rising to R385 trillion ($64 billion) by January 1998. The stock of GKOs and OFZs has risen steadily, from 2 percent of GDP in January 1995 to about 4.4 percent of GDP in January 1996, 10.5 percent of GDP in January 1997, and 13.9 percent by 1998.

Although this is a small percentage (internal debt as a percentage of GDP) compared with advanced Western economies, the stark difference is that almost all of it must be refunded every half year. The prospect of refunding at decreasing interest rates in 1998 was waylaid by the sharp backup in interest rates in December 1997, meaning that a huge percentage of the government budget is consumed by interest payments. If higher interest rates remain in force in 1998, it will require an additional 2 percent or more of GDP, beyond that previously estimated, to

fund the government's deficit. (There is no long-term government debt market in Russia.)

As a result of the shift from CBR credits to the issue of government debt, debt financing has created a vibrant, and profitable, market in Russian debt. The average maturity of GKOs and OFZs rose from 108.2 days at the end of 1995 to 207.2 days in mid-1997. As maturities lengthened, interest rates declined, from an annualized rate of 200 percent in mid-1996 to 18 percent in late 1997. When the "Asian financial contagion" hit Russian markets in December 1997, the CBR let interest rates rise back above 30 percent (above 40 percent in early 1998) until the reduction to the mid-30s in March 1998.

Foreign Participation in the Domestic Debt Market

To help finance the budget deficit, in early 1996 the government permitted foreigners to purchase a specified share of the total value of bonds at primary auctions. However, it restricted the maximum interest rate for nonresidents to 20–25 percent in dollar terms compared with 70 percent and higher in ruble terms for residents, though this gap steadily narrowed. Special S-Accounts were established, which required that foreigners buy future contracts for delivery of dollars with a one-month wait if they wished to sell government bills and bonds and repatriate the proceeds in foreign currency. The CBR abolished S-Account restrictions on January 1, 1998, permitting instant repatriation. Between August 15 and October 15, 1996, international investment in the GKO Treasury bill market was about $2.1 billion. International investors added greatly to their stock of GKO and OFZ issues from the end of 1996 through 1997, for the compound rate of return was extremely high by global standards. At the end of 1997, foreigners held $14.5 billion in GKOs and $1.8 billion in OFZs.

As the Asian currency crisis unfolded, foreigners cashed in, repatriating about $1.3 billion of GKOs between October 1997 and January 1998.

As inflation fell, thanks to the growing success of the CBR in getting control over the money supply, several Russian banks and large firms, such as largely government-owned Gazprom and Lukoil, began to borrow abroad in 1996 and early 1997. In some respects, this was tantamount to foreign borrowing by differently named branches of the government and the CBR, as the CBR remained the lender of last resort for all Russian foreign debt. This process of foreign borrowing stalled temporarily in late 1997 when the currency and stock markets of Asia collapsed.

Private Holdings of Foreign Currency

Russia's official net international reserves are dwarfed by private holdings of foreign currency. Russians do not trust their government, especially when it comes to currency. The collapse of the ruble during 1991–1995 and the loss of deposits shattered public confidence in the ruble and in the banks. In January 1998, net domestic assets of the CBR stood at R141.2 trillion, net international reserves at $4.2 billion, and the monetary base at R164.5 trillion (about $27.4 billion at the exchange rate of the day). Russian households were estimated to hold in the neighborhood of $40 billion or more in U.S. banknotes, or nearly ten times the level of net reserves and well over 100 percent of the dollar value of both ruble notes and net domestic assets.

There is no shortage of hard currency in Russia, but there is a problem in converting the bulk of it into investment, either directly into dollars or via conversion into rubles. The Russian government officially de-dollarized the economy in the hope that the exclusive use of rubles for retail transactions would reduce velocity and inflation. But dollars remain important in Russia, as

evidenced by the massive capital flight and accumulated stocks under mattresses. Russia has consistently run a large trade surplus—$17 billion in 1994, $20.4 billion in 1995, $26.9 billion in 1996, and $19.8 billion in 1997—although rising imports have reduced the current account surplus, which includes trade in both goods and services, to single-digit levels in 1997 (and the current-account surplus turned negative during the second half of 1997).[3] Beginning January 1, 1998, the government imposed a new 2 percent tax on money converted from dollars to rubles and from rubles to dollars to discourage Russians from acquiring additional dollars in the first place.

An enormous stock of potential foreign assets is in private hands that are not part of the official accounts of the country. There is, unfortunately, little likelihood that the government will persuade holders of those dollars to put them to work in the country's ersatz banks, which is another compelling reason to establish real banks.

Foreign Investment

To date, direct foreign investment (DFI) has played a limited role in the Russian economy. Most foreign capital inflows have taken the form of purchases of GKOs, OFZs, and equities. During 1991–1995, cumulative DFI in Russia amounted to about $5 billion, compared with, say, $7 billion in much smaller Hungary. The first promise of large-scale DFI occurred when Uneximbank joined with American financier George Soros and Deutsche Morgan Grenfell to win the auction for Svyazinvest in July 1997. This was followed by two additional alliances: (1) BP with Sidanco/

3. Individual purchases of foreign goods by pseudotourists, who are in fact "shuttle traders," enter the service accounts even though those are imports of real goods. The value of that trade is in the billions of dollars.

Uneximbank and (2) Royal Dutch Shell with Gazprom and Lukoil, each formed to bid for Rosneft, the last remaining large state-owned oil company.

Between 1991 and 1997, total DFI amounted to $9.7 billion. Total DFI and portfolio investment, as of January 1998, stood at $36.2 billion. Direct foreign investment thus contributed about 27 percent of foreign investment in equities and enterprises.

Enterprise Arrears

The evidence presented in chapter 2 demonstrated that the growth in enterprise arrears (EAs) was the chief determinant of monetary policy during 1991–1995. The situation changed markedly during 1996–1997, the second phase of Russia's monetary development.

Russia is beset with numerous arrears: enterprise arrears, tax arrears, and wage arrears in the public and nonpublic sectors. President Yeltsin issued an order in 1997 to eliminate public sector wage arrears by year's end and largely accomplished that goal, thanks to foreign loans and overdue tax payments from several large Russian enterprises. His edict did not apply to the much larger stock of wage arrears owed to nongovernment employees. But in 1998 payroll arrears were a contributing issue to Yeltsin's sacking his cabinet.

In chapter 2 we demonstrated that enterprises used interenterprise, wage, and tax arrears as a means of securing government subsidies. Table 3 shows that a change in the monetary regime had no impact on the expansion of all these arrears. The table itemizes arrears on January 1, 1994, in the midst of the old accommodative monetary regime in which a ruble of interenterprise credit resulted in a corresponding ruble increase in money issue. The table compares the level of arrears, both in absolute

Table 3. Arrears in Nominal (Billion Rubles) and Real Terms (January 1994 = 100)

	1/1/94	*1/1/96*	*Real*	*1/1/98*	*Real*
Stock of receivables in arrears	R35,957	R289,300	110.4	R676,400	190.9
Tax arrears (including payroll taxes)	3,028	86,800	393.3	316,601*	1,061.1
Payroll arrears	815	13,380	225.3	52,637†	655.4
Stock of promissory notes (est.)	10,000	75,000	102.9	250,000	253.7
Memorandum item: Bank credit‡	30,019	185,975	85.0	255,607	86.4

*R554,900 billion, with fines and penalties
†R54,499 billion on February 1, 1998, and R57,768 billion on March 1, 1998
‡Not fully comparable because 1994 does not include loans in foreign currencies. A full comparison would show more decline in real terms in 1995–97. Bank credit is included in the table for illustrative purposes only. It does not constitute arrears.
Sources: Central Bank of Russia and State Statistical Committee, various releases.

and real terms for January 1, 1996, and late 1997 under the new monetary regime, using 1994 as the base year.

During 1996–1997, unpaid receivables nearly doubled, tax arrears (without fines and penalties) nearly tripled, and payroll arrears almost tripled in real terms. Promissory notes, or *veksels* (see below), increased two and a half times in value. The figures for bank credit are not strictly comparable in that 1994 does not include loans in foreign currencies. The real comparisons thus overstate the level of bank credit; the decline would be much sharper if only ruble loans were included for 1996 and 1997 or if dollars were included in the data for 1994.

The continued rise in enterprise arrears, but with the relative decline in bank financing as a percentage of enterprise liabilities,

reflects, first, the phasing out of CBR credits to enterprises (which accounted for 7 percent of total enterprise liabilities in 1994) and, second, the emergence of tight monetary conditions, which resulted in a rise in real interest rates. In response to tight credit conditions, enterprises manufactured their own financing through tax arrears, payroll arrears, and so forth. The difference in the past two years, compared with 1991–1995, is that arrears have not driven monetary policy; rather, they have affected the country's public finances, forcing up the government's costs of servicing public debt. In the long run, sustained economic growth depends on reducing and ultimately eliminating the arrears problem.

THE PERSISTENCE OF ERSATZ BANKS

At the risk of undue repetition, it must be repeated that real banks accept deposits and make loans, a point taught in every elementary economics course. Russian commercial banks hold few deposits. The state Savings Bank, which holds large deposits, makes few loans. By definition, neither the commercial banks nor the Savings Bank are banks or financial intermediaries. Rather, Russian banks are akin to business enterprises but shuffle financial instruments for their own profit instead of producing real goods and services.

An attempt at running a real monetary system in 1995 forced a change in the business activities of Russian banks. They switched from interbank and private-sector credits (though largely to their own captive, often money-losing enterprises or to the enterprises of which they were captive) from CBR resources toward operations in government securities. As interest rates of government bills rose (amounting to annualized rates of 163.7 percent in 1994 and 159.3 percent in 1995), the share of GKOs

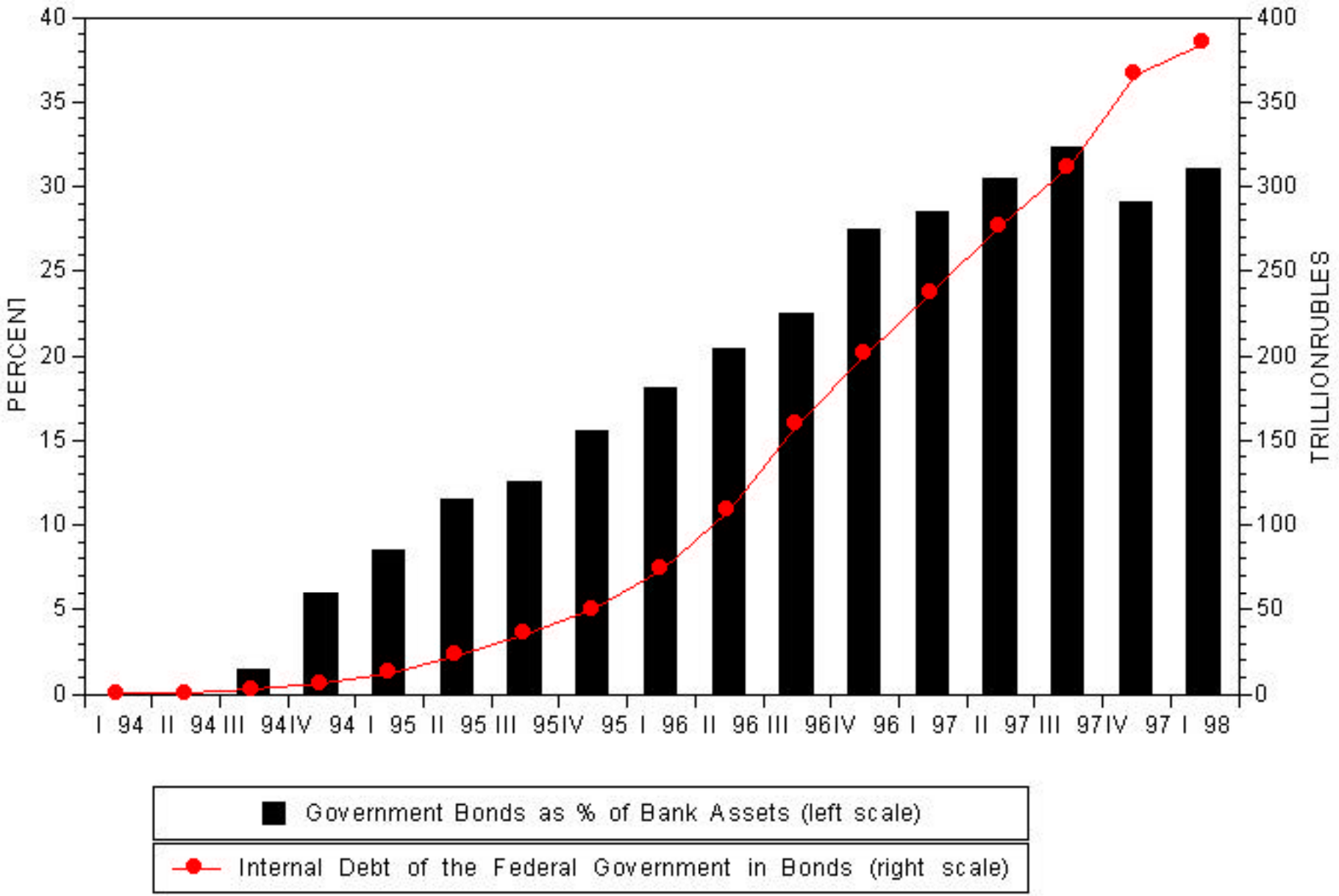
in the total assets of the banking system rose from 8.5 percent at the end of 1994 to 31 percent at the end of 1997 (see figure 7).

It is interesting to compare 1993–1994 with the three years encompassing 1995–1997. During the first two years, the budget deficit (excluding short-term debt service payments) was respectively 10.4 and 10.7 percent of GDP, while the total deficit came to 10.4 and 11.4 percent (the latter figure includes short-term debt service equal to 0.7 percent of GDP). During 1995–1997, the annual deficit ranged between 3.0 and 3.6 percent of GDP (although adding in debt service payments increased the total deficit to 4.8–7.6 percent for the three years). Interest payments as a percentage of GDP on short-term government debt rose from 0.7 percent in 1994 to 1.8 percent in 1995 to 3 percent in 1996 and to 4 percent in 1997. Since banks derived the bulk of their earnings from interest on government bonds, the banks were

Figure 7. Federal Government Debt and the Share of Government Securities in Bank Assets, Russia, 1994–1998 (quarterly data).
Sources: Central Bank of Russia and Russian State Committee on Statistics, various releases.

Figure 7

FEDERAL GOVERNMENT DEBT AND THE SHARE OF GOVERNMENT SECURITIES IN BANK ASSETS
RUSSIA, 1994-98 (quarterly data)



Sources: Central Bank of Russia and Russian State Committee on Statistics, various releases.

effectively recapitalized to the tune of several percentage points of GDP between 1995 and 1997, which still did not make them solvent.

Yields on GKOs, along with yields on subsequently issued OFZs, began to decline in mid-1996. This decline created severe problems throughout the banking system. Many banks (370) were liquidated by the CBR, and many other small banks were merged with one another or into larger institutions. At the end of June 1997, 742 banks had their operating licenses withdrawn by the CBR and were awaiting liquidation. (These small banks, although many in number, represented only 2 percent of the assets of the banking system.)

As GKO yields declined, the stock market came to the rescue. Between mid-1996, after President Yeltsin's reelection, and the end of 1997, the Russian stock market was the best-performing market in the world in percentage terms. Russian banks stocked up on equities, which helped improve their profits and balance sheets. The stock market tailed off sharply in the fourth quarter of 1997 but was still up substantially at year's end.

Another source of profit for the banks was operating the government payments system and Russian customs accounts. At the end of 1997, the government removed both flows from the commercial banks and placed them directly with the Treasury but in 1998 returned the customs accounts to the commercial banks.

As always, the hope is that banks will begin to intermediate household savings to the corporate sector, instead of channeling household funds to the government and government subsidies to enterprises, thus starting the growth process.[4] That is, of course,

4. "Banks [are] producers of money. . . . The existence of banks enables productive enterprises to acquire money balances without raising capital from ultimate wealth-owners [the households]. Instead of selling claims (bonds or equities) to them, it [the enterprise] can sell its claims to banks, getting money in exchange: in the phrase that was once so common in textbooks on money,

the big question and the subject of chapter 4. But first it is necessary to set the banks in the context of the real economy. This brings us to the dominant Russian economic institution known as FIGs, the acronym for financial-industrial groups.

Financial-Industrial Groups

There is a big difference between nominally privatizing enterprises and forcing them to behave as real private enterprises in a marketlike setting.[5] The Russian voucher process of privatization gave control over enterprises to managers and, to a much lesser extent, to workers and outside funds. Those who gained control were primarily interested in seizing assets for short-term gains, given the insecurity of property in Russia, rather than reforming the enterprises into profitable, value-adding businesses.

Establishing FIGs was the brainchild of the government, reflecting the execution of state policy toward specific sectors or enterprises. The idea was that banks would act as middlemen between the government and firms, funneling subsidies and state loans from the government to enterprises. This arrangement also held out the promise of converting the financing of business itself into a commercial enterprise. In the first generation of FIGs, the enterprises owned the banks, not the other way around.

The government hoped to use FIGs to rationalize energy and resources production and other major industries and sectors. But the model failed on two counts. Russia did not have sufficient

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the bank coins specific liabilities into generally accepted liabilities." Milton Friedman, "The Quantity Theory of Money—a Restatement," in Milton Friedman, ed., *Studies in the Quantity Theory of Money* (Chicago: University of Chicago Press, 1956), p. 14.

5. This segment draws on a cover story, "Out of the Ashes," that appeared in the November 1996 issue of *Business Central Europe*, pp. 9–11.

funds to finance the modernization of industry, and the FIGs were unable to manage their companies efficiently.

FIGs were turned upside down in 1995. The process of transformation was the loans-for-shares scheme implemented by the leading banks. On the transformed FIG model, the underlying assumption (perhaps hope is the better word) was that selling controlling stakes in companies to competent commercial banks would put the firms in the hands of the few people qualified to restructure them financially, who would hire Western managers to run them efficiently.

By late 1996, three major FIGs emerged: Interros, closely linked to Uneximbank; the Alfa Group, a private partnership developed by a group of domestic entrepreneurs linked to Alfa Bank; and Menatep, linked to Menatep Bank. Uneximbank acquired Norilsk Nickel and Sidanco, while Menatep got Yukos, a large oil company. (Examples of purely industrial FIGs include Lukoil and Gazprom, the large oil and gas companies.)

The new FIG model requires that the banks get controlling stakes in the firms in their groups, drag them forcibly into the market economy, and gain access to Western capital. For example, in 1997, Uneximbank attracted more than $500 million in capital from BP in the sale of 10 percent of its oil-related firm, Sidanco. The banks, if successful, will fix up and ultimately sell off to real private investors viable firms that add, not subtract, value to the real economy. The banks, in this model, are the equivalent of investment banks, not industrial conglomerates. As the process of fixing and selling off enterprises picks up steam, real growth would follow.

The risk, of course, is that a handful of dominant FIGs will simply build up monopoly positions and fend off real competition or that a few banks will want to control as many industrial assets as possible but not make the necessary investments in capital and management to restructure and make profitable their subsidiary

value-subtracting or stagnant enterprises. Another risk is that, in the rush to gain control of as many assets as possible, the banks will overextend themselves and that one or more large banks might fail. The biggest risk is that their dominant position in both finance and industry will give them easy access to public funds, real quasi-fiscal power!

The bank-led FIGs have become the new powerful redistributors of resources in the Russian economy. But, as some may assert, the bank-led FIGs were the only means to acquire, restructure, and sell real value-adding enterprises to create a real market economy. Their long-run prospects, however, are open to question.

The failure of the *keiretsu* in Japan and *chaebols* in Korea (Asian variants of the Russian FIG model) casts doubt on the long-term viability of concentrating financial and industrial assets. *Keiretsu* and *chaebols*, at least initially, did not have a common budget with the government. But they grew to acquire one. The experience of the Czech Republic, in which the government owned the banks, which owned the investment privatization funds, which owned the companies, and which resulted in the failure of microeconomic restructuring of enterprises, has prompted the Czech government to sell its shares in the banks to foreign banks and to break up its FIG model.

It does not make economic sense for banks to have as their chief clients for loans the firms they own. The incentives are wrong. Banks can often earn higher profits by lending to their industrial subsidiaries than by restructuring those firms into profitable enterprises. What may be good for the banks is not good for the broader economy. The development of real banks in Russia is going to require that FIGs give way to a separation of banking from real commercial and industrial activities.

With this background, let us consider the balance sheet of the banking system as of December 1, 1997. The "standard" balance

sheet that appears in table 4, when compared with its counterpart in table 1 for the end of 1995, appears to show a dramatic improvement in the health of the banking system. Total assets appear to have increased more rapidly than total liabilities, doubling the equity of the banks (even after adjusting for inflation). Nonborrowed reserves also appear to have nearly doubled. Thus the standard balance sheet implies that great progress was made during 1996–1997 in improving the solvency and liquidity of the banking system.

The "revised" balance sheet for December 1, 1997, table 5, tells an entirely different story. Negative nonborrowed reserves increased sixfold compared with their counterpart in table 2 for the end of 1995, which means that liquidity in the banking system had further deteriorated. As to solvency, both assets and liabilities nearly doubled during 1996–1997, but the banks remained in

Table 4. Standard Balance Sheet of Russian Commercial Banks as of December 1, 1997 (all values in billions of current rubles)

Assets		*Liabilities*	
Reserves	62,884	Demand deposits	121,143
Foreign assets	82,484	Time deposits	105,745
Claims on the government	188,186	Foreign exchange deposits	77,898
Claims on enterprises (performing loans)	289,423	Government deposits	30,150
Claims on other financial institutions	497	Central Bank credit	10,527
Undistributed assets	2,190	Bank-issued bills of exchange, equal to quasi–Central Bank credit	20,361
		Foreign liabilities	115,113
		Undistributed liabilities	0
Total Assets	625,664	Total Liabilities	480,937
Memorandum item: bank liquidity (nonborrowed reserves)	52,357	Equity	144,727

Table 5. Revised Balance Sheet of Russian Commercial Banks as of December 1, 1997 (all values in billions of current rubles)

Assets		*Liabilities*	
Reserves and CB deposits	62,884	Demand deposits	121,143
Reserves	36,200	Time deposits	105,745
CB deposits	26,684	Foreign exchange deposits	77,898
Foreign assets	85,484	Government deposits	30,150
Claims on the government	188,186	Central Bank credit	10,527
All claims on enterprises (performing) (equities, loans issued as bank bills of exchange, performing money loans)	273,098	Bank-issued bills of exchange, equal to quasi–Central Bank credit	37,226
Equities (market value)	100,000	Foreign liabilities	115,113
Loans issued as bank bills of exchange	37,226	Bank bonds (tradeable)	9,733
Money loans (performing)	135,872	Undistributed liabilities	0
Nonperforming loans (principal) (for information only)	(25,053)	Loans to bank-owned enterprises (estimated)	65,000
Nonperforming loans (interest) (for information only)	(25,912)	Contingent liabilities: direct government loans to bank-owned enterprises (est.)	8,000
Claims on other financial institutions	497	Contingent liabilities: tax arears (est.)	60,000
Undistributed assets	2,190	Contingent liabilities: payroll arears (est.)	10,000
Total Assets	609,339	Total Liabilities	650,535
Memorandum item: bank liquidity (nonborrowed reserves)	(11,553)	Equity	(41,196)

even a more negative equity position than two years before. The ratio of assets and liabilities to equity, however, markedly deteriorated during 1996–1997. Put another way, the banking system generated a significant increase in credits on a zero capital base. The Russian financial system is, to put it mildly, living dangerously at the public expense as it creates a hazard for the fiscal

Table 6. Monetary Survey, Balance Sheet of the Central Bank of Russia and the Commercial Banks (billions of rubles)

	1/1/96	*1/1/97*	*7/1/97*	*1/1/98*
Assets				
Net foreign assets	70,223	49,335	84,563	7,225
Domestic credit	363,673	539,298	580,915	669,414
Claims on the government	166,588	311,467	328,805	378,856
By commerical banks	62,639	150,721	187,093	191,078
By CBR	103,949	160,746	141,712	187,778
Claims on enterprises	196,570	227,589	252,011	390,548
Claims on non-banks	525	242	100	9
Liabilities				
Money	151,267	192,402	242,496	269,362
Currency	80,800	103,800	136,900	130,500
Demand deposits	70,467	88,602	105,596	138,862
Quasi-money	124,513	164,922	180,760	189,570
Bank bills of exchange	11,859	30,372	23,882	27,896
Other liabilities	46,489	22,940	16,522	(29,759)
Equity	99,768	177,996	201,820	219,572
Memorandum items				
Net domestic assets	68,100	123,000	106,100	141,200
Net international reserves, $ million	7,700	1,700	11,000	4,200
Monetary Base	103,800	130,900	167,000	164,500
M_2 (includes banks with revoked licenses)	220,800	295,200	363,800	384,500
M_2 (excludes banks with revoked licenses)	220,800	288,300	352,000	370,200

Source: Central Bank of Russia, various releases.

system. These circumstances explain why the entire credit structure came perilously close to collapse at the end of 1997 as the ruble came under pressure and why the CBR had to defend the ruble at all costs.

Table 6 presents an IMF-style monetary survey, which combines the assets and liabilities of the Central Bank of Russia with those of the commercial banks. Looking at tables 4, 5, and 6, let

us review the major trends in the banking system during 1996–1997.

As we have said many times, any apparent expansion of bank credit is not due to the creation of deposits as in normal commercial banking systems. In Russia, a principal source of financing economic activity in 1996–1997 was the creation of money by the CBR as it repurchased, or recycled, government debt. An increasingly important source of financing in 1997 was the creation of rubles by the CBR as it bought up foreign capital inflows with newly created rubles.

In 1996, the CBR repurchased short-term debt from the banks and banks capitalized high rates of interest in (paper) equity. CBR claims on the government increased from R104 trillion to R161 trillion, or 55 percent, during 1996. That R57 trillion increase in debt repurchase led to an increase of R55 trillion in net domestic assets. That monetary expansion sparked an inflation scare and nearly depleted foreign exchange reserves, as holders of rubles perceived that the exchange-rate band could no longer be sustained at the end of 1996.

The new monetary system of 1995–1996 effectively replicated the previous regime of direct CBR credit to the government and the banks, except that the new regime securitized this credit in the form of government bonds, recycled through the banks. The fixed exchange-rate regime helped reduce inflation, but it also constrained the CBR's ability to repurchase debt. As 1996 drew to a close, the new monetary system was on the brink of failure.

In the first half of 1997, the CBR purchased nearly $10 billion of foreign exchange from the banks and the government, issuing rubles in exchange. Those purchases of foreign exchange reflected rising demand for rubles by foreigners. This fresh burst of outside resources enabled the CBR to expand the money supply, keep the banking system liquid, and also preserve the exchange-rate

band and the monetary system that was based on it. As previously described, this monetary expansion became possible through the sale of government debt to foreign investors and the serendipity effect of the past privatization and bank recapitalization policies: Banks were cashing in their shares in natural resource enterprises granted by the government to foreign investors. By this time, the Ministry of Privatization, not the CBR, had become Russia's effective monetary authority.

In addition to openly transferring shares in mineral wealth to banks, the Ministry of Privatization also conducted a series of secret swaps of the equity of insolvent banks (an effective partial nationalization) for government equity in oil corporations. That was especially important in late 1995 when, after the rise of interest rates and the liquidity crisis, major banks lacked funds to purchase enterprise shares even at a great discount. One of the most prominent Russian banks, Menatep, was saved this way.[6] The switch from recycling government debt to recycling shares in mineral rights and shifting bank recapitalization to foreign investors could continue while the supply of shares in natural resources lasted. But this means of recapitalizing banks was undermined by the Asian debt crisis as foreign investors fled emerging markets in late 1997. Russia was hit particularly hard: Net foreign assets of the monetary authorities and commercial banks collapsed from nearly $15 billion in mid-1997 to $1.2 billion in January 1998 and then turned negative, rising to more than minus $2 billion in March.

Banking activity in the real economy during 1995–1997 was hardly noticeable. Performing loans increased from R128 trillion in January 1996 to R136 trillion in December 1997, that is,

6. Chrystia Freeland, "Moscow Sold Shares in Oil Companies in Exchange for a Stake in a Commercial Bank," *Finansovye Izvestiia*, no. 10 (February 1, 1996): 1; Gennadi Pisotsky, "The Bank Is Authorized to Swap and Spin," ibid.

declined by 21 percent in real inflation-adjusted terms. The share of performing loans in bank assets fell during this period from 41 percent to 22 percent. The share of government debt in bank assets increased from 8 percent in January 1995 to 20 percent in January 1996 to 31 percent in December 1997 and far exceeded performing loans to enterprises by 38 percent. The volume of government debt in bank assets more than tripled during 1996–1997 and ended up in the growth of banks' paper equity. Banks did not mobilize the savings of the population and did not create additional deposits. They simply automatically multiplied CBR additions to the monetary base. The ratio of M_2 to cash hovered at three to one, in marked contrast to the ratio of ten to one or more in Western market economies.

Veksels

In addition to all the other problems we have described for Russian banks, there is another: bills of exchange or promissory notes. Russian banks have issued a growing stock of private bills of exchange, or promissory notes, named *veksels* after the German bills of exchange of the nineteenth century. *Veksels* work as follows. Russian banks extend loans to enterprises in the form of private bills of exchange. These banknotes resemble large, lump-sum checks. They are redeemable in cash by the issuing bank at a particular date. In the meantime, the notes circulate like regular money, being endorsed and passed along from one holder to another. *Veksels* are generally used only among enterprises and other businesses, not by individuals. Their credibility is not backed by some hard assets of the issuing bank set aside as cover for notes; rather, their credibility rests on the public's willingness to accept them as a means of payment.

Banks began to issue *veksels* in substantial amounts after the fixed exchange-rate regime was put into place, which reduced the

issue of CBR credit and created a liquidity squeeze. *Veksels* replaced the CBR accommodation in liquidity with self-liquidity. Banks do not place reserves with the CBR for the right to issue *veksels*. The interest rate of *veksels*, at the end of 1997, was in the neighborhood of 40 percent.

The problem with *veksels* is that, in Russia's financial system, they are another form of direct or indirect quasi-CBR credit. The CBR regulates the total amount of *veksels* that can be issued and which banks can issue them. In those regulations, the CBR implicitly ensures the convertibility of *veksels* into real credit, the equivalent of real money.

In comparing table 5 with table 2, we see that the quantity of *veksels* more than doubled during 1996–1997, amounting to about 6 percent of bank liabilities on December 1, 1997. That sum, by itself, exceeds the value of bank reserves held with the CBR (R37 trillion and R36 trillion, respectively). *Veksels* have made the structural illiquidity of the banking system worse.

Corporations have also issued *veksels*, which trade at a much higher premium than bank-issued *veksels*. One reason is that corporate *veksels* are not necessarily redeemable in cash, but rather in kind in some instances, and that corporate finances are even shakier than those of the banks.

In addition to bank- and corporate-issued *veksels*, cities and regional governments also issue their own private money. Together, they amounted, at the end of 1997, to R350 trillion, nearly three times the ruble currency in circulation. *Veksels* complicate the task of building a real monetary system by adding liabilities to the country's financial system and putting the banks at higher risk.[7]

7. Adam Smith wrote over two centuries ago about the "fictitious bills of exchange" drawn and redrawn between banks and enterprises in larger and larger amounts. Since there are no real "debtors" behind these bills, they are eventually redeemed by the Bank of England. This "artful contrivance" ruins

SUMMARY

The recycling first of government bonds and then of privatized natural wealth kept the financial system afloat but failed to produce real growth. All that really happened was that the government subsidized banks—to do what? The hope was that subsidized banks would transmit subsidies to enterprises, as they had done under the monetary policy of directed credit and high inflation of 1992–1994. The story during 1995–1997 was that the government subsidized banks, which bought government debt, which was used to finance subsidies to the banks. The real economy was nowhere to be found in that equation. As a result, enterprises, which were deprived of the flows of monetary accommodations of enterprise arrears through bank credit as in earlier years, switched to self-accommodation through building up tax arrears (further compounding the government debt problem). By various official counts, the stock of enterprise tax arrears to the consolidated budget grew from 3 percent of GDP in 1994 to more than 20 percent in early 1998.[8] Tax arrears increased the budget deficit; financing the deficit through high-yield bonds increased government debt. This was a continuous double fiscal trap. The true underlying financing of this fiscal regime stemmed from implicit tax increases, such as payroll arrears and rising user fees on utilities, as well as from central bank seigniorage, including the continuous inflation tax.

Russia did not have normal fiscal and banking systems during

"public credit" and the monetary system and brings on "the distress of the country." Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (London: T. Nelson and Sons, 1895), pp. 127–28.

8. According to the State Tax Service (the Russian equivalent of the U.S. Internal Revenue Service), the consolidated tax arrears of enterprises reached R554.9 billion, or 21 percent of GDP in February 1998 (*Finansovye Izvestiia*, February 24, 1998). Of this amount, R297.9 billion is owed to the federal budget excluding social trust funds. Those numbers include fines and penalties.

1996–1997. A normal monetary system could not exist under such conditions, even if the central monetary authority appeared to have real instruments of monetary policy. Real fiscal and banking systems, the anchor of monetary policy, are essential to the conduct of a fixed or quasi-fixed exchange-rate regime. In the absence of fiscal and banking systems, what began in the second half of 1995 as a monetary regime based on a fixed exchange rate ended up in 1997, remarkably, as a quasi–currency board regime based on government grants of natural wealth to banks and their resale of mineral rights to foreign investors. Such a regime was impermanent from the start because mineral rights, once sold to foreigners, cannot be recycled.

The Asian contagion highlighted the fragility of this regime. As foreign investors began to cash out at the end of 1997, the CBR was forced to let interest rates rise to persuade Russians and foreigners to hold rubles. A devaluation of the ruble would have ended the incipient monetary regime that the government had worked so hard to maintain. CBR sales of dollars, to preserve the exchange-rate band, contracted the monetary base in early 1998. The monetary system thus hung in the balance as the authorities sought out new sources of foreign capital—foreign loans, additional IMF grants.