CHAPTER FOUR

Will Russia Maintain Its Emerging Monetary System and Develop Real Banks? 1998 and Beyond

As demonstrated in chapter 3, the emergence of a real monetary system in Russia stemmed from the pressure of the IMF and other international creditors and some perhaps lucky happenstance. In any event, the CBR lost its freedom to issue credits to the central and regional governments and to enterprises. Rather, it began to behave as a real central bank through the issue of currency, the regulation of banks, open market operations (even if its repurchase of bonds was excessive), and setting its refinancing rate close to the market rate of interest.

WILL RUSSIA MAINTAIN ITS TRIAL MONETARY SYSTEM?

Does the chairman of the CBR (and for that matter the president, prime minister, and first deputy prime ministers) understand the principles of money and banking that are taught in introductory economics courses? There is no way to be certain. Have he and his fellow directors (along with the top government officials) learned how to operate the standard tools of monetary policy in a way that will bring about price stability and create an economic

climate conducive to growth? Or is the CBR simply captive to changing economic and financial circumstances, temporarily restricted by international arrangements from full freedom of action.

There is anecdotal evidence that the CBR is still learning about monetary policy and management. For example, it tried to simultaneously maintain its low refinance rate and defend the ruble as foreign reserves drained from the system in early December 1997. It took a private Western investment banker, Renaissance Capital's Boris Jordan, to explain to the CBR that it could not fix two levers of monetary policy simultaneously. Even his elementary arguments were not persuasive until $5 billion in reserves drained abroad within the short span of a week and the entire banking system was on the verge of collapse. Foreign liabilities of all domestic banks substantially exceeded their foreign assets at the prevailing exchange rate, and any ruble devaluation would have dramatically increased the ruble value of their net foreign liabilities.

As long as Russia depends on the IMF, the World Bank, and other international creditors for financial support, the CBR is likely to function as a normal monetary authority and defend the ruble within an acceptable exchange-rate band. If and when the Russian government decides that it no longer requires international aid, and therefore need not adhere to IMF monetary and fiscal targets, the government could instruct the CBR to issue new credits. The jury is still out on this question.

It is important to trace the path through which the Russian government achieved internal financial stabilization, that is, financed its deficits. The method was to issue and roll over short-term, high-yield government bills and bonds, not a sustainable practice over the long run. During the past few years, and into early 1998, both foreign and domestic (largely Russian banks)

investors required high yields to hold government debt (in part, reflecting a fear of ruble devaluation).

A vicious circle thus developed. As the cost of servicing government debt continued to mount, and as it had to be rolled over given its short-term maturity, the government continued to inject real assets, at subsidized prices, into restoring the depleted true capital of Russian banks.

The solution, of course, was to eliminate deficits through more rigorous tax enforcement and elimination of numerous direct and hidden subsidies, including self-subsidies in the form of tax arrears. However, aggressive tax enforcement, forcing Russian banks to pay the tax liabilities of their enterprises, has resulted in the banks' occasionally threatening to dump bonds to the government's peril.

Here is where banking reform and a more stable, solvent government go together. The CBR can instruct the banks to submit their true balance sheets, which would include all comprehensive liabilities, including the tax arrears of enterprises owned by banks. The simple rationale for this request would be to check the banks' capital adequacy. When all hidden liabilities (bank-issued bills of exchange, enterprise tax arrears, enterprise payroll arrears, etc.) are included, and all hidden but nonviable assets (nonperforming loans, etc.) are subtracted, most banks, including the major banks, would be revealed as insolvent.

With full balance sheets in hand, the CBR could start the process of reform by, first and foremost, swapping banks' liabilities with the government (tax arrears of enterprises) for the banks' claims on the government (bond holdings). The government would recover its bonds instead of repurchasing them, thereby greatly reducing the internal debt and debt service costs. That would dramatically relieve the strain on the public finances as it eased pressure on the ruble.

The fiscal position of the government would become much

healthier because both the size of the debt and future debt service costs would be reduced. The monetary position would be healthier because dependence on foreign investors to buy public debt would diminish and the threat of their fleeing would subside. The real economy would be healthier as interest rates came down. And the banking system would be healthier as the banks' balance sheets were cleaned up, allowing the central bank to implement a comprehensive banking reform. We now turn to delineating such a reform.

DEVELOPING REAL BANKS: A PROPOSAL FOR REFORM

There is one piece of good news. In the first week of January 1998, the Russian government gave its initial approval to two major U.S. banks (Bank of America and J.P. Morgan) and two major German banks (Deutsche Bank and Commerzbank) to open subsidiaries in Russia. Those four were among twenty foreign banks that had applied for licenses to set up subsidiaries. Although several foreign banks had operated offices in Russia that focused on business such as financing trade deals, the new subsidiaries would be permitted to engage in full-scale, domestic banking operations.

The full details of their operations will become clear with time. Ideally, the foreign subsidiaries will be able to engage in unrestricted retail branch banking, accept deposits from the public, and make commercial and consumer loans in both rubles and foreign currency. Foreign subsidiary banks differ from FIG-centered banks in that the growth of their business depends on the real demand for money, not on government assistance. Such a development would help transform Russian ersatz banks into real banks. It is hoped that all twenty foreign banks and more

will be permitted to open full-scale operations in Russia in the near future.

At the beginning of 1998, however, foreign banks only represented about 4 percent of all banking capital in Russia. As a result, the growth of real credit, and real economic activity, will still depend on Russian commercial banks for the next few years. It is important, then, to consider how Russian banks might be reformed to help finance growth.

A Modest Proposal

The objective of bank reform is to build a new banking system of private credit markets. In the new system, depositors should be able to place their savings in new, private, independent, well-capitalized domestic and foreign banks. This process requires an orderly transformation of the banking system and the bankruptcy of insolvent banks.

In a nutshell, the proposal involves the swap of assets, of debt for equity, with the following constituent elements.

The federal and regional governments need to establish *funds* owned by various groups of holders of the governments' internal debt—for example, depositors of the state Savings Bank who lost their savings during the big inflation of the early 1990s. Other holders of implied government liabilities include those Russian citizens with claims on current and future government expenditures (e.g., members of the municipal housing queues, pensioners, households entitled to free or subsidized health care and education, and so forth). *These funds can be capitalized with real assets*, such as natural resources, pipelines, forests, and municipal and agricultural land, among others.

Although in recent years the government gave away a large amount of valuable assets in subsidies to bankers and other preferred interests, the government still owns big stakes (hundreds

of billions of dollars) in the natural gas and oil industries, their pipelines, the power industry, and so on. Vacant municipal land for housing development is still largely untapped. These *real* assets could be swapped for both the current and the future liabilities of the federal and regional governments to groups such as those listed above. Swapping real assets for debt liabilities using this formulation would create new institutional investors with real assets and, at the same time, reduce or eliminate future government liabilities by reducing the stream of fiscal expenditures on social programs. In effect, the swap would privatize publicly financed social programs.

How would such a swap include a banking reform? The newly capitalized funds could establish new banks and either replace or take over existing insolvent banks. The existing debt of the commercial banks, whether to the Central Bank or the Savings Bank, would be privatized to—become the liability of—the owners of the new funds (and banks); in return, the new funds/banks would acquire the equity of the indebted commercial banks. The swap or exchange process would include the Savings Bank, which would also be privatized to the new funds/banks and their depositors, who would assume the liabilities of the Savings Bank in exchange for its equity.

To clean up the mess that now characterizes the ersatz banks, which masquerade as real banks in Russia, a high priority is ensuring that their balance sheets during the private takeover process reveal the extent of each institution's insolvency. In particular, nonperforming loans should be subtracted from assets and set aside in escrow. In addition, bank-issued *veksels* should be added to their liabilities. Properly speaking, the banks should be forced to set aside—as a reserve requirement with the Central Bank—the entire value of these promissory notes (liabilities), the financial equivalent of travelers checks, insofar as they represent

the equivalent of implicit Central Bank credit (becoming explicit if and when monetized).

The markets would then select those banks that are to survive under the new private ownership arrangements, thereby directing an orderly bankruptcy process. Swapping debt for equity would thus prevent bank failures, closures, panic runs on banks, the depreciation of the currency (with its concomitant inflation), and the further contraction of real credit (thereby preventing further economic contraction).

The takeover of indebted and insolvent banks would amount to a wholesale true privatization of the banking industry and, equally important, separate the commercial banks from the government and the common budget. After the swap, the new owners would exchange the nonperforming debt of enterprises, which had been set aside in escrow, for part of their equity. The new banks would become shareholders in enterprises but in a manner completely different from current FIG arrangements. The difference would lie in the fact that the new banks and the enterprises in which they acquired equity (in exchange for nonperforming loans) would no longer have access to government subsidies or subsidized CBR credit.

Our approach differs from that often proposed in both the academic and the popular literature, namely, to write off nonperforming loans and recapitalize banks at government expense. That approach has become especially prevalent in light of the financial crisis that emerged in Asia during the second half of 1997. Our objection to such an approach is that it subsidizes both inefficient enterprises and inefficient banks at a huge cost to taxpayers. Moreover, it invites future mismanagement, if not malfeasance. Rich countries with strong fiscal systems, such as the United States or Japan, may be able to afford such waste, but Russia is much too poor to attempt this strategy.

The debt for equity swap we propose has several desirable

features. It would establish efficient ownership, secure stakes in enterprises, and achieve corporate control in firms whose shares the new funds/banks would choose to keep as a source of income. To the extent that any of the acquired enterprises are profitable, the profits provide resources on which to generate new credit. The new institutional bank owners would have little interest in rolling over the debt of insolvent enterprises. They would be unwilling to risk their good capital, endowed by the government in exchange for canceled entitlements, just to keep bad capital from liquidation. It never makes sense to throw good money after bad. Those new financial institutions should resell their enterprise equity on the market and use the proceeds to invest in profitable activities or use their liquidity for making profitable loans. The new incentives will break up, once and for all, the common budget chain linking the government, banks, and enterprises under the existing arrangements.

The new system would be directed toward maximizing market-earned profit for shareholders, resulting in the direction of credit and investment to profit-maximizing companies and growth-generating household purchases. Because banks would have municipal land in their initial capital and be able to sell it through mortgages, a private housing sector would emerge and construction would contribute to economic growth.

As discussed earlier, the debt/equity swap should also include the swap of bank assets (heavily in government bonds) for bank liabilities (tax arrears owed by bank-owned firms and other debts to the government and the Central Bank) and the swap of bank equity to which those assets correspond. During this process, the government would reduce the amount of its short-term outstanding debt, along with the fiscal costs of debt service. The government would then have the breathing space to replace high-yielding, short-term debt with a spread of longer-maturity debt

instruments, as found in most normal market economies, thereby further reducing fiscal outlays.

Stretching out the maturities of government bonds could be part of the debt/equity swap agreement with the new institutional owners. The government could replace the existing stock of short-term public debt with a spread of maturities. Recall that banks experienced a sharp reduction in their income between the middle of 1996 and the end of 1997 as interest rates dramatically declined. Indeed, were it not for a rapid rise in the value of equities held by banks, the entire banking system would have come perilously close to collapse. A more even spread of variable-length government bonds would help smooth out the interest earnings of bonds held in bank vaults. It would also, at crunch time, reduce the pressure on the government to find another way to inject fresh assets into the banks whenever their earnings fell in the face of declining bond yields. A gradual replacement of short-term Treasury bills with long-term bonds as a source of bank assets, on which banks can generate credit, would not cost the government or the taxpayer additional resources.

Let's be clear about what the debt/equity swap would accomplish. When the new system is fully mature, the Central Bank of Russia will be an independent monetary institution and will no longer bear any implicit fiscal liabilities. The ruble note issue, the CBR's currency liabilities, will be backed by the exchange-rate value of its net international reserves and the reality of a growing economy, generating higher output and foreign exchange earnings.

To complete the financial system, the commercial banks will develop a portfolio of assets (loans) backed by the real resources they secured from the government in the debt/equity swap and by their holdings of more-stable, long-term government bonds (which works to the benefit of both the government and the banks).

The system as a whole will take on currency board–like characteristics, rather than remain a fiat system limited solely by international dictates. The CBR will be constrained in its note issue by law and by its need to hold sufficient international reserves to maintain a stable exchange rate. The commercial banks will be constrained in their credit creation by the value of the real resources at their disposal and by the need to earn a positive rate of return on their loans (since government subsidies will no longer be available to make up for losses). Credit will grow in line with profitable, productive economic activities.

To summarize, banking reform and the establishment of private credit markets simultaneously achieve a costless rescheduling of internal debt and diminish a perilous fiscal crisis. Taken together, the process creates a market-based banking system, an independent monetary system, and a more solvent, less debt-burdened fiscal system in one fell swoop.

In the best of all possible worlds, the newly established funds and banks should be run by foreign managers. In fact, the new institutional owners are likely to seek out foreign managers for their integrity and professional skills. After all, Russian bankers are deeply distrusted by the Russian public. The evidence is stark: Russian households hold $40 billion or more in no-interest-bearing American dollar bills. In contrast, interest-earning household deposits in Russian banks are well below their private dollar hoards, and most of those sit in the safer state Savings Bank.

The principal objective of a banking system should be the mobilization of domestic savings for capital formation. If the Russian public begins to own banks through private institutional funds, and begins to trust their new managers, households would begin to convert their dollar hoards into interest-bearing ruble deposits.[1] Such a conversion would strengthen the ruble and

1. If the political climate were right, Russia could grant *legal currency status*

greatly increase the available credit for firms and households (e.g., home mortgages). Deposit multiplication through the banking system would increase capital formation. After an initial confidence-building period, the flow of regular savings from income would continuously expand credit and investment.

Another incentive and risk reduction for mobilizing deposits (getting dollars from mattresses) could be dollar-denominated convertible accounts. Under this scheme, deposits could be directly backed by equity shares in natural resource firms and be freely convertible on demand at the stock market rate. Depositors could be paid either interest or dividends, as they desire. In reality, this operation cuts through exchange and brokerage transactions but, if done within the same bank, ensures depositors' confidence.

The government could lend some of its natural resource shares to the Central Bank in exchange for purchasing dollars from the banks' convertible accounts. The Central Bank could then repurchase dollar-denominated government bonds from foreigners (to avert a run on the ruble) and remit the bonds to the government, thereby canceling its resource loan. This short-term measure could reduce the country's short-term foreign debt exposure. It would also allow the CBR to build up foreign exchange reserves at the long-term market value of assets.

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to the U.S. dollar, which would allow banks to accept dollar deposits and make dollar loans on a coequal contractual basis with rubles. In that event, both the ruble and the dollar would circulate as *official* currencies, as is the case with the peso and dollar in Argentina. In the current climate, Russian households are not likely to trust their dollars to Russian banks. The government would have to authorize foreign banks to open branches in Russia on a broad scale, and those foreign banks would probably have to guarantee, by recourse to assets in their home countries, the dollar deposits placed with them. Russia is probably not ripe for such a reform, given that it recently de-dollarized the economy. But allowing dual currencies to circulate would help ensure the stability of the ruble, as any departure from operating a sound monetary system would cause a shift from rubles to dollars.

Also, the government could place additional equity in natural resources in its own accounts in banks to be exchanged for the dollar-denominated convertible accounts when households deposit their dollar savings. This would eliminate the need for the government to sell assets at a discount to foreign investors to acquire dollars to support the currency and finance its budget deficit. Or, if depositors prefer to hold interest-earning dollar deposits instead of equity shares, their money could be placed in trust with the Central Bank. This would amount to private ownership of that part of CBR reserves of foreign exchange. Either option would secure the stability of the monetary base, reduce the need for new currency issue, and thereby minimize future currency crises.

It can be argued that this proposed reform, while economically rational, is not politically feasible. The structure of interests that has developed between the government and the FIGs is likely to resist any diminution of its financial or political control. Still, the proposal indicates a path open to Russian authorities should the FIG model, the banks, or the currency collapse in the near future. The Russian public would surely favor this reform.

If Russia fails to develop real banks in the near future, we doubt that the Russian economy or its people are likely to enjoy the benefits of sustained growth anytime soon. There may be other ways or modifications of our approach that would also improve the prospects for growth. But repeated hortatory claims about so-called market reforms and *The Coming Russian Boom* have thus far failed to produce growth. Nor have these claims provided constructive options for Russia's people or its policy makers. It's time to come forth with fresh ideas. This volume is a step in that direction.

POSTSCRIPT

What does the future portend if Russia fails to establish real independent banks? The starting point of Russia's commercial banking system is that each bank, apart from the state Savings Bank, has faced a daily scramble to survive since its birth. This book describes how the government has resorted to multiple, creative, direct, and indirect means of injecting fresh assets into the country's ersatz banks to make them appear solvent and liquid. All these means—whether it be Central Bank accommodation of interenterprise credit, high-yield government bonds, low equity transfer prices, resale of equity to foreign investors, IMF loans, eurobonds, or the issue of bank and corporate *veksels*—have something in common. They rest, ultimately, on the transfer of real wealth from the country at large to the banks and their industrial partners or holdings.

The wealth and income of Russia currently derive from its vast stock of oil, gas, minerals, timber, and other natural resources. Since 1991, the government has been drawing down its sources of wealth to sustain the banks, in the hope of jump-starting growth, by transferring control over an increasing share of these assets to a handful of favored, privileged firms and, in lesser degree, to foreigners. Once the government has privatized the last of its natural resource firms, it will have exhausted its ownership of real resources and its ability to continue to furnish new sources of capital to the banks.

It is this process of fresh asset injections that has kept the banks in business even though they have been collectively insolvent and illiquid at virtually every point in time. But the government will soon run out of assets to inject. To make matters worse, in the year 2000, the Russian government will have to begin repaying the IMF in amounts larger than it expects to receive.

Table 7 provides an overview of Russia's financial system as

Table 7. International Solvency and Liquidity of the Russian Financial System, January 1998 (claims on foreign assets without foreign debt to the former Soviet Union denominated in nonconvertible currency against foreign claims on Russian assets) ($ billion)

	FISCAL AUTHORITY			MONETARY AUTHORITY			COMMERCIAL BANKS			CORPORATE SECTOR AND SUBNATIONAL GOVERNMENTS			TOTAL		
	Total	*Long term*	*Short term*	*Total*	*Long term*	*Short term*	*Total*	*Long term*	*Short term*	*Total*	*Long term*	*Short term*	*Total*	*Long term*	*Short term*
Assets															
Total				21.3	3.5	17.8	11.3	3.4	7.9	5.0	3.0	2.0	37.6	9.9	27.7
Reserve assets				17.8		17.8							17.8		17.8
Currency				12.9		12.9							12.9		12.9
Gold				4.9		4.9							4.9		4.9
Nonreserve assets				3.5	3.5		11.3	3.4	7.9				14.8	6.9	7.9
Equity (est.)										5.0	3.0	2.0	5.0	3.0	2.0
Liabilities															
Total	150.8	132.3	18.5	13.3	0.2	13.6	18.1	3.7	14.4	30.5	30.0	0.5	212.7	166.2	46.5
Loans (including eurobonds)	134.5	130.5	4.0	13.1		13.6	18.1	3.7	14.4	4.0	3.5	0.5	169.7	137.7	32.0
Bonds (GKO and OFZ)	16.3	1.8	14.5										16.3	1.8	14.5
Other				0.2	0.2								0.2	0.2	
Stocks and corporate bonds (est.)										26.5	26.5*		26.5	26.5	
Net	−150.8	−132.3	−18.5	8.0	3.3	4.2	−6.8	−0.3	−6.5	−25.5	−27.0	1.5	−175.1	−156.3	−18.8

Source: Russian Central Bank, various releases

*Quasi long term

Note: Figures may not add due to rounding

of January 1998. The data are segregated into long- and short-term dollar assets and liabilities of the government (fiscal authority), the CBR (monetary authority), the commercial banks, and the corporate sector.[2] On January 1, 1998, net international reserves (NIR) of the Central Bank stood at about $4.2 billion. (By March 1, 1998, net international reserves had fallen to $0.5 billion.) The actual sum of foreign reserves available to the CBR is higher, closer to the published "gross international reserves," or reserve assets, figure. In the table, multiyear IMF loans are counted as short-term liabilities even though most of them are greater than one year in duration and even though IMF repayments due in 1999 and 2000 are likely to be offset by new IMF and World Bank loans.

Thus the bulk of Russia's official gross international reserves, which amounted to just under $18 billion in January 1998, is available to defend the ruble—unless the IMF were to raise objections to running up an official, large, negative "net" position. Breaking an IMF target on the level of NIR is strongly discouraged, although the IMF has let this and other rules slip in the past, when slippage served its convenience. The gross reserves include $4.9 billion in gold, but it is highly unlikely that Russia would or could sell much of its gold reserves overnight, which leaves only $13 billion in liquid gross reserves.

Turning to the commercial banks, their net, short-term foreign liabilities amounted to about $7 billion, a figure that substantially exceeds the CBR's net international reserves. As inflation and interest rates came down, Russian banks headed for the international credit markets en masse. Foreign banks were eager to lend to Russian banks at Libor (London interbank offered rate)

2. Russian holders of dollar accounts in Russian banks are not included in these figures; withdrawals from these accounts do not affect international payments. But they still can add to a currency crisis if the money demand among Russians shifts from rubles to dollars.

plus 3 to 5 percent, given Russia's promising economic prospects. As a result, Russian banks rapidly increased their foreign liabilities in 1997. It was this exposure to the commercial banking system that compelled the CBR to defend the ruble in late 1997 at any cost.

The corporate sector also has net foreign liabilities, consisting largely of $26 billion worth of stock, but most of this can be regarded as quasi long term. It is not possible for foreign investors to sell more than a small chunk of Russian equity for dollars at any point in time. Daily turnover on Russia's stock exchanges is well below $100 million, and most of this volume takes place between domestic buyers and sellers. Foreign holders of equity in Russia are, perforce, in it for the long run whether they like it or not. It is much easier to liquidate bonds and convert the proceeds into dollars than to do the same for equities. Indeed, the corporate sector enjoys positive short-term assets in that its holdings of foreign securities and real estate in Western market economies can be liquidated overnight.

Yet another problem area is the shrinking trade balance, which was running in late 1997 at half (or less) the level of the past few years. Depending on the accuracy of the forecasts, a current-account deficit may occur in 1998. Oil prices are at near record lows. At $13 a barrel, the production of oil for export is no longer profitable for many companies.

The problem that confronts the CBR is, as we have demonstrated, the country's fiscal situation. As of January 1998, $14.5 billion worth of short-term Treasury bills was in foreign hands. To this must be added another $4 billion in short-term loans and eurobonds, putting net short-term foreign liabilities at $18.5 billion. Massive foreign dumping of GKOs is enough to bring the ruble down, which explains why the government raised its refinance rate sharply, from 18 to 42 percent during the latter weeks

of 1997 (although it was able to reduce, in several steps, the rate back to 30 percent in mid-March 1998).

If our analysis of the ill health of Russia's financial system is correct, what accounts for a partial decline in interest rates on government debt in the first quarter of 1998 and the success of Russian banks, enterprises, and local governments in raising funds in the eurobond market during the first half of 1998? The nine-month GKO fell to just under 27 percent in a successful auction during the first half of March, even though Moody's downgraded Russian foreign currency debt, both public sector and corporate bonds, to Ba3 on March 11, 1998, saying that Russia remained vulnerable to shock waves from the Asian financial crisis. GKO rates had stood at more than 40 percent in late 1997. In early March 1998, the Moscow City Telephone Network (MGTS in Russian) successfully placed a three-year, $150 million eurobond. The issue was oversubscribed, launched at a price equal to U.S. Treasuries plus 690 basis points (U.S. Treasuries plus 6.9 percent) and was performing well in secondary market trading. That was a remarkable turnaround, as an attempt one week earlier by another Russian firm, Almazy Rossii-Sakha, to place eurobonds fizzled and was withdrawn. Encouraged by MGTS's successful placement in the eurobond market, the federal government raised lira- and deutsche mark–denominated eurobonds during the first four months of 1998.

Russian debt commands a high premium over U.S., European, and other emerging market debt. During the first week of March, for example, Russian sovereign debt was trading at a premium of about 5.4 percentage points over ten-year U.S. dollar-denominated eurobonds. Only Indonesian bonds commanded a higher risk premium among all emerging market debt. The bonds of major Russian banks, such as Uneximbank and Alfa Bank, were trading at anywhere from 1,100 to 1,800 basis points above U.S. Treasuries, compared with smaller spreads of 400 to 490 points

during July and September 1997. Russian bank debt is exceptionally high risk, as those spreads indicate.

The Russian debt market is not for the faint of heart. It pays high returns but poses high risk. But in a world of flush global money managers, the amount of money placed in Russian debt, or equities, is literally a drop in the bucket of daily investment allocations. The total value of Russian foreign debt is a tiny fraction of a percentage point of global debt markets. Daily turnover in Russia's stock markets is swamped by daily trading in just one or two U.S. large capitalization stocks. Since money managers are under pressure to secure higher returns in just fractions of a point, placing a tiny portion of their funds in the Russian market appears to be rational.

The increase in the value of U.S. household assets between 1986 and 1996 reveals an explosion in funds looking for higher returns. The U.S. Federal Reserve Board reported that, during those years, GDP increased about 75 percent, while the value of pension assets rose about 180 percent, Treasury securities just under 200 percent, corporate equities about 230 percent, and mutual funds some 370 percent. The value of household assets grew much faster than GDP. A similar pattern—of asset growth exceeding GDP growth—also applies in Europe. All this money has to be put to work somewhere, and global asset allocation is now part of the standard investment decision.

Russia offers higher returns than the lower-risk markets of the United States and Europe. From the standpoint of money managers, it is rational to take a small stake in Russian financial instruments since it holds the promise of higher returns. As events in late 1997 indicated, however, money can flow out of Russia even faster than it comes in.

It is equally rational for Russia's federal government, banks, enterprises, and regional governments to tap the eurobond market. By raising foreign loans, the government can finance its deficit

at lower interest rates, which also eases the pressure on domestic ruble interest rates as the government reduces its need to borrow domestically. Russian banks can make productive use of foreign cash by profiting on the difference between foreign and domestic interest rates. Russian enterprises can raise money abroad at cheaper rates than at home. Regional governments need cash any way they can get it. Every domestic player in the Russian economy has an incentive to borrow abroad. Western money managers, flush with cash, are eager to capitalize on the higher spreads of Russian debt and potential higher returns from Russian equities, which is what happened during 1996 and 1997, until the Asian currency crisis spilled over into Russia's financial markets.

As the outstanding stock of Russian foreign debt increases, the system as a whole comes under greater risk, much as happened throughout Asia before the currency crisis that erupted during the second half of 1997. The net short-term debt of the Russian financial system at the start of 1998 was $18.8 billion, owing largely to eurobonds and foreign ownership of domestic bonds (see table 7). As the federal government, regional governments, banks, and enterprises increase their stock of foreign debt, the net short-term liabilities, or exposure, of the financial system increases in tandem. All this debt is explicitly or implicitly guaranteed by the government and the Central Bank. When the next ruble scare erupts, for whatever reason, the pressure on the financial system will be even greater.

Foreign borrowing in and of itself is not necessarily harmful. But it imposes special risks in the case of Russia because there is no real banking system and because the banking system is an integral part of a single financial system combined with the Central Bank and the government (the fiscal authorities). It is exactly this problem that has been the focus of this volume, especially given the country's fiscal situation.

All things considered, the state of Russia's external accounts

is, to say the least, precarious, as is the hard-won ruble stability. Total short-term liabilities exceed gross international reserves by a substantial margin. To the extent that the country succeeds in placing large amounts of new foreign bond issues, either by the federal and regional governments or the banks and their enterprises, net short-term foreign liabilities will rise, thus exposing Russia's financial system to even greater risk in the event of a fresh outbreak of the Asian currency crisis. In that event, interest rates would have to rise substantially to defend the ruble.

To the extent that the government is forced to pay high interest to defend the ruble, the banks can continue to remain in business by earning high interest on their government debt, but this will come at the expense of real investment and growth. What might the government do after it runs out of natural resources to transfer to the banks? It might seek to reassert control over some or all of the natural resources previously given to the banks on subsidized terms or devise schemes to recover control over previously privatized oil, gas, and strategic minerals.

Another approach might be to change the flow of funds connected with the export and sale of natural resources, in which the proceeds of sales flow first through the state, leaving the FIGs with the residual claims after the government has extracted whatever share it wishes. This would reverse current practice, in which FIGs secure the earnings and then pay taxes when and if they wish. This second approach nicely fits the model of Moscow mayor Yuri Luzhkov, a prospective candidate for the July 2000 presidential election. The city government is reputed to take a cut of all investment flowing into the Moscow region and a cut in the earnings of Moscow-based enterprises.

A third approach is to force the FIGs to issue shares to the government, which would give it effective control over the proceeds of natural resources. The Moscow City Telephone Network, for example, in early 1998 authorized a 50 percent increase

in its shares, which it then transferred to the city government at no charge. This was a further integration of an ostensible private enterprise with a political entity.

It is hard to see where this vicious circle will end, until and unless Russia develops real banks. We have put forth one proposal for such a reform. We welcome others. But the failure to establish real banks in Russia, which remain independent from both the government and the CBR, suggests continued stagnation. Time may be running out on the hard-won existence of the Central Bank if ersatz banks do not give way to real banks in the near future.

THE LAST FOOTNOTE

The flight of foreign capital from Russia in 1998 exposed the extent of the insolvency of the Russian financial system and shattered Russian financial statistics. The combined net foreign assets of the CBR and the commercial banking system fell into the negative column in February 1998, exceeding minus $1 billion, falling to minus $2 billion in March, although they nearly recovered to zero in April. Net international reserves appeared to be zero or even slightly negative in March—a big red flag for the IMF.

As 1998 unfolded, it became technically impossible for the CBR to maintain a consistent set of financial accounts that purported to show a solvent banking system because the CBR found itself in a negative net short-term dollar position. This meant that it could no longer offset the dollar deficiencies of the commercial banks as it, too, was deficient in dollars. At this point, the multiyear pretense of a solvent banking system was no longer important, as the CBR was on the brink of violating its agreements with the IMF. It should be noted that, in selling dollars to protect the ruble within the exchange-rate band, the CBR reduced the

stock of domestic currency, thus weakening the balance sheets of the banks. The economy, which in 1997 exhibited feeble signs of bouncing back from a protracted depression, ground to a halt in 1998.

After not disclosing information on the banking sector for a few months in early 1998, the CBR in April 1998 released a new series showing that the true volume of deposits and bank assets was lower than previously reported. The change was due to the fact that the assets and liabilities of defunct banks, whose licenses had been revoked, were now excluded from the revised statistics. Astonishingly, throughout 1997, the CBR had counted in the official series the financial claims of nonexistent banks. The new CBR series also showed that the volume of various bills of exchange in the banks' portfolio of assets, whose real value is overstated, was higher than previously believed. In addition, the CBR ceased publishing the amount of nonperforming loans and other disaggregated data on the banks. These gaps, which it is hoped will be remedied at some future date, would make it possible to apply our revised balance sheet framework to the Russian banking system for the beginning of 1998 and beyond.

However, a few new inferences can be made now. First, the structural insolvency of the banking system is deeper than we documented and reconstructed in tables 2 and 5. Second, the ruble is even shakier than we implied in tables 6 and 7. These revelations render our overall analysis inadvertently optimistic.

The hard-won stability of the Russian currency looks less and less sustainable, not only in the long run but also in the short run. Another global or domestic crisis may bring a devaluation that could reignite inflation and further depress the economy. A reform along the lines we propose, or one with similar objectives in mind, seems no longer to be merely an intellectual exercise but rather a salvaging operation of a country in which the United States and the world have obvious stakes.