February 18, 2000
O.V. Viugin

THE MACROECONOMIC POLICY (Section Contents)

3. Tax Reform.
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4. Structural Factors of Stability
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6. Main Principles of the Monetary Policy.
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During the forthcoming period, the macroeconomic stability in Russia will be passing serious ordeals. The factors that are capable of significantly undermining the macroeconomic stability lie on the budget side and on the balance of payments side. On the budget side, those include a forthcoming tax reform, whereby the nominal tax burden would be reduced, and the servicing of the high foreign debt, which, if effected in full, will require an equivalent of 9 to 10 percent of GDP. On the balance of payments side, there are risks generated by the fluctuation of prices for Russian exportable raw materials, as well as the risks caused by possible material changes in the capital account. If taking place together, these changes may cause the need in a painful adjustment of the fiscal policy and in sterilization of the excessive ruble–denominated liquidity.

Even supposing that in the few years to come the Russian economy would show sufficiently high rates of development, for instance, 5-6 % per annum, the cost of servicing of the foreign and domestic sovereign debts over these years would reach 8-9 % of GDP. Given this heavy debt burden, a situation is unavoidable with a hard taxation pattern along with inadequately poor (as compared with the taxation) services provided by the state. This mismatch can lead to there being no sense at all in paying taxes, therefore, to low tax collection. A possibility of conducting a tax reform of any kind would be blocked, which would have an adverse effect on the growth rate of the economy.
The tax reform is fraught with a hazard that, notwithstanding the fact that a decision on reducing the nominal tax burden is obvious and correct, in 2001-2002 there could occur a temporary reduction of tax proceeds of the consolidated budget.

Therefore, an optimal plan for revising the tax rates, conditions and rules applicable to taxation should be elaborated.

The catastrophic slump of prices for Russian exportable products in 1998 played an important role in the development of the financial crisis in August of the same year. In the second semester of 1999, there was a sharp improvement in the price situation with Russian exportable raw materials. Along with considerable curtailing of imports due to depreciation of the ruble, this led to the formation of a significant external surplus, using which it was possible, despite a sharp aggravation of the capital account and continuing capital flight, to finance the largest share of payments on account of the external debt and to slightly increase the size of the national foreign exchange reserves. The ruble–denominated liquidity generated through the purchases by the Bank of Russia of foreign exchange from the exporters was partly sterilized due to accumulation of the primary surplus of the federal budget and partly, due to the post-crisis growth of demand for the national currency. On the whole, however, the level of the surplus and the drop in the circulation rate were insufficient to prevent the appearing of the excessive ruble liquidity on the financial market, because the Bank of Russia refrained from excessive strengthening of the ruble. Obviously, in the next few years it would be advisable to refrain from too fast strengthening of the ruble in order to support competitive power of Russian enterprises on the home market during their restructuring. Furthermore, it cannot be ruled out that the prices for Russian exportable products could undergo a considerable decline and then, following a period of strengthening of the ruble in real terms, its painful depreciation would have to be carried out in order to support the balance of payments. On the contrary, in case of favorable developments in the political and economic situation in Russia the strengthening of the capital account is possible, too, which may manifest itself in the reduced net outflow of capital or even its inflow into this country. If under those circumstances a policy of strengthening the ruble continues on a limited scale, then large–scale measures would be needed for sterilization of the excessive liquidity, although there are obviously certain limits to such a policy.

Therefore, due to strong dependence of the balance of payments on the exportable prices situation and capital movements, along with the significant debt burden on the budget, the macroeconomic situation in Russia will be rather difficult to manage in the next few years.

2. **Debt Strategy.**

It looks obvious that Russia will need to have its debt burden relieved in the long term. The understanding of this issue by the creditors have already been reflected in the decision of the Paris Club that granted a two–year deferral to Russia on the FSU debt and expressed an intention to conduct negotiations on the global debt burden relief in the fall of 2000. Quite recently, the London Creditors Club has agreed to write off approximately 36 percent of the
FSU debt to the Club and has granted a 30-year debt rescheduling. One can suppose that the Paris Club would propose more or less similar conditions of debt relief. This means that over the next five years the annual payments on account of the external debt would amount to US$12 billion to US$14 billion, or 6% to 7% of GDP. A realistic level of payments should not exceed 4-5 % of GDP. Obviously, for maintaining the solvency and internal financial stability for the next few years Russia would need annual external financing in the amount of US$3 billion, or 1.5% of GDP. Quantitative parameters of such a strategy are given in the table below. In the long term, the strategy should provide for a considerable reduction of the state debt to a level not exceeding 50% of GDP, while new borrowings should be mostly made exclusively for the purpose of debt profile management and optimization of the debt servicing cost.

3. **Tax Reform.**

Mr. S.D.Shatalov has presented the text for this section in hard copy. On February 16, 2000 the text will be also presented in the electronic form.

4. **Structural Factors of Stability.**

Mr. Gavrilenkov promised to present this section, but has not done so. I can write it myself, but it would take me another week to complete.

5. **Requirements to the Fiscal Policy.**

The main challenge of the fiscal policy is to lay ground for the financial stability in the medium term. To this end, over the next few years it is necessary to provide accumulation of the primary surplus of the budget that would be sufficient to commence the process of reduction of the state debt at least to a level of 60% of GDP. Afterwards, a long–term fiscal strategy should provide for a gradual cessation of large borrowings both internally and externally so as to significantly reduce the public debt. In a shorter term, the role of the budget as a liquidity regulator in the financial sector is bound to increase. Accumulation of the primary surplus will also play an important role in the sterilization of the ruble liquidity generated through accumulation of foreign exchange reserves by the Bank of Russia’s purchasing of convertible currency from the foreign exchange market. In order to have this issue resolved, it is required to provide a further growth in tax collections and exercise thorough control over the levels and directions of spending. The task of raising the federal budget revenues up to 14-15% of GDP looks quite realistic conditional on the provision of a further growth of financial flows among enterprises and elimination of barter and noncash forms of settlements among enterprises and budgets. In this case, a task can be set of maintaining the achieved level of noninterest expenses of the federal budget for the years to come while simultaneously reaching the primary surplus of 3.5% of GDP, which is sufficient to prevent a further growth of the public debt, and bringing its share in the GDP down to 70%
as soon as by the year of 2002. The major macroeconomic parameters, characteristics of the budget and those of the public debt are given in the table below.

### Table: Macroeconomic Indicators and the Budget: Russia in 2000-2002.

<table>
<thead>
<tr>
<th>Macroeconomic Indicators</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>3.2</td>
<td>3.5</td>
<td>2.4</td>
<td>3.8</td>
</tr>
<tr>
<td>– relative to the previous year, %</td>
<td>3.2</td>
<td>3.5</td>
<td>2.4</td>
<td>3.8</td>
</tr>
<tr>
<td>– billion rubles</td>
<td>4476</td>
<td>5754</td>
<td>7017</td>
<td>8398</td>
</tr>
<tr>
<td>– billion US dollars</td>
<td>182</td>
<td>190</td>
<td>205</td>
<td>224</td>
</tr>
<tr>
<td>Gross investment, % of GDP</td>
<td>10.0</td>
<td>9.8</td>
<td>10.4</td>
<td>11.2</td>
</tr>
<tr>
<td>Inflation (consumer price index), %</td>
<td>60.9</td>
<td>24.2</td>
<td>19.1</td>
<td>15.3</td>
</tr>
<tr>
<td>– GDP deflator (year-to-year)</td>
<td>60.9</td>
<td>24.2</td>
<td>19.1</td>
<td>15.3</td>
</tr>
<tr>
<td>– December-to-December rate</td>
<td>36.5</td>
<td>25</td>
<td>18</td>
<td>15</td>
</tr>
<tr>
<td>Exchange Rate, rubles per US dollar</td>
<td>24.6</td>
<td>30.2</td>
<td>34.2</td>
<td>37.5</td>
</tr>
<tr>
<td>– annual average</td>
<td>24.6</td>
<td>30.2</td>
<td>34.2</td>
<td>37.5</td>
</tr>
<tr>
<td>– by year-end</td>
<td>27</td>
<td>32.7</td>
<td>37.5</td>
<td>41.8</td>
</tr>
<tr>
<td>Real Exchange Rate, as percentage of the 1997 level.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance of Payments Indicators, billion US dollars</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– export of goods</td>
<td>74.5</td>
<td>78.9</td>
<td>80.8</td>
<td>83.9</td>
</tr>
<tr>
<td>– import of goods</td>
<td>40.3</td>
<td>43.6</td>
<td>47.0</td>
<td>51.3</td>
</tr>
<tr>
<td>– balance of trade</td>
<td>34.2</td>
<td>35.3</td>
<td>33.8</td>
<td>32.5</td>
</tr>
<tr>
<td>– current account balance</td>
<td>24.6</td>
<td>25.8</td>
<td>24.3</td>
<td>23.0</td>
</tr>
<tr>
<td>– capital account balance (less the IMF)</td>
<td>-21.4</td>
<td>-21.9</td>
<td>-19.4</td>
<td>-17.4</td>
</tr>
<tr>
<td>Gross International Reserves</td>
<td>12.5</td>
<td>13.2</td>
<td>16.6</td>
<td>18.2</td>
</tr>
<tr>
<td>– billion US dollars</td>
<td>12.5</td>
<td>13.2</td>
<td>16.6</td>
<td>18.2</td>
</tr>
<tr>
<td>– months of import of goods and services</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>For information:</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>World average price for crude oil, Urals, US dollars per barrel</td>
<td>17.4</td>
<td>17.6</td>
<td>18.0</td>
<td>18.0</td>
</tr>
<tr>
<td>Budget Indicators</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues</td>
<td>606</td>
<td>851.6</td>
<td>989.4</td>
<td>1242.9</td>
</tr>
<tr>
<td>– in billion rubles</td>
<td>606</td>
<td>851.6</td>
<td>989.4</td>
<td>1242.9</td>
</tr>
<tr>
<td>– as percentage of GDP</td>
<td>13.5</td>
<td>14.8</td>
<td>14.1</td>
<td>14.8</td>
</tr>
<tr>
<td>Expenditures</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– interest expenses, billion rubles</td>
<td>157.9</td>
<td>205.5</td>
<td>260.6</td>
<td>310.7</td>
</tr>
<tr>
<td>external debt</td>
<td>98.4</td>
<td>142.2</td>
<td>201.9</td>
<td>254.9</td>
</tr>
<tr>
<td>domestic debt</td>
<td>59.5</td>
<td>63.3</td>
<td>58.7</td>
<td>55.8</td>
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</table>

<table>
<thead>
<tr>
<th>Macroeconomic Indicators</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>– interest expenses as percentage of GDP</td>
<td>3.5</td>
<td>3.6</td>
<td>3.7</td>
<td>3.7</td>
</tr>
<tr>
<td>– noninterest expenses, billion rubles</td>
<td>514.0</td>
<td>667.3</td>
<td>747.2</td>
<td>942.2</td>
</tr>
<tr>
<td>– noninterest expenses, as percentage of GDP</td>
<td>11.5</td>
<td>11.6</td>
<td>10.6</td>
<td>11.2</td>
</tr>
<tr>
<td>Total Deficit</td>
<td>65.9</td>
<td>21.2</td>
<td>18.4</td>
<td>10.0</td>
</tr>
<tr>
<td>Primary Surplus</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– billion rubles</td>
<td>92.0</td>
<td>184.3</td>
<td>242.2</td>
<td>300.7</td>
</tr>
<tr>
<td>– as percentage of GDP</td>
<td>2.1</td>
<td>3.2</td>
<td>3.5</td>
<td>3.6</td>
</tr>
<tr>
<td>Net External Financing</td>
<td>22.1</td>
<td>3.0</td>
<td>-65.0</td>
<td>-37.5</td>
</tr>
<tr>
<td>– borrowings (ignoring those from the IMF)</td>
<td>54.1</td>
<td>60.5</td>
<td>68.4</td>
<td>75.0</td>
</tr>
<tr>
<td>– principal repayment</td>
<td>32.0</td>
<td>57.5</td>
<td>133.5</td>
<td>112.5</td>
</tr>
<tr>
<td>Net Internal Financing</td>
<td>43.8</td>
<td>18.1</td>
<td>83.4</td>
<td>47.5</td>
</tr>
<tr>
<td>Public Debt as of End–Period</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– as percentage of GDP</td>
<td>96</td>
<td>88</td>
<td>79</td>
<td>71</td>
</tr>
<tr>
<td>including internal debt</td>
<td>534</td>
<td>504</td>
<td>475</td>
<td>455</td>
</tr>
<tr>
<td>Public External Debt, billion US dollars</td>
<td>153</td>
<td>150.8</td>
<td>147.9</td>
<td>146.9</td>
</tr>
<tr>
<td>– interest payments</td>
<td>4.0</td>
<td>4.7</td>
<td>5.9</td>
<td>6.8</td>
</tr>
<tr>
<td>– principal repayment</td>
<td>5.0</td>
<td>5.5</td>
<td>5.0</td>
<td>4.2</td>
</tr>
<tr>
<td>including to the IMF</td>
<td>3.7</td>
<td>3.6</td>
<td>1.1</td>
<td>1.2</td>
</tr>
<tr>
<td>External Debt Payments by the Bank of Russia</td>
<td>0.6</td>
<td>0.6</td>
<td>0.5</td>
<td>1.5</td>
</tr>
<tr>
<td>External Borrowings</td>
<td>1.4</td>
<td>1.2</td>
<td>3.0</td>
<td>2.0</td>
</tr>
<tr>
<td>including those from the IMF</td>
<td>0.6</td>
<td>0.6</td>
<td>2.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Tied Loans</td>
<td>1.4</td>
<td>1.4</td>
<td>1.0</td>
<td>1.0</td>
</tr>
</tbody>
</table>

6. Monetary Policy

The undoubted progress achieved by Russia’s monetary authorities in reducing the rate of inflation does not allow supposing the normalization of the monetary policy in Russia has taken place. There are three main arguments in favor of this opinion:

The federal budget has been the main source of demand for the Bank of Russia’s additional liquidity. The fact that the Government did not receive the budgeted external loans made it more actively use the Bank of Russia’s credits in order to service its obligations under the portion of the external debt that Russia has agreed to fully service.
The Bank of Russia found itself to have a very limited choice of instruments for the conducting of the monetary policy and management of aggregate liquidity. Foreign exchange transactions have become nearly the only instrument available.

A relatively steady (not growing) demand for rubles by the nonfinancial sector of the economy has resulted in the emerging of the problem of money overhang, excessive liquidity accumulated by the banking sector.

**Crediting the Government**

The needs of the federal budget in the provision of financing of its expenditures obviously exceed its revenue capacity or ability to attract sources of financing from the market. Given this, the Russian authorities, beginning late September 1998, resumed actively and consistently the policy of state debt monetization by using the Central Bank credits for financing the needs of the federal budget in the servicing of its obligations. As a result, the growth of money supply is caused to a significant extent not by the growing demand for money by the economy, but rather by the budget’s needs in financing its expenditures. For instance, over the last 100 days in 1998, the share of the budget\(^1\) in the increase of reserve money reached about 68%, while the same indicator for 1999 was equal to 65%.

**Financial markets**

A second and, perhaps, more important from the institutional point of view, consequence of the monetary policy oriented to the meeting of needs of the budget, was that in the absence of an operational market for government papers and demand for money by the financial and nonfinancial sectors, the Central Bank has nearly completely lost the opportunities for liquidity regulation in the banking sector. The Bank of Russia did not have instruments other than transactions on the foreign exchange market for day-to-day regulation of the volume of money supply.

Ruble-denominated deposits attracted by the Bank of Russia served to a certain extent as a day-to-day regulator of this kind, although this instrument has a number of disadvantages. Firstly, the yield on deposits, especially short-term deposits, was staying at a very low level throughout the year. Secondly, deposits at the Bank of Russia are illiquid assets that are impossible to sell or pledge if there is a need in liquid resources.\(^2\) Thirdly, this instrument is unidirectional for the Bank of Russia, because its use can lead only to liquidity withdrawal, but it cannot help provide additional liquidity to the banking sector. Furthermore,

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1. The sum of the ruble-denominated credits from the Bank of Russia plus the ruble equivalent of foreign exchange-denominated credits plus government securities purchased by the Bank of Russia for the formation of the charter capital for the ARCO.

2. In mid 1999, the Bank of Russia allowed early withdrawal of banks’ deposits, however, at a two-days’ preliminary notice and with a significant loss in revenues.
the principles applicable to attraction of deposits and determination of interest rates on deposits do not allow the Bank of Russia achieving qualitative goals, making it take a passive stance, inasmuch as the initiative in the use of this instrument belongs to banks.

An obvious solution to the current Bank of Russia’s situation could have been either a restoration of the market for government borrowings, or an active use of bonds issued by the Bank of Russia. Initially, novation of government papers that dragged on for over six months and the related termination of transactions on the secondary market prevented the GKO–OFZ market from restoration after the 1998 financial crisis. Later on, in spite of the repeated statements on the possible issuance of new debt notes, the Ministry of Finance has never undertook this measure that is critical for the restoration of normal operation of the market and normal “dialogue” between the issuer and investors. The stance of the Ministry of Finance in this matter obviously had an exclusively fiscal explanation: new domestic borrowings, due to constraints on the level of budget deficit, were to become an alternative to the Central Bank credits, that alternative being more expensive and less convenient in terms of maturity, because borrowings from the financial market are possible to make for shorter periods, and their repayment is obligatory.

Bonds issued by the Bank of Russia, the decision on whose issue was taken back in the summer of 1998, could have served as an alternative instrument for the restoration of the financial market. However, initially the Government, under the influence of a deconstructive stance of the Federal Security Commission that deemed it illegal to have bonds issued by the Central Bank, made the Central Bank to suspend the issue of debt instruments pending adoption of appropriate amendments to the legislation. Later on, after the above amendments were adopted in July 1999, it was the Bank of Russia itself that did not use the opportunity at hand.

Thus, none of the two state institutions that were able to undertake practical steps for the restoration of the financial market has done anything to make it happen, this way constraining even more the capacity of the Government in day–to–day regulation of the money supply.

“*The money overhang*”

Every central bank in the world faces a challenge of regulation of the money supply, regardless of whether it is quantitative parameters of money aggregates or the level of interest rates that it uses for targets. At certain points in time, the need in a more active use of such instruments becomes especially acute. In case of the Russian situation, the monetary instruments, perhaps, are even more important, because one of the specific features of an economy in transition is an inescapable fight against excessive liquidity by the monetary authorities.

Inflow of capital into the economy and the related growth of foreign exchange reserves are the sources of such excess in countries that are successful in their reforms. This “threat” is
obviously not the case for Russia yet. However, one of the reasons that the Russian reforms have not been successful so far is the lack of independence of the monetary policy, whose trends are predetermined by the needs of the federal budget.

This kind of dependence unavoidably brings about a mismatch between the behavior of the money supply growth and the behavior of demand for money by the Russian economy. The events that took place in 1999 have shown that the financing by the federal budget will not only cover all the requirements for money in the economy, but will also regularly generate “surplus” ruble resources.

The banking sectors appears unable to absorb the liquidity generated by the Central Bank, because the demand for the ruble resources by the nonfinancial sector, obviously, cannot grow faster yet than does the economy, while the capacity of the financial sector is also limited due to the lack of sustainable operational financial markets.

As a result, from time to time there were considerable amounts of excessive monetary resources accumulated in the Russian banking sector, which were concentrated either at correspondent accounts with the Bank of Russia, or at bank deposits with the Bank of Russia. The volume of “excessive” ruble resources in circulation in the Russian economy can be evaluated at approximately 30 billion rubles, i.e. about 6% of the total amount of monetary reserves.

In the short term it is probably hard to rely on the large–scale use of Bank of Russia transactions on the open market for the purpose of liquidity regulation. Therefore, attention should mainly focus on the role of the budget in the management of monetary liquidity. In order to avoid serious damage to the level of noninterest expenses of the budget in doing so, it is necessary to use the reserve represented with the still high level of noncash forms of mutual settlements in the economy. Firstly, a consistent government policy in the area of tax collection in the cash form by all the budget levels is capable of significantly increasing the budget revenues, which can be partly used for accumulation of the required primary surplus without any damage to the noninterest expenses. Secondly, the amendments that are to be introduced to the current legislation (the Civil Code, the Law on Insolvency (Bankruptcy)) would allow the government and the natural monopolies to apply stricter measures against delinquent payers, which will undoubtedly give rise to a greater demand for money in the economy and will contribute to the improvement of the tax payments situation. The impact of these factors — greater demand for money and higher budget revenues — could result in making liquidity management quite a feasible objective.

7. **Restructuring of the Banking Sector.**

The banking sector is a key element in the economic infrastructure in any country. The traditional key objectives of the banking sector include effecting settlements among the economic agents domestically and internationally, as well as accumulation of savings and
their transformation into investments. During a banking crisis, there, as a rule, occur failures in the operation of the banking sector, and the whole sector or its significant part appears unable to execute its functions. Obviously, suspension by the banking sector of execution of its specific functions can cause destructive consequences for the entire economy. For precisely this reason, any government will conduct an active policy in order to restore operational capacity of the banking sector, with spending considerable funds for this purpose sometimes.

A policy aiming at overcoming the consequences of a banking crisis will generally include the following set of basic measures:

- **Anti-crisis measures**, the main objective of which is to maintain liquidity in the banking sector and to restore its function as an intermediary for effecting settlements, to overcome the panic among creditors and depositors and to end the run on banks;

- **Restructuring**, reorganization of the banking sector in order to clear up the banking sector, for which the government will activate bankruptcies of insolvent banks, stimulate and initiate the processes of bank mergers and takeovers;

- **Recapitalization**, aimed at restoration of the principal function of the banking sector — that of a financial intermediary — for which the government will apply efforts for increasing capital in the banking sector and upgrading the capital quality.

It should be noted that the above is a rather conventional classification based on an attempt to define the goals, hence, the tools that the state uses. Of course, in practice, no country has ever set itself a task of strictly demarcating the above measures in fighting the consequences of a banking crisis. On the contrary, diverse problems have quite often to be addressed in parallel to each other.

1. **Response to the Crisis by the Government and the Bank of Russia**

   Of all the problems on the agenda for the restructuring of the banking sector, the Russian authorities have fully accomplished only those pertaining to the initial, **anti-crisis measures**: stopping the run on banks and restoration of the functions of the banking sector as the payments organizer. A sharp liquidity increase in the banking sector was the main and quite obvious tool for addressing these issues. This was occurring simultaneously along several lines:

   - Initially, the Bank of Russia decided on reducing the legal reserve ratio for the banks, whose large portions of assets (over 20%) had been invested in the GKO-OFZs. According to our estimates, the banks have received approximately 4 billion rubles that way;
   - The Bank of Russia has provided significant liquidity support to Sberbank (RF Savings Bank) so as to allow its continuous operation in cashing the household deposits and thus
ensuring restoration of confidence of the population in the banking sector. There were various kinds of support provided (asset redemption and crediting), and according to the authors’ estimation, its total amount reached 25 to 30 billion rubles over August–September of 1998, of which Sberbank repaid about 15 billion rubles as the credits became mature by early November;

- In late September–early October of 1998, the Bank of Russia undertook a largely spontaneous reduction of the legal reserve ratio\(^3\), allowing the banks to partially use the legal reserves for effecting payments.

- According to our estimates, the reduction of the legal reserves because of this decision amounted to approximately 12 billion rubles. A similar measure for reducing a share of funds to be kept by commercial banks at the central bank was taken in Malaysia. There, however, a uniform decision was taken for all banks — the ratio was reduced from 13.5% to 4%;

- After the depreciation of the ruble, beginning in the second half of September of 1998, the Bank of Russia started to intensely purchase foreign exchange on the market. According to our estimates, the foreign exchange purchased by the Bank of Russia amounted to approximately 2 billion rubles by end–September, and for doing so the Bank of Russia had issued about 30 billion rubles.

- As from late September of 1998, the Bank of Russia started to extend credits for the financing of the federal budget deficit, their total amount reaching 10.5 billion rubles by end–October.

Over September and October overall, the Bank of Russia had provided additional liquidity to the banking sector in the amount of 80 to 90 billion rubles, or 8% to 9% of bank assets (which was equal to 3.0 to 3.1% of GDP). As a result, whereas in early September 1998 the total clients’ payments recorded in the balance sheets but not effected by banks amounted to 4.2 billion rubles, by early October the same value had grown to reach 14.7 billion rubles and by early November had reduced to 7.6 billion rubles. Therefore, by end–October of 1998, the banking sector had available sufficient liquidity for the restoration of normal operation of the settlement mechanism\(^4\).

At the same time, since October 1998, the Bank of Russia started to extend “stabilization credits” to certain individual banks (SBS-Agro, Bank of Moscow,}

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3 That can be viewed as a spontaneous measure because the Bank of Russia only introduced a ceiling (30%) for the use of legal reserves by banks, however, without practically controlling the directions of outgoing payments. Besides, banks that tried to effect their clients’ instructions by liquidating their assets found themselves in a disadvantageous position — having no ineffectuated payments, those banks could not have their legal reserve ratios reduced.

4 Undoubtedly, a significant portion of those funds went for increasing the volume of cash in circulation (which had grown by 33 billion rubles over the same period), which approximately equals to the amount of outflow of the household deposits from the banking sector over the same period.
MOST-Bank); however, the measures were aiming at resolving the problems of low liquidity and unprofitableness of those banks rather than at overcoming the liquidity crisis of the banking sector. Although, probably, those funds were partially used by the banks for effecting the previously deferred client payments.

Already on September 2, 1998 the Central Bank declared the launching of the work for bank restructuring.

An audit of banks’ capitals was to be the first step of the work. In compliance with the Bank of Russia instructions, all the banks were in one month’s time to evaluate their losses incurred due to the decline in quotations of securities, their commitments under the foreign exchange dealings, as well as to calculate the necessary increase in the provisions for losses from credits and bills of exchange due to aggravated financial standing of their borrowers. Based on the estimates calculated with paying due attention to the impact of the crisis on the standing of banks, the Bank of Russia intended to continue further efforts with supposed participation of international financial consultants, auditing firms, and investment banks. Without waiting for the results of capital revaluation, the Bank of Russia decided on introducing temporary management in two largest banks (SBS-Agro and Inkombank)\(^5\) that had practically lost their solvency and already by late August had incurred tangible financial losses. In a more or less similar situation the government of the Republic of Korea applied an even stronger measure to the two largest “dead” banks — nationalization.

Eventually, however, the Bank of Russia policy in this area appeared not resolute enough, which was especially striking against an active stance taken by the authorities in South East Asia.

The need in prompt revocation of licenses from insolvent credit organizations is caused, first of all, by the fact that actions taken by many banks as they were facing a crisis became illegal, increasing the clients’ losses. According to many reviewers, the pace of carrying out liquidation procedures by the Bank of Russia did not change and even slowed down in 1999. An intention of the Bank of Russia widely publicized in the fall of 1998 to accelerate the revocation of licenses of credit organizations so as to bring the number of liquidated banks up to 200-300 by the end of 1999 has never been implemented. The number of operational credit organizations was going down in 1999 by 1% per month on the average, which, by the way, is about one-half of what was the case in the second semester of 1998\(^6\). During the banking crisis in South East Asia, the authorities decided on much more resolute measures for license revocation. As the crisis began, operations of 7% to 17% of credit organizations in Korea and

\(^5\) Although the decisions had been doubted and suspended by the courts of first appearance, we believe that was a vivid demonstration of the Bank of Russia’s intentions.

\(^6\) According to the most recent statements made by the spokesmen of the Bank of Russia, licenses could be revoked from 50 credit organizations by the end of 1999. Therefore, the number of operational credit organizations could reach approximately 1,330 by early 2000.
Indonesia were suspended (in Thailand this level reached as high as 44%). Eventually, up to 27% to 37% credit organizations terminated their activity (in Thailand, 45%)\(^7\).

In a whole number of areas the Central Bank rejected continuation of the previously commenced actions that aimed to overcome the crisis. For instance, already in the middle of September the Bank of Russia had terminated its efforts for arranging the negotiations between Russian borrowers and foreign creditors on debt rescheduling for credits subjected to the moratorium of August 17\(^{th}\). Temporary management was recalled from the bank SBS-Agro; the Bank of Russia had never used its right of recovery of its pledged stock under a loan that the bank in question had failed to repay but, on the contrary, extended to the bank new credits to a total amount of more than 5.2 billion rubles.

Somewhat later, during negotiations with nonresidents on GKO-OFZ rescheduling, the Bank of Russia had lost a unique opportunity to “redeem” nearly all the debts of Russian banks to nonresidents under forward contracts — to do so, it was needed to agree to a certain increase of the amount of the down payment (in cash) when rescheduling the papers. As a result, the banks alone that are under the government control paid dozens of millions of dollars to nonresidents in meeting their liabilities.

The Bank of Russia’s decision made in late June 1999 on revocation of licenses from the six largest Russian banks came rather unexpectedly. There is no doubt that there were more than enough formal reasons for revocation of licenses from those banks. However, absolutely the same reasons existed and continue to exist with many other banks, to which this approach has never been applied. Moreover, in the fall of 1998 the grounds for revoking the licenses from most of the six banks had been much more serious: since that time two of the banks (Mezhkombank, UNEXIMbank) had conducted fairly successful negotiations with their creditors on debt rescheduling, the Bank of Moscow that enjoys support from the Moscow City Government and Moscow municipal budget started rehabilitation of another one of the six banks (Mosbusinessbank). It is quite likely that the main reason for making such a decision was a strict stance of the IMF that demanded from the Russian authorities compliance with their commitments of April 1999.

The stance taken by the IMF is clear enough: there is a banking crisis occurring in Russia, and, according to experience gained elsewhere, the quicker and more resolute is the manner in which the authorities fight its consequences, the less the losses for the economy are. The lack of timely actions by the Russian authorities for implementation of a reasonable strategy turned in that case into a strict requirement from the IMF, which, if viewed in isolation from the actual situation, looks fairly sensible — one should revoke licenses from insolvent banks.

Over the previous year there was a considerable aggravation of the problem of rather lengthy delays with liquidation procedures with respect to banks whose licenses had been

revoked. As a result, the number of “dead” banks is growing — as of early December 1999, there were 1025 such banks as against 1004 as of early 1999. Obviously, liquidation technologies do not allow handling a large number of dying banks. Previously, quite often there were no creditors of those banks who were interested in liquidation of dead banks, or the pace of liquidation processes was affected by the lack of adequate funds for conducting or completion of liquidation in a large number of banks. Whereas at this point in time, the key hindrance is the legal and technological imperfection of liquidation procedures, which gives the owners and managers of a bank under liquidation an opportunity to drag out its end for as long as they can. This is especially vividly exemplified by the largest banks, with respect of which liquidation procedures have been initiated (Inkombank, “Imperial”, MENATEP), where hundreds and thousands of legal or physical persons are the victims and, therefore, are interested in fast consideration of their cases. The practical experience with liquidation procedures has shown that owners and managers of bankrupt banks have truly unbounded capacity for impeding the process until it is blocked and comes to a full stop.

The Bank of Russia revoked Inkombank license on October 29, 1998. The bankruptcy proceeding started in November 1998 to be suspended on May 27, 1999. Since then, four more judicial sittings have been held, and at the last of the four, on October 7, 1999, the lawfulness of license revocation was confirmed, after which the bankruptcy proceeding should be resumed. MENATEP’s license was revoked on May 17, 1999, while the court took the decision on bankruptcy on September 29, 1999. The process of recognizing MENATEP bankrupt took more than four months and five judicial sittings. However, as the example of the bank “Imperial” shows, the fight can go on even after decision on bankruptcy is made. The license was revoked from “Imperial” on August 25, 1998; on May 25, 1999, following a lengthy litigation, it was recognized bankrupt, but on June 4, 1999 the Bank of Russia suddenly suspended its decision on license revocation. Since then, three more judicial sittings have taken place, and the legal status of the bank remains unclear until now.

The policies conducted by the Bank of Russia and the legislator look defensive and continuously lagging behind as far as this matter is concerned. Continuously facing the same problems in the course of liquidation processes, they should have generalized on their
experience to appropriately amend the legislation so as to prevent dragging out case consideration to the detriment of creditors and depositors.8

In an attempt to adapt the supervision and regulation practice for the banking sector as a significant part of the capital has been lost, the Bank of Russia has agreed to certain changes in the regulatory framework. Obviously, most of the changes pertained to the problem of capitalization of credit organizations. The blow on the capital base of Russian banks that was struck in the fall of 1998, required adjustment of the Bank of Russia’s stance regarding the methods of formation and methodology of calculation of bank capital. To this end, the following decisions were taken:

• In November 1998, bank shareholders were granted the right to effect payments on account of increase of the charter capital by credit organizations with material assets in the form of bank buildings.9 That measure by no means could contribute to an increase in the really disposed capital, and it is unlikely that many shareholders were divesting real property in favor of a dying bank; rather, it was the other way round.

• By March 1999, a procedure was developed for paying contributions to the charter capital of credit organizations through converting the credit organization’s liabilities into participation in its charter capital.10 We believe that decision was correct, although it came a little late. According to available information, there is actually only one bank (Avtobank) that implements this procedure.

• In May 1999, requirements to the minimal size of bank capital were canceled,11 with the exception of banks that have branches or subsidiaries outside of Russia, which is in line with international practice. There had been a fight going on between the banking community and the Bank of Russia for several years as the Bank of Russia attempted to

8 The stance taken by the banking community looks rather inadequate, being aimed at shifting the costs of the crisis to the extent possible on to the state as the banks themselves do not take any real steps for anti-crisis cooperation. After licenses had been revoked from a number of larger banks, the Association of Russian Banks (ARB) addressed the President of Russia in early July, noting, among other things, that “Instead of rehabilitation of banks that have lost their capitals mostly through the fault of the RF Government and the Bank of Russia, the RF Central Bank started a process of intense revocation of bank licenses.” In ARB’s opinion, support provided by the Bank of Russia to commercial banks was short and was limited to extending to some of them short-term, expensive credits in the amounts that were not adequate to resolve the problem of solvency restoration. Furthermore, in ARB’s opinion, the larger banks have become “problem banks through the fault of the Government and the Bank of Russia” and, in this connection, ARB suggests that “a decree should be issued by the President of the Russian Federation to instruct the RF Government to submit to the State Duma a draft law on the restructuring of the unpaid credits obtained by operational Russian commercial banks from foreign banks as public debt.”


10 CBR Instruction # 527-U of March 25, 1998.

11 CBR Instruction # 567-U of May 27, 1999.
establish a minimal capital size for banks at 1 million ECU. Despite the fact that about one half of the operational credit organizations did not meet this criterion in 1997-98, the Bank of Russia believed that their influence on the shape of the economy was close to nil\textsuperscript{12}.

- By June 1999, a procedure for making payments for the charter capital of credit organizations with government securities (OFZ-PD) was developed\textsuperscript{13}. This was again an entirely reasonable measure, although given low liquidity of the market for the above papers, actual proceeds to be obtained by the banks would be low.

At the same time, in October 1998 the Bank of Russia decided on introducing special standards for regulation of bank operations during the financial crisis, which made more than illusionary the effect of the supervisory standards. In accordance with that decision, banks were allowed until July 1, 1999 to undertake risks depending on their capital size as of August 1, 1998. In our view, calculation of economic ratios regulating operations of commercial banks based on the size of nonexistent capitals and the use of the pre-crisis ruble–to–US dollar exchange rate in the calculations (in accordance with the relevant instructions issued by the CBR) were not really meaningful. It is clear that application of pre-crisis ratios for the purpose of supervision could put nearly all banks into the group of banks that steadily violate all or nearly all standard ratios, and that was a fairly typical situation for countries facing banking crises. Traditionally, measures taken by the supervisory bodies in a situation like this include refusal of the use of certain individual ratios for a certain period of time, making some ratios indicative ratios, again for a certain period, application of special, less strict ratios. In all cases, however, the supervisory bodies have used actual information for appraisal of the shape of banks.

For instance, in Malaysia the definition of overdue credits was eased, in Thailand the capital adequacy ratios were reduced and the rescheduled overdue debts came to be considered real assets, Indonesia also revised the standards applicable to credit supervision and classification. At the same time, in the above countries more strict requirements were introduced for the standard provisions for losses from loans, credits to affiliated persons, and the size of the open foreign exchange position. It should be underlined that after the crisis the capital adequacy ratios applicable to investment banks were made stricter in South East Asia.

According to our estimates, 80-90% of the operational banks meet the current economic ratios (correspondingly, the share of problem banks does not exceed 20% of their total number, the share of assets of the problem banks in the total assets in the banking sector also not exceeding 20%, which is an evidence of a uniform distribution of larger and smaller banks among the problem banks). Like before the crisis, the use of maximum risk per borrower ratio or maximum risk per related borrowers ratio (H6 ratio) and the maximum risk per creditor

\textsuperscript{12} The Bank of Russia’s Reply to the Association of Russian Banks. \textit{Biznes i banki}, no. 21-22, May 27, 1998.

\textsuperscript{13} CBR Instruction # 571-U of June 8, 1999.
(depositor) ratio (H8) is disputable. Given the existing level of capitalization, these ratios will significantly restrict lending operations by banks, especially medium–sized banks.

One cannot but note here that in this area, too, the countries of South East Asia went significantly farther down the road — their position was based on a need to expand active operations of the banking sector. For instance, in Malaysia the similar ratios were reduced from 30% to 25% of the capital size after the crisis, and an indicative plan for an 8% expansion of the credit portfolio of banks was also announced for 1998 (in Thailand, for 7% in 1999). It is important to note that a national policy was in place in those countries for restructuring the corporate debts to banks. In Thailand, there is a consultative committee for corporate debt restructuring, and a similar committee was established in Malaysia, too. An Indonesian debt–restructuring agency, along with providing methodological support, acts as an intermediary between debtor companies and creditors.

2. Bank Restructuring Through A Regional Approach

The Bank of Russia has proposed some conceptual approaches to solving the problem of restructuring of the banking sector. Such an attempt was made back in the fall of 1998 when the Bank of Russia came up with a concept of a new structure of the banking sector. Later on, the concept was further elaborated in the "Program of urgent measures for restructuring of the banking sector in the Russian Federation" that was presented to the Government in October 1998. The core of the concept included definition of federally important banks (which, in their turn, were subdivided into state–owned banks and private banks) and “pillar” regional banks; these were the banks, on which the Bank of Russia thought it necessary to focus its supportive efforts. The attitude towards all other banks (large, but not federally important banks; medium, and small banks) was based on the principle of their total independence and lack of any interest of the authorities in their future. These latter banks were to either survive or die, depending on their own positions and efforts, they could not rely on support by the state, and they had to seek and occupy specific market niches (servicing narrow client groups, working on specific financial markets).

The rationale behind this approach was that the Bank of Russia proposed to carry out the process of demarcation between the viable and nonviable banks as soon as possible, identifying banks that were able to continue their operations (and disposed of or were able to "absorb" sufficient capital); banks, to which the state was going to render support; and banks that had to be liquidated. However, in that case the Bank of Russia lacked clear enough criteria for classifying banks by the group, had no administrative capacity for quickly liquidating insolvent banks, and had no constructive stance regarding the sources of funds needed to provide financial support to banks and the principles of allocation of such support.
The Bank of Russia proposed to break the operational banks down into the following groups:

**Group 1:** steadily operating banks that do not face large difficulties in the management of current liquidity and that are able to function without an additional state support addressing their current problems on their own;

**Group 2:** regional banks that were to become "pillar" banks in the future regional banking sector in Russia;

**Group 3:** individual larger banks that are unable to continue their banking activity on their own, but that are unreasonable to close down because of too high social and economic costs of their closure;

**Group 4:** banks that face a significant shortage in liquidity or own capital.

The above grouping was actually done based on three criteria, the first of which is relatively objective (financial standing: banks were distinguished into sustainable banks and problem banks), while the other two criteria were absolutely subjective. Out of all the banks, several groups were identified, including sustainable regional banks (i.e., those to become "pillar" banks), and the largest banks were treated separately as banks whose liquidation could cause "extremely undesirable consequences for the whole economy". For such banks individual restructuring strategies were to be used. As a result, the Bank of Russia faced the necessity of making numerous individual decisions regarding which of the banks that find themselves in a more or less similar situation should continue and which would be liquidated. The whole work for identifying the bank groups and agreeing on the composition of the list of "pillar" banks dragged on until the spring of 1999, so that the time was lost for making specific decisions.

Turning again to the experience of other countries, we look at Indonesia, where banks were classified in March 1999 by their financial standing alone into sustainable (74 banks), viable (9 banks), and nonviable (24 banks). Mergers were carried out among the sustainable banks, and almost all the viable banks received state investments in the first semester of 1999 through a bank–restructuring agency.

Based on the results of the work carried out, the Bank of Russia intended to identify 81 banks in 59 regions as "pillar" banks for the regional banking network, which totally accounted for about 5.4% of the total assets in the banking sector and about 10.8% of the total deposits of physical persons held at commercial banks (ignoring Sberbank). Of that number, 55 banks were identified as financially sustainable banks that were able to operate without financial support by the state, while the remaining 26 banks needed state support. The Bank of Russia deemed it inappropriate to identify "pillar" banks in 22 regions in Russia because of
"adequate" availability of banking services in the respective regions and also taking into consideration the stance of the regional executive authorities.\textsuperscript{14}

The weakest point in the proposals made by the Bank of Russia that led to their unfeasibility, after all, was the lack of elaboration of one of the most important aspects — sources of financing for the program of recapitalization of the banking sector. The Bank of Russia determined that 120 billion rubles was needed for the restoration of the banking sector back in the fall of 1998 to confirm the same estimate in the spring of 1999. However, the sources of financing for that program have never been identified. The Government believed that the measures were not to be financed by the budget; the Bank of Russia have not proposed any radical ideas of its own regarding the possibility of using its own resources; opportunities have not been identified for attracting outside sources of financing for the program, including the international financial institutions. Of course, there can be no simple and clear-cut solutions here. This is especially true for Russia that has to seek resources needed for the servicing of the external debt and maintaining social stability following the economic collapse.

Meanwhile, the state bodies view their participation in the banking sector restructuring as participation in the formation of the charter capitals of less large, as a rule, regional banks, or in the form of provision of financial support to the large Moscow–based banks.\textsuperscript{15} The Bank of Russia deems that “shareholders of banks with foreign capital participation could allocate 7.5 billion rubles for recapitalization, while 5 billion rubles would be obtained from domestic sources.” Certain hopes in the bank recapitalization are set on the activity of regional authorities (2.5 billion rubles). That, however, is doubtful considering numerous unresolved financial problems that the regions face. Therefore, the identified financial sources will only cover 25 to 30\% of the capital shortage in the banking sector. The government bodies, judging by the composition of the sources, are prepared for minimal participation by the banks’ shareholders in the recapitalization of the banking sector, tending to rely even more on foreign investors.

\textsuperscript{14} "On the Situation in the Banking Sector and Issues in its Restructuring", a presentation made by Chairman of the Bank of Russia, Mr. V.V.Gerashchenko at the Ninth Congress of the Association of Russian Banks.

\textsuperscript{15} There are some public officials who believe that establishment of the Russian Development Bank with a charter capital of 3 billion rubles provided by the budget will also mean significant advancement. At the same time, establishment of such a bank without its having a clear investment strategy, bearing liability for implementation of the latter and having potential sources of financing (apart from the budget) has no meaning at all. Over the recent years, the state has already established several banks with similar objectives (RosEximBank, Bank for Support of Entrepreneurship, All-Russia Bank for Regional Development, …), but none of them has proved its viability.

\textsuperscript{16} Proceedings of the Moscow Banking Forum, October 6, 1999.
3. **ARCO: A Policy or An Imitation?**

Until now, the main efforts applied by the state bodies (the Bank of Russia and the ARCO) have been focused on rendering provisional financial support and assistance in the restructuring to a few Moscow–based banks and a number of regional banks. Until April 1999 — up of active operations by the ARCO — the Bank of Russia had been extending to certain banks the so-called “stabilization credits” at soft interest rates. The total indebtedness of banks under the Bank of Russia credits was estimated at 12.2 billion rubles as of July 1, 1999, but the Bank of Russia has made public neither the principles underlying selection of banks eligible for support, nor the conditions on which the support was granted. The banks that have received credits from the Bank of Russia obviously differ very much one from another in terms of their financial standing and their prospects for the future; often their profits are even less than the benefits they gain from the difference in the interest rates (the Bank of Russia credits were extended at one-third of the refinancing rate as the market interest rates were two to two and a half times as high as the refinancing rate). The credits were extended for one year (the maximal statutory period for the Bank of Russia credits), and in the fall of 1999 the Bank of Russia actually resigned itself to those credits being unpaid and decided on their prolongation. In a situation like this, we think it is absolutely necessary for the Bank of Russia to assign the claims under such credits to the ARCO so that the Agency could control the process of rehabilitation of the respective banks along with the banks that receive credits directly from the ARCO.

The Agency for Restructuring of Credit Organizations (ARCO) started operation in the spring of 1999, although the Government had adopted first documents on its establishment back in the fall of 1998. Whereas in South East Asia the time lag between the appearance of the signs of an acute crisis and establishment of agencies similar to the ARCO was much shorter: 3 months in Thailand, 5 months in Indonesia, and in Malaysia alone it was as long as 10 months. Protracted debates in the executive and legislative authorities regarding ARCO’s status and objectives (that stopped only in the summer of 1999 with the enactment of the law “On Restructuring of Credit Organizations”), dragging out of the solving of organizational, financial, and personnel issues pertinent to its operation led to a situation where the Agency had no clear-cut vision of its operation before the middle of the summer of 1999 when the bulk of the financial resources allocated by the budget had already been spent. It is important to note that in South East Asia the financing of the restructuring agencies, although effected at the expense of the states and national banks, was to a large extent carried out through bonded loans, a mechanism that is very difficult to use in the Russian environment.

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17 Once the ARCO was launched, the Bank of Russia has practically withdrawn from addressing the issues of banking sector restructuring while “keeping” the matters of clearing (at the level of regional offices) of the plans elaborated by the credit organizations for their financial rehabilitation. Given that there are 252 credit organizations in the banking sector that meet the criteria set forth in the Bankruptcy Law, to date 195 banks have presented their financial rehabilitation plans while 50 banks have either come up with unrealistic measures, or taken no actions at all.
Pursuant to the Federal Law “On Restructuring of Credit Organizations”, a bank may be transferred under the ARCO management, provided that during the six preceding months:

– its share of household deposits amounted to at least 1% of the total household deposits held at credit organizations in the Russian Federation; and/or

– its share of assets in the form of credits extended to legal entities amounted to at least 1% of the total asset value of credit organizations in the Russian Federation; and/or

– its share of household deposits amounted to at least 20% of the total household deposits at banks located in a given subject of the Russian Federation; and/or

– its share of assets amounted to at least 20% of the total share of assets of banks located in a given subject of the Russian Federation.

And also provided, that its capital adequacy ratio as calculated in compliance with the law “On the Central Bank of the Russian Federation (Bank of Russia)” does not exceed 2%.

It appeared that only seven (!) banks (according to our estimates, 2-3 larger and a few smaller banks) were eligible under the above criteria. Which should imply that the time is ripe for their revision.

Currently, ARCO mostly works with small and medium banks implementing projects that are not large, while the bulk of financial resources has been allocated not for raising the level of capitalization in the banking sector, but for covering financial needs of the banks, i.e., actually, for rendering financial aid to the bank owners.

For implementation of credit organization restructuring projects, the federal budget has allocated 10 billion rubles, an amount that at the same time has formed the ARCO’s charter capital. To date, ARCO has already decided on the lines of spending for 7.5 billion rubles; work has begun on 14 projects covering 19 banks located in 10 regions; certain banks have already been transferred under ARCO management (SBS-Agro, AvtoVAZbank, “Rossiyskiy Credit”, Investbank, Kuzbassugolbank, “Peter the First” Bank, RNKB, and Chelyabkomzembank). Thus, ARCO is now “in control” of about 7% of assets in Russia’s banking sector.

The analysis of the available information does not allow finding a general logic or resulting purposefulness in ARCO operation. The Agency has not formulated yet its goals and objectives or principles for selection of banks and regions for the provision of support; moreover, we feel that until now ARCO has not achieved clear understanding of problems that Russian banks face.

Selection of banks by ARCO for their restructuring poses even more questions regarding the general direction of ARCO’s actions. For instance, one of the first bank to go under ARCO management was AvtoVAZbank, probably, the most “problem” bank in Samara
oblast, where, by the way, there is a sufficient number of banking institutions; a bank that had been suffering a most acute financial crisis since 1996, whose shareholders had not only been reluctant to help it, but, on the contrary, had taken all their financial flows from it. Since about the same time the distress signals had been coming from the bank “Eurasia”, whose most vigorous lobbyists included the authorities of the Republic of Udmurtia that had categorically refused to assist the bank with their own means, and “TverUniversalBank”, whose financial survey ARCO is about to complete now. In Chelyabinsk oblast, where again there is no real shortage in banks, ARCO has “undertaken care” of Chelyabkomzembank, whose accumulated losses amount to 11 million rubles and uncovered liabilities, 68 million rubles. Obviously, given the circumstances, the 100 million rubles’ allocation by ARCO would largely go for financing the accumulated losses and would be unable to noticeably revert the situation of the bank.

There is an even greater oddity in ARCO’s decisions on providing assistance to (rather than restructuring of) Moscow–based banks. Whereas there may be a rationale behind extending a credit to Alfa Bank — because the bank is going to expand its regional network (although selection of regions will remain the bank’s choice rather than the choice of the government bodies that have promised to focus on regions that are short in banking services), the project of restructuring of another Moscow–based bank, RNKB, can hardly be called anything but odd. Firstly, Moscow obviously faces no shortage whatsoever in banking institutions. It is rather on the contrary, with their excessive number preventing the Bank of Russia from organizing proper supervision over them. Secondly, ARCO participates in the RNKB rehabilitation project together with the Bank of Moscow that was unable itself to remain afloat in the fall of 1998 without a credit from the Bank of Russia and has not repaid that credit so far. Thirdly, sharing in halves with the Bank of Moscow the financial burden in the rehabilitation of RNKB, ARCO receives a minority share in the capital of the bank under restructuring.

One more ARCO project — the SBS-Agro Bank — cannot be viewed other than ironically at all. Obviously, the scale of losses is so great and the bank’s real assets are so insignificant that it simply does not make sense to restore it. However, ARCO, under the pressure from the Government and the Bank of Russia, started to resolutely address the problems of the bank and began to make payments to the bank’s creditors using its own resources. Given that the financial gap between the assets and the liabilities of SBS-Agro amounts, according to various estimates, to 30 to 50 billion rubles, it could take the federal budget years and years to come to repay someone else’s liabilities. It looks that the sole actual goal of the ARCO project in question was giving the owners of the bank an opportunity to escape responsibility and avoid a bankruptcy case.

On the whole, out of 10 billion rubles received from the budget, ARCO has decided so far on the use of only 650 million rubles (0.015% of GDP) for immediate increase of capital of banks (the banks in question being, as a rule, small and weak). Whereas an amount of 2.5 billion rubles has been allocated for... crediting the federal budget (!).
4. **What the Principal Objective Could Be?**

Doubtful prospects of restructuring “through regionalization” were predetermined not only by the lack of clarity about the sources of financing of the process, but also by the loose targets of the concept itself. Since the latter was being developed as the banking crisis was at its peak when the banking sector showed poor performance on effecting of payments, this was particularly perceived as a key objective. Without any underestimation whatsoever of the importance of continuous operation of the payment system, it is still necessary to emphasize that a state policy for restructuring of the banking sector cannot possibly view restoration of normal circulation of payments as its only goal. If we were to make this function the corner-stone of the banking sector, then one should believe that the least expensive way to restore the banking sector would be its localization within the Central Bank and Sberbank that are capable of providing settlement services throughout the country. Moreover, relying on regional banks in the creation of a workable payments system would cause a multitude of problems relating to cross-regional payments — banks located in a given region would not have stable links with banks located elsewhere and, therefore, mutual risks would grow while the velocity of effecting cross-regional payments would decline.

Obviously, as seen in the perspective of the interests of the economy, the most important function of the banking sector, for the restoration of which state funds should be allocated, is the function of financial intermediation — accumulation of savings and their transformation into investment. It is also clear that banks are unable to perform this function unless they dispose of sufficient own means: [otherwise] they would continually be confronted with prudential constraints on the attracting of clients’ resources and extension of credits.

After the crisis and bankruptcies of a number of the larger, multiple branch banks, the regional component of the Russian banking sector has considerably grown. Restoration of the banking sector is impossible without creating large enough interregional banks that would be able to overcome regional isolation, interlink the regions into relatively independent economic communities, and to provide capital mobility throughout Russia.

Activation of the process of transformation of savings in the post-crisis period is impossible without regaining public confidence in the banking sector. A law on guarantees for private deposits has not been enacted until now, and the prospects for agreement of positions of the various branches of authority in the short term are doubtful. Countries of South East Asia were much swifter in taking similar measures: Thailand did so one month after the crisis, Malaysia and Indonesia — 3 to 4 months after the crisis. There are detailed deposit insurance schemes that continue to be developed in these countries. The Indonesian example shows how necessary their thorough elaboration is: the authorities in Indonesia, having closed down 16 large banks, issued guarantees to the population for their deposits that do not exceed 20 million rupiahs (approximately US$5,000). As a result, after a heavy withdrawal of deposits from commercial banks, the funds only partially returned to the state-owned or foreign credit organizations while the rest of the money left the Indonesian banking sector.
The matter of the key principle in regard of the national strategy for restructuring of the banking sector, however, should be, in our opinion, creation in Russia of large banking institutions. For national–scale companies to operate in an efficient way and for implementation of large business projects, adequately large banking institutions are needed. For Russia that abounds in mineral resources and has accordingly large companies, the issue of concentration of banking capital is extremely topical.

Since its onset, the Russian banking sector has featured a relatively low concentration of capital. During the initial period (1992-94), the Central Bank used to apply minimal requirements to the newly established banks, which, along with highly lucrative nature of the banking business, led to formation of a large number of small banks having little of own capital. The change in the macroeconomic situation in 1994-95 predetermined modification of the requirements imposed by the Bank of Russia, which abandoned the policy of active stimulation of the processes of creation of new banks in favor of making more stringent the requirements applicable to both newly established and operational banks. This trend shows itself in the raising of the minimal charter capital requirement\(^\text{18}\), in the first place, and in revision of capital adequacy ratios in line with the relevant international standards\(^\text{19}\).

There is no doubt that smaller banking institutions are very much needed for the economy; in many cases they can play a very important role. Developments that took place last year have vividly shown that small and medium banks appeared much less vulnerable to a whole number of risks associated with banking, which proved to be disastrous for larger banks. Furthermore, to a certain degree small banks (sometimes, medium banks, too) are in less need in capital than larger banks are. Most often such banks are controlled by a narrow group of owners including enterprises that are their principal clients at the same time.

The resource base of such banks is represented with funds kept at clients’ accounts; credits are extended, as a rule, for short periods with a purpose of covering cash gaps. In the current circumstances, the banks in question actually perform as cash departments or mutual aid funds, without bearing significant credit risks. We think that for such banks the role of bank capital as a source of reserves is not large due to low risks. Basically, it would be advisable to categorize them as nonbank credit organizations with somewhat limiting the scope of their licenses along with relieving them from the obligation to meet certain ratios or establishing for them different performance ratios.

The overall economic situation, on the one hand, and actions taken by the regulators, on the other hand, have brought about the upward trends in the volume and concentration of the bank capital, these processes developing nearly in parallel from 1996 to the middle of 1998.

\(^{18}\) As from March 1994, the minimal charter capital for newly established banks is equivalent to over 1 million US dollars.

\(^{19}\) That mainly showed in the expansion of the list of risky assets and in the making more stringent of the risk ratios, as well as in additional accounting for resources allocated to the shareholders or insiders.
The total bank capital increased 1.9 times (1.4 times in US dollar terms) from early 1996 to mid-1998 to reach 139 billion rubles (22.5 billion US dollars). The number of operational credit organizations dropped by 30% to reach 1598 over the same period.

**Fig 1. Classification of Banks By Capital Size as of January 1, 1997**

Considering the actual circumstances, Russian banks whose own capital is below 30 million rubles in nominal terms can also be categorized as small banks. Despite all the macroeconomic shocks during 1997–1999, their share has remained nearly constant and rather high (about a half of all banks).

The share of medium or large banks with own capital over 30 million rubles in nominal terms in the overall banking sector has risen from 22% to 28% over the period from early 1997 to mid-1998.

The level of concentration of the bank capital is inadequately reflected by such indicators as the number and share of banks with the own capital of over 30 million rubles, especially given the considerable variation in the value of the ruble. In our view, the level of capital concentration could be determined in a clearer way by using such indicator as the share of capital of the larger banks in the total capital of the banking sector, as well as by evaluating the maximal crediting capacity of the larger banks.
Table 3.1 are an evidence of a steadily growing concentration of the bank capital in Russia. The share of the larger banks in the total capital of the banking sector has markedly grown despite the banking crisis that mostly affected precisely the largest banks, some of which (Inkombank, TOKO Bank, “Imperial”) have lost their licenses. Replacing these, new leaders have come, which were able to increase their capital and very much expand their operations (Gazprombank, MDM-Bank, GUTA-Bank, Rosbank, etc.).

It is not less evident either that despite the increase in the largest banks’ share in the capital of the whole banking sector, their crediting capacities have markedly declined after the crisis. As compared with early 1997 (the heyday of Russian banks), the crediting capacities of the largest banks have dropped nearly 3 times.

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20 Of course, the considerable reduction in the total number of banks that automatically increases the share of an unchanging number of larger banks has had an effect on the sharp growth of this indicator during 1997-98.

21 Inkombank used to be the second largest bank in Russia in terms of the asset value and the sixth largest in terms of the size of capital; “Imperial” was the 10th and 16th largest; and TOKO Bank, 19th and 17th, correspondingly.

22 It is not a mere chance that we take the possible size of a foreign exchange–denominated credit as a criterion — large participants of foreign trade transactions whose requirements in credits are certainly more correct to evaluate in foreign exchange are the largest and most reliable borrowers in Russia.
TABLE 1. SCALE AND DYNAMICS OF CONCENTRATION OF BANK CAPITAL IN RUSSIA

<table>
<thead>
<tr>
<th>Share (percentage) of the large banks in the total capital in Russia’s banking sector</th>
<th>1.01.95</th>
<th>1.01.97</th>
<th>1.01.99</th>
<th>1.12.99</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 50 largest banks</td>
<td>48.8</td>
<td>45.6</td>
<td>65.4</td>
<td>64.6</td>
</tr>
<tr>
<td>Top 100 largest banks</td>
<td>56.5</td>
<td>51.7</td>
<td>72.4</td>
<td>72.2</td>
</tr>
<tr>
<td>Maximal size of credit(^{23}) that a bank can extend to one borrower, million US dollars</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>An average of the top 50 largest banks</td>
<td>25.4</td>
<td>56.1</td>
<td>20.3</td>
<td>22.3</td>
</tr>
<tr>
<td>An average of the top 100 largest banks</td>
<td>14.7</td>
<td>31.2</td>
<td>11.2</td>
<td>12.4</td>
</tr>
</tbody>
</table>

Source: Bank of Russia, calculations by the authors

Therefore, in terms of performing by banks of their principal economic function — accumulation and redistribution of monetary resources — there has occurred a considerable decline in the capacity of the large Russian banks and the whole of the banking sector after the crisis.

Competitive positions of Russian banks on the world markets have dramatically changed: in early 1997 ten Russian banks possessed capital in excess of 250 million US dollars, which made them members of the top 30 list of the largest banks in Eastern Europe, whereas by early 1999 only three banks met this criterion: Sberbank, which remains the largest bank in Eastern Europe in terms of both asset value and size of capital, and Gazprombank and Mezhprombank.

Comparison of concentration of capital between Russia and Eastern Europe shows that in most East European countries the level of capital concentration is higher than in Russia. For instance, 10 largest banks accounted for over 46% of the total capital in the whole of the banking sector in Poland in 1998, and 52% — in Hungary, while in Russia this indicator was slightly over 40%. One of the reasons for it is that at the stage of transformation of the system of state–owned banks the issue of capitalization of banks was paid much more attention in East European countries. As a rule, the governments participated in a much more active manner in the formation of banking institutions by providing them with a start-up capital, retaining for long their participation in bank capitals, allowing nonresidents wide opportunities for investing in the banking sector\(^{24}\). One can assume that intensive

\(^{23}\) In accordance with the effective CBR Instruction # 1, the maximal amount of resources that a bank may extend to one borrower or a group of related borrowers shall not exceed 25% of the bank’s own capital.

\(^{24}\) Currently, privatization of the state interests in the bank institutions is one of the most important sources for the national budget in Poland. In 1999, privatization of the interests (48% and 52%) in two banks in Poland has turned in 1.6 billion US dollars for the budget.
privatization and liberalization of the banking sector in Russia (the government’s refusal from active participation in the capital of banks — except Sberbank and Vneshtorgbank) as the sector was relatively isolated from competition with foreign banks has predetermined to a large extent low capitalization of the Russian banking sector.

Given the current situation, it would be advisable to have a restructuring and recapitalization strategy of the Russian banking sector that focuses on creation of large, multiple branch banks. In terms of the asset value and size of capital such banks could be part of the top 500 largest banks in Europe (which means that the minimal capital of the respective banks should amount to 200-250 million US dollars, and their asset value, 1000-1200 million USD). If bank institutions of such a scale appeared, it would significantly change the relationships both between the banking sector and the real sector in Russia and between the Russian banking sector and the world financial markets.

Only large banks can be capable of providing the whole set of state–of–the–art banking services to a large number of clients, accumulating sufficient financial resources and redistributing those among the sectors in the economy, fulfilling credit needs of the largest Russian enterprises, providing the cross–regional flow of monetary resources, and attracting foreign investments and capital into the Russian economy.

6. **What Can the Government Do?**

Furthermore, the current actual situation makes us discuss not a program to address all the banks or groups of banks, but actions that the authorities could take with respect to individual banks. In order to implement such a strategy, the government can and should use methods for enlargement of bank institutions and rise of bank capital concentration, such as:

- Undertaking measures for restructuring of individual large banks that face financial problems on a limited scale;\(^{25}\)
- Participation of the government in recapitalization of large banks that were able to retain their financial stability during the crisis but have lost a large share of own capital. According to the international practice, the use of public funds for capitalization of banks should come along with imposition of very strict requirements to the banks so as to rule out their undertaking risky transactions or groundlessly acting in the interests of the shareholders or managers;

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\(^{25}\) The ARCO was just on the point of implementing a program of this kind for the bank “Rossiyiskiy Credit”. Initially, mostly the owners and managers of the bank were the authors and implementers of the program, while ARCO was rather performing a role of the “umbrella” for the process. (Programs of this kind, according to the international practice, should involve removal of the former bank owners from decision–making.) Postponement of the start of the program for more than a year raised doubts whether it was possible to make the bank operational, even after settlement with the creditors, and ended up with the owners’ holding aloof from the attempts to solve the bank’s problems. The whole burden of straightening it up was on the ARCO.
• Initiation of mergers and amalgamations of bank institutions, including enforcement measures, especially with respect to government–controlled [entities]. For instance, in Indonesia, with participation of many foreign consultants, there is a process of merger underway of four state–owned banks with transferring overdue credits to an agency for bank restructuring. The resulting bank whose assets will account for one-third of the whole system’s total is intended for privatization upon curtailment of costs. Malaysia also conducts a policy of mergers of large banks. In case of Russia, it would be advisable to consider the transition from the currently prevailing scheme for providing financial assistance (by the Ministry of Finance, ARCO, or the Bank of Russia) and restructuring of regional banks by the state to a scheme whereby the respective banks are transferred under management by the existing sustainable bank entities or affiliated as branches of the latter;

• Targeted attracting of foreign capital for restoration of viability of multiple branch banks that have become bankrupt but the volume of whose liabilities is relatively low. Such banks can be exemplified with Promstroybank or Mosbusinessbank. Funds required to cover the losses of each of the two banks are 60 to 100 million US dollars, which is incomparably less than the costs that any investor would have to incur in the creation of a bank network of a similar scale. Obviously, prior to attracting outside investors the state should guarantee safety of the bank assets and not allow such actions by the bank managers or owners as lead to an increase in bank liabilities.

Growth of capitalization of Russian banks and performing by them of the function of transforming savings into investments can be provided in the medium term through a considerable expansion of operations of foreign banks in Russia and through restoration of interaction between the domestic banking sector and the world capital market. Given the shortage of funds, the state authorities can and should agree on the increased participation by the foreign capital in the Russian banking sector, taking an active stance in this matter. On the one hand, the Bank of Russia can impose stricter requirements to capitalization of the subsidiaries of the foreign banks operating on the Russian market, which have lost their capital during the financial crisis. On the other hand, the government can propose to foreign banks to split participation in the restructuring of Russian banks between the two sides. Furthermore, the government can demand from the foreign banks operating in Russia that they take more active measures for expanding their businesses, which will make it necessary for them to augment their bank capitals and be more active in their advancement on the market for banking services.

Currently, the Bank of Russia encourages increase in the share of nonresidents in the capital of the Russian banking sector through capitalization of debts of the Russian banks to nonresidents, that is, by means of transformation of claims from foreign creditors into participation in the charter capital of the respective banks. Foreign investors, however, are

26 “On the Situation in the Banking Sector and Issues in its Restructuring”, a presentation made by Chairman of the Bank of Russia, Mr. V.V.Gerashchenko at the Ninth Congress of the Association of Russian Banks.
not eager to do so, especially as the debt conversion mechanisms proposed by the Bank of Russia have not proved their efficacy so far.

In Thailand, there are several strategies for addressing the issue of the assets of problem banks, which are being implemented simultaneously. The Agency for Restructuring of the Financial Sector (ARFS) attempts to quickly sell the credits and fixed assets of problem banks. Most liquid assets were sold at approximately one-half of their book value, while the less liquid assets were difficult to sell even at 20% of the same. For redeeming and raising the value of credits for construction projects, an organization for management of mortgage credits was established. Besides, a new bank was established in Thailand at the expense of the international financial institutions for buying up highly liquid assets, which later on took over one of the largest banks that had gone bankrupt. The government financed all the above entities. A "bad" bridge bank was established for management of overdue credits of the Bangkok Bank for Trade. The government is pushing private banks to apply similar mechanisms. A bridge bank for largest investment banks under liquidation was established in Korea, too.

In Malaysia, a specialist state–owned company financed by the government bought up assets with bonds to be redeemed by the central bank. The scope of activity of the company goes beyond management of problem bank assets, including also provision of incentives for crediting the most important sectors of the economy, first of all, export. Along with it, there operates a subsidiary company of the central bank, which establishes control over the management of banks that had already sold to the state company all acceptable credits and recapitalizes those.

An Indonesian agency for bank restructuring works on presale preparation and marketing of the assets of problem banks. The Agency has taken management of large insolvent multiple branch banks.

In Russia, the government, including the ARCO, is rather constrained in its choice of instruments to be used in the process of bank restructuring. The specificity of the Russian banking crisis and that of the sources of losses that Russian banks have incurred (price risks and forward transactions) do not allow using “traditional” methods for recapitalization of the banking sector that other countries apply — redemption of bad assets. The Russian authorities need to more clearly formulate a diagnosis for each bank that they are going to work with, identifying the reasons and character of its insolvency and selecting, where possible, appropriate tools for overcoming the difficulties. It is quite obvious that there can be

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27 Usually, banks will incur losses due to degradation of the asset quality and, therefore, decline in the prices for assets, or because of insolvency of the borrowers. In such a situation, the government bodies will redeem the assets at their book value (or at a price close to the book value) assuming all the risks associated with the assets. It often happens that some of those assets restore their value with time, and their sale will let the government to partially compensate its expenses. In Russia, banks encountered sharp appreciation of their liabilities due to depreciation of the ruble, or incurred losses from their forward transactions. In this case, banks do not have assets, redemption of which would help improve their financial standing. Shifting the losses on to the government is the only way of doing so.
no single, universally applicable set of tools — methods of addressing the problems of banks

Considering the actual situation of Russian banks, the following “standard problems” of banks can be identified, which may make the ARCO “pay attention” to the respective banks, and the appropriate instruments:

<table>
<thead>
<tr>
<th>Problems, and Their Causes</th>
<th>Possible Instruments</th>
</tr>
</thead>
</table>
| **Shortage of bank capital.**  
This can result from incurred losses and will not necessarily entail loss of solvency. The bank will retain the ability to meet all of its current liabilities, and its problems will “only” include failures to meet the prudential ratios. | Establishment for a specified period of time of individual prudential ratios based on the realistic but tight dynamics of growth of the bank’s own capital. 

Acquisition by the government of a share in the bank’s capital (extension to the bank of a subordinated credit) to restore the capital to the level that meets the bank supervision ratios. In order to prevent inflationary effects, the bank will spend the funds thus received for the purchase of long-term, low-interest-rate government securities. Supplementary conditions (options) may provide the right of the bank owners or managers to redeem the stock prior to redemption of the government papers. In case they decline to use this right, the government will sell the interest that it owns in the bank. |
| **Current shortage of liquidity.**  
This results either from mistakes by the bank management in exercising control over assets–liabilities maturity matching, or from the sale by the bank of its liquid assets for meeting the sharply amplified claims by the clients. In this case the bank is sound in the long term, its assets are of good quality and are capable of providing normal operation of the bank. | Redemption by the government of performing assets and their subsequent sale to other banks. 

Involving by the government of banks where the government has a dominant participation in capital in sharing the funding of good, long-term assets. 

Extension of credits for liquidity support. |

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28 By no means it is implied that these instruments should be necessarily applied to all problem banks. Assessment of the scale of financial costs in each particular case, its comparison with a potential effect, and deciding on the advisability of the respective actions are certainly the responsibility of the government bodies. We only try to offer our recommendations on the efficacy of various instruments in various circumstances.