

***Russian Financial Transition:
The Development of Institutions and Markets for Growth***

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Abstract

A well-developed financial intermediation industry increases domestic savings, efficiently allocates investment resources to the most productive uses in the economy and increases the rate of economic growth. In the Soviet economy the banking system served as a means of collecting household savings and a means of distributing centrally determined capital grants to enterprises. Banks then audited enterprise financial activities to ensure compliance to the financial plan. After a decade the transition from the Soviet banking system to a market oriented banking system is incomplete and fraught with uncertainty. While the number of financial institutions has increased dramatically, the state sector still dominates financial sector activity, the legal and regulatory framework is incomplete, information necessary for risk management is of poor quality and policy makers and regulators have been slow to act to improve intermediation services. While significant progress has been made, the commonly recognized characteristics of a sound financial system are not yet met.

Keywords: Russia, Finance, Institutions, Markets, Economic Development

Contents

I. Introduction

II. Development of Financial Institutions and Competitive Markets

Why focus on banking sector?

Demonetisation and non-payments

Financial Repression and Liberalization

III. Characteristics of the Banking System: Crisis and Recovery

System Characteristics and Policy Framework

Recovery of Banking Activity

IV. Concerns and Issues

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I. Introduction

The Russian financial crisis of 1998 not only destroyed the credibility of financial policy makers and the confidence of investors, but also delayed significant institutional reforms necessary for long-term economic progress. While the favorable external environment of the mid-1990s provided support for domestic reforms and adjustment, events in global financial markets alone are not sufficient to explain the domestic financial collapse. Russian financial authorities were not only determined to prevent exogenous external shocks from spilling over into domestic financial markets, but also determined to defend the exchange rate peg as the domestic GKO market collapsed.² The failure to deepen the reform of institutions and appropriately manage financial risk at both the macroeconomic and microeconomic level set the stage for crisis. The deterioration in the terms of trade and the government's inability to maintain federal revenue flows worsened fiscal imbalance and overall macroeconomic internal balance. Huge interest rate swings and the devaluation of the ruble destroyed the balance sheets of major banks.³ The Russian economy moved from a somewhat optimistic macroeconomic environment in 1997 and the first quarter of 1998, to financial collapse by the end of 1998.⁴ By mid-1999 the economy had stabilized and policy makers were taking measures to bolster the fiscal system.⁵ Does the positive economic news represent real progress in domestic structural reform and solid economic performance? Or, have the increases in the world price of oil and stabilization of global financial markets provided the supportive external environment that allows the fragile Russian economy to grow even without significant domestic reforms?

In this paper I will focus on development of the domestic banking industry not only as an essential element of transition to a market economy, but also as a necessary factor for long-term economic growth. There is an extensive theoretical and empirical literature indicating a significant

² GKO, gosudarstvennye kaznacheiskie obiazatelstva, are short-term treasury bills. Foreign investors owned about 30% of GKOs. Granville (2000), p. 201 reports that in early 1998 there were some US\$365 billion (more than 3,000% of the banking system assets) of outstanding foreign exchange forward contracts, mainly the result of foreign counter parties hedging their GKO investments. Devaluation would, and ultimately did, render many banks insolvent.

³ See Granville (2000), pp. 196-203 for a description of the GKO market collapse, resulting devaluation and debt default.

⁴ During the early 1990s there were expressions of concern about the stability of the banking system and in 1995 there was a liquidity crisis on the inter-bank lending market. However, some analysts were dismissive about the possibility of a banking system crisis: "This talk about crisis in the midst of one of history's largest banking booms has an air of unreality to it." Warner (1998), p. 335. It was true that banks had extraordinary opportunities for profits because of the low cost of funds, but conditions can and did change rapidly. Less than a year later in the same journal, but after the crisis, Buchs (1999), p.700 notes "... it is less the crisis itself but the timing of the crisis which was a surprise in Russia."

⁵ For a review of economic performance during the 1990s see IMF (1999), OECD (1997) and OECD (2000). Selected economic data may be found in tables 1-3 of the appendix. OECD (1997) Annex V also provides a detailed chronology of economic events and policy measures. On August 17, 1998 Russian authorities devalued the Ruble, imposed a unilateral restructuring of GKO debt and declared a 90day moratorium on private debt repayments. Estimates of losses to investors range from \$US 20 to \$US 90 billion. IMF (1999), p. 39. For a detailed description of the 1998 crisis see Buchs (1999) and "What Went Wrong," *Russian Economic Trends*, September 1998. And for a description of the results see Westin (1999).

causal influence of the level of financial development upon long run economic growth.⁶ Financial development improves the allocation of savings to investment opportunities. The possibility of choosing more productive investments, which in turn generate higher rates of aggregate economic growth, requires improved management of liquidity risks, more efficient diversification of investor's portfolios and higher quality of information about various projects and investor's abilities. As the demand for these services arises, specialized institutions develop. But, the literature indicates that aggregate income and savings must reach certain levels, or thresholds, before institutions and markets develop spontaneously. In transition economies economic policy makers may intervene, providing an environment for institutional development that may supercede spontaneous market developments.⁷

If one takes a more activist, "supply leading" financial development approach to transition and development, policy makers first must ask: 1). Among financial institutions what areas should be developed/supported first? 2). What are the most appropriate mechanisms to enhance the efficiency of the financial institutions identified? 3). What is the impact of competition and what is the optimal level of competition (in banking)? And, then, more specifically, 4) at what stage of financial development is the Russian economy and what policies should be implemented to enhance long term economic growth?

In the next section I briefly address questions one and two based upon a brief review of the financial development literature. This provides a framework for analysis of policy and institutional developments. Section 3 is a review of the banking sector's recovery from the 1998 crisis. Here I also discuss policy and institutional issues which must be resolved to ensure stable, long-term economic growth. Section 4 concludes with concerns and issues to be resolved.

II. Development of Financial Institutions and Competitive Financial Markets

The Soviet centrally planned economy had little need for a developed financial sector. The payments system was simple and sound: cash was used for household transactions and enterprise deposit transfers were made within the monobank for inter-enterprise transactions. Capital and

⁶ The level of financial development is usually described by measures of "depth," for example, the ratio of banking assets to GDP, or market capitalization to GDP, etc.. Berthelemy and Varoudakis (1996) and Pagano (1993) provide a brief review of the connection between financial development and growth. Levine (1997) also provides a survey of issues of financial development and growth, Levine and Zervos (1998) examines potential links between both stock markets and commercial banks and growth, while Beck, Levine and Loayza ((2000) and Levine, Loyaza and Beck (2000) provide more recent empirical evidence linking financial development to economic growth.

⁷ The literature discusses two approaches to financial development. "Demand following" financial development follows widening of markets and product differentiation, which then requires more efficient risk diversification and control of transaction costs. This type of financial development is viewed as passive or it plays at most a permissive role in the growth process. "Supply leading" financial development precedes the demand for financial services and proponents argue it has a clear autonomous positive effect on growth due to the enhanced ability to mobilize resources, moving them from traditional to modern, high growth sectors. Supply leading financial development may dominate the early stages of development or transition, making possible the financing and increasing the effectiveness of sectors, institutions and activities neglected under central planning, until demand following financial development takes over (a la' Gerschenkron, 1962).

investment funds were available via direct grants from the state budget according to the central plan. The banking system functioned simply as a payments system and state auditor to monitor plan fulfillment.⁸ Monetary policy was accommodating, ensuring that cash supplies met demand and enterprise deposit creation from the state budget corresponded to plan, both according to micro objectives as well as balancing in the aggregate to prevent inflation. Barter transactions in both the household and enterprise sectors and unplanned transactions within the enterprise sector were tolerated to smooth the operation of the plan. The financial plan governed the allocation of society's savings among potential investment opportunities typically based upon political objectives rather than financial criteria.⁹ While the banking system in a market economy is a critical element of the payments system, it also plays an active role in the allocation of investment resources.

Why focus on the banking sector?

In the Soviet system the banking system did not provide financial intermediation services. Developed market economies, though, have both stock and bond markets and developed financial intermediaries such as banks. There is considerable discussion about which is more important. There is also a debate about the effectiveness of universal banking vis-à-vis specialized banking coupled with stock markets. Despite the nuances and the different routes taken, developed market economies have tended to converge toward a similar model of corporate finance. In developed economies, retained earnings or internally generated funds account for roughly 60 to 90% of investment financing, bank loans account for roughly 15 to 30% and bond and equity offerings just a few percent. In developing economies both bank loans, accounting for 25-35%, and equity markets, accounting for as much as 25%, play a slightly more important role in investment financing than in developed economies. While this varies over time and across countries, retained earnings remain the dominant source of funds, with bank lending next, and equities markets relatively unimportant in terms of providing finance for investment projects. In fact, Stiglitz (1993) argues that stock markets are primarily a means of sharing risk, not raising investment funds. When there are production risks, information asymmetries and costly monitoring, debt contracts with fixed repayment dates will always be preferred (by investors) to the purchase of shares with periodic reimbursement by payments of dividends that are subject to productivity shocks. Thus, bank intermediation is likely to play a significantly larger role in investment financing regardless of stage of development.

Monitoring costs are minimized with debt contracts because such costs are incurred only in the case of insolvency, while financing via shares requires continuous, ongoing monitoring. Banks and lending intermediaries have an advantage over stock and bond markets because they can be more efficient in terms of information gathering and monitoring. It is not efficient for an individual investor to undertake these costs, but banks can spread them out over many investors (depositors). Because some of the information collected on the performance of a firm becomes

⁸ The three primary functions of the Soviet monobank were financial control of enterprises, dispersment of funds allocated by the central plan and mobilization of domestic savings to finance domestic debt of the state sector.

⁹ For the classic description of the Soviet system of money and banking see Garvey (1977). For a more recent discussion of both Soviet banking and transition in the early 1990s see Tompson (1997).

public, there is also a free rider problem that makes capturing payment for monitoring costs problematic. With large diversified portfolios banks can guarantee a yield on deposits and make a credible commitment to monitoring investment projects. Thus, the informational advantage of banks as a source of external financing of investment is a strong argument in favor of emphasizing the development of the banking system as a means of enhancing capital accumulation. In fact, Wright, Buck and Filatotchev (1998) provide evidence that banks in Russia are beginning to develop oversight and monitoring relationships with loan recipients, albeit at a relatively slow pace. Banks may not be superior to stock markets at all stages of development, however. Both provide diversification and management of liquidity risk, provide a monitoring mechanism, which improves the management of resources, and provide means of evaluating the returns on investment activities, all of which contribute to the efficient allocation of resources. Competition among banks and between banking intermediaries and stock markets leads to lower intermediation costs and contributes to economic growth. But competition also leads to increased probability of insolvency, credit rationing and related adverse effects on growth. The optimal level of competition is a policy issue of importance in both market economies and transition economies.

The performance of intermediation services takes a well functioning payments system for granted. In any economy a well functioning payments system, a reliable and flexible means of exchange and payment, is necessary for growth. While the Soviet economy payments system was reliable, it was not flexible and does not satisfy the needs of participants in a market economy. Without direct capital grants from the central budget, enterprise projects must compete for funds, either internally, from retained earnings, or externally, from bank loans or securities offerings. Outside-the-payments-system transactions such as barter are also possible, but are costly. These costs often eliminate potential productivity gains due to increases in the division of labor and thus reduce the profitability of potential projects. In a market economy a financial system with low transaction costs develops in order to reduce the opportunity cost of holding money. As a result the payments system in a market economy evolves toward a credit system managed by banking intermediaries. Technological advances continuously reduce the information costs of utilizing credit while financial assets and credit instruments gradually replace traditional monetary assets. This is reflected by increases in the weight of financial activities in GDP as economic development takes place. Thus, the velocity of narrow monetary aggregates increases after a certain stage of development and the increase in this measure of velocity is paralleled by the development of intermediation technologies.¹⁰

Demonetization and nonpayments

In a transition economy changes in the velocity of narrow money aggregates must be interpreted with caution, however. Measurement problems are severe. In Russia the method for calculating GDP is being refined, defining and measuring monetary aggregates is difficult, and the

¹⁰ Note that in very early stages of economic development the economy is increasingly monetised as transactions become more complicated and sophisticated, thus there is a secular downward trend in money velocity. However, after some threshold level of development, pressure to reduce the opportunity cost of holding money leads to the replacement of money with credit instruments and an increase in the velocity of narrow money aggregates. The strong empirical link between GDP and degree of monetisation is demonstrated by Goldsmith (1969).

amount of dollars in cash in circulation is large and difficult to measure.¹¹ Further, significant changes in the behavior of economic agents have occurred and creation of new monetary and credit instruments is rapid and unpredictable. Demonetisation in the Russian economy may increase or decrease velocity for reasons completely independent of financial development. For example, in 1994 the Central Bank of Russia (CBR) began to implement more stringent prudential regulations at the same time monetary policy was tightened. A crisis in the inter-bank lending market in 1995 led financial intermediaries to innovate, creating new types of securities to facilitate payments.¹² There was a rapid increase in the use of cash surrogates including barter, sometimes complicated offset arrangements (*zachety*), bills of exchange (*veksels*), and various federal, regional and local securities.¹³ There was also a rapid increase in payments arrears. While some of these activities may be considered a first step toward financial deepening, employing primitive payments and intermediation technologies with high transactions costs, such as barter and illiquid offset arrangements, is clearly a step backward.¹⁴ Only if orderly secondary markets for *zachety* and *veksels* are developed may it be interpreted as a step forward. Matters were complicated at this time as the practice of issuing credit denominated in bills of exchange allowed banks to facilitate tax evasion, disguise bad loans by converting them to *veksel* credits and avoid provision requirements. Lack of transparency in accounting complicated matters further as prices varied depending upon the means of payment, confounding efforts to improve corporate governance, restructure enterprises and enforce tax and other regulations.¹⁵ Corruption and illegal activities also flourished.¹⁶ By 1997-98 money surrogates accounted for over half of industrial transactions and consolidated budget revenues. In many regions of the country this share reached 70%.¹⁷

While Pinto, Drebenstov and Morozov (2000) argue for a complete dismantling of the nonpayments system, there were some positive aspects.¹⁸ It in fact represented an evolutionary step in the financial development process. In response to very contractionary macroeconomic policy and the elimination of direct enterprise subsidies, in a system with soft budget constraints,

¹¹ Buchs (1999) reports dollarization of 10% of GDP.

¹² Tightening of monetary policy and higher real interest rates led to liquidity problems and banks in turn borrowed heavily on the inter-bank loan market for liquidity. Both volume and rates increased leading many banks to withdraw from the market. On August 23-24 overnight rates spiked, lending was rationed and the market collapsed. The Central Bank was only partially accommodating and several hundred banks failed. See OECD (1997), p. 82 for additional details.

¹³ OECD (1997), Annex II discusses the development of various money surrogates. *Veksels* may be promissory notes or, if tradable, bills of exchange. They perform a much broader role, however, serving as the equivalent of debt instruments like certificates of deposit, commercial paper, simple IOUs and bonds.

¹⁴ While OECD (1997), Chapter 2 describes the introduction of new securities and means of payment as important innovations and monetary and institutional changes at this time in a positive tone, the chapter concludes with a section titled "Commercial banking in the Russian Federation: the first signs of stability or impending crisis?" Conditions deteriorated rapidly from the time of printing and within a year the financial system collapsed.

¹⁵ Barter and offset prices tended to be higher than *veksel* prices that in turn were higher than cash prices for the same commodities. See OECD (2000) pp.91, 92.

¹⁶ See Gaddy and Ickes (2001), Woodruff (1999) and Commander and Mumssen (1998) for further analysis of non-monetary transactions and the impact upon decision-making in the Russian economy.

¹⁷ For additional details on demonetisation see OECD (2000), Chapter 2.

¹⁸ Note that Pinto, et al. (2000), p. 1, defines non-payments as 1) arrears and 2) all forms of non cash settlements including barter, *veksels* or promissory notes and tax offsets whereby government spending arrears and overdue tax payments are mutually cancelled. I focus on non-cash payments or cash surrogates since these actually are a means of conducting payments, either at a discount or premium, which may compete with payments within the banking system.

cash short enterprises resorted to non-cash surrogates for payments both with each other and with the Treasury. Fiscal authorities permitted and enhanced the development of non-cash instruments for fiscal purposes as a means of supporting inefficient enterprises, which could no longer be subsidized directly. As international financial institutions objected to the use of a particular instrument it was eliminated, but quickly replaced by another nearly equivalent instrument.¹⁹

The share of non-cash transactions varied by industrial branch, but clearly increased through the 1990s, as indicated in Figure 1 and Table 1. The increase in offset arrangements in 1996-1998 also paralleled the increase of enterprise payments arrears, as they became the dominant form of non-cash payments. While it may be argued that offset arrangements prevented a further contraction in the economy and to some extent provided liquidity (some offsets were tradable) they also were very inefficient as a means of payment since transactions costs were extremely high and they facilitated the continuing distortion of relative prices.²⁰ With the development of alternative credit instruments barter should decrease over time.

There are three causes noted for the Russian demonetisation: 1) barter occurred between enterprises that had Soviet era links and was facilitated by trade institutions that act much like Gosnab²¹ did, 2) macroeconomic policy, the elimination of directed credits and high interest rates, increased the opportunity cost of money, encouraging financial innovation and the creation of non-money means of payments, and 3) barter and varying prices for differing means of payment facilitated tax avoidance. Clearly all three reasons contributed to the demonetisation, but by 1999 world oil prices and export earnings increased, and interest rates came down, all providing greater liquidity to the economy overall, and the need for monetary surrogates declined. The banking system stabilized and transaction levels within the payments system returned to more normal levels. While stable, the system is still far from liberalized.

Financial Repression and Liberalization

McKinnon (1973) defines financial repression as any policy or regulation that prevents financial intermediaries from operating at a level in accordance with their technological potential. Typical repressive policies of the banking system in a market-type economy are forms of implicit or indirect taxation of financial intermediaries or transactions. The most common are bank reserve requirements with low or zero yield, ceilings or controls on lending and deposit rates, and the

¹⁹ For example, treasury tax offsets were employed in 1994-1996 then replaced by direct monetary offsets in 1996, 1997, which were replaced by reverse monetary offsets in 1997, 1998, which in turn were replaced by targeted financing. See Pinto, Drebensov and Morozov (2000).

²⁰ It is also important to note that a large portion of the increase in arrears was due to the accumulation of penalties and fines on enterprises for late payment of taxes and payments to the government. Government-organization to government-organization payments arrears do not accrue fines and penalties and thus the proportion of enterprise arrears to government as a proportion of total arrears increased. Penalties and fines amounted to 65% of all debt to the Federal budget by the end of 1997. While the initial payment arrear is viewed by some as an increase in “soft credit” to the enterprise sector, the accumulation of fines and penalties probably should not be. See Mumssen (1998) and OECD (2000).

²¹ Gosnab, the State Committee on Material and Technical Supply, was one of the most important state committees instrumental in developing, coordinating and enforcing the central plan during the Soviet era.

inflation tax on monetary assets in general. The costs include the loss in efficiency due to the distortions in interest rates, credit rationing and overall discouraged savings due to low deposit rates.²² In addition, the market structure itself must be considered as a potential limiting factor on the development of the financial system. Stiglitz (1994) emphasizes market failure and the need for government intervention of various sorts to improve efficiency in the financial system.²³ There is considerable debate in the literature on both the optimal level of competition and the need for and type of government intervention, however.²⁴

With virtually no lending activity, strict controls on deposit accounts and rate ceilings and complete monopolization of the banking system during the centrally planned era, the Russian banking system has evolved from what may be considered an extreme in terms of financial repression. To complicate matters Russian bank management was not prepared to operate the newly created commercial banks as profit maximizing banks in a market economy.²⁵ Russian banks were not able to identify potentially profitable investments, due to the lack of business reputations and reliable credit histories, predominance of insider control (politically supported) in enterprises, weak contract enforcement and an underdeveloped legal system. Although bank managers are slowly developing the skills to engage in effective project appraisal and monitoring, they have weak incentives to develop these skills as long as there are alternative, cheaper sources of high profits, like government securities.

The benefits of liberalization seem obvious, but the pace and timing of liberalization are critical. Many argue that the fiscal deficit must be under control prior to liberalization because significant increases in interest rates to dampen growth or control inflation may lead to adverse selection in bank lending activity, thereby threatening the soundness of the banking system. In addition, many argue that a perfectly competitive banking industry will under provide financial services because of the public good nature of the information on profitability of entering the deposit market by individual banks and the high cost of entering the market. Thus, Hellman, et al. (1997) argue that “mild” financial repression may be beneficial because it creates rent

²² The costs can be significant. In a study of twenty-six developing countries the inflation tax was estimated at 2.8% of GDP and ceilings on interest rates generated a tax equivalent to 1.8% of GDP. See Berthelemy and Varoudakis (1996).

²³ Stiglitz (1994) notes seven types of market failure: 1) monitoring as a public good, 2) externalities of monitoring, selection and lending, 3) externalities of financial disruption, 4) missing and incomplete markets, 5) imperfect competition, 6) Pareto inefficiency of competitive markets, and 7) uninformed investors. He then provides a taxonomy of government interventions which may be appropriate. Levine (1996) provides a framework for policy analysis and government intervention. Harwood and Smith (1997) provides an extensive look at financial development strategies for developing countries.

²⁴ For example, Jaramillo-Vallejo (1994) takes issue with Stiglitz’s arguments for government intervention.

²⁵ Tompson (1997) argues that at least through the mid-1990s Russian banks really did not bank. They did little to collect deposits and did little lending except to the state. A large share of their liabilities were free and a large share of their assets were idle. Banks maintained a high level of excess reserves even during highly inflationary periods. This activity is not necessarily financial repression via government policies, but by poor management. Iskyan and Besedin (2000) call Russian banks “bank-like institutions” and Schoor (2001) maintains most banks are simply treasury operations of their enterprise owners.

opportunities that enhance incentives for financial deepening and deposit mobilization.²⁶ And Van Wijnbergen (1983) argues that informal financing that developed early in many developing economies may actually be more efficient than intermediated financing in a liberalized system. But this is true only if the informal sector has higher quality information on risk and lending opportunities. While all three caveats may apply to the Russian economy to a limited extent, recent research indicates that the effects of financial liberalization on economic growth are “not subsumed by other economic reforms or proxies for the development of capital markets and financial intermediation.”²⁷ Therefore liberalization, *per se*, should proceed as quickly as possible.

A liberalized financial system contributes to overall economic growth by increasing savings. Financial markets and banking intermediaries improve the mobilization of savings, providing higher than expected yields and greater diversification of risk. This in turn encourages financial savings rather than the purchase of consumer durables (or real assets with a low rate of return). Such a reorientation of savings reinforces the deepening of the financial system.²⁸ This pattern may not be observed in the transition economy as pent up consumer demand is released in the initial period. The financial crisis in Russia (as well as other transition economies) then introduced skepticism on the part of savers and weakened the credibility of the financial system overall. The fact that there is no universal deposit insurance system for Russian savers also discourages savings. Because Sberbank is the only institution with state support perceived to be equivalent to deposit guarantees, households transferred deposits from independent, private commercial banks to Sberbank.²⁹ The share of total household deposits held by Sberbank increased from just over 50% in mid-1994 to over 85% by January 1999, then declined slowly to just over 75% in April 2001. One reason that other commercial banks, private and state-owned, cannot compete in the deposit market is because they lack the deposit guarantees that Sberbank offers implicitly. Thus, to increase savings government policy should reduce the risks to depositors associated with saving via bank deposits by developing a system of deposit insurance and by eliminating the household deposit monopoly Sberbank enjoys. There has been tremendous resistance to this, however, as evidenced by the continuing discussion of the proposed federal laws on deposit insurance.³⁰

²⁶ It is difficult to ascertain what level of repression is optimal. E.g., mild financial repression may include deposit rate ceilings, which enhance franchise values. However, if ceilings and other regulations diminish competition and hinder the efficient allocation of resources diminishing growth then liberalization is in order.

²⁷ Bekaert and Harvey (2001), p. 11.

²⁸ Actually, income and substitution effects make the a priori outcome on growth indeterminate.

²⁹ The August 1998 crisis led Sberbank to lose half of its net assets when the government defaulted on GKO's. The government bailed out Sberbank, whereas depositors at other failing institutions (Menatep, Most, SBS-Agro, Inkombank, Mosbiznesbank, and Promstroibank) were required to transfer deposits to Sberbank at unfavorable terms. See Buchs (1999) p. 693 and Schoers (2001).

³⁰ The Antimonopoly Ministry, however, has initiated three proceedings against Sberbank and the CBR since the beginning of this year. However, all decisions taken concerning the promotion of competition in the banking sector must be submitted to the CBR, which “seems to deliberately hinder any attempts to achieve this task.” *Russian Economic Trends*, (April, 2001), p. 6. It should also be emphasized that Sberbank's advantages in the deposit market also contribute to an inefficient allocation of capital at the macro level since its assets are held predominately in government securities or loans to large state owned enterprises, replicating investment patterns of the Soviet era..

A liberalized system also improves the allocation of resources, increasing capital productivity and economic growth. The inherent difficulties of resource allocation, with productivity risks, insufficient and imperfect information on the return on investment and entrepreneurs' skills, provide opportunities for creation of financial intermediation services. Financial institutions provide diversification of risks associated with productivity and demand shocks, manage liquidity risks and evaluate potential projects and entrepreneurs. These activities increase the rate of economic growth by increasing the resources invested in productive activities, increasing technological specialization,³¹ reducing the premature liquidation of capital³² and increasing productive efficiency. Evaluating projects and entrepreneurs, essentially assessment and monitoring, has very large fixed costs which financial intermediaries can spread over many investors, no one of which would be willing to pay the initial fixed costs. The intermediary can evaluate more projects, collect more information and provide it in a standardized form to large numbers of investors who then choose among varying levels of risk depending upon their risk preference. As a result of better assessment of risk and better information, more resources can be directed toward the most productive or profitable projects. Monitoring and diversifying systemic shocks also allows an increase in resources invested in productive, but riskier projects, therefore increasing the overall productivity of the economy's capital stock.

The working of financial intermediaries described above stands in stark contrast to the allocation of capital in the Soviet system in which crude indicators of effectiveness, imperfect information and political forces guided central planners' investment decisions. The Russian banking system is painfully evolving from one which served as the agent of central planners toward a system of market driven, profit oriented financial intermediaries. But it is far from that goal. First, the financial services industry is far from competitive. Although the number of commercial banks is large, just over 1,300, activity is highly concentrated. As of April 2001 Sberbank accounted for over 75% of household savings deposits. Sberbank accounts for about 20% of lending and Vneshtorg bank accounts for about 5%. These banks have very little lending experience and will likely favor large enterprises in priority sectors not unlike the Soviet pattern of investments. As Table 2 indicates total domestic credit as a share of GDP is about 60% of the comparable market economy (ME) and private sector credit relative to GDP is less than 50% of the ME benchmark. Second, while the number of privately owned banks is decreasing, the state also continues to found new banks, Rossiiski Bank Razvitiya (the Russian Development Bank) in 1999 and Rosselkhozbank (the Russian Agricultural Bank) in 2000, which are likely to have different investment objectives, enjoy the implicit guarantees of the state, and therefore will likely provide directed, soft credits to industry and agriculture. Given that private sector lending activity is lagging dramatically (as indicated in Table 2) a more appropriate policy may be the creation of institutions subject to market discipline, but designed to meet the financing needs of small and medium enterprises in the private sector. On the positive side, smaller, regional banks, which were less affected by the 1998 crisis, are in a position to expand their activities.³³

³¹ To reduce the risk of disruption in the demand for products produced with highly specialized technologies (technology risk) firms often invest in less specialized and therefore less productive, flexible technologies. Therefore, diversification via activities of financial intermediaries, allows more investment in highly specialized, more productive technologies.

³² The law of large numbers reduces the probability that all depositors/investors withdraw at the same time.

³³ See Schoors (2001)

Third, information on enterprise performance, potential investment returns and entrepreneurial talents is very limited and of poor quality regardless of whether intermediaries or individual investors collect the information. In fact, even official, legally required information is often incorrect.³⁴ Fourth, most banks are acting primarily as treasury operations of their owners or acting implicitly as an agent of the government in lending activities, in effect continuing the history of centrally directed capital grants, but now with a weak expectation of repayment. As indicated in Tables 3 and 4 below loans (claims on the private sector) account for roughly one-third of the banking sectors assets. Tompson (1997) notes in 1995 that only 49.5% of assets were nominally income earning, probably much less if non-performing loans were excluded.³⁵

The distribution of assets indicates moral hazard issues remain a serious problem. It was suggested above that the introduction of deposit insurance would enhance competition, increase aggregate savings and improve the allocation of liabilities within the banking system. A second, perhaps more important reason to introduce a system of risk-based deposit insurance, is that an explicit system of guarantees is a more efficient means of reducing moral hazard and improving resource allocation than the current system of implicit guarantees. Since the financial institution itself determines the size of the implied guarantee, the institution can expand the implicit subsidy by doing more and riskier lending. Explicit risk-based guarantees can be limited, however. By pricing the deposit insurance in accordance with the institution's risk profile moral hazard can be limited and discrepancies between depositors', insurers' and lenders' risk tolerances are narrowed. Thus, a system of risk based deposit insurance benefits not only individual depositors, but also reduces system risk by reducing moral hazard. A prerequisite for an effective system of risk based deposit insurance is the ability to measure risk, i.e., accurate financial information and uniform accounting standards providing greater transparency of bank activity. Legal reforms in the Russian banking system are gradually providing the foundations for these prerequisites, but currently, accurately measuring risk exposure of individual banks is difficult if not impossible.

The financial system is not passive in a market economy, but accelerates growth in the real sector. The organization of financial intermediation networks is expensive, however. The level of financial sector development and economic activity is inter-related. Because the bulk of costs in establishing an intermediation network are the initial fixed costs, threshold effects are typical. An economy develops a specific type of intermediation system corresponding to the overall level of economic activity, which may be proxied by the level of per capita income. Then as per capita income increases, at some point the benefits of expanding or innovating within the intermediation system are perceived and capturable, the next stage of financial development begins. The benefits of deepening the financial system have a positive effect on overall economic growth and create the possibility of a circular relationship between financial development and growth. In this case a

³⁴ Iskayan and Besedin (2000), p.5 reports that "a CBR audit of financial statements submitted to it found that roughly half of a representative group of banks systematically falsified reports." In addition, even if information reported is correct, Russian accounting standards make it difficult to understand an enterprise's condition and inter-enterprise payments problems, and non-payments, make it difficult for managers to assess their own enterprise's performance, much less to convince potential lenders/investors.

³⁵ Thomson (1997), p. 1176. Note the level of lending was low and very short term, typically 30-60 days. No doubt the high and variable inflation of the time was a significant deterrent to lending. Although inflation has been reduced banks still tend to lend short term to finance transactions (e.g., imports) or acquisitions rather than longer term investment projects.

“virtuous circle” in which high income levels support development of the financial system and development of the financial system makes possible higher rates of growth. On the other hand, an underdevelopment trap or low-level equilibria may result. In an underdeveloped economy with few growth prospects, low-income levels make the development of the financial system impossible, which in turn hinders the allocation of resources to investment and further weakens growth.³⁶ When financial institutions are inadequately developed selecting more flexible, less specialized, and therefore less productive technologies mitigates production risk. But reduction in risk by technological flexibility in production weakens the incentives to develop financial markets and banking intermediaries that involve substantial fixed costs. This results in a low level equilibrium with an underdeveloped financial system.³⁷ A more developed financial system enables selection of more specialized, more risky but more productive production technologies. And, the resulting increase in risk is more easily diversified and mitigated by the existence of a developed financial system.

Before turning to a description of the Russian banking system it is important to realize that the banking industry in a market economy is typically not a perfectly competitive industry, but characterized by varying degrees of imperfect competition. Thus, in a transition economy policies should encourage competition, recognizing that the optimal level of competition is unclear. Natural imperfections in the banking system in a market economy arise due to the information intensive functions of the system. The activity of gathering and processing information on investments involves large fixed costs, which leads to imperfect competition and market segmentation. Because lenders (savers) and investors (borrowers) are generally not the same individuals there are information asymmetries since investors have better access to information about the quality and likely success of investment projects than lenders do. Therefore the functioning of financial markets is characterized by adverse selection and adverse incentives. Although banking is often monopolistically competitive Stiglitz (1994) argues greater competition is a two edged sword. Compression of intermediation margins via greater competition erodes profits and makes the system more vulnerable to productivity shocks as it increases the possibility of insolvency. Unlike other sectors insolvency in the banking sector can have wide spread negative repercussions on the rest of the economy as the volume of lending and activity in the real sector decline. Also, when a bank goes bankrupt the information it has collected on its particular clients or sector of lending activity may simply disappear. If so this leads to borrower rationing, which has a negative impact upon growth – the opposite effect that we would expect from compressing intermediation margins. The optimal level of competition, or the optimal intermediation margin, is not that of a perfectly competitive market. Reaching that optimal level is difficult in a well functioning market environment and particularly difficult in a transition environment like that of Russia today.

III. The State of the Banking System: Crisis, recovery and crisis?

³⁶ See Greenwood and Jovanovic (1990), Levine (1992b), Townsend (1983).

³⁷ See Saint-Paul (1992).

System characteristics and policy framework

While the overall level of financial development in a transition economy is difficult to measure, traditional indicators of financial development indicate the Russian financial sector is underdeveloped vis-à-vis market economies even after the crisis and stabilization of the system. As Table 5 indicates banking system assets as a percentage of GDP has increased from 22.2% in 1995 to 32.0% in 2000. This ratio for a market economy is typically in the 50-60% range.³⁸ Loans to GDP has increased from 8.7% to 12.3%. Banking system capital as a percentage of GDP has fluctuated, but averaged about 5.5%, in the range of a market economy, typically 5-6%.³⁹ While these aggregate measures seem to be improving it should be noted again that total domestic credit relative to GDP is about 60% of the comparable market economy and private sector credit relative to GDP is well less than half that of the comparable market economy (see Table 2). Further, these proportions have not changed during the last five years. Importantly the aggregate measures conceal the fact that the Russian banking industry is highly concentrated. At the end of 1997, just prior to the 1998 crisis, the top five banks accounted for 36% of total assets, and the top 50 accounted for 71%.⁴⁰ Also, as mentioned above, Sberbank holds roughly 75% of household deposits. Including enterprise deposits the top five banks accounted for 58% of ruble deposits and the top 50 banks accounted for 65% at the end of 1997.⁴¹

Since 1998 bank restructuring has taken place, albeit at a pace that some see as too slow. The crisis led to a dramatic decline in bank capital and a deposit run on the large Moscow banks leaving the majority of them insolvent. The Central Bank of Russia adopted emergency measures forcing six large commercial banks to transfer the bulk of household deposits to Sberbank, with any remaining deposits frozen.⁴² This prevented further withdrawals by the population and stabilized the payments system. However, the CBR was unable to move quickly to close large insolvent banks, which were at the heart of the influential Financial Industrial Groups, or to extend rehabilitation credits in a timely manner. Although the Bank had the power to revoke licenses and take over the management of insolvent banks, the attempts to do so immediately after the crisis were unsuccessful.⁴³ Legal delays and political maneuvering allowed assets to be transferred from the failing institutions to newly created shell banks and balance sheets were unilaterally restructured. Although the Agency for Restructuring Credit Organizations (ARCO) was

³⁸ Great Britain and Japan are extremes with bank system assets as a percent of GDP at 270% and 159% in 1990 and 1993 respectively. Warner (1998), Table 2.

³⁹ Note though that GDP has fluctuated greatly and published data are sometime suspect. Therefore these ratios should be interpreted with caution. See Iskyan and Besedin (2000) p. 21.

⁴⁰ Russian Federation (1997), p. 88.

⁴¹ Russian Federation (1997), p. 88.

⁴² These banks were Inkombank, SBS-Agro, Mocht-Bank, Rossiiskii Kredit, Menatep and Promstroibank. Also see OECD (1997) Annex I for a discussion of the largest 23 banks prior to the crisis.

⁴³ For example, the CBR's initial attempt to revoke the license of Inkombank was contested in court and it was not until June 2000 that the revocation of the license was allowed to stand and a Moscow arbitration court named external managers to liquidate the bank. See Iskyan and Besedin (2000) for a chronology of this case and a primer on asset stripping. Also see Schoors (1999). Another notable case is that of Promstroibank. In July 1999 the CBR withdrew Promstroibank's license and it was declared bankrupt. Various government officials declared their support of Promstroibank, the bankruptcy procedures were halted and the license suspension declared illegal, even though the bank was insolvent. In November 2000 an arbitration court ruled the CBR's actions were legal and proceedings were to continue. See *Russian Economic Trends* (November, 2000), p. 17.

established rather quickly, in November 1998, its effectiveness also was limited in the early period after the crisis.⁴⁴ It was capitalized with R 10 billion, the state holding 51% of its shares and the Central Bank of Russia 49%, an amount estimated at about 10% of that necessary for a complete recapitalization of the banking system.⁴⁵

By mid-2000 the results of ARCO's modest efforts were becoming visible.⁴⁶ Temporary administration was imposed upon Most Bank in May and Vneshtorgbank purchased it in October 2000. SBS Agro and Mezhkombank were bankrupted. Bankruptcy proceedings continue with Promstroibank and Menatep, Mosbusinessbank and Imperial Bank remain in receivership, or are battling for survival.⁴⁷ The first bank to emerge from ARCO management, in 2001, is Chelyabkomzembank, purchased by Rosselkhozbank the wholly state-owned bank created in April 2000. A restructuring plan for Uneximbank was approved and shareholders approved its merger with Rosbank (the bridge bank of Rossiisky Credit).⁴⁸ In addition, the Central Bank is expected to divest itself of ownership in all banks. It sold its interest in five Russian owned foreign-based banks (roszaganbanks) to Vneshtorgbank this year and will sell its ownership in Vneshtorgbank by 2002 and in Sberbank by 2004.

The foundation of the Russian banking system is provided by two fundamental laws, the Law on Central Bank of the Russian Federation and the Law on Banks and Banking Activity and by various parts of the civil code, in particular bankruptcy provisions and the tax code. The Central Bank of Russia carries the responsibility for not only monetary policy, but also bank licensing and prudential and regulatory oversight. Although the banking laws originated from the Soviet era, they have been amended many times. The 1995 amendments gave the Central Bank greater independence and made it the lender of last resort.⁴⁹

In 1999 Russian authorities provided a stronger foundation for bankruptcy and bank rehabilitation, and the framework to accelerate the process of bank restructuring by passing two new laws. The Law on Insolvency of Credit Organizations strengthened the CBR's intervention powers and the Law on Restructuring of Credit Organizations (June 1999) gave sole responsibility for restructuring banks to ARCO, provided for an equitable and transparent mechanism for shareholder write downs, and empowered ARCO to invalidate transactions made with the intent to defraud depositors and creditors of insolvent banks.⁵⁰ In the spring of 2001 the Duma passed three bills (incorporating most of the Putin government's proposal referred to as the Gref Program or the "IMF package") which gave the Central Bank of Russia additional supervisory powers, introduced

⁴⁴ It lacked funding and authority. Its first board meeting was held in March 1999. See *Russian Economic Trends*, March 1999, p. 3.

⁴⁵ *Russian Economic Trends*, December, 1998, p. 3

⁴⁶ While there are tangible results of ARCO's efforts critics maintain they are negligible since these banks are very small compared to the overall banking system and these bailouts may be seen as benefiting incompetent managers and therefore increasing moral hazard. The overall benefit to the banking system remains an open question.

⁴⁷ See *Russian Economic Trends*, various issues, (2000), (2001).

⁴⁸ Note that Uneximbank may be the only bank to be successfully restructured without assistance from ARCO or any other state agency. *Russian Economic Trends*, October 2000, p. 13.

⁴⁹ For additional details see OECD (1997), pp. 83,84.

⁵⁰ IMF (1999).

the legal concepts of a banking group and holding, streamlined the procedures for bankruptcy of credit organizations and revised the responsibilities of bank founders, shareholders and managers.⁵¹ *Inter alia*, specific legal criteria were introduced to facilitate the CBR's actions to withdraw banking licenses and initiate bankruptcy procedures which are expected to eliminate the legal wrangling typical of most recent actions initiated by the CBR. Given the new legislation it appears that a second phase in bank restructuring may now be undertaken.⁵²

Recovery of Banking Activity

Only recently has macroeconomic performance allowed banks to rebuild reserves and slowly increase the level of confidence of depositors and investors. Growth in the banking sector has been driven by the overall positive developments in the real sector and increasing demand for banking services. Bank loans increased 66% in 2000 and nine out of ten banks were reporting profits. By the first quarter of 2001 assets of commercial banks reached 93% of the pre-crisis level in real terms, and hard currency assets were 43% of total assets.⁵³ As personal incomes recovered, household deposits in the banking sector have increased and the share held by Sberbank has stabilized at just over 75% in June 2001. (Also see Figure 2.) By the spring of 2001 lending had increased to about 40% of assets in the Russian banking sector. This is improved, but still very low compared with the 80-90% typical of a bank in a developed market economy. Further, Sberbank and Vneshtorg Bank, the two largest state owned banks, accounted for most of the lending to the real economy.⁵⁴

Although lending has increased, Russian commercial banks still hold unusually large amounts of non-income producing excess reserves, illustrated in Figure 3. Due to the high risk of lending to the productive sphere of the economy loans amount to less than 45% of assets. Nearly 15% of assets are held in non-interest bearing accounts at the CBR. Given the high inflation environment this obviously impacts bank profitability. The lack of lending to enterprises, investment into the real economy, also limits economic growth. This is not a new phenomenon, however. Throughout the 1990s banks held very low levels of income earning assets.⁵⁵ This is attributable to the inability of bank managers to find, evaluate and monitor viable investment projects, and extreme caution with respect to the possibility of bank deposit runs and risks associated with inter-bank lending. The government has pressured banks to increase lending and, as mentioned above, created two new banks, Rosiiski Bank Razvitiya (the Russian Development Bank) and Rosselkhozbank (the Russian Agricultural Bank), to expand lending in critical areas.⁵⁶

⁵¹ See Iskyan and Besedin (2001), Appendix B for a summary of the Gref Program and the corresponding legislation.

⁵² *Russian Economic Trends*, June 2001, p. 8.

⁵³ *Russian Economic Trends*, June, 2001, p. 7.

⁵⁴ *Russian Economic Trends*, May 2001, p. 6.

⁵⁵ See OECD (1997, pp. 85-86).

⁵⁶ Of course the consequences of such pressures are problematic to the extent that related-party lending some of which may not be market driven intermediation, and lending to state institutions distorts the allocation of financial capital. Related-party lending and its consequences is very difficult to measure, however. See Iskyan and Besedin (2001) p. 15.

Increased lending is a double-edged sword, however. The rapid increase in bank lending requires increased diligence upon the part of bank regulators. Although bank capital increased 43% in 2000, under capitalization is still a serious problem.⁵⁷ Total equity capital is no more than 6% of GDP. Further, under relatively weak supervision many banks violate existing accounting rules, supplying the CBR with false financial statements. Regional offices are alleged to ignore the exaggerated statements of financial performance. According to the CBR 60% of banks overstated their profits and equity in official reports. At the same time CBR regional offices classified 9% of these banks as stable and with no faults. In addition, according to the CBR at least 20% of the banks classified as stable may be in difficulty.⁵⁸ To improve financial reporting, in October 2000 the CBR launched the introduction of International Accounting Standards for six banks. For these banks IAS based reports will be provided in 2001. Other banks are expected to adopt IAS reporting, but over a process of many years. While adopting IAS is highly beneficial, CBR authorities at all levels must also be diligent and determined in enforcing prudential regulations. While significant legislative progress has been made, CBR regulatory efforts are still insufficient.

IV. Concerns and Issues

It is clear that Russian policy makers have made much progress in reconstructing the banking system in the aftermath of the 1998 crisis. Recent legislation has increased the authority of the Central Bank to expedite bankruptcy and restructuring programs for individual banks and the economic recovery has provided an environment for improving bank profitability. The banking system in the aggregate, however, is still far from a vibrant, sound banking system. Koch (1998) provides a framework for analysis of the banking system presented in Table 6 below. In each of the six categories there is substantial work to be done.

As mentioned above new legislation improved the legal juridical framework, but much of the legislation is untested in practice. The bankruptcy code is improved, but it is too early to tell if legal challenges and political pressures have been eliminated from the process. Accounting, disclosure and transparency is improving and the CBR's recent project on International Accounting Standards is a tremendous step. However, even when bank reporting reveals problems authorities have been reluctant to take appropriate actions. For example, in the Spring of this year the CBR reported "the risk exposure of Russian banks exceeds all reasonable limits."⁵⁹ But the CBR does not appear to be taking any action to ameliorate excessive risk exposure. Will the CBR be able and willing to take a more active approach in system risk management?

⁵⁷ This is for the banking system. Of the approximately 1300 banks, the 1,115 smallest have capital ranging from US\$0.1 million to US\$5 million (Iskyan and Besedin (2001), p. 14). Many of these institutions simply conduct treasury functions of their enterprise owner or operate as foreign exchange offices rather as banks

⁵⁸ *Russian Economic Trends*, July 2000, p. 14.

⁵⁹ *Russian Economic Trends*, April 2000, p. 6. While banks may be lending to more risky ventures there is also a serious problem in matching the term structure of assets and liabilities. Approximately 25% of loans are for terms of one year or more whereas about 14% of liabilities are for a year or more. Without a highly liquid, capital market with sufficient depth a liquidity crisis may easily develop.

The 1998 crisis revealed that stakeholder oversight and institutional governance was a serious problem. New legislation was required to better define the legal liabilities of managers and enable management to be replaced during the restructuring process. Internal controls were notoriously weak and creditor rights were not clearly delineated and forcefully represented by authorities during the early phase of restructuring. Managers were able to strip the assets of banks and effectively rob depositors and creditors. ARCO still holds ownership stakes in over a dozen banks in the process of restructuring and new legislation will likely enable the process to work more smoothly in the future. However, political pressure and legal challenges will not likely disappear.

Market structure issues, ranging from the concentration of the industry, efficiency of financial products markets, relative lack of lending to the private sector, ease of entry and development of new financial institutions are a serious concern. Certain markets remain nearly monopolized. Sberbank's domination of the household deposit market gives it enormous power in the enterprise lending market. Further, many argue there remains too much state ownership to effect competitive market-oriented behavior on the part of financial institutions. Sberbank and Vneshtorg Bank are more than 50% owned by the Central Bank, ARCO has a dominant share of over a dozen institutions, and the Russian Federal Property Fund owns a majority of Roseksimbank. The creation of the Russian Development Bank and the Russian Agriculture Bank seem to move the industry toward greater participation by the state rather than less, and greater lending to state owned enterprises rather than to the private sector. In addition, state organizations account for very large shares of deposits and assets for many banks. All of which provides tremendous opportunity for political pressures to influence bank behavior. One positive factor is that the Duma has required the Central Bank to divest itself of ownership of commercial banks by 2005. Exactly how this is done is of critical importance. To date the Central Bank has sold its stake in five roszagranbanks to Vneshtorgbank – ownership remained in the state sector. While this does remove one conflict of interest and enables the Central Bank to take a slightly greater arms length view of these banks, the state still has ownership of them and political pressures are only one small step further away.

In addition, money and capital markets lack depth and breadth, which in turn may allow an individual, apparently healthy, participant to precipitate a market wrenching liquidity crunch.⁶⁰ In 1995 the Central Bank was slow to provide additional liquidity and nearly 200 banks failed. Can the Central Bank identify participants with excessive risk exposure and limit their participation to dampen system risk? Tough supervisory and prudential regulation is required. Given the admissions of rather lax enforcement of existing regulations, not so stringent enforcement of loan classification and provisioning requirements and the propensity for individual bank's to distort information in the reporting process, serious questions remain.

Finally, the safety net for depositors, an explicit, universal deposit insurance program, paid for by the banks, but targeting household depositors is critical. It is the foundation for creating

⁶⁰ For example, in May 2001 Infobank, a creditworthy institution with many large retail customers, nearly went bankrupt defaulting on payments on the inter-bank credit market. This could have precipitated a liquidity crisis similar to that of 1995. *Russian Economic Trends*, June 2001.

greater confidence in the banking system and increasing the amount of savings mobilized and available for investment. It also allows smaller banks to compete with Sberbank for deposits, promotes competition, reduces moral hazard and diversifies system risk. Yet the Duma, after much debate and many readings has failed to act.

In summary, tremendous change has taken place in the Russian banking system through the 1990s and since the 1998 crisis. The overall economic environment has improved and supported the recovery of the financial system. It is an open question however, whether or not the systemic changes and the attitudes of regulators and policy makers have changed sufficiently to prevent a banking crisis comparable to that of 1998.

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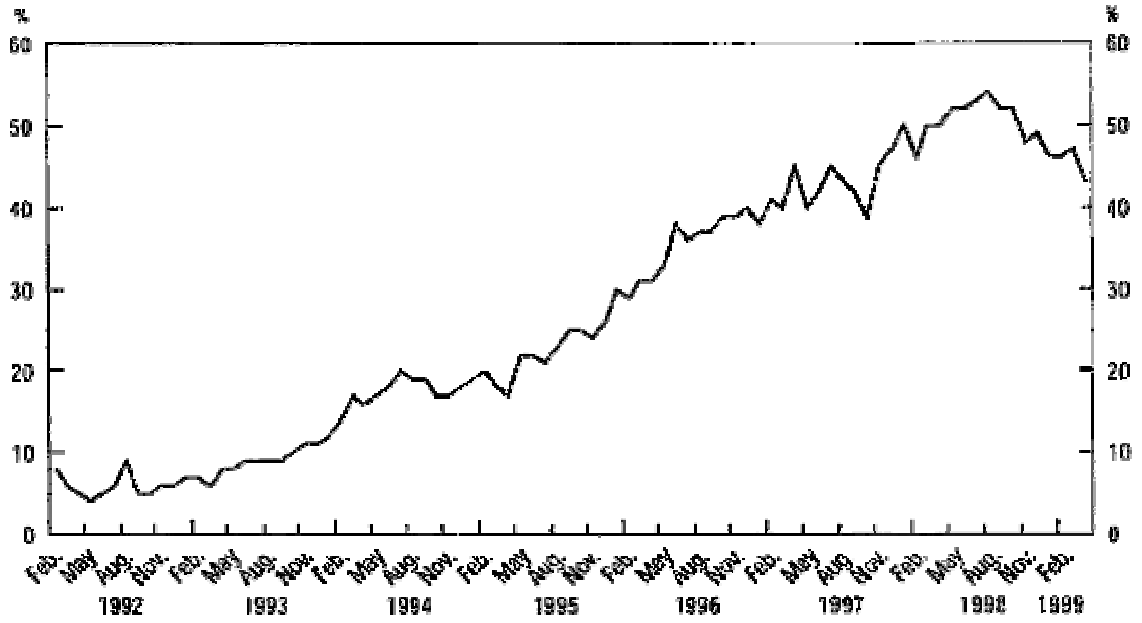
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Figure 1: Share of non-cash receipts for industrial firms



Source: OECD (2000) p.85. Original Source: Russian Economic Barometer.

Table 1: Types of Payments by Large Firms and Natural Monopolies by Industrial Branch, December 1998. (As a percentage of total payments).

	Cash	Offsets	Securities	Barter	Other	Total
All firms	43.4	29.5	11.5	7.5	8.1	100
Electricity	19.5	45.2	16.7	4.1	14.5	100
Fuels	39.4	36.5	15.2	4.7	4.2	100
Machine-building and metalwork	14.1	37.4	31.3	13.5	3.7	100
Construction & Construction materials	26.0	44.6	7.8	18.5	3.1	100
Transportation	37.4	45.8	11.0	0.3	5.5	100
Light industry and food	69.8	12.7	4.0	7.6	5.9	100
Agriculture	65.1	3.3	0.5	28.6	2.5	100
Trade and public catering	84.4	11.6	3.2	0.3	0.5	100

Source: OECD (2000), p. 87. Original source Goskomstat.

Table 2: Total Domestic Credit and Private Sector Credit as per cent of GDP and Market Economy Benchmark.

	1994	1999
Total Domestic Credit, % of GDP	31.7	32.7
ME Benchmark, %	52.0	51.3
Proportion of Benchmark level	61.0	63.7
Private Sector Credit, % of GDP	12.1	11.5
ME Benchmark, %	44.2	43.3
Proportion of Benchmark level	27.4	26.6

Source: Derived from Tables 1 and 2 of Fries and Taci (2001). Benchmarks are based upon regression estimates of each ratio as a function of GNP per capita for a sample of 127 market economies. See Fries and Tacci (2001) for details.

Table 3: Consolidated Accounts of Credit Institutions (million rubles, December 31)¹

	1995	1996	1997	1998	1999	2000
Reserves ²	36712.3	47123.4	72974.5	67762.9	160017.3	301124.5
Foreign assets	46149.4	72874.8	72717.3	219593.0	370651.3	476581.8
Claims on general govt. of which, claims on governments of constituent territories of RF and local self-government bodies	62638.5 721.7	150721.3 2790.4	194689.0 18691.8	259401.6 24445.6	437675.2 19870.5	526020.7 18531.3
Claims on non-financial state enterprises	62460.4	69371.4	33217.4	33078.8	46901.2	73972.6
Claims on non-financial private enterprises and households	133786.8	157337.2	236438.4	345962.6	521644.8	867132.2
Claims on other financial Institutions	525.0	242.0	8075.9	7270.7	13060.2	14525.0
Total Assets	342272.4	497670.1	618112.5	933069.6	1549950.0	2259356.8
Demand deposits	69331.9	87303.0	162532.1	149470.7	249673.7	443020.9
Time, saving and foreign currency deposits of which, deposits in foreign currency	124496.6 55255.7	164898.7 69447.7	158714.8 80454.7	283996.1 190872.7	456527.8 290212.9	680646.9 420090.5
Deposits, access temporarily restricted ³	--	--	6270.5	22595.1	10223.6	6373.3
Money market instruments	11858.5	30372.2	42435.9	43311.9	107817.2	191059.0
Foreign liabilities	29969.8	58892.5	104197.4	203136.8	222626.6	248920.7
General government deposits of which, deposits of governments of constituent territories of RF and local self-government bodies	9741.1 4251.9	11557.2 4210.6	18236.1 9139.9	20676.5 10148.2	28671.8 15626.8	54547.2 36641.8
Obligations to monetary authorities	8005.1	6798.8	8779.8	71893.6	200121.4	205439.4
Capital accounts	66687.8	123817.5	143909.4	157594.7	293199.4	437265.2
Sundry (balance)	22181.5	14030.3	-26963.5	-19605.7	-18911.6	-7915.9

Notes:

1. From the consolidated balance sheets of credit institutions, Sberbank Savings Bank, and Vneshekonombank.
2. Reserves of credit institutions comprise cash reserves in vaults and their funds in accounts with the Central Bank of the Russian Federation.
3. Deposits with temporarily limited access comprise funds in accounts with credit institutions which cannot be used by their holders within a certain time limit in accordance with a contract or transaction terms or current conditions of a credit institution's activity.

Source: *The Bulletin of Banking Statistics*, various issues, Central Bank of the Russian Federation

Table 4: Selected Assets and Liabilities of Commercial Banks, including Sberbank.
(In billion rubles).

	Total Assets	Claims on the general government	Claims on the private sector	Bank savings by Russian citizens (ruble household deposits)	Foreign currency deposits	Foreign liabilities
1995	342.3	62.6	133.8	70.6	55.3	30.0
1996	497.7	150.7	157.3	118.4	69.4	58.9
1997	622.7	191.5	225.9	148.2	80.5	104.2
1998	933.1	259.4	346.0	149.5	190.9	203.1
1999	1549.7	437.7	521.6	211.1	290.2	222.5
2000	2259.4	526.0	867.1	304.2	420.1	249.0
2001 (April)	2472.0	561.3	989.2	342.5	477.1	256.4

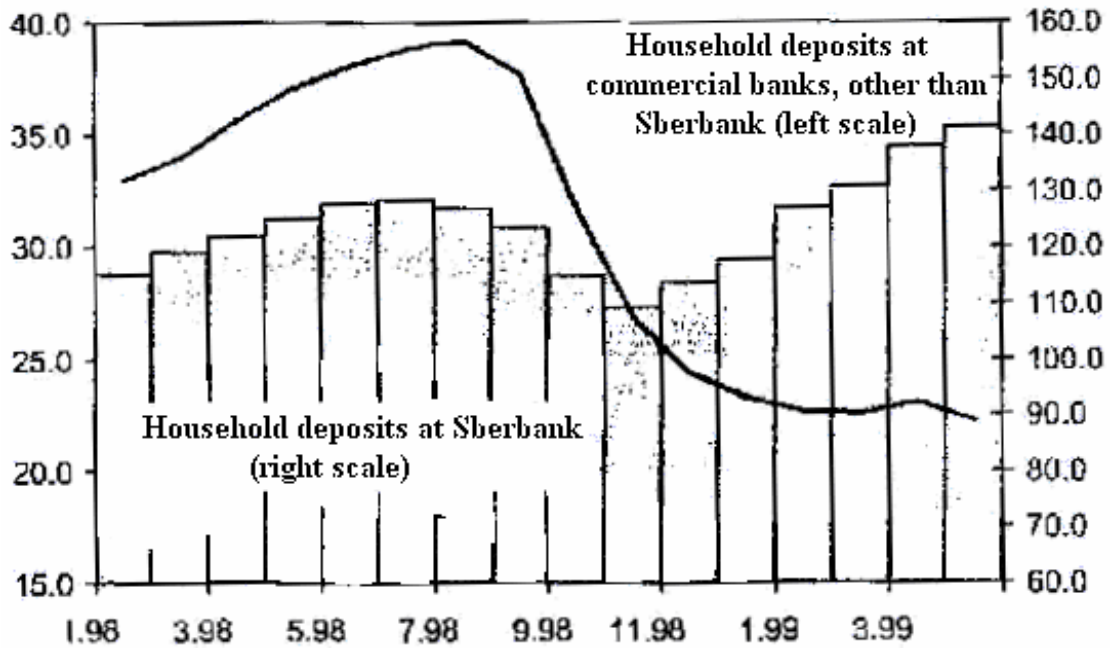
Source: *Russian Economic Trends*, June 2001, Original Source: Goskomstat, CBR

Table 5: Banking System Characteristics (end of period).

	1995	1996	1997	1998	1999	2000
Assets/GDP	22.2%	23.2%	25.1%	34.0%	32.6%	32.0%
H.H. Deposits/ GDP	4.6%	5.5%	6.0%	5.5%	4.4%	4.3%
Loans/Assets	39.0%	31.6%	36.3%	37.1%	33.7%	38.4%
Loans/GDP	8.7%	7.3%	9.1%	12.6%	11.0%	12.3%

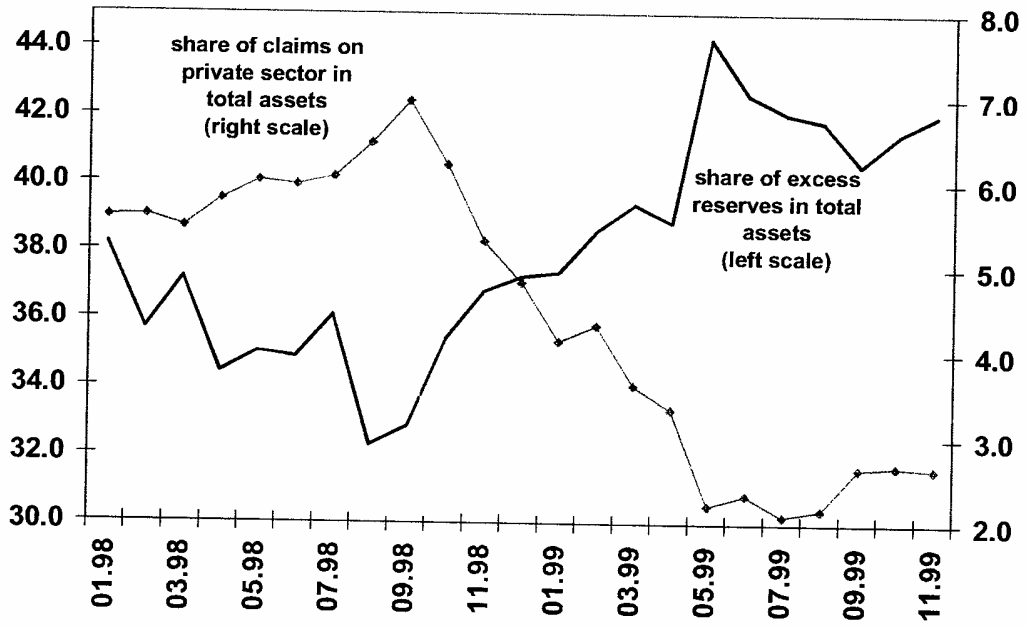
Source: calculated from tables 2 and A-1.

Figure 2: Household Deposits in Sberbank and other commercial banks in billion rubles



Source: Russian Economic Trends, June 1999, p. 4. Original Source: Goskomstat

Figure 3: Share of commercial banks' claims on the private sector and share of excess reserves in total assets (%)



Source: Ivanova and Schoors (2000) p. 5

Table 6: Indicators of a Robust Financial System

1. Legal and juridical framework

Well-defined property rights and contract law
Market contracts easily enforceable in practice
Ability to pledge and seize collateral
Well-developed bankruptcy code

2. Accounting, disclosure and transparency

Loan valuation, asset classification and provisioning practices reflecting sound assessment of counterparties
Effective and regular auditing mechanisms
Information on the creditworthiness of financial institutions made publicly available on a regular, frequent basis
Timely publication of relevant aggregate financial data (macroeconomic indicators, reserves, banking sector statistics, etc.)
Availability of impartial credit-rating or credit information facilities

3. Stakeholder oversight and institutional governance

Capital adequacy requirements commensurate with risk
Replacement of management for poor performance
Enforceable legal liability of managers
Pervasive use of effective systems of risk management and internal control

4. Market structure

Financial sector open to qualified new entrants, including those from abroad
Share of foreign participants in total assets
Financial sector concentration ratios
Liquid interbank money and capital markets
Regulations permitting a full range of financial instruments
Sound and effective payment and settlement systems

5. Supervisory/regulatory authority

Independent from political interference in the daily conduct of supervision and appropriate accountability for achieving clearly defined objectives
Power to force disclosure, impose penalties, etc.
Adequate resources for staffing, training, compensation
Conducts supervision on a consolidated basis

Shares information with other supervisors

Verification of information on risk management and internal control systems and on asset quality by regular examinations or external audits

Adherence to norms established by international consultative bodies (Basle Committee, etc.), in principle and in practice

Measures to address particular types of risk:

Evaluation of risk management systems

Connected lending

Risk exposure and loan concentration

Special attention to foreign currency and interest rate risk management and exposures

Heightened scrutiny of asset quality and capital adequacy in the face of sharp asset price movements

Strategy for addressing financial insolvency:

Procedures for prompt corrective action or the equivalent

Appropriate exit policy

6. Design of the safety net

Explicit rather than implicit deposit insurance, paid for by banks and targeted especially towards protecting small depositors

Appropriate allocation of losses among stakeholders

Stringent conditionality for the use of public money

Source: Koch (1998). Original source: Group of Ten (1997).

Appendix Tables

Table A1: Selected Economic Activity

	Nominal GDP	Real GDP, (s.a.)	Nominal consumption of goods and services	Real consumption of goods and services**	Nominal expenditures on new construction and equipment	Real expenditures on new construction and equipment
	(R bn)	(1997=100)	(R bn)	(1995=100)	(R bn)	(1997=100)
1995	1 540.5	102.6	664.8	100.0	267.0	128.5
1996	2 145.7	99.1	950.1	97.9	376.0	105.3
1997	2 478.6	100.0	1 124.0	100.9	408.8	100.0
1998	2 741.1	95.1	1 339.9	95.5	407.1	88.0
1999	4 757.2	100.2	2 191.7	82.7	670.4	92.7
2000	7 063.4	108.6	2 911.4	91.0	1 165.2	108.8
2001 (April)			1114.3	93.0	331.0	110.2

Notes:

* Series on consumption and investment differs slightly from SNA concept.

** Nominal consumption deflated by CPI.

s.a.: seasonally adjusted

Source: *Russian Economic Trends*, February 2001. Original Source: CBR.

Table A2: Monetary Aggregates (end of period)

	Monetary base	Net international Reserves (NIR)*	Net domestic assets (NDA)**	M0 - currency in circulation	M2***	Outstanding stock of GKOs and OFZs nominal
	(R bn)	(\$ bn)	(R bn)	(R bn)	(R bn)	(R bn)
1995	103.8	7.7	68.1	80.8	220.8	73.7
1996	130.9	1.7	123.0	103.8	288.3	237.1
1997	164.5	4.0	142.1	130.4	374.1	384.9
1998	210.4	-8.4	249.3	187.8	448.3	n.a.
1999	324.3	-3.2	0.0	266.5	704.7	n.a.
2000	519.6	16.0	88.6	419.3	1144.3	184.2
2001, April	531.1	20.4	n.a.	435.4	1210.0	189.5

Notes:

* Since June 2000 NIR and NDA are estimated by RET.

** Net Domestic Assets (NDA) of the monetary authorities equal monetary base minus net international reserves. NDA is calculated using exchange rates of R27/\$ for 2000, R24.18/\$ for 1999, R6.0/\$ for 1998, R5,560/\$ for 1997, R4,640/\$ for 1996, R3,550/\$ for 1995. In 1999 there were some changes in methodology for NDA and NIR data.

*** M2 includes currency in circulation, demand deposits, and time deposits (there is a break in the series from December 1996, from then it includes only deposits at banks with active licenses).

Source: *Russian Economic Trends*, June 2001, original source: CBR

Table A3: Interest rates (average annual rates)*

	CBR refinance rate*	Lending rate**	Deposit rate**	Overnight interbank rate	GKO average secondary market yield, all maturities	RTS index, monthly average
	(%)	(%)	(%)	(%)	(%)	(01.09.95=100)
1995	185	320.3	102.0	190.4	161.8	80.9
1996	110	146.8	55.1	47.6	85.8	160.3
1997	32	32.0	16.8	21.0	26.0	427.9
1998	60	41.5	17.1	50.6	n.a.	277.6
1999	57	40.1	13.7	14.8	n.a.	106.9
2000	32	24.2	6.5	7.1	12.7	199.5
2001, April	25	17.4	3.5			166.0

Notes:

* Unweighted monthly average.

** Data prior to January 1997 are not compatible with current methodology. From 1998 data on lending rate are for commercial banks excluding Sberbank.

Source: *Russian Economic Trends*, June 2001, original source: CBR.

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