

# Introduction

**David Lane**

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In the post-communist societies, the paths of transition to a market and privatized economy are embedded in the legacy of the structure of state socialism. The hegemonic role of the state, as regulator, provider of welfare and owner of economic wealth made state socialism qualitatively different from the capitalist systems of the West. The countries of the former USSR (and particularly the Russian Federation) have not, on a comparative basis, made a successful transition to a market economic system or to a pluralist political order. The research in this volume considers just one element in the transition process: the rise of commercial market-oriented banks, their links with government and non-financial companies and their role as intermediaries in the provision of finance for investment. The contributors also consider the international aspects of Russian banking and particularly the impact and consequences of the financial crisis of 1998.

Discussion of economic transformation/transition in the post-communist countries has revolved around the focal points of the introduction of markets and the privatization of assets. The banking system, the role of money and their implications for economic development have been considerations of a secondary order brought into focus as a consequence of the hyperinflation of the early 1990s and the financial collapse of 1998. The essays in this collection are arranged in three parts, the first covering the evolution of the post-communist system of banks and their functioning, the second focusing on governance and the third considering global aspects of Russia's financial crises, reform and the implications for foreign debt. It is hoped that the collection will provide an outline of Russian banking in the post-communist period.

The legacy of state socialism to the evolving banking system in Russia is addressed in the chapter by David Lane, who argues that the processes of Soviet banks were not conducive to the formation of a capitalist type of banking system. Soviet banks had no role in the appraisal of risk, either in the production of commodities or with respect to enterprises which produced them. The absence of money as an independent regulator of economic activity has led to the 'remonetization' of the economies of post-communist countries. In the case of Russia, however, the ways such

remonetization has taken place have been one of the fundamental faults in the process of transformation. Under conditions of modern capitalism, banks have the function of managing a monetary payments system; to further accumulation, they allocate savings to investment; they perform entrepreneurial functions with respect to business; they also utilize money to make money, often by depositing abroad. Many chapters in the book acknowledge that Russian banks have played a very minor role in the provision of capital for Russian industry and have been more concerned with financial speculation. Martin Myant makes the case that Eastern European banks have been somewhat more successful. They were part of a better ordered system of transition from state socialism and there was a greater concern with stability in countries such as Czechoslovakia. Also, even under the communist system banks were more effective. The financial and economic environment was also more conducive to an effective banking system. Proximity to Western Europe and the greater affinity with a market culture have led to a more positive role being played by foreign banks, which have been able to penetrate the market and also buy shares in local banks. However, he points out that, as in the Russian Federation, banks pursuing profit and self-interest would not rationally support the high-risk domestic industries and so the economic transformation of industry, without government pressure, would have been thwarted.

It is recognized that the movement to a market economy has taken place in the context of a high level of dependency on the state: a large part of the economy is still controlled by it and government institutions have large stakes in different types of bank. A path-dependent approach is taken in many of the chapters and this explains why non-financial companies, which themselves may be partially owned by the state in various forms, have large stakes in many banks. The chapter by Satoshi Mizobata demonstrates that the government provides large subsidies to non-financial corporations. In this context, he shows how different political interests seek either greater state control of banks or the large-scale privatization of state assets in banks. Both his chapter and that by William Tompson emphasize the very small contribution that the banks in the post-Soviet period made to investment in the real sector and their very low commitment to granting long-term loans. In this respect Tompson points out that they are constrained by a high-risk environment with a dearth of borrowers with good prospects of repaying debts. A theme which runs through many of the chapters is the way in which banks sought profits through the purchase of government loans.

Popular literature defines control of Russian companies in terms of 'oligarchs' many of whom derived their power from bank capital. Tompson's chapter modifies this view somewhat by arguing that the power wielded by

banks as autonomous units has been exaggerated. Banks were unable to survive without support from the state which controls one-third of the banking sector's assets. The focus of control, he contends, has moved to parent holding companies which are in the non-financial sector. It is here, particularly in export-oriented industries such as gas and oil, that profits and economic power are concentrated.

The role of banks in the purchase of assets in the 'loans for shares' process is taken up by Duncan Allan. The point again is made concerning the dependence of the emergent banks on the state, which had the authority to privatize public assets and which gave the banks the possibility of self-enrichment. This chapter sets the banks' role in purchasing shares on the basis of loans in the context of privatization policy and of political pressures. Here insider dealing undoubtedly led to some banks securing undervalued assets. However, the branch ministries and managerial interests as well as existing non-financial companies were able to bring their own interests to bear and significantly reduced the scope of the proposals. Once more, Allan points out that 'state patronage remained the key to business success', echoing voices in other chapters, and he concludes that banks were lobbyists rather than oligarchs.

An inadequate legal framework and possibilities for corruption are also characteristics of the business environment of post-communist banks. Heiko Pleines considers the role of Russian banks in illegal capital flight, tax evasion and money laundering. He contends that while the banks are implicated to some extent in these forms of crime they are not major players, accounting for no more than 20 per cent of illegal capital flight and 10 per cent of tax evasion. He also concludes that there is no evidence to substantiate the view that organized crime controls a large part of the banking sector, though it applies to some small banks.

Mizobata and Lane suggest that the reciprocal ownership of assets by banks, non-financial companies and state institutions has led to the evolution of a depersonalized and corporate form of capitalism in Russia. The privatization of companies, both financial and non-financial, led to a dominant pattern of corporate control in which clients of banks are significant shareholders. This is detailed in a study of three Russian banks in Chapter 4.

The move to a market and the initial monetarization of the economy led to high profitability of financial operations consequent on the level of inflation (2317 per cent in 1992 and 842 per cent in 1993) and the fall of the value of the ruble against the dollar. As shown in the chapter by Brigitte Granville, between 1992 and 1995 large budget deficits were financed by monetary issue. Government bonds (GKOs) were issued with rates of interest rising from 42 per cent in February 1998 to 150 per cent in May of that year. By 1998, external government debt had reached \$150 billion and

internal debt \$44 billion, of which one-third was owed to non-residents. The government defaulted on this debt in August 1998. Granville also deals with the way in which the Russian government is dealing with the problems of the banking sector. She points out that bank restructuring has been disappointing and that many insolvent banks remain. Bank lending is still very low: only 18 per cent of GDP compared to 57 per cent in the Czech Republic. Opening up the sector to foreign banks is suggested as a way forward. Improved corporate governance and restructuring of the banking sector are necessary to achieve better microeconomic management.

The chapter by Sheila A. Chapman and Marcella Mulino attempts to explain the currency crisis in terms of a multiple set of factors. Though it is impossible in this brief introduction to do justice to their argument, they suggest that there were intertwined factors: an inconsistency between domestic policies and a fixed exchange rate, speculation against the currency and also the consequences of broader financial crises. They consider that the IMF's liberalization policies were incompatible with the structural weaknesses of the Russian economy during the transformation process. Thus the policy of defence of the ruble (advocated by the IMF) was not sustainable. Devaluation, they contend, could have happened sooner with overall positive results.

After the crisis of 1998, Russia's foreign debt stood at more than 100 per cent of GDP: much above the average of 33–35 per cent of developing countries. The ratio of currency reserves to debt was only 6.6 per cent, compared to the average of developing countries of 28 per cent. Claudia M. Buch, Ralph P. Heinrich, Lusine Lusinyan and Mechthild Schrooten discuss the political economy of banking reform in the context of ongoing negotiations on foreign debt restructuring. They argue that banking reform is important for post-crisis recovery because of the important role sound banks could play both in the financing of domestic investment and in the intermediation of foreign capital inflows. Because economic recovery improves Russia's ability to service its foreign debt, banking reform is in the interest not just of the government, but also of its foreign creditors. This creates room for negotiations between the government and its foreign creditors about restructuring the debt as a way to share the costs of reform.

Julia Solovieva deals in her chapter in more detail with the ways in which foreign investors put money into Russian banks and the ways in which the default has affected their investments. She distinguishes between equity and fixed income investments and gives examples of the difficulties faced by investors during the restructuring period that followed the crisis. She contends that the 'safest' pre-crisis investments were not necessarily the ones where the recovery rates were the highest, and protracted delays further eroded the value of investments.

The general conclusions of the book are that the Russian banking system is unique in comparison to the major paradigms of Anglo/American and German/Japanese systems. It has been and is highly dependent on the state. Russian banks have not played an important part in support of the non-financial sector; their lending has been very short-term. Banks lack a legal framework and have participated in corrupt practices. However, most if not all the contributors to this volume would see the institutional framework and the legacy of the state socialist system as important determinants of the economic and political activity of the banking system. The formation of a commercial banking system in the context of a spontaneous movement to capitalism and a weak state have been contributory factors in its weaknesses. Finally, many of the contributors are positive about current developments. Broader structural reform of the economy and the strengthening of the legal system advocated by the Putin administration are considered to be necessary conditions for the banking system to develop and play a positive role in economic development.

