WILL THE CENTRAL BANK OF RUSSIA REMAIN INDEPENDENT?

By Michael S. Bernstam and Alvin Rabushka

In late December 2000 and early January 2001, a spate of stories appeared in the Western and Russian press that President Vladimir Putin was determined to overhaul Russia's banking system. Reports circulated that he sought to oust the chairman of the Central Bank. In televised remarks, Mr. Putin stated that the banking system was not functioning properly and that the Central Bank had not done all it could in developing and stimulating the banking system.

These complaints about Russia's banks are not new. (See our previous articles, "Russia Has no Real Banks" and "Russia's Banks are Corrupt and Unreformed.") They mirror criticism by the International Monetary Fund, the World Bank, and numerous foreign national and private lenders, especially since the Russian government defaulted on its domestic debt in August 1998 and on its international debt in 1999.

These reports raise two immediate questions. First, would replacing the Central Bank chairman raise the probability that Russia will develop a real banking system in the near future? Second, are there any intrinsic problems that preclude the development of real banks, which would perform the function of intermediating savings from depositors to investment for potentially viable firms?

There is an unstated, generally unrecognized, but perhaps more important matter that must first be addressed. In Russia's post-1991 evolution from central planning, a new economic system has emerged, what we call enterprise network socialism (ENS), described in Chapter 1 of our book, *From Predation to Prosperity*. ENS has reversed the traditional roles of the Central Bank in the conduct of monetary policy and the government in the conduct of fiscal policy. By the application of its mandatory 75% conversion rule of foreign currency earnings into rubles, the Central Bank has become Russia's implicit chief tax collector. Meanwhile, through its sales and repayment of bonds, the Treasury has a large influence on monetary policy. (See our previous article, "How Big Are Russia's Foreign Exchange Reserves.")

Restoring the proper functions to the Central Bank and the government requires breaking up ENS. Replacing any head of the Central Bank would not necessarily accomplish this objective, but could put at risk the current high level of tax collection if the 75% conversion rule is softened or abandoned to satisfy those who favor unrestricted capital account convertibility of the ruble.

Breaking up ENS would not only permit the restoration of traditional functions to the Central Bank and the government, it would also lay the foundation for the development of a real banking system. The mechanics of this process are spelled out on pages 90-98 in Chapter 4 of *Fixing Russia's Banks*. The objective of bank reform is to build a new banking system of private credit markets. The process requires an orderly transformation of the banking system and the takeover of insolvent banks. Simply put, the proposal involves the swap of assets, of debt for equity, which would result in the creation of mutual funds capitalized with natural resources. Households whose deposits were confiscated or destroyed would receive a proportional share of the newly-created, privately-held assets.

There are no intrinsic obstacles to the development of a real banking system which can be attributed to the negligence or misfeasance of the Central Bank. Perhaps the Central Bank could do more in encouraging the breakup of ENS. But any measures or recommendations it might put forth would require approval by the government and legislative action. The obstacles lie in the structure of interests that constitute ENS, which can only be broken up by concerted government action.

Breaking up ENS is both the basis for laying the foundation for sustained growth (see our previous article, "Can Russia Grow Faster than 4 Percent? Yes, if...") and a real, market-based banking system.