Financial Sector Reform in Russia: Déjà Vu All Over Again

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In the beginning, when Russia and other countries emerged from the collapse of the Soviet Empire, the International Monetary Fund, the World Bank, and scores of international advisors rushed in to establish a new field of study, of so-called "transition economies." Right at the outset, they urged the application of the triad of macroeconomic stabilization (reducing inflation and getting the external accounts into balance), price liberalization (freeing up both internal and external prices), and privatization (transferring ownership of state-owned enterprises to private firms). (See *From Predation to Prosperity*, Chapter 2, pp. 2-8 and 12-18, in which the triad of stabilization, liberalization, and privatization is shown to be internationally incompatible and unfit for post-central plan economic systems.)

Since 1990, this body of public policy analysis has chronicled the successes and failures, largely failures, of the transition economies to make the shift to market economies. The international institutions and scholars have developed a checklist of obstacles to the transition, which are widely known in the economics literature. The leading culprits are rent-seeking, the soft-budget constraint, crony capitalism, capital flight, real appreciation of the domestic currency, and so forth. These obstacles to reform apply to banking and financial services, the development of competitive markets, and so on.

More than a decade has now passed since Russia and other newly-independent economies have been trying to shift from their former central-plan to modern market economies. The results have been less than stellar, as the GDP of many of them still remain below 1992 levels. (See *From Predation to Prosperity*, Chapter 2, which provides a detailed decade-long overview. Figure 2.1 summarizes the data. Figure 2.2 compares the cumulative growth rate with adherence to the IMF policy package, revealing a negative correlation.) And yet, the IMF and transition scholars continue to sing in chorus from the same prayer book.

The most recent example took place in London on December 3-4, 2002. Geoffrey Barnard and Poul M. Thomsen, IMF Resident Representatives in Moscow, delivered a paper on "Financial Sector Reform in Russia: Recent Experience, Priorities, and Impact on Economic Growth and Stability." (Http://www.imf.org/external/country/rus/rr/2002/pdf/120402.pdf) It reflects IMF business as usual, or deja vu all over again. To explain the failure to reform Russia's financial sector, and the generally dismal prospects for long-run growth, the authors enumerate a laundry list of cliches. The paper lacks any systematic framework within which to understand this recurring failure, or why prospects for sustained, high growth are dim.

Below is the laundry list, to which we append our previously washed and pressed replies:

(1) Real appreciation of the ruble. ("Getting the Macroeconomic Balances Right? Or Achieving High Growth? Are the Two Compatible in Russia" "What Real Appreciation of the Ruble? A Postscript: Is Real Depreciation Setting in?" "What Real Appreciation of the Ruble?" "The New IMF Orthodoxy for

Russia Is the Old Protectionism for Africa" "Appreciating Ruble Appreciation" "Can More Liberal Subsidies Spur Growth and Reduce Inflation?" "Too Many Dollars?")

(2) The Dutch Disease. ("The Dutch Disease: Peter the Great's Real Legacy?")

(3) Rent seeking. (*From Predation to Prosperity,* Chapter 1, pp. 4-5)

(4) Monopolistic market position.

(5) Widespread corruption and crony capitalism. ("Russia's Banks Are Corrupt and Unreformed")

(6) Capital flight. ("The 100% Repatriation Rule: An Option for Russia" "Is Financial Liberalization Good for Russia?" "Capital Flight?")

(7) Low monetization of the economy. (*From Predation to Prosperity,* Chapter 1, pp. 10-22; "New Data Confirms the Basic Relationships in the Russian Economy: Ten Years of the New Economic System Revisited")

(8) Household savings held in dollar cash. (*Fixing Russia's Banks*, Chapter 4)

(9) Lack of trust: of population in banks, of banks in borrowers, of foreign counterparties in Russian banks, and banks in each other. (*Fixing Russia's Banks*, pages 91-108)

(10) Weak supervision of banks by the Central Bank of Russia. ("Will the Central Bank of Russia Remain Independent?")

Their solutions include deposit insurance to level the playing field between state and private banks (with denial of entry to unsound banks), strengthening banking supervision, and not seeking major changes in state banks at this time.

A laundry list of cliches is a poor substitute for analysis. In *Fixing Russia's Banks* we set forth a comprehensive balance sheet for both Russia's commercial banks and its monetary authority. We explained in Chapter 4, pp. 91-98, how debt-for-equity swaps could build a new banking system that would replace indebted, insolvent banks with new private owners, which would result in the development of genuine private credit markets. To this day, neither the IMF or other transition scholars have yet proposed any real reform of Russia's banks. Rather, they, as exemplified in this most recent IMF paper, choose to reiterate shopworn cliches, and then wonder why Russia's banks, and its economy in general, remain in need of reform. (See *From Predation to Prosperity,* Chapter 4, pp. 17-27 where we show that our framework is applicable to the full range of economic policies, not just banks.)