SHORTING RUSSIA'S BANKS

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After the purchase of Bank One by J.P. Morgan Chase, we, among many others, were asked to comment on the merger. Financial markets seem to be currently enthusiastic about it. But like all business decisions, the wisdom or miscalculation of this merger will be evaluated by future returns and share prices. The next question we were asked is how does this story compare with Russia.

How, indeed? The purchase price of one U.S. bank is about equal to the entire deposit base of the Russian banking system. J.P. Morgan Chase paid (in its own stock) the equivalent of $58 billion to shareholders of Bank One for the merger. A quick look at the latest balance sheet of Russian credit organizations, available on the web site of the Central Bank of Russia, yields a simple calculation. Ruble-denominated demand deposits and savings and time deposits of both households and enterprises in Russian banks summed up to R1,782 billion in December 2003. At the going exchange rate of $1=R29, this amounts to $61 billion in round numbers. This is about the purchase value of Bank One, which, before the merger, was the sixth largest U.S. bank in the size of assets.

The size of the Russian economy can be preliminarily estimated around R12 trillion in 2003. The ratio of deposits to GDP is often used to assess financial depth, capital formation, and the level of financial intermediation and development in general. This ratio ranges from 70 to 120 percent of GDP in Western market economies and China (calculated from the IMF, *International Financial Statistics*). In Russia, deposits of R1.8 trillion in the R12 trillion economy yield the deposits-to-GDP ratio of about 15 percent. This is higher than in most African countries but lower than in most Latin American, let alone East and South Asian, economies. The deposits-to-GDP ratio around 15 percent in 2003 represents a recovery from 8-10 percent in the mid-1990s. This still has a long way to go to recover the deposits-to-GDP ratio of 55 percent, the level of middle-income countries achieved in Russia under Communism and central planning before the reform of 1992. (For the data and detailed discussion, see *Fixing Russia's Banks*, especially figure 5 on page 35). Russia's banks are still failing to accomplish the primary objective of any banking system, to intermediate household savings into productive investment as one of the conditions for economic growth.

To put the issue back into a comparative context, the total assets of the Russian banking system in late 2003 reached about R4.8 trillion or 40 percent of GDP. In dollar terms, total assets of the entire Russian banking system amounted to $160 billion. Total assets of large individual U.S. banks compare as follows: U.S. Bancorp, $189 billion; Washington Mutual, $287 billion; Bank of America after the merger with Fleet Boston, $966 billion; J.P. Morgan Chase, after merging with Bank One, $1.1 trillion; and Citigroup, $1.19 trillion. Total assets of Russia's banks are smaller than those of any single large U.S. bank.

Put in a broader context of Russian economic recovery, there are limits to growth fueled by Central Bank restrictive quasi-fiscal policies and oil receipts. (For a detailed discussion of Russian recovery in 1999-2003 and overall economic fluctuations in 1992-2003, see Addendum to Chapter 1 of *From Predation to Prosperity*, "The Roller Coaster of the Russian Economy"). Sustained growth requires, among many

other pre-conditions, a functioning financial system. In 1998 we published *Fixing Russia's Banks: A Proposal for Growth.* On pages 91-98 we put forth a proposal, including a swap of debt for equity, that would transform Russia's banks into a new banking system with private credit markets. Giving the current status of the Russian banking system, which we have just illustrated, this proposal still offers a viable alternative.