# RUSSIA'S BANKS ARE CORRUPT AND UNREFORMED

by Michael S. Bernstam and Alvin Rabushka

The Moscow correspondent of *The Economist*, in the issue dated September 30-October 6, 2000, reported that Russia's banks remain corrupt and unreformed. The failure to reform Russia's banks, wrote the correspondent, is hampering the development of a vital source of financing for restructuring Russian enterprises. The correspondent describes Russia's banks as "bank-like institutions," a phrase taken from a new study on Russia's banking system, written by Kim Iskyan, a banking analyst for Moscow brokerage firm Renaissance Capital. The correspondent further cites Iskyan's study to the effect that without reform, another crisis is inevitable, especially if foreigners begin lending large sums of money to Russian banks, as they did before the August 17, 1998, default and devaluation.

The correspondent heaps blame upon Central Bank of Russia chairman, Viktor Geraschenko, for his failure to close down insolvent banks and those tied to oligarchs and regional chieftains. The correspondent writes that "The only real initiative during the past two years has been to pump billions of roubles of subsidies into banks..." The correspondent sees little prospect of real reform so long as Geraschenko retains his post. This charge may be unwarranted.[1]

We are tempted to chastise Rip Van Economist for being asleep at the wheel these past few years. In July 1998, we published an article in *The Wall Street Journal* and a book devoted solely to the subject of Russia's banks.[2] We used the term "ersatz banks" to describe these financial institutions, which served primarily to redistribute public subsidies to enterprises, and which continue in that role today.

We set forth in Chapter 4[3] of that book a proposal for reforming Russia's banks. That proposal is still applicable today. The proposal consisted of two key elements. First, we proposed a series of debt-for-equity swaps, which would transfer bank equity directly, and natural resources equity indirectly, into the ownership of Russian citizens in the form of mutual funds, retirement accounts, and other financial assets. Second, we proposed that foreign banks be permitted branch banking in foreign currency inside Russia, with deposits guaranteed up to a certain level by foreign banks head offices. The second measure was intended to attract some of the more than $40 billion in U.S. currency that is hidden in cookie jars and under mattresses, which could then provide the basis for loans to potentially viable enterprises.

At the very time that *The Economist* warns of another financial crisis, Catherine Belton, Moscow

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[1]As we wrote in an article posted to this web site on September 11, 2000, Geraschenko may have played a major role in keeping the ruble afloat during late 1988 and throughout 1999. See http://www.russiaeconomy.org/comments/091100.html

[2]Michael S. Bernstam and Alvin Rabushka, *Fixing Russia's Banks: A Proposal for Growth* (Stanford: Hoover Press, 1998). The book is posted on this web site.

[3]Ibid., pp. 90-98.

correspondent for *Business Week*, writes in the October 9, 2000, issue that Western investment banks are back in Russia in force, seemingly oblivious to the losses they took over two years ago. A first reaction is that readers of *The Economist* must not be reading *Business Week* and vice-versa. A second reaction is that Western investment bankers must believe that the era of serial Russian defaults and devaluations are over, that Russia has turned the economic corner, even if the current high price of oil comes down in the near future.

We are less sanguine about the future. Until Russia breaks up its network of value-subtracting enterprises, these investors are likely to be disappointed again.[4]

[4] See Michael S. Bernstam and Alvin Rabushka, *From Predation to Prosperity: Breaking Up Enterprise Network Socialism in Russia*, Chapter 1. The chapter is posted on this web site.